S. HRG. 102–608

MIDDLE-INCOME TAX CUTS

HEARINGS

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED SECOND CONGRESS

FIRST SESSION

ON

**S. 11, S. 955, S. 1009, S. 1014,
S. 1411, S. 1846, S. 1865,
S. 1875, S. 1924, and S. 1984**

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CONTENTS

TUESDAY, NOVEMBER 26, 1991

Opening Statements

Page
Bentsen, Hon. Lloyd, a U.S. Senator from Texas, chairman, Senate Finance Committee 1
Grassley, Hon. Charles E., a U.S. Senator from Iowa 3
Rockefeller, Hon. John D., IV, a U.S. Senator from West Virginia 4
Bradley, Hon. Bill, a U.S. Senator from New Jersey 6
Roth, Hon. William V., Jr., a U.S. Senator from Delaware 16
Baucus, Hon. Max, a U.S. Senator from Montana 17
Moynihan, Hon. Daniel Patrick, a U.S. Senator from New York 27

Committee Press Release

Bentsen Calls Hearing on Middle-Income Tax Cut; Families Took Hit During 1980s, Deserve Help, Chairman Says 1

Administration Witness

Kemp, Hon. Jack, Secretary, Department of Housing and Urban Development 20

Congressional Witnesses

Specter, Hon. Arlen, a U.S. Senator from Pennsylvania 8
Gore, Hon. Al, Jr., a U.S. Senator from Tennessee 10
Downey, Hon. Thomas J., a U.S. Representative from New York 12
Mikulski, Hon. Barbara A., a U.S. Senator from Maryland 18
Reischauer, Dr. Robert D., Director, Congressional Budget Office 34

Public Witnesses

Steinbruner, John D., director, foreign policy studies program, Brookings Institution, Washington, DC 41
Weill, James D., general counsel, Children's Defense Fund, Washington, DC .. 43
Mattox, William R., director of policy analysis, Family Research Council, Washington, DC 45

TUESDAY, DECEMBER 12, 1991

Opening Statements

Bentsen, Hon. Lloyd, a U.S. Senator from Texas, chairman, Senate Finance Committee 55
Chafee, Hon. John H., a U.S. Senator from Rhode Island 57
Moynihan, Hon. Daniel Patrick, a U.S. Senator from New York 58
Boren, Hon. David L., a U.S. Senator from Oklahoma 58
Bradley, Hon. Bill, a U.S. Senator from New Jersey 60
Breaux, Hon. John, a U.S. Senator from Louisiana 62
Hatch, Hon. Orrin G., a U.S. Senator from Utah 63
Baucus, Hon. Max, a U.S. Senator from Montana 65
Grassley, Hon. Charles E., a U.S. Senator from Iowa 65
Dole, Hon. Bob, a U.S. Senator from Kansas 67

Page

COMMITTEE PRESS RELEASE

Bentsen Schedules Additional Tax Cut Hearings 55

ADMINISTRATION WITNESSES

Brady, Hon. Nicholas, Secretary, Department of the Treasury 68
Darman, Hon. Richard G., Director, Office of Management and Budget 71
Boskin, Hon. Michael J., Chairman, Council of Economic Advisers, Washington, DC 72

FRIDAY, DECEMBER 13, 1991

OPENING STATEMENTS

Bradley, Hon. Bill, a U.S. Senator from New Jersey 113
Rockefeller, Hon. John D., IV, a U.S. Senator from West Virginia 114
Breaux, Hon. John, a U.S. Senator from Louisiana 115
Riegle, Hon. Donald W., a U.S. Senator from Michigan 116
Daschle, Hon. Tom, a U.S. Senator from South Dakota 118
Moynihan, Hon. Daniel Patrick, a U.S. Senator from New York 119

PUBLIC WITNESSES

McKenna, Nancy, Cliffside Park, NY 126
Cusella, Antoinette T., Cleveland, OH 127
Yancey, Vicki L., Springfield, VA 128
Cohen, Paul, Philadelphia, PA 130
Kohut, Andrew, director of surveys, Times-Mirror Center for the People and the Press, Washington, DC 147
Burtless, Gary, senior fellow, economic studies, Brookings Institution, Washington, DC 149
Phillips, Kevin P., author, the Politics of Rich and Poor, American Political Research Corp, Bethesda, MD 151
Sinai, Allen, chief economist, Boston Company Advisors, New York, NY 171
Hunt, Lacy H., Ph.D., chief economist, U.S.A., Hongkongbank Group, New York, NY 175
Linden, Fabian, executive director, Consumer Research Center, New York, NY 177
Buchert, Robert Jay, first vice president, National Association of Home Builders, Washington, DC 179

ALPHABETICAL LISTING AND APPENDIX MATERIAL SUBMITTED

Baucus, Hon. Max:
  Opening statements 17, 65
Bentsen, Hon. Lloyd:
  Opening statement 1, 55
  Prepared statements 197, 221
  "Description of Proposals Relating to Middle-Income Tax Relief and Economic Growth," Joint Committee on Taxation staff report 198
Boren, Hon. David L.:
  Opening statement 58
  Prepared statement 221
Boskin, Hon. Michael J.:
  Testimony 72
  Prepared statement 223
Bradley, Hon. Bill:
  Opening statements 6, 60, 113
Brady, Hon. Nicholas:
  Testimony 68
  Prepared statement 235
  Responses to questions submitted by Senator Daschle 236
Breaux, Hon. John:
  Opening statements 62, 115
Buchert, Robert Jay:
  Testimony 179
  Prepared statement 238

Page

Burtless, Gary:
- Testimony ... 149
- Prepared statement ... 253

Chafee, Hon. John H.:
- Opening statement ... 57
- Prepared statement ... 266

Cohen, Paul:
- Testimony ... 130
- Prepared statement ... 267

Cusella, Antoinette T.:
- Testimony ... 127
- Prepared statement ... 269

Darman, Hon. Richard G.:
- Testimony ... 71
- Prepared statement with attachment ... 270
- Responses to questions submitted by Senator Daschle ... 272
- Responses to questions submitted by Senator Breaux ... 272

Daschle, Hon. Tom:
- Opening statement ... 118

Dole, Hon. Bob:
- Opening statement ... 67
- Prepared statement ... 277

Downey, Hon. Thomas J.:
- Testimony ... 12
- Prepared statement ... 279

Durenberger, Hon. Dave:
- Prepared statement ... 280

Gore, Hon. Al, Jr.:
- Testimony ... 10
- Prepared statement ... 282

Grassley, Hon. Charles E.:
- Opening statements ... 3, 65
- Prepared statement ... 283

Hatch, Hon. Orrin G.:
- Opening statement ... 63
- Prepared statement ... 284

Hunt, Lacy H., Ph.D.:
- Testimony ... 175
- Prepared statement ... 285

Kasten, Hon. Robert W., Jr.:
- Prepared statement ... 306

Kemp, Hon. Jack:
- Testimony ... 20
- Prepared statement ... 311

Kohut, Andrew:
- Testimony ... 147
- Prepared statement with appendix ... 320

Levin, Hon. Carl:
- Prepared statement ... 324

Linden, Fabian:
- Testimony ... 177

Mattox, William R.:
- Testimony ... 45
- Prepared statement with attachments ... 325

McKenna, Nancy:
- Testimony ... 126

Mikulski, Hon. Barbara A.:
- Testimony ... 18

Moynihan, Hon. Daniel Patrick:
- Opening statements ... 27, 58, 119
- Prepared statement ... 340

Phillips, Kevin P.:
- Testimony ... 151
- Prepared statement ... 348

Reischauer, Dr. Robert D.:
- Testimony ... 34
- Prepared statement ... 349

Page

Riegle, Hon. Donald W.:
Opening statement 116

Rockefeller, Hon. John D., IV:
Opening statements 4, 114
Prepared statement 358

Roth, Hon. William V., Jr.:
Opening statement 16
Prepared statement with attachments 359
S. 1865—"Defense Tax Rebate Act" 361
"Government Policy and Personal Retirement Saving," by Steven Venti and David A. Wise 458

Sinai, Allen:
Testimony 171
Prepared statement 494

Specter, Hon. Arlen:
Testimony 8

Steinbruner, John D.:
Testimony 41
Prepared statement 507

Weill, James D.:
Testimony 43
Prepared statement 512

Yancey, Vicki L.:
Testimony 128
Prepared statement 514

COMMUNICATIONS

A. Philip Randolph Institute 516
Coalition for Labor Union Women 516
Federation Against Inequitable and Regressive Taxation 518
Goodman, Craig G. 522
Goodman & Co. 532
International Council of Shopping Centers 533
Jewelry Coordinating Committee 538
Labor Council for Latin American Advancement 541
Renshaw, Prof. Edward 542
Warwick, Robert A. 544

MIDDLE-INCOME TAX CUTS

TUESDAY, NOVEMBER 26, 1991

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:00 a.m., in room SD–215, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Also present: Senators Moynihan, Baucus, Bradley, Daschle, Packwood, Roth, Danforth, Chafee, Symms, Grassley, and Hatch.

[The press release announcing the hearing follows:]

[Press Release No. H–51, Nov. 22, 1991]

BENTSEN CALLS HEARING ON MIDDLE-INCOME TAX CUT; FAMILIES TOOK HIT DURING 1980'S, DESERVE HELP, CHAIRMAN SAYS

WASHINGTON, DC—Senator Lloyd Bentsen, Chairman of the Senate Finance Committee, Friday announced a hearing next week on cutting taxes for middle income Americans.

The hearing will be at *10 a.m. Tuesday, November 26, 1991* in Room SD–215 of the Dirksen Senate Office Building.

"The last decade has been a tough one for middle income American families. During the 1980's they saw their taxes go up while their incomes fell, by nearly $1600 on average. I want to make sure that middle income American families—who got so little from the policies of the 1980's—get at least a share of the peace dividend, now that the Cold War is behind us," Bentsen said.

"Lowering their taxes would improve their prospects—by helping build consumer confidence and by boosting the economy in other ways," Bentsen said.

"Senators Roth, Mikulski and I have introduced legislation to give families a tax credit of $300 for every child under age 19, thereby reducing income taxes by 25 percent for a family of four making $35,000 a year, and to restore and expand the Individual Retirement Account. It would be paid for by a modest cut in defense spending," Bentsen said.

"We'll want to take a close look at this bill and other proposals to cut taxes for middle income American families," Bentsen said.

OPENING STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM TEXAS, CHAIRMAN, SENATE FINANCE COMMITTEE

The CHAIRMAN. If you will please be seated, we will get under way. If you would cease conversation.

As families sit down for Thanksgiving dinner, it will be a time to reflect on a basic American belief that with hard work, all of us are capable of improving our standard of living.

For generations, children have claimed what seemed to be a birthright; a step up in life. That promise of a step up, almost unique to America, stands to become as worthless as stock in a bankrupt S&L. Today's generation of male high school graduates will be the first to do worse than their fathers. For too many American families, the dream of homeownership is turning into an economic "Nightmare on Elm Street." Home prices collapsed last year, causing a stunning $181 billion plunge in family worth. That is the first such decline in two generations.

Two paychecks became a necessity of life in the 1980's as the costs soared for basic necessities of life. A typical family today pays $1,300 for a health insurance policy that cost them $150 in 1980. And that policy today has higher deductibles and less benefits, more co-payments.

Families with children saw their taxes increase while their income dropped by some $1,600 on the average in that decade. We need to turn that one around. I have introduced, along with Senator Roth, Mikulski, and others, a bill that would give hard-pressed, middle-income Americans a tax cut; one that would help jump-start this economy.

We have proposed a $300 tax credit for every child under the age of 19 which would reduce the income tax of a family of four making $35,000 a year by one-fourth.

We are also proposing to expand individual retirement accounts. That would give the economy an additional kick by immediately freeing up some $530 billion in existing IRA and 401 accounts. This legislation would also allow middle-income Americans to use their savings to buy their first home.

Our tax cut would be fully financed by a 5-percent cut in the 5-year defense budget that was submitted by the President a year ago. The world has dramatically changed since then. According to press reports, the Joint Chiefs of Staff are considering additional cuts of as much as 8 percent. After being ignored by the policies of the 1980's, middle-income families are surely entitled to a share of this piece dividend.

The tax cuts would go into effect on January the 1st, and the defense cuts would not start phasing in until fiscal 1993, thereby giving a real economic boost to the economy. I am today releasing an econometric analysis by DRI which concludes that the IRA provision alone would help jump-start the economy; it would create an increased projected growth by 10 percent next year; it would create 85,000 new jobs during the year, and over 200,000 new jobs in 1993; and it would add nearly 50,000 new housing starts each year.

Together with the Child Tax Credit, our proposal would add $24 billion to the economy next year. Families need help—our economy needs help. The administration has been following an economic policy of denial and delay and it is time for us, working in cooperation, to step up to these problems and to deal with them.

In my view, cutting taxes for middle-income Americans is a top priority. I have outlined our legislation, and I know that several of my colleagues have proposals of their own to discuss. I am looking forward to hearing more about them.

Today we are hearing from Secretary of Housing and Urban Development, Jack Kemp, who has some important views on the subject of tax cuts in his area of responsibility, and from other knowledgeable witnesses today.

[The prepared statement of Senator Bentsen appears in the appendix.]

The CHAIRMAN. I am going to ask my colleagues to hold their comments to 3 minutes, because we will have a number of them coming in, and we have a number of votes coming on the floor as we try to wrap up this session.

I would now defer to my colleague, Senator Grassley.

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. Mr. Chairman, at the end of 3 minutes, I will quit and put the rest of my remarks in the record.

The CHAIRMAN. Thank you.

Senator GRASSLEY. I greatly appreciate your convening the hearing today, because this is an extremely important issue; the issue of tax cuts for middle-income Americans. So, I commend you for your leadership.

Now, looking at the witness list, except for Secretary Kemp and Senator Specter, one would get the impression, would one not, that only Democrats are interested in family tax cuts and have initiatives on the table.

The CHAIRMAN. Well, let me say on that, Senator Grassley——

Senator GRASSLEY. Would that come out of my 3 minutes?

The CHAIRMAN. No, it will not. But let me answer that by saying to you that I invited some Republicans, in particular, the Secretary of the Treasury and the Director of OMB, and they chose not to offer their ideas. Perhaps they have not decided on what they are for.

Senator GRASSLEY. I have a comment on that, as well.

The CHAIRMAN. Good.

Senator GRASSLEY. But, first, before I comment on the administration, I would like to say that a number of us in Congress, including Republicans, have offered proposals to accomplish tax fairness for families.

Some of us Republicans have been trying to make middle-income tax credits and their cuts a priority for over a year. My only regret is that we have not been able to achieve these family tax cuts before now.

Being the minority party in Congress, combined with the help of a reluctant White House, has not necessarily helped our cause, Mr. Chairman. I admit that.

Nevertheless, once this hearing is over, I have little doubt that we will only be hearing about Democratic initiatives.

However, I would note that Senator Coats' legislation which has been in the hopper for a long time, has not been on the agenda, or mentioned in the briefing material.

Now, despite the administration's missteps on this issue, I highly commend Secretary Kemp for bucking White House insiders and carrying on the torch of Republican tax cuts.

I can only hope that the administration will see the light and get out in front on this growing movement.

As I have stated, despite the lack of press attention, a number of us Republicans have been trying for at least a year to get family tax cut proposals on the table.

Last April, as a member of the Budget Committee, I offered an amendment to the Budget Resolution recognizing the need for Congress to pass tax cuts for families. Now, Mr. Chairman, this amendment was adopted overwhelmingly 18 to 1 in that committee.

The CHAIRMAN. Senator, let me reward you for your early arrival. Use your full 5 minutes so you do not have to talk so fast.

Senator GRASSLEY. Well, all right. Last May, I introduced the Emergency Tax Relief for Family legislation, which is comprised of a package of two bills. The first bill, S. 1013 would expand the young child tax credit up to $500 to families with adjusted gross incomes of under $50,000, and with children under 5 years of age.

Now, Congressman Frank Wolf, in the House, is a sponsor of a companion bill. Currently, this credit is tied to the earned income tax credit and is only available to families with an adjusted gross income of under $21,000 and with children under 1 year of age. In addition, the maximum credit is only around $350.

My second bill, S. 1014 would increase the dependent exemption from the current $2,150 to $7,000 by the year 2000. This is approximately what the exemption would be if it had kept up with inflation. The nearly $5,000 loss due to inflation underscores a growing unfairness to families reflected in the Tax Code.

I joined with Senator Coats and Congressman Wolf over a year ago. We took the lead in Congress in pushing tax fairness for families. Increasing the dependent exemption seemed to be the easiest way to address the problem since this mechanism was in place and well known.

In addition, these exemptions are phased out for higher income families so that the wealthy do not benefit from them. However, a major shortcoming in this approach is the fact that low-income working families with no taxable income would not be helped with just an increase in the dependent exemption which is not refundable. I therefore introduced an increase and modification in the young child tax credit which is refundable and which will help low-income families.

I ask that the balance of my statement be placed in the record.

[The prepared statement of Senator Grassley appears in the appendix.]

The CHAIRMAN. That will be done. Thank you very much, Senator. I am going to ask my colleagues which I have not done before, but because of the shortness of time and the number who have asked, if you would limit your comments, each of you, to five minutes. Then we will take your entire statement in the record.

And since we have a bill on the floor that is within the jurisdiction of this committee, I am asking Senator Rockefeller to speak first. If he would then afterward leave to go over and manage the bill, I would appreciate that. Senator Rockefeller.

OPENING STATEMENT OF HON. JOHN D. ROCKEFELLER IV, A U.S. SENATOR FROM WEST VIRGINIA

Senator ROCKEFELLER. Thank you, Mr. Chairman. Let me get to the point. There is an enormous feeding frenzy in Washington right now on the part of both parties and many people to try to find a way to give tax relief to the middle class. I think that is very important and very laudable. I would introduce a note of caution, though.

The National Commission on Children feels very strongly about the same thing. The Chairman of the Finance Committee, Senator Lloyd Bentsen, authored the legislation that created the National Commission on Children, which I chaired.

We came to the very strong, unanimous, bipartisan conclusion that any tax credit given on the personal income side should be given to families with children and to all families with children.

Our concern, Mr. Chairman, is that in a country where work is meant to be rewarded, where, if you play by the rules and, therefore, work hard, there should not be an indication that some families with children are better than other families with children. And, for that reason, we attached the word "refundable" to our proposed tax credit.

It is the unanimous feeling of the National Commission on Children that all families who are trying to make it by the rules, and even some who cannot, but are trying, that in all those families, bringing up children is a first priority in this country; that parents are doing their best against unbelievable odds—lack of time, lack of income, presence of stress—to be good parents, but that they are finding particularly it is hard in terms of income.

The refundable tax credit of $1,000 is the centerpiece of our income security proposal in the National Commission on Children. But it is not the only part of our income security package.

We want to see the earned income tax credit made more available to more people who would be eligible for it, and we want the forms that are involved with the earned income tax credit to be more simplified, more understandable.

We also have what we think is a very important addition to Senator Moynihan's and this committee's Family Support Act of 1988, which would make available between $25 and $35 billion in the private economy which is owed by absent fathers to their families and children.

In other words, under the law, so-to-speak, they owe, but so many of them are not paying. And we have figured out a way to close the loop on them and to thus cause some $25 to $35 billion of the private economy—no Federal money involved—to flow to children and families who need support.

I guess my point on the refundable tax credit, Mr. Chairman, is that we should not say that only those families who pay an income tax—who earn enough to pay an income tax—are eligible for a tax credit.

That is like saying that the many families in which one of the parents is working full-time, but at a minimum wage job, that they do not count, because they do not come up to the level of where they have to pay in income tax.

Or where both parents in a family may be either working part-time or full-time, but again at low wage jobs where they do not come up to that level where they have to pay in income tax.

So that the concept of a refundable tax credit of $1,000, to us, is the central part of our package of income security part, which, taken together, would lift the overwhelming majority of families in poverty in this country out of poverty, and help every single family.

Well, some people say EITC is designed to help the working poor, and it is a good first step, but it does not do the job.

So, we think that the refundable tax credit to all families, saying to America that all families, whether they are bringing up children of rich families, poor families, families in between, that if you are bringing up a child, you are doing the most important thing that you can do in this country and you deserve the help.

You deserve, if you are paying an income tax, to keep $1,000 more of the income that you are already making. You keep it. Do not send it in to the government.

Or, if you are below that point where you pay an income tax, it would be a refundable tax credit. We think that is a sacred principle, Mr. Chairman, in that all children in this country are important.

We are at the point now we are within 10 or 15 years of one worker in this country supporting two Social Security retirees, whereas back in the 1960's, it was 15 workers. We do not have a single child to waste, and we think, therefore, that a refundable tax credit giving a tax break to all families is important. I thank the Chairman.

[The prepared statement of Senator Rockefeller appears in the appendix.]

The CHAIRMAN. Senator, let me say that I want to congratulate you on the superb job you have done as the Chairman of the Children's Commission, and the incredible hours you have devoted to it, the energy you have committed, and the leadership you have shown. And on your refundable tax credit, I am sympathetic to that.

What we introduced here is a bill to build on, not the end. And what we are trying to show is that we were directing this at middle-income people who have taken quite a hit, which we did not try to assist to that degree in the last bill, or the bill before that one.

Last year, as you well know, we passed legislation for an $18 billion earned income tax credit. That is doubling what we have spent on that in years past; a major move in that direction.

Now, this is a major move on middle income. And we are going to do some supplementary things and all of these Senators have ideas as to what we ought to do about it, including you and the other two ready to testify. So, I appreciate very much your contribution. Are there any comments for the Senator? Yes. Let me now finish with these, and we will get back to the opening statements, for those who arrived late. Thank you very much, Senator Rockefeller.

Senator Bradley.

OPENING STATEMENT OF HON. BILL BRADLEY, A U.S. SENATOR FROM NEW JERSEY

Senator BRADLEY. Thank you very much, Mr. Chairman, for the opportunity to testify today, and I thank you also for your leadership on the issue of providing tax cuts to America's families in a time of real need.

It is time that we cut spending and give the money back to America's families. It is as simple as that. I think it is also time that we have to be held accountable for how we spend taxes. In last year's budget agreement when we asked everyone to tighten their belts, we did not eliminate one of the existing 4,000 government programs—not one.

Clearly there are some programs that have outlived their usefulness, and we ought to eliminate those and give the money back to America's families. But also, let us be realistic about what we are doing.

None of these proposals—mine included—will automatically jump-start the economy in the recession, or guarantee long-term future growth and prosperity. Our problems are deep and very serious, and they require evaluation of more than just the Tax Code.

But the fact that we cannot solve all of our economic problems tomorrow does not mean that we should not start today. And what we need, above all, is trust. American people are very skeptical of their elected officials right now.

In order to regain that trust, I think we have to prove that we are on their side. That means putting money back in their pockets and being very specific about how we will pay for it.

The proposal that I offer you today does that. It provides a $350 tax credit for every child in America, meaning a family with three children would pay $1,050 less in taxes each year, and it pays for it by making specific programmatic cuts; $80 billion in specific defense cuts, and $38 billion in specific domestic cuts; indeed, eliminating several programs that have outlived their usefulness.

Now, why do we do this? I do not think I have to tell the Finance Committee about the pressure middle-income families, all families are under; high health insurance costs; the cost of housing, college tuition.

In fact, Mr. Chairman, as you probably know, looking at the average post-tax per capita income—families with children in America are the lowest income group—below singles, below families without children, below the elderly.

In fact, the real median family income for young families between 25 and 34 fell by 5 percent in the 1980's. And you might add to that the costs, housing costs have gone up four times in 20 years; college costs have doubled; two-thirds of women with children are working and child care costs have skyrocketed. The need is clear.

So, Mr. Chairman, the proposal that I offer, a $350 tax credit for every child—every child in America—is characterized by several aspects that I think separates it from some of the other proposals.

First, it is indexed to inflation, and, therefore, will grow over time. By 1995, it would equal about $400 per child. This is in addition to the $2,000 exemption which is not eliminated under my proposal.

This will provide $116 billion of tax relief for America's families over the next 5 years; approximately 32 million American households would benefit directly from this proposal.

So, the first point is it is universal, and it is indexed, second point. Third, it is refundable. That means families who do not owe Federal taxes will receive back from the government a check for $350 per child.

Why refundability? Without it, Mr. Chairman, 25 percent of our families would receive no benefits, and those families are precisely the ones who are suffering most. I think that any tax relief aimed at children must be universal for all families on the grounds of fairness and building a better future for all families.

The Federal income tax threshold next year for a family of two children is about $15,000. If the credit was non-refundable, families below this income level—about a quarter of all families—would receive nothing, and another 10 to 15 percent of the families would receive only a partial credit. To me, this just does not make sense. Costs have been going up for all families, not just those making more than $15,000 a year.

Of the 32 million U.S. households with kids, about 4 million are on welfare. Of the roughly 60 million kids in the U.S., about 7 million are on welfare. Refundability would help these welfare families, but making the credit non-refundable would not just hurt welfare families. If the credit was non-refundable, about 3 to 4 million non-welfare families would also receive nothing, and an additional 3 to 4 million non-welfare families would receive only a partial credit.

So, Mr. Chairman, I would hope that we could move on this tax credit. And, as I said, it is paid for by specific cuts.

The message is to cut spending and give the money back to America's familie:. A $350 tax credit for every child; a family with three children saving over $1,000 in taxes, and doing so by cutting $80 billion in defense spending and $38 billion in specific domestic spending cuts.

I thank the Chairman for time. And when I return to the panel, I will not claim my opening statement time.

The CHAIRMAN. Any questions of Senator Bradley?

[No response.]

The CHAIRMAN. Thank you very much, Senator.

Senator Specter.

STATEMENT OF HON. ARLEN SPECTER, A U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Senator SPECTER. Thank you, Mr. Chairman, and members of this distinguished committee. I support the pending legislation: Senator Bentsen's proposals for tax cut on middle Americans and the Super IRA's.

I come, in addition, to discuss briefly S. 1984, which is the proposals which Senator Domenici and I offered last week to make available now to middle-income Americans up to $10,000 of existing IRA's, providing they are spent on consumer goods, with the thrust being to stimulate consumer purchasing power now.

The special concern that I would offer, Mr. Chairman and members of the committee, is that action be taken soon, promptly, like immediately. I realize, however, that in the last day of this session, it is not likely that we are going to pass legislation.

Last week I urged the Congress to stay in session during December to address this legislation, and made a similar appeal to the administration, and in fact, discussed the proposals of Senator Domenici and myself with Secretary of the Treasury Brady, Chairman of the Federal Reserve, Alan Greenspan, Chairman of Economic Advisors, Michael Boskin, and also Chief of Staff, Governor Sununu.

I was told by ranking administration officials they thought it not worthwhile, not wise, to pursue an economic package in December under the pressure of adjournment, because decisions might be made which were not as wise as those which would have more time.

Speaking only for myself, I disagreed with that on the grounds that Congress responds when there is a timetable and that the problems are so urgent in the economy today and the recession—yes, I said recession—is so serious, if, in fact, it is not even more than a recession, that Congress ought not to be in adjournment, but ought to be addressing these problems.

But the administration has plans for the President's program to be outlined in the State of the Union speech, and then to take its due course with the Congress. I am concerned about that because if the State of the Union is made in late January or early February, and then the Congress starts to consider the issue and does so in February, and in March, and in April, and in May, we have a way of consuming all of the time which is available.

My sense is if we moved on S. 612, or if we moved on the proposal which Senator Domenici and I have offered to make available funds now for spending from IRA's, or if we were to amend the proposal which Senator Domenici and I have offered to encompass the provisions of the Bentsen-Roth program, that is on so called capital expenditures about which Senator Bentsen spoke on the floor last week, namely first-time home purchases, or college education, or medical expenses, then it will be enormously beneficial to do that at the present time.

I note that S. 612 was introduced on March 12 of this year, and that at that time it had 74 co-sponsors, including 29 Republicans, so that Senator Grassley's very cogent early comment that Republicans are represented on this issue is reinforced by the fact that there were 29 Republicans who stepped forward to co-sponsor this legislation back on March 12. The question arises in my mind, Mr. Chairman and members of this committee—and I think all those present are co-sponsors—why have we not acted on S. 612 up to the present time? That is the same question I asked on the Senate floor last week when we had a spirited debate among Senator Bentsen, Senator Roth, Senator Chafee, Senator Domenici and myself.

I would reiterate, Mr. Chairman, it is even yet not too late in the day. I understand the protocol on such issues having originated in the House, but they are not too far away. There have been occasions when revenue bills, although not originating in the House, have been enacted into the law when originating in the Senate.

But I do not like to go back to Pennsylvania and face my questioning constituents on why Congress has not acted. I would prefer to stay in session and continue these proceedings and really face up to why this spectacular legislation—I hope you will not mind, Mr. Chairman, if I call your legislation spectacular—74 co-sponsors, with a good bipartisan mix is not enacted to try to stimulate the economy now. I yield back the balance of my time.

The CHAIRMAN. Thank you very much for your testimony.

Senator SPECTER. This would not happen on the Judiciary Committee, Mr. Chairman. [Laughter.] Thank you.

The CHAIRMAN. They do have problems on Judiciary, do they not? [Laughter.]

Senator SPECTER. Yes. We have problems and questioners.

The CHAIRMAN. Our next witness is Senator Gore, and Congressman Thomas Downey. Here are two legislators who have had a deep interest in the subject of middle-income tax fairness and have worked hard with the legislation. I look forward to hearing from you.

STATEMENT OF HON. AL GORE, JR., A U.S. SENATOR FROM THE STATE OF TENNESSEE

Senator GORE. Mr. Chairman and members of the committee, thank you very much for the opportunity to testify this morning. And may I particularly acknowledge the contribution that you personally have made, Mr. Chairman, and the leadership you have provided with your proposal for tax relief for middle-income Americans. I also want to acknowledge the work of Senator Bradley and Senator Rockefeller, also members of this committee.

My colleague, Congressman Downey, and I offer a different plan, but share your commitment to providing meaningful tax relief to middle-income American families who are facing unbearable financial pressures.

All across our country, millions of Americans and their families know what the White House apparently does not know: this recession is real and it is not over with. It is as real as a mortgage that cannot be paid, a doctor's bill not covered by insurance, and college tuition beyond a family budget.

Americans know that we are on the wrong track and we need some significant changes. They also know that during the last dozen years, the rich have gotten richer and the poor have gotten poorer and the Reagan-Bush tax policy has been part of the reason why.

And as we look at what we should do now, I think it is fair to spend just a moment reviewing what has happened on tax policy in the last decade. This first graph, Mr. Chairman, is one that members of this committee are very familiar with. It shows a percentage change in the average family income after taxes from 1977 to 1992.

This is adjusted for inflation. And, as you can see, those in the top 1 percent have had their real after-tax income go up in adjusted dollars 136 percent. Their incomes have more than doubled in real terms.

And the middle-income taxpayers those families at $31,000 per year—the median, as you well know, is about $34,000 per year—their real after-tax income has declined; and all those below $30,000 a year have seen a real decline in their after-tax income.

Now, if I could look at the second graph just briefly. Tax changes have been one of the principle reasons why these changes occurred. You can see the changes since 1977 in billions of dollars paid in taxes by income group.

The top 1 percent there on the far right have had an $83 billion decline in their taxes in real terms, while middle-income Americans have had a real increase in their taxes after you adjust for inflation.

So, when we talk about how to fix this problem, let us remember what has contributed to the problem and how it has come about.

Now, Congressman Downey and I have a proposal which focuses on giving the relief to middle-income families with children. We focus on a refundable tax credit for children, further changes to the earned income tax credit—and we pay for it.

It is easy enough, Mr. Chairman, to do as some of the Republicans have done, propose another tax cut—theirs, of course, is again aimed at the wealthy—and not propose a way to pay for it. We propose a way to pay for our tax cut.

Ours also is aimed at those who need it. I would like to briefly illustrate the difference between the Republican proposal and the Gore-Downey proposal. I brought a common children's toy, Mr. Chairman, to illustrate the difference. These are actually adjusted for the distribution. These are mathematically accurate.

This is the gravy train of the personal exemption proposal. This is the richest category, the very top group, families earning more than $125,000 per year. And this tallest column is the size of the benefits they would get under the Republican proposal, which, again, is not even paid for.

The next group, above $75,000 a year, would get this next largest amount in tax benefits. Those getting $35,000 a year would get far less, and those middle-income taxpayers on the low side of the middle-income category would get only $338 per year, bringing up the rear of the Republican gravy train.

Now, Gore-Downey, by contrast, we call the Little Engine that Could. This is what Gore-Downey would do by way of distributing the benefits. The wealthiest families above $120,000 a year would get some relief, but not very much. $60,000 and above, a little more, but not much more.

Middle income families with children, under Gore-Downey, would get the most benefits of our proposal. That is the way it is designed. And those who are not working would have the incentive to go to work, to take advantage of job training, and to get on the work rolls, so that you would have an incentive to work and make more because the more you move into the income earning category and the more you make into the middle-income category, the better you do.

So, in conclusion, Mr. Chairman, our proposal is paid for, the benefits are distributed to those families that need the benefits; and it is paid for by those who have benefitted unjustly by the changes of the last decade. Thank you, Mr. Chairman.

[The prepared statement of Senator Gore appears in the appendix.]

The CHAIRMAN. Gentlemen, I will look forward to seeing you on the 6:30 news. [Laughter.]

Congressman Downey.

Senator GORE. I am not sure anyone but President Kemp will be on the 6:30 news. [Laughter.]

The CHAIRMAN. Congressman Downey.

Congressman DOWNEY. Mr. Chairman, I would observe that we have everyone that disagrees with the administration present.

The CHAIRMAN. Go ahead, Congressman.

STATEMENT OF HON. THOMAS J. DOWNEY, A U.S. REPRESENTATIVE FROM NEW YORK

Congressman DOWNEY. Mr. Chairman, before specifically talking about the Working Family's Tax Relief Act which my colleague, Al Gore, has just outlined graphically, let me explain why this legislation, in my view, is both vital and necessary.

In the early 1980's, President Reagan promised America that a rising tide would lift all boats. But the President did not say that this would be a selective tide; one which would raise up the big fancy yachts, squeeze the ordinary mid-size ships against the docks, and leave the rest of the boats sitting on the bottom.

The fact is that despite 7½ years of sustained economic growth during the 1980's, individuals in the bottom 40 percent of the income distribution chain experienced significant losses in income.

And, since 1977, while the richest 1 percent of the population received a total of real relative gain in pre-tax income of $271 billion, today the richest 1 percent of the population has more income than the poorest 100 million Americans. If this is a high tide, what will the water front look like when the tide is low?

The Congressional Budget Office has estimated that Federal taxes have increased $13 billion per year for middle-income families between 1977 and 1992, while taxes on the richest 1 percent have been lowered by $65 billion.

And single-parent families have been discouraged for working, because for every dollar they earn, the reduction in Federal benefits or tax increases exceeds 50 cents, and often approaches one dollar.

This is the result of rising tide, or trickle down economics. Although many suspected this in 1980, we now have tangible evidence that this approach has failed. We have a $3.8 trillion debt; middle-income families worry about making ends meet; and the working poor struggle simply to survive, and something has to be done to change this.

The Working Family Tax Relief Act—or Gore-Downey—addresses these problems in three simple ways. First, it gives working families a meaningful tax cut by replacing the personal exemption for children under the age of 18 with a more progressive, refundable credit of $800, which Al has graphically demonstrated with the Lego trains.

Second, it assists working poor families by expanding the earned income tax credit and making the credit more sensitive to family size. This will strengthen the belief that work pays.

Finally, Gore-Downey addresses the imbalances of the past decade by requiring the wealthiest Americans to pay their fair share of taxes. Let me just cite two examples of the benefits of Gore-Downey to working families.

For working families with children and incomes between $10,000 and $75,000, Gore-Downey would provide a tax cut of more than $20 billion a year. Federal taxes would fall 8.1 percent for a four-person family with an income between $35,000 and $50,000.

With the horizon a little crowded by the excellent work of Senator Bradley and you, yourself, Mr. Chairman, the tax relief proposals that I want to highlight make some differences. And one of the things that distinguishes us from all but Senator Bradley's is that we provide a refundable child care credit. And I cannot emphasize enough the importance of refundability. A non-refundable credit would exclude a fourth of the children in the United States. Additionally, some 45 percent of Hispanic children and 50 percent of black children would receive no benefit unless the credit is refundable. The Gore-Downey refundable credit would remove 600,000 families from poverty.

Second, the cost of the Gore-Downey child credit, more than $90 billion, has been paid for through an increase in taxes on the richest Americans. This leaves any anticipated savings in defense spending to be used for other urgent need.

Also, by increasing the tax on the top income level, it will bring an element of fairness, which has long been absent, into the Tax Code.

Third, the expansion of the earned income credit included in Gore-Downey will continue the effort to help the working poor stay afloat. It builds on welfare reform, the Child Care Act of last year, and other legislation which was crafted to help and encourage people to get to work.

In conclusion, I must note, Mr. Chairman, that this issue is only one aspect of providing relief to working families. They need comprehensive health insurance, an unemployment insurance system that works, and better financial aid to send their children to college. But most of all, they need an economy that not only grows, but this time grows for every working family. Thank you.

[The prepared statement of Congressman Downey appears in the appendix.]

The CHAIRMAN. Thank you very much, gentlemen. I have only one question, because I understand your legislation. You have a tax increase that takes effect in 1992, and your cut does not take effect until 1993. If that is correct, and we are in a serious recession, do you not have some concern about the contractionary effect of this legislation? Are you concerned that it might deepen the recession?

Senator GORE. Mr. Chairman, we brought this proposal forward in May, and we are bringing it to you with the recommendation that you take it into consideration with the work that you have under way on the committee, make such modifications as you believe might improve it.

I believe a faster introduction of benefits is needed in order to stimulate the economy. We have also suggested to you in private conversations ways to cut down on the size of the bill we are proposing by phasing in the age at which the tax credit from 18, starting at 13, and phasing it on up, and other potential changes. Circumstances in the economy are so bad now I believe that benefits should be introduced more quickly.

The CHAIRMAN. Thank you. Are there further questions of the witnesses? Yes, Senator Grassley.

Senator GRASSLEY. Just a comment, Senator Gore and Congressman Downey. I think to be totally accurate in your chart, if you are going to blame the Reagan-Bush years, you are going to have to start with January of 1982.

Because, as I recall, you included in there 1977 till now. We cannot be held responsible as Republicans for the years 1977 to 1982.

Those were kind of dismal economic years as well, under Democratic budgets.

So, I have not had a chance to look at the impact, but I think you are going to get an entirely different picture if you take 1977 through 1981 out of there. Reagan's first budget would be 1982.

Congressman DOWNEY. One of the efforts in comparing statistics—and this is a great game that people play—is that we try to take peak periods; a peak of a period of prosperity to another period of prosperity, or the trough of a recession to a trough of a recession as opposed to trying to take the Reagan years.

I believe Senator Gramm and some other members, and Congressman Gingrich had their own plan that started to take a look at statistics based on 1982 or 1983 until the present time. And that was comparing the bottom of a recession with the peak of a recovery. That is not what we want to do.

What we try to do in the most sincere bipartisan way was to take periods of time that are roughly comparable, which would be a period of relative prosperity beginning in 1977 and going through 1989, which is where these statistics go to.

Senator GORE. May I briefly add that the charts were constructed according to the assumptions Congressman Downey has just outlined.

In my statement which accompanied the charts, I focused on the Reagan-Bush tax cuts as being singularly unfair in the distribution of their benefits. I believe that statement to be true, although it is correct, as you say, that the charts would look a little different if they just started in 1981 or 1982.

Senator GRASSLEY. I do not find any fault with you taking economic periods for comparison void of partisan comment. But if you are going to include partisan comment and you are going to include the years 1977 through 1981, then obviously there have got to be some brickbats thrown at the Carter Administration as well. I am done, Mr. Chairman.

The CHAIRMAN. Thank you. Senator Packwood.

Senator PACKWOOD. Tom, just out of curiosity, what do you think would be a fair percent of income a person making $500,000 of wage income in New York should pay, Federal, State, local; all taxes; automobile taxes, property taxes, sales taxes, income taxes?

Congressman DOWNEY. In 1977, Senator, the average after-tax income for a wealthy New Yorker was about 35 percent. It is about 29 percent if you just include Federal taxes. It is higher in the City of New York, when you include city tax and New York State tax. But I have discussed this with wealthy New Yorkers, and they do not mind paying a little more in income tax. [Laughter.]

Senator PACKWOOD. Maybe they would not mind paying it if we just took away the deduction for State income taxes instead of income taxes.

Congressman DOWNEY. Well, we tried that, Senator.

Senator PACKWOOD. But you were not very enthusiastic about that idea.

Congressman DOWNEY. No. No, I was not.

Senator PACKWOOD. That would make them pay more.

Congressman DOWNEY. I think what would happen if we did that is you would have already problems in the real estate industry which are serious become catastrophic if we decided to not allow the deductibility of State and local taxes.

Senator PACKWOOD. But give me a percentage, if you can, of somebody living in Manhattan, because I am familiar with the tax structure there. Would 50 percent be unfair, to pay half of your total income in taxes?

Congressman DOWNEY. Well, I mean, I think that people at the top income in my State have done remarkably well over the last couple of years in terms of seeing their real taxes decreased. And I think that it is reasonable for us to expect that what we do here with Gore-Downey would increase their taxes somewhat, and I think they should be taxed.

I do not think wealthy New Yorkers should feel that they have anything less at stake in making this country work. It seems to me that you can only have so many locks on the doors and cops on the beat to protect you from a generation of New Yorkers that have nothing to look forward to. And that is what wealthy New Yorkers have to do. They live behind their security guards in their apartment complexes, afraid to go out at night, because we have so many people in this country who do not share in the wealth of this country.

And I think that for wealthy Ne'7 Yorkers to pay a little bit more in tax to give middle-income and lower income families an opportunity to have more of a tax cut, I think that is a very reasonable thing for us to expect.

Senator PACKWOOD. Well, I think lots of people are not going to quarrel with you, but I am just trying to find what is an optimum fair figure, the maximum amount you have to take from them.

Congressman DOWNEY. I would want to know a lot more about a family making $500,000, what their investments were, how many children there were, before I would hazard a guess as to what I think they should pay.

I think they should pay more, in short answer to your question. They have done remarkably well in paying less over the last couple of years. We have lowered their top rate from 70 percent down to 32 percent; their average rate from 35 percent down to 29 percent. I think it should go up.

Senator PACKWOOD. Al, do you have any answer to the same question?

Senator GORE. Well, Bob, I will only speak to the Federal part. Tennessee has a very different situation than Oregon, or New York, or Texas. But where the Federal part of it is concerned, I think it is fair, given the benefits that would be provided by Gore-Downey, to ask that the cost of it be paid by those who have gotten this tremendous disproportionate benefit in the last dozen years or so.

We can do one of several things. We can propose tax cuts and not pay for them, but given the size of the budget deficit, we just cannot do that. We can propose to pay for them through cuts and defense spending, and maybe the committee will decide to do that.

However, a lot of us have made proposals over the last several years that are going to be paid for supposedly through cuts in defense spending, and that is going to be something that will be earmarked by some for other things.

Or, we can recognize that the deficit constrains the way in which we can use fiscal policy and take account of what has happened in the last decade and give the benefits where they are really needed to the families that are having the worst time of it right now, and pay for it by asking a little bit more from those whose real after-tax income has gone up 136 percent in the last decade. I think that is fair.

Senator PACKWOOD. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bradley.

Senator BRADLEY. Thank you very much, Mr. Chairman. I have only one question for the witnesses. Who owns the Legos? [Laughter.]

Senator GORE. The child of Greg Simon, on my staff.

The CHAIRMAN. Thank you gentlemen. Thank you very much.

Senator GORE. Thank you, Mr. Chairman.

Congressman DOWNEY. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Roth, did you want to make a comment?

OPENING STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM DELAWARE

Senator ROTH. Thank you, Mr. Chairman. I would like to make my opening statement. I first of all appreciate your leadership and the fact that we are holding these important hearings.

Whether Congress likes it or not, when it comes to taxes, America is rebelling; rebelling from California to Connecticut, from New Mexico to New Jersey. And, like the central character in the movie "Network," Americans are mad as hell and they are not going to take it anymore. And frankly, I do not blame them.

Last year, this Congress passed the largest tax increase in history at the very time the economy was slowing down. It totalled some $18 billion in the first year alone. And on top of that, State taxes increased $17 billion.

Together, these increases took more than $35 billion out of our economy. Now, is it any wonder with well over 19 percent of our Gross National Product tied up in Federal taxes, why this recession has only been prolonged?

And ladies and gentlemen, let me tell you what the American people want, it is not income redistribution, they want growth, jobs, and opportunity.

And without a doubt, there is a tremendous impact that the White House can have on improving America's immediate economy and its competitive future and it all begins with tax cuts.

There is no way our country can be taxed into prosperity. Statistics show that for every dollar Congress increases taxes, it increases spending by a $1.59. And that is why we have a deficit today. The plain and simple fact is Congress cannot control spending.

And those who say otherwise, those who say it is not Congress' inability to control spending, I dare them. I dare them to go home this Thanksgiving to tell their constituents the reason we have a $300 billion plus deficit is because Americans are not paying enough taxes. They know that is not true.

And that is why I am very encouraged by the legislation that Senator Bentsen and I have introduced. It represents a good beginning, and I applaud the Chairman for his leadership.

Likewise, I have introduced my own plan, S. 1865, to offer an even more broad-based tax cut; one that would not only affect families with children under 18, but all Americans, with the exception of millionaires.

Under my legislation, individual tax rates would be reduced to three new brackets: 12, 25 and 28. There would be no tax break for those earning a million dollars, and that 31 percent bracket would continue.

A family of four earning $35,000 would save $792 in Federal income tax; a 20 percent cut in the rate they pay today. These tax rate cuts would be paid for by reducing the defense budget by 9.5 percent, or $130 billion, and other government spending by $30 billion over 5 years.

I will just take a second more, Mr. Chairman. In short, my plan includes a 3 percent tax rate reduction, as I have already described; a Super IRA, as you and I have co-sponsored; an incremental investment tax credit; and a lifting of the Social Security earnings test.

I would ask that a copy of my proposal, S. 1865, be inserted into the record of these proceedings, together with the CBO distribution analysis. I would only close by saying there are many proposals worthy of study. But, again, what the people want are growth, jobs, and opportunity, not merely playing around with income redistribution. Thank you.

[The information appears in the appendix.]

The CHAIRMAN. Thank you, Senator.

Senator Baucus.

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you very much, Mr. Chairman. I appreciate your holding this hearing. We are not going to have a major tax bill this year, but we are certainly going to be addressing this issue next year.

And so I think before Congress convenes next year, this is a very opportune time to have this hearing to get the markers down to allow different Senators to give their opening shots as we lay the bases for next year's debate.

It is also opportune because the economy has continued to wallow, unemployment is not going down, and for too many families, the future looks bleak. Times are simply tough.

Even in my State of Montana, a State that has weathered the recession better than many others, there is a profound sense that things will not get better in the foreseeable future. Montanans, too, want action.

Millions of Americans confront the acute pressures of the current recession. But on top of all that, we also face the chronic crisis of stagnant incomes, lost opportunities, and the decline of overall competitiveness in our Nation.

The reality is simple. A decade of excess consumption, and a decade of under-investment has come home to roost at a time when our economic growth has bottomed out. So, our short-term economic problems are being compounded by our more structural difficulties.

In short, there can be no real recovery with just a short-term solution. America's families deserve a break. I do not question that. But it would be short-sighted if we allowed our immediate problems to obscure the more fundamental failure in our economy, namely, the systemic deterioration of our ability to compete in the world marketplace.

We must recognize that for the past decade, we have under-invested in human, in physical, and technical capital needed to support America's competitiveness in a new global economy.

Without this investment, there is no assurance of jobs or growth, or a better standard of living for us and for our children.

So, I commend you, Mr. Chairman, for your leadership in looking at the plight of the middle class, and for holding this hearing today.

But I hope that when the tax debate resumes next year, we will address not only needed middle-income tax relief and income tax redistribution, but the critical need to improve our long-term economic prospects you take some of this piece dividend, such as there is, and turn it into a dividend for America's not only short term, but long term future.

I look forward to working with you and other members of the committee in this important task. Thank you.

The CHAIRMAN. Thank you, Senator. And we will be doing that. As I stated earlier, this is something to build on.

Our next witness, Senator Mikulski. And she is a co-author of the Bentsen-Roth-Mikulski tax legislation for middle-income Americans.

STATEMENT OF HON. BARBARA A. MIKULSKI, A U.S. SENATOR FROM MARYLAND

Senator MIKULSKI. That is exactly right, Mr. Chairman, and that is why I am here today to speak in strong support of giving tax relief to America's middle class. And that is why I am an enthusiastic supporter of the Bentsen-Roth-Mikulski tax break for the middle class.

I am not new to this subject. This time last year when we were in hand-to-hand combat on the budget agreement, I stood up on the floor of the United States Senate and said that the middle class had no more to give; that they were either tuition poor or mortgage poor; that they have been stretched by high property taxes, sky-rocketing health insurance, and hyper car insurance rates; and they just had no more to give.

Now, 1 year later, we find that they are even more stretched to the limit. And that is why I support the legislation authored by Senators Bentsen and Roth, and of which I am a co-sponsor.

Why do I like it? First of all, it gives an honest and helpful tax break to middle class families and one that will show up right now in the checkbooks as we give our families much-deserved relief. We will also be ensuring that the confidence of this country is restored, and that our economy is back on track.

America needs a tax cut like this. When I am out in the shopping malls of Baltimore, it looks like a bomb scare. People just are not shopping. And when they do come inside a store, it is like they look, but they do not buy.

Many families are struggling just to hold on. Buying groceries for a family of four can cost $170 a week. These people need a break now. Now, $300 which we would give as a tax break back to the middle class might not sound like a lot of money in Washington, but it sure sounds like a lot of money in Highlandtown, in Hagerstown, in Darnstown, in Barnestown.

For Maryland families cruising the Beltways looking for bargains, $300 is very important. It will help buy Buster Brown shoes, a winter coat, and other kinds of things that families need.

I am a pretty good bargain shopper myself, and I know that kids' clothes are expensive. This tax credit will help families not only in Maryland, but across the country in order to help the family budget, and I believe will go a long way in helping the Federal budget. This legislation means direct tax relief by a deduction in yearly taxes for families of four up to $600.

The other thing I like about the Bentsen-Roth-Mikulski proposal is that it enables people to accumulate assets by allowing everyone to have a $2,000 IRA, and also to be able to withdraw money early if it helps in asset building.

You can withdraw your IRA early—before you are age 59—to either help a family member buy a home for the first time, or to go to college. I happen to believe the accumulation of a college education is asset building.

This legislation says that the government will help those who practice self-help. Too often we have proposals that says no help to those that practice self-help, and I think this legislation will go a very long way in changing that.

During this last year, we have seen America come home from a war in the desert, we have seen the collapse of Communism. And I believe that now, as we begin to shift our National priorities, it is time to come home, America, and I think this is the legislation that will do it. I yield back my time, and I look forward to participating in the debate.

The CHAIRMAN. Well, Senator Mikulski, you have a great knack of taking some of the most complex problems and interpreting those in ways that folks can understand them, and I congratulate you. Thank you very much. We appreciate your help. Any questions?

[No response.]

The CHAIRMAN. Thank you.

Senator MIKULSKI. Thank you.

The CHAIRMAN. Our next witness is Secretary Kemp, a man who is respected for his candor, his courage, his compassion, and his long-term interest in the tax laws of this country. He is a co-author of one of the major pieces of tax legislation to have passed the Congress and he is a man whose concern for housing has been recognized by all of us, who has directed some very forward-looking policies. We are very pleased to have you, Mr. Secretary.

STATEMENT OF HON. JACK KEMP, SECRETARY, DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Secretary KEMP. Thank you, Mr. Chairman. Last night on television, they included you as suggesting that I was to testify before your very important committee. There was some anxiety among my family as to what was going to occur.

The CHAIRMAN. Well, I looked around for your security this morning.

Secretary KEMP. And let us face it, things that are taking place in this very hot political climate are subject to misinterpretation. I want to make it unambiguously clear that I am here, Mr. Chairman, not on behalf of anyone but myself, as the President's Secretary of Housing and Urban Development.

I am here as the Chairman of his Low-Income Opportunity Board, and I am here because I sent you a copy of my testimony last week to the Joint Economic Committee on what this country needs to do, Democrat and Republican, White House and Congress, public and private-sector, to combat the conditions of poverty in our nation's rural and inner city pockets of poverty.

When I told my daughter—who happens to have been a former school teacher—about what I was going to say, she called me on the way to work this morning and she quoted from Martin Gilbert's new biography of Winston Churchill. Churchill said in the 1930's that: "the worst policies were the result of the failure of the leadership in the House of Commons and in the British Tory Government to tell the truth to the British people."

She said, Daddy, just tell the truth. Of course, then she warned me that Lloyd Bentsen would probably say that he knew Winston Churchill. [Laughter.]

That Winston Churchill was a friend of his, and Jack, you are no Winston Churchill.

The CHAIRMAN. I think I remember the rest of that line. [Laughter.]

Secretary KEMP. There is a great deal of wisdom in this committee and on this earth, and it is all divided up among the people. And I am here to share with you my little piece of the wisdom that I have learned from my experiences traveling the country for the President to the pockets of incredible poverty and despair.

I am not here on behalf of your middle-income tax cuts, Senator Bentsen, although I have favorably commented on what you are attempting to do and the problems you have attempted to address. I have done the same about Pat Moynihan's suggestions.

I was a colleague and comrade in the tax battles of 1986 with Bill Bradley and others to lower the tax rates. My good friend, Bill Roth, and I were co-authors of an across-the-board, almost 30 percent cut in the tax rates in 1981.

I am not here on behalf of the wealthy. I am here on behalf of the people who would like to become wealthy some day. I am not here on behalf of the middle-class.

I was looking at my Joint Economic Committee testimony and I realized that it is impossible to accomplish any of the goals that we share in combatting the poverty and despair that grips all too many people in this country without major tax changes.

I have sent you my testimony and I will not read it, much to the relief of you and our friends in the press. But I mentioned that as you would think about extending the Low-Income Housing Tax Credit, as I applaud the committee for doing, it seems to me that it does not make any sense to talk about low-income housing that will help the poor without talking about more jobs in our nation's distressed inner cities or pockets of poverty—be they in rural or urban America.

The President sent up an Enterprise Zone bill that would eliminate the capital gains tax on any man or woman that would invest in a new business that hired people off the welfare and unemployment rolls in the inner city.

Earl Graves, of Black Enterprise Magazine said the biggest trouble of minority businesses and the biggest problem for black entrepreneurs is getting access to "seed corn," access to venture capital, access to the oxygen for their businesses.

So, Charlie Rangel introduced, as a part of the President's Enterprise Zone proposal, the expensing for investment in an inner city or Enterprise Zone firm.

If a woman leaves welfare and takes a job in America today, her income goes down. And there are many of us on both sides of the aisle that believe that some form of an Earned Income Tax Credit is appropriate.

In fact, that, too, is a part of the President's proposal—thanks to Jack Danforth and others, we now have it in legislation; Rangel in the House, Danforth and Lieberman in the Senate—that would allow people to leave welfare, take a job, and not see their income go down, but go up, thanks to a refundable or an Earned Income Tax Credit.

It is no secret that the administration has sent up a budget that would allow IRA's to be used as a down payment for a home, and I applaud many of you on this committee for thinking about how IRA's can be expanded to include the formation of assets.

What we are talking about in fighting poverty is to give people not just income streams, but asset accumulations so they can own property, get the jobs, become businessmen and women, entrepreneurs, home owners.

I think that is the single greatest problem in the past war on poverty that ha~ spent $2.4 trillion since 1964; but poverty still seems to be winning.

Finally, it is no secret that the family needs a tax break, but how empty it would be if it is just to redistribute wealth, as many of you have mentioned.

Now, it has to be said, and I am going to say it. The President's proposal to cut the capital gains tax to 15 percent and index it, sent to this body in 1989 as part of President Bush's State of the Union and part of his budget message, in my view, Mr. Chairman, along with eliminating the tax on capital gains in the inner city, is absolutely essential to the single most important ingredient of a growing economy; that is, the formation of new jobs through the formation of new businesses.

On this chart is a statistic that I think is pretty demonstrably self-evident to anybody who takes the time to look at it, but since 1986 or 1987, something has happened to the formation of new businesses. The entrepreneurial sector of the economy began to sharply fall in the formation of businesses.

And you cannot fight poverty in an economy that is impoverishing that sector of the economy upon which we depend for the creation of new jobs, new technologies and new formations of capital.

And I want to suggest that there is one other statistic that could go right along with it, and I will mention it because it is one that I read about in the morning paper.

The bail out of the FDIC is going to cost $70 billion either this year or next. The Congress has been asked to recapitalize the RTC to the tune of $80 billion in 1991.

The fall in the value of capital assets—in this case, fixed assets—residential household values, as well as commercial real estate, caused, I think, in large part by the 1986 tax law—in which I took some pride, and many of you did as well—in bringing down the rates.

We made, in my view, a very serious mistake by leaving unindexed a tax on the formation of capital that is discouraging not only the formation of new business starts, but causing the further decline in the value of fixed household assets as well as commercial real estate, putting, therefore, tremendous pressure on our banks, our thrifts, our insurance companies, and locking the poor out of access to capital. And I will stop with this thought, Mr. Chairman.

The total net worth of the United States of America has been estimated to be $30 trillion. Black Americans, African Americans represent 13 percent of the total population of America, but they own less than one-half of 1 percent of the total capital stock of America.

I want to make a point that has yet to be made in the debate. You cannot get rich, or get wealthy, or accumulate assets on wages alone. You have got to be able to get a wage, a stream of income, be able to save, earn, and then make an investment and take that profit and someday put it at risk.

And there is no way to get wealthy in America today for poor people if they are consigned to a Tax Code that confiscates the reward for working, saving, earning, and putting their limited capital at risk.

One other point I want to make, and this is the conclusion, I would ask this august body to put aside class rhetoric, put aside envy, put aside egalitarian redistribution of wealth schemes, and, as you take up your very important deliberations, consider how this democratic, capitalistic economy can possibly survive in a competitive world when it is taxing away the formation of the very capital that is necessary to make this country what it was meant to be in the beginning: a nation where there is a job for every man and woman who wants one, a home for every person who needs, and desires and aspires to one, and the type of an education that has obviously been on the minds of the Congress and the President for so long.

I appreciate very much your attention to these issues, Mr. Chairman. I remember your vote for the Steiger Amendment back in 1978. I would ask that the Congress put aside partisanship.

I will certainly carry this message to our administration that we need to put aside our concern and fear and anxieties about what would happen in the Congress, and for the good of this country, for the good of the middle class, for the good of the poor who want to become middle class, get a tax measure passed that will do what you said you wanted to do in 1978 when you helped cut the capital gains rate by 50 percent and bring it down from 49 to 28.

I applaud your efforts, Mr. Chairman, and appreciate the attention. I look forward to your questions.

[The prepared statement of Secretary Kemp appears in the appendix.]

The CHAIRMAN. Thank you very much, Mr. Secretary. I know of your support for the R&D and low-income housing credit, and we have made some progress in that in this committee yesterday.

Secretary KEMP. I appreciate that, Mr. Chairman.

The CHAIRMAN. And we did it on a bipartisan basis. You are quite right, I helped lead the fight in the Senate in the cut of the capital gains tax by bringing it down from 49.125 percent and then down to 40 percent, and then down, finally, to 20 percent.

But the other side of that coin was that at the same time we had a much higher personal income tax.

Secretary KEMP. Yes, we did.

The CHAIRMAN. And it was much more of a locking effect than it is today, without as much of a variance between the personal income tax and the capital gains tax.

But as we brought it down, I can recall, too, that the Reagan Administration was talking about that if we raised the capital gains tax, that was one of the ways we were going to pay for lowering the personal income tax. That was the argument.

Now we have got the argument on the other side—that you make money from lowering the capital gains tax. As you have correctly cited, however, I understand the appeal of capital gain.

But assuming as a matter of equity, that those of wealth are the biggest gainers in the deal, is it not reasonable to say that if CBO is right, and that it cuts the revenue of the government for those 5 years, if they are right in that regard, is it not equitable that those people of that higher income would replace that by some other payment on their income? Where do you go to pick it up? That is the problem we face.

Secretary KEMP. I appreciate the question.

The CHAIRMAN. And I sat there trying to work something out with the President in the budget deal last time.

Secretary KEMP. Yes.

The CHAIRMAN. I thought, perhaps, we had him leading our way until someone convinced him otherwise.

Secretary KEMP. Well, all of the empirical evidence is to the contrary. That is, that every time we have raised capital gains tax rates in the post-World War II period, we have lost revenue. And every time it has been cut, we have gained revenue.

But I do not ask you to believe Jack Kemp, and I know you have got a staff that can find that empirical evidence as to what would happen. I do not trust the models of the CBO, or those of our own Republican econometric models, as long as they do not take into consideration why people put their capital at risk.

But, Mr. Chairman, it seems to me axiomatic that we should set the tax rates on the formation of capital, and on labor, and on the family that would be most encouraging to those three very important factors of this Nation's economy.

And I think the evidence is absolutely self-evident to any honest and well-meaning investigator on the left or the right who looks at the economy and realizes that every time we have cut the tax rate on capital gains and had an incentive to put capital at risk, revenues have gone up.

But Alan Greenspan testified before the Senate Banking Committee on our RTC oversight responsibilities that the only act that would immediately add value to the fixed assets of America, i.e., real estate and residential property, would be cutting the capital gains rate.

I believe that, Seidman believes it, Wayne Angel believes it, most of the Democratic candidates running for President have some form of a capital gains tax cut. But I am not here to talk only about the capital gains tax cut. I am here to suggest that the people who are going to benefit the most, Senator Bentsen, are not the rich.

The capital gains tax is a voluntary tax. It is a transaction tax. If you do not sell anything, you do not have to pay it. Rich people are already rich. They do not care about it; their capital gains are behind them.

The people who have capital gains ahead of them are those who want to be able to see the value of their home rise, the value of their business investment rise, the value of their stocks or bonds rise, or get access to those assets.

And I think the system is now locking a lot of people out of access to assets capital because we are confiscating the rewards for taking risk, both for poor people and middle-income people.

The CHAIRMAN. Thank you. Senator Packwood.

Senator PACKWOOD. Jack—and I want to phrase this carefully, because you never want to say that this is a low-taxed country—but comparatively speaking, we pay less taxes than our industrial competitors in total. I mean in Federal, State, and local taxes.

Secretary KEMP. That is not relevant, though.

Senator PACKWOOD. No. Well, that is what I want to ask you——

Secretary KEMP. All right.

Senator PACKWOOD [continuing]. Whether it is relevant or not. And it may not be. Japan and the United States paid 30–31 percent total taxes, Canada about 35, most of the Western European countries in the 35 to 45 bracket, and Scandinavia about 50 percent in ~~terms of~~ total taxes.

And I support your conclusion on capital gains making revenue; I think it does. But is it, in and of itself, enough of a stimulus to make the difference in terms of pulling this country out of the economic doldrums?

Secretary KEMP. Bob, let me answer the question very specifically. But before I do, let me just address the previous premise upon which you based your question, and that is, is the total tax burden the most relevant statistic, and I do not think it is, with all due respect. We are the only country in the world with an unindexed capital gains tax rate. And the problem that Al Gore and Tom Downey were talking about is that the family income which has been pushed by inflation into higher tax brackets, has reduced the value of the exemption of the tax credit for children.

So, in effect, what you are trying to do, I think, is important—to restore equity and value to the exemption. Had it been indexed for inflation since Harry Truman helped put it in in 1946, the family exemption, or child exemption would be worth $6,000–$7,000.

Putting that aside for a moment—which we should not, altogether—I made the point that Japan hardly taxes capital gains. West Germany does not even tax it. Mexico does not tax the investment in the Mexican Bolsa for anybody who puts money into the Mexican stock market.

No country has an unindexed capital gains tax rate except the United States of America. We are punishing the formation of capital, and we are watching the decline of the entrepreneurial system to which the world is beginning to beat a path.

Now, having said that, Senator Packwood, the incidence of taxation is different than the burden, and the incidence of taxation placed upon the formation of capital, and the formation of labor, and the formation of the family causes the burden to fall on the poor.

And I am suggesting that we are making the wrong case for capital gains when we suggest that it is for Donald Trump. It is not for Donald Trump. It is not for Sam Walton of Walmart, and it is not for John Johnson the owner of Ebony Magazine, and Jet, who is, I guess, the wealthiest black entrepreneur in the country, according to Forbes Magazine. It is for the people who want to become entrepreneurs.

You cannot get access to capital today, and we are drying up the very formation of capital that is necessary to combat poverty, create more businesses, create more ownership for minorities, create more jobs, and create the type of economic growth that is absolutely essential to doubling the GNP of this country.

I really believe it is a mistake only to focus on deficits, debt, and spending and not focus on the denominator: the size of the Gross National Product. And if we would put our minds to it, Senator, and had a tax system along with capital gains and other proposals, many of which the President supports and is in his budget, I believe that we could have, by the end of this century or early next century, a doubling of the GNP. The revenues from an $11 trillion economy are a lot higher than the revenues from a $5 trillion economy.

And clearly, we could do a lot of good things for infrastructure, for schooling, and for this country if we had another $300 billion of revenue. And the only way we are going to get more revenue is, I think, lower the tax rate on the family, on labor, and on capital formation.

The CHAIRMAN. Are there other questions of the Secretary? Senator Roth.

Senator ROTH. Thank you, Mr. Chairman. It is, indeed, a pleasure to see Jack Kemp here. I do have a couple of questions I would like to ask, because I strongly agree with you that what the purpose of our tax reform should be is growth.

What I would like to ask you, Jack, is if you were putting together a tax package to create the kind of growth, the kind of economy you are talking about, what would be the elements of that growth package?

Secretary KEMP. Senator Roth, I would appreciate it if I could confine my remarks to the testimony that I have given to the Joint Economic Committee. I do not speak for the administration on tax policy; that is very clear. The only way I can maintain my credibility, both on Capitol Hill, and in the administration, and with the people that I represent, is to stick to the agenda for combatting poverty that is outlined in my testimony.

It is no secret that I believe that what Senator Moynihan and you have talked about, what other members of this committee have talked about, is essential to the long-run health of our National economy.

What Al Gore and Tom Downey did not tell us is that the single biggest problem for the middle-income family—and I can tell you it also exists in low-income people—is the increase in the payroll tax that took place in this country in the late 1970's and the early 1980's.

I think something has to be done about passive loss restrictions. We treat investment in real estate to such a degree that it is causing the absolute collapse of residential and particularly commercial real estate, and it is driving up the cost of the bail-out of banks, insurance, and the thrifts.

The only issue at the moment, however, that can help get American moving again immediately and add value to the assets of the American people, unlock the vast stock of capital, help save California, New York, New Jersey, Massachusetts, New Hampshire, and the rest of the country from these fiscal deficits and add to the tax base of the States, and the localities, and the Federal Government, is an immediate, across-the-board reduction in the capital gains tax rate and unlocking of that huge stock of capital.

The President asked for it 2 years ago. The Congress has, for some reason, unfortunately turned this into such a political issue that we are now going to have to wait till next year.

Had it passed, I believe with all my heart in 1989 when he sent it up here we would not face the collapse of the banks, the FDIC system, the recapitalization costs of the RTC, and the pressure and the loss of net business formation and jobs.

And the hour is late, and if you are unemployed, homeless, out of work, and in despair about your families future, it is an eternity to have to wait for action that I think should have been done a year ago. We have been talking about Enterprise Zones now, Senator Bentsen, for 10 years.

I applaud your efforts to extend the Low-Income Housing Tax Credit. But let me ask you a question. Do you think any rational human being who puts his or her capital at risk in low-income housing today in America is going to do it on the basis of a 6-month LITC? Does anybody really think that that is the way to drive this economy by giving people a 6-month extension of the Low-Income Housing Tax Credit?

I mean, we are, for some reason, looking at the economy for 6 months, and not looking at the economy as, I think Senator Baucus suggested, over the period of the whole decade of the 1990's and what type of a competitive economy we will want at the turn of the next millennium, the next thousand years.

I am not criticizing you, Senator Bentsen, at all. But it seems to me sad to think two things. Number one, we are extending these tax benefits for 6 months, and then number two, we fail to pass an Enterprise Zone bill to put some hope and jobs into the nation's pockets of poverty in rural and urban America.

The CHAIRMAN. Let me say to you, Mr. Secretary, there is no question that I would like to see permanent extension of those provisions. And I think every member of this committee would. It is a question of the budgetary constraints we have and how we replace it with revenue. That is our problem.

Secretary KEMP. Right.

The CHAIRMAN. Senator Moynihan.

Secretary KEMP. You can pay for it by cutting the capital gains tax rate, by the way. [Laughter.]

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Mr. Chairman, I had hoped to get Jack to say two things, which he has just done, in response to Senator Roth. But it would not do any harm to say them a second time. The first has to do with the structure of tax payments in this country today.

In the 1980's, the share of Federal revenues from the personal income tax was reduced about 4 percent, but the Social Security payroll tax share was increased by over 20 percent. And so, now three-quarters of Americans pay more Social Security tax than they do income tax.

And that is also true of small businesses that you are concerned with. An employer pays that payroll tax whether they are earning money or not. So, start up companies are doubly disadvantaged.

You could agree, could you not, Jack, that one good jolt to this economy would be to cut that Social Security tax to where it is perfectly in balance? We are now spending about $1.5 billion a week of Social Security trust funds on other things. If we let the people who made that money keep it, that would do something for the economy, would it not?

Secretary KEMP. Your expression says it all. The only way, Senator Moynihan, that I can possibly maintain, as I said earlier, my credibility, is to testify on the President's low-income opportunity——

Senator MOYNIHAN. Exactly. Right.

Secretary KEMP [continuing]. And tax issues that are in his budget.

Senator MOYNIHAN. Jack, let me then——

Secretary KEMP. But it is no secret that I have applauded your effort to draw attention to the fact that the payroll tax—I am not trying to play both sides of the fence. I think most people that know me know I do not do that. But it is very important that I not make statements about tax policy for which I am not responsible.

As an old tax-cutter of Bill Roth fame, I think the payroll tax is probably, at the lower level of the economy, the most serious impediment to small businessmen and women hiring other people. I think it is killing the welfare mother who wants to take a job, or the unemployed father who wants to take a job. And we address it in our Enterprise Zone legislation.

So, it is critical to lowering the cost of labor, but you cannot lower the cost of labor, Senator, without lowering the cost of the formation of capital so that workers are working with more productive tools, machinery, equipment, and technology.

Senator MOYNIHAN. Jack, could I also just say that I was very pleased and not surprised to hear you say that. I think, in effect, you said we need to revisit the 1986 legislation with respect to passive losses on real estate. You do agree?

Secretary KEMP. I definitely agree that we need to do something immediately to stop the hemorrhaging of value in capital assets of America.

Senator MOYNIHAN. Yes. Yes.

Secretary KEMP. That is, fixed, as well as financial.

Senator MOYNIHAN. Which is paralyzing financial institutions.

Secretary KEMP. Yes, it is.

Senator MOYNIHAN. Thank you very much.

The CHAIRMAN. Let me say that this is the first witness we have had outside of members to speak this morning, and we have quite a few left.

Senator BRADLEY. Mr. Chairman, I just have one brief question. Let me thank the Secretary for his testimony and his candor, and for his obvious commitment to the people in this country who are not living in as good of conditions as many others.

Secretary KEMP. Thank you.

Senator BRADLEY. With that in mind, particularly with your own commitment to those who are poor, one of the issues before the committee is whether we should adopt a tax credit for children. And that will be in the mix of things that we consider.

At a minimum, if we go the route of a tax credit for children and do not make it refundable, we will be excluding 25 percent of the children, and those will be the poorest children. How would you feel about those children if we do not include them in a package that has to do with a Child Tax Credit? In other words, I am not asking you to take a position, but speaking for those who are poor, to exclude them would be sending a very terrible message about where the priorities of the Congress and the administration are, would it not?

Secretary KEMP. Bill, it is a well-known fact that 47 percent of all African-American children born in America today are born immediately into poverty. Thirty-nine to 40 percent of Hispanic children are born immediately into a family in poverty.

So, it makes a great deal of sense to address the problems that poor or low-income—and I believe temporarily low-income, because I do not believe anybody statically wants to spend their life being classified as part of some class or some welfare group—but clearly, something must be done.

We doubled the exemption from $1,000 to $2,000 in the 1986 tax law. You and I, in part, are responsible for removing from the Federal Tax rolls altogether several millions of people.

I think we need to revisit that issue and make sure that when that woman with two children in downtown District of Columbia wants to get a job and takes a job, that she finds her income going up, not down. And if a refundable Earned Income Tax Credit for children is the only way to do it, then that is something that I think the Congress must address along with the administration.

And as the President's Low-Income Opportunity Board Chairman, I would be highly sympathetic, because I have seen what has happened to a welfare system that really rewards welfare higher than it rewards going to work.

And that is not the problem of the welfare recipient, that is the problem of the Tax Code and the way we define AFDC payments, welfare, and other non-cash benefits.

Senator BRADLEY. As you know, if we went the route of increasing the exemption, the greatest value of that would be to the upper income tax payer as opposed to the lower income. If we went the route of a tax credit, that would be a direct benefit—the same benefit—to all income levels, but it would be a larger benefit to lower income Americans.

Secretary KEMP. There is a case to be made for the exemption, and there is a case to be made for the credit. And I want to reserve for the experts to tell me what has the most impact upon a poor Chicano woman in Milwaukee, Wisconsin, who was fined $15,000 for saving $3,000 for her daughter's education. I want to find out what type of change we need to make so that Grace Capetillo, who saved $3,000 on AFDC, was fined $15,000 for violating the AFDC payment law. And she said she will never save again, because it is a violation of the welfare laws.

And I think we have to revisit the whole welfare system and call for radical perestroika. And what comes out of that perestroika on welfare could very well be a credit as opposed to an exemption.

But I would not want to sit here and propound tax policy, not knowing, as Senator Bentsen said, what are the costs, what does it mean to the budget, et cetera. And I am going to leave that for the debate that is sure to come.

All I know is you cannot fight poverty when the country is becoming poorer, and this country is becoming poorer because of the regulatory and tax-driven recession into which we have been pushed.

And I think it is absolutely essential to help get this country moving again, and the faster, the better. Because if you are out of work, 2 months is an eternity.

The CHAIRMAN. Thank you very much. I would say, Mr. Secretary, I share very much the sentiments of Senator Bradley and Senator Gore, and some of the comments you made about refundable tax credits, and there is more to be done.

But I would also say, and we must remember, that last year we enacted an $18 billion increase in the Eearned Income Tax Credit, which represents a major benefit to low-income working families. This result is a doubling of the EITC for the working poor.

Secretary KEMP. Right.

The CHAIRMAN. So, we are making some headway. Not enough however, more needs to be done.

Senator SYMMS. I know the Chairman is in a hurry, and I will be very brief. But I just want to try to leave the Secretary feeling a little optimistic as he leaves here this morning.

First, Mr. Chairman, I would like to thank President Bush for having Jack Kemp in the Cabinet. I think that your statement needs to be repeated over and over again.

And I would like to encourage you to continue to make the point that if Republicans and Democrats could set aside the clash that we had when Senator Mitchell decided in 1989 that we were not going to pass the capital gains tax, that we were going to have fairness as a political issue in 1990, then we would not be in as bad a mess as we are in.

But now that we are in the mess, I believe that your message is being heard, and I would encourage you, in the Cabinet meetings, to talk to the people that are responsible for tax policy.

Because I still believe that if the President and the Secretary of the Treasury could enthusiastically get behind the idea to accept the Moynihan tax proposal and tie it to reducing the capital gains tax so the capital gains tax would pay for the Moynihan proposal in the budget, then we would give this economy a real shot in the arm. Some of the other things then, if we could do it, would also help.

So, I am not going to ask you whether you support that idea or not, because I know you, and I do not have to ask you. I can tell by the smile on your face that you do support that idea. And when you get to the proper forum, I would encourage you to continue to push it. And I thank you, Mr. Chairman.

The CHAIRMAN. Senator Hatch.

Senator HATCH. Jack, you have done an excellent job of staying in the pocket today. A few scrambles here and there, but I want to tell you that I agree with everything you said. I am a co-sponsor of the Chairman's bill, and I think he is doing us a favor by doing it.

But I think we need to do more than that. I think we need an integrated economic policy approach. And I think we need a constructive tax reform program which includes at least four things, and I would like to ask you if you just agree with these comments.

Secretary KEMP. All right.

Senator HATCH. Number one, I think we need to remove and/or moderate tax features that impede economic growth-generating activities, particularly barriers to private saving and investment and that raise the cost of private-sector uses of production capabilities. That seems to be a great deal of what you have been talking about.

Secretary KEMP. Right.

Senator HATCH. Number two, I think we need to remove or moderate tax features that distort the market's price signals, hence, impair the efficiency of our market system.

Number three, I think we need to remove or moderate tax provisions that impair the competitive position of American businesses in the world marketplace.

And number four—and I think this may be the most important of all, because I think if America is all mixed up and ruined, it is because of our budget policies—I think we need to provide discipline of spending decisions and that will require tremendous improvement in the budget process.

Now, those four things, I think, at a minimum, we have got to do in an overall, integrated, coordinated economic policy, and I want to know if you agree with that.

Secretary KEMP. Well, I do agree with that. And particularly the part about our international position. Orrin, let me say to you as a friend, and as a long-time fellow soldier in the cause that there is no country on this earth that I know of—at least in the industrial world—that has a capital gains tax unindexed as high as ours.

Senator HATCH. I agree. It is ridiculous.

Secretary KEMP. And what has happened, if you bought an asset, either financial or real estate, or a home in 1979 or 1980 and you wanted to sell it in 1991, the real effective tax on that asset is close to 65 to 70 percent. It is confiscatory and it is a mistake.

And the reason I want to lower it is not to help rich people get richer. I want to unlock the stock of capital so poor people can get access to capital, so poor people can get rich, so that the homeowners can watch the value of their most important asset, go up, rather than continue to fall in value.

And I want to close, Mr. Chairman—and do not use your old line on me on this one, either—but back in the old days of the 1970's when I represented Buffalo, New York and watched the steelworkers, auto workers, factory workers of New York State paying an effective marginal tax rate of close to 40 to 45 percent on the Federal, State, payroll, and other taxes, I became enamored with what President Kennedy had done in 1963.

And the more I studied it—his across-the-board reduction in tax rates, across-the-board, now, that is, and the lower end of the capital gains tax that President Kennedy cut by 30 percent in 1963—I memorized something and it needs to be said.

"I am not here to lose revenue. I do not think we should increase the deficit. I do not think we should do anything that slows down the process by which we get a rising revenue base for all of the States and all of the Federal Government." He said, "It is a paradoxical truth that tax rates are too high today and tax revenues are too low and the soundest way to raise the revenues in the long run is to cut the rates now."

Now, which tax rates we have to lower is subject to the vagaries and the vicissitudes in the debate that is going to take place. But I want to suggest that clearly, right now, the family, the working men and women of America and the formation of capital are overtaxed and we should stop making a confusion between tax rates and revenues. They are different.

And that is the subject of the problem that Al Gore and Tom Downey had. They confuse tax rates with tax revenues, and we should not make that mistake in this very important body, and I know you will not. Thank you.

The CHAIRMAN. All right, gentlemen. Thank you.

Secretary KEMP. Thank you, Mr. Chairman.

The CHAIRMAN. Let me say, Mr. Secretary, in your comments about the extent—Senator Grassley is still asking for additional recognition.

Senator GRASSLEY. I think you just about touched on, at your last sentence, what I wanted you to. You did not hear Senator Gore and Representative Downey, but they had these charts that dated a period of time from 1977 to 1991. And they showed the unfairness of what developed as a result of, I presume, it was Kemp-Roth's tax cut.

As an author of those tax cuts, and having to address an issue by the opposition that they were unfair, I would like to hear your answer to that.

Secretary KEMP. Well, they are only looking at the Tax Code as a dollar-for-dollar static trade-off with tax revenues. They forget that in 1978 when we first began to talk about lowering tax rates, people were investing in tax shelters; municipal tax-free bonds, offshore investments, and everybody knew that something was wrong with a Tax Code that reached up to 70 percent on so-called unearned income.

Now, luckily, we removed that ad hominem attack on savings from the Tax Code by lowering the tax rates to 50, and then they came down to lower. The only point I still make is that (a) by bringing down the rates across the board it was fair; (b) it was distributionally fair; it did it for everybody. I think there was a 26.5 percent cut in everybody's tax rates across the board.

But it said—the most important thing that Gore and Downey have missed—that low-income people some day hope to be middle-income people some day.

And I think Senator McGovern made that mistake in 1972 when he advocated cutting taxes for people under $17,000 and implicitly raising them for people above $18,000.

And after his campaign was over, I happened to ask him 1 day, why did you think your plan never got through the Congress? He said, I never realized, Congressman—that is what I was in those days, a rookie Congressman—there were so many people earning $17,000 a year who someday hope to earn $18,000 a year.

The one thing I have learned in the inner cities of America, there is no one that wants to bring down the house of a rich man to house a homeless man, they just want more housing.

I do not know of anybody who wants to take the job of a person from the suburbs to get a job for themselves. They just want more jobs. I do not know of anybody who wants America to be turned into a game of musical chairs came so that when the music stops the big guy elbows out the little guy and gets the last chair. We need more chairs.

And I agree with Tom Downey; a rising tide will not lift boats that are sunk on the bottom of the harbor. We need a rising tide, and we need government programs and policies and tax changes that will help those boats get repaired so that they, too, can float.

I do not think America was built on the idea of egalitarian redistribution of wealth. It was built on the basis of creating wealth and giving people access to opportunity to create it for themselves. And that is what is, I think, the glory of this worldwide revolution towards democracy, and, entrepreneurial capitalism.

But what a shame it would be to win it in Eastern Europe and lose it in East Harlem, East St. Louis, East Palo Alto, East L.A., or the barrios along the border of your State, Senator Bentsen.

We have got to do something about low-income housing, but we have got to do something about more jobs for low-income people.

And it is a crying shame that we are going to adjourn before we pass the President's Enterprise Zone Bill. Thank you very much.

The CHAIRMAN. Thank you, Mr. Secretary.

Senator CHAFEE. Well, Mr. Chairman.

Secretary KEMP. Oh. Excuse me.

Senator CHAFEE. Mr. Secretary, it seems to me that in these hearings we have got three things that we are considering. The first is fairness under the Tax Code, and I am interested in that, and obviously you are, too.

The second concerns treating our children in a better fashion—I notice that the Children's Defense Fund is going to testify later—and we are all interested in being able to do that. I think the thing in which I am the most interested, and in which you are interested, is how do we make the economy of this country grow? How do we make the pie bigger?

Secretary KEMP. Right.

Senator CHAFEE. Now, obviously you believe this can be done through the cut in the capital gains rate, and you have been a forceful advocate of that for a long time.

Secretary KEMP. Among several things that have to be done.

Senator CHAFEE. Yes, but hang on one second. I supported the blending of the capital gains rate in 1986 with our regular income tax rates, getting rid of the differential, with the objective being bringing down the overall rates.

Secretary KEMP. Right.

Senator CHAFEE. Now, in your chart there, you show an interesting factor: the decline in business formations. But the thing I cannot understand—now I do not have much time, so I will make this very brief. Why was it delayed until really July 1990 when we passed the tax changes effective as of January 1, 1987? That is the first question.

The second question is, I have begun to come around to resurrecting an effort that we have been back and forth on in this committee, namely the investment tax credit. I have come to believe that really that is the route we ought to proceed.

But, first, the answer to the question, why did it take so long to have this effect that you show so dramatically in 1990, when we passed the tax in 1986?

Secretary KEMP. Clearly, the recession has had a very negative impact on the formation of new businesses, or it may be the other way around. Secondly, we have raised the cost——

Senator CHAFEE. I mean business formation went up despite the passage of the tax and they reached——

Secretary KEMP. No, it flatted out. If you look at the growth, if I had taken that back to 1978 when the Stagger Amendment passed in a bipartisan way, you would find that it would be way down and it has been a steady road up. And all of a sudden, it began to peak out in 1986 and then dipped, went back up a little bit, and then has really dipped.

So, clearly, you have a problem with a tax on the formation of the very essence of job creation, i.e., capital. You cannot have capitalism without capital. And my friends, you cannot create new employees without first creating new employers.

And the most dynamic part of the job-creating economy is the entrepreneurial sector and an investment tax credit, Senator, simply goes for machinery and equipment for mature industry, and is very costly.

It does not go to the net entrepreneurial, high-tech, growing sector of the economy which creates most of the new net jobs, and that is what I was talking about: creating more new jobs, particularly for poor people and minorities who are the most hurt by this economy.

The CHAIRMAN. Thank you very much. Let me say, Mr. Secretary, when you commented on the 6 months extension for low-income housing——

Secretary KEMP. Right.

The CHAIRMAN. I would remind you that the administration's budget only calls for a 1-year extension, and I share your concern over both of those.

Secretary KEMP. You know that I was not criticizing you.

The CHAIRMAN. No. I understand.

Secretary KEMP. I was simply saying that it is a shame that we do not make permanent——

The CHAIRMAN. I just wanted to show you the problem that we are facing. Right. Mr. Secretary, you have been a very interesting, informative, and a good witness. We appreciate it.

Senator MOYNIHAN. Vigorous.

The CHAIRMAN. Thank you very much.

Secretary KEMP. Thank you.

The CHAIRMAN. Let me state that Senator Moynihan will preside. I am faced with the problem of being in a conference resolution that we are trying to finish, so he will take over.

Senator MOYNIHAN. I would ask our guests to be a little quiet now.

Our next and final solo witness is the very able Director of the Congressional Budget Office. Dr. Reischauer, we welcome you, sir. Did you bring a statement? You always do. You brought a huge statement. I suggest you have too many staff, or did you write this yourself?

Dr. REISCHAUER. I cannot tell a lie; I did not write it myself.

Senator MOYNIHAN. That is right. Well, did an assistant to your assistant write it, or did an assistant write it? Go ahead, sir.

STATEMENT OF DR. ROBERT D. REISCHAUER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, WASHINGTON, DC

Dr. REISCHAUER. Senator Moynihan and members of the committee, I appreciate the opportunity to be here this morning. With your permission, I am going to submit my statement for the record, and I will summarize the statement by addressing six different questions that I think illuminate recent trends in family income and tax burdens.

Senator MOYNIHAN. Sure.

Dr. REISCHAUER. My remarks will concentrate on families with children and how they have fared in relation to other families. Such families are the focus of the Tax Fairness and Saving Incentive Act of 1991, which has been sponsored by the chairman and other members of this committee.

The first question I want to address is, how do the incomes of families with children compare to those of other families? The answer is that after adjustments are made for family size, those with children have lower average pre-tax incomes than those without.

In 1989, the average income of families with children was less than four times the poverty level, while for non-elderly childless families it was a bit over five times the poverty level, and for elderly families over 4½ times.

The second question I want to address is, how fast have the incomes of families with children grown over the past 12 to 15 years? Unfortunately, the answer is, quite slowly.

Between 1977 and 1989, the average pre-tax income, adjusted for inflation and family size, for families with children—and for non-elderly childless families—grew by less than 10 percent. By contrast, the average adjusted pre-tax income of elderly families grew by more than 30 percent.

The third question I will address is, have these trends been uniform across the income spectrum? The simple answer is no.

Both families with children and childless families in the bottom three income quintiles—the bottom 60 percent of the income distribution—experienced virtually no change in their average incomes between 1977 and 1989. Families in the fourth—next-to-highest—quintile experienced a slight increase in average income, while the average of families in the highest quintile grew by more than 22 percent.

The fourth question I will address is, what has happened to the income tax burden of families with children? Overall in 1992, families with children are projected to pay about 10 percent of their incomes in Federal individual income taxes. I choose 1992 because that is the point at which most of the tax changes made in the 1990 legislation will be phased in. This 10 percent is roughly the same rate that these families paid in 1977.

If we survey this 15-year period, therefore, we find virtually no change in the effective tax rate. The percentage for families with children is a bit below that for childless, non-elderly families, and a bit above that for elderly families.

Families with children in the lowest quintile will see their income tax burdens fall as the subsidies they receive through the refundable Earned Income Tax Credit continue to expand. Families with children in the middle three quintiles will also face effective income tax rates in 1992 that are projected to be lower than the rates that they faced in 1977. At the top of the income distribution, families with children are projected to pay virtually the same percentage of pre-tax income in individual taxes in 1992 as they paid in 1977.

The fifth question I want to address is, what has happened to the total tax burdens, as distinct from the income tax burden?

Between 1977 and 1992, total effective Federal tax rates are projected to increase slightly for families with children and marginally for non-elderly childless families, while they should fall slightly for elderly families.

Among families with children, only those in the bottom income quintile will face lower total effective tax rates in 1992 than they faced 15 years ago. As you know, the increase in total effective tax rates for other families with children has been primarily the result of rising payroll taxes.

The final question I will address is, how has after-tax income changed since 1977? The average after-tax income for families with children, when adjusted for inflation and changes in family size, should be about 4 percent higher in 1992 than it was in 1977.

Although the 1989 data—the last actual figures—showed an 8 percent increase in after-tax income, that increase will be cut in half by the current recession and by the small increase that has taken place in effective tax rates as a result of Omnibus Budget Reconciliation Act of 1990.

Concern has mounted over the slow growth in living standards of families with children. So let me say a few words about the policy responses available to address the problem.

Permanent solutions must deal with the root causes of low pretax income. Among these are limited earnings capacity, and willingness and ability to work.

Specific policies that could help in this regard include strengthening our educational system, improving our job training system, expanding employment opportunities, and providing child care and other supportive services to those who want to obtain and keep jobs.

As a shorter-term solution, a number of tax proposals have been offered to help middle-income families with children. Among these is the Tax Fairness and Saving Incentive Act of 1991, which many members of this committee have co-sponsored. That bill would include a non-refundable credit of $300 for each child under the age of 19.

The credit would cut taxes for the average family with children by about $370 in 1992, and it would raise the after-tax incomes of the average family with children by about 1 percent. After-tax income of families with children in the second and third income quintiles would rise by between 1.5 percent and 20 percent. Because the credit is not refundable, however, families in the lowest quintile would see little change in their after-tax incomes.

But bear in mind, as I mentioned earlier, that those families have benefitted significantly from the liberalizations that have taken place in the earned income tax credit over the last half decade.

That concludes my presentation, and I will be happy to answer any questions that you might have.

[The prepared statement of Dr. Reischauer appears in the appendix.]

Senator MOYNIHAN. Well, I think we know all that. The question is getting to be how do you say something new on this subject. Part of what is puzzling Americans, I think, is that we have family income—median family income—that is lower today than it was in 1973.

And we have never had an experience in the history of the nation like this, from colonial times. The Great Depression lasted 9 years, yet average weekly earnings are lower today than they were when President Eisenhower left office. We are in kind of a regression.

We have the first generation of Americans who may not live as well as their parents. And, for some reason that baffles me, we do not seem to understand that the Cold War cost us, too. We see the Soviet Union in ruin; collapsing, disintegrating, having ceased, for practical purposes, to exist. And we suppose that it had no consequences on our side: it did.

And steelworkers make more money in Japan than they make in the United States today. Manufacturing wages in Italy are higher than they are in the United States today. This does sink in with us, partly because we have no word for it. I mean, I used the word regression. It is not a recession; it is a generation-long decline.

And you note that given the increasing use of Social Security funds as general revenue, which is what we are doing—given the increase in payroll taxes—for families with children, for all but the lowest income quintile, the total effective tax rates are higher in 1992 than they were in 1977.

We have not cut taxes, despite all that talk; we have raised them. And we raised them in the most regressive way, and in the most questionable way as a matter of public finance.

The Rochester Democrat and Chronicle once said what we were doing to the Social Security trust funds is thievery. And I was on a television program with my late, beloved colleague, John Heinz, and the television interviewer from up in New York said, "Senator Heinz, would you agree with the proposition that what is going on with the trust funds is thievery?" And he said, "Certainly not. It is not thievery; it is embezzlement," which is a distinction you might make as a businessman.

But what I would like to know is to what degree are particular problems of families with children is associated with family structure? What is the illegitimacy ratio in the country today?

Dr. REISCHAUER. Roughly one out of four children is born out of wedlock in the United States today, and that is up from roughly 1 out of 20 in 1960. So we have had a major change in social structure in that area.

Senator MOYNIHAN. We have had a 500 percent, a five-fold increase, I think 26 percent is the latest number.

Dr. REISCHAUER. I stand corrected.

Senator MOYNIHAN. Well, it is 29 percent in the United Kingdom. They are trebling in 15 years. We have quintupled in 30. There is something post-industrial about this. There is not——

Dr. REISCHAUER. I think in Scandinavia the numbers are even higher.

Senator MOYNIHAN. I think they are higher, and I think it reflects different social arrangements.

Dr. REISCHAUER. Correct.

Senator MOYNIHAN. These are what are known as common law marriages, as against marriages in which, as Jack Kemp was talking about, children are born into poverty.

Now, we are not going to get very far with what seems to me to be a post-industrial situation in which a two-parent family, that nuclear family is not disappearing, but in large sectors of the population, it is disappearing or has disappeared.

There are health districts all over the City of New York where the illegitimacy ratio is 80 percent, and the institution of marriage has effectively disappeared. So, do not be surprised if we have child poverty.

Now, what are the correlates of these things? It seems to me that if we go on talking about child poverty as if we were in the Depression and the mills had closed down, we are not going to get anywhere.

It would be, generally speaking, that in the last generation persons over 65 have gotten better off in this country, and persons under 18 have gotten worse off. Would you not say that?

Dr. REISCHAUER. That is what the various tables and charts in my testimony show quite clearly.

Senator MOYNIHAN. Yes. Well, that is, I think, primarily a phenomenon of family composition. If you look at your figure two on pre-tax incomes, pre-tax incomes for families with children in the highest quintile, they go up nicely. And those will be nuclear families, so-called. Or are they? It would be very interesting, and you could do this for us.

Dr. REISCHAUER. We have the figures. I do not have them with me.

Senator MOYNIHAN. Yes.

Dr. REISCHAUER. But by and large, the families with children in the highest quintile are overwhelmingly two-parent families—and largely two-worker families as well.

Senator MOYNIHAN. Right.

Dr. REISCHAUER. As you know, there has been increased labor-force participation in this country, with more and more women going to work, so a lot of families have two earners. It is hard to be a two-earner family if you are in a single-parent family.

Senator MOYNIHAN. It is very hard. Statistics prove it. That is one of the few things can statistics can be said to prove, that there are very few single-parent families with two earners.

What we would try to do in this committee, we have tried, without any success, because no one still gets it on our committee, to say that we need to begin to analyze this phenomenon in the way we began to learn to study unemployment starting about 50 years ago.

In the Age of Industrialism, the social question was unemployment. And we did not know what it was, and we did not have a name for it until this century. When did the word "unemployment" get into common usage? About 1910, I think. It used to be just people were standing around on streets, and what was the matter with them?

I mean, President Harding had a conference on unemployment in 1921. A national Presidential conference, and he produced that observation that when a lot of people are out of work, unemployment results. Well, that is about as much as they knew.

As you know, it was not until the Employment Act of 1946 that we set out to measure it. We did not know to measure it. We used to take it during the census once every 10 years and our census was taken in April of 1930, and then April of 1940. And in our official data, there is no depression.

Alvin Hanson did a probability sample of unemployment as a WPA project in 1939, which is the first number. In the Economic Report of the President, the unemployment rate begins in 1948; very late in the experience.

We would hope to have something similar in the way of measurements of child dependency and family structure, because it begins to look like dependency. It could be the equivalent of unemployment in the era ahead of us.

And while there are no questions about economic growth being important, this rise in dependency has taken place over 30 years of quite satisfactory, if not exceptional, economic growth. Would you not agree to that? 1960 to 1990 was not the worst time in the history of American economy, was it?

Dr. REISCHAUER. No, it was not.

Senator MOYNIHAN. No. It was a good time.

Dr. REISCHAUER. It is a period that had rapid growth in the first half, and fairly sluggish growth in the second half.

Senator MOYNIHAN. Yes. But on balance——

Dr. REISCHAUER. And major changes in family structure, much of which occurred during the first half.

Senator MOYNIHAN. During the period of rapid growth.

Dr. REISCHAUER. Correct.

Senator MOYNIHAN. Then you began to see the change during the period of rapid growth.

Dr. REISCHAUER. From the mid-1960's through 1980, basically.

Senator MOYNIHAN. Yes. So, having learned that, it is obvious that the reason we have a change in family structure is that we had economic growth, right?

Dr. REISCHAUER. Wrong.

Senator MOYNIHAN. Wrong?

Dr. REISCHAUER. That would not be my first hypothesis.

Senator MOYNIHAN. Well, but that is where the causality comes in.

Dr. REISCHAUER. We have had other periods of rapid economic growth where family structure did not dissolve.

Senator MOYNIHAN. So, then there's something else going on.

Dr. REISCHAUER. I think there is something else.

Senator MOYNIHAN. What is it?

Dr. REISCHAUER. This subject is a little beyond the scope of the testimony that I was asked to give. Unfortunately, I do not have the same protection that Secretary Kemp had——

Senator MOYNIHAN. I cannot talk about that. I would give you the answer, but——

Dr. REISCHAUER. I think, quite frankly, that a lot of it had to do with the change in social mores and the development and widespread use of birth control, family planning, and legalized abortions.

Senator MOYNIHAN. Well, family planning and legalized abortions would not increase the illegitimacy ratio, it would decrease it.

Dr. REISCHAUER. But it was part of a sexual revolution that began to take place in the mid-1960's.

Senator MOYNIHAN. It may be. What we say is we have no——

Dr. REISCHAUER. If you recall, there was a term called a "shotgun wedding"—which I tried out on my kids the other day and drew a complete blank.

Senator MOYNIHAN. Right.

Dr. REISCHAUER. And I think that summarizes quite clearly what has happened in the last 30 years.

Senator MOYNIHAN. Well, what I would hope to see is that we begin an annual report on dependency that will begin to give us some numbers, some base data on this subject. We know very little about it. By and large, the interest groups have wanted to know less than even that which we do know. It has been threatening. Unemployment data was threatening, too.

Dr. REISCHAUER. There is information that you yourself have used quite skillfully in your writings: data drawn annually from the current population survey, which will give you the changes in the structure of family life. But those data do not tell you very much about the sources of income that support children who are dependent. And that is what I think you are interested in.

Senator MOYNIHAN. Very little of that. Very little longitudinal data. The equivalent of a monthly labor review, which, you know, goes on, and on, and on, and on. And pretty soon, you know something about the subject. That is not there. It has been a forbidden subject, and the only people who have suffered are the children. And they do not know they are suffering because they do not listen to C-SPAN and these hearings.

We did one bit of data. This committee has responsibility for these children, but it is just not our subject. When the Economic Opportunity Act began in 1965, we did set up one good thing—at least in Michigan—the Panel Study of Income Dynamics.

And we recently asked them to take their 5,000 families—now it is larger than that—and it has been running 25 years. What was the actual experience of welfare dependency for the cohort of children born 1967, 1968, and 1969, which is thick enough to get good probability out of? And the answer was 22 percent of all children born in those years were on welfare before reaching 18; 72 percent of all black children.

Now, to be on welfare, as Secretary Kemp pointed out, is to be a pauper. That Mrs. Capitto, was that the name that he mentioned, we ought to find out about her. It would be very good to find out about her. A welfare mother in, was it Wisconsin?

Dr. REISCHAUER. Milwaukee, I think.

Senator MOYNIHAN. Milwaukee. She had the nerve to save $1,000 to send her daughter to college, and they caught her and fined her $15,000, because paupers are not allowed to save money. That is what being on welfare is. You are a pauper.

And if they catch you with any money in a bank account, they can put you in jail. It is not a pretty word; not a pretty condition. It is a condition which is the more than average experience of some sectors of our population.

We think that if you project the 1980 number for zero to seven, that of children born in 1980, we would probably get almost a quarter of American children will be on welfare, and over 80 percent from minorities. I think that is a little high, but it is getting astronomic.

What I guess I would like to ask you, Doctor, is if you could ask CBO to look at these child poverty phenomena from the perspective of family composition, you might get a cut at it that would tell you some things that just ordinary quintile, undifferentiated families might——

Dr. REISCHAUER. Well, we actually have some data of that sort, and I will be glad to share that with you.

Senator MOYNIHAN. Why do you not send it back to us, will you?

Dr. REISCHAUER. Sure. Fine.

[The information follows:]

The following table shows the most recent data on poverty rates for young children from the perspective of family composition.

PERCENTAGE OF RELATED CHILDREN UNDER 6 YEARS OLD LIVING IN POVERERTY IN 1990

	All Races	White	Black	Hispanic origin
In all families	23.0	17.8	50.5	40.2
In married-couples families	11.6	10.8	19.9	28.2
In families with female householder, no spouse present	65.5	60.4	72.6	76.5

Source: Bureau of the Census, Current Population Reports, Series P-60, No. 175, *Poverty in the United States: 1990*, (1991).

Senator MOYNIHAN. Good. And thank you very much. And I am glad to know that you think that the Social Security payroll tax should be cut. Senator Grassley.

Senator GRASSLEY. I have no questions of this witness. I do of the next panel, if we cover them.

Senator MOYNIHAN. Thank you. Thank you very much, Doctor.

And our next and final panel is made up of three fine representatives of Washington organizations. We have Dr. Steinbruner, who is director of the Foreign Policy Studies Program at the Brookings Institution; and Mr. James Weill, general counsel for the Children's Defense Fund; and Mr. William R. Mattox, who is the director of policy analysis for the Family Research Council. We welcome you, gentlemen.

In the practice that we have, we will follow our sometimes random allocation of listing of names. Dr. Steinbruner, you are first, sir.

STATEMENT OF JOHN D. STEINBRUNER, DIRECTOR, FOREIGN POLICY STUDIES PROGRAM, BROOKINGS INSTITUTION, WASHINGTON, DC

Dr. STEINBRUNER. Thank you, Mr. Chairman. I have prepared a statement that I will submit for the record.

Senator MOYNIHAN. We will do that in everybody's case.

Dr. STEINBRUNER. All right.

Senator MOYNIHAN. And you go ahead and take your time.

Dr. STEINBRUNER. Very briefly, I want to comment on my understanding of the feature of the legislation before you that would remove some $73 billion from the defense budget and apply it to other purposes. I want to comment specifically on the national security implications of such a reduction.

This $73 billion, as I understand it, is to be taken out of the total defense outlay figure that will accrue from 1993 through 1997. That represents a 5 percent reduction in the expected outlays.

I would acknowledge the inevitable argument from Pentagon planners that any such reduction will reduce national security by at least that amount. Implicit in that argument is the thought that we are being perfectly efficient, or, at least as efficient as we can reasonable be in the use of our defense resources.

It will not surprise you to discover that I doubt that we have achieved such efficiency. I believe, therefore, there is some scope for entertaining this reduction with no reduction in security whatsoever, conceivably, even an improvement, if we are particularly wise in how we allocate it.

There are two basic methods for achieving efficiencies of that sort. One is to tailor the force levels more narrowly to their plausible mission requirements under current and emerging circumstances, and the second is to develop more comprehensive regulation in military deployments that would make the mission requirements more predictable and less demanding. Both approaches can be pursued. They can be put together; they are not mutually exclusive. Indeed, they tend to rely on one another.

Realistically, I think we need to recognize that one cannot extract resources from the defense budget quickly or suddenly. Defense reductions take time because of the momentum of technical weapons programs and personnel training. Even 5 years is a short period of time. For that reason, I have projected 10-year program costs of the defense budget and the major options. I compare the 5-year expenditures that you are after in the context of that 10-year program.

I would note that the current defense budget—which will, in current dollar outlays, spend some $3 trillion over the course of the 10 years if it unfolds as planned—has made some adjustment for the obvious change of circumstances, but it has not altered the character of traditional American security. The Defense Department is preparing to deter a very large strategic opponent at traditional levels of nuclear weapons capacity. The strength of deterrence would not be meaningfully diminished against historical standards. And it is also preparing to respond to an unknown threat arising within a few weeks anywhere in the world, unilaterally if necessary.

The efficiencies that I have suggested to you can be achieved first by tailoring the forces more narrowly to the fact that it is now quite difficult to find plausible threats of the traditional sort, and it is quite easy to find reliable friends who will help us if they do come about. We could have lower force levels in a world of this sort where the size of the threat is not as great, and the capacity of allies is much greater. Indeed, it is probably a good idea to do that, even within the framework of traditional security. Having a force structure that is out of size or out of proportion causes suspicions that may come back upon us.

The more radical approach, however, is to supplement this traditional reactive security with more aggressive forms of organization that would be designed to contain threats and to prevent them from getting to the point where we have to fight them. We call that cooperative security.

The figures, let me just summarize to you.

Senator MOYNIHAN. You called that cooperative?

Dr. STEINBRUNER. Cooperative security arrangement.

Senator MOYNIHAN. Would you say that once again? Do you mean NATO?

Dr. STEINBRUNER. No. I think it has to be a more inclusive arrangement than NATO has been. It would include——

Senator MOYNIHAN. An example would be NATO.

Dr. STEINBRUNER. No. NATO is a collective security arrangement designed to resist aggression once it arose, but not to control the size and disposition of all forces, such that it was difficult to invade anybody. NATO could not prevent a very large establishment from being assembled nearby.

The idea of cooperative security is to organize general reductions of forces and limitations on them such that these threats simply cannot arise in short-term. Were that done, we would have a lot of warning. Major threats could only arise over longer periods of time.

It is akin to the distinction between preventive medicine and acute care. In acute care, you wait until somebody comes in with a heart attack and you treat it. In preventive medicine, you try to do things that prevent the heart attack in the first place. And both things can go together.

The force structures associated with ideas are matters of judgment. I have tried to give an illustrative example that might be mainstream judgments plausibly emerging from the American political system.

To conclude with the bottom line, let me note that these options I have described—the more efficient form of traditional collective security—would save in outlay terms over the period of your concern—1993 through 1997—some $88 billion. That is over your target. The more extensive cooperative security arrangement over that same period in current dollars would save on the order of $140 billion in 1993 through 1997, and they would have much larger savings in the 10-year period of time.

The bottom line is that you can, indeed, in principle and with greater discipline in the defense planning system, extract resources without damaging national security, and if it is done in the right way, it might even encourage improvements in national security.

[The prepared statement of Dr. Steinbruner appears in the appendix.]

Senator MOYNIHAN. We thank you very much. We will get back to each of you. Is that right, Senator Grassley?

Senator GRASSLEY. Sure.

Senator MOYNIHAN. Mr. Weill, good morning, sir. Good to have you.

STATEMENT OF JAMES D. WEILL, GENERAL COUNSEL, CHILDREN'S DEFENSE FUND, WASHINGTON, DC

Mr. WEILL. Thank you, Senator Moynihan and Senator Grassley. The Children's Defense Fund really appreciates the opportunity to testify here this morning on the critical tax and family income issues that you are considering.

This committee has led the way to a number of recent improvements in health and child care programs, and in the Earned Income Tax Credit. And Chairman Bentsen's initiative to create the

National Commission on Children was important in producing a broad consensus on the next steps to take for America's children.

That commission report reflected a growing agreement between liberals and conservatives and Democrats and Republicans that some form of refundable children's tax credit is an essential building block of a strong, pro-family policy in this Nation.

Both middle-class and lower-income families have been badly battered by economic changes in the last two decades. At the same time, the very affluent have had both real income gains, and large tax cuts. As a result, we have had a growing gap between the rich, on the one hand, and the middle-class and the poor on the other.

Exacerbating this growing gap have been growing gaps between younger families and older families, and between families with children and those without children.

As S. 1921—Senator Bentsen's bill, co-sponsored by many members of this committee—recognizes, a children's tax credit is the best way to start to address these problems and to provide support to America's families with children and tax relief for the middle-class.

S. 1921 is absolutely on target in its focus on families with children and its focus on a credit, rather than some other mechanism, like expanding the personal exemption.

The bill, like the proposal from Senator Gore and Congressman Downey, like Senator Bradley's plan, and like the National Commission on Children proposal, takes this essential first step of a children's credit.

The problem with the bill is that it is critical to middle and low-income children and their families that the children's tax credit be refundable, as it is in the other plans but not S. 1921.

Several witnesses have pointed out here this morning that one-quarter of America's children will not benefit at all from this tax credit if it is not made refundable.

Nearly half of black and Hispanic children will not benefit if it is not made refundable, and a disproportionate share of children in the south and the southwest, the poorer parts of this nation, will also be left out.

In addition to the one-quarter of American kids who would not benefit at all, millions more children would receive less than the full benefit of the credit if it is not refundable, because their families' tax liability is less than the credit amount.

In total, close to one-third of all children, the neediest 20 million children in this country, would not receive anything, or would receive only a partial credit, if it is not refundable.

Most of these children are from working families. While many of them rely on AFDC, or Social Security, or SSI, foster care, or other payments like that, and they are the most desperately in need, a majority rely primarily or exclusively on their parents' earnings. And these families who will be wholly or partially left out reach up into the heart of the middle class.

We are talking about parents who are making $5, $7, $9 an hour; $12,000, $15,000, $19,000 a year. They are going to be left out, in whole or in part, unless the credit is made refundable.

We need to make the credit refundable to reach this less well-off one-third of America's children and help them meet their needs in paying rent and other basic expenses.

A question has come up several times this morning that I want to digress for a minute and address. The question has been asked: did we not help the lowest income families with children enough last year when we expanded the Earned Income Tax Credit?

The Earned Income Tax Credit, which was expanded in 1986 and again last year is, indeed, a wonderful tax credit for low-income working families in this country. But it is not a panacea for their problems.

The 1986 increase barely restored poor people's lower 1979 levels of taxation, and last year's increase was designed, in large part, to offset other, regressive tax increases in the budget package.

In addition, as wages have fallen in the last few years for families with children, the EITC has been framed not only as a way to offset rising payroll taxes on those families, but also as a substitute for the failure of the minimum wage to keep up with inflation, as meeting their child care expenses, and as meeting a number of other purposes.

The EITC, while a wonderful device, cannot help families meet all these needs. Families, in addition, need a refundable tax credit to start to meet their basic needs.

The lowest one-fifth of America's families with children have seen their incomes drop since the late 1970's.

They are the Americans hurting the most. That is the reason why this Nation has the highest child poverty rate when compared to other Western industrial democracies, a rate often two to three times those of our competitors.

One way to get these poverty rates down is through refundability of the credit.

I see my time is up, Mr. Chairman. We appreciate the opportunity to speak here today.

[The prepared statement of Mr. Weill appears in the appendix.]

Senator MOYNIHAN. Thank you, Mr. Weill. Mr. Mattox, you wanted to address the same subject, I believe.

STATEMENT OF WILLIAM R. MATTOX, DIRECTOR OF POLICY ANALYSIS, FAMILY RESEARCH COUNCIL, WASHINGTON, DC

Mr. MATTOX. Mr. Chairman, Senator Grassley, I want to thank you for the opportunity to address your committee today about the need for tax relief targeted to middle-income families with children. I sincerely hope this hearing will lead to the adoption of a major pro-family tax bill designed to strengthen the economic autonomy and health of middle-income parents.

Mr. Chairman, just about everyone these days seems to have a plan designed to offer middle-income tax relief of one kind or another. While the Family Research Council is encouraged by the growing interest in pro-family tax relief, we recognize that all middle-income tax relief plans are not created equal.

Thus, as the committee continues its consideration of legislation designed to reduce the tax burden on middle-income taxpayers, we would urge you to give your greatest attention to these four objectives.

First, we would urge you to focus on the family. The sluggish performance of the American economy in recent months has generated considerable public attention and concern. This attention and concern and well-founded. Many Americans have lost their jobs, and many others are having trouble making ends meet.

Lest anyone be mistaken, however, America is facing more than just an economic recession, and I think this was made clear by some of your comments just a moment ago.

For at least the last 25 years, our Nation has been mired in what we would call a family recession. And the steady decline in family stability and well-being means that many children have lost their fathers, and many others are lacking a healthy home life.

Even if the family recession had no bearing on the serious social and economic problems facing our country, it would be right and appropriate for public policymakers to seek to shore up the economic autonomy of families with children through tax cuts targeted to parents. Families, after all, face a Federal tax burden today that is unusually high by historical standards.

In 1948, for example, Federal income and payroll taxes claimed just 2 percent of the annual earnings of a median-income family of four. Today, Federal taxes siphon 24 percent of a median family's annual income.

Since the family recession is indirectly and inextricably linked both as a cause and an effect to the current social and economic problems facing our Nation, it is all the more important that any tax cuts adopted in this Congress give serious attention to the needs of families with children.

Neglecting such concerns in a head-long pursuit of some economic quick fix could prove to be penny-wise but pound foolish. Indeed, the long-term health of our economy and our society depends greatly on a dramatic upswing in our Nation's leading family indicators.

To be sure, pro-family tax cuts alone cannot pull our Nation out of its family recession, but pro-family tax cuts are, nevertheless, very significant, because such relief would allow parents to regain some of the economic independence and autonomy that have been lost in recent years to other institutions, particularly the State.

Put another way, pro-family tax relief would empower families to carry out those vital functions, such as the rearing of children, which they are uniquely equipped to perform. Thus, pro-family tax relief should be the centerpiece of any middle-income tax relief plan. It should be the engine driving tax reform.

Accordingly, we would urge you to favor plans which tie relief to the presence and number of children over those such as the Rostenkowski Adult's Only Income Tax credit bill, and various payroll tax cut bills which treat families with children no differently than Yuppies with poodles.

We would also encourage you to adopt changes in the Earned Income Tax Credit which would eliminate the Tax Code's current bias against low-income married couples with children; we would encourage you to expand the current Young Child Tax Credit—as Senator Grassley has proposed—to address, among other things, the Tax Code's "parenting penalty;" and we would encourage you to make certain that increases in pro-child tax benefits take effect immediately and that these cuts are permanent and that the benefits are indexed.

Secondly, we would ask you to not scrimp on children. The fact that so many recent tax bills include provisions designed to reduce the tax burden on families with children attests to the growing consensus among conservatives and liberals, Democrats and Republicans, that middle-income parents are over-taxed.

While there is reason to be encouraged by this growing consensus, there is reason to be concerned that most of the major proposals that have been advanced thus far fail to grasp the severity of the problem.

Eugene Steuerle, a former Reagan Treasury official who now serves as a fellow at the Urban Institute, has calculated that if the tax exemption for children had been properly adjusted since 1948, the exemption would now be $8,200 instead of $2,150.

This means that if Congress were to provide a median-income family today the same per-child tax benefits offered in 1948, the current tax exemption would need to be quadrupled, or a new tax credit worth nearly $1,000 per child would need to be created.

Third, we would ask you to limit tax relief to taxpayers. Curiously, several prominent proposals promising "middle-income tax relief" make little or no distinction between welfare recipients and taxpayers with children. They offer refundable tax credits to all families, including low-income, child-present households where the household head is not married, gainfully employed, or receiving child support.

Even if one believes cash assistance to welfare recipients is warranted, it is disingenuous to use the banner of middle-income tax relief to secure this result. Not only is a "bait-and-switch" strategy of this kind dishonest, but it threatens to sabotage legitimate efforts to reduce the tax burden of families with children.

Finally, we would urge you to not hold pro-family tax relief hostage. There are a number of tax proposals floating around; a number of other sub-issues about how proposals would be funded, whether or not economic growth provisions would be included in a package. We believe these are important debates; they need serious consideration.

But we would hope that the consensus that has been built on pro-family tax relief would not be held hostage by the partisan bickering that is taking place over many of those issues.

Thank you very much, Mr. Chairman, for the opportunity to testify before your committee. I look forward to answering any questions that you or Senator Grassley may have.

[The prepared statement of Mr. Mattox appears in the appendix.]

The CHAIRMAN. Thank you, Mr. Mattox. You mentioned, Senator Grassley, that perhaps you would like to begin the questioning, sir.

Senator GRASSLEY. Thank you very much, Mr. Chairman. I think I will start with Mr. Weill. You made a statement, I believe, that the tax credit needs to be refundable. I would agree with your statement.

But, in addition, do you not also agree that a children's tax credit should have a phase out so that the wealthy who obviously do not need it as much would not get it?

Mr. WEILL. We would be perfectly comfortable if it were phased out at the top. Our concern is that poor children, both from working families and non-working families—and if I have the opportunity, I would like to address Mr. Mattox's point—be included in this; those 20 million children.

If, in order to obtain revenue to do that, it is necessary to phase out the credit for upper income taxpayers, as, to some extent, the personal exemption is currently phased out, we would be supportive of that.

Senator GRASSLEY. Mr. Mattox first, and then maybe also Mr. Weill, there have been some recent discussions about undoing many of the changes in the Earned Income Tax Credit that were made last year in order to simplify the credit and encourage its use. How do you analyze those efforts, and do you think there is something that should be done?

Mr. MATTOX. I think generally we would support the concept of simplifying the EITC to encourage greater use. We do not have any problem with that goal or principle.

We do, however, vehemently object to efforts to eliminate the Young Child Tax Credit, which is a sub-part of the Earned Income Tax Credit. We believe the adoption of the YCTC was an important step forward in last year's budget process.

We believe that the young child credit not only should be preserved, but, as your proposal has advocated, that it be expanded: (1) in the dollar amount available to families; (2) in the income range that would be affected, and (3) in the age of children that would be affected.

If you are changing the income criteria such that the EITC is essentially available to families under $20,000 to $21,000, and a Young Child Tax Credit may go up to families as much as, say, $50,000 a year, as your bill has proposed, it seems to me that you have drawn a distinction between these two credits that would merit just splitting off the Young Child Tax Credit by itself, rather than having it be a sub-part of the EITC.

In sum, I think that simplification can be achieved in ways that preserve the gains that were made last year, rather than attacking them.

Mr. WEILL. We generally support simplification in order to have more low-income tax payers use the EITC. We strongly support that. We have not been so actively involved in the debate that we have taken positions on each of the sub-issues that involves, but we do recognize the need to have simplification efforts.

We have also begun, along with the National Women's Law Center, a campaign to reach taxpayers through child care centers, and otherwise, and help them use the EITC. But we recognize how difficult that is to do under the current complex rules.

Senator GRASSLEY. Mr. Mattox, you made reference to the Individual Retirement Account. What do you think of the proposed changes in the IRA reform? I guess also speaking for your Family Research Council.

Mr. MATTOX. Yes. I think here, again, we would support many of the objectives of those who have put forward legislation in this area. We believe that it is appropriate to look for ways to expand the uses of IRA accounts so that families can use them for purposes other than retirement.

Clearly, there are a number of families—particularly young families who have not yet reached their peak earning years—who place a greater priority in their savings schemes on saving for a home or for college tuition than for retirement. It seems appropriate, then, to recognize these as legitimate uses for an IRA account rather than strictly limiting IRA's to retirement.

We do, however, question whether expanding IRA benefits to those above $50,000 a year is a high priority at this point. We do not object on philosophical grounds to that concept.

It becomes a question of priorities, and we would question whether, in light of the serious need to reduce the tax burden on families with incomes between $15,000 and $50,000 a year, a proposal of that kind ranks as high on the list of priorities.

Senator GRASSLEY. My last question, Mr. Mattox, would deal with—this is kind of a philosophical question. At least I view arguments against increasing the tax benefits for families with children when they say it will not necessarily strengthen the family. I think those are philosophical arguments.

You obviously think otherwise, and so I would like to have you respond to those arguments where people take the point that it will not strengthen the family.

Mr. MATTOX. Yes. I am glad you asked this. I think there are a lot of people who question whether or not a pro-family tax cut would provide the kind of "bang-for-the-buck" that a lot of people are looking for. And we have no illusions about tax relief for families being a magic bullet.

Obviously, private behavior is affected by many variables, of which the tax burden that a family faces is only one. But we do not believe that it is possible to significantly strengthen the family unless we strengthen its economic vitality.

And to the extent that tax relief for families gives parents an opportunity to keep more of the money they have earned and gives them greater economic freedom and independence, we think that pro-family tax cuts take a significant step in the right direction towards strengthening families.

This does nrt at all mean that we should avoid addressing many of the cultural and moral questions that also play into family decline. It simply means that we cannot kid ourselves into thinking that the family decline over the last 25 years does not have an important economic dimension thst needs to be addressed.

Senator GRASSLEY. Thanks to each of you. Thank you, Mr. Chairman.

Senator MOYNIHAN. Thank you, sir. I would just like to make the point to you gentlemen that the whole discussion of tax cuts in a situation where we have a $400–$500 billion deficit is a little abstract. And I observe what I said a couple of years ago would happen.

What we are now doing is redistributing the Social Security payments. First you take that money out of people's pockets, and then you hand it over here and hand it over there. That is not what Social Security benefits are paid for. They are pension benefits; they are disability benefits.

When President Roosevelt set up the program—we have a record of this—in 1940, a professor at Columbia, an authority on public administration, went down to see him. He was down here doing something, and he went to see the President.

And he said, "You know, Mr. President, I have been looking at this Social Security arrangement, and we are putting in an awful lot of money just collecting everybody's nickels and dimes and posting them"—by pen and ink, they would have done in those days—"to their cards."

And we could just as well just take in the money and pay it out when the time comes, and you would not know the difference. This was Wallace Sayre—I think Dr. Steinbruner would recognize his name—a great professor at Columbia in Public Administration.

Roosevelt said, "I am sure you are right on the economics, but not on the politics. I want every nickel that goes into that trust fund to have someone's name on it so none of those damned politicians on Capitol Hill can get their hands on those monies." Well, that was 50 years ago. Now we have, and we are spending them at $1.5 billion a week.

And nobody seems to care the least little bit what that does to the integrity of social insurance. If it does not matter, you pay it in and it is spent for other purposes than it is specifically intended to, you are corrupting the whole idea. And we are so lost that we do not even sense the corruption.

Twenty-5 years ago, I wrote a piece for America magazine on children's allowances, pointing out that we are the only industrialized democracy in the world that does not have a children's allowance.

President Kennedy got very interested in the subject from Senator Neuberger, who was working on the Alaska-Canadian Highway in World War II, the Alcan Highway, and found the Canadian child allowances, and he introduced a bill—and Kennedy was a cosponsor—but we have never been good at family policy in this country; we are very nervous about it.

But can I ask you, just as we have got to face these facts, avoidance has certainly characterized the worsening of our family conditions. Of the quarter of the children in the country who are poor at this moment, 50 percent of American children will live in a single-parent family before they are age 18, but of the quarter that are poor right now, how many are in two-parent families, what proportion?

Mr. WEILL. Among poor children, about half of them are in two-parent families—or, for a handful of those in single male-headed families. And the other half are in female-headed families.

Senator MOYNIHAN. So, it is about 50/50.

Mr. WEILL. If I could expand, Senator Moynihan, and talk for a minute about the single-parent issues and out-of-wedlock birth issues that you raised with Dr. Reischauer, I would like to address that for a minute, if I might.

Senator MOYNIHAN. Please. Please do.

Mr. WEILL. We absolutely agree that it is essential that this Nation address the causes of out-of-wedlock births and get the out-of-wedlock birthrate down. We also absolutely agree, and we have worked with you, to improve the child support enforcement system so that absent fathers pay their fair share. I would just make two other points.

One is that, in addition to social behavior, as Mr. Mattox said, economics plays a role in driving up out-of-wedlock birthrates, too. Ben Franklin said, about two centuries ago, that "The number of marriages . . . is greater in proportion to the ease and convenience of supporting a family. When families can be easily supported, more persons marry, and earlier in life."

And some of the decline in the marriage rates and increase in out-of-wedlock birthrates over the last two decades has followed the decline in wages for young men. And so, there is an economic role as well as a social role in fixing this problem.

But in the meantime, as this Nation addresses this problem of single-parent families—which it is essential that we address—it is also essential that we not leave one in four American pre-schoolers and one in five American children living in dire poverty. We have to address that simultaneously.

And a children's allowance, as you suggest—and the closest thing we have to it right now are the refundable children's tax credits on the table—is the best first step towards that goal.

Senator MOYNIHAN. No. I do not disagree in the least. I would say to you that if we had the kind of changes in the labor market that we have had in family structure, there would be a whole body of analysts here in Washington who would be working at it, writing about it, checking it, trying to tease out some information, and they would have their counterparts all over the academic world, and the Chairman of the Council of Economic Advisors—whose job was created by the Employment Act of 1946—would know that it was his first task to get some answers for the President for the Economic Report that comes each January here. I see Mr. Mattox nodding. We do not have that now.

Mr. MATTOX. No, you are right. We have a tendency at times to focus too much attention in the wrong direction. Often, we are not sufficiently focused on some of the family variables that significantly affect economic performance and economic behavior.

So, I think you are exactly right, that we need to be increasingly focused on this question of family structure and the relationship it has with child poverty.

I was struck in reading an article recently which showed that it was marriage, and not workfare, or transfer payments, that constituted the number one escape route out of poverty for families with children.

Accordingly, I think that we need to be looking increasingly at some of the ideas that Governor Tommy Thompson in Wisconsin has put forward, which adjust tax and welfare benefits to remove disincentives for marriage among low-income families.

Senator MOYNIHAN. I was once Assistant Secretary of Labor, with a very nominal charge of the Bureau of Labor and Statistics. Thirty years ago, the unemployment rate was a very controversial number. People did not trust it. It was only 15 years old; not even quite that.

And they fought over it; why are you making it high; you are making it too high; you are making it too low; you are twisting it; but little by little, things settled down. We now know it is a good number. It comes out with corollary analyses that are very helpful. I would like to thank you, gentlemen, for what you are doing. The pay is not probably very good, nor is it at Brookings.

Dr. Steinbruner, a question. I think your proposition that the "true test of the United States as a super-power will be whether it can now arrive at a more realistic balance between its military and economic power than it has done in the recent past." That is from your book with Bill Kaufman, is it not?

Dr. STEINBRUNER. That is right.

Senator MOYNIHAN. By which I mean—well, do not let me tell you what you mean, you tell this committee. Do we correctly take you to feel that the level of defense outlays in recent years has not been commensurate with the performance of our economy and may, indeed, have depressed that performance? Say it in your words, and do not repeat what I said if you do not think that is what I meant.

Dr. STEINBRUNER. I think that is right. The primary reason is that if you go back to the 1950's, we started using the national security effort to motivate, finance and direct national technical investment, developing whole series of technologies that have very broad implications: computers, radars, things that have spilled over into the commercial markets.

We did it largely with national security expenditures. The whole situation is radically altered in the intervening period, and that is not the way to make national technical investment now.

In fact, defense programs are typically lagging about 10 years behind the leading edge of commercial markets. So, we are hurting ourselves with the resources put into defense that are not necessary, whereas in the 1950's you could say, oh, what the heck, it helps the economy generally, it promotes technical progress. You can no longer say that; there are very severe trade-offs, and we have not sorted this out.

In addition to that, just within the consideration of security itself, the problem is radically shifting. The problem is no longer primarily deliberate aggression. At the moment, it is the threat of chaotic disintegration of the major opposing military establishment.

Senator MOYNIHAN. And it need not stop there.

Dr. STEINBRUNER. Right.

Senator MOYNIHAN. The reason your testimony is so important to us, or at least to this Senator, is that I feel the Cold War institutions are still in place in this town and really are not reconciled to what has happened. You say the Berlin Wall came down on November 9, 1989. Prove it. You know, supposing it was a trick. You know, they have done that before. They pretended.

In 1979, Newsweek had a forum on the 1980's, big thoughts, what will happen in the 1980's? And I wrote a piece which seemed to me unexceptional. I said, "In the 1980's, the Soviet Union will break up. Now, be very careful when that moment comes, because the question is, who is going to get hold of those war heads. That can be a very dangerous moment."

And yesterday, the United States Senate passed by a very overwhelming vote, half a billion dollars to go over and buy war heads from the Soviet Union on the grounds that they have been sending the signal, get these out of our hands or we will start using them on each other, as you were saying.

But our institutions were incapable of comprehending the breakup of the Soviet Union. I mean, I said it on the floor, I said it in the intelligence committee. Can you not see it coming? They are going to break up. The economy has failed, the ideology has died, and ethnicity is rising.

Would I be wrong in saying that the institutions just did not grasp that?

Dr. STEINBRUNER. No. I think you are correct. This is too big a shift in perspective. It is happening not only to American institutions, I think American public opinion has not shifted as well.

We have not quite realized that the character or the nature of the security problem we are facing has altered entirely. And, therefore, it is not just a matter of being more efficient and doing the same old thing; we have to do very different things, and quickly.

Senator MOYNIHAN. And we do have a problem of ethnic conflict moving around the world, moving around Africa, South Asia.

Dr. STEINBRUNER. Indeed.

Senator MOYNIHAN. And we do not have much of a device for that, do we? War has broken out in Europe; the first war since 1945. Hideous atrocities, large-scale bombing, artillery barrages. And where? In Yugoslavia.

Dr. STEINBRUNER. Outside of our jurisdiction. Right.

Senator MOYNIHAN. And we have not been able to do a thing.

Dr. STEINBRUNER. We cannot do anything. And the insight there is that the superior firepower which we, indeed, have assembled and do have, cannot be applied, because we do not have the legitimacy to operate. And it turns on legitimacy more than on firepower. That is part of what we have to——

Senator MOYNIHAN. Say a little bit more about the legitimacy.

Dr. STEINBRUNER. We do not have the principles, and standards, and objectives, and the authority established to intervene in that situation.

Senator MOYNIHAN. What gives you the right to go in and say, Croates, you go there, and Serbes, you go there.

Dr. STEINBRUNER. That is right. That cannot be done on a national basis, obviously.

Senator MOYNIHAN. The U.N. Charter says you may not intervene.

Dr. STEINBRUNER. The U.N. Charter specifies rules for intervention, and the principles which must guide it. And it says basically there must be an international consensus organized to do this, otherwise no. And we have not really developed that thought to the point where we have——

Senator MOYNIHAN. We have not developed it. The U.N. may not interfere in the internal affairs of a member State. That is in the Charter. But also in Article 1, Section 2, it guarantees all peoples the right to self-determination.

Now, Dr. Steinbruner, the people of Croatia have the right to self-determination?

Dr. STEINBRUNER. I believe they do have the right to self-determination, but there is something implied about the means used. There is a Declaration of Universal Human Rights emerging from the U.N. that has something to do with human rights extending beyond sovereign prerogatives. We have not sorted these things out.

Senator MOYNIHAN. It does. But in 1952, I think, when the decolonialization was beginning in earnest, the General Assembly worked very hard on a proclamation on this matter, and it came up with a six-point declaration that said, "All peoples have the right to self-determination." That was the first point. And the last point was, "There can be no interference in internal affairs of any nation." So, you leave it there.

We thank you all. I particularly want to thank Mr. Mattox and Mr. Weill. It is a lonely life you live out there, and Dr. Steinbruner, we are very much in your debt for very important testimony. And that was our hearing. We thank our cameramen, our lights, drama, action.

[Whereupon, the hearing was adjourned at 1:07 p.m.]

MIDDLE-INCOME TAX CUTS

THURSDAY, DECEMBER 12, 1991

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:05 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Also present: Senators Moynihan, Baucus, Boren, Bradley, Breaux, Dole, Chafee, Grassley, and Hatch.

[The press release announcing the hearing follows:]

[Press Release No. H-52, Nov. 27, 1991]

BENTSEN SCHEDULES ADDITIONAL TAX CUT HEARINGS

WASHINGTON, DC—Senator Lloyd Bentsen, Chairman of the Senate Finance Committee, announced Wednesday he has scheduled a second and third hearing on tax cut legislation for next month.

The hearings will be at *10 a.m. Thursday, December 12, and Friday, December 13, 1991* in Room SD-215 of the Dirksen Senate Office Building.

"'The Finance Committee already has begun work on tax cut legislation this year, holding its first hearing on Tuesday. I want to continue work on this proposal, which is of vital concern to so many Americans, so I'm calling additional hearings in December," Bentsen said.

"As was abundantly clear from the testimony at our hearing Tuesday, middle-income American families need and deserve some help. Too many Americans are seeing the dream of home ownership turning into an economic Nightmare on Elm Street," Bentsen said.

"Home prices collapsed last year, which caused a stunning $180 billion plunge in family net worth—the first such decline in two generations. Two paychecks have become a necessity in the 80's as costs soared for the basic necessities of life. Today, a typical American family pays $1,300 for health insurance, an amount that has jumped sharply from $150 in 1980, and gets less for its money because deductibles and co-payments have soared. Families with children saw their taxes increase during the past decade, while their incomes fell, by $1,600 on average," Bentsen said.

"Senators Roth, Mikulski and I have proposed legislation to cut taxes for families by giving them a $300 tax credit for every child under age 19. That would reduce the tax bill for a family of four making $35,000 a year by 25 percent. Other Senators have made some important proposals that we're taking a close look at, as well, in efforts to get some needed relief to America's families," Bentsen said.

OPENING STATEMENT OF HON. LLOYD BENTSEN, A U.S. SENATOR FROM TEXAS, CHAIRMAN, SENATE FINANCE COMMITTEE

The CHAIRMAN. If you will please be seated and cease conversation this hearing will get underway.

We are very appreciative of having the administration before us this morning. In order to get to their testimony, I am going to ask my colleagues, including myself, to limit opening statements to 5 minutes. If you want to give any of that time back, it will be appreciated.

The Finance Committee this morning begins 2 days of hearings on taxes, on the economy and on hard-pressed middle-income families. A study released by the Congressional-Budget Office yesterday showed that middle-income families with children took a double hit during the 1980's. They saw their taxes go up and they saw their incomes go down.

Health costs of a typical family have almost tripled since 1980. The cost for basic necessities, such as housing, education, transportation, went right through the roof. The 1980's, in fact, were the most anti-family decade since the great depression.

Unfortunately, the 1990's threaten to be worse. The CBO reports that the decline in family incomes has accelerated since 1989. The 1980's were not only anti-family, they were also anti-growth and anti-savings. Net investment as a share of gross national product fell by one-third. Over 2 million high-powered manufacturing jobs went to Asia. America now has more government workers than they have manufacturing workers. Servicing the Federal deficit will soon overtake defense spending.

During the 1980's, with a handful of exceptions, American industry fell behind international competition and that deterioration has become more pronounced in the new decade. America is now in the longest period of slow or no growth since the Great Depression. Over the last 3 years per capita income has fallen for the first time since Herbert Hoover was President. Housing starts are the lowest they have ever been since World War II. Family incomes have fallen to the levels of 15 years ago and that is despite the fact that in many of these families they are now two paycheck families with both parents working.

This administration which made promises in the last election of 30 million jobs has produced fewer jobs than any since the depression. The outlook is for little or no improvement with the Chamber of Commerce, the CBO and other forecasters projecting rising unemployment and weak growth for both incomes and productivity next year.

For several months Congress has been prodding the administration to work with us to jump start our economy and provide some relief for victims of these hard times. Thousands of jobs, billions of dollars of income have been lost during that time. Now, 18 months after the recession began, we are seeing hopeful signs of a willingness to cooperate in the search for economic policies that are adequate to our Nation's needs and we welcome that.

I have introduced legislation to cut middle-income taxes, to restore and expand the IRA that enjoys bipartisan support in the House and in the Senate. I am convinced it is one good answer to our economic problems. There are others. But one thing is certain, the time for action is long past.

I would like to defer now to my colleague, Senator Moynihan, the Senator from New York.

I beg your pardon. Senator Chafee, you were first, if you would go ahead.

OPENING STATEMENT OF HON. JOHN H. CHAFEE, A U.S. SENATOR FROM RHODE ISLAND

Senator CHAFEE. Thank you very much, Mr. Chairman. I appreciate this opportunity for us on the committee to examine the proposals to address our sluggish economy, including your suggestion, Mr. Chairman, of a tax credit for each child under 18 in a family.

Mr. Chairman, I very strongly believe that the Americans and particularly the middle class, have three main concerns on which we ought to focus our efforts. These concerns are: first, having a job, either keeping the job they have or making sure they find another one if they seek one; secondly, maintaining the value of their home; and thirdly, keeping their health insurance and controlling rising health care costs.

I personally do not believe that short-term tax credits or individual tax cuts will address these concerns. I believe we must not compound our current economic problems by seeking quick fixes which have no lasting effect and which may greatly add to the Federal deficit. Our goal should be to improve America's economic health and international competitiveness.

In other words, what I would like to see us concentrate on is making our businesses more competitive so they'll provide more jobs. Obviously, the President and the Congress must work together to develop a legislative package to address these concerns.

Specifically, I would do the following: To create and maintain new jobs, I believe we ought to establish a targeted investment tax credit. We ought to index the basis of capital assets for inflation. I would do this prospectively, starting now for inflation that occurs in the future. I believe we ought to make several of the expiring tax provisions permanent—the R&D tax credit, the moratorium on the 861–8 allocation rules, the targeted job tax credit and the exclusion for employee educational assistance. And finally, in this category of jobs we ought to repeal the luxury tax on boats which has been such a disaster.

Secondly, Mr. Chairman, I believe we need to restore the confidence of the American people in the real estate industry. To do this we must make the mortgage revenue bond program and the low income housing tax credit permanent. Those are two of the other expiring provisions.

We ought to allow penalty-free withdrawals from individual retirement accounts for the purchase of a new home; and we ought to revise the passive loss rules as they apply to the real estate industry, changes that we made in 1986.

And third, Mr. Chairman, to help control the cost of health care we must equalize the tax treatment of health insurance for all Americans by making the cost of health insurance premiums tax deductible for those who purchase their own health insurance whether on their own or as a self-employed individual.

We ought to provide health expenditures, tax credits for low and middle-income taxpayers. We ought to encourage the development of group purchasing arrangements for small businesses. We ought to reform health insurance practices to help small businesses. We should encourage the development of managed care plans. We should reform medical liability laws and encourage the use of preventive care.

So, Mr. Chairman, I look forward to the testimony of our witnesses. You have an impressive delegation here from the administration and I look forward to working with you to develop a package that will include provisions to address what I believe are these three real concerns for Americans—retaining their jobs, maintaining the value of their homes, and keeping their health insurance and controlling rising health care costs. Thank you very much.

The CHAIRMAN. Thank you, Senator Chafee.

Senator Moynihan?

OPENING STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Mr. Chairman, I will be brief and, I fear, repetitive. But that is a role that goes with being Chairman of the Subcommittee on Social Security here.

Yesterday, the CBO reported in a letter to Chairman Bentsen that a family with two children in the middle quintile of our income distribution which would be $37,300 on average, will pay $100 more in Federal taxes in 1992 than they would have done in 1980. But shall we not be clear that the bulk of these taxes is not income tax, but Social Security contributions, so-called payroll taxes. Payroll taxes are what has gone up.

Seventy-one percent of American workers pay more in Social Security tax than in income tax. The Social Security system is now in surplus and the surplus is being diverted to help finance the budget deficit.

Any tax cut we talk about, any programs we talk about, we are in effect talking about using Social Security revenues to fund them.

Two years ago the Rochester Democrat and Chronicle referred to what was going on as thievery. Our beloved former colleague, John Heinz, and I were on a television program. John was asked did he agree that what was going on was thievery. And he said, "Certainly not; it's not thievery. It's embezzlement."

But I do make the point that a generation from now when it turns out that we have embezzled, if you like, these funds to the extent we are going, $1.5 billion a week, we are not going to be thought of very well. We can still make up our mind not to do this.

On the subject Senator Chafee mentioned of job creation, nothing would more effectively get jobs moving than cutting Social Security taxes—135 million workers would receive increased pay the next week. And as the National Federation of Independent Business points out, for three-quarters of small businesses their largest tax burden is payroll taxes, and they pay them whether they're profitable or not. This certainly would stimulate small business, that source of job creation which as Dr. Boskin knows is far the largest.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Boren?

OPENING STATEMENT OF HON. DAVID L. BOREN, A U.S. SENATOR FROM OKLAHOMA

Senator BOREN. Thank you very much, Mr. Chairman. I want to join with the others in expressing my appreciation to you for scheduling these hearings.

As we enter the final days of 1991 America's families speculate about the future with a deep sense of unease. They are concerned about the economic difficulties they faced this year. They are concerned that they will continue and perhaps increase in months to come. They are not confident about the future, and they worry that their children will grow up, work, and live in a country of more limited opportunities and resources.

These hearings are an initial step in transforming those fears into a more hopeful future for our Nation. As we begin this effort to restore confidence and to revitalize the economy, we must put aside our partisan differences and work together to craft a program that can provide short-term economic relief while also ensuring long-term growth and productivity.

Mr. Chairman, there simply is no time for bickering among members of Congress or between the administration and the Legislative Branch. Even in this Presidential election year, we should stop worrying about scoring political points and get on with solving the serious problems that we face. It is a time for solutions, instead of politics.

The most immediate problem facing us is to stimulate the economy and to provide relief for Americans now. We are focusing these efforts on middle-income taxpayers because they have felt the effects of the recession so acutely.

As we consider ways to give middle-income families the tax relief they deserve, let us not forget that one of the greatest struggles now facing these families is the skyrocketing costs of providing a college education for their children. If you are very wealthy or very poor and qualify for scholarships and grants, you will have little trouble educating your children. But those who are being squeezed in the middle earn just enough so that their children do not qualify for benefits, yet they do not earn enough to afford to send their children to college.

While middle-income children make up three-fourths of the college-aged population they get only about 4 percent of student aid and scholarships. The average cost of going to college has now reached about $10,000 each year, ranging from $6,000 in public colleges to an average of $20,000 in private colleges. The average middle-income family has only about $60,000 in net worth, most of it in home equity.

This means that even if the family sold their home to educate their children, they still could not meet the cost of educating two or more children. As a result, most middle-income families are forced to take out large educational loans. It is high time that we add to our list of legislation a proposal that would allow tax deductions for interest paid by parents and students on educational loans.

I plan to introduce a legislative proposal of my own to address this need, as well as to assure that scholarships for study either in the United States or abroad are not taxed. In addition, I am working on a provision to create a college savings plan to which parents can make contributions for their children's college education. The interest earned by such accounts would be tax-free.

But while we work on the short-term problems, we must not lose sight of the larger challenge to restore competitiveness and to secure the future for the next generation, as our colleagues have already discussed. The tax code is a useful tool in encouraging businesses and individuals to use their resources to benefit economic growth.

There are many ways in which this powerful tool can be wielded. I will mention only a few of them. First, Congress must enact a carefully crafted cut in the capital gains tax rate to reward long-term investment. Not speculation, but long-term investment.

Second, we must no longer write our tax code by considering only its domestic impact. It is absolutely essential that we consider its provisions as they relate to the tax policies of our international competitors. We must weigh the impact of our policies on the comparative costs of capital savings in other countries.

This means that we must reexamine the potential effects of the depreciation schedule for business investment and the alternative minimum tax on our ability to compete. It is estimated that 40 to 60 percent of U.S. companies now pay the alternative minimum tax or will pay it this year. It is time to reevaluate the effects of the 1986 law on our ability to compete in the world marketplace.

Third, in the long run we must adopt policies designed to encourage savings rather than consumption. I will introduce an investment rollover bill that will defer the taxation of interest earned on savings placed in certain qualified accounts as long as that money remains as savings or is otherwise invested. Only when the accumulated earnings are withdrawn to finance consumption will the taxpayer be required to pay taxes on the gain.

Fourth, as we consider any changes in tax policy, we must be aware of the taxpayer's need for certainty as they make investment and saving decisions in the long run. In the past few years we have established tax policies, the tax deductibility of IRA's for all taxpayers, for instance, only to eliminate them soon thereafter.

I commend you for wanting to restore them now for all taxpayers, Mr. Chairman.

Other programs such as targeted jobs tax credits are temporary, forcing us to reconsider them frequently and forcing taxpayers to make economic decisions in an unsettled tax environment. Individuals cannot plan when we have a stop-and-start tax policy.

The task before us is a complex one that involves difficult choices for our Nation. But I look forward to working with you, Mr. Chairman, to meet this challenge in the course of the work of our committee.

The CHAIRMAN. Thank you.

Senator Bradley?

OPENING STATEMENT OF HON. BILL BRADLEY, A U.S. SENATOR FROM NEW JERSEY

Senator BRADLEY. Thank you very much, Mr. Chairman.

As we begin today's hearings I want to note what has taken place in the last 10 years. In the last 10 years communism has collapsed in the Soviet Union, democracy has come to Eastern Europe, and the Giants have won two Super Bowls.

But even with all these changes in the last decade one thing remains frighteningly familiar. That is the claim that tax breaks for the wealthy will actually increase revenues and prosperity.

In 1981 this committee held a hearing similar to this one and the witness was the Secretary to the Treasury, Don Regan. He said in response to several questions about whether tax cuts would increase revenues, "In spite of our tax reductions, revenues will still rise by 28 percent through 1984 when the budget balance is first attained and by 57 percent over the entire period."

Well, did that happen? No. Absolutely not. Instead giant deficits.

Mr. Chairman, the only thing more incredible than the statement of Secretary Regan in 1981 was that once again some are making the same claim. Here we are 10 years later in what I call a slow motion depression where banks will not lend, and people will not spend, and businesses will not invest, and productivity is down, and unemployment is up, and poverty is up, and people are feeling that their lives are going out of control. Certainly, people feel they have lost their ability to control their economic circumstances.

Some offer as an answer to this crisis the solution that caused the problems in the first place. But even then in 1981 Secretary Regan said, once again, "We should test the results of what we are saying." In other words, whether reducing taxes on the wealthy actually do produce more revenues.

But, Mr. Chairman, if you test a vaccine and it fails, you do not administer it to the next patient that comes along. And yet that is precisely what some are arguing in this year's consideration of tax legislation. We have had a ten-year test and it has failed. It is about time that we get beyond theology and start to confront the reality out there, a reality of crisis that is reducing the expectations of a better life for millions of American families.

I think that at a minimum what the American public deserves is a serious plan from the administration to deal with the problems that we face today. Now I define a serious plan as being (1) honest about how we are going to pay for things; (2) accountable in its specificity; and (3) comprehensive in its approach.

I do not think we got that kind of plan in 1981 and I do not know if we are going to get that plan today based upon the testimony of the administration before the Ways and Committee last week. I do not consider that to be a comprehensive plan.

Instead, I am afraid we are going to get some more gamesmanship; cut taxes, have more revenues; and minor actions—all we need to do is cut capital gains and the economy will soar once again. It is a more serious problem and it deserves a more serious answer than we have gotten today.

In terms of those middle-income families, all American families, I think the answer is pretty clear. We ought to cut spending, both defense spending and domestic spending, and give the money back to America's families. All children should have a $350 tax credit, all children. Not some, all children. And we should pay for that by cutting spending.

Senator Boren mentioned college education. I believe in my State—we will hear a witness tomorrow that I think will describe it eloquently—52 percent of the people believe their children will have a lower standard of living than they will. I think the key of that is the diminishing prospect of a college education.

I think we ought to put a surtax on people that make more than $1 million to finance a program that would allow anyone in America up to the age of fifty to get up to $33,000 a year to go to college and to pay that back as a percent of their future income for a specified number of years.

I think if we did those two things we would begin to restore some people's trust. Middle-income families, all families, would have more money in their pocket and their children would have the chance for a better future.

But at a minimum what we are going to have to do is admit that the budget deal last year is a straight jacket on our deliberations and it has to be abandoned. It was flawed last year in my opinion; it remains disastrously flawed today. We are giving more significance to a piece of paper that was signed by politicians at both ends of Pennsylvania Avenue than we are to the fall of communism in the Soviet Union; and all that implies for lower defense spending and the needs of American families.

Mr. Chairman, I hope that we are going to have some serious testimony from all the witnesses and we will be able to get into this and produce a serious piece of legislation.

The CHAIRMAN. Thank you.

Senator Breaux?

OPENING STATEMENT OF HON. JOHN BREAUX, A U.S. SENATOR FROM LOUISIANA

Senator BREAUX. Thank you, Mr. Chairman; and thank the witnesses for being with us and for being patient. I thank you, Chairman Bentsen, for having these hearings because it is showing the American public that the Congress is serious about trying to find some solution to the economic problems we have in this country which are quite severe.

There's a great political philosopher from somewhere in Mississippi, Mr. Chairman, named Jerry Clower. Jerry tells the story about Marcel Leadbetter and his buddie, Leroy. They go out and go coon hunting. They are walking through the woods which has a whole bunch of densely tall pine trees and they figured they had treed a coon. They could not get him out of the tree so Marcel says, well I am going to go up in the tree and I am going to shake the tree limb and shake him down. Leroy, you shoot him when he falls to the ground.

Marcel got to the top of the tree and found out that it was not a coon that they had treed it was a wild cat. There ensued when they met up at the top of the tree, a lot of gnashing and fighting and biting and screaming and Marcel was in a bad, bad way. He hollered down to Leroy at the bottom of the tree, he said, "Leroy, shoot up here amongst us. One of us needs some relief. [Laughter.]

Senator BREAUX. Now if anybody is wondering what the moral of that story is, it is the fact that there are a lot of desperate people out there in this country that want Congress to do something. They are not so sure what we ought to do. Some of them are saying, we do not care whether it is right or wrong, just do something.

I think that is the real challenge of this committee, is to do something, but to do the right thing.

I think we have two issues here. One of them is tax fairness and the other is economic growth. On tax fairness, I do not think there is a question, at least in my mind, that we ought to do something for middle-income people who have been, I think, short changed over the last decade.

I am a co-sponsor of the Chairman's bill that addresses that question. I think it is important. I have a doubt that it is an economic growth package or an economic stimulus package. Giving someone a $200 or $300 a year bonus because of a tax change could be as small as under a $1 a day. It is certainly not going to stimulate growth in the economy, at least in this Senator's mind. But, it is important from a redistribution standpoint and a tax fairness standpoint.

The second issue is, what do for economic stimulus and to create new jobs. That is I think a more difficult question. I have introduced a capital gains tax cut. For some on my side that is heresy. But I do it in a way that I think guarantees fairness.

The problem we have had on capital gains is no one knows whether it is going to gain or lose revenues. I say let's set that argument aside, pass a capital gains tax cut. Treasury says it is going to gain $12 billion; Joint Tax says it is going to lose $12 billion. I have a safety net with my legislation that says, let's take the chance.

If it gains revenues everybody is a winner. New jobs are created; new growth is created; long-term investment, I think, is encouraged. But if it does not work, and there is a loss, let's not make the average middle-income taxpayer pay for it. My bill does that by creating a fourth new income tax rate of 36 percent; joint filers with taxable income of $500,000 or more. That is less than two-tenths of 1 percent of all the taxpayers in this country. The rate would only be raised if the capital gains tax cut loses revenues. If a capital gains tax cut does not lose revenues, everybody is a winner. If it does, middle income and working people in this country do not suffer. I think it would be something that would help stimulate new investment and certainly long-term growth.

I also think we ought to do away with the luxury taxes. That is a growth package. We are causing people to lose their jobs and people are not buying products. I think one of the problems in the country right now is that we have high supply and low demand. We need to encourage people to buy things. Repealing the luxury tax would help meet this goal.

We have a bill to repeal the boat tax, which I think is very, very important.

I think these hearings are very important, Mr. Chairman. I congratulate you for calling them.

The CHAIRMAN. Thank you.

We are pleased to have the Minority Leader here today.

Senator Hatch?

OPENING STATEMENT OF HON. ORRIN G. HATCH, A U.S. SENATOR FROM UTAH

Senator HATCH. Thank you, Mr. Chairman. I appreciate your holding these hearings and I want to welcome the leaders from the administration before the committee today. I think it is very important that we have these hearings and I would like to commend your work, Mr. Chairman, and others for getting relief to the families of America.

They are struggling and they need our help. I am particularly interested in the testimony we will be hearing over the next 2 days on economic policy.

We all know the country is in trouble. We all know there is considerable pressure on the President and the Congress to do something about the economy. However, some politicians and economists argue that any action now will just shift money from one sector to another and they advocate a do nothing now but wait approach to economic policy.

While this argument has merit under certain circumstances, I believe there are things that can be done now to actually expand the economy. Chief among these would be incentives to encourage capital formation and business expansion.

I believe that any effective economic package must contain tax incentives to encourage and allow businesses to start and grow. We need to modify our current policies to make American businesses more able to compete in a global economy and we have to remove the barriers to personal savings and investment that currently exist.

Most importantly, we need to provide strong discipline on government spending and growth. Now, Mr. Chairman, I do not want to take a lot of time. I would like to go through and tell you some of the ideas that I have on what might make a difference, but I am more interested in listening to our witnesses today.

But since I have to leave relatively early I would just like to mention that I hope our witnesses will cover, especially Dr. Boskin, at least two questions or two areas that I think are extremely important.

Number one, there have been claims that even after experiencing the longest peace time expansion in the nation's history, workers and families are no better off today than they were before the expansion began and the middle class is in decline. Now that is an argument that is being made.

In particular, Chairman Boskin, I would like you to comment on that, if you could, in your opening statement, which I hope I can hear.

Secondly, again I would like to ask the panel, but particularly Dr. Boskin, administration forecasts are criticized as being too rosy or should I say rosy scenarios in the past. Yet in this administration, in the Bush administration, your forecasts appear to be very accurate. At least that has been my impression. And more accurate than many of the private forecasters and the Congressional Budget Office itself.

So I would like you to comment on that, why that is so. And I think it is important for all of us to understand that you have been pretty much on the money with regard to some of the problems we have had. But I would like some comment on that if you could in your opening remarks. It would mean a lot to me.

Mr. Chairman, again I would like to go through a whole long list of approaches I would like to take, as we all would, but I will just leave it at that and look forward to hearing the testimony.

Thank you again for holding these hearings.

The CHAIRMAN. Thank you.

Senator Baucus?

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Chairman, in the interest of time I will not read my full statement. Let me say I also am not reading my full statement because it has some of the same themes that most of the previous Senators have stated.

It is my view, however, that these economic problems we face will not go away until there is more good old-fashioned, honest to goodness bipartisan leadership and we do, in fact, work together.

There is a reason I think why even with low interest rates and with the low inflation rates businesses are not investing, consumers are not spending. It is very simple. I think it is because Americans are pretty wise, they are pretty smart. They have figured out that our country is in trouble internationally, competitively, wondering what in the world is going to happen to turn around the onslaught of the Japanese or the other countries, wondering what we can—and they do also realize in my view that we have underinvested significantly in the last decade at least.

We have overconsumed. We are facing problems this country has never faced before. The simple reduction or lowering of interest rates is probably not going to make that much difference. Lower tax breaks are probably not going to make that much difference. That is, with the budget deficit we cannot lower taxes enough to make a big, big difference. They are worried about the short-term, but they are also very worried about the long-term.

The solution, frankly, is good old-fashioned hard work on the part of all of us. It is honesty on the part of the administration and Congress. It is leveling with people. In fact, I think our present and long-term problems are so great that we should consider a kind of war-time cabinet approach, that is bipartisan, where the President, in fact, comes to the Congress, the democratic Congress, and says, look, we have a problem here.

Politics aside, ideology aside, we have to solve this together, honestly together. And that means not taking pot shots at the Congress. It means Congress not criticizing the President so long as we do work together. I think frankly we should consider an approach along that line our problems are so great.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Grassley?

OPENING STATEMENT OF HON. CHARLES E. GRASSLEY, A U.S. SENATOR FROM IOWA

Senator GRASSLEY. Mr. Chairman, I participated in these hearings when they started in November. It was a very productive day. I think these next 2 days will be very productive as well and I thank you very much for holding them.

I was encouraged as I watched the hearings last week on the House side by some of the administration's testimony. The administration finally seems to be getting behind some kind of middle-income tax cut which I have been urging them to do for some time. Unfortunately, there is no middle-income tax program on the table yet.

It seems that when the issue is mentioned it is almost an afterthought. As one Republican Senator I think that this is a mistake. If there is one thing the American people agree on, it is that they are taxed too much. CBO's study released yesterday confirms that Americans are paying too many taxes. Republicans have historically championed tax cuts and it is extremely important to get back on track and to continue this cause.

As I mentioned in the first day of these hearings, I have had a family tax relief proposal in this committee for months. It has been a Republican issue and the administration cannot afford to lose sight of it. It is extremely disappointing to hear critical statements from the White House regarding these tax cuts.

Charges have been made that interest rates may rise or that these cuts will not help economic growth or they will bust the budget agreement. Now it appears to me that as long as these tax cuts are paid for responsibly, constraints on the budget will continue and the markets will react favorably.

In addition, the CBO agrees that tax cuts would have a positive effect at least in the long run on any economic recovery that takes place. So I would just, once again, urge the administration to put middle-income tax relief forward on at least an equal par with other proposals, such as capital gains reduction in any economic recovery package.

The greatest point of contention, of course, revolves around how to pay for such a package. We seem to have at this point three major proposals—the House Democratic proposal to tax the so-called rich; Chairman Bentsen wants to use defense cuts; and the administration has floated reducing Medicare benefits and foreign subsidies.

I support using defense cuts for tax cuts, along with limitations on domestic spending increases. A study done for the CATO Institute estimates that if defense savings are turned into tax cuts the resulting economic activity would create new jobs and stimulate revenue to help reduce the deficit.

On the other hand, taxing the so-called rich to redistribute income will never work and will, I believe, be counterproductive. In fact, you can confiscate all income over $1 million and you run government just for a few days. Pretty soon under that scenario you would have no more rich and pretty soon you would have no more government. Now maybe that is what we ought to do. I do not know.

I also have very strong reservations about administration suggestions to reduce Medicare payments. These proposals have not gotten very far in Congress in the past. They are unlikely to find a great deal of support even from Republicans.

My hope is that before next spring the President and Congress will be able to agree on an economic recovery package that includes middle-income tax cuts, capital producing measures, such as investment tax credits or targeted long-term capital gains reduction, passive loss relief for real estate and expansion of IRA's and incentives for the farm economy, such as permanent extension of the Beginning Farmer Bond program which I have introduced.

I am going to stop there, Mr. Chairman, except to reemphasize something Senator Boren said, that is the necessity for emphasizing education as part of economic development and economic promotion. That would be to allow once again the interest deduction for educational loans. This has also been an issue that I have been involved with and have introduced legislation to accomplish.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Dole?

OPENING STATEMENT OF HON. BOB DOLE, A U.S. SENATOR FROM KANSAS

Senator DOLE. Mr. Chairman, thank you very much. I will ask that my statement be made a part of the record and I will just indicate that we have all been here before and we are all looking for the same thing. Certainly Congress has some responsibility as everybody has indicated. It is my hope that we can work together with the administration and, say, within 30 days after reconvening agree on some package and pass it.

I have looked at all these different packages. As far as I can tell no one has invented anything new. I do not see anything that just jumps out as some new idea that no one has ever thought of. So there is nothing out there that hasn't been thought of before.

In fact, many of the things out there that have been in the President's package have been languished in Congress for quite some time. So the President's got a package. He has had one up here for years. It deals with more than taxes. I think we'll make a mistake if we think we are going to turn around the economy just by dealing with tax cuts.

We have trade policy. We have bank reform. We have regulatory reform. There is a whole list of initiatives that the President has suggested. In some cases they go beyond the jurisdiction of this committee. I believe we have to ask ourselves honestly, are we going to really have any impact whatever we do on the economy.

Some have suggested a $200 tax cut or a $300 tax cut to stimulate our $6 trillion economy. We have to take a look at monetary policy in addition. Does it lag behind? Has it been too slow? Can they do more? I think so.

So the bottom line as far as I am concerned, is that we all have great ideas on how to cut taxes, but I am not certain that from a policy perspective, that it might be the best thing to do. We need to make that determination in this committee as Senator Baucus suggested, as we normally do in this committee, on a bipartisan basis, working with the Chairman, working with Senator Packwood and others.

The Republican members of this committee met with President Bush this morning. He again wanted to underscore and indicate his deep concern, and interest in getting something done and getting it done in a bipartisan way, and getting it done very quickly. Because if we go through the usual bickering and the bidding war around here and do not pass something until next June or July it may come too late to have any impact and the economy will take care of itself. Hopefully we will have recovery without all these great ideas that some of us have talked about on both sides of Congress—the House and the Senate.

But having said that, certainly we look forward to hearing the administration witnesses. I watched a great deal of their testimony on the House side on C-SPAN and I know pretty much what they plan to say.

But the bottom line is there are a number of people in this country who are pretty responsible, who are afraid that we may do some things that will have an adverse impact, increase the deficit, make it more difficult for somebody's children, put more people out of work. That is precisely the thing we should not do.

I look forward to hearing the witnesses and I thank the Chairman.

[The prepared statement of Senator Dole appears in the appendix.]

The CHAIRMAN. Gentlemen, we are very pleased to have you. I apologize for the hoarse winter throat that I have.

But you have heard the concerns of the various members of the committee. A plurithery of ideas and I share the hope that we can work it out in a bipartisan way. I do not think we can do it otherwise. We have an awful lot at stake.

In turn, I think it is critical that we move expeditiously, that we really have an impact. I am delighted to have you here and look forward to hearing your views.

Secretary Brady?

STATEMENT OF HON. NICHOLAS F. BRADY, SECRETARY, DEPARTMENT OF THE TREASURY

Secretary BRADY. Thank you, Mr. Chairman and members of the committee. I'm pleased to testify today on the state of the United States economy and the President's proposal for economic growth.

Mr. Chairman, you have not called this hearing to intensify the discord, but rather to advance the discussion about what we can agree on that will help the economy. It is an important task. There have been a number of different proposals put forward, and more importantly fundamental differences in philosophy exist.

It will not be fruitful to dwell on how we got here. We need to address the economic challenge and to meet it squarely.

I believe there are two fundamental problems—one short term and one long term. The short term problem is sluggish economic activity and uncertainty about the economy. For the long term we need solutions which will promote higher growth, savings, future investment and productivity.

A key problem is our low rate of national savings which is caused by both excessive Federal deficits and inadequate private savings. The reason the low savings rate is important is that in the long run you cannot invest more than you can save.

To leave the general and be specific, our task is to implement economic policies that will raise the standard of living of Americans. Between 1970 and 1990 real per capita income increased 43.1 percent. But this general growth trend has not been unbroken over the past 20 years. Growth will return if we adhere to certain basic criteria.

The Bush Administration would suggest the following four guiding principles:

(1) Our goal should be to promote maximum social, political and economic progress through overall economic growth that is shared by everyone. Our solution cannot be, to fight over the particulars of managing the distribution of sluggish growth. It must be to adopt measures to increase growth in the first place.

(2) We must adopt measures that create jobs and stimulate savings and investment. Jobs are what America needs. Increased savings and investment will finance productivity gains that enable a higher standard of living for all.

(3) The American people have sent us a message—do not increase taxes. All that does is send more money to Washington where it is inefficiently spent.

(4) Do not take fiscal actions that increase interest rates. This makes it harder for Americans to buy homes. It increases the costs of investment and lowers the number of jobs created.

Many have asked about our current economic situation. Where are we? Are we in a slow recovery or double-dip, shallow recession? The answer is, we are in a transitional phase. The economy receded in the fourth quarter of 1990 and the first quarter of 1991, emerged from the down turn and showed modest growth in the second and third quarters of 1991; and early estimates indicate it is slowing again in the fourth quarter of this year.

This is not an unusual pattern for recoveries. In every one of the eight post-World War II recoveries there was a slow down of growth during one of the quarters during the first year of recovery.

But perhaps more important, why are we where we are? There are several reasons. We had a war during which the price of oil went to $40 a barrel. We've had 2½ years of restrictive high interest rates which have only recently abated. The country as a whole took on too much debt and much too little has been done to create the climate for increased jobs and investment.

Now the war is over. Interest rates are headed down. Corporate America has turned the corner on accumulation of debt and households have made significant strides in reducing their debt burden. Now we are left with the task of providing jobs investment.

Many of the fundamentals are in place. Interest rates are at a 14 year low. Inflation is under control. Inventories are lean and exports continue strong. We understand that the American people are worried and their confidence has suffered. They are worried about the value of their homes and their ability to own a home. And they are worried about jobs. They are worried about the condition of financial institutions. And perhaps most of all, they are worried about the ability of the United Stater Government to respond to their real concerns without dissolving in a partisan warfare.

The President understands exactly the state of feelings in the country. He knows the people are worried. He has no intention of staying with the status quo. He is not satisfied with old solutions. He will present a program to Congress that will address these concerns head on and ask for its swift consideration as Senator Dole has stated this morning.

The President said it best. "I will ask Congress to lay aside election year politics at least long enough to enact a common sense series of economic growth measures to get the job done."

The administration has been urging Congress to enact a program for economic growth for the last 3 years. While we have indicated that we would be flexible and have been prepared to negotiate, the core elements of the tax part of that program have not varied. They are a capital gains tax cut, permanent research and development tax incentives, incentives for first time home ownership, incentives for savings and incentives for job creation through all of the above, and the creation of additional incentives for enterprise zones.

Any policy that is designed to get the economy moving again must motivate the individual entrepreneur. Historically, the way to job creation and growth has been the guy with an idea who tried to make it work. It is precisely that type of small business activity that restoring a capital gains tax differential will stimulate.

However, the most important benefit would be to stimulate values in the real estate industry. Nothing could be more important to the economy.

Second, we ought to make the R&E tax credit permanent. This credit is important to the nation's ability to compete in the global marketplace and will be much more effective if made permanent.

Third, we need to assist the housing industry, and in particular encourage first time home buyers. The budget proposal for penalty-free IRA withdrawals will enhance the attractiveness of deductible IRA's by making them more flexible. This increased flexibility would provide an incentive for more taxpayers to save for the purchase of their first home.

Fourth, we need to increase savings by Americans. Our proposal for Family Savings Accounts is affordable and could be enacted quickly. Family Savings Accounts would be popular because they would provide a simple tax-free way for people to save for downpayments on homes, education and medical expenses.

Fifth, we need to continue our focus on job creation. All elements of our package have this objective.

We've made these proposals in three budgets now and we have proposed the means to pay for them in each of these budgets. Had the Congress enacted them, I believe the economy would be stronger. These proposals will create jobs and they will encourage long-term investment and they should be part of any credible economic package.

The President has also asked us to present him with other plans to stimulate the economy as well as options for middle-income tax relief. The President shares the concern for tax relief for the middle class, but he wants to do so in a manner that does not increase the deficit, does not increase tax rates, and does not impede long-term economic growth in either the short or the long term.

As the President has said, he will announce these decisions. He is working on these decisions currently and will announce his decisions after the turn of the year in the State of the Union address.

In this regard, proposals to increase tax rates on one group to pay for tax relief for another are not the proposals for economic growth. Economists have rightly stated that such proposals are social policy, not an economic growth agenda.

With regard to the so-called tax on millionaires, let me say there has not been one proposal which does not use such a tax as a disguise to divert attention from the fact that the proposal also contains hefty increases for those well below the millionaire class.

Two bipartisan achievements of this Congress that would help those who are out of work during this period of adjustment demonstrate that when Congress and the administration work together the country is served. I am referring to the extension of unemployment benefits to ease the burden of those whose benefits have expired and the transportation bill.

That legislation will not only improve the country's infrastructure, the transportation bill, by increasing highways, tunnels and bridges but at the same time according to Transportation Department estimates will create over 600,000 additional jobs.

Let us not forget one important thing. The United States is a great country. Our citizens, our values, our natural resources will continue to sustain our ability to be number one.

In conclusion, Mr. Chairman, I believe we must work together to address these problems. The American people deserve nothing less.

The CHAIRMAN. Thank you, Mr. Secretary.

[The prepared statement of Secretary Brady appears in the appendix.]

The CHAIRMAN. We would be pleased to hear from you, Mr. Darman.

STATEMENT OF HON. RICHARD G. DARMAN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. DARMAN. Thank you very much, Mr. Chairman. Chairman Bentsen, Republican Leader Dole, distinguished members of the committee, it is a pleasure to appear before you once again.

Mr. Chairman, I have a prepared statement which I would respectfully ask be included in the record.

The CHAIRMAN. That will be done.

Mr. DARMAN. Thank you.

I am fearful that we may be accidently consuming all the time for questions. So with that possibility in view, I would offer only a few brief comments. They happen to be drawn from page 3 of my prepared statement.

I would simply note, Mr. Chairman and members of the committee, that our problem is conceptually divisible as many have suggested into a short-term problem and a long-term problem. The short-term problem is getting the economy out of its sputtering condition, doing so quickly as the President has suggested, and as you, Chairman Bentsen, and Senator Dole have suggested again today; and doing so in a way that is not inconsistent with our long-term interests in stronger and sustainable growth.

I would note that even if the short-term economic problem did not exist, however, there would still be a need to enact the President's comprehensive agenda for long-term growth. There is much loose talk about the need for an agenda. To some this seems to mean the need for a single fix, the proverbial silver bullet.

Unfortunately, the world in my view is too complex for simplistic solutions, although they are often much easier to communicate. No one policy measure, whether a middle class tax benefit or preferential capital gains treatment or any other single measure I am aware of will suffice.

What is needed for the long term is a comprehensive approach to growth. And to the best of my knowledge, there is at the moment only one such agenda that has been developed in detail—the President's.

I would call your attention to a summary of outstanding elements of that agenda which is appended to my prepared statement as Exhibit 1.

Senator DOLE. Is that this long list?

Mr. DARMAN. Yes, Senator Dole. That's that long list. And, of course, the detailed proposals that accompany it extend to thousands of pages. [Laughter.]

That agenda, comprehensive though it may be, we do not assert is sufficient. The President has said there is more that needs to be done. The agenda will be complemented by additional Presidential initiatives in the .near future. But I would note that even as it stands, the President's agenda is, at least to my knowledge, the only detailed and comprehensive agenda on the table.

Finally, Mr. Chairman, if I could just add a couple of brief comments in response not to the substantive suggestions of many Senators that have already been made—I assume we will be questioned about that—but with respect to two tonal elements. I am in agreement with both suggestions if I understood them correctly.

One, that of Senator Breaux. As I understood his anecdote, he is suggesting that we must do something. We all agree. But at the same time we should be careful not to let Leroy shoot Marcel. I think that that is prudent advice.

And with Senator Baucus, whom I understood to suggest that although we have perhaps some substantive disagreements, part of our problem may also be that the country is disturbed that for whatever reason, we here in Washington are not getting ourselves together properly and getting our jobs done. To do that, we will need a spirit of bipartisanship and a special commitment to intensive work in the weeks and months ahead.

We certainly, on behalf of the administration, as the President has suggested, wish to approach this serious problem in exactly that spirit.

So with that said, Mr. Chairman, I thank you for inviting us and look forward to responding to your questions.

The CHAIRMAN. Thank you.

[The prepared statement of Mr. Darman appears in the appendix.]

STATEMENT OF HON. MICHAEL J. BOSKIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, WASHINGTON, DC

Dr. BOSKIN. Thank you, Chairman Bentsen, Republican Leader Dole and other distinguished members of the committee.

Let me first ask that my full statement be placed in the record.

The CHAIRMAN. That will be done.

[The prepared statem ͻnt of Dr. Boskin appears in the appendix.]

Dr. BOSKIN. Let me begin first by trying to give a brief summary of where the economy has been, where I think it is now, and where I think it is headed. Secondly, let me talk briefly about our long-term productivity growth problem, the problem of raising standards of living over decades rather than the next few quarters or the next year or two.

Let me just say that I obviously concur with the statement summaries given by my distinguished colleagues. I also have appreciated, for many, many years and well before entering government service, the courtesy, respect and interaction I have had with this committee and the overwhelming majority of its members.

The economy's performance has been quite far from satisfactory for some time. After a period of somewhat sluggish growth the American economy entered its ninth post-World War II recession in the summer of 1990. Most private economists believe that the economy began a recovery sometime in the spring of 1991. In early summer I emphasized that concern over the durability and strength of the recovery was quite legitimate. The early stage of the recovery, from about May to July, was at the moderate pace we had expected in the administration. This was slightly below what the average of private analysts and the CBO had expected, although the differences between us and them were rather modest. Since then the recovery has indeed flattened out.

Why did 80 percent of private economists surveyed by the National Association of Business Economists agree that a recovery had begun in the spring? Real consumer spending was growing, industrial production was rising at a pretty hefty pace from March to July, payroll employment was beginning to rise after many, many months of decline, and housing starts had been regularly improving as was noted earlier, from a pretty depressed base .

While I believe economic growth, if any, will be sluggish at best over the next few months, the foundation exists for an improved economy thereafter. Inventories are in check, the U.S. international competitive position has greatly improved relative to years ago, and nominal interest rates are low. Inflation is down and declining, leaving the Federal Reserve in better position to take necessary actions to improve the economy within the context of its overall and desirable goal of low and stable inflation.

The economic expansion we had—the longest one in our peacetime history—that ended in the summer of 1990 did not end on its own. Expansions end because external shocks hit the economy, policy mistakes are made, or widespread imbalances, more traditionally an over-accumulation of inventories that must be worked off, develop in the economy.

In August of last year, obviously, an external shock did indeed occur. The invasion of Kuwait by Iraq and the subsequent oil price spike—oil prices getting to $40 a barrel—was superimposed on an economy that already had been growing sluggishly for the prior year and a half. Certainly, the economy was pushed either into or deeper into recession.

There were several reasons for the slow economy prior to the recession. But let me first indicate that had Desert Shield and Desert Storm not occurred, and had Saddam Hussein been in control of the Saudi oil fields and oil prices been at $30 to $40 a barrel right now, the leading industrial economies in the world, rather than stuttering, would be in far worse shape.

But there were several reasons for the slow economy prior to the recession. I think while the oil shock was important, too much attention at that time focused just on the oil shock and Saddam Hussein, instead of on some fundamental underlying problems in our economy and some of our policies, policies that had been followed over a period of years.

There was a lingering effect of the tight monetary policy followed by the Federal Reserve in 1988 and early 1989 in an effort to engineer the so-called soft landing to ease what I think were legitimately perceived as incipient inflationary pressures in the economy. That always is followed by a period of slow down in the economy.

There was a worldwide increase in long-term interest rates in 1990 as new demand for capital was being manifested, for example, in Eastern Europe, in the Soviet Union, and most obviously, with respect to German unification. That put upward pressure on U.S. interest rates as well.

There were unexpectedly tight credit conditions, popularly known, Mr. Chairman, as the credit crunch. When the history of this period is written, people will continue to argue what exactly made credit less available to certain sectors of the economy. Clearly, the causes included the fallout from problems in real estate markets in many regions of the country; overreaction in the regulatory process, perhaps in response to the savings and loan problems, which prevented banks from undertaking profitable lending opportunities; and the new international capital standards which contain several features driving banks from credit risk and commercial-industrial lending to interest-rate risk and government securities. Whatever the reasons, and however one wants to partition the blame, clearly for many sectors of the economy less credit was available at any given level of interest rates, especially to small and medium sized businesses—those that have traditionally relied on the banking sector for their credit. Commercial and industrial lending by commercial banks was flat from November of 1989, already in 1989, to July of 1990. They simply collapsed thereafter as my first chart at the back of my written testimony shows.

We have slower growth of the labor force because we don't have the baby boom entering the labor force and because the large increases in second-earner families and female labor force participation—key features of the 1970's and through the mid-1980's—have slowed. Obviously this is slowing economic growth as well.

Finally, there were indeed large imbalances that had built up in the economy. Various members of the committee have referred to some: significant overbuilding of commercial real estate, and accumulation of debt by households and businesses. While there was a corresponding growth in the value of assets, a point often ignored by those who look only at the growth of debt as the sole problem in the economy, the high ratio of household debt to income, and of corporate debt to profits, may not have been sustainable, as my Chart 2 shows. Households and corporations are currently reducing leverage in an attempt to improve their balance sheets. At the same time, policies are being implemented to improve the Federal balance sheet. The working off of these imbalances create structural adjustment problems for the economy and imply a slower growth through what Secretary Brady has called "this transition phase." This contrasts with more traditional inventory imbalances, the correction of which causes relatively brief short-term fluctuations in income, production, and employment. There are many other types of structural readjustments underway in our economy. Indeed, our economy is always undergoing them.

Let me spend one second trying to clear up a semantic problem. The terms "expansion," "recession," "recovery" are technical terms used by economists, not to describe the level of economic activity, but rather the direction in which the economy is moving. There is quite a bit of confusion when many private economists say the recession ended in the spring. No one should take that for a suggestion that the economy is in good shape. All it means, and was meant to mean, is that the decline in production, employment and other indicators that had been going on previously had ceased in the spring and the economy had begun to pick up.

Despite the serious problems, I think it is important to point out that the economy does have some important upside potential. I will explain that in one second. But since Senator Hatch asked, let me just briefly state that a year ago at this time when the administration was making its forecast for preparation of the budget, Desert Shield was underway, Desert Storm had not yet begun. We were in the midst of the oil price shock. The war had not started. There was a lot of uncertainty. Our outlook was the decline in GNP in the fourth quarter of 1990 and the first quarter of 1991 would be large, the economy would then flatten out and begin to rise at a rate that was about half the rate of post-war recovery averages. It was quite modest, a little below private forecasters and the CBO. That was on track until the last period in which, as I said, the recovery has flattened out. If was a little more accurate than private forecasters on balance tended to be, and the CBO, for this year, but that difference is modest. Since you asked about our history, I think we have been quite reasonable and more accurate on balance over the 3 years of the Bush Administration than private forecasters have been. There are many reasons for that, not the least of which I should say is probably luck because economic forecasting, as I always remind the members of this committee, is an imprecise science. We are trying to guess at events that may or may not occur and how people will behave when interest rates and oil prices change. And they do not always behave in the future as they have in the past.

The data available thus far for the fourth quarter suggest that growth, if any, will be slight. Since midsummer, as I have said, the economy has slowed considerably. In December the so-called "Blue Chip" forecasters' consensus—really their average—was for real GNP to grow at 1.3 percent in the fourth quarter, down from the 1.9 percent they had indicated the previous month. Last week when I testified before the Ways and Means Committee I said I thought their November forecast was too high and I thought they would be revising it down. They did. I think their December forecast is also probably too high and I would expect them to revise it down in January.

There is some upside potential in the economy, as well as downside risk. The problems that led us a year ago to predict a recovery at about half the average of the post-war rate, credit conditions, the slower response of monetary policy and of the economy to monetary policy than have been traditional, the financial conditions of households and corporations, the fiscal drag from the State and local sector, and certainly the prospective absence of the very large fiscal stimulus which often occurs late in a recession or early in a recovery were all reasons to expect a slower——

The CHAIRMAN. Dr. Boskin, I am deeply appreciative of your having put the rest of the statement in the record, but let me state there are a number of questions that are brought about that we would like to ask. If you could summary, please.

Dr. BOSKIN. Let me summarize and just say, that is why we thought the recovery was going to be quite modest. Obviously, if any of those things do better the economy is likely to do better. If any of those things do worse there is some down-side potential.

I would like to add just two final remarks. One is that the slow down in the U.S. has occurred around the same time as all the slow downs in almost every other industrial economy. Many have been much deeper and much longer. Some occurred before the U.S. recession was declared; others are happening at this time. Japan, for example, has slowed substantially recently.

The growth of our exports has been a major reason why the decline in GDP and the rise in unemployment have been substantially less than in the early 1980's or in the average post-war recession.

Finally, let me just conclude by repeating the concern about longer term growth and responsible fiscal policy, as well as trade, regulatory, monetary, and other policies that maintain an appropriate discipline on the future growth of expected deficits, taxes, and spending in whatever they attempt to do to try to improve the short-term state of the economy. Indeed, it is my own view that the long-term productivity decline, which began in the late 1960's—productivity collapsed in the early 1970's, and there was only a very modest rebound in the 1980's—is our single biggest economic and social problem. Productivity growth is the foundation for rising standards of living and of our long-term growth. While our absolute level of productivity remains well above that of other countries—as one of my charts here shows—they have been gaining on us. If we do not adopt a comprehensive agenda to improve our productivity growth, encompassing all of the items on the President's agenda, and perhaps others, it is clear to me that it will be difficult for America to maintain its leadership role as the world's number one economy as we look out over several decades.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Dr. Boskin, I think the question of productivity is one of the most serious ones we have. But the only fellow I see up there that has been there 10 years is Mr. Darman.

Mr. Darman, in the 10 years you have been there, we have seen the productivity growth of this country the worst that it has been since the days of Herbert Hoover. In the last 3 years we have seen our economic performance the worse that it has been since World War II.

What can we do to turn that one around? Don't just tell me capital gains.

Mr. DARMAN. Thank you, Senator Bentsen. I would not want to belabor the point, but if you would not mind turning to Exhibit 1 of my prepared testimony, capital gains is the first item on that list. I believe it would help long-term productivity for many reasons I believe that most members of the committee agree with that assessment.

Second on the list is research and development investment for productivity improvement. We have proposed substantial direct Federal investment in R&D, greater than in the past, with special emphasis on generic technologies in the applied civilian R&D area, where we are lagging in some cases. In others, like biotechnology, we have a lead, but it is at risk.

The CHAIRMAN. Let me ask you, when you talk about it in a generic way, does that mean support of something such as Sematech?

Mr. DARMAN. Well, we are supporting Sematech, but our support goes beyond Sematech. We just signed a bill yesterday, which we worked out on a bipartisan basis for high performance computing much more broadly, and for a major national infrastructure that will allow applications of high performance computing in everything from environmental protection in weather forecasting to education to health to energy research and so on. This new law enables us to use this technology in a wide range of new areas as well as traditional private sector areas where we can improve our efficiency enormously.

I will not, as I said, belabor the point, but I think if you look down the list, the point I was indeed trying to make with this list is that we have to get at many important things, only some of which are tax-related. But also if you look at the next item on the list, human capital investment, I do not believe our productivity is going to improve in the way that it will have to in order to get back to the pattern of the 1950's and 1960's, unless we really do have radical improvement in our education system.

I have placed service sector productivity improvement on the list. Secretary Brady has spoken extensively on our banking system, and I know many here agree. In many respects, it is not competitive with the Japanese and other major international players. It requires modernization.

The health system, as Senator Chafee pointed out, we spend too much on this—well, you know, you have all heard this and done more on this than anybody. And so on down this whole list. Almost all of it, not all of it, but almost all of it, would improve productivity if we did the responsible things under each of these headings improve productivity.

It is my personal view that if we do not do an awful lot of these things, we will not get our productivity up satisfactorily. We will not be able to achieve the kind of real growth rates that I think we are expecting and hoping for.

The CHAIRMAN. Secretary Brady, now you were talking about growth shared by everyone. I like that thought. But the problem is that back in the 1980's growth was not shared by everyone. And I get concerned about middle-income folks. In particular, I am concerned when I see the top 1 percent double their income, and then I see middle income have a loss of some $747, and those with children take a bigger hit.

The strength of this country is really its middle-income folks. And there is a question of fairness there when they are having a tough time making ends meet. Don't you think that we should be addressing middle income to a greater degree than we have?

Back in 1981 we took a very major cut in the top personal income tax rate. Last year we did $18 billion on earned tax credits in helping the poorest people. These benefits are spread over 5 years, representing a 50-percent increase in the earned income tax credit program. But it seems to me we have really not addressed some of the concerns of middle-income. Of course, I understand and I agree with the observation that more jobs need to be created, but it seems we could be of some help in the area of easing the middle-income tax burden.

Would you comment on that?

Secretary BRADY. Thank you, Mr. Chairman.

Of course we agree that the middle-income taxpayer is being squeezed. But I would like to comment with some other figures which indicate a slightly different perspective. The top 1 percent of taxpayers paid 27 percent of the Federal income taxes in 1988, and that is a large increase from the 17.9 percent that were paid in 1981. The top 1 percent paid 25.7 percent in 1986 and 24.8 percent in 1987.

The share paid by the top 5 percent of taxpayers also shows a large increase from 35.4 percent in 1981 to 45.6 percent in 1988. So I think the share paid by higher income bracket people has gone up.

With regard to your basic concern, tax breaks for the middle class would be important to implement as long as we can do them in a way that does not increase the deficit and does not raise taxes on somebody else.

The CHAIRMAN. Well I see my time has expired.

Senator Chafee?

Senator CHAFEE. Thank you very much, Mr. Chairman.

Mr. Darman, in your statement you talked about a comprehensive approach and we share that. I think every single member of this committee is deeply concerned about the quality of education in the United States and what effect that is going to have on our competitive position, not necessarily solely in the next century but in the balance of this century likewise.

It seems to me that some of those activities are what you might call long-term, and hopefully we can wrestle with them in 1992. However, I believe there is a sense of urgency, shared by each one of us here today, that within the first 100 days of 1992, by April 15, or whatever it is, this committee must develop some legislation that will help our economy.

So, therefore, as we look at what we might do rapidly—and I am going to ask the same question of Mr. Brady likewise and Mr. Boskin, too—what can we do? In other words overhanging everything it seems to me is this real estate problem—from the RTC, from the banks that are in deep trouble trying to dump their real estate. What do you propose?

Frankly, I am not sure we are going to get very far by allowing IRA withdrawals for first-time home buyers. That is a good first step, but I think we are going to need more incentives to help the real estate market. So could you give me some help? One on the real estate values, and if you could not take too long became I am going to ask the same question of Mr. Boskin. Secondly, I would like your thought on investment tax credit, whether limited or restricted. Those are my two questions.

Mr. Darman, you first.

Mr. DARMAN. Senator Chafee, would you mind if I deferred to Secretary Brady in his capacity as Secretary of the Treasury and chief spokesman so that you get one answer. The differences, if there are any subtleties of difference between us, seem to me to be not as important as what would you like to have understood as the administration's position. If you would not mind, I would defer to him.

Senator CHAFEE. We would prefer three answers. It makes it more interesting. But my time is racing by here. So make the answers brief.

What can we do in real estate? Secretary Brady?

Secretary BRADY. Senator Chafee, I think we all recognize the real estate problem as being the central one that you have outlined. Unfortunately, you know, some of the answers are ones that we have given before, which is that if you were to put in a capital gains tax, certainly real estate would be the prime beneficiary.

Senator CHAFEE. Well, how would you do that, Mr. Secretary? Would you index the asset for inflation or would you provide an exclusion depending on the time held?

Secretary BRADY. The exact nature of the proposal, Senator Chafee, is not as important as the fact that we get one of some kind before us, so that taxes on real estate assets can be reduced.

Aside from tax policy, we have made an enormous effort to meet with the regulators over the last year to try and make sure that they understand that what the Congress and the administration want is a sensible approach to the regulation of lending for real estate. That effort has resulted in the promulgation over some 30 changes in the regulators' manuals instructing them to take a sensible view with regard to how real estate should be valued.

We think that that will have a very positive affect on real estate but it will not happen overnight, because these things take time to get into the process. There are some 7,000 to 10,000 regulators depending on how you define it.

Senator CHAFEE. And I think Mr. Bowsher said that was quite dangerous what you have done.

Secretary BRADY. I know. I do not know where Mr. Bowsher has been during the real estate crisis. But to say, as he did, in his testimony yesterday, that we ought to be stricter about how we value real estate, he must be looking at a different world than I am.

Senator CHAFEE. Okay. What about the reenactment of something in connection with the investment tax credit? Is that going to do us any good?

Secretary BRADY. We are taking a good, hard look at that, Senator Chafee. The history of investment tax credits is that they are somewhat effective. They also seem to be put in at a time during the recovery cycle when the recovery is already underway.

But you have to be careful, as they say in tax parlance, not to "buy the base." In other words, we should not give people extra income for things that they are already going to do. Nonetheless, an investment tax credit may be effective.

Senator CHAFEE. My red light has not come on.

Mr. Boskin, investment tax credit, do you think it will do some good?

Dr. BOSKIN. Well, I would agree with Secretary Brady. The history has been that they have been effective, at least partially. There is always a concern that if you are moving investment from one activity to another, or forward in time, it will just mean you lose later. But I think the history certainly has been that they have been effective. I think he is quite right that to the extent one looks at it, it might be preferable to have it on an incremental basis rather than for all inframarginal investment.

I would add——

Senator CHAFEE. What do you mean? How would you do it incrementally?

Dr. BOSKIN. Well, we have something like that in the R&E tax credit. For example, you get it on increases rather than the first installment.

Senator CHAFEE. Oh, you mean the increase. I see.

Dr. BOSKIN. Rather than over some base or something like that.

Senator CHAFEE. Thank you.

The CHAIRMAN. Senator Moynihan?

Senator MOYNIHAN. Mr. Chairman, I am going to pick up from Senator Breaux's theme that Mr. Darman discussed. There is a tale of a trapper in the Adirondacks in the middle of the—[Laughter.]

Dr. BOSKIN. Any relation to Marcel?

Senator MOYNIHAN. No, a totally different world.

He got into a fight, a wrestling match with a bear one evening. As the poem went at one point, "Oh, God, he cried in great despair, if you won't help me; don't help the bear."

In our present situation it strikes me that it is as likely we will do things that are wrong as are wise. At the Jerome Levy Institute at Bard, they refer to our present situation as a controlled depression. And the experience of our Depression of the 1930's is that we kept doing the wrong things.

I see in Dr. Boskin's very able testimony the implicit assertion that the deficit is now so high that the Keynesian stimulus is just beyond us. It will not work. We have some things like the transportation bill that will create 600,000 jobs, perhaps more. But the capacity of the government to use lever of fiscal stimulus is very different than in previous recessions.

In the meantime, if you talk to people in New York, what they worry about is that the price of real estate has dropped such that the portfolios of the great institutions, the great financial institutions are in jeopardy.

Could I ask you, Dr. Boskin and Secretary Brady, if you would like, do you not think this—Senator Chafee was asking about this—do you not think we have a situation where simply market changes have put our financial institutions in the kind of jeopardy that it took World War II to get out of after the 1929 crash?

Dr. BOSKIN. Well, I would certainly agree, Senator Moynihan, that the decline in real estate values has been one of the major problems in our economy. It was, I think, at the core of the structural changes that I have been talking about. I think there was a rise, especially on the commercial side but also residential side, when things went up too rapidly relative to sustainable levels, for various reasons I would be happy to go into later. I will not now cover them for issues of time. People consumed out of that increased wealth. Now as that has declined people are hunkering down. On the commercial side, obviously, there was substantial overbuilding for various reasons and there is a substantial decline in values. Those are items in the portfolios of many financial institutions and those are causing serious problems.

The equity in a home is the single largest asset for a majority of American households. I think one of the major reasons that consumers and families are very concerned right now is that it was their nest egg, or they were consuming out of it, or it was something that they could use to deal with emergencieś and contingencies.

So I think you are quite right that restoring asset values, particularly in real estate, is at the core of our economic problem.

Senator MOYNIHAN. How is it done? I suppose the Secretary has to answer that.

Secretary BRADY. Would you repeat the question, please?

Senator MOYNIHAN. How do you do it?

Secretary BRADY. As I said in my answer to Senator Chafee, we have to consider a more generous view of real estate by the lending banks, Senator Moynihan. That is, we must convince the regulators that the regulations that we have literally put into print in their manuals should be ones that they adhere to. That is important.

I am frank to tell you that they do not like some of the changes that we have made. We have made one further change which they like even less: We have required them to commit in writing to the fact that they have studied the changes and that they are putting them into effect. So at the end of their examination they say something I learned from my first boss, who said, "Brady, I am tired of listening to you talk. Write it down on a piece of paper and put your John Hancock underneath it."

They are going to have to do that with these particular changes which have been cleared through Alan Greenspan and Bill Taylor and Bob Clarke and Tom Ryan of the OTS; they will acknowledge that those changes are in place and in effect and they are implementing them. Then their supervisor does the same thing.

Their supervisor looks at those reports from the individual regulators and puts in his own signed report that he has taken note of that same process and verifies that the process is underway and being adhered to. It is a simple-minded, simple way to go at it. It is not being uniformly well received by the regulatory community, but that is what we are doing.

Senator MOYNIHAN. Could I just ask him one second? What do we do about institutions whose loan portfolios are now below the levels at which loans were made?

Secretary BRADY. Well, the obvious answer is to——

Senator MOYNIHAN. And I am not irresponsible.

Secretary BRADY. No, I understand.

But the obvious answer is to put into place regulations and law changes which help to raise real estate values. Now, obviously, as we work our way through the over-supply of real estate we have those real estate prices will raise themselves by natural demand. That will take time.

In the meantime we do not want any overburdening of financial institutions by the regulatory community.

Senator MOYNIHAN. Thank you very much, sir.

The CHAIRMAN. Senator Boren?

Senator BOREN. Thank you, Mr. Chairman.

As we focus on the long term and restoring our ability to compete, we often hear that we do not want to use tax policy to distort investment decisions that would otherwise be made by the market. As I was commenting in my opening remarks, we have to focus upon the relative tax burden in this country as it relates to the tax burden in countries with which we are locked in competition.

I certainly understood that as a Governor. If I was going to look at gasoline taxes or cigarette taxes or even corporate income taxes, I needed to know what the surrounding States in my region were doing. Similarly, we understand we are part of the international economy.

Let me just ask, are we developing a series of statistics that enable us to compare the tax burdens in this country in certain key areas relating to savings and investments of different kinds, statistics that would enable us to determine whether our tax policy is really appropriate given the tax burden in other countries.

I have seen such studies. For example, researchers at the University of Maryland have studied the different segments of industry, engine blocks, for example, and their statistics indicate that a company in the United States might recover 25 percent of its investment in the first 5 years after making it under our laws. They might recover 60 percent in Germany; 70 percent in Japan; 80–90 percent in Korea and other places where we are in competition.

Are we beginning to focus on, and will the administration consider in any proposals which the President ultimately makes, the international aspect of our tax rates on certain kinds of economic activity versus those tax rates in other countries?

Secretary BRADY. Senator Boren, I do not have that study with me. We do have a lot of information back at the Treasury. I would be glad to try to codify it and supply you with a summary of it.

[The information requested follows:]

Question. Are we beginning to focus and will the Administration consider in any proposals which the President ultimately makes the international aspect of our tax rates on certain kinds of economic activity versus those tax rates in other countries?

Answer. The OECD is completing a study comparing corporate and individual tax parameters across countries. As the study exists only in draft form at the present time, the Treasury Department will furnish it when it becomes available. In the meantime, Assistant Secretary Gideon will ask the Committee on Fiscal Affairs of the OECD for permission to circulate the existing draft of the study.

Secretary BRADY. I do not always want to go back to the same subject, but I would say that with regard to the capital gains tax in Germany there is none after a holding period of 6 months and in Japan there are two ultimate ways of computing it. Under the method that most people use there is only a 1-percent tax on capital gains.

In that particular category both of those two countries have an enormous incentive for capital gains. As many people point out, they also have higher income tax rates. So that is somewhat of an offset.

Dr. BOSKIN. I just have one quick summary statement. I think it is well known that a very large number of studies come to one consistent conclusion: while the overall rate of tax, combined Federal, State and local in the United States as a share of GNP or income, on balance, is not high relative to the other industrialized countries—Japan is lower but most of the European countries are higher.

A general description of the comparison would be that our effective rates of real taxation on real investment and saving is higher here than abroad. Abroad, they rely much more heavily on taxes on consumption, for example, value added taxes.

Senator BOREN. Well I think that is something we really need to consider. I would urge you to look not only at the capital gains, but at depreciation schedules, at the impact of the alternative minimum tax and other aspects of our tax code as they affect our ability to compete.

That is one of the reasons I opposed the 1986 Act; I felt that we were really trying to divorce tax policy from economic policy. I do not see anything wrong with using the tax code as a mechanism for encouraging economic activity that will make us more competitive in the world. I think we really need to step back and look at that, even if it requires some trade-off on rates so that we encourage the kind of activity we want.

Let me just mention one other item. Again I mentioned this in my opening remarks, and Senator Grassley touched on it as well. He has a long interest in this area.

We seem to be moving in the wrong direction in terms of educational benefits. We are talking about middle-income relief. We are also talking about what will help us in the long run competitively in this country. I think we all realize that education is a part of rebuilding our competitive strength, along with saving and investment and new plant and equipment and the rest of it.

Instead of allowing the deductibility of educational interest on educational loans, for example, we have now moved to a different policy. I keep getting reports that the IRS is now even moving to try to identify scholarships, especially scholarships for overseas study, and impose taxation on scholarships and grants by treating them as if they were income.

How do you react to the idea that in terms of giving middle-income relief and also doing something that in the long run will encourage additional education on the part of our people, strengthen our economy in that way, we should examine the possibility of restoring the deductibility—perhaps with some limits, some caps, either in time or amounts—on the interest on educational loans? Also, how do you react to the idea that we should remove all scholarships from taxation?

Dr. BOSKIN. Well, I may be a bit in a conflict of interest having been a professor for many years, Senator Boren. Let me just say unequivocally that improving our educational outcomes, our education performance is the single most important thing to improving America's economic future. There is no doubt whatsoever about that.

Human capital, labor costs and labor income, including fringe benefits are three-quarters of cost and income in our economy. We cannot remain the world's leading economy if we do not have the world's leading labor force. Many people here have spoken about their concerns about income distribution. One of the big characteristics that we have noted in the widening gap in earnings between those with college education and those with high school education. I think that is a major cause of it.

It is also clear that the costs of education have risen considerably. I will try to make this as brief as possible. And when Senator Bradley and some others, I think Senator Moynihan, Senator Bentsen point out that tuition costs have risen a lot I think they are quite correct.

I think the description of what has happened in the middle class that has generally been given is not correct on average. But for those, for example, who have two kids going through school, the consumer price index is not a good index to the cost of living to them because they have the tuition to pay which is going up much more rapidly and it is bunched in time.

So we have a set of proposals which we have focused on in the America 2000 program to try to put choice and competition and accountability and performance at the heart of elementary and secondary education reform which we think are vital. It is not the only answer, but a major answer. And we certainly think that it is awfully important to keep our colleges and universities which are not only the best in the world but very deep in negalitarian in that sense relative to other countries strong.

On the specifics of any of these things, about taxing scholarships, I need to defer to Secretary Brady or maybe we can have the staff get back to you on something that specific.

The CHAIRMAN. Senator Bradley?

Senator BRADLEY. Thank you very much, Mr. Chairman.

Let me share with you my concern that we are in a slow motion depression and that we are in a period where time passing clearly means things are getting worse.

In the 1920's we spent ourselves into a binge crash. In the Great Depression, people were afraid to spend. Things kept getting worse.

In the 1980's we lent ourselves into a binge. The S&L crisis, banks, financial institutions now are not lending.

My question to you is: In this kind of atmosphere why wouldn't the President step forward now and tell us his program? Two months is a long time. Why wouldn't he step forward now with a program? And don't you think you are risking a much deeper down turn if we wait 2 months?

Secretary BRADY. Well, Senator Bradley, I cannot let that pass without saying it is not accurate to say the President has not had a program. He has had one before Congress, since January or February of this year. The same program that to some large extent that he has had for the last 3 years. So I cannot let that pass.

But I would not also want to let it pass the idea that he is not working currently on a program. He certainly is and it will be a strong one brought out after the first of the year. Congress is not in session at this particular point in time. I think your concerns about the economy are well placed. But I think the course of action that we are on, which is to respond to the President's request, to not stay with the status quo, but make some changes that will create jobs and investment is one that will benefit the American people. We can put it into place when Congress returns in January and February.

Mr. DARMAN. Senator Bradley, could I add a couple of words? And I hope not consuming your time.

If you look down the list that I have provided in Exhibit 1 of proposals the President has already made.

Senator BRADLEY. I have that list and that is where I was going. So you go ahead and comment first because I have an observation about it, too.

Mr. DARMAN. Okay. Well, I would be more than happy if you would rather wait.

Senator BRADLEY. No. No. I would rather hear you.

Mr. DARMAN. Thank you.

I was just going to note that if you look down this list, many of these items have been pending for 3 years, some for only 1 year. Take the capital gains cut, there has been no congressional action. Instead of making the R&D tax credit permanent, it was extended only 6 months. We have proposed making it permanent. We have gotten nothing on the educational choice proposal. With regard to the healthy start proposal, we got about one-third of what we asked for. On our financial services reform, proposal we got practically zero reforms.

Now everybody agrees that our financial service sector requires fundamental restructuring, yet we got close to nothing. The health cost containment proposals which I offered to this committee, were dismissed on the first day and never seen again. The IRA improvements we proposed, and the family savings accounts—no action. Our mandatory program reforms, resulting in $47 billion worth of savings—not one of them was accepted.

The administration's tort reform/product liability reform/malpractice reform proposals—no action. Civil justice reform—no congressional action. The national energy strategy and enterprise zones—zero action.

I am not saying this to try to be confrontational. I just note that it is the case that there has been no action on a wide range of things that would be helpful for the long term.

If I could speak to the short-term for a moment. It is of course not 2 months. It is now roughly 1 month until the State of the Union address. The President has said, and I think that this is sensible, that in this intervening period we should try to do what we are doing here right now, and I hope to do more of it in the few weeks ahead, which is to find our way to an agreement so that when everybody comes back with fresh spirit—a little less bitterness than when everybody left—we have done enough ground work so we can act quickly.

Some today suggested perhaps within 30 days or by April 15. Whatever it turns out to be, I think if we do the work right between now and when everybody is back, we can actually get action faster than if we had tried to force the issue at this very moment.

Senator BRADLEY. Okay.

Now there are 24 items on this list. Which of them put money back into the pockets of middle-income taxpayers and how much? I mean I see a list here if I am a family out there trying to figure out how I am going to make ends meet this year and I look at this list of 24 things, I do not see a whole lot that is going to give me more money to deal with my problems, whether it is rising health costs or college costs or higher State and local taxes.

Mr. DARMAN. Well, you see, this is an interesting question as you know extremely well.

Senator BRADLEY. Is there a specific you can point to?

Mr. DARMAN. Yes. I would point to the entire list and suggest that this is specific. I am going to give you a two-part answer.

One part is that if this list were enacted, the economy would be a great deal stronger in both the short and long term. There would be more jobs for everybody, especially the middle class. That is where jobs are.

Senator BRADLEY. How much does this reduce the deficit?

Mr. DARMAN. Relative to doing nothing, by the fifth year it would be in excess of $100 billion.

But let me get to the second point. Well, the first point. I bet you intellectually agree with that. For example, look at international market expansion. You have been eloquent on the subject of the importance of free trade.

Senator BRADLEY. I am asking you a specific question today.

Mr. DARMAN. For the middle income——

Senator BRADLEY. Today. What in this list is going to put more money in the pocket of families who are sitting around a kitchen table today figuring out how are they going to pay the bills?

Mr. DARMAN. I will try my two-part answer. Part one, for reasons you, yourself, have argued well many times, several of these items increase American jobs, which increases American income. That is point one.

Point two, since that point is unfortunately not too well appreciated for whatever reason in the political environment, we are also looking at proposals that would directly put cash in the hands of middle-income Americans, such as those that have been raised by you and by Senator Bentsen and by many distinguished Republicans and so on. We are looking at those.

My personal view is that they are less efficient in terms of job creation and less productive for the long term with respect to middle class jobs. But at the President's instruction we are looking at those, too.

The CHAIRMAN. Senator Breaux.

Senator BREAUX. Thank you, Mr. Chairman. And thank the panel.

I have three questions I would like the panel to address. The first one is to Secretary Brady. On page 4, Mr. Secretary, you have made the point that proposals to increase tax rates on one group to pay for tax relief for another are not proposals for economic growth. I probably agree with that.

But considering what has happened to the tax rates in this country over the last several years with the top rate dropping from 70 percent down to 31 percent. Middle-income people have been hit with seven separate Social Security tax increases among other things. Isn't the question of fairness sufficient to consider revising the rate structure without the question of economic growth? Isn't fairness important enough to say this is something that should be done?

Secretary BRADY. Well, Senator Breaux, the question of fairness, of course, is important. But it is a separate question and I think it is implicit in your statement that that is the case. We are not going to, as Bob Reishauer testified eloquently this last week, reduce growth and stimulus to the economy by changing the distribution of income.

Senator BREAUX. I agree with that. Let's put that aside.

Isn't fairness in and of itself sufficient to recommend this?

Secretary BRADY. It certainly is. But I would point out that if you consider who benefits from programs of the Federal Government as a whole, you will see that those in the lowest quintile of the income distribution in the United States get $6,500 more out of the Federal tax and transfer system than they put in.

Senator BREAUX. I think we are focusing on middle-income taxpayers in this bill.

Secretary BRADY. On the other side, I might say, that in the highest quintile, the richest people in the United States put in $21,000 more than they get out. That is a fair system. It can be argued that it ought to be more fair or less fair, but that is the way the system operates at this particular point in time.

Senator BREAUX. Would you agree that the fairness reason alone is sufficient to look towards changes in the middle-income tax structure?

Secretary BRADY. I would have to look at a particular proposal, Senator Breaux, because each one has its own advantages and disadvantages. I cannot comment on that in the abstract.

Senator BREAUX. Let me give you a real one then. The House Republicans under Congressman Gingrich has introduced what I would call the "basket" approach to tax changes. They threw in a dozen proposals and said this is the way to stimulate economic growth.

I do not see any revenue offsets anywhere in proposals under the Gingrich plan. There are lot of tax cuts in the Gingrich plan, but I do not see anybody who supports it looking for any offsets. I am very concerned that if that were adopted the deficit would be substantially increased.

Gentlemen, in general do you think we could adopt all those recommendations in that "basket" and not do damage to the deficit? Do you think it pays for itself?

Secretary BRADY. Well, let me just comment on the very narrow point of the tax change paying for itself. According to the Office of Tax Analysis in the Treasury, there is a net revenue gain over the 5-year period of about $1.4 billion. The Joint Committee on Taxation does not agree with that estimate. They say it loses some $25 billion. That is part of the argument we have had for years about the effects of IRA's and capital gains taxes on Federal revenue.

Senator BREAUX. What is the administration's position on the Gingrich proposal?

Secretary BRADY. We have said any number of times in the testimony before the Ways and Means, there are a number of proposals in the House conference proposal which are ones that have already been in the President's budget—a capital gains rate tax cut, for example. There are others. There are four or five that have been in his budgets right along. There are some that have already been adopted by Congress since that time.

Senator BREAUX. You do not endorse all of the items that have been offered?

Secretary BRADY. As I said before, Senator Breaux, I do not know as it is going to be helpful to anybody's efforts to increase jobs to focus on this narrow proposal. There are any number of proposals out there. Let me say here what I said then. The idea that was put forward by the Republicans, in my opinion, leads the way to the answer.

What we need to get out of the slow growth that we are in now are policies that generates jobs and investment. There is nothing more unfair in my mind than a guy who does not have a job. And so some group of people comes forward with a proposal that aims in that direction. That's a good way to start. Let's see what we can make out of it.

Senator BREAUX. Let me ask my final question. It's a question regarding capital gains. I think one of the big road blocks in Congress has been that Joint Tax tells us it is going to lose something like $11.4 billion. We asked Treasury and Treasury says it is going to gain $12.5 billion. And no one wants to move forward because nobody knows what is going to happen.

I have taken the approach of basically following the President's proposal on the capital gains reduction for assets held 1, 2, and 3 years, but I put in what I call a safety net that says if it loses money it is paid for by a new fourth tax rate on those joint filers that make over $500,000 in net taxable income per year, which is less than two-tenths of 1 percent of the people in this country that pay taxes.

But if it does generate revenues like the administration says, well then everybody is a winner. What are the comments about that type of an approach?

Secretary BRADY. First of all, you have called attention to an enormously important fact. One of the real mysteries to me since I have been in Washington, is how two organizations could be so widely apart on this particular point. I think it is irresponsible that we do not have an answer to that.

But your idea that we have an adjustment at the end of this period I think has some good sense to it. I think it would be an administrative impossibility to make the calculations. How would the test be identified and spelled out? You would have a big argument over that.

Obviously, the Joint Committee's definition of how that is determined and whether the revenues did or did not come in are going to be totally different than the Office of Tax Analysis. You will then have the same argument.

Senator BREAUX. Well, we are working on trying to work with Joint Tax and Treasury to try to come up with something that would get us that answer in a fair and equitable way.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator Grassley?

Senator GRASSLEY. Thank you, Mr. Chairman.

To any of you who want to answer, there has been a lot of economists who are saying what is the problem here is we really need to have a higher deficit. I do not think any of you agree to that, more spending in other words, as opposed to tax cuts.

One of those I read about was John Kenneth Galbraith, as an example. I think we need to get your reaction on record because this is a very significant difference in philosophy.

Mr. DARMAN. Well, Senator Grassley, I hate to give you an "on the one hand this and the one hand that" answer. But I think the very careful calculation we have to make as we go forward on these things is whether any of the proposals, including ones that might increase the deficit, do not do as much harm in raising the long-term interest rate as they might do good in terms of adding stimulus.

It is a hard calculation to make. I will say this, however, that the short-term interest rate since the budget agreement last year has come down some 4 percent, some 400 basis points.

On the other hand, the long-term interest rate, which is one that is controlled by the free market and not by the Federal Reserve, has barely inched down. It is down some seven-tenths of 1 percent. The reason for that is that the people who put up that money around the world are watching us very closely.

They are saying we do not think you are going to be able to solve this problem, or we are very worried you will not be able to solve this problem within the confines of fiscal responsibility. So they are sitting there saying I will wait and decide how much I am going to ask for my money until I see how you are going to come out on that particular problem.

It just cannot be that the short-term rate comes down 4 percentage points and the long-term rate does not even come down one, unless it is a very severe warning to us that if we take off on some sort of a fiscal stimulus that busts the budget to any significant degree, that long-term interest rates are going to go up and mortgage rates are going to go up and we will have defeated the very goals that we are trying to achieve.

Dr. BOSKIN. I would just add one or two quick comments to that. I think people look at, as Secretary Brady has hinted, not just the current level of the deficit. Economic impact is poorly measured by the nominal dollar number that we keep hearing about because it includes a lot of temporary RTC outlays and other things. The fact of the matter is people will look at what they expect—future spending and therefore either future taxes of deficits to be. So I think it would be likely that a bursting of the discipline on spending would cause at least a partial and perhaps a substantial offset to any direct stimulus.

I also think that it is important to understand that the composition of spending matters a lot. From the beginning in the Bush administration, we have tried to reorient spending towards things which would enhance the productivity of the public and private sectors, in R&D, as in the transportation bill that was just passed and so on.

And I think it is also important, and maybe Director Darman will come back to this, to understand why we have put in place substantial controls on the growth of future spending and discretionary spending. This is a very large part of the budget, which, while subject to pay-as-you-go rules, is still projected to grow at a very substantial rate. Many people talk about that as just a budget problem, but it is also an economic problem. If these types of expenditures keep gobbling up a growing share of the GNP, less will be available to channel into productive investment in our future.

Senator GRASSLEY. There are a lot of bills in Congress that propose spending a lot more money—mandated health benefits, health care reform. You can go on and on. If Congress were to pass those now and the economy is not in too good of shape, what sort of an impact would they have on the economy?

Mr. DARMAN. Well, Senator, I think you have already had the answer that we would give. If we appear to be abandoning fiscal discipline, we think it could be counterproductive, like these bills would be.

I wanted to just add one little figure for your consideration. We are running these very large deficits. What people do not sometimes appreciate is it is in some substantial measure because of interest obligations on accumulated debt.

We are spending over $200 billion a year on interest on debt held by the public. If you include, as Senator Moynihan would, the interest on obligations and trust funds, the number is now over $300 billion a year and rising. We will pretty soon be at a quarter of a trillion dollars a year in interest on debt held by the public alone.

That is larger than the projected deficit. In other words, if we did not have all of that interest—I am not in any way suggesting we should not pay it—but if we did not have it, we would be in surplus. So the debt as a percent of GNP is rising. That is not in the sustainable long-term. We simply cannot keep doing that.

And one of the reasons that long-term financial markets are not responding as favorably as one would like is they know this. They look at this. They see the financial structure. So until sooner or later we address the basic financial structure problem, along with all these others we are talking about, we are not going to get the performance out of the economy that we would want.

And if we look like we are going to make things worse, you have to expect long markets to reflect that.

Senator GRASSLEY. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

Secretary Brady, in the Chairman's question about the income distribution in America, he pointed out how dramatically American's incomes have changed. That is, there is a greater maldistribution of income in America generally over the last, say, decade or 12 years. That certainly is the common perception in America. Ask any household, middle-income household, they will tell you that. They cannot pay the bills.

Ask any wealthy American over the last roughly decade, they like getting or receiving more after-tax income. A lot of them feel guilty about it, frankly.

You know, I was kind of surprised at your response indicating that at least you are trying to create the impression that the opposite is the case. Isn't it true that in fact after-tax incomes of Americans has changed dramatically in roughly the last decade, the last twelve years. That is, the after-tax incomes of the wealthiest 5 percent, 20 percent, 1 percent have risen dramatically; whereas, the after-tax income of Americans in the lower fifth and certainly middle areas have not risen. The lower have fallen and the middle have barely risen at all.

Isn't it true that the real key here is after-tax income and that is the problem here. It is partly the Tax Code but it is also partly caused by the vast explosion in incomes of the top 5 percent, the top 1 percent, of Americans in the last 10 years.

Dr. BOSKIN. Maybe I can respond to a few things. I think you seem to have made several points, like what happened in the income distribution, and how do you compare the after-tax to before tax credit.

Senator BAUCUS. I am only trying to explain the confusion, the disparity, the apparent disparity, between the Chairman's statistics and the Secretary's statistics. I think the answer is that the Secretary just spoke in terms of taxes paid. In fact, the real key which most Americans really care about is their after-tax income.

Dr. BOSKIN. Let me just make two quick points about that. One is, I think the Secretary quite properly talked about after-taxes and after-transfers. The Federal Government budget spends much more on transfer payments to people than it does on purchases of goods and services. It is a larger amount of our tax system. So what he correctly pointed out is to look at the net figures of any tax changes and transfer changes. For example, last year there were some small increases in excise taxes. People pointed out those are paid by the full range of the income distribution. But as the Chairman pointed out, there was a huge expansion of the earned income tax credit which goes to people at the bottom. So people at the bottom had a major improvement with that.

Senator BAUCUS. Mr. Boskin, I don't want to get into a lot of obfuscation, a lot of details. Just bottom line. Isn't it true that after-tax incomes of the top 1 percent, 5 percent, 20 percent has risen dramatically in the last, roughly, decade.

Let me just give you the CBO's study. I'm just going to ask you if you think it is accurate or inaccurate. CBO, a bipartisan organization, says that the poorest one-fifth in America found that their after-tax incomes declined. First of all, I think we all know what it says. The Senator from Kansas obviously indicates he knows what I'm going to say and he knows what it says.

But, see, it also goes on to address the point by the Senator from Kansas. It says, "The real key here is to address the changes at the top of the business cycle." There is one versus the other. That is a proper place to start and a proper place to end. The CBO analysis with 1977 to 1988—very close, but not exactly, to the top of the last business cycles. It is a rough approximation but it is not perfect.

The very basic point being that generally Americans' after-tax incomes in the middle-income areas have not risen, have not kept up with the top 1 percent.

Now let me just for example the top 1 percent have risen 122 percent. The top 5 percent have risen 60 percent. The top 20 percent have risen 34 percent. The 20 percent just above the middle have risen 9 percent. The middle fifth have risen 4 percent. The second fourth-fifth have fallen 3 percent and the poorest fifth, 5 percent. That is between 1977 and 1988.

Do you dispute those figures?

Dr. BOSKIN. The study was released yesterday and I have not had a chance to review it and I will get back to you on the specifics and the figures.

[The information requested follows:]

RESPONSE OF CHAIRMAN MICHAEL J. BOSKIN TO A QUESTION ASKED BY SENATOR BAUCUS REGARDING INCOME GROWTH

The most commonly used measure of income, and the one I will refer to here, is money income, as defined the Bureau of the Census. Money income is a pre-tax concept. The results below will differ from those found in the CBO study we discussed because CBO makes a series of adjustments to money income that are not fully explained in the report.

Between 1977 and 1988, the years in the CBO study, real median household money income rose by 7.2 percent. Real median family money income rose by 7.4 percent.

Income growth figures can depend on starting and ending points. For example, inflation in the late 1970's and the subsequent recessions in 1980 and 1981–2 that rid high inflation from the economy caused real median household income to *fall* by 1.7 percent between 1977 and 1982. Likewise, real median family income fell by 3.2 percent.

Between 1982 and 1988, when the economy grew substantially, real median household income grew by over 9 percent. Real median family income grew by 11 percent.

One can also look at after-tax figures. Subtracting out all Federal taxes using CBO's estimates of such tax rates for the middle-income quintile (as published in the Green Book) indicates that real median after-tax household income grew by 6.8 percent between 1977 and 1988. (The Green Book does not publish similar numbers for 1982. Nevertheless, it seems highly likely that real median after-tax income followed the same patterns as before-tax income, falling in 1977–82 and then rising in 1982–88.)

Similar income growth patterns occurred in each quintile for households. Average money income in each quintile rose between 1977 and 1988. For the bottom four quintiles, this overall rise consisted of a fall between 1977 and 1982, and an increase between 1982 and 1988. In the top quintile, average income rose much more in the latter than the earlier period. Average after-tax income rose in each quintile between 1977 and 1988. The biggest increases occurred in the highest quintiles.

These results indicate that in the 1980's, households in all quintiles benefitted from economic growth and average income—before-tax and after-tax—grew for households in each quintile.

Dr. BOSKIN. I do want to make two very important conceptual points. That is, where one takes starting and ending dates makes these figures swing around a lot. The fact of the matter is, the most horrible period, as the Chairman would put it, since the 1930's for American real incomes was the period 1979 to 1981. The fact is that wages did not even come close to keeping up with the horrible double-digit inflation of the late 1970's and early 1980's. Then, of course, we had the recession in 1980, and then in 1981. That accompanied the disinflation from 13 percent to 4 percent inflation. So if you want to say that from here to here there was not much change, the fact is, things went like that and then back up again over that period.

I am sure people from different sides of the aisle would compare things because of their feelings about how it would stack up to different people's responsibilities and perceptions.

But that is point one, that the figures have to be looked at very carefully in that record.

Secondly, I do not mean to belabor the point, but these figures do not include feeding back in the transfer payments and I think that is very important to do.

Senator BAUCUS. They do.

Dr. BOSKIN. Not all transfers as a matter of fact.

Senator BAUCUS. Well, the CBO study says it does.

Dr. BOSKIN. Not all transfers.

Mr. DARMAN. Could I just try to clarify two simple points? One, on these various studies, we have not had the chance to see the latest one. You will get methodological arguments. We produce counterstudies to get counterstatistics and so on. Both studies are respectable. They look at it a little different way: change the bases, make a different argument.

Two, that is irrelevant in my opinion because if you ask the question, do we want to do more for middle-income Americans, the answer is unequivocally, yes. I assume we all do. The question we have to focus on is what is the most effective way to get this economy growing on a sustainable basis so that middle-income Americans have more rapidly rising income and more secure jobs.

That is what we all agree on. But the question is, what is the best way to do that. That is the question, I think. It is not whether we want to.

The CHAIRMAN. If I could, please. We need to move along.

Senator Dole?

Senator DOLE. We throw these words around, "middle income," like everybody knows what we are talking about. Everyone has said "middle income," like there is a chart out there describing everybody within this group.

What are we talking about when we talk about middle-income taxpayers? Are we talking about the same group? When I ask you a question do we both have the same idea—$50,000, $75,000? What is a middle-income American—single, married with children?

Secretary BRADY. I think the definition you've given, Senator Dole, is about right. I think we have also identified the fact that everybody has a different definition of it.

Senator DOLE. I think first we have to sort of set some parameters. I know there are some statistically. If you are single, what is it, $37,000; if you are married with children, $50,000.

Senator BRADLEY. Median income.

Dr. BOSKIN. The family exactly in the middle, half above and half below, would be in the high thirties, depending on how you measure it. Obviously you would want a band around that. A commonly used thing by academic economists, for example, would be to take those say below $15,000 or $20,000 as lower income, $20,000 to $50,000 or slightly above as middle, and above that as upper income. With this you would have 60 or 70 percent of the population in the middle.

Now it does not mean the same thing in rural Mississippi as it does in New York City.

Senator DOLE. Right. But I think the point I would make is that we are leaving the impression that everybody below $1 million is middle income.

I think those who are watching and see what we are doing may not understand. We are talking about middle income. We may leave them out because they are only making $80,000, $90,000, $100,000. They are not middle income. So I think we ought to somehow set parameters.

Secondly, we have over the years in this committee done a pretty good job in trying to be responsive to middle-income Americans. We passed the 1981 tax cut which Congress loaded with a lot of things. It probably went too far. They had almost unanimous support as I recall. I think we did have 20 to 0.

Mr. BRADLEY. No, you did not. Mr. Chairman, you did not.

Senator DOLE. That is just the one from New Jersey, I think. But 19 to 1. And then 1986. New Jersey is a special case, they have a real problem up there. [Laughter.] But in any event, in 1986 we had, a tax cut that was strongly supported. In any event, we all talked about fairness, middle-income taxpayers. We are all a part of it. Now we have some of the same members who voted for these tax cuts saying what is wrong with our tax policy.

Well, they were here in 1981 and 1986 and they are here today. I think as Mr. Darman has pointed out, we are going to try to do something that focuses on middle income. Who does not want to help middle income? Everybody out here in the audience, I assume, believes they are middle income. That is why they all came, because they know it is all directed towards them. Anything we do is going to help middle-income taxpayers.

So having said that I think we have to ask a couple of basic questions. Are we going to stay within the budget agreement? The Senator from New Jersey says we should not. It is just a piece of paper. It is the only discipline we have had in this town as long as I have been here. Does the administration have a firm fix on whether to stay within the budget agreement or go outside?

Secretary BRADY. Our feeling is that the budget agreement should be adhered to.

Senator DOLE. I hope that is the general view of members of Congress.

Then we have contradictions. We have people that want to encourage savings through IRA's and others want to encourage consumption with a quick tax cut. Now how do you reconcile those positions where you have consumption on one side and savings on the other? Both good policies goals, but are they going to get the economy going if we have some IRA program where you can save money? Or do we want people to spend money?

Secretary BRADY. You have identified a problem for all of us together. We have two problems, Senator Dole, as you have said many times. We have a long term problem and a short term problem. Obviously putting something into effect something that I think most of us would have some sympathy for, which is increased vehicles for savings, be they the Family Savings Account or something like Senator Bentsen has put forward will to help in the long run.

There is not any question about that in my mind. On the other hand, to say that it is going to have an enormous effect immediately may be stretching the point, even though that may be the reason in combination with other things that finally lifts us from the mind set that things are going to get continually worse.

Senator DOLE. Another point I would make is it seems to me we cannot forget monetary policy. They have been a little timid at the Fed. They do move along, but you have to push and nudge and everything else to get any movement at the Fed.

I would ask Dr. Boskin, isn't there a little more flexibility there? Can't the Fed do a little more?

Dr. BOSKIN. Well, they are certainly in much better shape to do that than in similar situations in the past. Inflation is down and declining. We see real interest rates, which often are slightly negative, at this stage are positive. And money growth has been either below or at the very bottom of their target range. They want it to be higher. Some of that is the bank. Some of it is other things. So I think within their general goal of low and stable inflation they certainly have ample room to do more.

Senator DOLE. And finally, before the bell rings, it would seem to me that we might want to consider a two stage process. One where we agree that we are going to do maybe one thing, whatever it is, and we are going to do that within a week after we are back here. The President is going to outline it in the State of the Union message. We are going to agree on one thing. That is short term. That is to get money in the pockets.

Then we are going to do a longer term package we might complete, say, by maybe 30 days or 45 days later. But otherwise we are going to get into a bidding war and Congress is going to end up as we did in 1981 when we added billions and billions of dollars in—we took every special interest amendment in the world and called it tax reform.

Yes?

Mr. DARMAN. Mr. Leader, I was just going to say that I think your suggestion is a sound one in that I understand it would, say, divide the problem—a short term piece and a longer term piece. People have to believe that there is also going to be a long term piece or else they are going to try to load everything they wanted in the second one in the first one.

So the second possibility has to be real as well. I just note that. And a further point having said that. I recognize many people have ideas on how to change the budget agreement, including several Senators here today and the Chairman. I would suggest that even if that were going to be done, that is a much more complicated negotiation, even if the administration did not exist. Chairman Panetta has come out against moving from defense to a family tax cut. Chairman Byrd has come out against it.

If we get in a protracted negotiation over that issue, we will not be able to meet any realistic short-term target in my opinion.

The CHAIRMAN. Well, let me state that my feeling is very strong that we should stay within the outside parameters of the budget agreement, and not bust the budget. Because when we made that budget agreement there were two great super powers in the world. Today there is only one, and we are it. Therefore, I think that line between defense and discretionary accounts and taxes can be and should be pierced insofar as evaluating it for what we face now.

Let me state further that when we are talking about real estate, the crux of much of our problems, we passed a passive loss provision retroactivity which was a bloody outrage and I fought it every step of the way because the limited partners quit carrying their obligation; which went back to the general partner, when they went broke; the obligation went back to the S&L's and they went broke.

I prophesied every bit of it in front of this committee as I fought that kind of retroactive limitation. I think what we are seeing today is the biggest transfer of wealth that we have had in this country since reconstruction. As you see what has happened to real estate, see it lose value you see put on the market at bargain basement prices.

Mr. Secretary, you have tried to correct some of that by not offering property at liquidation values because that is where we were going in trying to get some of the long-term earnings out of real estate and I congratulate you on that. I think that is a step in the right direction.

I think also that for the short term that we ought to look as someone has said to an investment tax credit, but it ought to be incremental. I believe that one should not be getting credit for what one is already doing. It ought to be patterned after the R&D credit and it ought to be targeted so it does not cost too much and really ends up increasing productivity and manufacturing in our country, so that we can be more internationally competitive. I think that is one of these things that we ought to give serious consideration as we move forward.

And insofar as personal savings, Mr. Secretary, I see some advantages to the back-ended IRA or the family savings plan. Senator Roth and I put it in ours. But we have also kept the traditional $2,000 charge off at the beginning. I think that is necessary. I believe it takes that carrot to get people to really make the savings choices that have to be made.

Now let me comment further and you can educate me on this one. When interest rates are so low for short term and yet the long-term rate continues to stay relatively high, representing a disparity that is much more than we traditionally see it, why shouldn't we sell more short-term securities and not as much long-term and, therefore, have the advantage of the savings on the low interest rates and not put as much pressure on the long-term market.

Can you give me a short answer so I do not use up all my time here?

Secretary BRADY. We are looking at it. The 30-year bond only raises net for the government, 7½ percent of the funds we need each year.

Do you want a longer answer?

The CHAIRMAN. Are you saying you are moving in that direction? Is that what you are saying?

Secretary BRADY. We are looking at it, but you have to realize that we are only affecting the 7½ percent of the net Treasury requirement for funds a year.

The CHAIRMAN. Mr. Secretary, at this stage I will take whatever I can get.

Dr. Boskin, let me ask you one. You just touched on it and I know it is a very volatile subject, but I get people like Dr. Solo and others who come in, Nobel Prize winners, talking about a back tax and a consumption tax. I sure know right now when you are in a recession you cannot put a consumption tax on when you are trying to get people to spend more.

But in the long term is that a possible solution as a substitution for some of the other taxes we have?

Dr. BOSKIN. Well, I think many studies have suggested that there might be benefits to eliminating income taxes and replacing them with either consumed income taxes done through an income tax-like system or a value added tax. The administration has not done a serious study of this and I am not stating any administration policy. But I think it is very important that any look at any potential revenue raiser such as that be tied very closely to control over spending. I think many people have noted that it has been a primary source of the expansion of social spending in Western Europe. I think also that although many people have noted the theoretical niceties of the value-added tax, often the legislative processes in other countries wound up whittling away with special exemptions and deductions and deletions so that the base was much narrower when you actually imposed the tax than on a comprehensive measure of value added.

But in general I think over a longer span of time it is certainly something that deserves further study.

The CHAIRMAN. Well, that is a safe answer and I think a proper answer under the conditions.

Let me say when you talk about the growth package that you have offered, I really do not believe the administration has made that much of a priority. When I look back at the negotiations last year and I think how some of us were ready to trade for the President's capital gains, take it with a 33-percent rate and were turned down. Now you ended up with no capital gain and a 32 percent rate.

Secretary BRADY. Is the top rate 31 percent?

The CHAIRMAN. Well, not the effective. It gets up to about 32 percent.

Secretary BRADY. Well with other adjustments, it may be that, or higher.

The CHAIRMAN. That is right.

Secretary BRADY. I do not want to give you a captious answer, Mr. Chairman, but you know it has been our opinion that the capital gains tax cut should stand on its own. I know you have been a supporter of it over the years.

At this particular point in time, we do not believe raising taxes in this kind of an economy is the right thing to do. I do recall the discu.sions we had last year.

The CHAIRMAN. All right.

Senator Chafee?

Senator CHAFEE. Thank you very much, Mr. Chairman.

Secretary Brady, members of this committee that I respect are pressing for a $300-400 tax cut for this group we call the middle class, whatever that definition is. And although I am certain that folks in my State like others elsewhere are all for a tax cut, in going around the State I do not find that is a top priority at all.

I think they share the concern I have that what it is going to do is increase the deficit in leaps and bounds; and if we are going to spend money like that the way we ought to spend it is something that is going to have a more direct effect in improving the economy, whether it is investment tax credits or whatever it is to make us more competitive.

I must say when I hear these suggestions of this $300-400 tax cut for the middle class this is not anything new. I can remember when the Chairman of this committee, Senator Long, got after the Carter Administration that came in. I think at the time they were going to give everybody $50, something to that effect. Senator Long analogized it to going up in an airplane shoving out the money with a pitch fork.

But now I find the administration is talking that way. Mr. Darman suggested that you are going to come up with some kind of a proposal for this middle class. I have great difficult with that.

Sure, I would like a tax cut. I am sure Rhode Islanders in the middle class would like a tax cut. But when they think of the alternatives, when they think of doing something to improve the value of their home or something to improve their prospects for a job, they would opt for those every time.

Why are you going for this program that will give everybody $300–$400, every family?

Mr. DARMAN. I do not believe I did that, Senator Chafee. What I said was that, although I did not use your name, I was in agreement with you. I said that I did not think—I think it was in response to Senator Bradley—I did not think that was the most efficient or effective way to get the economy growing.

However, the President has instructed us to look at that, a set of options, along with a range of other options; and he has not yet made his decision. I did not say it necessarily would be included in a package. Furthermore, the definition of what counts under that heading is quite wide, I think.

If you had targeted incentives for home purchasers for the middle class, that is for the middle class. There are a lot of different ways things can be structured that benefit the middle class, some of which might have a more favorable effect, some less—some more direct, some less direct.

So we have not made a judgment on that issue yet. We have simply been instructed by the President to include analysis for that, and other options for his decision.

Senator CHAFEE. You folks look on capital gains as a real tallis man that is going to do a lot of wonderful things. I have always been skeptical of that. I enthusiastically support the 1986 Tax Act where it eliminated the capital gains differential.

Is the theory under the capital gains that it is going to encourage entrepreneurs, is that the principal rational for the capital gains cut?

Secretary BRADY. Definitely. I think that the impetus that was started back by the Congressman from Wisconsin, whose name I have forgotten now——

Senator CHAFEE. Steiger.

Secretary BRADY. Yes, Bill Steiger produced an enormous amount of investment and job creation during that period of time.

Now that was aimed at smaller companies where actually most of the job creation takes place. But that is absolutely the rationale behind it.

The furthest thing in all of our mind is to create some sort of a windfall for people in the higher brackets. But if you are looking for things that will stimulate people to move their investments around, then that is an obvious candidate for improvement.

Senator CHAFEE. Can you statistically demonstrate that there has been a cut off in capital investment since the 1986 Act? I mean, you know, the whole objective of the 1986 Act was to get rid of these credits, exemptions, deductions and lower the rates. I want to go along with it, because as I say the administration indicates it is a real tallis man. It is going to do wonderful things. But I am not so sure I understand how.

Secretary BRADY. Let us come back to you, Senator Chafee, with some statistical evidence. I do not have it with me this morning.

Senator CHAFEE. All right.

[The information requested follows:]

Question. Can you statistically demonstrate that there has been a cutoff in capital investment since the 1986 Act?

Answer. Business fixed investment spending depends on many determinants of the current and expected future profitability of capital. Tax policy affects business investment through the cost of capital. Higher tax rates on capital gains, all else equal, raise the cost of capital and reduce investment spending.

Because investment spending is determined by many factors, it is not possible to demonstrate that a particular change in investment is due to a change in the capital gains tax, though many empirical studies document that tax-induced changes in the cost of capital reduce investment. It is, however, straightforward to demonstrate that in the period after 1986, capital gains realizations shown below have decreased, suggesting the responsiveness of those realizations to the tax rate on capital gains.

Year	Capital gains realizations
1986	$333.3 billion
1987	144.1 billion
1988	165.0 billion
1989	153.1 billion
1990	122.0 billion (based on preliminary data)

Senator CHAFEE. Let me ask one final question. That is for Mr. Darman. That is, there is a lot of talk about cutting the defense budget. Is that going to affect employment with these transfers from the defense budget over? It is always look at as a way of increasing domestic spending. Cut the defense budget and increase domestic spending.

But when we cut the defense budget we are also cutting jobs, are we not, in the economy?

Mr. DARMAN. Yes.

Senator CHAFEE. I thought my question was more complicated than that. [Laughter.]

But now the light is red. I will come back.

The CHAIRMAN. Senator Moynihan?

Senator MOYNIHAN. While the markets are still open in New York City I think I would like to use this opportunity to ask Mr. Darman, would you like to clarify your statement to make it clear that you do not propose to balance the budget by suspending interest payments on the debt? Could you give us a yes or no answer to that?

Mr. DARMAN. Thank you very much for the opportunity to clarify, Senator Moynihan. I definitely do not propose in any way to do anything other than support 100 percent the backing, the full faith in credit of the United States behind every U.S. Government bond.

Senator MOYNIHAN. Now, Senator Chafee, he can give a complicated answer to a simple question.

I wanted to ask just one question. The Chairman had mentioned Bob Solow. I am sure Dr. Boskin knows that he and Francis Bator have recently put out a proposal in which they address the question of fiscal drag at State and local governments. Walter Heller, your distinguished predecessor 30 years ago, developed the idea of fiscal drag had developed in the Bureau of the Budget, because the Congress would not spend money.

The revenues would come up with the rising of the recovery but then we would not spend any money up here, so there would be a fiscal drag.

Dr. BOSKIN. Not only was I younger then but behavior was different then too, apparently.

Senator MOYNIHAN. We have solved that problem.

But seriously, out in California, our very able former colleague Governor Wilson has just proposed to cut benefits for children under welfare and Social Security, AFDC, by a quarter. That is happening all across the country. We watch welfare benefits here. They have been cut by a third since 1970.

But now as a budget measure a man as able and humane as Pete Wilson is saying these 3-year-olds are eating too much and we are going to just cut their food allowance. Would it be one reasonable thing to ask what Solow/Bator asked as a 1 or 2 year injection of Federal funds to the State and local governments that are now in such travail? I would ask you, Mr. Secretary or Mr. Boskin.

Dr. BOSKIN. Well, I would certainly agree that fiscal drag is about twice as large as one would normally expect, given the rise in unemployment and decline in GDP. So they are off their kind of cyclically-adjusted trend line.

I think there is an open question, quite aside from whether it is a good idea to do it, about what they would do if additional funds were given to State and local governments—whether they would just decrease the tax increases or slow some other things down or whether they would actually get the spending out.

So I think there are probably better ways to deal with that. I think as the only long-time resident of California in the room, I would say that California—indeed, many Governors, including your own—has severe fiscal problems. But California has a very unusual budget situation because it has a constitution about the size of the Manhattan telephone directory with all these specific directives and initiatives passed every year. There is almost no flexibility on the budget side for the Executive and even very little for the legislature.

Senator MOYNIHAN. Can I ask you, Doctor, is there a government in the Western World, other than ours, where faced with a budget problem the Governor, President, Prime Minister would say I have an idea, let's cut the food allowances for babies by a quarter? You do not have to answer, sir.

Dr. BOSKIN. I do not think Governor Wilson would characterize his proposal that way, number one. I think there are—well, I will get back to you on his description of it, I am sure.

But the fact of the matter is that there is a large fiscal problem in the State of California. There is a very severe economic problem in the State of California.

Senator MOYNIHAN. Let me be clear. I said you will not find a more humane person in our government that he. And I did say that.

But we are in a situation where a man like Pete Wilson is saying those babies are having too many bottles. I hope we can get the sense that we are not just talking about a middle income, if not all that well off.

This is a pauper class and we are reducing——

Dr. BOSKIN. There is no doubt whatsoever that we have serious economic problems. They are not confined to any one specific State or region or industry and I agree with that.

Senator MOYNIHAN. Would you agree we should have a national welfare benefit?

Dr. BOSKIN. I personally do not believe it makes sense to nationalize the welfare system because of, number one, Federalist principals. But immense differences exist in the cost of living from region to region and area to area.

Senator MOYNIHAN. Would you agree that the council could figure out and compute those differences?

Dr. BOSKIN. I think that the Council could approximate them. I find it very difficult to believe that the political process would wind up using them.

Senator MOYNIHAN. Thank you very much, sir.

Mr. DARMAN. Senator Moynihan, could I just take what is remaining on the yellow to red signal there of your time for an additional comment?

I think—[Laughter.]

I'll pass. Thank you.

The CHAIRMAN. Senator Boren?

Senator BOREN. Thank you, Mr. Chairman.

Going back to the question that Senator Baucus asked earlier, and without getting ourselves back into the definition problem, the figures that he cited on the growth of after-tax income were broken down in terms of income levels in the country—the top 1 percent, the top 5 percent, the top 1/5th and so on.

That chart, which he cited, certainly does indicate that there is a growing gulf between the haves and have-nots in this country and that the middle income, those in the third, fourth and fifth quartiles—or 20 percent of the population—have really been certainly losing out, while those in the top 1 percent, the top 5 percent and the top 20 percent are faring very well.

Now I understand, and I do not disagree with, all the comments that have been made about job creation. That is the most important thing in the long run, and it will help those in the middle. It is extremely important that we have a long-term policy. But I heard expressed earlier some reluctance.

The President has "ordered" us, I think Mr. Darman said, to look at middle-income tax cuts "while we do not think it is very important," let me put it this way, "we do not think in the long run it is as important as other things we could do. We are going to look at them because the President said so."

So let me ask you just directly—economic growth, long-term planning aside, as important as all that is—from the point of view of social justice and the point of view of simply having a more equitable tax code, and understanding that the tax rate itself has a tremendous impact upon this huge increase in after-tax income by the top 1 percent and the top 5 percent, while the income of the bottom 60 percent have been dropping, should we not look to the tax code as a way of trying to redress these inequalities in after-tax income, separate and apart from all of our comments about long-term strategy for economic growth?

Do you personally and does the administration support examining the disparities of income growth in after-tax income that now exists in the country? As the Chairman has said, the greatest transfer in history perhaps. And does the administration examining the favor impact that the tax code is having on these huge, developing disparities on after-tax income.

Secretary BRADY. Senator, when Senator Bentsen was talking about the greatest transfer in history he was talking about the real estate area and not about this particular problem.

I am going to address your question in a second. You have to separate as we go forward in this discussion which as we have all said, we all want to work with each other, two different objects. One is to engender growth and jobs and investment in order to increase the sluggish level of economic activity in the country.

Senator BOREN. I agree with that.

Secretary BRADY. That is the number one issue.

Senator BOREN. I agree with that.

Secretary BRADY. That will not be addressed by discussions about the fairness of the tax system. That is a totally different subject.

Senator BOREN. Separate issue.

Secretary BRADY. It is a separate issue which is in fairness.

Senator BOREN. A separate issue.

Secretary BRADY. If we are talking about this particular issue of fairness then I have to say there are any number of statistics that you can look at. Since we had the CBO study which was put forward this morning, which we will take a look at and reply to, let me again put forward this chart so you can see it better this time, which indicates who benefits and who pays for the efforts of the Federal Government, not only in taxes but in transfers.

It shows very clearly that those are separated into five different income segments for the totality of the United States; and it shows that those in the highest 20 percent of the income distribution paid into the system per individual $21,000 more than they took out. This escalates down until you get to those who are most needy and deserving. It shows they got out of the system, on balance, $6,500.

The whole system of the U.S. Government, including not only the system, but also the delivery systems of Social Security benefits, Medicare, Medicaid, and so on are already skewed and aimed this way. That is right and just and the way it should be.

If you are asking whether we can do something about adjusting the way this particular charter operates we can always talk about that. But I go back to——

Senator BOREN. Well, that is what I am asking. Specifically, is it a matter of concern to you? Is it a matter of concern to the administration——

Secretary BRADY. Of course it is a matter of concern.

Senator BOREN [continuing]. That the figures indicate that the top 1 percent in after-tax income have had an increase of over 100 percent; the next 5 percent, I believe, had an increase in the 60-percent range; the top 20 percent, 34 percent; and then others down into the single digits and even into the negative areas.

Dr. BOSKIN. If I could just——

Senator BOREN. Go ahead.

Dr. BOSKIN. If I could just make one comment. Whatever one believes about the top, where I think there are differences in both philosophy and views about what would happen to the economy in the long term, I think we would all agree that the country needs a major improvement in productivity growth, especially for those who are less productive, who do not have college educations. They have raised their before-tax incomes.

In general, I think if you ask economists what is responsible for the evolution of the income distribution over time, the tax system would be a very minor part of it. There are much more fundamental, underlying things in households and so on.

Senator BOREN. Our time is about out. I understand that. Let me ask one specific question because I think it is so important we try to reach a bipartisan consensus and take three or four items, or two or three, and act upon them when we come back in January.

Is the administration prepared to negotiate without precondition and put everything on the table? We had in the past, for example, something of an offer that might have taken place about capital gains versus top rates, as has already been indicated. The administration in the past ended up not negotiating on that matter.

Can we assume that everything is on the table, subject to negotiation, to try to work out a bipartisan compromise that can show we can work together? It would instill some confidence in the people by seeing us stop the differences of opinion, the debating, and get on with action.

Secretary BRADY. Senator Boren, I do not know precisely what you are aiming at. If one of the things that you are aiming at is raising taxes at this point in time——

Senator BOREN. No, I am not talking about raising the total tax burden. I am talking about whether or not we could at least negotiate about certain proposals. Senator Breaux, and I have joined him, has a standby proposal that if indeed capital gains cuts lose revenue—I do not think they will—there will be a standby mechanism to raise rates at the very top to pay for it.

Now are we going to be able to at least negotiate about these matters without precondition?

Secretary BRADY. Certainly we can negotiate about that kind of a matter without preconditions. I would only say that in that particular matter we are going to get back to the difference between the Office of Tax Analysis and the Joint Committee on Taxation that has a totally different way of defining these things. It is very difficult, but I applaud your statement and it is something that we are going to look hard at.

Senator BOREN. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Bradley?

Senator BRADLEY. Thank you very much, Mr. Chairman.

I have a number of questions, so if you could just answer the question that I ask.

Let me ask Dr. Boskin, now that we are in this slow motion depression, the issue has been divided into short term and long term. The question is: How big a stimulus do we need in the short term from the fiscal side, from the tax side? How big a stimulus?

Dr. BOSKIN. Let me just first quickly say that I talked about semantic issues. We have serious economic problems, but I do not think anybody would call it a depression. During the depression we had a 25-percent unemployment rate. It is 6.8 percent now. GNP fell by a third, not by 2 percent.

Senator BRADLEY. Direction. Slow motion depression is a description of a direction, not a definition.

Dr. BOSKIN. Okay. All right.

Senator BRADLEY. So how big a stimulus now?

Dr. BOSKIN. My personal opinion is that, within the confines of maintaining serious fiscal discipline, a variety of things can be done to enhance the short- and long-term performance of the economy. I do not believe that anything very small in a $6 trillion economy, as Senator Dole said, is likely to have much of an impact.

Senator BRADLEY. So how big? I mean we have to decide how big a tax incentive package. How big? $5 billion, $10 billion, $20 billion?

Dr. BOSKIN. Something that is $10 billion or $20 billion would have little impact on the economy. But I think whether and how, and how to structure it, depends on what is done on the spending side, on the structure of monetary policy and other things.

Senator BRADLEY. No, but I am just talking about juicing the economy up. Should it be $20 billion?

Mr. DARMAN. It is the character of the tax proposal, Senator Bradley, that will make much more——

Senator BRADLEY. But do you agree it should be a net stimulus? It should be a net stimulus.

Mr. DARMAN. No, not necessarily.

Dr. BOSKIN. What do you mean by a net stimulus?

Senator BRADLEY. I mean cutting taxes.

Mr. DARMAN. I think the character of the——

Senator BRADLEY. If you are going to cut taxes it is a net stimulus.

Mr. DARMAN. Well the character of the stimulus program is more important than the size, within the range that I expect we all will be dealing. The character will turn out to be more important, and just getting it done, showing we can get something done.

Senator BRADLEY. No, I understand all of that. I just want to get a number so that we can see if we are talking about the same basic thing.

Dr. Boskin, can you say yes we need a stimulus?

Dr. BOSKIN. Well I certainly agree that if the economy is very sluggish we need a stimulus, whether the stimulus should come from a fiscal policy or from monetary policy or elsewhere.

Senator BRADLEY. Okay, but if you take it fiscal you are either going to increase spending to stimulate or you are going to decrease taxes. My question is: How much?

Dr. BOSKIN. Well, at the current time I believe that we should maintain fiscal discipline. So I am not in favor of something that would be a large deficit raiser in the short term.

Senator BRADLEY. Okay. So then no net stimulus?

Dr. BOSKIN. But I think the structure of the tax system, as Dick Darman was trying to say, is quite important. I think there are some things that can be stimulative without increasing the deficit.

Senator BRADLEY. Let me ask you this. One of the things that is suggested is the tax credit per child. I suggested that and I think Senator Bentsen suggested it for middle class children. There are 60 million kids in the country, 32 million families. If all 60 million got a $350 tax credit per child—that means a family with three children would pay $1,050 less in tax—and we pay for that by cutting spending, now Pat Buchanan has endorsed that. Does that help or hurt the chance?

Dr. BOSKIN. I would not make any comment on that. I would say the following though. Whatever the desirability of that as social policy, that is social policy. It is very unlikely that will have much of a stimulative impact on the economy. I do not know of any economists who believe cutting direct purchases by $1 and taxes by $1 is very stimulating.

Senator BRADLEY. But how are you going to do that then if you do not want to have a net stimulus? You have to either cut taxes more than you raise taxes or then you cut spending or you do not have a net stimulus.

Dr. BOSKIN. In the traditional Keynesian sense I think that is correct. But I think there can be things done with the tax structure, for example capital gains differential, that would help in the long run and in the short run.

Senator BRADLEY. Okay. Let me try to get down a few others here.

Mr. DARMAN. Could I add one word? Mr. Chairman, do we have a moment?

The CHAIRMAN. Yes, go ahead.

Mr. DARMAN. Without counting it, or count it against Senator Dole's time or something.

The CHAIRMAN. Go ahead.

Mr. DARMAN. Senator Bradley, I would note that Senator Gramm, for example—a colleague of yours and a friend of ours—has also proposed an approach that is conceptually similar that says, let's take the defense savings, whatever they turn out to be, and reinvest them in American families. If you ask as an abstract matter, would we favor as a structural shift over time that the peace dividend be used in some substantial measure for tax relief for middle-income Americans, the answer would be yes.

That is a policy position with respect to a structural shift over time. It is a separable question from what is the best way to get the economy growing.

Senator BRADLEY. I will not belabor the point. Short term you need a net stimulus. Otherwise, they offset each other.

Mr. DARMAN. A second point. Your own program and Senator Bentsen's, on a 5-year basis, proposes to be deficit neutral. It is possible, because of the way budget accounting works, to have things be net stimulative, even if they are deficit neutral in particular years, because of the change in the character of the things you are spending on or reforming, if they are reforms.

It is possible that you can have pluses and minuses in the same year that net to zero, but which are themselves still stimulative.

Senator BRADLEY. Mr. Darman, I see the yellow light. I have about four more questions. But I do want to follow up on a statement that you made earlier. Because I think if we are going to have discussions there has to be a level of candor.

In my question to you about the 24 items in the long term growth I asked you how much do these reduce the deficit.

Mr. DARMAN. No, you said how would they.

Senator BRADLEY. Would they reduce the deficit? And you said $100 billion in year 5.

Mr. DARMAN. In the fifth year, right.

Senator BRADLEY. Now as I look at these items 11 of them increase spending—6 of them are process; 5 are structural; and 1, maximum 2, actually raises money.

Mr. DARMAN. No, that is because you are—I said quite carefully, I believe the transcript will say, I said relative to doing nothing. I assume that if we were to enact this versus do nothing that there would be a real growth difference between extraordinary sluggish growth and let's say about 2 percent real growth. Still not boom growth because we have some other structural problems to work out that are not yet in 5 years adequately addressed with this.

Senator BRADLEY. So these do not actually reduce spending or increases taxes. These in your view stimulate growth so that in 5 years we would, if we did not do these, have $100 billion more on the deficit.

Mr. DARMAN. At least. And I believe that if you think doing nothing would produce a slow motion depression, which is what I heard you say, then by enacting these you would get very much larger savings.

Senator BRADLEY. All right.

The CHAIRMAN. Let me say that I recognize that the proposal I have made is a modest stimulant. It is directed toward trying to help middle-income Americans who have taken the toughest hit, those with children. In fact, it is partial fairness. A family of four with an income of $35,000 a year would receive a 25-percent personal income tax cut.

With the IRA I was concerned about taking that much money out of the economy and adding to the deficit, but it does release the savings in IRA's and 401(k)s for the purpose of taking it out without penalty for buying that first home or sending the kids to college. So to that degree in the early term, it could be at least a partial stimulant. Over the long term, no question. No question in my mind. We have to get savings up in this country. Our savings rate is about a fourth of that of the Japanese, and is certainly less than half of that of the West Germans.

I look at the Japanese turning to their infrastructure and spending their money more at home in the Pacific Rim; and I look to the West Germans who are buying our securities, now spending their money in East Germany and trying to develop a market share in Eastern Europe, and I just think it is critical that we get our savings up in this country. The IRA is a vehicle that can help.

I think part of it is psychological. When it comes to April 15 and you have all these financial institutions with full-page ads getting people to think about that, and Americans sit down to write that check to the IRS or to their IRA, I think they are going to write it to their savings account.

I have seen so many economists that thought it was just a shift in savings. And yet we had that testimony that they have been changing their minds. They have been moving on that. But I think in amplifying it the way we are talking about amplifying it a real benefit will be gained. For example, if you go out and talk to a 25-year-old about his pension, his eyes just glaze over. Retirement is way off there somewhere. But if you talk about that first home and being able to buy it, they can relate to th^t. Or if you are talking to a young couple about sending their kid, to college, they understand that. And then to take care of a severe medical illness unexpected. And today, with all the problems we are having with health insurance costs, the provision allowing for withdrawal from IRA's to meet unexpected medical expenses is certainly understood by families who face these tremendous costs.

That is why I have been listening and trying to see what we can do in putting together hopefully a bipartisan package that will be productive in the short run and in the long run. That is not an easy combination.

Senator Chafee?

Senator CHAFEE. Thank you very much, Mr. Chairman.

Let me just say in connection with the suggestions of taxing the rich, I think we have learned from experience that two things happen from what starts out to be a surtax or an additional rate on the rich pretty. One, there is not enough income from it. It does not prove to be the gold mine that people anticipate. So therein follows the next step, which is to make that same tax applicable to those in the lower rates or the lower incomes. So you start downward.

When I first came on this committee the top rate was 70 percent—70 percent was the top marginal rate for those earning incomes in the United States. So to think that this Nation does not know how to go upward in the rates and that we have not had experience with that, we have indeed had experience.

The Republican members of the committee were very pleased when it was the Democratic members of the committee who suggested coming down from the 70 percent. We though it was a little gross for us to suggest it. But thank goodness we had a lot of thoughtful Democrats on the committee that said this is crazy to have the top marginal rates at 70 percent.

I would like to ask a question of any of you gentlemen. Senator Dole said here that he envisions there being two rounds of these tax efforts. The first round would be something done very quickly and would include one item. I cannot believe it would be a restricted one item, but let's say it was restricted to three.

Then he suggested there would be a second round. I had the feeling that you gentlemen nodded to that and thought that is what would happen. So my question is: What would you suggest for that first round? Mr. Darman?

Mr. DARMAN. I am sorry, Senator Chafee, I would have to defer on that. I think the others would as well. We have not thought this through yet as to how to divide this. We have only been talking about that in the last few days. And in any case, the President has not made his final decisions on what to add to our package. So I do not believe we can tell you right now.

I do believe we owe you an answer and that the system will only work here if we can say here are the few things we want right now and here are the others that we think should be in a second package.

Senator CHAFEE. Well you indicated earlier that when you do your first round you are probably going to announce what you are going to do in your second round, otherwise everybody would jump in on the first round.

Mr. DARMAN. Yes.

Senator CHAFEE. Well, let me just say this and this is a plea, that in your first round you would include an item or all of the items would include efforts to create, improve the economy, toward the creation of jobs, something that Secretary Brady touched on in his opening testimony.

I think in his opening statement he used the word "jobs" something like 10 times. I heartily subscribe to that. I think what our people want are jobs. I do not think they want individual tax cuts. At least that has been my experience in my State. They are worried about jobs. They are worried about the value of their house and the real estate you indicated that most individuals their greatest worth, their greatest asset is what they have in their house. And finally, they are concerned about the increase in health care costs.

But jobs is the number one thing. So I would hope that you would remember that as you go into your deliberations, each of you gentlemen.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Senator Bradley?

Senator BRADLEY. Thank you very much, Mr. Chairman.

I was unclear as to precisely what you are suggesting about real estate. Dr. Boskin did talk about overbuilding in real estate and 25 percent of commercial real estate is vacant now. Secretary Brady talked about trying to get the banks to lend more to real estate.

What is the position precisely to deal with this phenomenon of a dramatically declining value of real estate in the country where you have countless occasions where somebody had a property, $15 million, and they were able to borrow $10 million. It dropped to $8 million in value and suddenly they can only borrow $6 million and they are called to send in the rest to the bank, the difference between the $10 million and the $6 million.

This phenomenon, it is kind of an undertow out there on the one hand. On the other hand there is an absence of investment in manufacturing sector as well. So what is the administration's position?

Secretary BRADY. Senator Bradley, there are at least three main parts to the program. First, the excess of real estate, particularly commercial real estate, is working its way through the system. The pace is slower than we want; the problem is still significant, as you have pointed out.

Second, we are working on a daily basis and I do not want to go through my discussion again with the regulators and the commercial banking institutions about how the present oversupply of real estate might be held in the banking system without unduly severe penalizing the banks by having severe regulations which automatically write down the value of that real estate.

Over time our system in this country for dealing with gluts has been to warehouse them in our financial institutions. It would be foolish indeed if we had a system in place which in effect went in the opposite direction because of excess regulation. We are working on that.

Third, an economic stimulus would create the necessity for more real estate, thereby reducing the severity of the present problem. We feel that the institution of a capital gains tax reduction would significantly reduce this particular problem. There are some other things as well, But——

Senator BRADLEY. Other than capital gains is there any tax suggestion that you have?

Secretary BRADY. It has been suggested that we look again at the passive loss provisions which were taken out in the 1986 Tax Act. That was something that was part and parcel of that 1986 Tax Act which is of an article of faith to most members on this committee. I think that at this particular point in time going back, except in some maybe limited way into that provision is something that I would not think most people would be in favor of.

Among other things, such a reversal might create the problem of people who pay zero taxes; that is something in 1986 that was taken care of, and I do not believe it ought to be looked at again with great seriousness.

Senator BRADLEY. Thank you very much, Mr. Secretary.

Dr. Boskin, if there was a dollar drop in the price of oil, how much would that mean to the U.S. economy?

Dr. BOSKIN. It would be a small net stimulus, as we are an importing nation. It would take——

Senator BRADLEY. Could you quantify what it would mean?

Dr. BOSKIN. Over a span of time it would be a few billion dollars of GNP. The drop would have to be considerably larger than that to add up to a few tenths of a percentage point of growth or something like that. But to calibrate it, the huge rise in the oil shock was estimated to take about $30 billion a year at an annual rate out. So $1 relative to what was on average a $10 or $12 rise you would have to divide by ten.

Senator BRADLEY. So it is $3 billion you would say, roughly?

Dr. BOSKIN. Yes, off the top of my head. I will get you an exact calculation, but it is small. It is a few billion dollars, yes.

Senator BRADLEY. So $1 drop in the price of oil is the equivalent of a $3 billion tax cut roughly?

Dr. BOSKIN. A few billion dollars. Of course it has internally redistributional issues from producing areas to consuming areas.

Senator BRADLEY. Right.

Secretary Brady, you earlier in your testimony talked about a lot of the proposals that represent themselves to be millionaire surtax actually are upper middle-income surtax because they always go down and grab people who are in the upper middle level because there are more and, therefore, more revenue is raised.

Would you oppose something that was solely a millionaire's surtax?

Secretary BRADY. I think the answer is that we would oppose it. We would have to see what the purpose of the tax was, of course. Let me restate my position, Senator Bradley. We have not seen yet one single proposal that have had the character that you have just identified. Every single one of these things that have a millionaire's tax on it is a very small part of the revenues raised.

In the case of Chairman Rostenkowski's tax program where $46 billion was raised for tax credit, $6 billion of it came from the millionaire's tax and $40 billion was raised by raising the top tax bracket from 31 to 35 percent. The changes come in a package. The millionaire's tax never comes alone.

Senator BRADLEY. Well, I will send you a copy of my bill. Because it does put a millionaire's surtax on, only a millionaire's surtax. With the money that is raised from it, a little under $1 billion, to be used to pay for families to send their children to college, for a new college program.

So the reason I asked that was to try to see if there was a willingness to entertain it if it was very specifically limited to over $1 million in order to give a chance for virtually anybody up to the age of fifty to get a college education.

Mr. DARMAN. Could I just add one word? And I think this is echoing Senator Chafee perhaps, but it is also echoing Senator Bradley from the early 1980's through at least 1986. That is this argument, if you designed a millionaire's tax at some rate, whatever it is, that is higher than the present, and you said to yourself that is all there is, except some benefit it pays for, you then have to ask, what happens over time.

One thing you know is that you have just increased the incentive for very wealthy people to avoid that tax. You've increased their incentive to lobby to get one loophole or another established.

When the loophole is created it is normally created not just for the wealthy but for lots of people. So, this tax system starts to degenerate and you have a net loss. The wealthy do not pay the high rate and more people do take advantage of the loophole and then the Senate Finance Committee and Ways and Means have to come back and fill the hole.

How do they do it? They start moving the rate down. And you used to speak well of how the high rate system degenerates over time. That, I think, is the main reason not to go back to a higher rate system, because over time it degenerates to the point where you get this absurd condition where you write down on a piece of paper that the law says pay 70 percent or 93 percent, and the actual taxes paid are lower for the wealthy than they were when you had a lower rate. You do not want to do that.

Senator BRADLEY. Well, no one is arguing to go back to an 11 rate system. The question is really whether the revenue——

Mr. DARMAN. These things happen a step at a time.

Senator BRADLEY. And I also have not detected in the last 4 or 5 years any decrease in the interest, on the part of various interests, to try to get their particular provision back in the Code.

I mean I do not know if a 10-percent surtax on the people making more than $1 million a year, which is a very small number of people, would actually produce an explosion in lobbying efforts. It seems to me people around town are making pretty good money lobbying for the last 4 years to try to undo what was done in 1986.

Secretary BRADY. The point, Senator, is they have not gotten very far.

The CHAIRMAN. Let me say, gentlemen, we are very appreciative of your attendance and I think it has been a productive exchange. Thank you very much for coming.

Secretary BRADY. Thank you, Mr. Chairman.

Mr. DARMAN. Thank you, Mr. Chairman.

Dr. BOSKIN. Thank you, Mr. Chairman.

[Whereupon, the hearing was recessed until 10:00 a.m., Friday, December 13, 1991.]

MIDDLE-INCOME TAX CUTS

FRIDAY, DECEMBER 13, 1991

U.S. SENATE,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to recess, at 10:03 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Bill Bradley presiding.

Also present: Senators Baucus, Boren, Pryor, Riegle, Rockefeller, Daschle, Breaux, and Hatch.

OPENING STATEMENT OF HON. BILL BRADLEY, A U.S. SENATOR FROM NEW JERSEY

Senator BRADLEY. The committee will come to order. Yesterday the committee heard from spokesmen from the administration who promised an economic plan next month. I take them at their word that they will join us in aiming relief at American families.

Today, in addition to listening to experts and our distinguished colleagues, we are going to have a chance to listen to those people who those policies are supposed to help. Rather than talk about our own proposals I would like to keep my opening remarks short because I think it is more important that those citizens who are here to tell us about their circumstances have a chance to offer their testimony.

But I would like to share with the committee excerpts from letters from citizens in New Jersey. A woman from Yardville, NJ wrote to me the following: "My husband and I jointly earn $35,000. And believe me, we're struggling. Paul earns $30,000 per year. We have two children and a mortgage of $1,100 per year. When you add up other expenses, food, there is no way he could support us by himself. I go to work, too. But a good bit of that is eaten up by nursery school and babysitter costs. Our car insurance premium is obscene. Our property taxes have gone through the roof. And any raise we get from our employers is dwarfed by the yearly increases we get hit with."

In other words, disposable income is down, and even where there have been raises in the 1980's costs have risen more.

A woman from Union, New Jersey writes, "I work very hard to support myself and my children. I must work overtime just to make ends meet. I often drive to work and back, 54 miles a day, with less than $5 in my pocket. I got caught in a storm recently with an almost empty tank of gas because it was a day before payday."

A man from Shorthill, NJ writes, "I am not rich and I am part of a two-wage earner family with two young children and a third on the way. My wife has to work for us to make ends meet. In the community which I have chosen to live, 44 percent of my income goes to pay my mortgage, with another 9 percent needed for property taxes. I am left with just enough money to pay for basic necessities such as food, clothing, utilities and child care. I live paycheck to paycheck."

These are voices of New Jersey families under financial stress. My greatest hope for the hearing today is that we will not forget what we hear from them. When we are looking at capital gains cuts or tax credits or passive losses or a variety of other arcane tax recommendations, I hope we will remember these families are looking to us to help them meet their monthly payments, to help them send their kids to college, to help them build a better world for their children.

The kitchen table should be a place where families talk about where to go on vacation, not whether they can afford one—where children decide what college to attend, not whether they can afford to attend college.

Whether it is my own Family Tax Relief Act that provides a $350 tax credit for every child or the self-reliance scholarship idea that would provide up to $33,000 for any American up to the age of 50 to go to college or any other number of ideas that are before this committee at this time, we simply have to help these hard-pressed families have a better chance.

Later it will be my pleasure to introduce the New Jersey representative of the first panel. But at this time I would like to yield to other Senators who have an opening statement.

Senator Riegle? I'm sorry, Senator Rockefeller in order of appearance before the committee.

OPENING STATEMENT OF HON. JOHN D. ROCKEFELLER IV, A U.S. SENATOR FROM WEST VIRGINIA

Senator ROCKEFELLER. Thank you, Mr. Chairman.

I welcome our distinguished witness and apologize that we have brief statements. I agree with you, Mr. Chairman, very much that a hearing of this sort, listening to real people, is what counts.

Senator Mitchell and I have spent 2 days in the south on Health Care hearings; and we had the experts talk to us. But it is when people with literal problems put those problems out before you that public policy or the lack of it springs to life.

Senator Moynihan, the first witness, and a member of this committee, knows more I would guess about income security policy, economic policy, than probably anybody in this body. I look forward very much to hearing him and not delaying his testimony. So I will be brief.

Mr. Chairman, the committee, the Congress and the administration face a backlog of issues that we have put off for a long time and the bills are all coming due. We must overcome a serious recession if we can; we must ensure long-term economic growth if we can; we must address many long neglected national needs from rising child poverty to crumbling bridges; and we must be sure the tax laws are fair if we adjust them. So that, for a change, the burdens are fairly placed on those best able to pay.

The public push for government action comes after years in which Americans have been urged to lower their expectations about government; and, indeed, government has been deemed to be one of our problems around here in the last decade. Some would agree with that of course and in some cases they would be right.

But anyway, no wonder there is so much confusion in Washington. It is apparent that those who have for so long preached the virtues of government inaction are swimming. They are at a total loss. As with much action that has been long delayed the price is now a lot higher. The options are narrower than before. Policy must be simultaneously navigated among the dangers of debt and deficit, of failing banks and fragile markets, and of unemployment and inflation.

But I do believe that the talent and the resources of this nation are much more than a match, even for these economic problems that we face. What we have been lacking, and it is not entirely just at the White House, but here also, has been political will.

I continue to believe that tax relief for families with children as recommended by the National Commission on Children is important. Our tax credit would help relieve excessive burdens borne by families who are finding it very difficult to make a go of it these days. It would ease the pain during the current recession, but even more important it would be a long-term investment in our country and for our children.

Accompanied by investment in technology and human capital and by tougher trade policy, our proposed tax relief for families can help create a new era of economic opportunity. I do believe that.

What we need today is a good debate, and we are having it, about proposals like these. We need a debate about priorities. We need a frank and objective analysis of the balance needed to steer through a mine field of economic problems. And we need to hear a commitment to action.

What I hope we will not hear are refrains of the misguided counsels of drift or the discredited agenda of the trickle down school of economics or the disregard for the long term, disregard for our children.

Mr. Chairman, I will leave it at that. Thank you.

Senator BRADLEY. Senator Breaux?

OPENING STATEMENT OF HON. JOHN BREAUX, A U.S. SENATOR FROM LOUISIANA

Senator BREAUX. Thank you very much, Mr. Chairman. I am pleased to have our distinguished committee member as our first witness this morning.

I think that one of the points I was trying to make yesterday is that we really have two concerns before the committee. One is a question of tax fairness and we are going to hear from a number of people on that question. I think there is legitimate reason to adjust inequities that have occurred in the last decade with regard to who pays the taxes to the Federal Government in this country. But tax fairness, I think, is a different question from what are we going to do about economic growth in getting this country out of a recession.

Adjusting the taxes by lowering one group's and raising the other's I do not think really contributes to economic growth. So I think we are really challenged with what are we going to do, what to propose as a Congress, to spur economic growth and to get us out of the recession.

I also tried to make the point yesterday that people are telling us to do something. In an article this morning in the Wall Street Journal, NBC poll says that voters are demanding political leaders to do something, almost anything, to spur economic recovery. That is our challenge and that also should be our concern. We should not rush to judgment and do something even if it is wrong.

I think we have to resist, and I think the public is telling us that, trying to out bid each other with tax cuts. One of the things that the poll also points out is that voters are less concerned with reducing their own tax bill than they are in trying to cure the economic recession.

So I do not think we win any points, either politically or economically, by just rushing out and cutting taxes and not doing something about economic growth, which is what I think people really want.

The final point is that I followed very closely Senator Moynihan's proposal, which I think has great merit, on the Social Security taxes. Interestingly, Pat, the poll points out, however, that the tax cut that voters most strongly oppose by 67 to 27 percent is the one that many economists say would have the most direct impact on their pocketbooks, which is a reduction in the Social Security payroll tax.

So we have to educate and I think you are certainly qualified to do that.

Thank you, Mr. Chairman.

Senator BRADLEY. Senator Riegle?

OPENING STATEMENT OF HON. DONALD W. RIEGLE, A U.S. SENATOR FROM MICHIGAN

Senator RIEGLE. Mr. Chairman, thank you.

I want to give a report from yesterday in addition to an opening comment. Senator Mitchell, the Majority Leader, and also, of course, a member of this Finance Committee and I, along with Senator Levin were out in Michigan yesterday conducting a Health Care hearing to take testimony on the problems in the health care area for citizens without health insurance.

We also visited two auto plants—a Ford plant and a Chrysler plant—to talk about the economic difficulties that are going on in the automobile industry of which health care costs are a major part.

I can tell you about the stories we heard yesterday throughout the State of Michigan where the unemployment rate is now 9.8 percent. It is the highest of any of the big States in the country. Tremendous economic damage is taking place in our country and it is affecting individuals. It is affecting businesses of all sizes. It is affecting essentially all of our institutions, public and private.

We have an urgent economic problem on our hands and I think it is going to take a very strong and ambitious economic recovery program to really take and turn things around the way they must be turned around.

We have those problems also in the banking system. I speak to that from the point of view of my vantage point as Chairman of the Senate Banking Committee. We have just passed legislation in that area designed to deal with the cascade of bank failures that are coming at us each week and each month.

We have now made a $70 billion taxpayer loan to the Bank Insurance Fund so that when banks fail individual depositors will be able to get their money back under the Federal deposit guarantees. But we have just had testimony from Mr. Bowsher at the General Accounting Office after passing that legislation that a single big bank failure of a major bank in the country could deplete the entire amount of money that has been provided to shore up the insurance fund.

So we are in a very highly stressed economic situation in terms of how the general economy is operating today, the substantial unemployment, the long length of the recession and the great stress that is accumulated, particularly within the financial system.

If we fail to take an appropriate and strong action as a nation I think we run a grave risk of these problems getting much worse, much worse. These are not self-correcting problems. These are problems that if left alone will steadily work against each other in a way that will put us in a kind of downward spiral. I think one can document that with evidence of all kinds.

I think tax cut ideas are appropriate for us to look at. But we have to go beyond that. And if we do not understand that, then we are going to misdiagnose the problem and fall short on the answer.

We need a massive investment program in America. We are helping every other country in the world today and not doing much to help our own. Just today a very ambitious plan unveiled to help the Soviet Union and clearly they need help. They have problems. But we are only 4 percent of the world's population. There are other countries in the world that ought to be helping in situations like we see in the Soviet Union.

But we also have a fundamental problem here in America where we are not investing enough in our own country and in our own people. Our productivity levels are way below what they need to be and we are losing the economic future. So we need a very strong plan.

If the President and his people cannot come up with one then they are going to have to move aside and we are going to have to get a new President in this country that can think in bigger terms, because America's future is clearly at stake here and our ability to help ourselves, let alone help the rest of the world, is going to depend upon getting this economy on a very strong and sustained upward track. And to do that means a major investment program.

I will just conclude by saying we have an enormous flow of pension money in this country that is collected every day, every week, every month and that has to be invested. A lot of it right now is flowing out of America because investment opportunities abroad look more attractive.

I think we may have to find a way to create some incentives to keep that river of pension money available and reinvested in America's economic future, our job future and our productivity future and in our economic security looking down the road.

To say to our young people or people of all ages, sorry, we do not have a job for you or we cannot find a way to make our system perform strongly enough to accommodate your aspirations and the needs of you or your family is not an acceptable answer. And any leader in our government who cannot do better than that really needs to step aside, starting at the top and coming right down through the Congress.

Thank you, Mr. Chairman.

[Applause]

Senator BRADLEY. Thank you very much.

If you would refrain from applause in the committee room, although I would agree with you. You were applauding the right thing.

Senator Daschle?

OPENING STATEMENT OF HON. TOM DASCHLE, A U.S. SENATOR FROM SOUTH DAKOTA

Senator DASCHLE. Thank you, Mr. Chairman. I also would share your view that there is general agreement about what Senator Riegle said.

I had the good fortune to listen to each of my predecessors speak, and I find myself in complete agreement with exactly what they have said. I think that we are plagued as much by a psychological depression as we are an economic depression.

There is this deep sense that our country cannot deal with these problems effectively, that we do not have the leadership, that our country is drifting, that there is no strategy today.

I just had the opportunity to speak for a week with my farmers and workers and businessmen in South Dakota, and that is clearly the sense that I get, that Washington has failed to lead in this very important matter. And how different it is in facing a problem directly confronting every American as we are in this situation from what we faced just a year ago as we looked to the Persian Gulf.

The President came on television, and he said, "We are going to war." And every day we would have briefings and charts, and everybody would come in and tell the Congress exactly what it is we were doing on a daily basis. Wolf Blitzer was out there somewhere telling us what happened in the Pentagon, and we had Peter Arnett over in Bagdad.

Well I think it is time we get that group together again and somehow devise the same kind of mentality, the same kind of resources, the same kind of strategy and certainly the same kind of leadership that was demonstrated so effectively in the Persian Gulf. Let's have that same kind of mentality in dealing with issues just as much a problem confronting Americans today, every bit as much if not more than what we face in the Persian Gulf.

I want to see Wolf Blitzer in the middle of some unemployment line telling us how bad things are there. I want to see Peter Arnett in the middle of New York City. I want to see the President come on television and tell us what he would have us do.

But there is no strategy today. That, in my view, is creating the psychological depression that exists throughout the country today. We need more than just tax relief. As important as tax relief is, as Senator Breaux has indicated, we need a comprehensive approach in dealing with this issue. Comprehensive in regard to tax fairness, repairing some of the incredible tax inequities that have developed over the past decade. We need tax tools that have been addressed already by some of my colleagues. We need public and private infrastructure repair, perhaps more than anything else.

Investment in our infrastructure is critical, and no one had more to do with our investment in infrastructure during the first session of Congress than our first witness and our colleague, the Senator from New York.

I believe, as so many of my business people have indicated in the last couple of days, if we are really going to deal with this problem, become competitive and deal with the problems affecting business, more than just about anything else we need health care.

Most of my business people are experiencing health care cost increases somewhere between 20 and 35 percent a year. And no tax law, regardless of whether it is a credit or a capital gains bill or anything else we do, is going to address this issue effectively. We have to have comprehensive health care reform or we are not going to have the kind of economic prosperity in this country that we all want.

And finally, we cannot ignore the economics of fair trade and competitive trade. Those comprehensive pieces of reform are absolutely essential if we are going to deal with this problem effectively, and if we are going to give the people in the next couple of months the confidence that they need to be sure that we, as leaders of the nation, can effectively address the problem.

I thank the Chairman.

Senator BRADLEY. Thank you very much, Senator Daschle.

Our first witness today is our respected colleague from New York, Senator Moynihan. I want to thank you for testifying first and allowing me to chair during your testimony.

STATEMENT OF HON. DANIEL PATRICK MOYNIHAN, A U.S. SENATOR FROM NEW YORK

Senator MOYNIHAN. Mr. Chairman, I would like to reaffirm a theme that went through the statement of our colleagues over here with a remark that Jessica Matthews has in her column in the Washington Post this morning. She speaks of the Federal Government in Washington generally having got used to failure, that we do not get any of the things done we say we are going to do and really do not expect to.

If you kind of look at this hearing, sir, if the cameras could just please turn around, you will find an empty bank all the way on the other side of the aisle. It surprises me, but there you are.

My testimony once again will go the particular question of the Social Security trust funds, how we are using them and how we ought to do, and how as Senator Breaux said the misuse is beginning to become part of an accepted practice.

In 1977 this committee and the Congress, in effect, took the Social Security system to a partially funded basis. That means instead of just taking in each year as much as we paid out, with a little cushion, we have started to build a large reserve.

We did not pay much attention to that effect. I was on the conference committee and remember how little we were about it, how little we were aware of it, the implications. The implications began to be clear in the second half of the last decade when a surplus appeared. That surplus is now running at about $1.5 billion a week.

It will be at the end of this decade about $3 billion a week. It is the largest flow of capital in the history of public finance. Three years ago the National Economic Commission, cıeated to make proposals to the incoming President, whoever he might be, said to President Bush that if you will balance the operating budget so that the Social Security surplus is used to buy down the privately held public debt, you would double the national savings rate. In one move you would double the savings rate. That revenue stream is in place. The largest of its kind in the history of political economy.

But we did not. Instead we settled for something that is not only bad economics but profoundly wrong as government ethics. We settled for using those pension funds as if they were general revenues. Senator Riegle spoke of those pension funds. If any Detroit manufacturer started using those pension funds as if they were general revenues, he would go to jail.

That is what we are now doing. We are growing accustomed to it and the next generation is not going to forgive this. We are going to be looked back at as people less than honorable. It is already showing up in our revenue structure. I can give you a little chart talk here.

If you look over on the left hand side you see 1980. The orange color is Social Security revenue; green is corporate taxes; and blue is income taxes. You go a decade forward and you see corporate taxes have very sharply diminished. That is probably the leveraging of American corporations. There is so much debt out there.

The big increase is in the payments to the Social Security trust funds. Seventy-one percent of American households pay more tax as Social Security than income tax.

I have a statement here I would like to just put on the record and then I will go through a few points. I will not take a long time.

The first point is that we already have a year's reserve in the Social Security trust funds. There would be no difficulty putting Social Security back on a traditional pay-as-you-go basis with absolute safety. We have no need for the current payroll tax rate until about the year 2015.

The demographics are just such that our age structure does not change for about another 25 years. That is good. We have no problem with maintaining this fund. Our problem is what are we doing with using pension funds for purposes other than which they were created.

Franklin D. Roosevelt is on record in this. In 1940, Luther Gulick of Columbia University came to see him and said, Mr. President, you know, we have all that money coming into Social Security now. We post it to each individual account. It is nice, but it really does not make any good economics. We just collect it and pay it out when it was due.

And Franklin Roosevelt said, oh, no. I know it may not make economic sense, but I want every penny in that trust fund to have a man or a woman's name on it so that none of those politicians up on the Hill can ever get hold of it. Well, we do not have Roosevelt around, but we have the record.

The second point I would like to make is that in proposing to balance the loss in revenue from trust funds by cutting defense we would reduce the structural budgetary imbalance we now face, an implacable one. For the year 2000 we now project a budget deficit of $435 billion; and we do not even any longer think of it as something inconceivable as it would have been a decade ago.

The third point is tax regressivity. During the 1980's the share of revenue from income taxes was cut 9 percent, but the share from payroll taxes went up 21 percent. Here is the best chart I could ever think we could get for you, Mr. Chairman. That red line is the pre-tax income back in 1980, the top 1 percent. It shows how the decade goes. And it goes whoosh. Then you see that the top 5 percent sees its income go up as well. Then the middle quintile, that family you were talking about earlier in New Jersey, the middle quintile making $31,933, call it $32,000. That is the person right in the middle.

That income is flat for the boom decade. Not a thing happens. Then you move to the middle chart and you see the Federal tax burden illustrated. Down goes the top 1 percent; down goes the top 5 percent; nothing happens to that middle-income family in New Jersey or West Virginia or Michigan, Louisiana, the High Plains.

The last chart shows after-tax income. After-tax income, the red line again, the top 1 percent, whoosh it goes up. The top 5 percent goes up at a good rate. That middle-income level is flat.

Now let's look at average weekly earnings. Average weekly earnings in the United States today are lower than they were when Dwight Eisenhower left the Presidency. We do not have a word for that. I use the word regression. Thirty years. That is right, 30 years go by. We used to be known as the people of plenty.

You know, industrial wages in Italy are higher now than in the United States. Thirty years without an extra penny. If we went back to pay-as-you-go in Social Security, workers would at least have a few extra bucks at the end of the week.

The last chart, Mr. Chairman, is real median family income, which is the largest, the best real measure of well being in this country. It is lower today than it was when President Nixon left office. That is what is happening to Americans. A fellow could have got married in 1973, man and wife, and been married now 17 years, kids in junior high school, and not have a nickel extra in income, going from being a young married person to being a person of middle years.

That has never happened to us in our history. Never. The depression lasted 9 years. We have never stopped talking about it since. Median family income has been flat for 17 years.

The last point I want to make, sir——

Senator RIEGLE. Would the Senator yield just on that point for moment?

Senator MOYNIHAN. Yes.

Senator RIEGLE. Because this is such a powerful illustration of median family income being stagnant and not increasing. As a matter of fact if you go back over those 17 years do we not find now that in most families there are two people working, husband and wife, to earn as much as one wage earner might well have earned 17 years ago?

Senator MOYNIHAN. That is exactly what happened, Senator. The first chart showed you the average weekly earnings were the same as they were in 1960. The family earnings grew for another 13 years by wives and mothers going to work. Now I mean it is as simple as that.

Our proposal would cut that husband and wife's taxes, increase their income, by $750 a year. It is their money. And we have good economic judgment that it could create a million jobs.

This bill is supported by the AFL–CIO. It is supported by the U.S. Chamber of Commerce. It is most emphatically supported by the National Federation of Independent Business which makes the point that for small businesses, where most jobs will be created, the largest taxes they pay are payroll taxes, and they pay them whether they are making money or not.

I say I think this is good economics. But once again, at the risk of being repetitive, fellows, our immortal souls are at stake here. These are pension funds. We have no business spending them for anything else than that for which they are collected.

Thank you, Mr. Chairman.

Senator BRADLEY. Thank you, Senator Moynihan, for your testimony.

Senator Riegle?

Senator RIEGLE. Senator Moynihan, before you leave, because of the importance of what we are talking about I would like to engage you on a related point. I do so because I think you are probably as thoughtful a social scientist as we have around, not just within the Senate, but certainly on a national level.

You have an extraordinary city in New York City to represent within your State. I have a comparable city, in some respects. Detroit is a major urban center, one of the largest in our country. When I look at what I see going on today, just in terms of the economic difficulty and erosion and the social stress that is accumulating in your State, in your large cities, my State, my large cities, growing underclass, a tremendous problem of inadequate income and you see it in housing, you see it in lack of housing, you see it in lack of health care, lack of education, even personal safety on the street.

I am more and more of the view that because we are not tending to our economic future and building a stronger national economy that the social conditions within our large cities are becoming stressed beyond anything that I have seen in my 25 years here in the Congress.

I have been struggling for a way even to describe the condition. And what I find myself using as a descriptive phrase is that we are developing a kind of clock work orange society where you are starting to see anti-social activities, random drive-by shootings, people dropping rocks off expressway overpasses on whatever car happens to be coming by.

But the signs of what happens when a society in effect is not given a chance or afforded a system in which to have some steady economic growth and conditions become so uneven and so inhumane in various ways that your society, your social fabric, literally starts to pull itself apart. I am seeing that in our larger cities. I think the economics are accelerating that.

I would be very interested in your view. You represent the largest city in this country. I know that you have a lot of these same problems there that we do and are struggling to deal with them. I would just like your comment on that.

Senator MOYNIHAN. Senator Riegle, you have just described the single most important question this Nation faces or rather this Nation is not facing but ought.

Our subcommittee, which is the Subcommittee on Social Security and Family Policy is beginning to make estimates which we hope will become an annual report on what are the life chances of a child born in different parts of our country with respect to being dependent on welfare.

Now welfare is not just a condition of low income or unemployment. To be on welfare is to be a pauper. Not a pretty word. Not a pretty condition.

Sir, in my City of New York we now estimate that of the children born in 1980 in our country some 30.1 percent, call it 30 percent, will have been on welfare before age 18, will have been penniless and in the hands of the State and city.

In our city of New York, it is about 52 percent as we estimate it. Sir, in your City of Detroit, if you will give us—Alan Sinai is in the audience and so we have to be careful with our economics. So is Rob Shapiro. If you will give us a plus or minus 2 percent, I have to tell you that 60 percent of the children born in 1980 in Detroit will have been on welfare by age 18.

If you know that, you know just about all you need to know about how awful that future is. And it is a result of 30 years with no increase in average weekly earnings; 17 years with no increase in median family income. These things are connected. How they connect is beyond, I think, what our knowledge is. But the fact, the reality is there. And we are now beginning to measure it, sir.

Senator BRADLEY. Thank you very much, Senator Moynihan.

Senator MOYNIHAN. Thank you, Mr. Chairman.

Senator BRADLEY. Senator Breaux?

Senator BREAUX. I think it is important to have this on the record. The number I mentioned, Senator—about why people do not favor what you are proposing—indicates there is a lot of misunderstanding about your proposal and maybe you could address it fairly quickly.

It said the tax cut which the voter is most strongly opposed—67 to 27 percent—is a Social Security tax reduction and here is what they say is why. The pollsters suggest that many people believe that a cut in the tax means a cut in the Social Security benefits as well.

Can you please put on the record the response to that?

Senator MOYNIHAN. Sure. It is a lie. They have been told a lie. Somebody got elected to the House of Representatives in Northern Virginia last November by this lie.

The lie starts out with don't mess around with Social Security while we are stuffing it in our pockets. John Heinz, a beloved member of this committee, was asked, 2 years ago I was sitting next to him on television and the Rochester Democrat and Chronicle in New York State had said what is going on with the trust fund is thievery. John was asked by the interviewer, she said, "Senator Heinz, would you describe what is going on with the Social Security trust funds as thievery?" He said, "Certainly not. It is not thievery. It is embezzlement."

But if you start being told, no, no, no. It is not hard to frighten people. These are complicated things. A majority of nonretired adults in our country do not think they will get their Social Security and never have. Yet has never been a day late or a dollar short in a half century.

You know, we have a responsibility not to lie to the American people. If we cannot tell them the truth at least we do not have to try misleading them. You ought to have seen the mailings that came out of the Republican Campaign Headquarters in Northern Virginia saying this Democratic candidate thinks you ought to go back to pay-as-you-go. She is putting your retirement in jeopardy.

What we are putting in jeopardy is the integrity of the United States Government, in my view, sir.

Senator BRADLEY. Senator Hatch?

Senator HATCH. Thank you, Mr. Chairman. I just want to compliment my friend and colleague. I have a great deal of respect for you in this area, among other areas, but certainly in this area. I agree with my friend and colleague from New York that Social Security payroll tax has become an onerous and burdensome thing on American workers.

This tax hits the middle and lower income tax workers the hardest. These are the taxpayers who need our help the most. So you have made a very good set of points here today. We are talking here about middle-income tax relief and economic growth. Two things—middle-income tax relief and economic growth, and jobs which is part of the economic growth. You have made every one of those points I think contently.

And by cutting the Social Security tax rate for both the employer and the employee you would accomplish both of these, right?

Senator MOYNIHAN. Absolutely, sir.

Senator HATCH. Did you want to interrupt there?

Senator MOYNIHAN. No, sir. I just wanted to agree with you.

Senator HATCH. Okay.

You would be putting money into American workers' pockets that I think could be spent and would help the economy at this time. You would be putting money into employers' pockets that could be used to increase investment and create jobs. You are absolutely right that this would have an immediate effect in helping the economy.

I think this proposal would create the jobs that you are talking about here today. It would give immediate tax relief to the American families that are hit the hardest in this society. I want to tell you, I support you and I support this cut; and I urge everybody to do it.

Now I want to ask you a question that is important. American workers pay Social Security taxes on the first $53,400 of their wages. So everyone on that list is paying heavy Social Security taxes.

Senator MOYNIHAN. Yes, sir.

Senator HATCH. And those beyond.

Thus, the middle and lower income workers are affected by this tax the most in my opinion. Would you agree with that?

Senator MOYNIHAN. By definition, sir.

Senator HATCH. Okay. Would you agree that cutting this tax would have a greater impact on the middle class than cutting the income tax rates?

Senator MOYNIHAN. Yes, sir; I would.

Senator HATCH. So would I.

I think it is about time that America listened to you on this issue and I think it is about time we listened to you and quit playing games with the middle-income tax policy and start what is best and in the best interest of the people.

The tax cuts of the early 1980's lightened the income tax burden on the typical family. However, the overall tax burden on the typical family has risen 60 percent. Am I right?

Senator MOYNIHAN. You are absolutely right, Senator.

Senator HATCH. Okay.

Let me ask you this, do you agree that one of the main offsets to the tax cuts was the several payroll tax increases and that these increases hurt the middle and lower class workers a lot more than the wealthy workers?

Senator MOYNIHAN. Yes, sir; I very much agree with that.

Senator HATCH. I thought you would.

Raising the income taxes of the wealthy has been advocated as a solution to this insecurity or inequity. Yet this would not lower the payroll tax burden of the middle class. Would that really give relief to the middle and lower classes in this country?

Senator MOYNIHAN. In and of itself? No, sir.

Senator HATCH. Okay. We agree.

Now should we not instead look to reducing the payroll tax rate because of the immediate effect it would have, the fairness of it, the help to middle America, the help to these people who are having the roughest times out there who are paying through the nose. One of the reasons that green line was level is because of these taxes; isn't that right?

Senator MOYNIHAN. Senator Hatch, you and I are going to have to stop agreeing this way. [Laughter.]

Senator HATCH. I am giving you a bad reputation.

Senator MOYNIHAN. Yes, sir.

Senator HATCH. You agree with me.

Senator MOYNIHAN. My view is exactly yours and I agree with what you have said. Yes, I think you are stating the facts, sir. It is not a view.

Senator HATCH. I know.

I just want to tell you, you and I can differ on matters from time to time, but in this area I have to tell you, I just absolutely admire what you are trying to do. I have to say if a Republican tried to do this he would lampooned all over America and he would be criticized for trying to tinker with Social Security.

You have a reputation of working with these problems with regard to people who are middle and lower income people and people on welfare, and you have a thoughtful, reflective reputation throughout America in this area. There is nobody in the Congress, either in the House or in the Senate, who I think has spoken more reflectively or more thoughtfully on these subjects, and in particular this.

So as a Republican, I want to personally praise you. I want to personally tell you I support you. I want to personally tell you that you are right. This would help middle and lower income America more than anything else we could do; and I want to personally thank you for having the courage to lead the fight in this area. I will do everything I can to help you.

Senator MOYNIHAN. You are very generous, sir.

Senator HATCH. Thank you.

Senator MOYNIHAN. Thank you very much, Mr. Chairman.

Senator BRADLEY. Thank you very much, Senator Moynihan.

[The prepared statement of Senator Moynihan appears in the appendix.]

Senator BRADLEY. I would like to call the first panel now. It consists of Nancy McKenna, Cliffside Park, NJ; Antoinette Cusella, Cleveland, OH; Vicki Yancey, Springfield, VA; Paul Cohen, Philadelphia, PA.

All of you are citizens who deserve the right to tell us how your economic circumstances are doing. I am particularly pleased that Mrs. McKenna could come from New Jersey to share her views. Mrs. McKenna is married and has three children; she has a full-time job and is a homeowner. In a very real sense she is the backbone of America, and it is the backbone of America, the middle class, who work hard, pay their taxes and increasingly feel like they are slipping further and further behind.

I think the committee will benefit from your testimony today, Mrs. McKenna, as well as from all those that we will hear from.

I welcome you all to the committee and I offer the floor to each of you. So why don't we begin with Mrs. McKenna.

STATEMENT OF NANCY McKENNA, CLIFFSIDE PARK, NJ

Mrs. MCKENNA. Gentlemen, I would like to thank the committee for allowing me to come here and speak. My husband and I find it very frustrating when we applied for financial aid last year for our son to go to college. We were told we make too much money and we own a home. If you want the financial aid, sell your home.

I would like to know where we would go. We have to other children. And you have to take a loan out to send your son to college and then you have another tuition, too, right after Christmas. Then you have to take another loan out and you are stilling repaying the first loan you took out. It just seems that it is a never-ending battle.

My husband is an electrician in New Jersey and his job security is not good. He can get laid off at any time. He can be out of work for 2 or 3 months at a time or 2 or 3 weeks at a time, whatever the case is. I had to start full-time in June in order to send my son to college.

When he applied the first time he applied for Mammouth College and he was told he could get a $2500 student loan. We looked into the cost of Mammouth and it is $17,000 to send him there; and there was no way we can afford that. So he looked into a college in Connecticut and we applied for financial aid there and we were told, no, we do not qualify for anything.

It is just very frustrating to see. My husband works hard. I work hard. And we are not getting anywhere. I want to be able to give my children the best in things that we did not have growing up or the opportunities. But my son, I asked for the student work loan, the student work program up at the college. I was informed it is a form of financial aid, which he has not qualified for.

To go off campus and work there were so many people out of work that the family men have the jobs that the students would normally get. So it is like you are right back in the same situation. What do you do when the next tuition bill comes? Do you tell your son, I am sorry, but we cannot afford to send you. You have to, you know, quit school and get a job and not pursue your dream. I just do not know anymore where to go for help.

The job situation is terrible. There are a lot of people out of work. I have a lot of friends that are in the same situation I am in. It is like no matter committees you listen to, no matter what hearings you turn on TV, you do not hear answers, all you hear is people talking. You do not see any action taken.

I just want to get up one morning and turn on the radio or put on the TV and say well this is what is being done. Fill out this form and we will see what we can do for you. We are very frustrated with just about everything.

Thank you.

Senator BRADLEY. Thank you very much, Mrs. McKenna.

Ms. Cusella?

STATEMENT OF ANTOINETTE T. CUSELLA, CLEVELAND, OH

Ms. CUSELLA. Good morning, Chairman, members of the committee. I would like to thank Senator Bentsen and his staff for inviting me to speak to you today. I am from Cleveland, OH where I work as a legal secretary for a large Cleveland law firm.

I am here today to lend support to Senator Bentsen's Super IRA proposal. I feel that it is the most comprehensive package for a complete economic recovery for this country. From 1981 to 1986 I participated in the IRA's. In 1986 that right was taken away from me because of the change in the laws. So I could no longer contribute.

Now I want to build a home, but I cannot build a home unless I can use my IRA funds which are tied up. If I could build a home, I could put many people to work. I would have to hire an architect, a general contractor, electricians, plumbers. I would be buying new appliances, which would help the steel industry. I would be putting the money back into my local community. I would be taking out a loan at my local savings and loan. It would not be going overseas; it would be staying here helping this country.

In addition, there would be a built-in tax savings of between $2,000–$4,000 for myself which I could turn around and reinvest in a new IRA. Right now I have no deductions. I am paying the full rate for tax and so consequently I cannot save any more for a downpayment, nor can I save any more for retirement. But I cannot do any of this unless Senator Bentsen's proposal is passed.

The money that I have tied up in my IRA is earning around 6 percent interest. There is not enough money in my fund for retirement; and at 6 percent interest there is never going to be enough money there for retirement.

On the other hand, in my community homes are averaging an increase of 10 to 20 percent annually and I feel that this is a much better form of investment for me for my retirement.

I think the beauty of Senator Bentsen's bill is that I would be spending money to build a home, putting people to work on the one hand; on the other hand, I would be saving enough money on taxes to reinvest in an IRA, plus I would be building equity towards my retirement.

I have read some of the other proposals suggesting a $10,000 cap on IRA withdrawals. I do not think that goes far enough. With closing costs running between $5,000–$6,000, $10,000 does not go very far at all. I think if you want a complete economic recovery for this country you have to allow us to use all of our IRA funds to invest in a home.

I am asking you to support Senator Bentsen's bill and pass this legislation as soon as possible so that I can start building a home, and I can start putting people to work in my community and throughout this country.

Thank you.

[The prepared statement of Ms. Antoinette appears in the appendix.]

Senator BRADLEY. Thank you very much, Ms. Cusella.

Mrs. Yancey?

STATEMENT OF VICKI L. YANCEY, SPRINGFIELD, VA

Mrs. YANCEY. Good morning and thank you for inviting me here to speak today. My name is Vicki Lynn Yancey. I am an analyst with a major consulting firm in the Washington, DC area. I am 34 years old, college educated, and married, with two elementary school children. I consider myself an average middle class representative and it is of the middle class that I would like to speak.

Like much of our middle class I was brought up with the American dream. Both of my parents were the children of immigrants. Neither went to college. Yet during the 1960's my father bought a house and raised five children in New Jersey on his salary as a welder. My mother stayed at home. They budgeted their money carefully and did without luxuries, but all five of us grew up in a secure middle class environment.

Four of the five children have gone on to college. My parents' expectation was that we would continue the tradition of having a better life than the generation before. My siblings and I now tell the story of American life in the 1980's and 1990's.

My sister in Atlanta is married with two children, has a college degree and works full-time to support the family income. She would love to be home while her children are young, but they cannot pay their mortgage without her salary.

My two youngest brothers finished college last year and are living at home, trying to find work during the recession. One who had found work was recently laid off.

My third brother, following in my father's footsteps chose not to go to college and insisted that his wife stayed at home. They have two children and would like to have a large family. They also live in a small apartment in a very poor area and depend on money from my father to get by. A middle class life style is not possible.

As for me, despite the fact that my husband has an MBA, we learned it was virtually impossible for a family of four to live a middle class existence in the Washington area on one salary. Everything we have been brought up to believe has proved obsolete as we struggle to make ends meet and were unable to buy a home.

I have now worked for several large firms in this area and I cannot recall a time over the last 10 years when I have not been around working mothers. Even during my tenure as an at-home mother, for instance, I tried to make ends meet by caring for other women's children. I was also one of many working mothers in the military.

I have known many, many professional women with children over the years and I have yet to meet one who is completely happy and secure to be in the work place who does not feel stressed or guilty. And many have said they would like to be home if they could. I pay the price and my children pay the price because we want our children to grow up with the comfort and security of a middle class upbringing.

This is how it is in the real world. It makes me angry when I hear people say that the middle class has not changed, who deny the reality that is all around them. While the experts argue over statistics, my high school friend works at Shoprite and laments the time it takes away from her young daughter.

This is not the legacy I want to hand down to my children. Indeed, I wonder what life will be like for my children's generation when the expectation is they will be unable to attain what their parents had. When two paychecks are not enough, then what?

A whole generation of men and women who have already been required to grow up in a day care environment will have even less to give to their own children. My spouse and I would like to be in a position to help our children when they start out on their own, if we can. However, if progressive legislation does not decline within the middle class, this will become increasingly difficult.

At this time my husband and I have no savings, a home that has decreased in value, and we wonder where we will get the money to send our children to college. Diving deeply into debt in our middle age is a very unappealing possibility.

The middle class is burdened not only with soaring college bills, but also with expensive health care and the growing responsibility for aging parents. As a good example, my mother suffered a brain tumor 7 years ago and has been comatose since the operation. The medical bills have been almost beyond comprehension. Half of everything my father has worked for will be turned over to the State for medical bills upon his death.

I do not expect him to help me financially. To the contrary, many people of my generation will be looking for ways to help their own aging parents as well as their own children. The middle class desperately needs relief.

The world has changed a great deal since the 1960's. Our health care policy costs us $2200 a year, assuming that no one gets sick. Day care for two children costs us the equivalent of a second mortgage and we do not have the luxury of extended family nearby to help out as our parents did.

Senator Bentsen's tax cut proposals reflect a sound common sense approach that I can understand and appreciate. It is an exciting thought that should these proposals be enacted perhaps my husband and I could invest in our first IRA. With that investment we could begin the process of ensuring our future, including our children's education.

I ask that the committee not be deterred by criticism that the proposal does not help childless couples. Childless couples are not as financially hard hit as a group as those who are trying to raise a family. With a family comes not only the increased economic burden but also the unending trauma of women torn between work and children. Some women may choose work; some women may choose home. But the key is that the choice should be there. For many middle class women there is no longer a choice, except perhaps the choice to remain childless.

I hurt for my brother who is trying to do what he believes is right for his family because he cannot give his children all that they deserve. I sympathize with the plight of women whose heart tells them to be at home while their children are young, but whose budget tells them otherwise. And I worry about a country that seems to be consumed with a monetary tug of war between the rich and the poor, while the middle class is left to shift for itself.

Even to a layman like myself, Senator Bentsen's proposal seemed best designed to provide relief to the millions of middle class families who need it most. People like my brother, who would like to have another child, may feel more confident in having one. Those people who are looking for free money will find it is not contained in this proposal.

Most importantly, it sends a clear and strong signal to people like myself that the hardworking middle class are no longer being discounted.

Thank you very much for allowing me to address the United States Senate.

Senator BRADLEY. Thank you very much, Mrs. Yancey.

[The prepared statement of Mrs. Yancey appears in the appendix.]

Senator Bradley. Mr. Cohen?

STATEMENT OF PAUL COHEN, PHILADELPHIA, PA

Mr. COHEN. Good morning, Mr. Chairman, and the members of this committee. My name is Paul Cohen. I am a 51 year old husband and father of two from the Northeast section of Philadelphia. I have worked nearly my entire life as a supermarket department manager.

I was laid off in March of this year from a job as a Dairy Manager in a Thriftway Supermarket. I have been totally unable to find work since that time. I am an active member of the Philadelphia Unemployment Project, an organization of unemployed workers that represent the interests of the unemployed of the Philadelphia area.

My unemployment benefits ran out in mid-September. Two months later I was forced to apply for welfare, something I never in my life dreamed I would have to do. I thank God and Senator Bentsen that the extended benefit program was passed last month and I am now receiving unemployment again. But I have no idea where and when I am going to be able to find a good job to support my family.

I started working for Foodfair Supermarket chain part-time in 1955 when I was 15 years old. Other than 2 years in the United States Army I worked for Foodfair for 24 years as a Department Manager. I made a good salary. I felt I had a job that I could retire from—food. No one ever heard of food stores going under. Everyone has to eat. I thought I had a life time job with a pension to retire from.

However, Foodfair got involved in rapid expansion and remodeling in the late 1970's. They bought the JM Fields Discount Stores, Horn & Harden stores, Penn Food stores and others. They became overextended. As rumors about problem spread, Foodfair brought the store and department managers to meetings where they tried to blame us for their problems because we did not minimize our losses of moldy cheese or the ends of lunchmeats or overbuying the perishable items.

Six months later in 1959 with a week's notice over 400 Foodfair stores closed, leaving thousands of us without jobs. Ninety-8 percent of these stores are still functioning as supermarkets under different names today. Foodfair was profitable. Management drove the chain under.

Since then I have worked in several supermarkets. The longest, an employee-owned supermarket called O&O Market, for 6½ years. This store closed in 1989. All my jobs, since Foodfair were privately owned stores, not a part of chains.

After the closing of O&O in 1989 I came up against a recession. One employer cut my health benefits entirely. I got a job with full benefits managing a dairy department in a newly opened Thriftway Supermarket. Six weeks after I opened the dairy department I was laid off and replaced with a much cheaper worker. It was and is clearly an employer market.

Here I am 51 years old. I had no idea how bad it would be out there. I look in the newspaper and word "Supermarket" has disappeared from the want ads over the 6 or 7 months. You need a big, big in to get a job at a supermarket today. I cannot seem to get one.

I have applied for small truck driving and delivery jobs. They want you to use your own car or the job turns out to be sales and jobs for commission or often house-to-house sales. It is just not me.

I have applied for over 25 deli jobs. When I go to apply I see everyone working there less than half my age. I do not list my wages on my resumes so I do not scare the employer away. They do not call me back, but the next week you see the same job advertised in the neighborhood paper. They just do not want an overqualified, middle-aged family man who they assume need a livable wage. You know they are right. I do need a livable wage.

I have applied for grocery jobs in neighborhood stores, stocking shelves. They get kids to do this for less than minimum wage. The big change, they only hire part-timers and move them up. I applied Wednesday this week at a Shopping Bag at a middle class neighborhood in Philadelphia. They told me they are cutting back, not hiring, despite it being the Christmas season.

I got a day's job at a gourmet deli recently where I worked for 12 straight hours. I should get at least about $8 an hour for being an experienced counter person. He only gave me 65 lousy dollars at the end of the day.

I tried to get a job as a part-time night stock clerk at Shop Rite, just to get my foot in the door. They gave me an extensive psychological test besides the application. They still did not hire me.

I am scared to death. I do not know what I am going to do at the end of February when my benefits run out again. I see no light right now. My mortgage is $550 a month and I barely get it up so far. I have been getting utility assistance to pay some of my bills, but it has been tough.

This unemployment situation has been a shock to my children. During the month I was forced to go on public assistance my youngest daughter, who is 9½, said to me, "We are on welfare?" My kids are insecure right now. They are very emotional since I have been out of work.

We and the millions like us need help and need a decent job with health benefits to support my family. My extended benefit check will run out February 22, so will the checks of up to 3 million other American workers; and a 13 week extension will not be enough for us unless the economy picks up immediately.

But all of us see more mass layoffs being announced in the paper. I am speaking on behalf of the Philadelphia unemployment project and the millions out of work like myself. We desperately need a further extension of the unemployment benefits beyond February 22.

We also need a government to consider creating public jobs, programs to put us back to work, meet the needs of our community. Just yesterday a large layoff was announced in the Women Against Abuse program in Philadelphia due to lack of funds. The Salvation Army, the Peoples Emergency Center and homeless shelters are also being cut back despite tremendous needs. A job program would employ people to provide services and many others.

Senator BRADLEY. Mr. Cohen?

Mr. COHEN. Yes, sir.

Senator BRADLEY. Could you wrap up?

Mr. COHEN. Yes, sir.

We need a decent job. There is much that is needed to be done. Finally, Mr. Chairman, the committee is discussing a tax cut to stimulate the economy. I would like to urge you to consider to cut the taxes on the unemployment compensation. Millions of jobless unemployed will have a difficulty paying taxes on their unemployment benefits. No withdrawal is withheld from unemployment checks. An income tax return would be wiped out because of the tax on the unemployment benefits.

If you want to help the middle class, do not forget people like me who are being pushed rapidly into poverty by this terrible recession. We will use a stimulus that comes from the tax cut on the unemployment benefits immediately. We have no choice. We have nothing else to spend.

Thank you for the opportunity to represent America's unemployed at this hearing. We have worked long and hard to build this country, now there is no work. We are counting on you to help us.

Thank you again.

Senator BRADLEY. Thank you very much, Mr. Cohen.

[The prepared statement of Mr. Cohen appears in the appendix.]

Senator BRADLEY. Let me thank all of the panel for sharing your very personal stories with us. It is very important that we all understand that the lives of millions of Americans are being affected daily by a deteriorating economy. It is not a matter of statistics or numbers, but it is a matter of real lives. I think your testimony here today conveys that.

I want to thank you.

Let me ask you, if you could, tell me which cost is hitting you the hardest as you struggle to make ends meet. I am struck that in my own State of New Jersey in a recent poll that 52 percent of the parents who were asked said that their children would have a lower standard of living than they do. That is a profound statement about future prospects and about how people in my State feel about their future.

I am just curious in your own circumstance if you could change one thing, what would it be. Or you may pick two things.

Mr. Cohen?

Mr. COHEN. Primary, on the top of my mind, is the health and welfare of my wife and children, above all. That I am scared to death, sir. You know, right now with a little assistance the children could be protected better somewhat. But as an adult I would have to be carried in pretty bad for the system to take care of me. That is the main thing. If health and welfare was taken off the minds of the unemployed or even everybody it would be so much nicer.

Then we would not have to worry about keeping your house from being taken away. That would be second.

Senator BRADLEY. Ms. McKenna?

Ms. MCKENNA. Well, what I would like to see changed is like I said before, the tuition. I would like to see just about everybody get aid, whether it be a new proposal coming out. And secondly, I would like to see more jobs. I would like to see people at work.

Senator BRADLEY. You have a son who is in high school.

Ms. MCKENNA. Yes.

Senator BRADLEY. As you think about your son's future and the prospect for college, how will you pay for that?

Ms. MCKENNA. I am very scared. I try not to think about it right now because I have one in there that I am trying to get through. And putting money aside to save for my second one's education would interfere with paying for my first one's education. Then I have a third one that is right behind him. So we are living from paycheck-to-paycheck and we are going from day-to-day. We are hoping just that the economy will get better as we go along.

Senator BRADLEY. You refer to yourself sometimes as the middle class poor.

Ms. MCKENNA. Yes.

Senator BRADLEY. What do you mean by that?

Ms. MCKENNA. Lower class poor, middle class poor. I feel that the middle class people should be given the money and they will make the economy rise. They will put the people to work. The middle class people will work. Like this lady said, they will hire the electricians, they will hire the plumbers, they will put the money back into the State and back into the towns and your economy will rise.

You know, as a middle class woman I constantly get my shoes repaired. If we had more money I would buy new shoes. I wouldn't constantly get them repaired. I would put the money into buying new shoes.

Senator BRADLEY. Ms. Yancey?

Ms. YANCEY. I guess I would have to say day care. It is something that sometimes I do not even see added into the figures of everyday living. But we pay right now about $200 a week for day care for two children, which adds up very, very quickly. I do not know how we could decrease the costs and maintain quality, but it is obviously one of our biggest expenses.

Senator BRADLEY. As all of you contemplate what kind of relief might come from the Government, if you had to choose between a capital gains cut and some form of credit similar to Senator Bentsen's, or the one I have offered, or Senator Moynihan's proposal, say the $350 credit per child, meaning you pay $350 less in tax for every child that you have. Three children, $1,000 less in tax. Versus a capital gains cut, which one speaks to you as a middle class family person?

Ms. MCKENNA. I do not think it is the capital gains. Because a person in my position, we do not have anything to make any profit on. Everything is just—you know, like I said we live from day-today. The $350 tax cut for each child and your proposal for the $33,000 for college sounds excellent. It gives you hope that my 13 year old will have an opportunity to go to college.

Senator BRADLEY. Ms. Cusella?

Ms. CUSELLA. Well, somehow or other these proposals that are supposed to start from the top and trickle down somehow to help the middle class never seem to get to the middle class. I think that you have to start creating jobs for the middle class, stimulate the economy for the middle class.

And I think that Senator Bentsen's proposal for using this IRA money for first time home buyers does that. It certainly would help me and help my community and put many people to work. And if I can employ at least 10 people building my house, if you multiply that times a million, I think that is going to help the economy a lot more than a capital gains tax relief.

Senator BRADLEY. Ms. Yancey?

Ms. YANCEY. I do not support, I have never supported a cut in the capital gains tax. There was an article in the Post just a few days ago that pointed out people like myself who may need that once in a life time or twice would simply roll that over into another home. We would not be the beneficiaries.

However, a tax credit for children would affect me directly. It would affect my family directly. It would be something that we would have to help us that would be tangible. We could see it and obviously that is what I support.

Senator BRADLEY. Thank you all very much.

Senator Rockefeller?

Senator ROCKEFELLER. Thank you, Mr. Chairman.

Your testimony is what we need to hear in this place because it is real and because it is spoken with great dignity and firmness and yet you are all hurting in various ways. I agree with you so strongly in the capital gains. Sometimes I am just filled with awe that the American people can abide and this will be political because this is what I intend it to be. I speak it with some anger.

Abide a whole administration for the last 10 years which has based all of its income policies and its economic policies on something called a capital gains cut which affects nobody at the witness table or most people out there in this country. I find it absolutely staggering that this kind of thing can be carried on for 10 years, now eleven years. And we let it happen.

In any event, I want to press one point. Mr. Cohen, Ms. McKenna spoke about, she said specifically, the middle class people should get the money.

Interestingly, most of you have spoken directly to Senator Bentsen's proposal. You spoke it more I think to the IRA. You spoke to the children's part. You did not speak to it, Mr. Cohen.

The only problem I have really with Senator Bentsen's proposal is it is something called nonrefundable. That means that you only get advantage for let's say the child care part of it if you pay taxes, which brings up an interesting point.

Mr. Cohen, I do not think you are going to be paying taxes next April. Ms. McKenna, you and your husband may well be paying taxes. I do not understand that there is any morale or effort difference, work ethic, attitude about family, attitude about children, between you and Mr. Cohen.

Ms. MCKENNA. Absolutely not.

Senator ROCKEFELLER. You will be taxes.

Ms. MCKENNA. Right.

Senator ROCKEFELLER. You will get a tax credit if you have children; Mr. Cohen will not because he will not be paying taxes.

You went through a litany, Mr. Cohen, of effort, of savage, desperate, all out anything effort to preserve your family and to give not you, to get benefits not for yourself, but to be able to take care of your wife and your children; and yet you come up short.

When you say you have not seen supermarkets in the want ads for the last 6 months, it is a stunning statement. What is happening is that minimum wage is eating up the country, the same minimum wage which we had to practically embarrass the administration into accepting, and to increase it a little bit.

Now is it fair, in fact, to say that only those people who pay taxes can get the benefit? That somehow those who do not pay taxes cannot get the benefit of a child credit because they are working at minimum wage jobs and do not happen to be paying taxes.

I mean many of the people who are not paying taxes in this country, a great many of them, there's a full-time worker in the household who is working at minimum wage; there is a part-time worker and a full-time worker in the household, but at minimum wage. They do not pay taxes.

Is it fair then to say that because somebody does not pay taxes, but that they are working or that they are trying to work and that they cannot stand not being "in the middle class" that that is fair? I am interested in your views.

Ms. McKENNA. No, I do not think that is fair. I think if you are working, whether you make minimum wage or middle class wage, that you should be entitled to the same tax benefits. You are paying to the same place.

Senator ROCKEFELLER. Ms. Cusella?

Ms. CUSELLA. Yes, I feel that way also.

Senator ROCKEFELLER. And why?

Ms. CUSELLA. Well, for one thing I think that there has been so much inequality in paying taxes and I think that there should start being some equality. I think that all of the middle class should have the same tax breaks so that they can all get the same benefits.

Senator ROCKEFELLER. Ms. Yancey?

Ms. YANCEY. Senator, I have an optimistic attitude towards these incentives increasing or helping to lift this recession we are in and that hardworking people are going to, through this legislation, eventually be able to find jobs.

I do not believe in abuses. I do not like the idea of people who have no incentive to find work still collecting this while hardworking people should be the beneficiaries, not people who choose not to work or aren't inclined or not motivated to work.

Senator ROCKEFELLER. It is a hard line to draw, isn't it?

Ms. YANCEY. Indeed.

Senator ROCKEFELLER. I mean, Mr. Cohen, and I did not hear all of his testimony perfectly and I have not had a chance to question him, but Mr. Cohen could very well be at this very moment without work. I mean he has been trying to stock shelves, he has been trying to do everything. And as he says, all he sees around him are kids being paid minimum wage. So that if he is trying but is not able to have work, somehow does there not have to be a value that honors his effort?

Mr. Cohen, please? Then I will stop.

Mr. COHEN. I should hope there is an honor for me trying to get work and out of respect for something to sustain my family as I had mentioned several times. It is just that there is a whole new world out there of so many other employed younger people that somebody who has unfortunately through no fault of his own got tossed away in economics and lost his job, cannot get back to where he was before 10 years ago, 15 years ago.

Senator RIEGLE. Would you yield at that point?

Senator BRADLEY. Senator Riegle, you are next.

Senator RIEGLE. Well, let me just say, I mean, the country cared about you then when they wanted your services, didn't they?

Mr. COHEN. Right.

Senator RIEGLE. And now they do not care about you. I mean isn't that basically the bottom line? I mean the country right now in terms of your situation sort of turned its back.

Mr. COHEN. Yes, I think so.

Senator RIEGLE. But whenever it was you served in the Armed Services, then obviously the country had a different view about your value. It seems to me you are just as valuable to the country today as you were when you put a uniform on.

Mr. COHEN. I think I am more valuable.

Senator RIEGLE. And we ought to respond.

I want to cover two things in the time I have. They are both a little different than what you have said so far and you have given very powerful, personal testimonies and I thank you for that.

There are some people that think the recession is over, that they do not think there is much hardship out there. I want you for a moment, just in a brief comment, to tell me not just from your own personal situation, but from what you see where you live, you know, out in your communities, people you know, your own gut feel as citizens how serious is this economic problem that is out there? None of you are old enough to have lived through the 1930's.

But the sense I have is that we have a very serious economic problem on our hands right today. Now obviously Mr. Cohen's case illustrates it in a very dramatic fashion.

Ms. McKenna, what is your view? I mean how serious are economic problems insofar as you can tell?

Ms. MCKENNA. They are serious. I will make reference with my children, how children try to keep up with other children. He has a pair of designer jeans; I want a pair of designer jeans. Well those kids that got the designer jeans first do not have them anymore.

Senator RIEGLE. So there is sort of a backwards slide going on?

Ms. MCKENNA. Right. It is just everything is going backward. We are all becoming equal.

Senator RIEGLE. All equal at a lower level?

Ms. MCKENNA. Right, going down.

Senator RIEGLE. Ms. Cusella, what do you see?

Ms. CUSELLA. I come from Lorain County. There is a big Ford motor facility there and U.S.S. Kobay, two of the major industries in this country, and they are both hurting very badly which we never thought would happen in a community like ours. And it is not getting any better.

And until we put people to work it is not going to get any better because who can afford a car today.

Senator RIEGLE. Exactly.

Ms. Yancey, how do things feel to you from your vantage point?

Ms. YANCEY. Well, just yesterday I turned on the car radio and heard that in this area three major companies have initiated drastic layoffs of thousands of people. This is becoming common place. I do not hear too much of people hiring in mass droves, but they are being laid off. So, yes, it is——

Senator RIEGLE. Let me jump. I am very conscious of the time and I want to get back to Mr. Cohen in a minute.

Mr. COHEN. Yes, sir.

Senator RIEGLE. When you look around the world, Japan today has a plan for their country and they are doing very well. Their people are doing well. They have health care. They have lots of jobs, lots of income.

Europe has a plan. America does not really have a plan that responds to the kinds of problems that you have described individually or the broader picture of how everybody in the country today or a vast number are in this terrible squeeze.

I am convinced we need a plan. I mean we need a plan where business and government and labor put America at the top of the list in order to see to it that people have an opportunity to live decently and to achieve their potential. That your son can go to college. We need that boy in school. We need you into a job. You ought to have a home that you can buy and accumulate some savings and have a home of your own. And you ought to have a situation where you are not worrying day and night about the day care money because you are trying to work, you and your husband, two jobs just to get ahead.

This country has an obligation to respond to the needs of its people. The problem is our government today is out of touch with that. It is off here on some lofty plain, sort of an elitist plain that is disconnected from the realities of the four of you or tens of millions of other people.

Now I want to make one other point. In the last 11 years in our trade deficit—now think about this—Japan has taken out of this country $460 billion. That is a half a trillion dollars going one way from America to Japan. If that money were still in this country all of you would be better than you are doing today. Over that same period of time $47 billion has gone to Korea. They have taken it out of this society. Taiwan has taken $118 billion since 1980. And now Communist China, which has a huge trade surplus with us, has taken out $31 billion.

Two-thirds of a trillion dollars over the last decade has gone from this country, from the base of wealth of this country, out of our country to these other nations. A lot of it due to trade cheating, quite frankly, because we do not have the same opportunities in their markets that they have here.

Part of the impoverishment that each of you are describing is because this country is not looking after its own economic interests or the well-being or the future of its own people. We are squandering our economic future. We are giving it away. And it so bothers me today that all the emphasis—we spend so much time helping other countries develop plans for their future and what kind of future do the four of you have?

I mean the fact that you should be so desperate, that you cannot find work in this country, as a man in your early fifties with the experience you have, is an absolute outrage. This country cannot function that way. We cannot have that situation go on. It is immoral and it is a danger to this country and it has to be changed.

Thank you very much.

Mr. COHEN. Thank you.

Senator BRADLEY. Senator Daschle?

Senator DASCHLE. I would applaud Senator Riegle for his comments. I thought they were very heart-felt. I know that he is responding to the very heart-felt testimony that each of you gave.

It is fascinating to me to see people who come from all different walks of life, who clearly are part of our middle class, the backbone of our whole society, come and speak with such simple eloquence, such a clear message. I mean, I do not know that we have had any more profound testimony than what we have just heard from the four of you; and I thank you for that.

Ms. McKenna, you said something right at the beginning that impressed me. You said, "You know, all I want is the confidence that something is going to be done." So often, I hear the words "when everything is said and done there is always a lot more said than done in this place." I am concerned about that because that is really what has caused so much of the frustration. We talk and we talk and we talk and we talk, but so little gets done.

I think that we began making some progress in December. We passed an unemployment compensation extension, which I think helped a little bit.

Mr. COHEN. Yes, sir.

Senator DASCHLE. But it was so limited. We passed a highway bill that will provide $151 billion. That, too, will help for the next 5 years. But that, too, is just a little bit. So we have so much more work to do.

I thought Senator Riegle hit it on the head when he talked about this comprehensive look that we have to take. But as we look at the next pieces—taxes—I am trying to get a better understanding of whether or not the credit would be viewed by you as much help.

We have had witnesses testify before you who have said, "What is $300 a child. That is nothing." Others have said, $300 a child will pay for the kid's clothes, will take me down the road a couple of weeks with regard to groceries." If you take $300 per child in your family situation—and I agree with Senator Rockefeller that it has to be refundable—give me some indication of the magnitude of assistance that would be for you.

Is that viewed as a trivial sum? Is it viewed as a substantial sum? Could you tell me how you would view that?

I think here in Congress, as Senator Riegle indicated, we sometimes seem oblivious to dollars. We are dealing with trillions of dollars so often. So you talk $300, and somebody looks at you with indignation. We do not have time to think of $300. But tell us what $300 per child would mean to you.

Go ahead, Mr. Cohen.

Mr. COHEN. Sir, it would be a good start, a little bit, but it definitely would not hurt. But we need besides money refunded, we need work, jobs, create and build things back here in U.S.A. That is where our problem is. It has been going on for almost 20 years now.

Senator DASCHLE. So a little bit, like unemployment, would take you down the road a little bit farther.

Mr. COHEN. A little bit more. Just a little bit.

Senator DASCHLE. But the permanent solution is good economic growth and some darn good jobs.

Mr. COHEN. Yes.

Senator DASCHLE. I hear you.

Ms. Yancey?

Ms. YANCEY. Well, for a family of four it would be $600 and that is significant. We would probably even break even and no owe tax for a change.

Senator DASCHLE. If you knew you would receive $600 that you did not have yesterday, could you give me some indication of what you would spend it on?

Ms. YANCEY. Senator, we live paycheck-to-paycheck. So $600 is an enormous amount. If we are 1 day late putting our check into the bank, we could bounce checks. An extra $600 for starters would just keep us from going in the hole in our checking account.

Senator DASCHLE. Thank you.

Ms. CUSELLA. That would not affect me because I do not have children. But I must tell you that because I am single and I do not own a home, I have no deductions. So I am paying quite a substantial amount to the government in taxes and I need some kind of a tax break myself.

That is why I think Senator Bentsen's plan helps everybody.

Senator DASCHLE. Okay.

Ms. MCKENNA. I feel the $300 is a start. That are under the age of 19, I have two children, so that would be $600 for me. That would help towards my oldest son's tuition for the following year. Yes, it would help. That would be $600 less we would have to worry about.

Senator DASCHLE. Mr. Chairman, I have no further questions. Thank you each.

Senator BRADLEY. Senator Hatch?

Senator HATCH. Thank you, Mr. Chairman.

I want to compliment each of you for being here today and giving us the benefit of your testimony.

Ms. McKenna, I understand your problem as a former building tradesman myself. I worked in the building and construction trades union for 10 years and I worked along side of an awful lot of electricians like your husband. Because I was a metal lather and we would work with them in putting in all of the ceilings, partitions, even floors in the construction area. And I understand the difficulties of recessions and the layoffs that come and the lack of money. You are not like on a salary.

Ms. MCKENNA. No, we are not.

Senator HATCH. If you get laid off, your monies are gone. I mean you are just broke.

Ms. MCKENNA. Yes.

Senator HATCH. And the only thing you have is——

Ms. MCKENNA. You could be laid off from 1 week to 1 month. You never know.

Senator HATCH. You bet. Well, I commensurate with you. I also as a Senator with three children in college I understand the problems with trying to get your kids through college; and certainly for middle class people who are having enough trouble just getting by.

Ms. Cusella, I am the co-sponsor of Senator Bentsen's bill and I agree with you. I think you ought to be able to have IRA's, invest in IRA's and use that money for first home purchases. I personally believe the President agrees with you and others as well; and I commend you for your testimony.

Ms. Yancey, I empathize with you. I was the prime co-sponsor of the child care bill that passed in the last Congress. As important as that was, that was a break through because it was the first time we laid out a formal child care approach in this country. As important as it was, we still do not have enough money in that bill or in the appropriations process to do what really needs to be done for single heads of household.

Two-thirds of all women who work today are either single heads of household or married to husbands who earn less than $20,000 a year. So they have to work and they are just frantic about what they do for their children. So I understand those needs very much.

And, Mr. Cohen, I can surely understand your plight. It is a difficult one.

Mr. COHEN. Thank you.

Senator HATCH. I would just have to say this, one of the problems we have here is trying to make the best determinations we can to get the economy moving again so that we can create jobs and in the end permanent jobs are what really create wealth and create opportunities.

You hit the nail right on the head, Mr. Cohen, when you said, yes, $300 a child would be very helpful to me at this time, but I would rather have a job.

Mr. COHEN. Yes, sir.

Senator HATCH. I would rather have a permanent job. I would rather go to work. Because I know I can earn more money that way and that would be more important to me than temporary relief that would come through a $300 tax credit or exemption.

Now I think that is important, too. One of the reasons the administration, and many Democrats and Republicans feel strongly about a whole raft of tax proposals, including capital gains, is it was predicted when the Jenkins-Archer capital gains rate reduction to 19.6 percent was proposed many economists estimated that would create almost immediately somewhere around a half million jobs and then another 700,000 or 800,000 jobs within a year or so thereafter.

The reason is is because people when they have capital gains tend to roll their monies into investments and creation of jobs and businesses and so forth. So do not discount capital gains rate reductions. Plus middle class people, you buy homes and you pay a relatively low amount at the time you buy compared to what it will increase to be. A lot of the increase comes from inflation that really is robbing you all those years anyway.

If you do not have a capital gains tax cut when you sell your home or have to sell your home you lose all that money because of the inflation that robbed you during all of those years, caused by bad economic policy, caused by people who are just trying to throw money at the middle class and people who are earning less than the middle class, instead of trying to have economic policy that will give stability, jobs, hopefully increases in living standards, and ultimately help the country as a whole.

So your testimony is important. It is profound and it has touched my heart. But keep in mind our job here on this Finance Committee is not just to play politics. We have got to come up with an approach, hopefully in conjunction with the President and with both parties in a bipartisan way to resolve these matters and no one particular thing is going to solve every problem.

But each of the things you have chatted about have been helpful to us here today and I would feel badly if I did not at least say that to you. So thank you for being here. We appreciate having you here and keep an open mind on some of these other tax approaches that may help even more than what seems to be a gift right now.

Senator Moynihan's approach, really the biggest tax system in the middle class have been Social Security increases that in many respects are unjustified. That is what he is saying. If we could put some reason under that system, we would immediate get money into your hands, while at the same time we would cause your income to rise, while at the same time be fair to everybody in the process.

So he is making a very important point that is tough to get across because everybody thinks you mention Social Security and something is wrong. You know, it is going to be a misuse. Well, it will not be.

Thank you. I appreciate you being here. I appreciate your testimony.

Senator BRADLEY. Senator Boren?

Senator BOREN. Thank you very much, Mr. Chairman.

I want to join with others in thanking all of you for your testimony today. Because I think that it is sometimes easy to think statistically, we forget we are talking about people with real problems.

In my State, we have been for 6 or 7 years in the kind of situation that is now sweeping the rest of the country. And even with the hard times that we have been through since 1983 and 1984, I think this year people are even more devastated. They are just really beginning to give up hope.

In the small town where I live back in Oklahoma, a town of about 8,000, on a very recent cold day when we had an early ice storm, I found people out on three different corners in that small town, with signs: "I'll work for food for my family." Two of them had their children in the car, and I talked with each one of them.

These were people who had a real story to tell. They were in desperate circumstances. Their benefits had run out at that time. It was before we had the extended unemployment benefits that would cover a State like mine. So I understand the real problems that we are dealing with.

I think your testimony already has made us more sensitive to several points. One: the concern that everyone has that if they finally fall through the safety net, particularly as it involves health care for their families, whether or not they will still be protected. I think that is something that certainly this committee must work on in the future in terms of making sure that that protection is always there, that people are not going to fall through the cracks, that their families are not going to be unprotected in terms of health care coverage.

Listening to the appeals for work reinforces my own belief that we not only need to look at tax policy as a way of helping right now. We have a tremendous backlog of unmet needs in our infrastructure in this country. We all know that our roads are falling apart. We need bridges. We need water systems repaired. We have all sorts of things that need to be done.

Well, in this time of unemployment, we must put people to work and make the investments in infrastructure that need to be made. I would like to see us do that, using both private contracting and bringing something back along the lines that we had with the WPA, which offered people an opportunity to work. I think it is time we realize we do not make people feel good about themselves unless we give them work, except on a temporary basis, by sending them a check.

People want to work. They want to feel they are contributing to their communities. I think that is something we need to do not only to jumpstart the economy, but to make all people a part of our society again. I would like to see us get back to an approach like that which worked under earlier times of hardship for our country. In fact, I am working right now on a new sort of WPA.

So I think we need both. I think we need government contracts out there to the private sector to rebuild this country. We need it anyway to make us more competitive in the world. Then I think we need to look at it in terms of reforming the system as well.

I would just like to ask this question. Perhaps it would be most appropriate directly to Ms. McKenna. I serve on a University Board of Trustees, and I find that if you are very, very poor, your children can pretty well get a free college education or come close to it.

Ms. McKENNA. Yes.

Senator BOREN. If you are very wealthy, you do not have to worry about it; you can afford to send them.

Ms. McKENNA. If you are middle class, you are out of luck.

Senator BOREN. You are out of luck in the middle class. And especially at some of the leading institutions of this country, which are the most expensive, just forget it if you are a middle-income person. You cannot afford to send your children.

I even went out and tried to get some families to help one middle-income child. I found that when other people contributed, that money counted that as a resource and he lost what little scholarship that he had. So it is almost impossible to even help middle-income people.

Now Senator Bradley, I, and others have worked on various ideas of how to do help the middle income. Have you had to take out an education loan yet, or do you anticipate you will have to take out loans, in order to educate your children?

Ms. McKENNA. Yes, we have had to take out a loan.

Senator BOREN. And most middle-income people have less than $60,000 net worth, and it is nearly always in their home equities.

Ms. McKENNA. You are right.

Senator BOREN. If you have two or three children, the only way you can educate them is to sell your home to educate your children.

Ms. McKENNA. All you keep doing is going back to your equity every time tuition is due.

Senator BOREN. Exactly.

And finally there is no home equity left. In the 1986 act I think we mistakenly did away with the deductibility of interest payments on student loans, especially in those first few years when you are paying mainly interest.

How much help would it be if we could make interest payments on your education loan deductible? Let's say you are paying $300, $400, $500 a month for interest on your loans. If you could take that and deduct that from your taxes, would that be a big help in terms of allowing——

Ms. MCKENNA. It would be a help, yes.

Senator BOREN. Because I think in many cases it could be as much as $2,000 to $3,000 a year in terms of reducing your taxes, which is money back in your pockets.

After listening to all of you, I suppose the other important thing, at least those that are still working, would be the deductibility of Social Security payments. That would be an offset even for you, Ms. Cusella, even though you do not have children, that would still help you as well.

Well, I appreciate again the testimony that you have given to us, and you have sensitized us all to some priorities that we really need to be looking at. I hope we can find ways to put people back to work, and I hope we can help families meet these responsibilities, like the responsibility, to educate their children, because that is an opportunity for the next generation as well.

Thank you very much.

Senator BRADLEY. Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

I think that frankly Senator Riegle pretty much hit the nail on the head when he said this country needs a plan. We need some kind of organization, some way to address our economic ills.

The question I am going to get at to each of you is the degree to which you personally are willing to give up something in order to get something.

What I am getting at is this: I think it is quite clear that our country is quite a bit different from all other industrial countries in that each of us as Americans is allowed a little more personal freedom than our individuals in other countries.

Japan is doing well, but the Japanese citizen has less individual freedom than does the average American. The average Japanese business has less freedom in a certain sense than does an American business person. That is true, I think, with almost all industrial countries. That is, Englishmen, the Frenchmen, the German have a little less freedom, individual freedom, compared with individual Americans.

Our country was founded on the principal of individual freedoms, free enterprise and lasse faire and individualism. Certainly our founding fathers left Europe over 200 years ago to escape tyranny. We set up our individual colonies and our own form of government, a Bill of Rights, shared powers in our Constitution. Our founding fathers distrusted power, distrusted government and spread out power.

Go west young man. You know, go west. Individualism. The automobile in America gave Americans a sense of freedom. Go to the moon, new frontiers, et cetera.

The question I am really asking you and will get to more specifically in a minute is really the degree to which you think it is proper now at America's point in history or for you individually as individuals, we are groping with economic problems, that it is proper to maybe give up a little "freedom" in order to get a little more economic security.

Now tax breaks help. That is only a very small part of the problem we face in America. We need to address, as someone said earlier, infrastructure—roads and bridges and highways. We need to address the problems that have been caused by deregulation of lots of industries and with S&L scandals certainly an example. There is a long, long list.

Our problem really is a cultural problem. It is a problem we are facing as Americans at this point in our history.

Let me focus on just one element of it and that is health care and health care costs. As you know, we Americans spend more on health care than does any other country. What are we getting for it? Not a lot compared with what we are paying.

A lot of people do not have health insurance. A lot of people who have some kind of health insurance do not have very good health insurance. It does not really cover what it should. The premiums are often high. American business is also paying high premiums and what do they get for it. It is a problem.

So let me be a little more specific here. Focusing now on only one small part of the problem, that is health care costs, I am wondering how much you are willing to give up in choice and individual freedom in order to have better health care and not have to pay as much for health care, to be more assured that you are going to have adequate health care.

More specifically, in the Canadian system, in Canada if a person is sick and needs emergency health care that person gets it. You go to the hospital, you go to the doctor, no questions asked, no forms to fill out. I mean you are taken care of. That is it.

Now on the other hand there are certain limits. The limits are for nonessential health care. Let's say a senior citizen is looking for a hip replacement. That senior citizen would have to stand in line maybe 4, 5, 6, up to 8 months in order to get a hip replacement. Or say a coronary bypass which is not essential at the moment, at the time, sometimes coronary bypasses take time to be performed.

I come from the State of Montana. We have 800,000 people in the State of Montana. We have nine MRI's. You know, that is fancy, diagnostic equipment. I was in Alberta just a couple of weeks ago and they have only two in the whole Providence of Alberta. Which is to say that if you are looking for the most sophisticated diagnostic services, in Canada you sometimes have to wait or you have to travel, go to great distances.

So again the question, are you willing to stand in line for some nonessential health care service, suffer the inconvenience of driving a greater distance, say, to get the fanciest testing in order to be assured that if you are ill, if you need emergency care you are going to get it. You do not have to worry about whether your health insurance policy covers you or not because it will.

You do not have to worry about changing jobs and having your health insurance policy be with you or not, because you will have it. I guess the basic question in this, are you willing to give up something in order to gain a little more economic security? In this case we are talking about health security.

My time is up. Just very, very briefly, Mr. Chairman, if I could, starting with you, Ms. McKenna.

Ms. McKENNA. That is something I would really have to think about, if I would be willing to give up my choices. I would really have to think. I cannot give you an answer on that right now.

Senator BAUCUS. Okay.

Next, Ms. Cusella.

Ms. CUSELLA. I am not so sure that with the facilities that we have in this country that we would have to give up all that much. I know in the Cleveland area we have several major medical facilities there and I am sure everyone of those major medical facilities has an MRI.

So if you took two of them out we would still have one. I do not know about other areas. But I think there is so much in this country that we could spread it around a little more fairly and it still would not be that difficult for the majority of people.

Senator BAUCUS. Thank you.

Ms. Yancey?

Ms. YANCEY. I would probably be willing to give up some for a long-range solution to the health care problem. It may become inevitable. If health care continues to become a problem and more and more of our GNP is spent on health care, it may become inevitable. But I am former military and I am used to standing in long lines. So I think I would probably be willing to give up some.

Senator BAUCUS. Okay.

Mr. Cohen?

Mr. COHEN. As an old union person we used to fight on union contracts not to give away something for our next contract and the next contract. I have learned over the years with that situation that you should never give up something that you fought hard for.

But when coming with health, we have so much good health facilities in the United States that if we cut back like the young lady down over on the end said, we will not be that inconvenienced and definitely I am priority to have better health care because when you do not have any health care the improvement would be a great deal to give up a little bit.

Senator BAUCUS. Thank you very much.

Mr. COHEN. You are welcome.

Senator BRADLEY. Well, let me thank the entire panel for taking the time to be here today. I think that you have added immeasurably to the committee's deliberations and I think you have given us some very vivid demonstrations of the need out there in the country, whether it is talking about educational opportunity or health care costs or the problems of the sandwiched generation or the 200 family or whatever.

I really do appreciate you making this come to life before the committee today.

Mr. COHEN. Thank you.

Ms. McKENNA. Thank you.

Ms. YANCEY. Thank you.

Ms. CUSELLA. Thank you.

Senator BRADLEY. Our next panel consists of Kevin Phillips of the American Political Research Corp.; Gary Burtless of the Brookings Institution; and Andrew Kohut of the Times-Mirror Center for the People and the Press. From Bethesda, Washington, and Washington.

Gentlemen, welcome to the Subcommittee. Let's begin from left to right, Mr. Kohut, then Mr. Burtless, and then Mr. Phillips.

STATEMENT OF ANDREW KOHUT, DIRECTOR OF SURVEYS, TIMES-MIRROR CENTER FOR THE PEOPLE AND THE PRESS, WASHINGTON, DC

Mr. KOHUT. I am happy to be here, Senator.

Senator BRADLEY. If you could, try to limit your comments to 5 minutes.

Mr. KOHUT. I will do my best.

I am going to try to describe the financial conditions of Americans, the so-called middle class crunch as it is revealed through the opinion surveys of the Times-Mirror Center for the People and the Press.

In 1987 the Times-Mirror Company set up a program to monitor basic political values and attitudes on social, economic, and political issues. Over the past 4 years we have conducted periodic surveys and we have found a consistency of change in two areas as we look at the American public.

First, we found a steady increase in the level of financial pressure experienced by the average American citizen. And secondly, and relatedly, obviously, a rising tide of disenchantment with the political and economic system.

My remarks today will concentrate on the economic and financial pressures that Americans face as revealed in our surveys, but it is hard to discuss them fully without touching upon their consequences on the trust and confidence that Americans have in the political and economic system.

Today the American public describes its economic condition quite differently than it did in 1987 when we started our polling. Although the stock market crashed only a few months ago, most people of 48 to 20 percent plurality said they were better off not worse off than they had been 4 years ago. Sixty-3 percent of Americans in 1987 said that they rated their financial situation pretty well. They said they were basically satisfied. But 43 percent said they often did not have enough money to make ends meet.

This is not to say that the public in 1987 or throughout the late 1980's was unaffected by the stock market crash or any of the major economic problems that seemed to be besetting the nation. Indeed, throughout the late 1980's the public consistently rated their own financial situation and their own financial prospects far better than they rated the country's. In light of the attitudes people expressed about the seriousness of the S&L crisis or the budget deficit or our trade problems, we described the public's undaunted financial optimism, personal financial optimism as a don't worry, be happy attitude.

Well, that was then and this is now. Today people are both unhappy and worried. In each of the annual surveys that we have conducted of the American population we have found somewhat more evidence of financial pressure. The percentage of people saying that they are satisfied with their finances fell from 63 percent in 1987 to 58 percent in 1990; and then to 56 percent in our most recent survey.

The percentage of people saying they often do not have enough money to make ends meet rose from 43 percent in 1987 to 47 percent in 1990 and now to 51 percent in a survey that we only completed last month.

In response to the frequently posed bottom line question we found more people in the current survey saying that compared to 4 years ago that were soft financially than say they are better off. In turn, the percentage of people who say they are basically satisfied with the way things are going in this country has sunk to a 6-year low. We find 34 percent of the public saying they are satisfied with the way things are going in this country.

This fundamental indicator of public trust has not been this low since pre-Reagan economic recovery days. Clearly people in all demographic groups are affected by worsening economic conditions, but people in middle and lower financial groups are far more affected than upper income people. Between 1987 and 1990 the percentage of people in the top economic quintile who say they do not have enough money to make ends meet is really no different.

But when we compare the answers of middle and lower income people the percentages were 49 percent in 1987 say they did not have enough money to make ends meet frequently, compared to 59 percent in 1991. Other questions of that series showed the same pattern.

I might add that the term "middle-income crunch" is a bit of a misnomer. People in the lowest income categories are being crunched to a far greater degree than people in middle-income categories while 53 percent of people earning $15,000 to $50,000 say they do not often have enough money to make ends meet, 77 percent of people who earn less say that.

Our trend analysis also shows that although blacks continue to rate their own financial situation far worse than whites, the financial position of whites, the financial pretense of white has grown far less, whites have become much more pessimistic than blacks in relative terms over this 4-year period.

These differences notwithstanding the vast majority of Americans in all income groups and all racial groups focus on economic and financial issues when we ask the public to cite their most important problems facing their own lives. The basic problems of making ends meet, the condition of the economy, jobs, unemployment, health care and taxes are the problems people tell us are the most important ones that they face when they think about the problems that are most troubling.

When the question is asked in terms of the priorities for the President, the public answers in the same tone. The public says the President's top priority should be reducing unemployment, improving the quality of education, improving health care and reforming the U.S. banking and financial industry.

As you might imagine, the fear of unemployment is much larger than the percentage of people who are actually unemployed. We find 5 percent in our last survey saying that someone in the household is unemployed. But 27 percent say there is a high chance that someone in their household over the course of the next year might become unemployed. That is essentially a third of all the people that we talked to, say either someone is unemployed or there is a good chance it might happen to them in the next year.

Even though unemployment is a very big problem on the majority, 52 percent say they worry more about rising prices than they worry about the chances of unemployment.

Health care is the price that the public worries most about. The number two consumer cost is higher education; and number three is housing. Obviously there are big generational differences with young people worrying about housing and older people worrying about education and housing; and middle aged people worrying about all three.

Not too surprisingly, in light of these concerns and trends our survey found the public voicing a strong desire that the government take a more activist role in dealing with the problems they face. A lopsided 61 percent majority favor using the peace dividend for spending on major domestic problems, such as health, education and the environment, rather than using it to reduce the deficit or for a tax cut.

As the level of financial pressure in America is——

Senator BRADLEY. Mr. Kohut, would you please summarize?

Mr. KOHUT. I want to say one more paragraph and then I will be finished.

As the level of financial pressure in Americans is increased feelings of futility and disenchantment with the system have grown. The percentage of people who think that the government is run for the benefit of the people has decreased steadily. And dramatically the percentage of Americans who agree that hard work offers little guarantee of success has risen from 29 percent in 1987 to 36 percent in 1990, and to 44 percent in 1991. A real measure of feelings of futility.

Thank you.

Senator BRADLEY. Thank you very much, Mr. Kohut. I am sorry to try to cut you off but we have a long list and we do want to try to give everyone a chance to ask questions as well.

[The prepared statement of Mr. Kohut appears in the appendix.]

Senator BRADLEY. Mr. Burtless.

STATEMENT OF GARY BURTLESS, SENIOR FELLOW, ECONOMIC STUDIES, BROOKINGS INSTITUTION, WASHINGTON, DC

Mr. BURTLESS. Thank you.

Let me mention a couple of the main points which are developed at some length in my formal statement.

The Congress is now considering changes in tax policy to deal with the recession. In framing new policies I think we should bear a couple of things in mind. The current pessimism about the state of the economy derives from two distinctive sources.

The first is that the country is obviously suffering in a recession, a recession that has been much more stubborn than anyone predicted a year ago.

Second, most workers, and a growing number of journalists and policymakers, have begun to notice that middle-income paychecks are not growing all that fast. In fact, for a sizable percentage of the work force paychecks have not grown much for nearly 20 years. An important minority of the work force has actually seen its paycheck shrink.

Now it would be foolish to change tax policy to address one of these two problems if the long term effect of the reform is to make the second set of problems even worse. In particular, I do not like the idea of offering across-the-board tax relief to the middle class or to any other class if one of the main consequences is to swell the flow of red ink emanating from the Treasury.

Bigger government deficits represent a serious and unnecessary claim on the nation's pool of private saving. Private saving is already low. The net saving left over after the Treasury has borrowed from the private sector is even lower. Low national saving can hold down future wage and income gains available to all workers, including workers in the middle class.

Let's try to find a policy that addresses both the short run problem, the recession, as well as the long term problem, which is the stagnation of pre-tax wages and incomes in middle class and poor families.

Enough unsolicited policy advice. Let me talk about a couple of recent income and wage developments. Much of the gloom over the current economy is tied to the perception that the middle class is shrinking and that its living standards are sinking. In the old days most American families could expect their incomes to grow from 1 year to the next, certainly over a 2- or 3-year period.

For example, in the 1950's median family income adjusted for inflation grew a third, and it grew a third in the next decade. Our experience since the early 1970's has not been nearly that good. Income growth fell off dramatically. In fact, it fell off 90 percent for the median family.

Unfortunately, too, the income gains since 1973 have been much more unequal. I have statistics in my testimony, but I am sure Senator Moynihan showed you similar ones. The people at the bottom have not done very well.

Before 1973 income growth was high for families everywhere in the U.S. income distribution. In those days a swiftly rising tide raised all ships. Since 1973 income growth has slumped everywhere, but mostly at the bottom and in the middle. In fact, after adjusting for inflation families at the twentieth income percentile are no better off today than they were in 1973.

When I divide up the recent past into two periods (in Figure 2), one before 1979 and one after 1979, we can see that families in the bottom quarter of the distribution have seen their incomes shrink since 1979. Households in the top fifth of the distribution have actually seen their income growth improve. So that figure tells a simple and I think frightening story about the past decade. A slowly rising tide lifted the yachts, but not the outboards or the rowboats.

Income growth slowed down for one main reason and that is productivity growth slumped. This dramatically slowed hourly wage growth. And, contrary to a frequent claim of supply side enthusiasts, productivity growth did not accelerate after 1980 except in manufacturing. Over all sectors of the economy, including both the service and the manufacturing sectors, productivity growth remains about as poor in the past few years as it was during the malaise of the 1970's.

In terms of employment, the U.S. economy prospered in the 1980's until the beginning of this recession. In terms of the standard of living it offered to middle-income workers, I am afraid that the economy remained stuck in neutral. But the question is: Why did inequality grow so much? Did that arise because of the slow growth in median incomes?

I will mention just three reasons. First, the growth in the number of single parent families. This tends to increase the number of families with relatively low income. Second, growing disparity of wages, especially amongst men. Men with good educational backgrounds and skills have continued to enjoy earnings gains. People at the middle and the bottom of the skill distribution have seen their wage earnings slump.

Because skilled workers remain relatively scare, their wages have been bid up, and that tends to drive up the differences between middle class and affluent families.

And finally, amongst women labor market developments have been much, much better. They have tended to enjoy earnings gains over the past decade. But it turns out that many of women's recent gains have been concentrated amongst women who are married to affluent men. Women who earn good wages are now much more likely to be members of well off households, presumably married to well paid husbands.

As women increase their employment and earnings this tends to push the incomes of the most affluent families and widen the gap between rich and poor.

Thank you.

Senator BRADLEY. Thank you very much, Mr. Burtless. That was very interesting.

[The prepared statement of Mr. Burtless appears in the appendix.]

Senator BRADLEY. Mr. Phillips?

STATEMENT OF KEVIN P. PHILLIPS, AUTHOR, THE POLITICS OF RICH AND POOR, AMERICAN POLITICAL RESEARCH CORP., BETHESDA, MD

Mr. PHILLIPS. My name is Kevin Phillips. I am a publisher of the American Political Report and the author of a book called, "The Politics of Rich and Poor."

What I would basically like to do today is go beyond the generality of the middle class squeeze and look at the interface of the middle class squeeze with the principal subject matter jurisdiction of this committee.

I think to talk about the economy is quite relevant. To talk about what has happened since 1973 in the larger sense of median family incomes and so forth is quite relevant. But I think it is useful to take a few moments to point out what has happened to the Federal Tax Code in the last 40 years in reference to the median family, the median income family, the average American family.

I think simply by going through it, and these data are a little bit ragged because they have not really been collected as well as they should have been. So I would recommend that partly one of the things you should do is collect the data. Figure out what has happened here. I doubt that the numbers will be quite the same as what I am saying; but the thrust will be quite the same as what I am saying.

I think that that begins to lay out the challenge that this committee faces and that this committee will have to undertake in doing its part in alleviating the middle class squeeze.

Now in a nutshell if you go back 40 odd years to 1948 and you look at the tax burden of the average American family, the median income family, it was then $3,000 a year. If you look at the Federal tax burden they faced, essentially they did not pay Federal income tax. Social Security was 1 percent of their income; excise tax, who knows, through another 1 percent in, you probably got it. In other words no real Federal tax liability for the median income family. This was the beginning of the golden hour of the American middle class.

Jump ahead to 1960. You are looking at a situation in which the income tax burden would have been about 10 percent, roughly; Social Security if you include the employer's contribution for the median income family about $5,600 would have paid something in the neighborhood of 5 percent; so your excise tax would give you another percent, call it 16.

The tax foundation for the year 1990 has said that the average American family paid 28 cents on the dollar in Federal taxes. So that is a pretty steep number. But that is just one part of a little chart you can make. The other part of a little chart you can make is what happened to the tax burden on the million dollar a year family. This, I think, is the embarrassment of people in politics today, and people who comment on politics, and people who lobby politicians, and economists who have not pointed out the contrast.

Because essentially if you go back and you look at the tax code that faced the million dollar a year earning family in the late 1940's and 1950's and end of the 1960's, you see a nominal and according to the statistical history of the United States effective tax rates of 75 to 85 percent on these families.

Now I know the loopholes come into play and that made a big difference. But you can go back into the chronicles of the 1950's and find endless complaints about the fact that for a lot of people in the upper brackets the tax was 55 percent, 66 percent, 70 percent.

So what do we have at this point in 1990 as the effective tax rate on the $1 million a year earner? Twenty-eight percent, twenty-nine percent, something in that range. Which is to say almost the same as the tax burden on the average American family.

So your fascinating little chart shows the rise of the effective tax rate on the median income family from practically nothing into the high twenties and the decline of the effective tax rate on the million dollar a year family from basically up in the seventies or eighties, take your choice, down into the high twenties.

Now if there is a reason why the American people should be dissolutioned with the tax reform process in this country it can be seen in that chart. If there is a reason why when people are asked by the pollsters they think the 1986 tax reform was no good, it could be seen pretty vividly on that chart. So what I think you have to do is bear in mind that if the emphasis on the middle class is going to become actual and legislative, not rhetoric, that you have a great opportunity to initiate a fair amount of that shift by taking this tax code which has become essentially an unfair tax code and restoring it to something resembling the balance that it had between the classes in what was really the hay day of the American middle class.

Now to do this I suspect that what you have to do is go to a progressive right structure that has four or five brackets. There is going to have to be a bracket which is a lot higher than where the bracket starts now. Again, I think a piece of research that could be done quite usefully would be to take where the top rates started in the past in American tax history and put them in constant 1991 dollars. You will find that using that the top tax rate always started at some place over $500,000, usually in the millions, which meant to say the average person or even the average well off, upper middle class family paid nothing like the tax rate that was paid by the people at the top.

So I think in terms of making your contribution to a changing climate of the United States by which a lot of things will flow to the middle class, that that is the principal opportunity that you have to do it. I hope you will and I will watch with great interest.

Thank you.

Senator BRADLEY. Thank you very much, Mr. Phillips.

[The prepared statement of Mr. Phillips appears in the appendix.]

Senator BRADLEY. We thank all the panel.

Mr. Phillips, yesterday we have the Secretary of the Treasury here, along with Mr. Darman and Chief Economist, Mr. Boskin. I asked them the question would they support a 10 percent surtax on people that make more than $1 million in income. They said no initially because they had not seen any proposals that taxed only incomes above $1 million. They saw proposals that taxed incomes in the seventies, eighties or nineties or early hundreds, but not just a million.

I reminded them that I put a bill in to put a 10 percent surtax on millionaires and to use that money to allow any person in America up to the age of 50 to be able to go to college, get up to $33,000 to go to college in exchange for repaying a percent of their future income into a trust fund.

That came as news to the Secretary of the Treasury and upon a second question to him—would the administration, if it were limited to incomes above $1 million support the surtax on incomes of more than $1 million—the answer was no.

What does that tell you about the climate that we are operating in?

Mr. PHILLIPS. Well, I am going to answer this in a semi-political context and from a semi-political background. I think I would like to speak on behalf of the 80 percent of Republican voters that when asked in the Wall Street Journal poll whether they would favor a surtax on millionaires said yes they would. Secretary Brady prefers to speak to the 20 percent of Americans or Republicans who took his position. I do not think that is a workable position.

I think to the extent that that reiterates itself as the position of the administration that they will see a reenactment politically of what happened back in October 1990 when that was the position of a President and his job approval rating in 3 or 4 weeks went from 70 percent to 48 percent.

There are a lot of people in the Republican party that do not support this pension for preoccupation with capital gains with a sense that you can, I do not like to say you can trickle down, but that your stimulus can be applied to an elite portion of the population and that you simultaneously protect that elite portion of the population.

So I disagree with Secretary Brady; and, Senator, I would agree with you.

Senator BRADLEY. Now if we were to put a 10 percent surtax on people with more than $1 million, the objective is to get them to pay more tax; is that not correct?

Mr. PHILLIPS. That is correct.

Senator BRADLEY. Therefore, if what we did at the same time we put a surtax on people that make more than $1 million we put back into the tax code several loopholes that allowed them, in fact, to avoid that tax, that could be counterproductive, wouldn't it be?

Mr. PHILLIPS. It would depend on the nature of the loophole. If the loophole actually genuinely did contribute to major economic growth and then generated revenues in other portions of the economy I would have to disagree with that. But without knowing what the loophole was I cannot really answer it.

Senator BRADLEY. Try capital gains.

Mr. PHILLIPS. Well, it depends again on capital gains. Now if you are talking about a bailout for old assets I do not think that is what we should be doing. If you are talking about changes in the capital gains structure that would support start-up enterprises, would deal with the indexing problem, would provide a differential between assets held short term and assets held long term, I think all of those could be useful objectives.

But the bailout of old assets as a goal here is not what I think we should be pursuing.

Senator BRADLEY. Who holds most of the old assets?

Mr..PHILLIPS. Well, it depends on the type of assets you are talking about. If you are talking about stocks, 60 percent of individually owned stocks are in the hands of the top 1 percent.

Senator BRADLEY. Okay.

Now moving down with your historical analogy, the exemption was worth $600 in 1948. That is the year you started as your base, the exemption for a child was worth $600. If that had kept pace with inflation and income growth, it would today be $8,000 a child.

Now in 1986 we doubled it from $1,000 to $2,000. That is still a long way from what would be your recommended course which is to track it from 1948 to the present day. Is that not correct?

Mr. PHILLIPS. That is exactly right. That is one of the reasons for the rapid escalation of the tax burden of the average family.

Senator BRADLEY. So what are we telling the average family who has children?

Mr. PHILLIPS. We are telling them that they do not get the same benefit out of the deduction that they got 40 years ago. I think what you are implying is that that should be changed so that they get something more approximating what used to be the case. If that is the question, I would agree with it.

Senator BRADLEY. Thank you very much.

Senator Riegle?

Senator RIEGLE. Thank you, Mr. Chairman.

Mr. Phillips on page 4, I know you were under the pressure of time and you went through the first part of your recommendation which is on the tax changes, and I think you have given us some good points to consider there, but then you raise a second point. I am going to just read what you say here into the record.

You say, "In the second," in terms of an action that ought to be contemplated or taken, "could involve some large scale effort to identify and deal with what is happening to both middle class purchasing power and the average family's private sector safety net." And you speak earlier of some kind of a bigger strategy beyond just tax rate changes.

I really have two questions that I would like to put to you. One is, I detect a sense of urgency in what you are saying, namely that you see trend lines that are taking us in a direction that we ought not to continue; and you need to make changes to change the way the trend lines would go.

I would like to know where you think the trend lines will take us if we stay on the track we are now. But at the same time I am very interested in what you think in a broader sense is needed to really attack the productivity issue, the growth issue. I mean what scale of plan ought we be contemplating now in 1991, sort of looking down through the rest of this decade?

Mr. PHILLIPS. If I can throw a question back. Are you talking for the need for some sort of generalized? I think I heard in some of your previous remarks reference to a plan of sorts for the United States in trying to fit these pieces of the economy together and figure out how they interact.

Senator RIEGLE. I am thinking of that. I do not mean by that—some people would assume that means government czars sit down somewhere and design a mass production plan. I am not talking about that. I am talking about some strategy that the leadership of this country, public and private, would put their heads together that would get us on a growth track that would take us on a different path into the future than the path we are traveling now.

So I am open to the configuration of the kind of big plan that I think the country needs. But it seemed to me you were suggesting here something along that line and I would be interested in your thoughts on it.

Mr. PHILLIPS. Well what I was suggesting particularly was to sort of do a research project into the adequacy of the current CPI and inflation data vis-a-vis the middle class. I think it is almost useless vis-a-vis the middle class. When you put the burdens in there for education, for day care, for auto insurance, for water bills, for all these things that are running far ahead of CPI, I think the CPI was never intended to be cited as just referring to the 30 or 40 percent of the population in the middle.

But it is quite inadequate to profile what is happening to the purchasing power of that 30 or 40 percent. I think you should revisit the reference of the consumer price data to the middle class specifically.

Then the second element here was to suggest that the unemployment calculations here are also poor with regard to the middle class because you have all kinds of people who have part-time jobs that want full-time jobs that are not counted in the unemployment numbers. There are people that have dropped out of the labor force because they have given up looking, who are not counted in the unemployment numbers.

There are people who are pretending they are self-employed consultants to try to save face and recycle into another job. They are not in the unemployment numbers. If we had good numbers, we would make better policy.

Senator RIEGLE. All right. Let me just stop you there then. I see where you were going with that. It was not clear to me. So let me back up for a minute.

Let's say we did the tax rate changes you were talking about, maybe five or six rates scaled differently as you have described here. If we could do that today and put that into effect and just leave everything else as it is, sort of leave nature take its course, should I draw from where your state of mind is right now that that really gets us off bad trend lines and on to good trend lines?

My gut tells me otherwise. I suspect it is too late in the game with too many problems that have been unattended too long and we need something that is much stronger in terms of an application of economic strategy to give us growth in the future that we will not get alone with just tax rate changes.

Mr. PHILLIPS. Well I agree with your gut. I think that that would be a symptom of a mind set change which would be very important. The fact that people did something like that, that they tried to reattune the tax code to emphasize the middle class again and to take the emphasis off the magic of somehow rewarding people who are in the LBO's or the other gimmicks we saw during the 1980's.

I think that would be symptomatic of what I would guess would be a lot of other changes you would make simultaneously, whether it is public investment of an infrastructure program or attempts to make changes in anything from job retraining to resensitizing on the data and trying to face up to where the priorities had to go in trade strategy and a national industrial strategy.

One of the weaknesses of the 1980's, not to prolong this point, has been to just assume that if the markets were allowed to work their way everything would turn out terrifically, whether it was in the tax code or LBO's or in anti-trusts or in foreign trade or in any number of other directions. That is an a strategic viewpoint.

When you take that view you say you do not need to strategize. The market is going to handle it. Wave your Adam Smith sign at the problem and it is going to be taken care of. That is a fundamental mistake I think we need to get out of the approach in a lot of different directions.

Senator RIEGLE. I agree with that. It seems to me the first panel of citizens in their own way were saying the same thing, that a wide open approach in a sense is giving us the results we are seeing today and that something more than that is needed.

I wish we could continue that because it seems to me if we cannot penetrate that question and get the debate up on that new plain, you know, there is going to be an awful lot of wheel spinning on things that are sort of micro details that may on the margin help some, but do not really break the back of this big problem that I think is really taking the country down the wrong path.

Thank you, Mr. Chairman.

Senator BOREN. Thank you very much.

Senator Daschle?

Senator DASCHLE. Thank you, Mr. Chairman. I want to commend you, Mr. Phillips, for fascinating testimony and your answers to the questions just asked.

I have two interests as we look at the tax question and how it applies to the economic mess we are in. The first is, the degree to which we look at tax issues these days seems to be related directly to the degree to which we find offsets. That is, we do not want to create a larger budget deficit. Some people have testified before this committee that we create and compound the problem by doing so. That is, we compound our problems by simply providing tax incentives without dealing with the deficit issue.

I would be interested in anyone responding to the following question. Which is more important, reducing the deficit or providing tax incentives to create growth? If the answer is that tax incentives are more important, to what degree do we generate growth if, indeed, that tax incentive is required to have an offset?

My other interest is, as we look down the road, which is more important: recreating some form of tax fairness in the long term for the lower and middle class or using the tax code, as has been suggested, for economic growth? Let's take the first question first.

What do you think would be the net impact of tax credits that require offsets?

Mr. Phillips?

Mr. PHILLIPS. Well, let me answer by saying it is getting harder and harder to take the deficit seriously as a precision tool for making ones judgment on these. I do not know what the projected deficit is right at the moment for any particular fiscal year that is coming. But the numbers that sort of cling in my mind are like $360 billion and things like that.

I mean once you are talking about feeding all these bailouts, you know, a little included but not entirely included and all the calculations that you have, it has gotten to the point where it is awfully hard to take some of this do not mess around with the deficit stuff quite as seriously. I mean I realize there is a political ingredient to say they have found ways to circumnavigate the deficit for some of these international assistance programs, but it has just reached a point I do not know if you asked Americans, if you found out what percentage of Americans think this deficit is going to be brought down, I bet it is very low.

If that is the case, then sure you do not want to unnerve the bond markets and you have to be responsible, but you cannot be paralyzed by whether the deficit is projected to be $354 billion or $368 billion or $377 billion. That is a lot of wiggle room.

Senator DASCHLE. Mr. Burtless or Mr. Kohut?

Mr. BURTLESS. Your question is whether tax incentives are better than the offsetting costs of having higher deficits. I would say that you can combine having incentives that are pro growth in the tax code without raising the deficit, because you can take offsetting tax action that raises other taxes that are anti-growth.

So you can have budget neutral tax incentives that spur growth. But I am a little bit skeptical that we can design very many pro growth tax incentives.

Does anyone in here remember IRA's? They were supposed to be pro saving incentives. I think someone studying the U.S. economy under a microscope in the 1980's would be hard pressed to find any evidence that private saving was spurred by that tax incentive.

Senator DASCHLE. Mr. Kohut?

Mr. KOHUT. I have as a public opinion nothing to add to that first question and an opinion on the second one.

Senator DASCHLE. I would be interested on the second question, given what remaining time I have, if you could address the issue of goals. Obviously, Mr. Phillips is a real expert in having studied the trends in economic fairness through the tax code in recent decades. But I would be interested in your view as to the long term.

We had four middle class people here that expressed the view that there is an inherent unfairness in the tax system today that needs to be addressed. They felt that a tax credit would go a long way to placating some of the concern they have.

But to what extent should we be looking at growth? To what extent do you view the need for some tax fairness to be the essential goal as we look at changes in the tax code?

Mr. KOHUT. Looking at the way people feel about the situation it is inevitable, given the strength and feelings in both areas, that you have to address both. People are very angry to just about any question that is a tax the rich question gets extraordinary support. People have seen for the past 5 years the gap between rich and poor largely increasing and there is no question that people are responsive to a redress of that situation in some way and actively calling for it.

On the other hand, economic growth and feelings of real financial confidence are really the values and attitudes that galvanize public opinion. You cannot ignore one for the sake of the other.

Senator DASCHLE. Quickly, Mr. Burtless or Mr. Phillips, do you have any response to that?

Mr. BURTLESS. I think that you can have pro growth and pro fairness tax reform. I do not think that there is necessarily a conflict between the two.

Mr. PHILLIPS. I agree with that. I do not see any necessary conflict. Obviously, if anybody can figure out exactly the way to do it, those are the changes that will have both a psychological pay off for the middle class and the actual pay off for the economy.

Senator DASCHLE. Thank you, panel.

Thank you, Mr. Chairman.

Senator BOREN. Thank you very much, Senator Daschle.

Senator Baucus?

Senator BAUCUS. Thank you, Mr. Chairman.

As you know, all of you on the panel, one of the reasons Congress enacted the 1986 tax bill was to reduce loopholes, some reductions in the credits, particularly some of the paper losses that wealthy people would take. In exchange for that, you know, the rates were to be lowered. Because the effective rates were not the same as the theoretical anyway.

In addition, an alleged reason for the 1986 Code is to have fewer brackets and simplicity because the Code was so complex. Americans at that time were very much complaining that the Tax Code was just way too complex, et cetera. I think it is no less complex today.

But certainly that was one of the driving forces behind the 1986 Tax Act. So I was wondering are you all saying, particularly you, Mr. Phillips, that in order to put some more "fairness" back into the Federal Tax Code that we may have to pay the price of more brackets, et cetera?

Mr. PHILLIPS. Well, I am certainly saying that. I do not know whether it is three, four, five or six. But I would just—I mean half of this is a prediction as well as a statement. If you look at the way politics is going and coming out of these previous deuton, speculative cycles when you phase into a troubled economy and then you get people changing the Code, they are angry at what has happened, in the distribution; and the rates go up. I think it is inevitable.

I think that the challenge in the next 3 or 4 years is going to be to hold the line on a sensible top rate, not whether it goes up from where because it is going to go up from here. But to stop it at some place like 40 or 42 which is not far off what would be a long term reasonable rate. But, yes, I think we will see more brackets than what we have now.

Senator BAUCUS. And also no more deductions or credits.

Mr. PHILLIPS. Not unless you can wipe K Street off the map. They will be deductions and credits.

Senator BAUCUS. I would like you to discuss the degree to which at least your data, your surveys, and your analysis you think the American people are willing to or think our country should have more of a plan. I made the point with the earlier panel that perhaps in order to get lower health care costs individual Americans may have to have fewer choices; and as fewer health insurance companies to buy policies from or fewer policies. A single payor system for example. Maybe stand in line for nonessential service.

Does any of your analysis, do any of your polling indicate that American people are willing to give up a little bit of freedom for our country to develop a "plan" assuming it is a sensible plan and assuming it is a plan where everybody is in on the benefits, not a plan where some get some benefits at others expenses, that is a degree to which you can gage fairness here?

Do people want more of a plan and if so are they willing to give up a little something, so long as the plan is one that is perceived as fair and reasonable?

Mr. PHILLIPS. I do not think we can have a national plan, not after we have seen countries that have had "plans" go down the tubes. But I think can we have a bit more of a national strategic sense that we weigh things, we try to interrelate them.

Senator BAUCUS. That is what I am getting at.

Mr. PHILLIPS. I think that is absolutely imperative. And I think that in a country of not shrinking resources, at least not the ability to expand them that we have had. There are a lot of people in the middle class have this sense, as Senator Bradley cited, people in New Jersey think their children think they will not be as well off. Well, to avoid that they will be willing tö have things allocated in some measure. Maybe rationed in some ways, with more attention on the noninfinity of our resources and opportunities, but not a national plan.

Senator BAUCUS. I do not mean a national plan. But I am getting at some sort of commonly shared strategic goal where public policy is developed in accordance with that strategic goal.

Mr. PHILLIPS. Multiple strategic goals.

Senator BAUCUS. Yes.

Would either of the other two like to respond?

Mr. KOHUT. Well, I think that the American public will get hind proposals that call for sacrifices that address specific needs that are very deeply felt. What this panel talked about in terms of the problems of paying for education or paying for health care. It is hard to think about in the abstract what sacrifices and what they are willing to give up. But there is no question that people feel a serious need in these areas and they are therefore willing to embrace plans that will call for some sacrifice on their parts and things on their part.

The issue is thinking about it in the abstract is quite difficult.

Senator BAUCUS. Mr. Burtless?

Mr. BURTLESS. I think you have to make a distinction between what people say abstractly about liking freedom and what they actually like that government does.

Senator BAUCUS. True

Mr. BURTLESS. The most popular programs of the Federal Government are Social Security and Medicare, and no other programs are even close. Yet those programs were attacked at their inception because they represent infringements on freedom. They obligate people to pay taxes while they work. In turn, people receive money back in their old age in the form of medical care benefits or pension benefits. And Americans love it.

Senator BAUCUS. Thank you very much.

Senator BOREN. Thank you very much, Senator Baucus.

Senator Pryor?

Senator PRYOR. Yes, thank you, Mr. Chairman. I want to apologize for missing most of this hearing, Mr. Chairman, and my colleagues and witnesses. But they have been very fascinating I am sure. I did not even this morning get to hear the four witnesses representing sort of a cross section of the middle class.

I am wondering, Mr. Phillips, were you here during their testimony this morning?

Mr. PHILLIPS. I was.

Senator PRYOR. I did not get to hear the statement of Mr. Darman and Secretary of the Treasury Brady, yesterday but I was given this morning a list entitled, "Exhibit One—Current Outstanding Elements of the President's Growth Agenda." And it looked to me to contain about 7 or 10 or 8 major items there of their agenda to create growth and maybe to help the middle class.

Is there anything on this list that would help any of those witnesses that we heard from this morning?

Mr. PHILLIPS. Well I think a lot of the items on the President's growth agenda represent as described in short captions things we could all agree with as generalities and the question then is in the interpretation and the specificity.

If were to read all these, which I certainly will not, I would say a lot of them are worthy goals. Now I would disagree with one thing on this list, and whether it is Dick Darman's little personal list or whether this is the priority of the administration, I do not put a capital gains cut at the top of the list of what the United States needs in the 1990's.

Senator PRYOR. That seems to be their number one item on the list. How long would that take, a capital gains cut, to help those four individuals we heard from this morning?

Mr. PHILLIPS. Well, it is awfully hard to see how the capital gains cut aimed at old assets which is designed, I think part of the concern is the solvency of various segments of the financial and real estate community. It is going to take a long time to make a difference to them.

That isn't necessarily an indictment of it it is the priority that concerns me. That should not be the top priority of the Government of the United States.

Senator PRYOR. What about some of these R&D increases, would that help either of these four people that we heard from today?

Mr. PHILLIPS. Well, I am not expert on the trickle down of R&D but I assume that it percolates up, too. I think you do need R&D in this country and I would not draw any conclusions from these descriptions.

Senator PRYOR. What about GATT, North American Free Trade Agreement and Enterprises for the Americas Initiative; would that help any of these four witnesses we have heard this morning?

Mr. PHILLIPS. Well, I suppose some of them could. Presumably, they will get certain things more cheaply if the GATT is brought to fruition. So I do not think that the broad statements are very indictable here. My only concern is, I think that is a tricky priority and I would like to see the administration more interested in ordinary people up and down the country and less in the abstractions of capitalist economics.

Senator PRYOR. Good.

Mr. Chairman, I am going to yield back my time in the interest of time. I know you have another panel.

Senator BOREN. Thank you very much.

Senator Riegle, would you like to ask another question?

Senator RIEGLE. If I may. Just one other thing with regard to Senator Pryor's last point. The gentleman who was here before, the unemployed 51 year old that has been everywhere to find a job and cannot find one. The idea of being able to buy cheaper goods from abroad, whether from Mexico or wherever when you have no job and no income is a rather hollow comfort.

I think we have a basic absence of good jobs problem in this country and no strategy for dealing with it. But I want to come back to the point that Senator Pryor was just engaging in with you a moment ago, Mr. Phillips, on whether we need a "national plan" or a "national strategy." You mentioned industrial policy back in your previous response to me.

As you and everybody here knows, these words in some measure become code words and they have different definitions so meanings radiate from them that may be different in the mind of each person. The thing that I am convinced of at this point is the problems, the cumulative economic problems in this country are now such that in the new world global economy they are not by themselves self-correcting.

In fact, you need a strategy if you want to have a good solid economic performance in America. And that if we do nothing, if we let nature take its course that will not evolve or evoke a workable strategy that will give America a good strong economic future.

I am inclined to agree with your points with respect to the Tax Code changes. I think that direction has sort of solid logic behind it. But that by itself I do not think really does enough to dent the big problem of a bad trend line direction into the future.

Therefore, I am thrown back to having to find the words to try to describe a strategy, a plan, an American vision. I mean, pick the words. But something that takes and accelerates the investment in this country in things that improve productivity, which is both plant and equipment, technology, the skill levels of our people.

I mean you were here when these people testified. Obviously if this woman's son over here drops out of school from New Jersey in all likelihood less apt to be productive in the future, not just for himself but for the country, than if he can stay in.

I do not see a debate yet coming forward in any clear way about the scale of a plan to build a stronger America and a stronger economic future that gets us off these trend lines. Mr. Kohut has told us, and he is quite right, I mean whether you take the anecdotal human data or you take the poll data, people see us going in the wrong direction.

The numbers on the chart show it and your numbers show it. We need a strategy and a plan of some large scale that starts to change this. Now I would assert that other nations have this, not directed by government czars, although Japan, Inc. is a pretty much closed operation in terms of the business and the gover‑ment sectors working in combination.

But I watch Europe Today. Europe is managing the function in a much more coordinated sort of long-term strategic sense with a series of separate countries than we are managing to do even within our own country. And it concerns me because I do not think there is any plan.

I would like to say one other thing. I think anybody that is bold enough to define the Brady Republicans from the non-Brady Republicans is probably bold enough to think in terms of, you know, some stab at the language of what would constitute a broader sort of strategic economic growth plan for America that would really fit our requirements, sort of looking down through the rest of this decade. That is what I would really like to hear.

Mr. PHILLIPS. It is about 8 years ago now I wrote a book called, "Staying on Top of the Business Case for National Industrial Strategy." It was based on an agreement with essentially the points you are making. The awareness I have that major elements of the business community had proposed everything from educational strategies to human resources, partnerships, and that a lot of industries had endorsed specific ideas of strategies, whether it was a telecommunication strategy, machine tool strategy, et cetera, et cetera, lots of specifics from different industries, lot of agreement that business and government had to work together.

This and simultaneously John Youngly, President of Hewlett Packard, was doing the same thing in the President's Commission on Competitiveness. Well the White House had no interest in this. None whatsoever. What we have seen in the last several years is that they have started to emerge strategic thinking. There has been a national transportation strategy of sorts, national energy strategy. There is the equivalent in some ways of the health strategy slowly taking shape.

There is a required trade strategy taking shape because of the 1988 Act. But there is a resentment when you suggest that this should all be linked together, this should be made coherent.

Now you get the same international corporations talking about having a tax code that helps them internationally. You have all heard the testimony of the inadequacy of the tax code for U.S. multinationals. Well I am sure they would like a strategy in that dimension.

But business is an ally in this respect, but not an ally that takes its voices into the councils of the White House. I think that is something that should be encouraged on the part of business, to take the areas where they agree that strategic thinking is necessary and stand up for them; and the councils of their trade associations or of their political parties.

Senator RIEGLE. Thank you, Mr. Chairman.

Senator BOREN. Thank you very much, Senator Riegle.

Having returned from a trip to Brazil not too long ago, I recently was reading a survey—I believe it was in the Economist—of what is going on in that country, what is happening to the social fabric of that country, because of the shrinkage of the middle class. They now have a very polarized society. They have a situation where some of the major cities are now on the travel warning list of the State Department. Order has broken down to some degree.

Reading that survey and then reflecting upon the figures, Mr. Phillips, that are set forth in your book and some of the recent surveys that have come out, even within the last 7 days, of the growing disparity of income levels in this country, the shrinkage of the middle class that has really been the glue that has held us together in our society, it causes me tremendous concern that we may be moving down the same path that we see in some of countries, like Brazil which has become an extreme example of what happens to a country when you lose this kind of balance in society.

I tried to press the Secretary of the Treasury yesterday by saying: Why do you think the middle class is shrinking in this country? He said we need more economic growth. We all are aware of the fact that manufacturing jobs we have lost in the last decade or last two decades paid an average wage above $400, and the jobs we have added have paid an average wage of less than $300 a week. We are aware of all those factors.

I note also the disparity of after-tax incomes in this country, which is growing at such an alarming rate—the top 1 percent up over 100 percent, the next 5 percent up somewhere 50 to 60 percent, then you get on down to the third 20 percent of the country and the bottom 20 percent and the next 20 percent up from that very low or negative growth.

But what I hear you saying, and I want to ask both Mr. Phillips and Mr. Burtless this, is that while these economic factors may have something to do with it, that the tax code itself and the rate of taxation, are having a very significant influence upon this change in the distribution of incomes in the country. Is that correct?

Mr. PHILLIPS. I would say that it has because in the 1980's you had several things that increased the ability to concentrate wealth at the top. First a decline in the tax on unearned income, first from 70 to 50 and then down to 28; and then, of course, a decline in the capital gains rate from 28 to 20; and you simultaneously have, of course, a boom in the financial markets that increased incredibly the capital gains realized. As a result this tax climate has been very favorable to accumulation of wealth at the top. I think that is quite correct.

I think we have had a broader climate in the United States that has been very favorable to "people at the top" and that we have lost the sense of middle America as the objective of American policy. For quite a while really thought of upper America. There are a lot of people on Capitol Hill six or 8 years ago used to have entrepreneurs in for these meetings, and they would worship at the feet of Horacio Alger, and we were looking towards the Americans with the great skills and the great abilities to do things, not to the people in the middle.

I think it is something that spreads across a whole gambit of things having to do with government. There has not been enough attention to the people in the middle. That has been the strength of every great economic power until it weakened, and then they were no longer great economic powers.

Senator BOREN. Well, we certainly see that with example after example around the world. That is why it is so alarming to me to see us moving along the same trend line. So what you are saying is that in addition to trying to create greater economic growth in this country and to create an educated work force and to return some of the jobs that require an educated work force, it will be necessary also to change the tax code to make it more progressive if we are also going to have a total plan to deal with this problem of the "shrinking middle."

Mr. PHILLIPS. I think that is right. You are seeing increased progressivity of tax at the State level. California just put on two new brackets.

Senator BOREN. Right—

Mr. PHILLIPS. I think it is inevitable and the question is channeling it well at an early stage, as opposed to it being overrun by some Huey Longism in some 2 or 3 years. Not that I expect quite a parallel to that, but the tide is moving.

Senator BOREN. Mr. Burtless, do you agree with that, that the lack of progressivity in the tax code is, at least in part, responsible for this growing gap in the country between the rich and the poor and the shrinkage in the middle?

Mr. BURTLESS. Well, I favor making the income tax system more progressive in this country, but I think we should recognize that really the direct influence of the tax code in this country in the 1980's on the final income distribution was relatively small. Most of what was going on was going on in pre-tax and pre-transfer incomes. The government contributed in a small but measurable way by depressing the incomes of people at the bottom end with restrictions on public assistance and unemployment benefits. And government raised the after-tax incomes of people in the top quintile by the way that it reformed taxes.

But I do not think that if you look at the changes in after-tax income they are terribly much different from what the changes in pre-tax and pre-transfer income have been. It has been the underlying economics which have pushed up these income disparities not just in the United States, but in other countries that we know about.

These other countries have frequently taken offsetting actions to try to ameliorate the impact of the economic trends. So, for example, the middle class is not shrinking in Canada or Sweden, even though the income disparities of pre-tax income have been rising there as well as here.

Senator BOREN. Has that been a combination, when you talk about the middle class not shrinking in some of the other countries in the way they are in this country? I would assume that they have taken some steps with regard to the progressivity of the tax code in their countries. Have they also taken some steps in the provision of services so that you reduce the kind of financial burden, be it for education or other things that you want to have on the middle-income mainstream of a country participating in? What other steps have they taken to ameliorate the burden?

Mr. BURTLESS. Well certainly any country that provides medical insurance more or less as a right to everyone has an advantage. Medical spending is a big drain on middle class and poorer families.

Senator BOREN. Would health care and education be the two major things?

Mr. BURTLESS. Well, in Canada the country has also liberalized unemployment benefits, perhaps not wisely, but nonetheless they have done that and that has reduced the effect of their awfully high unemployment rates on their after-tax income distribution. Plus, they have made more generous provision of social assistance to single parent families.

These things are all unpopular in our country, I think. But in the case of Canada it has the policies have certainly meant that the distribution of after-tax, after-transfer income, has not become as unequal as the distribution of pre-tax income became in the past decade.

Senator BOREN. In trying to bring people together as a common team in this country to rebuild our economic strength, you have to have a perception of fairness, everyone making an effort, everyone making some shared sacrifice to do it.

I know Mr. Crystal and others have written recently about the growing disparity in salaries between CEO's of major corporations in this country and the average worker salary. No less a person than JP Morgan once said that he did not think there ever should be more than a ten-fold differential in terms of salaries between the CEO of a company and the average worker.

And, indeed, in Japan there is an average differential of 20 times, 25 times. It is also true in Europe. In the United States the differential is now 100 to 200 times. In a few outrageous examples, we have had some executives now in companies having compensation packages as high as $100 million in 1 year; but $10 million is not unusual, for example—100 fold the average salary of workers—even in some companies where there are layoffs, and even in some companies that are not profitable, some companies that are losing money.

So you have both things, a growing disparity between the average worker and CEO pay; you have the lack of connection between the performance of a company for the stockholders and the investors and the salaries of its executives.

How important do you think that is? Does it contribute to the growing division in the country? Could it then lead to an overreaction as Mr. Phillips has said, almost a class warfare situation that could lead to taking action that would even go beyond what is wise and fair? Should we be looking also at this kind of problem wher we are trying to unite us in working toward the future of economic growth and greater prosperity for our country?

Mr. PHILLIPS. I think it is useful to take a look at what is happening in the upper reaches in corporations with things like Golden Parachutes and excessive salaries. Because there are a large number of surveys in the personnel and human resources area that suggest a massive disenchantment of lower level workers and even midrange managers in companies. They have a sense that they no longer count.

It is an grandiose feeding process at the top. Now it is quite clear that the SEC can make some changes if they want to that would allow shareholder resolutions to begin to raise questions about these compensation packages. I think if something does not happen in that dimension then it is going to be part of a generalized public anger that could lead them to overregulation of corporation internal decision making functions.

And instructing Boards of Directors ways that they have to do things, that can be done through State corporation law. I think it is a mistake to underestimate the extent to which if the economy continues to stagnate in the next year or two that you will not be generating out there all kinds of angry people that say these people cannot have all this while we do not have anything.

Senator BOREN. I understand the SEC, the potential of its changing its regulations to allow stockholder resolutions. Should we consider the deductibility of salaries and compensation paid to people at high levels—$10 million, $20 million, $30 million—should we consider changing the tax laws not to allow full deductibility as business expenses to pay amounts that go into the stratosphere?

Mr. PHILLIPS. I think you should consider it. I think you should hold hearings on it. And even if you do not end up having it in the final legislation, the people that know the hearings and get it from their Services and their reporting operations will have a nice little flag there that says, there is a point at which you are going to get burned.

Senator BOREN. Mr. Burtless?

Mr. BURTLESS. Well, in my heart I sympathize with the view that Time-Warner's productivity was not helped by the fact that their CEO commanded such an enormous wage differential over his ordinary colleagues who worked under him. But on the other hand, this enormous increase in the disparity between the top paid and the lesser paid has not just occurred in corporations where you might think that the salary structure is managed. It has also occurred in fields like entertainment and sports.

Senator BOREN. Yes.

Mr. BURTLESS. So the lottery is yielding much bigger prizes to the people who rise to the very top. Although I do not think that it is eliciting any better or more effort on the part of the people who are striving for the top prizes, nonetheless the fact is that it is occurring in all sorts of industries where people's wages are not regulated or not administered by some clerk.

Bill Cosby does not earn the sums he earns because some committee has decided what his compensation should be. He earns that amount by selling himself wonderfully to the U.S. public. I am not sure how one could regulate that in a way that would make the system more efficient.

Senator BOREN. Although I would assume that if you are dealing with large enterprises that have a large number of employees and people in middle management and the rest of it, we often look at the Japanese corporate model and the model in Europe with some corporations and talk about loyalty to the company. Everyone is driving the increased productivity at all levels.

Wouldn't you agree that it is bound to blunt that sort of sense, that we are all important, we are all part of a team, we are all trying to come up with our best ideas. We are all trying to give a little bit more to make the company a little more profitable when they see those kinds of differentials that do not exist in other countries to the degree that they do in this country.

Mr. BURTLESS. I am merely pointing out, though, that it is not just in corporate pay that these enormous disparities have turned up in the last 15 years.

Senator BOREN. No, I understand.

Mr. BURTLESS. They have turned up elsewhere and I agree completely with your view. In my heart I do not think that Time-Warner is a more profitable company because they pay their Chief Executive Officer as much as they do.

Senator BOREN. Right. Right. I understand what you are saying.

Mr. BURTLESS. I think if they paid him a twentieth as much as they paid him they might be more productive.

Senator BOREN. I understand.

Mr. Kohut?

Mr. KOHUT. Just one general comment on what I have heard. I do not think that the shrinking of the middle class and the perception of growing disparity between rich and poor is necessarily going to lead to a radicalization of American society immediately. I mean what it is going to lead to is a real willingness to accept change and a call for change.

All of these things were happening in 1987 and 1988, but the American public felt that it had some potential for growth and things would be better, average citizens felt that things would be better for them.

The difference now between now and then is that that no longer exists. I think what that represents is an opportunity for leadership to present programs of change and the public being willing to accept it. I do not think the natural reaction of the public and even the lower socio-economic sector of the public to become radicalized. I think that is extreme.

Senator BOREN. Don't we run the risk though that the perception and the anger about the disparity continues to grow, especially as we are not having real economic growth in the economy? In other words, as long as the pie is expanding and there is a rising tide and all boats are lifting to some degree, there is not the resentment. The resentment goes up when the pie is not getting any larger. In fact, when it starts to shrink the resentment really goes up as people are under stress. Is your polling data showing that?

Mr. KOHUT. Absolutely. And if that anxiety is not addressed then people get increasingly angry and radicalized. The issue is what will be the consequence of this.

Senator RIEGLE. Senator Boren would you yield at that point?

Senator BOREN. Yes.

Senator RIEGLE. This is a very interesting discussion. I would like to just add another component that I think directly relates to it.

That is, when you posed the question a while ago about where might we be down the road in terms of antagonism between wage earners in the society and people who are up at the top getting these huge salaries and the alienation that comes out of that and the hostility that Mr. Phillips in a sense forecasts, I would argue that you have the counterpart of that now in terms of a different kind of economic deprivation and problem, in a lot of our urban centers particularly, where the have nots who have no apparent way to get into the system. I mean through jobs, through education, through anything, sort of a growing permanent underclass—and when you put a severe recession in on top of that and you create greater and greater economic stresses of the kind that even our witnesses earlier were talking about. And whether you throw drugs in on top of that or you do not, you are going to have a rising crime level and a kind of viciousness goes on, driven in part by economic hardship and deprivation.

I think you are seeing it. I think you are seeing it all across this country. So down at a somewhat less sophisticated level of analysis of how people might feel about corporate managers that are paid too much money, I think there is a kind of unraveling of the social structure that is going on, driven in part by a closing down of economic opportunity by people who do not have incomes and who will resort to crime to go and find money, whether for drugs or other things.

I think all of the red lights are flashing. I mean everywhere you look in our society the red lights are flashing. And yet, we cannot seem to engage the problem. We cannot seem to put the economic strategy development for the whole country that can sort of get the whole country moving in a fashion where everybody has some reasonable chance to get into the game and prosper and thrive as they go down the track, we are not paying attention to that.

As a cold matter of fact, we are spending more time right now helping other countries develop gross strategies. Quite frankly in the United States-Mexico Free Trade Agreement it is really a JOBS program for Mexico. We just had a man here 51 years old, served in the Armed Services of this country, desperate for job, has a family, obviously has produced his whole life, and cannot find work.

I mean it is incredible to me what is going on here. And when you see this violence accumulating, and it is not just the violence of homeless people who freeze to death on city streets.

We have just had three individuals freeze to death in Detroit recently who were in that particular situation. One a man in his seventies who froze to death in an outdoor bus shelter outside of a hospital.

I mean the violence is not just somebody with a gun, it is the violence of what is being done to people's lives. So I think you are already seeing a kind of growing mayhem in our society. It is random and it may not hit us, but on the other hand we have had staff members right here on the Hill, two or three blocks from here, been gunned down on the streets of this city.

In part, I think because we are not facing the human problems in America. We have no strategy.

Senator BOREN. I think you are absolutely right. And again, I would encourage my colleagues to read this survey on Brazil because that is exactly what has happened. You have had an economic disparity which is now producing grave social consequences, including a huge increase in violence, in that society.

It is really an unraveling that I think they still have time to overcome. There are tremendous resources there. But it is very alarming, and it is such a clear lesson to us, as you just said, as to what will happen in our society if we allow it to continue.

I know we have gone overtime with this panel, but it has been very interesting to all of us and we are not going to short-change the next panel.

I would just like to ask one very brief concluding question to Mr. Phillips. Over time I have become more and more satisfied with my vote against the so-called Tax Reform Bill. I must admit that I did not put out press releases about it at the time I cast my vote against it. But as time has gone along, I feel my judgment has been somewhat vindicated.

In terms of trying to put more progressivity back in the tax code, I gather you are not saying that it is wrong to use the tax code as an instrument of economic policy with incentives to encourage the kinds of behavior that would be economically beneficial. Is that correct?

Mr. PHILLIPS. I agree with that. I think that one of the great misconceptions back in 1986 was that you could somehow or other sterilize the tax code and make it this instrument of neutrality that took decisions away from the tax code.

No, I think that that is absolutely necessary that some more incentives go back in the Code in terms of strategizing, which we are talking about having slipped out of America's arsenal of dealing with the economy.

Senator BOREN. Well, for example, we started with a figure, and we said we are going to reduce the top rate on taxes for individuals to a certain low level. Then we said, now we are going to come up with a way to pay for that. One of the ways we came up to pay for that, for example, was changing the depreciation schedule.

Now maybe in some areas it was overly generous. But there is now evidence that we made some mistakes in "reform." I was looking, for example, at engine blocks. In the first 5 years after you invest in producing engine blocks in this country, you recover something like 25 percent of capital. The Japanese companies recover 60 percent, the Germans 70 percent, Korea 93 percent, I believe, and so on. These statistics really worry me in terms of an unlevel playing field for international competition.

And obviously there were loopholes before 1986. There were some areas of distortion where we had not been efficient in directing investment through the tax code. But are there not some areas now that, in order to really bring back our ability to compete internationally and to create jobs and save jobs in this country, we need to have a reverse tradeoff to some degree?

Mr. PHILLIPS. I think that is right. In another survey which I think you all might be wise to undertake would be to analyze the changes in the tax codes of our major trading partners and the other G–7 countries, most of which reduced rates broadly during the 1980's, but to judge the extent to which they have continued a lot of their quasi mercantilist approaches to favoring their own industries and subsidizing their exports or what have you; and also to examine whether or not some of that may not be coming back into their codes and to the extent European unification is going to create a Goliath of mercantilism with a strategized tax system.

Senator BOREN. In fact, what you are really saying is that in terms of an instrument of trade policy, export policy, job creation, what we are likely to see are tariff barriers and other things fall, and more and more utilization of the tax code to assist in job creation and improving the health of basic industries and countries, giving them a better competitive position.

Mr. PHILLIPS. yes. I am not well enough acquainted with the internal dynamics of what they have to agree to through these processes to say. But it would not surprise me, given the influence of France and Germany, if you did not have industrial policies coming out through the tax codes and a lot of other devices.

I think that is something that should be studied very carefully.

Senator BOREN. Well, I agree with you. One of the things that has frustrated me most about the work of our committee, and indeed the Congress over the last several years—and it seems just insane to me—that we continue to write our tax code in a vacuum without considering the tax codes in other countries and the effect it is having on our industries and ability to compete.

We thank you all very much. I apologize to our next panel for the amount of time that we have taken. But we await your comments with great interest as well. It has been a very educational day for us in terms of the witnesses that we have heard from, those struggling to meet the tax burdens themselves, who are being squeezed in the middle, who are undergoing economic stress, and the impact those individual cases have when we look in the aggregate at our society and what we need to do about it.

Our next panel consists of Mr. Allen Sinai, chief economist of the Boston Company Economic Advisors of New York; Dr. Lacy Hunt, chief economist, U.S.A. HongkongBank Group of New York; Fabian Linden, executive director of the Consumer Research Center; and Robert Jay Buchert, first vice president of the National Association of Home Builders.

We welcome all of you. Mr. Sinai, we will begin with your remarks.

STATEMENT OF ALLEN SINAI, CHIEF ECONOMIST, BOSTON COMPANY ECONOMIC ADVISORS, NEW YORK, NY

Mr. SINAI. Thank you very much, Senator. I ask several questions. What is the state of the economy and its prospects? Why has there been no recovery? What do we do? I want to deal briefly with each of these questions and a synopsis of my longer statement.

At the current time there is no recovery from the recession in our economy. Worse, whether the economy recovered or not, that is a moot point as we may now be entering a secondary downwave. All the data we look at, the surveys, our own work, the anecdotal evidence, the underlying fundamentals suggest that nothing much is happening in the economy, although some seeds of better growth later and some potentially promising trends for the longer run are beginning to take shape.

The failure of lower interest rates, monetary policy alone, to provide any lift to the economy 1 year after a turn toward aggressively easier monetary policy is disturbing. In recent years the lags between monetary ease and a better economy most often have been six to twelve months.

As things now stand the economy looks to be in an extended recession. A slow recovery next year, not really a very satisfactory one, now appears subject to greater risk unless additional monetary easing and fiscal help are forthcoming. Growth in gross domestic product, we expect to be flat to down in the fourth quarter and probably about the same in the first quarter of 1992.

But GDP I think is a poor summary indicator of things these days. All along the GNP and the GDP numbers have been misleading in terms of how things really were going in the economy. About 65 percent of States, we think, still are in recession. The goods producing sectors—manufacturing, mining and construction—are weakening, flat, in recession.

Much of the services economy is in recession or flat in activity. Only health care and some parts of finance are expanding nicely. Agriculture and exports, both for goods and services are solid, but a new round of economic weakness overseas in Western Europe and in Japan threatens the exports of the U.S. economy, adding yet another risk to an already long list of downside possibilities.

Looking ahead, the earliest meaningful upturn that might occur now looks put off until at least March or April and probably will be contingent on further easing by the Federal Reserve and some fiscal stimulus from Washington. We are forecasting 1½ to 2 percent growth from the fourth quarter of this year to next year. That is less than one-third of the average pace of first year recoveries across all of our recovery episodes.

I do not think we could be optimistic about something we would really call an upturn until the second half of next year. The unemployment rate should rise to 7 percent or a little more. But that statistic is very misleading. The unemployment rate would be over 8 percent, if not for the unusually low labor force growth that has been occuring, just four-tenths of a percent over the last year, and only 548,000 persons since July 1990.

That is about one-third the increase that might be expected on demographic trends for the 1990's which, in turn, are about one-half what our labor force growth was in the 1970's and 1980's.

One by-product should be low inflation, 2½ to 3 percent. That is encouraging. Inflation should be no impediment to some additional monetary stimulus and fiscal support.

The budget deficit is estimated at about $360 billion next year. That is near 6 percent of gross domestic product. But despite that size deficit what actually has happened in the past year is that fiscal policy has been restrictive. Taxes were raised at the Federal level this year. They also were raised at the State and local government level at mid-year. Government spending in real terms, especially defense, ex the Gulf war, has been coming down. That is laudable for the long run direction or path for our budget, but in the short run, in the near term, it has been one of the most significant drags on our economy.

The big deficit is partly because of the big thrift bailout costs. They do not add anything to spending. In fact, they cost more in interest and raise interest rates somewhat. We are losing revenues because the economy is not growing—$50 billion to $60 billion.

If one calculates the budget impact on the economy, ex the war, ex the thrift bailout and at full employment, we will have about a $41 billion move toward fiscal restraint in 1992.

The recession itself, now really in its 17th month, a record length by our calculations, is only one page of a bigger story, to me a long period of sub par, chronically depressed, difficult, weak and puny economic activity, an economy that appears to be in a state of squeeze. We heard a lot about that here today. It is generic, not just low income, middle income, also to upper income, white collar, blue collar people. A kind of midlife crisis of adjustment and restructuring is in process, hopefully to set the stage for healthy expansion later on.

The transition is painfully difficult. It is filled with considerable downside risks that could alter the prospects for sustained noninflationary expansion in the longer run.

Since 1989 we have been in a growth recession. We have for 10 quarters in a row grown at less than our potential rate of growth, which we calculate to be a very anemic 2 percent per annum. Even after some sort of recovery is in place, there are serious questions over how the economy can sustain the kind of growth that we need to achieve enough production, incomes, profits and jobs for all of our citizens.

Well, the first step in fixing problems is recognizing that they are them. I think this is encouraging to me, and this may sound somewhat paradoxical, to see Washington and the country so concerned and focused on the economy. It is a major problem for us in the short run and the long run and sociologically.

The reasons for it I am not going to go into. The one that I mentioned, fiscal drag, and the fact that though the Budget Enforcement Act last year and though the Omnibus Budget Reconciliation Act was well intended and well meaning in terms of getting the deficit down, here in the short run it is actually causing us some problem because of the fiscal restraint that is in place.

It is very unusual in a recession. In fact, there is no parallel in the post-war era to have fiscal restraint while we have a recession. We have always used monetary ease and fiscal stimulus, more or less, to come out of recession. For 1 year now we have had monetary ease, at least on short term interest rates, and fiscal restraint and the evidence is pretty clear, the economy is going nowhere.

Let me turn briefly to what might be done without having gone through the long list of causes and what might be done. The reasons why we are doing so badly short run and long run and how we can do something to help us get over the short run consistent with where we want to be down the road are of interest.

The problem of no recovery I believe is a triad of variables. It is a lack of jobs, lack of income, lack of profits. You can pick any order you want. Those are the three that are causing the problem. Jobs are falling. We are down over a million jobs over the past year. Real income is up just slightly over the past year.

Real income per capita has been doing badly for a long time. And profits, measured by the S&P 500 company earnings are down now 3 years in a row. Without actions to raise income and jobs or create some jobs which will create income and then some spending or to push up profits which will create some jobs and income in part for all of this triad, the dynamics of the situation and potential negative side effects or weakness could complicate and make worse our ability to get over the short run and into the long run.

Jump starting the economy to me means an external impulse to the system to set of the internal mechanisms of expansion. This is typically done through monetary or fiscal policies. At the current time we have a lot of negative external factors, not any positive ones that I can find, other than lowering short term interest rates.

Any measures we take have to do double duty. They have to help lift the economy over the short run, but they need to set a solid base and framework for sustainable noninflationary growth in the long run. So I think a single policy is not enough for the kinds of suggestions I make.

I believe in the nature of a package that involves both monetary and fiscal policy; and some elements of the packages, some are favored, some are not favored. But I think first and foremost easier monetary policy is absolutely essential. A low profile of interest rates is important.

So long as inflation is under control, and in our kind of soft economy it will be under control, easier money and a lower interest rate profile should have very beneficial effects. The recommendation that I would suggest—this is not for you, the Senate Finance; it is for the Federal Reserve—is additional reductions of interest rates quickly and decisively by the Federal Reserve. I think the discount rate should have been reduced another half a point 3 weeks ago. And I think it should be reduced yet another half point 3 weeks from now.

There is I think time is being lost by what has been a very cautious, slow series of reductions on interest rates with the Federal Reserve following the markets rather than leading them.

On fiscal policy there are some ingredients that I would suggest one has to take account of. One, a modest dose, of about $20 billion to $50 billion of stimulus would pretty much offset the fiscal restraint that we calculate is coming in 1992. This would make the fiscal side of the ledger more neutral. It might not even be net stimulative given that restraint is coming.

Second, if possible, financing should be done within the budget agreement. After all it is the law of the land in order to maintain the fiscal discipline that has started. But more important than maintaining that law is a clear commitment of Congress and the administration to reallocate resources out of government and into the private sector and to reduce the full employment budget deficit towards balance.

If such a commitment could be structured without a law in the budget, that would be better. That law at this time is really a straight jacket and it was not intended to be that. But I am sure we all realize that the constraints and degrees of freedom are very limited.

I think, third, any fiscal package should be looked at in total, not component by component, but in total; and then a balance has to be struck with measures designed to generally and permanently lift the economy over the next year or so and at the same time push out the frontier of our potential output. I do think measures should be permanent since temporary or uncertain changes in budgets tend to have limited effect.

One possible package would be standard—tax reductions and increased spending. This is standard macroeconomics. Sized at $20 billion to $50 billion, this would be anywhere from three-tenths to nearly 1 percent of gross domestic product. That is well below the fiscal stimulus, far below the fiscal stimulus we have used in other recessions.

Seventy percent of it could be from tax reductions, lower taxes for middle and low income families. It could be lower rates. It could be lower Social Security taxes, credits against Social Security taxes, which has been suggested by Mr. Rostenkowski, I think, capital gains tax reduction and investment tax credits. Thirty percent could come from spending or increased transfers designed and targeted for improvements in infrastructure, repair and building, education programs or jobs.

Senator BOREN. Could I ask you just to summarize because we are running short on the time for the other panelists?

Mr. SINAI. Yes.

The package, in summary, we think would get us about 1½ percentage points of growth over the next year or two. What I suggested has a mixture of elements in order to provide some quick income and jobs relief, but also to enhance the long run incentives for increasing the productive potential of the economy.

Senator BOREN. Thank you very much.

[The prepared statement of Mr. Sinai appears in the appendix.]

Senator BOREN. Dr. Hunt?

STATEMENT OF LACY H. HUNT, PH.D., CHIEF ECONOMIST, U.S.A., HONGKONGBANK GROUP, NEW YORK, NY.

Dr. HUNT. Thank you very much, Senator. It is my pleasure to be here today as the Chief U.S. Economist for the HongkongBank Group and its principal subsidiaries, the Marine Midland Bank of New York and Carroll McEntee & McGinley.

The United States is in a very serious recession that I am afraid will probably drag on until the spring and perhaps the early part of the summer. Before this affair is over it may be one of the longest economic contractions on record, going back to the first dating of these downturns in the middle part of the last century.

On the surface the numbers so far indicate the downturn is relatively mild, but there are reasons to doubt the efficiency of a lot of the economic numbers; and once more revised statistical information is available and the returns are tabulated for the final part of this year, and the first part of next year, this is indeed likely to be a very serious recession.

Some recovery can be anticipated in the second half of 1992, but it will be incomplete. It will be halting. Many parts of the country, including the Northeast and the major population centers on the West Coast, will not exit from recession in 1992 and the same is true for many of our key industry groups.

The country suffers from a large number of serious problems, most of which are structural. Our debt relative to our level of economic activity right now is higher than at any time since the 1930's. In the household sector, debt now constitutes almost 95 percent of family income after taxes. And in the corporate sector, debt is now more than 20 times after-tax operating profit. We are leveraged up to the hilt.

The hidden ingredient in this economic decline is the amount of money that is being written off due to failing institutions. Historically, business failures have only been two to three-tenths of a percent of our economic activity. Last year the figure was four times greater than that. And when we get the figures for this year it will be even higher.

As a result of the severe underperformance of the economy I am afraid that the budget deficit this year will be $400 billion, or about 7 percent of the level of economic activity.

I have four recommendations designed to deal with the economic problems. They are not the total answer. In fact, there is no total answer that I am aware of. The first three are designed to make a forceful attempt to lower the long term interest rates. This year we have seen significant reductions in the short term interest rates. However, they have had no basic effect, because the long term interest rates have remained high and, in fact, after adjustment for inflation the long-term rates have continued to move higher.

There are three things that I believe could be done now, immediately, to try to bring the long term rates down. First of all, the Treasury should either suspend for a time or curtail the issuance of 30-year Treasury bonds, and shift the financing into Treasury securities of under 5 years. The Treasury is indicating that they are looking at this possibility, and well they should be. Because of the heavy demands of this amount of money on the capital markets, we have seen a steeping of the yield curve to unprecedented terms.

Second, to indicate the force behind this effort to reduce long-term interest rates, we should bring the portfolio management techniques of the Federal Reserve into the twentieth century. The Federal Reserve has a portfolio of $260 billion of Treasury securities.

At the present time less than 10 percent of the Federal Reserve's portfolio is invested in securities with a maturity of longer than 10 years. If the Federal Reserve, over the course of the next year, were to shift $1–$2 billion a month of Treasury bill holdings into longer than ten-year securities it would inject considerable liquidity into the longer term markets and permit the long term corporate bond yields and mortgage rates to come down, which is a pressing priority for an economy that is as overleveraged as we are today.

And third, when this operation is jointly undertaken by the Treasury and the Federal Reserve to bring down the long term rates, the Federal Reserve must not be idle and allow the short-term rates to back up, which would be the tendency if the Federal Reserve were to continue pursuing its gradualist policies which are obviously failing and which are obviously not getting the job done.

Accordingly, the Federal Reserve should simultaneously announce a stated intention in this time of high anxiety and economic stress that they are going to move the money supply at least into the middle range of their target and perhaps into the upper range of their target.

In the last 5 years the money supply has grown less than by any comparable 60-month span since the Federal Reserve has been collecting the current data series. That is simply too restrictive a monetary policy.

I have one final recommendation. It is on the fiscal side, and has to do with the position of our foreign-based troops. We have approximately 700,000 troops on foreign soil. We should make every effort to move these troops back to bases in the United States as soon as possible. A calculation which I put into my testimony, which was somewhat theoretical, if we could have moved over the last year 300,000 of these troops to bases within the United States, it would have provided almost $14 billion of stimulus, which would have eliminated about 40 percent of the decline in GNP.

Many of these troops will be mustered out over the next several years. They are going to need as much time as possible to find employment in the private sector in this difficult labor market. In addition, many of these communities will, in fact, see their bases phased down or closed out and they need breathing space.

While we are waiting for this mustering out process, bring the troops home as quickly as possible, and allow their dependents to operate in the United States, providing some temporary stimulus to the economic situation that we are in today.

All four of these proposals, the ones designed to lower the long-term interest rates, as well as bringing home the troops, will cost us nothing in terms of the Federal budget deficit, and, in fact, it is quite possible that maintaining the troops on domestic bases will cost us less, and certainly bringing down the cost of long-term bonds will not add to the F^deral budget deficit.

Thank you very much.

Senator BOREN. Thank you very much, Mr. Hunt. A very interesting suggestion. And those of us familiar with communities that have bases know first-hand about the stimulus that occurs when these troops come back home. We see that. We see the impact of it in the economies of those regions.

[The prepared statement of Dr. Hunt appears in the appendix.]

Senator BOREN. Mr. Linden?

STATEMENT OF FABIAN LINDEN, EXECUTIVE DIRECTOR, CONSUMER RESEARCH CENTER, NEW YORK, NY

Mr. LINDEN. We at the Conference Board have been tracking consumer confidence for almost 25 years now. Our most recent readings are among the dreariest we have encountered over that period of time. Confidence today, for example, is lower than it was in our last recession of 1982 despite the fact that unemployment was much higher than now, 10 percent versus 7 percent today; despite the fact that the decline in the economy was much more severe back in 1982 than today.

The prime answer for this greater disenchantment among consumers than under worse conditions is probably to be explained by the fact that this recession, unlike previous ones, has profoundly affected the white collar fraternity. In the past our recessions were largely blue collar, in manufacturing, et cetera.

But in today's ~~economic~~ environment we find again and again that white collar segments of the community are being considerably more affected than in the past. In the 1982 experience white collar unemployment was only half of that of blue collar unemployment. Today that gap has closed considerably, so that more segments of the Nation's population in this particular episode are being affected than in the one preceding.

Again and again, we are picking up concern about jobs. We heard that here this morning, very dramatically. In our latest survey, in November, for example, only 5 percent of those who participated said that they found jobs were plentiful; 50 percent, a ten-fold difference, said jobs were hard to get.

Looking ahead to the future, the next 6 months, a mere 12 percent said that they expected more jobs; 29 percent said that they expected fewer jobs. In normal times optimists outnumber pessimists on this question. Here we see a relationship of more than two to one on the negative side. It is sometimes suggested that the press has contributed a bit to the disenchantment of the consumer, with continuous negative reports on the state of the economy. There may be some merit in this, but very, very little.

For example, as we look at our own results, we find that those areas of the country that are most depressed, such as New England, have the lowest level of confidence by far. But in those areas of the country that are affected somewhat less sharply, such as the Mountain States, the level of confidence is more than twice that which prevails in New England.

So that the notion that the press is contributing to public pessimism is exaggerated.

The consumer's capacity to assess what is going on in the economy results from the simple fact that the consumer in the first instance is on the front line of the economy. Their personal experiences, the fortunes of the particular company for which they are working, less overtime or more overtime, an expanded night shift or a contracted night shift, rumors that back orders for this time of the year are high or low is the stuff that determines consumer sentiment and is also the stuff that reflects the state of the economy.

The present recession cuts across practically every segment of the economy. The young and the no longer young, the middle class, the lower income brackets and even the upper income bracket are considerably less confident than they were when things were going a lot better 2 years or so ago.

The decline in confidence is nothing that has happened instantaneously here. It is not an event that has come to us very quickly. Back in January of 1990, for example, our index stood at 107. By the end of that year in December it had dropped to about 60. Early in this year, with the Gulf crisis, it dropped to 55, an understandable situation when the country was at war. With the victory that was so mercifully quick, confidence snapped back sharply. In March our confidence reading had gained some 20 points from February.

However, after the euphoria of the war had worn off, and the realities of the economy became more a part of everyday life, our index reading dropped to 60 compare to 107 not so far back as January of 1990.

As the recession proceeds quite evidently more and more people are negatively affected. A look at some of our unemployment statistics tell a rather interesting tale. The BLS reports dutifully every month the Nations unemployment rate. The current level is roughly in the high 6.5 to 7 percent range. The average duration of unemployment is some 14 weeks according to BLS. Certainly there is no reason at all to question the accuracy of their numbers.

But there is another dimension to unemployment. Evidently, the man or woman who is unemployed in January is usually not the same individual who is unemployed in December. So if we have an extended period of unemployment, obviously increasingly large numbers of people are affected. In a Conference Board survey, conducted earlier this year, we asked people if anyone in their household had an unemployed episode over the past 12 months.

Twenty percent of respondents indicated that someone in their household had been unemployed for a week or more in the course of the past 12 months. The average duration of unemployment was 24 weeks. So that we get obviously a different view of the impact of unemployment on the population. The 6 or 7 percent figures what we get every month in a sense, accurate though they are, tend to understate the prevalence and the damage unemployment does to the ordinary American family.

We also asked people, those who have now returned to work, what percent have been able to return to the same place of business or a new job. Two-thirds had to find another job. In other words, it is not a temporary layoff as in the automobile industry. Those who are back at work in a different job tell us that 47 percent of men are earning less money than they earned at their job that they had lost.

For women the arithmetic is a little bit less harsh. But women earn less than men to begin with so that duplicating the prior earning level is a little bit easier than it is for the male.

What has been occurring over this year and a half or so has led to a very disenchanted consumer. Unless there is something to encourage or give some confidence and some faith, we are going to have a prolonged rough period. The consumer accounts for two-thirds of our economic activity. Consumer confidence is obviously one of the major elements in achieving a recovery.

Senator BOREN. Thank you very much, Mr. Linden.

Mr. Buchert?

STATEMENT OF ROBERT JAY BUCHERT, FIRST VICE PRESIDENT, NATIONAL ASSOCIATION OF HOME BUILDERS, WASHINGTON, DC

Mr. BUCHERT. Thank you very much, Mr. Chairman, members of the committee. My name is Jay Buchert. I am president elect of the National Association of Homebuilders and I am a single-family builder from Cincinnati, OH.

I appreciate the opportunity to come and appear before you here today on behalf of our membership which is 153,000 firms to discuss the state of the housing industry. Mr. Chairman, you and your committee have clearly demonstrated through the scheduling of this hearing that you are extremely sensitive to the problem facing the housing industry.

For that sensitivity the homebuilders are truly grateful and we urge you to respond to the needs of our failing economy by enacting an economic stimulus legislation package.

I will summarize my written statement which I ask to be included in the record.

[The prepared statement of Mr. Buchert appears in the appendix.]

Mr. BUCHERT. Mr. Chairman, housing is at the lowest level since World War II. The current nationwide recession can be characterized no less than a depression in the housing industry. There will be no sustained economic recovery without a recovery in the housing industry.

Over 682,000 jobs have been lost in the construction industry in the last 2 years, whose employment now stands at about 16 percent. Just last month 241,000 Americans lost their job; 39 percent or 95,000 were construction workers. Multi-family housing has suffered a net loss of units in 1991. We have taken out more demolition permits than we have building permits in the multi-family sector.

Consumer confidence is low and we know it because interest rates are at the lowest point they have been in 14 years and consumers are not responding. Wednesday President Bush called the economy's performance unacceptable and called for a clear, strong growth package.

Real estate values have dropped at least $100 billion since the passage of the Tax Reform Act of 1986. The solution we see is that the economy needs stimulus and Congress must act. Stimulus should be targeted where it will work and it should be focused and that is on jobs not really broad-based.

We believe that a tax credit for first time home buyers is the most effective solution. The credit should be for new construction and it should be for a 1-year maximum period. A tax credit is popular with the American people. A recent Wall Street Journal, NBC national telephone poll of 1,500 registered voters indicates that providing a tax credit for first-time homebuyers is favored by 81 percent of those surveyed, compared with 44 percent favoring a capital gains rate reduction, and 71 percent favoring expanded IRA's.

The American dream is still obviously owning your own home. Housing is poised for a recovery.

Senator RIEGLE. How big a tax credit do you think it would take to really have an impact?

Mr. BUCHERT. I have that in my testimony, Senator, in the next paragraph.

Housing is poised for a recovery. Seven times since World War II housing, as usual, as led this economy out of recessions. In addition, housing has a massive ripple effect on the economy and on jobs in all areas of this country.

For example, the single family housing component of the real GDP dropped by $12.6 billion in 1991. That accounts for 32 percent of the $39.1 billion drop totally in the GDP.

Mr. Chairman and members, things to remember are that a first-time buyer tax credit would be highly stimulative and a modest loss of revenue. In fact, a $2,000 tax credit would stimulate the production of 265,000 homes, a half a million jobs and $20 billion in new investment, with a cost to the Federal Government of only $900 million.

First-time buyer tax credit will provide a more immediate and effective stimulus to economic recovery than any other alternative stimulus proposal. It would stimulate far more spending than a tax credit or rebate with equivalent revenue impact.

We agree with John Kenneth Galbraith, who testified before the House Budget Committee, and said that concern for the Federal deficit must be suspended during a severe recession and a prime of the pump must be done to stimulate the economy. He stated that for a full recovery, the nation needs to lower bond and mortgage rates and rebuild real estate values. We agree.

We also agree with the Congressional Budget Office Director, Reischauer, who said if tax breaks on the middle class are offset by corresponding amounts with increases in taxes on the wealthy, there will be virtually no stimulative effect on the economy.

Homebuilders across the country look forward to further working with you and the members of the committee in proposing and implementing solutions to stimulate this Nation's economic recovery. Thank you very much.

Senator BOREN. Thank you very much, Mr. Buchert. You certainly make a strong case for the idea of a credit, especially the benefit and stimulus to the economy versus the cost in terms of loss of revenue.

Let me return just a minute to Mr. Linden with the confidence factor. I was very interested to hear you describe why the plunge in the confidence level has been deeper than usual, the fact that more segments of the economy are being affected, the fact that more families have been touched, which all this leads to fear and uncertainty about the future when someone in your own family or someone that lives next door has gone through this experience of being unemployed or of having a reduction in his or her standard of living—it takes a while for that confidence to return.

How important do you think it is in terms of restoring confidence that we come together as quickly as possible in the Congress and with the executive branch to reach some kind of agreement on three or four or five key things that we could agree to do now to help the economy through this difficult time and also to address the long term as well.

There is always the danger in an election year—there is a danger in any year, but especially with a Presidential election coming up—that we could get ourselves in a stand-off between Democrats and Republicans, Congress and the White House, over whose package is better, which package is fairer, and the rest of it.

How important do you think it is that we come to a consensus, that we reach an agreement, a compromise between the two branches and the two parties, so that we can come forward with a plan that we can all sign onto and say we think this is going to work? We think this is going to make a difference.

How important is that kind of agreement to confidence as opposed to a longer period of bickering and debate?

Mr. LINDEN. I think that it is evident that something like that be done. On the first level the immediate result would be to encourage entrepreneurs, those who have hesitated to invest, to move forward in a depressed economy with no sign on the horizon of any marked improvement.

As soon as we begin to generate more economic activity and the job outlook and the prospects of employment improve, there will be a very sharp increase in the level of consumer confidence. We can almost track consumer confidence with the level of unemployment.

Senator BOREN. Also, when we talk about the benefits that would come from an agreement entered into as quickly as possible and as broadly as possible, with as many people in Congress and the executive branch and in both parties signing on board, would it also be helpful? We have talked about trying to help those people who are under the greatest stress.

I understand what Mr. Buchert said just a minute ago, that it is not necessarily going to cause a huge amount of stimulus in the economy to bring about more fairness in the tax code or the perception of more fairness in the tax code. Those are two very different questions. The question of social justice and perception that has to be argued on that basis.

How helpful would it be though if we could address the problems middle-income people—we heard from a panel of them this morning—whose principal concerns are: what will happen to me and my family if we are without health insurance, for example, because we become unemployed? How do we educate our children with a shrinking real income, especially how do we provide higher education for them?

In addition to overall fiscal and monetary policy, would addressing those kinds of principal concerns about health care and about educational costs for the family, families caught in the middle, also be a factor in terms of restoring consumer confidence?

Mr. LINDEN. Yes, in a number of very obvious ways. A good deal of consumer spending is impulse buying. If a man or woman sees something attractive, they will purchase it if they have a sense of economic security and restrain themselves where they do not have such a sense.

So that the feeling that their financial situation will permit them to be more lavish in their expenditures will, of course, contribute to a higher level of consumer spending. Also, there has been a great deal of postponed buying over the past year.

In one of our surveys we asked people if they postponed making a major purchase over the past year because of the weakness of the economy. Over 35 percent said that they had inhibited their spending because of the unfavorable environment.

So anything that gives people a sense of more security, will make them be a little bit more easy in their expenditures, all of which would contribute, to economic recovery.

Senator BOREN. Thank you very much.

Dr. Hunt, of the four panelists, I think you were really the only one that focused on stimulus in terms of greater level of activity of a certain kind within the United States with your suggestion both of trying to bring as many of the troops back as we can consistent with our National security needs and also of prolonging a period of transition before their separation.

I think that is a very interesting suggestion. I have also been thinking of a lot of needs that we have. I have thought about whether or not we should in some modest way bring back programs like we have had in the past with CCC, National Youth Corps and some other programs. You think about needs we have in terms of law enforcement, capital improvements, public facilities, national parks, all sorts of other things that can be done.

Do you think it would not be wise for us to think of auxiliary police? Do you think it might be wise for us to think about some transitional uses of the armed forces as long as they are not jobs out in the private sector? Job growth is sluggish for some of these people so these activities could be offered even while they're housed at some of these bases and the will provide broader economic activity out in the surrounding regions.

Dr. HUNT. I think we have to be very creative about it. These are resources that we have already committed to. Right now the fact that we have the troops stationed in various locations, in Asia and Europe, those economies benefit from their spending patterns.

You are absolutely correct. Business people in military towns know what it means when the troops are home. There is also an effective multiplier. And if there are nonmilitary uses for these troops in this transition period because of the changed global circumstances, then I think we should use them for that purpose.

I was struck by what you said earlier. Now is the time where we have to bring out our most creative thought processes. I personally share the concerns of Fabian Linden. The people that we come in contact with—business people, middle range, upper range, lower range, consumers—are very concerned. They are not interested in this philosophical and partisan differences.

Senator BOREN. No.

Dr. HUNT. They are crying out for things to be done to get the economy on a helpful course. We have to consider the needs before us in the same way as if we were engaged in some sort of important military conflict. We must understand the urgency of the need.

Senator BOREN. Let me ask you this: none of you had really suggested that we might—although what Dr. Hunt just said verges on it to some degree—undertake what has been called public works projects, infrastructure projects, as have typically been undertaken. These initiatives would occur along with the credits for home building and direct stimulus to areas of the economy which have led us out of the recession and depression in the past.

We must also think about having to increase transfer payments, for example, as unemployment levels rise and public assistance payments increase? This is certainly a reflection of the number of people that have now gone through a period of unemployment. I am just looking at the figures in our State. We are now facing quite a shortfall in the welfare and social services area. Growth of expenditures there is under real stress.

Given that fact, in addition to what we do with monetary policy, what we do with tax policy either in terms of stimulative tax credits or some other actions we could take with regard to restoring our competitiveness and our productivity, wouldn't it be wise to have some sort of infrastructure, public works programs?

You know, the highway program, for example, stimulates the construction industry. Would it not be wise for us just to simply face the situation we have now, needing to stimulate the economy and needing to repair our infrastructure at the same time by undertaking these kinds of government programs, which, of course, again would be contracted out to the private sector?

Let me just go down. Mr. Buchert, would you have any comment on that?

Mr. BUCHERT. Let me make a comment and then give you two personal observations. The National Association of Homebuilders will be 50 years old. We will celebrate our 50th anniversary as our membership delivering housing to the American public for 50 years.

The National Association was founded in 1942 because there was a concern by some realtors that were building houses and some general contractors that were building houses that the government was going to take on the effort of providing housing for the war effort.

So they said we really need to be organized and we need to be the providers of housing in this country.

Senator BOREN. To show that you could do it in the private sector.

Mr. BUCHERT. Right.

So we developed the National Association of Homebuilders. I think that heads towards what you are saying. Let me give you two observations. I have been in this business 30 years. I went in business for myself a little over 18 years ago and that was a recession—1973–74. I had to option an 80 lot subdivision, and to keep larger builders who had been in business longer from getting that 80 lot subdivision, I had to draw out 20 building permits and commit to building those houses which were basically speculative.

The wisdom of the Congress in 1985, early 1985, said that if you buy a home that was permitted prior to a March date, I believe, March 25 or somewhere around there, in 1975, you can have a 2,000 tax credit. I sold all 20 of those homes within 60 days. And if you will remember the second half of the 1970's we continued to build at a rate of almost 2 million houses a year.

The second observation is that I build $65,000 homes in suburban greater Cincinnati, Ohio today. I sell them FHA and I sell them a combination of housing finance money for first-time buyers. The rate right now under the Ohio bond program is 7⅝. The young couples that come in and buy my homes are all first-time buyers. They are young people trying to get a start, trying to get a stake in that community. They need about $3,750 in the way of downpayment and closing costs to get into that house.

We are doing pretty well. I could be selling and building and creating jobs and keeping my subcontractors three times as busy if I could sell to people that came in my houses every Sunday those homes. The difference is, many of them have $1,200 or $1,600 or $1,800 or maybe even $2,200. But they do not have $3,700.

Senator BOREN. Right.

Mr. BUCHERT. $2,000 in that price range is a lot of money. And those buyers are out there. And oddly enough, even under these economic conditions, they feel pretty confident about their job status, about where they are and they are willing to take that risk at these low interest rates and make that investment.

I think the biggest thing we have going for us is those young couples still have families, they still love those families, and they want to raise them in the confines of a new home.

Senator BOREN. So you are talking about a combination of both the credits and savings devices that would allow the use from these savings for first-time home purposes?

Mr. BUCHERT. That is right. I think the private sector can do it with a little bit of initiative. With a little bit of help from the government, housing has always led us out of the recessions. You know, it has been our job. We are proud. As builders we say, we are the first into a recession. We take that beating, and then we are the first out.

We are looking forward to leading this Nation out of the recession.

Senator BOREN. Mr. Linden?

Mr. LINDEN. Well, certainly we all know how badly we have permitted our roads, bridges and other facilities to go downhill over the years and it is a bill we are going to have to pay for and pay for it soon. And what would be a better moment to do than when the economy seriously requires that kind of stimulation.

Senator BOREN. In fact, we would probably be able to do it at a lower cost than we would be able to do in boom periods.

Dr. Hunt?

Dr. HUNT. I think that your question is quite original, and I think that it is those types of questions that we need to be asking in this day and time. One of the things that we have to do is we have to use our resources more carefully. We have to get the greatest bang for the buck.

In the last 20 years we have pushed the share of the medical industry from 6 percent of GNP to 12 percent of GNP. If you could increase medical expenditures and make us wealthy we would be in a great boom. We are getting less and less. Any dollar of expenditure that you can shift from medical care to infrastructure building is going to boost the economy because there is a higher economic multiplier.

We are going to have to look very, very carefully at our use of resources. If there is some possible way to make a transfer to the badly crumbling infrastructure of our country, there is an area where we can actually stimulate the economy without making the deficit any worse.

Senator BOREN. Thank you very much.

Mr. Sinai?

Mr. SINAI. Well, your suggestion actually does the double duty that I was referring to for any measures that would be taken. In the statement I did say 30 percent of any stimulus could come from spending or increased transfers designed and targeted for improvements in infrastructure, repair, building, education or jobs benefit relief.

If you do that, you are going to get some jobs near term and you are also going to help our long run problem, our long run potential supply problem.

Our research shows that non-defense infrastructure adds to U.S. productivity and potential supply. Defense infrastructure contributes negatively.

Senator BOREN. I think you raise a very interesting point. It is something I hope that our colleagues will think about as we craft a solution. Because there are things that we can do that really do double duty, as you say. And if we can spend on infrastructure, it creates jobs, it helps the short term, but it also increases the long-term productivity.

If we can, for example, provide as I proposed yesterday tax deductibility for interest on educational loans, we give relief to middle-income people in terms of fairness, we relieve some of the anxiety that is out there in terms of consumer confidence, and we also increase long-range productivity for the economy at the same time because you are encouraging more training and education of your work force.

There are a lot of things that enable us to take constructive steps now to improve the economy that are things that are justified in and of themselves in terms of long-range productivity. It seems that the more we can focus on those, the better.

I appreciate the point that you made about looking for those double duty areas.

Senator Riegle, we will turn to you for our last round of questions for this panel.

Senator RIEGLE. Thank you.

Let me say although it is already the afternoon I want to thank all of you for the time and the care of what you have had to say to us today and to the country. I think this is enormously helpful to the discussion and to the debate. I just wish we could have the whole country sitting in, in a sense, on the discussion about our economic future.

The idea of the tax credit for a first-time homebuyer is an attractive one, partly because it is the highest value added item that individuals of any large number undertake to buy. I mean buying a house is the highest priced item for most people in our society that they consider doing.

The next highest is an automobile and we have terrible problems in the automobile industry in this country. It is a sickness that is now infecting our whole manufacturing industrial base. I was out yesterday, Senator Mitchell and I met with Lee Iacocca at a Chrysler plant in downtown Detroit and we were discussing these issues.

It seems to me that if we were going to go the route of a tax credit for a high-value added item, we might want to think about doing that in two areas. We might want to do that with first-time homebuyers for a period of time to stimulate some investment and movement in that area; and also with cars, say, that have a 75 percent American content for again a period of time.

Create a window where if somebody were to buy one of those cars that principally was produced with American value added they would get some tax benefit. I think you could probably show it an economic model at least for a period of time that you get a lot of that money back as well as putting lift into the economy.

But let me just leave that aside for a minute. I want to go to something else. That is, I serve as Chairman of the Banking Committee. So we have had occasion over the last 3 years while I have been Chairman to really have to go into the heart of the problems of the financing structure and they are serious and I think growing and not receding.

I say that with particular respect to the commercial banking system, which has been our focus just in the last legislative effort here.

When I look at the financial structure, I see great pressures there, not just in Federally insured depository institutions—banks, savings and loans—but also manifesting itself in a somewhat different way in the insurance industry and I think now even in pensions and the reliability of pensions to be sustained financially out into the future.

I think we have an extraordinarily serious financial problem on our hands. The recession, short-term/long-term, economic problems as it comes back in on our whole economic structure and our financial structure. I think all the red lights are flashing as I look at them.

And I think there is really an urgent need for a competent and well-engineered plan that can get some lift into this economy that deals, Mr. Sinai, both with the short run issue and the long run issue; and if we are smart enough to dove tail those things so that we do not have one cut against the other, but have one reinforce the other.

I am not sure yet that in our government there is anything like that sense of urgency. I mean it is true that we are having a hearing today and we had the administration's top witnesses in here yesterday. I think there is some sensitivity to what the poll numbers are showing, both politically and on economic policy questions. I do not detect yet, at least coming out of the administration a sense that there is a great urgency to really move aggressively with an economic growth strategy that can really help us in a measurable way, both short term and long term.

Maybe that will be forthcoming. But I did not detect any real flavor of that yesterday from the three administration witnesses. I mean there are some things they want to do but it is not, frankly, they do not put it in that context.

I talked with a person on Wall Street that I respect very much and have known for many years. I asked him the other day what he thought the odds were that if left unattended the economic and financial circumstances out there today could turn themselves into a depression, a 1990's style depression. No one quite knows what that would be like.

For some people they are in a depression now. Certainly the man who was here from New Jersey today. I think he would probably say he feels he is in a depression today.

I asked this Wall Street person what he thought professionally the odds were that this set of problems, some that we can measure, some that we cannot, could manifest themselves into a downward chain reaction, financial accident maybe happening here or there and then all of a sudden you are into a whole new condition and you really have in a sense a kind of depression, economic depression.

He put the odds at about 30 percent right now. He conditioned that by saying that is higher than he has ever put them before and on the other hand that means that, you know, as an investment decision maker he is betting that that will not happen, because he obviously sees a 70 percent chance that we will get through this thing.

He thinks the odds, however, of us failing to get a decent strategy and revisiting these issues two or three years down the road were the worst set of odds, is the likely course. I mean that was the more depressing part of the message.

Without scaring everybody to death, and that is always difficult when we talk about these things, on the other hand, I do not want the public in the dark about the seriousness of the problems that we are facing.

If we do not take forceful action, what kind of risk are we running that we could get into a chain reaction situation that could keep taking us down and would not self-correct? What are your views, Mr. Sinai?

Mr. SINAI. Our economy has never spontaneously combusted its way out of a downturn. The 1930's are a clear example of that.

What happens is that negatives do things that you cannot see in advance and we see many of those things happening now.

So I think that the urgency is immense. I agree with you. I do not think, and let me try to be impartial here, I do not think Washington is sensitized enough and fearful enough of the trends out there. I would describe the situation as the modern day counterpart to a depression.

The unemployment rate is a very misleading statistic.

Senator RIEGLE. So in effect you are saying you think we are in a form of a depression now?

Mr. SINAI. Things are in very, very, very tough shape at the moment. I am not counseling precipitous, unwise fiscal irresponsibility, but I think a hurry up, speed up in attention to the problem and coming up with a common ground priority set of a limited number of proposals that Democrats and Republicans can agree upon—Congress and the administration can agree upon—presenting that to the American people, I would rather have it done before Christmas than after Christmas myself.

Because I think as Fabian has said, they do not have much to look forward. A lot of our society does not have much to look forward to and it is not just the blue collar people, it is the white collar people. It is the executives. It is a whole society.

So I cannot tell you the sense of urgency I feel with respect to the situation the economy is now in. I use phrases like mid-life crisis. Out of that comes better times. The country has the ability, the intelligence, the resources to deal with this and I think the polls show very clearly that the public is getting very impatient waiting for the leaders—administration, Congress, economists, everyone—to get going.

Senator RIEGLE. Is it fair to say that if we continue to delay that the downward spiral type problems, where one problem tends to create another problem, can lead us to a point where in some area that we might not even see in advance, you can in effect get a financial accident of some kind?

Mr. SINAI. Well you actually need one of the risks. Now this is a downside risk. It might be a 10 percent odds kind of situation. But the real estate exposure of pension funds and life insurance companies, should the regulators move through the life insurance companies as they did through the banks, given the depressed values of real estate and really nothing out there to help real estate—the Tax Reform Act of 1986 did not really help it—and our economy is so levered on that, their exposure is rather sizable.

And what would happen if there were write downs and pension funds could not fund retirement and life insurance companies might call in a few life insurance loans? How then would Americans react if there was some risk to their insurance and some risk to their retirement money?

It is very dangerous when you have a sick patient to leave the patient when other systems are involved. You never know what can come out of that.

Senator RIEGLE. So I would just conclude, then I want to go to Dr. Hunt, that you without exaggerating it, you feel that this is a matter of extreme urgency.

Mr. SINAI. Yes. Absolutely.

Senator RIEGLE. Dr. Hunt?

Dr. HUNT. Well, I absolutely agree. I never saw the basis for all the forecasts that we were in recovery in the spring and summer. I felt that the economy was, in fact, deteriorating then. We are in something of a downward spiral. I absolutely agree with you, Senator. I do not think any of us understand the magnitude or the potential problem in banking.

And as I look at our situation today versus the 1930's to my way of thinking there is only one major difference and that is that so far our bank insurance guarantees of the Federal Government are holding. If they did not hold then we would have essentially the same situation today as we did then.

I am afraid that because of the extreme oversupply of office buildings and hotel rooms and motel rooms and all types of retail space——

Senator RIEGLE. Commercial real estate.

Dr. HUNT [continuing]. And warehouses that there is potentially a problem yet to surface in the insurance companies and possibly, as Allen Sinai said, in the pension funds.

We are at a very precarious situation and all of these massive layoffs and restructurings that are coming now add to this potential element of downward spiral. In fact, some of the firms that announced massive layoffs 3, 4, 6 months ago, thinking that they cleared up their problems, may find that they are not home free, because the layoffs that are occurring today add to weaker demand and then take the underpinnings out of what economic vitality we have. We are in a very precarious situation and there is no need to delay.

Unfortunately, I have a sense that the Federal Reserve has consistently misread the economy and they have been too slow, been inadequate, and they need to have been far more supportive than they have.

Senator RIEGLE. But you can reach a point, can you not, that if the Federal Reserve is slow and is behind the curve that you can finally get to the point where it does react that you have such a sick, and weak and downward spiralling economy that that by itself is not enough?

I mean I have heard you from this panel saying that now monetary policy by itself will not get the job done, that we have to add something on top of that and we had better make sure it is the right thing and we had better hurry and do it, because we have a situation that may be getting out of our control here.

Dr. HUNT. Well that is exactly right, and that is one of the reasons why I think it is important after doddling around for such a long period of time to get the money supply up and to try to use the resources that we already have to get the long term interest rates down.

Lowering the short term interest rates, we would have had some benefit from that, if that alone would do some good. But people do not borrow in the money market. They borrow basically 10 year or longer term money. We have to get the longer term rates down. That is why I believe strongly that we need to use the Federal Reserve's portfolio, as well as the way in which we are financing the Treasury deficit, to try to give people an opportunity to restructure this mountain of debt they have, before the economic situation deteriorates any further.

Senator RIEGLE. Mr. Linden, how great a sense of urgency do you have in the same context and responses of the last two?

Mr. LINDEN. I feel that 30 percent suggestion of your friend intuitively makes a lot of sense. There are things in the present environment which are almost unique in our post-war experience. For one thing, the vulnerability of the banks. A second thing is the down-sizing of various institutions: IBM, Time, Inc. They were not mere businesses. They were institutions and then businesses.

Senator RIEGLE. General Motors will have an announcement within the week we are told of the same general sort, another large major institutional business in this country.

Mr. LINDEN. Those are moderately scary events. One feels that there is something going on out there which we have not experienced in the recent past.

Mr. BUCHERT. Of course, Senator, I am a builder, not an economist or a prognosticator. But I think when you consider that housing is at the lowest rate in 50 years, we are not talking about since the 1984 recession or 1986 or 1972 or 1974 and 1982.

Senator RIEGLE. Right.

Mr. BUCHERT. We are talking about the lowest in 50 years. If something is not done, that will continue to climb. That is a real problem. I think extension of MRB's, low income housing tax credits is more than likely going to be done anyway. The sooner the better.

The other thing is really the value of real estate in this country. There is no doubt that the 1986 tax act with passive losses had a devastating effect. We have to return those values and that also must be addressed. So some of those things again are the things that we in our industry know begin to return us to a better condition.

Senator RIEGLE. There are two things that would be very helpful for us to have and that I would like to ask each of you to provide to us over and beyond what you may have given us today, just in the spirit of the importance of the discussion and the degree to which you have already made a great effort in coming here and preparing and giving testimony today.

I am convinced that we need this very strong, immediate, short-term strategy that can get some strength and lift into this economy. We are already late. I strongly agree with you, Mr. Sinai, we ought to be in here doing this this minute. And if we could roll the clock back and do it some months behind us, that would be even better.

So I do not think we have a minute to lose and I think we are in a situation of some great danger. I think we really are leaving our fate to too many random factors here at a time when there are great risks; and that just does not make sense, not for individuals or companies or countries certainly.

So I would be interested in any other thoughts that you have that would relate to short-term actions even as a result of this discussion that in turn fit into a longer term strategy. I am convinced as I look at how America is performing in this world economy that we are losing ground everyday. I see the destruction in the manufacturing base. I see the destruction of a whole lot of areas, partly because of trade problems, lack of investment, lack of productivity improvement, lack of savings, too much debt, just a whole series of things.

I am struck by the fact that America needs a long-term plan that really organizes an effort, not by government czars, I do not want to be misunderstood, but the leaders of our society and the private and the public sectors really have to, I think, work out together a growth strategy, an economic surge strategy for America that carries us through this decade and beyond into the next century.

I think if we do not do that and if we just leave things to chance, we are going to have a terribly disruptive future and part of the future is already here. I mean we are seeing manifestations in our society today and I think they are going to grow if we do not organize ourselves around a strategy that lets us keep pace and hopefully exceed the gains that the Japanese have been making, the gains that the Europeans are making, I think, with their consolidated European initiative.

Senator RIEGLE. I would like your ideas on long-term strategy. In this country we sort of get stuck over some of the words. You were here earlier and anything that smacks of industrial policy or phraseology like that tends to scare some people away. You know, that we really cannot think in terms of a national strategy. I think that is crazy. I think you have to have a national strategy that is well oriented.

I thought your idea of bringing the troops home and their families and let them be based here so the money stays inside the country is such a common sense idea. There are obviously some implications to it. But it ought to be done very quickly.

The same is true every time we buy a product built in America versus one built in a foreign country. I mean we can send all of our money out of the country if we want to for foreign goods but it is really a very bad strategy and you end up having a lot fewer jobs after that goes on for a long period of time.

I was citing earlier the fact that in our foreign trade deficit with just Japan, Taiwan, Korea and mainland China, we have had now two-thirds of a trillion dollars net go their way over the last decade out of this country. I mean if that money were here in this society moving around you would be building more houses and we would be doing a lot more things in America that are constructive to our own living standard.

In any event, I am going to finish by saying I would really welcome any long-term strategy ideas you have as well that go directly to the question of how does America craft for itself an economic strategy that works in this new world economy that helps us lift our productivity, helps us lift our living standards.

What are the things that would give us the sustained kind of growth and strength going out over the next several years? We need both. I mean we need to get out of this downward spiral right now. But then we need to get on a growth plain that we have not seen now in some years. So I would ask your thoughts on that.

I do not know if anybody has any quick thought they want to give. It is very late. But I would ask you to either make a comment now, but I would very much like any thoughts that you have that you are willing to put in writing.

Dr. HUNT. I have one thought. In the past our economy has really been the locomotive engine for the world. We pulled the world out of the 1981–82 recession. It was a global slowdown.

One of the things that is happening right now and I am not exactly sure that it is that well understood, there is a global slowdown taking place right now and I am not talking about the depression in the East Block which is a dead weight that is out there and none of us know where that is going, but there is a significant slowdown in Japan.

Japan is in what is termed a growth recession. The situation in Germany is soft and getting softer. And the Bundesbank is pursuing a very restrictive monetary policy. I realize that Germany has certain inflationary problems and they have certain budgetary problems that they are afraid of.

But in the current environment it seems to me that in view of what we have done in the past that we can ask for some reciprocation. What we need right now, frankly, to help the whole world is for Germany to pursue a more stimulative monetary policy.

There has to be some mixing of individual countries' monetary policies in light of the global condition of the world. We are in this together.

Senator RIEGLE. Let me just stop you there, Dr. Hunt.

Are we not in a situation right now of such great vulnerability that if the Germans were to unilaterally through the Bundesbank pursue a high interest rate policy that they could very well—that even by itself on the margin, given all the other weakness, could send the whole world economy into a much sharper nose dive.

Dr. HUNT. First of all they are already following restrictive policy, and taxes are also being raised in Germany. We need to be in close consultation with them.

What we do not need is for them to go further with their monetary restraint not at this time; and we also need the Japanese to participate in this global situation to a greater extent than they are.

Senator RIEGLE. But how ironic. You are exactly right about that. But how ironic it is that we in America have managed or mismanaged our economic affairs to such an extent that we have now reached a point of such extreme vulnerability that events like that, monetary policy events in a single country overseas might on the margin put us in a further tail spin that we cannot get out of.

I mean it is so outrageous when you think about it and when you think about how little attention I think we have paid to our strategic economic future that we should be in this kind of a position of risk, it just takes your breath away.

Dr. HUNT. We have to take control of our destiny. Our destiny right now, unfortunately, is flapping in the wind.

Mr. LINDEN. Senator, may I be forgiven?

Senator RIEGLE. Yes. I am finished and I thank you very much. Thank you all.

Senator BOREN. I want to thank our witnesses very much and also again thank Chairman Bentsen for convening these hearings. Those of us who have worked with our Chairman for a long period of time have enormous respect for his own expertise in the area of economic policy. His scheduling of these hearings certainly indicates the seriousness of purpose that exists not only on his part as Chairman, but by all the members of our committee.

I would hope, too, that if the President has a chance to review this tape or if, indeed, there are those monitoring these proceedings for him at the White House, that he would consider a final proposal. If he intends to announce to us in the State of the Union Address his economic policy recommendations, prior to that time, he should establish an informal working group. He should contact the Chairman of this committee and Chairman Rostenkowski and ask for a half a dozen members of each committee—the Finance Committee and the Ways and Means Committee, since they will be most involved on a bipartisan basis—to meet with him and consult with him prior to the preparation of that State of the Union Address.

Because I think that it would have so much more impact on the country if the President chose this course of action, instead of coming to us in January to say here are my proposals, now let's have a debate about my proposals for the next 30 or 60 days.

If he could come to us at the State of the Union Address and say: I have already undertaken a bipartisan consultation with the leaders of Congress, and particularly the two committees of Congress most responsible in the House and the Senate for action, and I come to you not presenting the economic plan of George Bush or this administration, but I come presenting to this Congress the bipartisan economic plan hammered out in a cooperative partnership together. Now let's pass it in 2 weeks. Not even 30 days or 60 days because we have already consulted. This is not a Democratic plan or a Republic plan, this is an American plan, let's hit the ground running. It would have such a positive impact.

So I hope if the President does review this tape or if he does have someone informing him as to what was said here that he will seriously consider the possibility of doing just that.

Knowing Chairman Rostenkowski's views and his ability to hammer out bipartisan solutions, I cannot imagine him turning down a request of the President. I know our Chairman is a statesman before all else. Our ranking member the same. Members of this committee, I think realize that we have a problem that is so serious that we do not need politics. We do not need to score political points. We need solutions.

The American people do not want a political fight. They want action. And the best way to get that action is to have consultation in advance, so that when the President makes his proposals to the country and to the Congress in January, he presents them with that background work already done, the debate in many ways already concluded, the consultation over, so that we can move ahead and get the job done.

I hope that will happen. I know one thing: in hearing the witnesses, including the members of this panel and those that we have heard for the past 2 days, and in thinking among ourselves about how to proceed, I think we have made enormous progress in terms of formulating ideas in our own minds about what to do.

I hope we can share these conclusions with the Executive Branch and get on with the task of getting the job done. So again I thank the Chairman.

Senator RIEGLE. Senator Boren, would you yield just for one minute on your idea?

Senator BOREN. Yes. I would be happy to.

Senator RIEGLE. First of all, I support it. I think it is a terrific idea. I think you are right, people want answers. They do not want a lot of hair pulling or, you know, political debate beyond some reasonable point.

I would suggest, however, that we amend that only slightly because we have heard today that we need fiscal stimulus.

Senator BOREN. Yes.

Senator RIEGLE. We also need, I think, some monetary policy adjustment.

Senator BOREN. Exactly.

Senator RIEGLE. I would suggest that in addition to members of our committee that we probably ought to have the Banking Committee which oversees monetary policy and probably the Budget Committee, at least I think the Chairman and the Ranking Member. Because any package is going to mean opening up the budget agreement as well.

But I think in order to shorten this process and in a sense to get to the immediate answer we ought—I think you have made a wonderfully constructive suggestion. There is no reason why those meetings should not start tomorrow morning.

Senator BOREN. I think we should do that. I do not know that it has to be even in a formal sense. I do not know that we have to have a formal——

Senator RIEGLE. But I think the President has to be there.

Senator BOREN. The President needs to do it. He can even start getting advice on an informal basis right away, then perhaps leading to the impaneling of a more formal consultation process near the end of the year, early into the next year. But I think the informal consultation needs to begin now. I think you are absolutely right.

We are going to have to look at reopening the budget agreement. We have to look at monetary policy as well. The budget agreement is going to have to leave room for, I think, infrastructure, public works and other improvements that are going to have to be part of this package as well as tax changes.

But I think it would be enormously helpful if instead of having private consultations internally within the administration, then announcing them to the Congress, then waiting for us to react, then going through the process of several weeks or perhaps several months of seeing if we can then hammer out a compromise having spoken for the first time publicly to each other rather than privately to each other, I think it would be enormously helpful to begin these private consultations and maybe in a very low key way to start in building toward bringing the people together in groups.

Maybe it first needs to be one-on-one or with two or three members of the House and Senate, the President getting a sense of that, and then finally bringing in more formal representation of the relevant committees. But I think the process should begin.

I cannot think of anything that would be a more hopeful sign to the American people as we start the new year. What a signal it would send if we can demonstrate that we care enough about the country, even with a Presidential election coming up, to try to work together in a constructive and statesmanlike way.

For a number of reasons, people in the country wonder if our institutions of government are really up to that kind of leadership anymore. I think it would be a very, very hopeful signal to send. So I hope that will happen.

I appreciate very much the comments of my colleague, Senator Riegle, who is certainly one of the most thoughtful members of this committee as he has demonstrated in the course of these hearings today.

I would put the full statement of Senator Bentsen, our Chairman, into the record. I know that he regrets that he was not able to be with us today. I think we all understand that we are in a flu epidemic, and he has not been immune from suffering.

But again, we would not be here were it not for his leadership and his insistence that we come together, his selection of an outstanding group of witnesses for us to hear who have truly informed us. While putting his statement into the record, I want to thank Senator Bentsen again for his leadership in this area.

Thank our witnesses and the hearings will stand in recess.

[Whereupon, the hearing adjourned at 2:43 p.m.]

APPENDIX

Additional Material Submitted

Prepared Statement of Chairman Lloyd Bentsen

[November 26, 1991]

As families prepare to sit down together for Thanksgiving dinner, it is a good time to reflect on a bedrock American belief: that, with hard work, we can prosper and raise our standard of living. For generations, children have claimed what seemed to be their birthright—a step up in life.

That promise of a step up, unique to America, stands to become as worthless as stock in a failed savings and loan. Today's generation of male high school graduates will be the first to do worse than their fathers.

For too many American families, the dream of home ownership is turning into an economic nightmare on Elm Street. Home prices collapsed last year, causing a stunning $181 billion plunge in family net worth, the first such decline in two generations.

Two paychecks became a necessity in the 80's as costs soared for the basic necessities of life. A typical family today pays $1,300 for health insurance—compared with $150 in 1980—and gets less for its money, with deductibles and co-payments skyrocketing. Families with children saw their taxes increase during the past decade, while their incomes fell, by $1,600 on average.

We need to turn that around. I've introduced, along with Senators Roth, Mikulski and others, a bill that would give hard-pressed middle income Americans a tax cut, one that would help jolt this economy out of the doldrums. We have proposed a $300 tax credit for every child under age 19, which would reduce the income tax bill of a family of four making $35,000 a year by 25 percent. Expanding individual Retirement Accounts—the IRA—as we're also proposing—would give the economy an additional kick by immediately freeing up some $530 billion in existing IRA and 401k savings to buy that first home.

Our tax cut would be fully financed by a 5 percent cut in the five year defense budget submitted by the President a year ago. The world has changed dramatically since then. According to press reports, in fact, the Joint Chiefs of Staff are considering additional cuts of as much as 8 percent. After being ignored by the policies of the 80s, middle income families are surely entitled to at least a share of this peace dividend.

Since the tax cuts go into effect January 1 and the defense cuts don't begin phasing in until fiscal 1993, our proposal would give us a real economic boost. I am today releasing an econometric analysis by DRI which concludes that the IRA provision alone would help jump start the economy. It would increase projected growth by 10 percent next year. It would create 85,000 new jobs during the year and over 200,000 new jobs in 1993. And it would add nearly 50,000 new housing starts each year. Together with the child tax credit, our proposal would add $24 billion to the economy next year.

Families need help. Our economy needs help. The Administration has been following an economic policy of denial and delay. It is time for us, working in cooperation, to step up to our problems and deal with them.

In my view, cutting taxes for middle income Americans is a top priority. I've outlined our legislation, and I know that several of my colleagues have proposals of their own to discuss. I'm looking forward to hearing more about them and hearing from Secretary Kemp, who has some important views on the effect of tax cuts on his area of responsibility, and from our other knowledgeable witnesses today.

DESCRIPTION OF PROPOSALS
RELATING TO
MIDDLE-INCOME TAX RELIEF
AND ECONOMIC GROWTH

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION
November 25, 1991
JCX-31-91

INTRODUCTION

This document,[1] prepared by the Staff of the Joint Committee on Taxation, provides a description of proposals relating to middle-income tax relief and economic growth, scheduled for a public hearing by the Senate Committee on Finance on November 26, 1991.

Part I is a summary of the proposals. Part II provides a description of the proposals, including present law and effective dates.

I. SUMMARY OF PROPOSALS

S. 1921, "The Tax Fairness and Savings Incentive Act of 1991" (Senators Bentsen, Adams, Akaka, Baucus, Boren, Breaux, Burdick, Daschle, DeConcini, Dodd, Ford, Hatch, Inouye, Johnston, Lieberman, Mikulski, Pryor, Roth, and Symms)

The bill would provide a refundable tax credit equal to $300 for each child residing with the taxpayer. The bill would also restore the pre-1986 deduction rules for contributions to individual retirement arrangements (IRAs) and create a new special IRA. Amounts contributed to special IRAs would not be includible in income if held in the special IRA for at least 5 years. Contribution limits for IRAs, special IRAs, and elective deferrals under certain other tax-favored arranges would in coordinated. Individuals would be permitted to transfer amounts in IRAs to special IRAs. The bill would add exemptions to the 10-percent tax on early withdrawals for certain distributions for certain medical expenses, first-time home purchase, and education expenses.

The bill would reduce defense spending in order to offset the cost of the bill's other proposals.

S. 1846, "The Family Tax Relief Act of 1991"
(Senator Bradley)

The bill would provide a refundable tax credit equal to $350 for each dependent child under age 18, and would reduce certain spending and modify the budget process to offset the cost of this credit.

[1] This document may be cited as follows: Joint Committee on Taxation, Description of Proposals Relating to Middle-Income Tax Relief and Economic Growth (JCX-31-91), November 25, 1991.

S. 1009
(Senators Coats, Burns, Gorton, Hatfield, and Mikulski)

The bill would increase the personal exemption for dependent children under the age of 18 to $4,000 in 1992 and would modify the rounding rules for indexed amounts.

S. 1411, "Middle Income Tax Relief and Family Preservation Act of 1991" (Senator Dodd)

The bill would set the personal exemption to $2,300 in 1992 and would provide an additional personal exemption for certain taxpayers based on the taxpayer's highest marginal tax rate. The bill would also provide an $800 refundable tax credit for children under age 5 that could be claimed in lieu of the personal exemption. The bill would increase individual tax rates, impose a surtax on certain high-income individuals, and increase the corporate tax rate. The bill would also repeal the restrictions on scholarships and fellowships added by the Tax Reform Act of 1986.

S. 955, "Working Family Tax Relief Act of 1991"
(Senators Gore, Bingaman, Cranston, and DeConcini)

The bill would replace the present-law personal exemption for children under 18 with a refundable tax credit. The bill would repeal the young child and supplemental health insurance competent of the earned income tax credit (EITC) and add an additional credit rate for families with three or more qualifying children. The bill would repeal present-law provisions that reduce personal exemptions and itemized deductions for higher-income individuals. The bill would increase individual income tax rates and impose a surtax on high-income individuals.

S. 1013 (Senator Grassley)

The bill would replace the present-law supplemental young child component of the earned income tax credit with an expanded supplemental young child credit available to taxpayers with qualifying children under the age of five.

S. 1014 (Senator Grassley)

The bill would increase the amount of the personal exemption in steps, culminating in an exemption amount of $7,000 for taxable years beginning after December 31, 1999. This personal exemption amount would be indexed for inflation occurring after 1999.

S. 1875 (Senator Lieberman)

The bill would set the regular personal exemption at $2,300 for 1992 and would allow a larger personal exemption in the case of children under the age of 10. Taxpayers who are eligible for the earned income tax credit would be able to claim a refundable tax credit in lieu of the personal exemption.

S. 11, "The Social Security Tax Cut Act of 1991"
(Senators Moynihan, Exon, Hatch, Helms, Hollings, Inouye, Kasten, Pell, Sanford, and Symms)

The bill would reduce the rate of the old age, survivors, and disability insurance portion of the payroll tax over a 5-year period and would increase the taxable wage base over the same period. The tax rate would increase again beginning after 2010.

S. 1984, "Consumer Confidence and Financial Flexibility Act of 1991" (Senators Specter and Domenici)

The bill would permit taxpayers with adjusted gross income below certain levels to make penalty-free withdrawals from individual retirement arrangements and certain pension plans if the amounts withdrawn are used to purchase or improve real property or to purchase durable goods. The bill would also extend certain expiring provisions.

II. DESCRIPTION OF PROPOSALS

A. S. 1921, "The Tax Fairness and Savings Incentive Act of 1991" (Senators Bentsen, Adams, Akaka, Baucus, Boren, Breaux, Burdick, Daschle, DeConcini, Dodd, Ford, Hatch, Inouye, Johnston, Lieberman, Mikulski, Pryor, Roth, and Symms)

Present Law

Family tax credits

Present law does not provide for tax credits based on the number of dependent children. However, taxpayers with dependent children are generally able to claim a personal exemption for these dependents. The total amount of personal exemptions is subtracted (along with certain other items) from adjusted gross income in arriving at taxable income. The amount of the personal exemption is $2,150 for 1991, and is adjusted for inflation.

In addition, eligible low-income workers may claim a refundable earned income tax credit (EITC) of up to 16.7 percent (17.3 percent for taxpayers with more than 1 qualifying child) of the first $7,140 of earned income for 1991. The maximum amount of credit for 1991 is $1,192 ($1,235 for taxpayers with more than 1 qualifying child), and this maximum is reduced by 11.93 percent (12.36 percent for taxpayers with more than 1 qualifying child) of earned income (or adjusted gross income, if greater) in excess of $11,250. The EITC is not available to workers with earned income (or adjusted gross income, if greater) over $21,245. Earned income consists of wages, salaries, other employee compensation, and net self-employment income.

The credit rates for the EITC change over time under present law, as shown in the following table.

Year	One qualifying child		Two or more qualifying children	
	Credit rate	Phaseout rate	Credit rate	Phaseout rate
1992	17.6 %	12.57 %	18.4 %	13.14 %
1993	18.5 %	13.21 %	19.5 %	13.93 %
1994 and after	23.0 %	16.43 %	25.0 %	17.86 %

The maximum amount of earned income on which the EITC may be claimed and the income threshold for the phaseout of the EITC are indexed for inflation.

As part of the EITC, a supplemental young child credit is available for qualifying children under the age of one year. This "young child credit" rate is 5 percent and the phase-out rate is 3.57 percent. In addition, a supplemental health insurance credit under the EITC is available to taxpayers who provide health insurance coverage for their qualifying children. The health insurance credit rate is 6 percent and the phase-out rate is 4.285 percent. Both supplemental credits are computed on the same base as the ordinary EITC.

Individual retirement arrangements

Under present law, under certain circumstances, an individual is allowed to deduct contributions (up to the lesser of $2,000 or 100 percent of the individual's compensation or earned income) to an individual retirement arrangement (IRA). The amounts held in an IRA, including earnings on contributions, generally are not included in gross income until withdrawn. Withdrawals prior to attainment of age 59-1/2 are generally subject to an additional 10-percent early withdrawal tax.

The $2,000 deduction limit is phased out over certain adjusted gross income (AGI) thresholds if the individual or the individual's spouse is an active participant in an employer-sponsored retirement plan. An individual may make nondeductible IRA contributions (up to the $2,000 or 100 percent of compensation limit) to the extent the individual is not permitted to make or does not make deductible IRA contributions.

The IRA provisions were originally enacted in the Employee Retirement Income Security Act of 1974 (ERISA). Under ERISA, an individual was permitted to make deductible IRA contributions only if the individual was not an active participant in an employer-sponsored retirement plan. The limit on IRA deductions was the lesser of $1,500 or 15 percent of compensation (or earned income, in the case of a self-employed individual).

The Economic Recovery Tax Act of 1981 increased the IRA deduction limit to its current level and removed the restriction on IRA contributions by individuals who were active participants in employer-sponsored plans. The IRA rules in their current form were enacted as part of the Tax Reform Act of 1986.

Explanation of Provisions

Tax credit

The bill would allow taxpayers to claim a refundable tax credit equal to $300 for each qualifying child of the taxpayer. A "qualifying child" would be defined as a child under age 19 who resides with the taxpayer (this definition is used in the EITC eligibility rules). The $300 figure would be adjusted for inflation for taxable years after 1991.

Individual retirement arrangements

The bill would restore the deductibility of IRA contributions for all taxpayers under the rules in effect prior to the Tax Reform Act of 1986 and would index for inflation the limits on contributions to IRAs. In addition, the bill would create a new special IRA to which a taxpayer could make nondeductible contributions. Withdrawals from a special IRA would not be includible in income if attributable to contributions that had been held by the special IRA for at least 5 years. The limits on contributions to deductible IRAs and special IRAs and the limits on elective deferrals under certain other tax-favored arrangements (e.g., section 401(k) plans) would be coordinated.

The bill would permit amounts in IRAs to be transferred to a special IRA. Amounts so transferred generally would be includible in income as if the amounts had been withdrawn from the IRA, except that the early withdrawal tax would not apply. In the case of transfers made before January 1, 1994, the amount includible in income is spread over the 4 taxable years following the transfer.

The bill would allow withdrawals from an IRA and from elective deferrals under (1) a qualified cash or deferred arrangement (sec. 401(k) plan), (2) a tax-sheltered annuity (sec. 403(b)), or (3) a section 501(c)(18) plan. The 10-percent additional income tax on early withdrawals would not apply to such withdrawals to the extent the amount withdrawn is used for the purchase of a first home, for certain education expenses, or for catastrophic medical expenses (i.e., medical expenses in excess of 7.5 percent of AGI). The bill would also provide that the exception to the early withdrawal tax for distributions after age 59-1/2 does not apply to deductible IRAs unless the contributions withdrawn have been in the IRA for at least 5 years before withdrawal.

Reduction in defense spending

The bill would provide for a reduction in defense spending to offset the cost of the proposed tax credit.

Effective Date

The provisions of the bill would generally be effective for taxable years beginning after December 31, 1991, except that the new exceptions to the early withdrawal tax would apply to distributions after the date of enactment.

B. S. 1846, "The Family Tax Relief Act of 1991" (Senator Bradley)

Present Law

Present law does not provide for tax credits based on the number of dependent children. However, taxpayers with dependent children are generally able to claim a personal exemption for these dependents. The total amount of personal exemptions is subtracted (along with certain other items) from adjusted gross income in arriving at taxable income. The amount of the personal exemption is $2150 for 1991, and is adjusted for inflation.

In addition, eligible low-income workers may claim a refundable earned income tax credit (EITC) of up to 16.7 percent (17.3 percent for taxpayers with more than 1 qualifying child) of the first $7,140 of earned income for 1991. The maximum amount of credit for 1991 is $1,192 ($1,235 for taxpayers with more than 1 qualifying child), and this maximum is reduced by 11.93 percent (12.36 percent for taxpayers with more than 1 qualifying child) of earned income (or adjusted gross income, if greater) in excess of $11,250. The EITC is not available to workers with earned income (or adjusted gross income, if greater) over $21,245. Earned income consists of wages, salaries, other employee compensation, and net self-employment income.

The credit rates for the EITC change over time under present law, as shown in the following table.

Year	One qualifying child		Two or more qualifying children	
	Credit rate	Phaseout rate	Credit rate	Phaseout rate
1992	17.6 %	12.57 %	18.4 %	13.14 %
1993	18.5 %	13.21 %	19.5 %	13.93 %
1994 and after	23.0 %	16.43 %	25.0 %	17.86 %

The maximum amount of earned income on which the EITC may be claimed and the income threshold for the phaseout of the EITC are indexed for inflation.

As part of the EITC, a supplemental young child credit is available for qualifying children under the age of one year. This "young child credit" rate is 5 percent and the phase-out rate is 3.57 percent. In addition, a supplemental health insurance credit under the EITC is available to taxpayers who provide health insurance coverage for their qualifying children. The health insurance credit rate is 6 percent and the phase-out rate is 4.285 percent. Both supplemental credits are computed on the same base as the ordinary EITC.

Explanation of Provisions

Tax credit

The bill would allow taxpayers to claim a refundable tax credit equal to $350 for each dependent child of the taxpayer under age 18. The $350 figure would be adjusted for inflation occurring after 1991.

Revenue-raising provisions

The bill would provide for reductions in a number of specified spending categories and for modifications in the Congressional budget process to offset the cost of the proposed tax credit.

Effective Date

The provisions of the bill would be effective for taxable years beginning after December 31, 1991.

C. S. 1009 (Senators Coats, Burns, Gorton, Hatfield, and Mikulski)

Present Law

Personal exemption

Taxpayers are allowed a personal exemption for themselves (and spouse, in the case of a joint return) and for each dependent of the taxpayer. The exemption is structured as a deduction in determining taxable income. The level of the personal exemption was set at $2,000 for taxable years beginning in 1989 and has been indexed for inflation in subsequent years. For taxable years beginning in 1991, the personal exemption is $2,150.

Rounding rules for indexed amounts

In the case of the personal exemption, the standard deduction the threshold for the limitation on itemized deductions, and the break points for the individual income tax brackets, if any indexed amount is not a multiple of $50, then it is rounded down to the next lowest multiple of $50.

Explanation of Provisions

Increase in personal exemption for certain dependent children

The bill would increase the personal exemption to $4,000 for dependent children under the age of 18 at the end of the taxable year. This amount would be indexed for inflation in subsequent years.

Change in rounding rules for indexed amounts

In the case of the personal exemption, the standard deduction, the threshold for the limitation on itemized deductions, and the break points for the individual income tax brackets, if any indexed amount is not a multiple of $10, then it would be rounded to the nearest multiple of $10. The bill is silent on what would happen if the indexed amount is a multiple of $5, but not of $10.

Effective Date

The bill would be effective for taxable years beginning after December 31, 1991.

D. S. 1411, "Middle Income Tax Relief and Family Preservation Act of 1991" (Senator Dodd)

Present Law

Personal exemption

Taxpayers are allowed a personal exemption for themselves (and spouse, in the case of a joint return) and for each dependent of the taxpayer. The exemption is structured as a deduction in determining taxable income. The level of the personal exemption was set at $2,000 for taxable years beginning in 1989 and has been indexed for inflation in subsequent years. For taxable years beginning in 1991, the personal exemption is $2,150.

Individual income tax rates

For 1991, the individual tax rate schedules are --

If taxable income is:	Then income tax equals:
Single individuals	
$0 - $20,350	15 percent of taxable income
$20,350 - $49,300	$3,052.50 plus 28% of the amount over $20,350
over $49,300	$11,158.50 plus 31% of the amount over $49,300

Heads of households

\$0 - \$27,300	15 percent of taxable income
\$27,300 - \$70,450	\$4,095 plus 28% of the amount over \$27,300
over \$70,450	\$16,177 plus 31% of the amount over \$70,450

Married individuals filing joint returns

\$0 - \$34,000	15 percent of taxable income
\$34,000 - \$82,150	\$5,100 plus 28% of the amount over \$34,000
over \$82,150	\$18,582 plus 31% of the amount over \$82,150

Alternative minimum tax

An individual taxpayer is subject to an alternative minimum tax (AMT) if the amount of that tax exceeds the taxpayer's regular tax liability. The AMT rate is 24 percent and is applied to the taxpayer's alternative minimum taxable income (generally computed by adding preference items to the taxpayer's regular taxable income).

Corporate income tax rates

For 1991, the corporate tax rate schedule is --

If taxable income is:	Then income tax equals:
\$0 - \$50,000	15 percent of taxable income
\$50,000 - \$75,000	\$7,500 plus 25% of the amount over \$50,000
\$75,000 - \$100,000	\$13,750 plus 34% of the amount over \$75,000
\$100,000 - \$335,000	\$22,250 plus 39% of the amount over \$100,000
over \$335,000	34 percent of taxable income

Treatment of scholarships and fellowships

The Code permits an exclusion from gross income for qualified scholarship amounts received by individuals who are degree candidates at an educational institution that normally maintains a regular faculty, curriculum, and enrolled body of students (sec. 117). "Qualified scholarships" are limited to amounts received by an individual as a scholarship or fellowship grant that are used for tuition, fees, books, and supplies required for attendance at the educational institution. As a result of the Tax Reform Act of 1986, amounts received for room and board (or other personal expenses) are included in gross income.

An exclusion from gross income is also provided for certain "qualified tuition reductions," meaning reductions in tuition provided to an employee of an educational institution for the education below the graduate level of the employee (or certain relatives or retired employees) at that institution or another educational institution. This exclusion from gross income is provided for a tuition reduction used for education above the graduate level if provided to a graduate student who is engaged in teaching or research activities.

The exclusion from gross income for qualified scholarships or tuition reductions do not, however, apply to any amount received that represents compensation for teaching, research, or other services by the student required as a condition for receiving the scholarship or tuition reduction.

Explanation of Provisions

Personal exemption increase for certain taxpayers

The bill would set the regular personal exemption to $2,300 for taxable years beginning in 1992 and would allow an additional exemption for certain taxpayers. To determine eligibility for the additional exemption, the taxpayer would first calculate his or her taxable income using the regular personal exemption. If the taxable income so determined would be subject to a statutory marginal rate of 15 percent, then the taxpayer would be allowed an additional $1,150 per exemption. If the taxable income so determined would be subject to a statutory marginal rate of 28 percent, then the taxpayer would be allowed an additional $575 per exemption.

All of the amounts above, including the regular personal exemption, would be indexed for inflation in years after 1992.

Credit in lieu of the personal exemption

If the taxpayer has a dependent child under the age of 5 at the end of the taxable year, then the taxpayer would be eligible for an $800 refundable tax credit in lieu of the personal exemption for that child. The amount of the refundable child credit would be indexed for inflation in years after 1992. These indexed amounts would be rounded up to the nearest $10.

Under the bill, the refundable portion of the child credit would be payable in advance for certain taxpayers who elect such treatment. The Treasury Department would be directed to pay such taxpayers approximately 80 percent of the estimated refund in quarterly installments.

Increase in individual tax rates

A 34 percent bracket would apply to taxable incomes above: $160,000 (married individuals filing joint returns); $120,000 (unmarried individuals filing as head of household); $100,000 (unmarried individuals filing single returns); $80,000 (married individuals filing separate returns); and $12,600 (estates and trusts). These thresholds are expressed at 1990 levels and would be adjusted for inflation to 1992 levels.

The alternative minimum tax rate would be increased from 24 percent to 27 percent.

Surtax on high-income individuals

A surtax would apply to individuals (including estates and trusts) with taxable income over $300,000 ($150,000 for married taxpayers filing separate returns). In the case of the regular income tax, the surtax would equal:

(10%)(1 - [$300,000/taxable income])(regular tax liability).

A surtax of 2.5 percent would apply to AMT income above $300,000 ($150,000 for married taxpayers filing separate returns).

In addition, the surtaxes would apply to the 28 percent rate applicable to capital gains income.

Increase in corporate income tax rates

The top marginal rate bracket for corporations (applying to taxable income in excess of $75,000) would be increased to 35 percent. Thus the corporate rate schedule would be changed to the following --

If taxable income is:	Then income tax equals:
$0 - $50,000	15 percent of taxable income
$50,000 - $75,000	$7,500 plus 25% of the amount over $50,000
$75,000 - $100,000	$13,750 plus 35% of the amount over $75,000
$100,000 - $335,000	$22,250 plus 40% of the amount over $100,000
over $335,000	35 percent of taxable income

Exclusion from income for scholarships and fellowships

The bill would repeal the amendments made to section 117 by the Tax Reform Act of 1986 and would return to pre-1986 law, so that:

(1) an unlimited exclusion from gross income would be provided for amounts received by a degree candidate as a scholarship at an educational institution (described in sec. 170(b)(1)(A)(ii)) or fellowship grant, including the value of contributed services and accommodations (i.e., room and board);

(2) an exclusion from gross income would be provided for amounts received incident to a scholarship or fellowship grant to cover expenses for travel, research, clerical help, or equipment;

(3) non-degree candidates could exclude certain scholarships or fellowships from gross income, subject to a limitation that the amount received not exceed $300 multiplied by the number of months for which the recipient received amounts under the scholarship or fellowship;

(4) if teaching, research, or other part-time employment services are required of all candidates for a particular degree (whether or not recipients of scholarship or fellowship grants) as a condition of receiving the degree, then the amount of scholarship or fellowship excludible from gross income would not be reduced by the amount that represents compensation for such services performed by the student; and

(5) certain Federal grants would be excludible from income, even if the recipient is required to perform future services as a Federal employee or to serve as a health professional in designated areas.

Effective Dates

All provisions of the bill except those dealing with scholarships and fellowships would be effective for taxable years beginning after December 31, 1991.

The provision dealing with scholarships and fellowships would be effective for all taxable years beginning after December 31, 1986. In addition, within one year after date of enactment, closed taxable years could be re-opened for taxpayers to claim a refund or credit of any overpayment of tax resulting from the provision relating to scholarships and fellowships.

E. S. 955, "Working Family Tax Relief Act of 1991" (Senators Gore, Bingaman, Cranston, and DeConcini)

Present Law

Personal exemption

Taxpayers are allowed a personal exemption for themselves (and spouse, in the case of a joint return) and for each dependent of the taxpayer. The exemption is structured as a deduction in determining taxable income. The level of the personal exemption was set at $2,000 for taxable years beginning in 1989 and has been indexed for inflation in subsequent years. For taxable years beginning in 1991, the personal exemption is $2,150.

Personal exemption phaseout

Under present law, the deduction for the personal exemptions claimed by a taxpayer is phased out for taxpayers with adjusted gross income (AGI) above a threshold amount. For each $2,500 (or fraction thereof) of AGI above the threshold, the deduction for personal exemptions is reduced by 2 percent. For 1991, the threshold is $150,000 for married individuals filing joint returns, $125,000 for unmarried individuals filing as head of household, and $100,000 for unmarried individuals filing single returns. These threshold figures are to be adjusted for inflation for taxable years after 1991. This provision is effective for taxable years beginning after December 31, 1990, and before January 1, 1996.

Itemized deduction phaseout

Individuals are allowed deductions for certain personal expenses, such as State and local taxes, home mortgage interest, certain medical expenses and casualty losses, and charitable contributions. Under present law, the total of otherwise allowable deductions for these items that may be claimed by a taxpayer is reduced by an amount equal to 3 percent of the taxpayer's AGI in excess of $100,000. In no event may the reduction in itemized deductions exceed 80 percent of otherwise allowable deductions. The $100,000 threshold is adjusted for inflation for taxable years after 1991. This provision is effective for taxable years beginning after December 31, 1990, and before January 1, 1996.

Earned income tax credit

Eligible low-income workers may claim a refundable earned income tax credit (EITC) of up to 16.7 percent (17.3 percent for taxpayers with more than 1 qualifying child) of the first $7,140 of earned income for 1991. The maximum amount of credit for 1991 is $1,192 ($1,235 for taxpayers with more than 1 qualifying child), and this maximum is reduced by 11.93 percent (12.36 percent for taxpayers with more than 1 qualifying child) of earned income (or adjusted gross income, if greater) in excess of $11,250. The EITC is not available to workers with earned income (or adjusted gross income, if greater) over $21,245. Earned income consists of wages, salaries, other employee compensation, and net self-employment income.

The credit rates for the EITC change over time under present law, as shown in the following table.

Year	One qualifying child		Two or more qualifying children	
	Credit rate	Phaseout rate	Credit rate	Phaseout rate
1992	17.6 %	12.57 %	18.4 %	13.14 %
1993	18.5 %	13.21 %	19.5 %	13.93 %
1994 and after	23.0 %	16.43 %	25.0 %	17.86 %

The maximum amount of earned income on which the EITC may be claimed and the income threshold for the phaseout of the EITC are indexed for inflation.

As part of the EITC, a supplemental young child credit is available for qualifying children under the age of one year. This "young child credit" rate is 5 percent and the phase-out rate is 3.57 percent. In addition, a supplemental health insurance credit under the EITC is available to taxpayers who provide health insurance coverage for their qualifying children. The health insurance credit rate is 6 percent and the phase-out rate is 4.285 percent. Both supplemental credits are computed on the same base as the ordinary EITC.

Individual income tax rates

For 1991, the individual tax rate schedules are --

If taxable income is:	Then income tax equals:
Single individuals	
$0 - $20,350	15 percent of taxable income
$20,350 - $49,300	$3,052.50 plus 28% of the amount over $20,350
over $49,300	$11,158.50 plus 31% of the amount over $49,300
Heads of households	
$0 - $27,300	15 percent of taxable income
$27,300 - $70,450	$4,095 plus 28% of the amount over $27,300
over $70,450	$16,177 plus 31% of the amount over $70,450
Married individuals filing joint returns	
$0 - $34,000	15 percent of taxable income
$34,000 - $82,150	$5,100 plus 28% of the amount over $34,000
over $82,150	$18,582 plus 31% of the amount over $82,150

Alternative minimum tax

An individual taxpayer is subject to an alternative minimum tax (AMT) if the amount of that tax exceeds the taxpayer's regular tax liability. The AMT rate is 24 percent and is applied to the taxpayer's alternative minimum taxable income (generally computed by adding preference items to the taxpayer's regular taxable income).

Explanation of Provisions

Tax credit for dependent children

The bill would replace the current personal exemption for children under age 18 with a refundable tax credit no larger than $800 per child. Each qualifying taxpayer would receive at least a credit of $400. The maximum credit would be equal to 20 percent of earned income (and child support received), not to exceed $800 per child. The $800 and $400 amounts would be indexed for inflation beginning after December 31, 1993.

The refundable portion of the child credit would be payable in advance for certain taxpayers who elect such treatment. The Treasury Department would be directed to pay such taxpayers approximately 80 percent of the estimated refund in quarterly installments.

Simplification and expansion of the EITC

The supplemental young child component of the EITC and the supplemental health insurance component of the EITC would be repealed. An additional credit rate would be added for larger families (those with three or more qualifying children). For 1994 and later years, the EITC schedule would be:

	Credit rate	Phaseout rate
Families with:		
1 qualifying child	22 %	17 %
2 qualifying children	27 %	17 %
3 or more qualifying children	32 %	17 %

For 1992 and 1993, the credit rates would be somewhat lower as they are phased in over a three-year period.

Repeal of personal exemption phaseout and limitation on itemized deductions

The present-law provisions under which personal exemptions and itemized deductions are either reduced or eliminated for higher income individuals would be repealed.

Revenue offsets[2]

Increased individual income tax rates

The present-law regular tax 31-percent rate would be increased to 32 percent, and a new 35-percent rate would apply to taxable incomes in excess of--

Single individuals	$ 78,400
Heads of household	94,000
Married individuals filing joint returns and certain surviving spouses	110,000
Married individuals filing separate returns	55,000.

The individual alternative minimum tax rate would be increased to 29 percent.

Surtax

An 11-percent surtax would apply to tax attributable to AGI in excess of--

Single individuals	$150,000
Heads of household	200,000
Married individuals filing joint returns and certain surviving spouses	250,000
Married individuals filing separate returns	125,000.

Effective Dates[3]

The provisions of the bill would apply to taxable years beginning after December 31, 1991.

[2] Following introduction, S. 955 was estimated to result in a revenue loss. In July 1991, Senator Gore announced his intention to modify the revenue offset portions of the bill as follows:

a. The 35-percent maximum individual income tax rate would be increased to 36 percent.

b. The 11-percent surtax rate would be increased to 15 percent and the AGI thresholds would be reduced. For example, the new threshold for married individuals filing joint returns would be $200,000.

c. The EITC provisions would be modified by eliminating any family size adjustment (larger credit rates for larger families), and using revenues raised from repeal of the supplemental young child and health insurance components of the EITC to increase the basic credit rate. Under the proposed change, the basic credit rate would be 20 percent for 1992, 22 percent for 1993, and 24 percent for 1994 and thereafter.

[3] In his July 1991 statement, Senator Gore proposed delaying the effective dates of the surtax and the $800 refundable credit to taxable years beginning after December 31, 1992.

F. S. 1013 (Senators Grassley and Coats)

Present Law

Earned income tax credit

Eligible low-income workers may claim a refundable earned income tax credit (EITC) of up to 16.7 percent (17.3 percent for taxpayers with more than 1 qualifying child) of the first $7,140 of earned income for 1991. The maximum amount of credit for 1991 is $1,192 ($1,235 for taxpayers with more than 1 qualifying child), and this maximum is reduced by 11.93 percent (12.36 percent for taxpayers with more than 1 qualifying child) of earned income (or adjusted gross income, if greater) in excess of $11,250. The EITC is not available to workers with earned income (or adjusted gross income, if greater) over $21,245. Earned income consists of wages, salaries, other employee compensation, and net self-employment income.

The credit rates for the EITC change over time under present law, as shown in the following table.

Year	One qualifying child		Two or more qualifying children	
	Credit rate	Phaseout rate	Credit rate	Phaseout rate
1992	17.6 %	12.57 %	18.4 %	13.14 %
1993	18.5 %	13.21 %	19.5 %	13.93 %
1994 and after	23.0 %	16.43 %	25.0 %	17.86 %

The maximum amount of earned income on which the EITC may be claimed and the income threshold for the phaseout of the EITC are indexed for inflation.

As part of the EITC, a supplemental young child credit is available for qualifying children under the age of one year. This "young child credit" rate is 5 percent and the phase-out rate is 3.57 percent. In addition, a supplemental health insurance credit under the EITC is available to taxpayers who provide health insurance coverage for their qualifying children. The health insurance credit rate is 6 percent and the phase-out rate is 4.285 percent. Both supplemental credits are computed on the same base as the ordinary EITC.

Explanation of Provisions

The bill would replace the present-law supplemental young child credit component of the EITC with an expanded supplemental young child credit available to taxpayers with qualifying children under the age of five. The maximum amount of the credit would be $500 for each qualifying child and the total amount of credit would be phased out ratably for taxpayers with adjusted gross income (AGI) between $50,000 and $60,000 (if greater, earned income would be substituted for AGI). Taxpayers claiming the expanded supplemental young child credit would not be permitted to claim the dependent care credit for expenses related to these children.

Effective Date

The provision is effective for taxable years beginning after December 31, 1991.

G. S. 1014 (Senator Grassley)

Present Law

Taxpayers are allowed a personal exemption for themselves (and spouse, in the case of a joint return) and for each dependent of the taxpayer. The exemption is structured as a deduction in determining taxable income. The level of the personal exemption was set at $2,000 for taxable years beginning in 1989 and has been indexed for inflation in subsequent years. For taxable years beginning in 1991, the personal exemption is $2,150.

Explanation of Provision

The bill would increase the amount of the personal exemption to $7,000 for taxable years beginning after December 31, 1999. The $7,000 figure would be subsequently indexed for inflation, similar to the indexing under current law. For taxable years beginning after December 31, 1991, and before January 1, 2000, the exemption amount would be determined by the following table:

For taxable years beginning in calendar years:	The exemption amount would be:
1992	$2,700
1993	3,200
1994	3,750
1995	4,300
1996	4,850
1997	5,400
1998	5,950
1999	6,500

Effective Date

The provision would be effective for taxable years beginning after December 31, 1991.

H. S. 1875 (Senator Lieberman)

Present Law

Personal exemption

Taxpayers are allowed a personal exemption for themselves (and spouse, in the case of a joint return) and for each dependent of the taxpayer. The exemption is structured as a deduction in determining taxable income. The level of the personal exemption was set at $2,000 for taxable years beginning in 1989 and has been indexed for inflation in subsequent years. For taxable years beginning in 1991, the personal exemption is $2,150.

Personal exemption phaseout

Under present law, the deduction for the personal exemptions claimed by a taxpayer is phased out for taxpayers with adjusted gross income (AGI) above a threshold amount. For each $2,500 (or fraction thereof) of AGI above the threshold, the deduction for personal exemptions is reduced by 2 percent. For 1991, the threshold is $150,000 for married individuals filing joint returns, $125,000 for unmarried individuals filing as head of household, and $100,000 for unmarried individuals filing single returns. These threshold figures are to be adjusted for inflation for taxable years after 1991. This provision is effective for taxable years beginning after December 31, 1990, and before January 1, 1996.

Earned income tax credit

Eligible low-income workers may claim a refundable earned income tax credit (EITC) of up to 16.7 percent (17.3 percent for taxpayers with more than 1 qualifying child) of the first $7,140 of earned income for 1991. The maximum amount of credit for 1991 is $1,192 ($1,235 for taxpayers with more than 1 qualifying child), and this maximum is reduced by 11.93 percent (12.36 percent for taxpayers with more than 1 qualifying child) of earned income (or adjusted gross income, if greater) in excess of $11,250. The EITC is not available to workers with earned income (or adjusted gross income, if greater) over $21,245. Earned income consists of wages, salaries, other employee compensation, and net self-employment income.

The credit rates for the EITC change over time under present law, as shown in the following table.

Year	One qualifying child		Two or more qualifying children	
	Credit rate	Phaseout rate	Credit rate	Phaseout rate
1992	17.6 %	12.57 %	18.4 %	13.14 %
1993	18.5 %	13.21 %	19.5 %	13.93 %
1994 and after	23.0 %	16.43 %	25.0 %	17.86 %

The maximum amount of earned income on which the EITC may be claimed and the income threshold for the phaseout of the EITC are indexed for inflation.

As part of the EITC, a supplemental young child credit is available for qualifying children under the age of one year. This "young child credit" rate is 5 percent and the phase-out rate is 3.57 percent. In addition, a supplemental health insurance credit under the EITC is available to taxpayers who provide health insurance coverage for their qualifying children. The health insurance credit rate is 6 percent and the phase-out rate is 4.285 percent. Both supplemental credits are computed on the same base as the ordinary EITC.

Explanation of Provisions

The bill would set the regular personal exemption to $2,300 for taxable years beginning in 1992 and would allow a larger personal exemption in the case of children under the age of 10 at the end of the taxable year. Taxpayers who are eligible for the EITC would be able to claim a refundable tax credit in lieu of the personal exemption.

Personal exemption for young children

In general

The amount of the personal exemption for a dependent child under the age of 10 would depend upon both the taxpayer's tax bracket and the age of the child. To determine the size of the child's personal exemption, the taxpayer would first calculate his or her taxable income assuming the child received the regular personal exemption ($2,300 for 1992). If the taxable income so determined would be subject to a statutory marginal rate of 15 percent, then the following schedule of child personal exemptions would apply:

Age of child	Child's personal exemption
Under 6	$7,000
6	$6,500
7	$6,000
8	$5,500
9	$5,000

If the taxable income determined above would be subject to a statutory marginal rate of 28 percent, then the following schedule of child personal exemptions would apply:

Age of child	Child's personal exemption
Under 6	$3,750
6	$3,482
7	$3,214
8	$2,946
9	$2,679

If the taxable income so determined would be subject to a statutory marginal rate of 31 percent, then the following schedule of child personal exemptions would apply:

Age of child	Child's personal exemption
Under 6	$3,387
6	$3,145
7	$2,903
8	$2,661
9	$2,419

All of the amounts above, including the regular personal exemption, will be indexed for inflation in years after 1992.

Denial of augmented deduction for high-income taxpayers

If the taxpayer's adjusted gross income exceeds a threshold amount, then only the regular personal exemption could be claimed for each child. (The threshold amount is not defined in the statutory language of the bill, but may be intended to equal that for the personal exemption phaseout.)

Denial of dependent care credit

If the taxpayer has an adjusted gross income below the threshold amount listed above and if the taxpayer claims the augmented personal exemption for a child under the age of 10, then that child would not be a qualifying individual in determining eligibility for the dependent care credit under Section 21 of the Code.

Credit in lieu of the personal exemption

If the taxpayer is eligible for the EITC, then he or she would also be eligible for a refundable tax credit in lieu of the personal exemption for each child under the age of 10. The amount of the credit would depend upon the age of the child as follows:

Age of child	Refundable child credit
Under 6	$1,050
6	$975
7	$900
8	$825
9	$750

The amounts of the refundable child credit listed above would be indexed for inflation in years after 1992. The indexed amounts would be rounded to the nearest $10 (rounded up if a multiple of $5, but not $10).

The refundable portions of the EITC and child credit would be payable in advance for certain taxpayers who elect such treatment. The Treasury Department would be directed to pay such taxpayers approximately 80 percent of the estimated refund in quarterly installments.

Effective Date

The provisions of the bill would be effective for taxable years beginning after December 31, 1991.

I. S. 11, "The Social Security Tax Cut Act of 1991" (Senators Moynihan, Exon, Hatch, Helms, Hollings, Inouye, Kasten, Pell, Sanford, and Symms)

Present Law

Contributions made under the Federal Insurance Contributions Act (FICA) provide funds to pay monthly benefits to retired or disabled workers and their dependents and to survivors of covered workers. Contributions are based on wages and earnings up to an annual maximum taxable wage base ($53,400 in 1991 for the Old Age, Survivors and Disability Insurance (OASDI) component). Both employers and employees contribute 6.2 percent of the taxable wage and earnings base for the OASDI portion of the payroll tax. Self-employed individuals pay tax at the combined employer-employee rate, but are permitted to deduct one-half of the payment as a business expense in determining their income tax liability.

Explanation of Provisions

The bill would reduce the rate of the OASDI (social security) portion of the payroll tax from the present level of 6.2 percent to 5.2 percent over a five-year period (this rate applies to both the employee and the employer). In addition, the bill would increase the maximum payroll tax base from the present level of $53,400 (for 1991) to $82,200 ovei the same five-year period. (The intent is to set the maximum payroll tax base for OASDI equal to approximately 90 percent of the total wage and salary payments in the economy. The current level is approximately 85 percent.) Due to the requirement that the Social Security system be in a position to meet all anticipated obligations over a 75-year horizon, OASDI tax rates would substantially increase after 2010, in part to finance the lower OASDI tax rate in the immediate future under the bill.

The following table summarizes the changing OASDI tax rates under the bill. After 1996, the maximum wage base would be adjusted for inflation, similar to the procedure under current law.

Year	Payroll Tax Rate	Maximum Payroll Tax Base
1/91 through 6/91	6.2%	$53,400
7/91 through 12/91	5.7%	$53,400
1992	5.7%	$60,600
1993	5.7%	$64,200
1994	5.5%	$70,200
1995	5.5%	$73,800
1996	5.2%	$82,200
1997 - 2009	5.2%	Adjusted for inflation
2010 - 2014	5.6%	Adjusted for inflation
2015 - 2019	6.2%	Adjusted for inflation
2020 - 2024	6.8%	Adjusted for inflation
2025 - 2029	7.5%	Adjusted for inflation
2030 - 2039	7.8%	Adjusted for inflation
2040 - 2049	7.9%	Adjusted for inflation
2050 and after	8.1%	Adjusted for inflation

Effective Date

The provisions of the bill would be effective for wages and earnings paid after January 1, 1991.

J. S. 1984, "Consumer Confidence and Financial Flexibility Act of 1991", (Senators Specter and Domenici)

Present Law

Taxation of distributions from IRAs and pension plans

Under present law, a distribution from an individual retirement arrangement (IRA) or a qualified retirement plan generally is taxed according to the rules relating to taxation of annuities. That is, the distribution is includible in gross income in the year it is paid, except to the extent the amount distributed represents the employee's investment in the contract (i.e., basis) (secs. 72 and 402). Early distributions from IRAs and qualified plans, including most distributions made other than on account of death before the holder or employee attains age 59-1/2, are subject to an additional 10-percent tax (sec. 72(t)).

In-service distributions of amounts attributable to elective deferrals under a qualified cash-or-deferred arrangement (sec. 401(k)) generally can be made only on account of hardship. The purchase of a principal residence may qualify for a hardship distribution if the distribution is necessary to the purchase.

Expiring provisions

Allocation and apportionment of research expenses

Pursuant to Treasury regulations promulgated in 1977, research and experimentation expenditures are generally allocated as follows: (1) expenses for research that is undertaken solely to meet legal requirements imposed by a government and that cannot reasonably be expected to generate income (beyond de minimis amounts) outside that government's jurisdiction are allocated solely to income from sources within that jurisdiction; and (2) remaining research expenses are generally apportioned to foreign source income based on either (a) gross sales, except that a taxpayer using this method may first apportion at least 30 percent of such expenses exclusively to the source where over 50 percent of the taxpayer's research is performed; or (b) gross income, except that expenses apportioned to U.S. and foreign source income using a gross income method cannot be less than 50 percent of the respective portions that would be apportioned to each income grouping using a combination of the sales and place-of-performance methods.

A statutory allocation rule applies to the taxpayer's first two taxable years beginning after August 1, 1989, and on or before August 1, 1991. In these two taxable years, the statutory allocation rule provided that 64 percent of U.S.-incurred R&E expenses were allocated to U.S. source income, 64 percent of foreign-incurred R&E expenses are allocated to foreign source income, and the remainder of R&E expenses are allocated and apportioned either on the basis of sales or gross income, but subject to the condition that if income-based apportionment is used, the amount apportioned to foreign source income can be no less than 30 percent of the amount that would have been apportioned to foreign source income had the sales method been used. After August 1, 1991, the R&E allocation regulation applies.

Tax credit for low-income rental housing

A tax credit is allowed in annual installments over ten years for qualifying newly constructed or substantially rehabilitated low-income rental housing. For nonsubsidized qualifying housing, the credit has a present value of 70 percent of the cost of low-income housing units. For housing receiving other Federal subsidies (e.g., tax-exempt bond financing) and for the acquisition cost of existing housing (e.g., costs other than rehabilitation expenditures), the credit has a present value of 30 percent of eligible costs.

For a building to be a qualified low-income building, the building's owner generally must receive a credit allocation from the appropriate State credit authority. An exception is provided for property that is substantially financed with the proceeds of tax-exempt bonds subject to the State's private-activity bond volume limitation. The annual credit ceiling for each State is $1.25 per resident per year.

The low-income housing credit is scheduled to expire on December 31, 1991.

Qualified mortgage bonds and mortgage credit certificates

Qualified mortgage bonds.--Qualified mortgage bonds (QMBs) are bonds whose proceeds are used (net of costs of issuance and a reasonably required reserve fund) to finance the purchase, qualifying rehabilitation, or improvement of single-family, owner-occupied residences located within the jurisdiction of the issuer of the bonds. The QMBs must meet purchase price and income eligibility limitations and other restrictions.

Mortgage credit certificates.--Qualified governmental units may elect to exchange qualified mortgage bond authority for authority to issue mortgage credit certificates (MCCs) (sec. 25). MCCs entitle home buyers to nonrefundable income tax credits for a specified percentage of interest paid on mortgage loans on their principal residences. Once issued, an MCC remains in effect as long as the residence being financed continues to be the certificate-recipient's principal residence. MCCs are subject to the same targeting requirements as QMBs.

Targeted jobs tax credit

Tax credit.--The targeted jobs tax credit is available on an elective basis to employers who hire individuals from nine targeted groups. The targeted groups consist of individuals who are either recipients of payments under means-tested transfer programs or who are economically disadvantaged or disabled persons.

The credit generally is equal to 40 percent of up to $6,000 of qualified first-year wages paid to a member of a targeted group. Thus, the maximum credit generally is $2,400 per individual. With respect to economically disadvantaged summer youth employees, however, the credit is equal to 40 percent of up to $3,000 of wages, for a maximum credit of $1,200.

The credit expires for individuals who begin work for an employer after December 31, 1991.

Authorization of appropriations.--Present law authorizes appropriations for administrative and publicity expenses relating to the credit through December 31, 1991. These monies are to be used by the Internal Revenue Service and the Department of Labor to inform employers of the credit program.

Explanation of Provisions

Penalty-free withdrawals from IRAs and pension plans

The bill would permit taxpayers whose adjusted gross income (AGI) is below a specified level to receive limited distributions from an IRA, or from amounts attributable to elective deferrals under a qualified cash-or-deferred arrangement (sec. 401(k)), tax-sheltered annuity contract (sec. 403(b)), or plan described in section 501(c)(18), without application of the additional 10-percent tax on early withdrawals. In addition, any amount includible in gross income by reason of such withdrawal would be includible ratably over the 4 taxable years beginning with the taxable year in which the withdrawal occurs. Under the bill, an ordering rule would treat distributions as made first from amounts that are includible in gross income of the individual when distributed.

To qualify for the special tax treatment provided under the bill, distributions would have to be used by the individual receiving the distributions to purchase or improve real property or to purchase durable goods. Each distribution would have to be spent for such purpose within 6 months, or, if earlier, by the date on which the individual files his or her income tax return for the year in which the distribution occurred. Distributions would be eligible for special treatment only to the extent they did not, in the aggregate, exceed $10,000.

Taxpayers would be eligible for the special treatment provided under the bill only if their AGI for their first taxable year beginning in 1991 did not exceed certain limits. Those limits would be $100,000 in the case of married individuals filing a joint return; $50,000 in the case of a married individual filing a separate return; and $75,000 in the case of any other taxpayer.

The special tax treatment provided under the bill would apply only to distributions made during the period beginning on the date of enactment of the bill and ending on December 31, 1992.

One-year extension of expiring provisions

Allocation and apportionment of research expenses

The expired statutory allocation rule would continue to apply to research expenses treated as paid or incurred during the taxpayer's first three taxable years beginning after August 1, 1989, and on or before August 1, 1992.

Tax credit for low-income rental housing

The low-income housing credit would be extended through December 31, 1992.

Qualified mortgage bonds and mortgage credit certificates

The authority of State and local governments to issue tax-exempt qualified mortgage bonds and mortgage credit certificates would be extended through December 31, 1992.

Targeted jobs tax credit

The targeted jobs tax credit would be extended for nine months, so that it would be available with respect to wages paid to employees who begin work for an employer before December 31, 1992.

Effective Date

The provisions of the bill relating to withdrawals from IRAs and qualified pension plans would be effective for withdrawals made after the date of enactment.

The extension of the tax credit for research and experimentation would apply to taxable years beginning after August 1, 1991.

The extension of the tax credit for low-income rental housing would apply to calendar years after 1991.

The extension of the provisions relating to qualified mortgage bonds and certificates would apply to bonds issued after, and elections for periods after, December 31, 1991.

The extension of the targeted jobs tax credit would apply to individuals who begin work for an employer after December 31, 1991.

PREPARED STATEMENT OF CHAIRMAN LLOYD BENTSEN

[December 13, 1991]

Yesterday, the Committee heard from spokesmen for the Administration who promised an economic plan by next month. I take them at their word that they will join us in aiming relief specifically at hardpressed middle income families.

Their willingness to deal with our problems rather than deny their existence is welcome and long overdue. Over the last three years real median family income has dropped $900, less than 50,000 jobs have been added to our economy and nearly 1.8 million American workers have lost their jobs.

A record number of workers have exhausted their unemployment benefits. The number of Americans on food stamps has risen to nearly 10 percent—one in 10 Americans are forced to rely on the government to help put food on their tables. And the share of young adults forced to move back in with their parents has leaped by 30 percent.

These are the most stressful days for American families since the Great Depression and they come at the end of the worst decade for families in nearly two generations. During the 1 980s low paying jobs replaced high paying ones, with more openings for janitor than any other job.

The number of middle income Americans shrank as families tightened their belts. income disparities widened dramatically. Millions of families today live in fear that an unexpected bill or a child's sudden illness will push them into genteel poverty. Last year, for the first time since the 30s, family wealth dropped countrywide.

Expectations that children will live better than their parents evaporated. At the very moment that hundreds of millions of people around the world are looking to America as an economic beacon, millions of Americans see their future prospects as dim. Consumer confidence has dropped to levels near those reached during the recessions of 1973 and 1980.

Restoring that confidence won't be easy. The key is restoring the faith of American families that their government is aware of their problems and stands ready to address them. That is why I have introduced a $300 child tax credit for middle income families, along with restoration and expansion of the IRA. There are other good proposals. But what is important is that in coming days we agree on a course of action to restore confidence and then take action as swiftly as possible.

PREPARED STATEMENT OF SENATOR DAVID L. BOREN

[November 26, 1991]

Mr. Chairman, I can understand the desire of members to raise other issues and perhaps offer other amendments. There are a number of issues I would like to raise, including legislation (S. 1522) which I introduced, along with Senators Durenberger and Pole, to clarify the tax treatment of farmer cooperatives.

Not only is it strongly supported by farmers, ranchers and their cooperatives around the country, it also has the support of a majority of the Senate and a majority of this Committee—including Senators Baucus, Pryor, Riegle, Daschle, Breaux, Danforth, Symms and Grassley—in addition to Senators Durenberger, Pole.

In clarifying the tax treatment of farmer cooperatives, it reflects what the courts have consistently held in similar cases. Further, it has previously been considered by this Committee and adopted as part of an omnibus budget reconciliation package. However, you'll recall we agreed to drop that provision and all other provisions unrelated to deficit reduction with the promise there would be another opportunity for consideration.

I do not plan to offer this or other amendments at this time. However, I believe we should have an opportunity to do so in the future and I will plan to offer this and perhaps other amendments at that time. Without this legislation, farmers, ranchers and their cooperatives will continue to be faced with considerable uncertainty and threatened with necessary and costly litigation.

PREPARED STATEMENT OF SENATOR DAVID L. BOREN

[December 12, 1991]

Mr. Chairman, as we enter the final days of 1991, we inevitably begin to anticipate the future, to wonder what lies in store for us during the next year. This year, America's families speculate about the future with a deep sense of unease. They are concerned that the economic difficulties they faced this year will continue, and perhaps increase, in the months to come. They are not confident about the future, and they worry that their children will grow up, work and live in a country of more limited opportunities and resources.

These hearings are the initial step in transforming those fears into a more hopeful and prosperous future for our nation. As we begin this effort to restore confidence and to revitalize the economy, we in the Congress must put aside our partisan differences and work together to craft a program that can provide short-term economic relief, while also ensuring long-term growth and productivity. Mr. Chairman, there simply is no time for bickering among members of Congress or between the administration and the legislative branch. Even in this presidential election year, we should stop worrying about scoring political points and get on with solving the serious problems we face. It is time for solutions instead of politics.

The most immediate problem facing us is.to stimulate the economy and to provide relief for Americans now. We are focusing these efforts on middle-class taxpayers because they have felt the effects of the recession so acutely. They foot more and more of the bill for government but qualify for almost none of the benefits of government programs. One increasingly heavy burden on the middle class is the social security payroll tax. Because of recent changes in the computation of that tax, the effective social insurance tax rate for families with children—including both Social Security and unemployment insurance taxes—is expected to rise from 7 percent of income in 1977 to approximately 10 percent of income in 1991. I therefore support the adoption of the proposal to provide a refundable tax credit equal to 20 percent of social security taxes paid. The credit would be capped, but the cap would be increased for every dependent child as part of the effort to direct tax relief programs to families.

As we consider ways to give middle-income families the tax relief they deserve, let us not forget that one of the greatest struggles now faced by these families is the skyrocketing cost of providing a college education for their children. If you are very wealthy or very poor and qualify for scholarships and grants, you will have little trouble educating your children. But those who are being squeezed in the middle earn just enough so that their children don't qualify for benefits, yet they don't earn enough to afford to send their children to college. While middle-income children make up three-fourths of the college-age population, they get only about 4 percent of student aid and scholarships. And although the average cost of going to college has now reached about $10,000 per year, the average middle-income family has only about $60,000 in net worth, most of it in home equities. This means that even if the family sold their home to educate their children, they still couldn't meet the cost of educating two or more children. As a result, most middle-income families are forced to take out large educational loans.

It is high time that we add to our list of legislation a proposal that would allow tax deductions for interest paid by parents and students on educational loans. I plan to introduce a legislative proposal of my own to address this need1 as well as to assure that scholarships for study either in the U.S. or abroad are not taxed. In addition, I am working on a provision to create a College Savings Plan to which parents could make contributions for their children's college education; the interest earned by such accounts would be tax-free.

Finally, with respect to the short-term need for economic stimulation, I am a cosponsor of the proposal of the Chairman and Senator Roth that would allow taxpayers to withdraw money from their IRA's as long as that money is used, among other things, to purchase a first home or to meet educational costs. The Bentsen-Roth IRA provision is warranted not only as a measure to meet short-term goals, but it is also consistent with the long-term goal of encouraging savings and productive investment.

While we work on the short-term problems, we must not lose sight of the larger challenge to restore competitiveness and secure the future for the next generation. In our concern to solve the pressing economic crisis facing America, we must keep long-term policy goals firmly in mind so that any proposal we adopt will be consistent with this broader picture. The tax code is a useful tool in encouraging businesses and individuals to use their resources to benefit economic growth. There are many ways in which this powerful tool can be wielded; I will mention only a few in my remarks today. First, the Congress must enact a carefully-crafted cut in the capital gains tax rate to reward long-term investment. Such a capital gains plan would provide for a 5 percent exclusion of the gain from any capital asset held for at least two years, and that exclusion would gradually increase to a 25 percent exclusion for assets held over ten years.

Second, we must no longer write our tax code by considering only its domestic impact. It is absolutely essential that we consider its provisions as they relate to the tax policies of our international competitors. We must weigh the impact of our policies on the comparative cost of capital, savings and investment rates. Indeed, investment spending in the United States compares unfavorably with that of other Western nations. Studies indicate that from 1973 to 1988 saving and investment as a percentage of our gross national product were lower than all but one of our major competitors. We will no longer be in certain businesses in years to come if our competitors recover two or three times as much of the cost of their investments in the first five years after making the investment as our companies can recover over the same period.

This means that we must re-examine the potential effects of the depreciation schedule for business investment and the alternate minimum tax on our ability to compete. It is estimated that 40 to 60 percent of large U.S. companies may pay the alternate minimum tax in 1991. In addition, many smaller businesses, like independent oil and gas producers whose economic decline has contributed to our growing dependence on foreign energy, also pay the tax. It is time to re-evaluate the effects of the '86 law on our ability to compete in the world marketplace. We should not shrink from utilizing tax incentives to encourage risk-taking and investment when sound economic policy requires it.

Third, in the long run, we must adopt policies designed to encourage savings rather than consumption. In January I will introduce "investment rollover" legislation that will defer the taxation of interest earned on savings placed in certain qualified accounts as long as that money remains as savings or is otherwise invested. Only when the accumulated earnings are withdrawn to finance consumption would the taxpayer be required to pay taxes on the gain.

Fourth, as we consider any changes in tax policy, we must be aware of taxpayers' need for certainty as they make investment and savings decisions for the long term. In the past few years, we have established tax policies—the tax-deductible IRA's for all taxpayers, for instance—only to eliminate them soon thereafter. Other programs, such as the targeted jobs tax credit, are temporary, forcing us to reconsider them frequently and forcing taxpayers to make economic decisions in an unsettled tax environment. Individuals cannot plan when we have a stop-and-start tax policy.

The task before us is a complex one that involves difficult choices for our nation. We have the opportunity to confront more than the problem of short-term economic stimulation; we can also address the need to construct a long-range economic program that will encourage investment, savings and growth. I look forward to meeting this challenge in the course of the work of our committee.

Prepared Statement of Michael J. Boskin

INTRODUCTION

Thank you Chairman Bentsen, Ranking Minority Member Packwood, and other distinguished Members of the Committee. I am pleased to join with Secretary Brady and Director Darman in testifying before you this morning on the state of the economy and on the President's proposals for enhancing economic growth.

Economic growth is not just an abstract concept. Enhancing long-term economic growth is the key to ensuring America's future. Growth will raise our standard of living; it will create a legacy of prosperity for our children; it will ensure that we are able to afford nontraditional goods and services, such as a better environment; it will enable us to provide new employment opportunities for the labor force and those seeking upward economic and social mobility; and it will allow us to maintain our leadership role in the world.

Because growth is so important, I will focus my remarks on longer term growth prospects and challenges as well as recent developments and the short term growth outlook of the economy. As will become clear from my testimony and that of my colleagues, the President has had a comprehensive strategy for improving the Nation's long-term economic growth since the beginning of his Administration. This approach encompasses many areas of economic policy, including a fiscal policy that reduces the medium-term structural budget deficit, freeing saving to finance productive private investment, and provides tax incentives to spur entrepreneurship, saving, investment, and research and development; support of a monetary policy that is conducive to solid non-inflationary growth; banking reform to make the Nation's banking system safer, sounder, and more internationally competitive; a regulatory policy that seeks to deregulate where economically desirable, and where necessary to regulate, to do so in a manner that is minimally disruptive to the economy; and an ambitious trade policy that seeks to open markets, create jobs, and expand growth both here and abroad.

The President's policy proposals go well beyond what are thought of as traditional economic policy in the attempt to enhance productivity, for example, civil justice reform and education reform.

RECENT DEVELOPMENTS AND SHORT-TERM OUTLOOK

The economy's performance has been far from satisfactory for some time. After a period of somewhat sluggish growth, the American economy entered its ninth postwar recession in the Summer of 1990. Most private economists believe that the economy began a recovery sometime in the Spring of 1991. In early Summer I emphasized that concern over the durability and strength of the recovery was quite legitimate. The early stage of the recovery, from about May to July, was at the moderate pace we had expected, slightly below what private analysts and the Congressional Budget Office (CBO) had expected. Since then, the recovery has indeed flattened out.

Why did eighty percent of private economists surveyed by the National Association of Business Economists agree that a recovery had begun in the Spring? Growth in real consumer spending averaged 1.8 percent at an annual rate in the second and third quarters; industrial production rose at a 9 percent annual rate between March and July; payroll employment rose significantly in May and in August; and housing starts in August were almost 150,000 units higher at an annual rate than they were in March, although this improvement represented an increase from a very depressed base.

While I believe economic growth, if any, will be sluggish at best over the next few months, the foundation exists for an improved economy thereafter. Inventories generally are in check, the U.S. international competitive position has greatly improved, and nominal interest rates are low. Inflation is down and declining, leaving the Federal Reserve in better position to take necessary actions to improve the economy within the context of the overall goal of low and stable inflation.

I will turn to a more detailed discussion of the outlook in a moment. Before I do, I want to put it into perspective.

After the longest peacetime expansion in the history of the United States, the economy entered the ninth recession of the post-World War II period in the third quarter of last year. Expansions do not end on their own. Expansions end because external shocks hit the economy, policy mistakes are made, or widespread imbalances, such as an over-accumulation of inventories that must be worked off, develop in the economy.

In August of last year, an external shock occurred. The invasion of Kuwait by Iraq and the subsequent oil price spike, superimposed on an economy that already had been struggling to grow for the prior year and a half, pushed the economy into a recession. Whether there would have been a recession had there been no oil shock is impossible to know.

There were several reasons for the slow economy prior to the recession. First, there were the lingering effects of the tight monetary policy followed by the Federal Reserve in 1988 and early 1989 in an effort to engineer a so-called soft landing to ease incipient inflationary pressure. Second, there was a worldwide increase in long-term interest rates in early 1990. An important factor in this rise was the anticipated increase in the demand for capital associated with developments in Eastern Europe and the unification of Germany. Because U.S. interest rates are influenced by developments in world markets, there was upward pressure on U.S. interest rates as well.

Third, there were unexpectedly tight credit conditions popularly known as the credit crunch. When the history of this period is written, people will argue about what exactly made credit less available to certain sectors of the economy. Clearly, the causes included the fallout from problems in real estate markets in many regions of the country; an over-reaction in the regulatory process, perhaps in response to the savings and loan problems, preventing banks from undertaking profitable lending opportunities; and the new international capital standards, which contain several features driving banks from credit-risk in commercial and industrial loans to interest-rate risk in government securities. Whatever the reasons, there was a substantial reduction in the availability of credit at any given level of interest rates, especially to the small and medium-sized businesses in the economy that traditionally have relied on the banking sector for their credit. Indeed, commercial and industrial lending by commercial banks was flat from November 1989 to July 1990. It collapsed thereafter, as demonstrated in chart 1.

Fourth, economic growth has been reduced due to the slower rate of growth in the labor force. This reflects, in large part, slower growth in the working age population, especially when compared to the 1970s and 1980s when the baby boom entered the labor force and the female labor force participation rate was rising. All else being equal, slower growth in labor input results in slower growth of output.

Finally, large imbalances had built up in the economy. There was significant overbuilding in commercial real estate, and accumulation of debt by households and businesses. While there was a corresponding growth in the value of assets—a point often ignored by those who talk about the growth of debt as the sole problem in the economy—the high ratio of household debt to income and of corporate debt to profits may not have been sustainable; see chart 2. Now, households and corporations are reducing leverage in an attempt to improve their balance sheets, at the same time policies are being implemented to improve the Federal balance sheet. The working off of these imbalances creates structural adjustment problems for the economy and implies slower growth during this transition. This contrasts with more traditional inventory imbalances, the correction of which causes short-term fluctuations in GNP, production, and employment.

Structural changes are, of course, a feature of modern economies. For example, during the 1980s the manufacturing sector of the economy underwent a successful restructuring, and its productivity rose at nearly a 4 percent annual rate between 1982 and 1990. Similar restructuring is going on today in sectors such as financial services. Further, the rapid rise in real defense purchases in the First half of the last decade stimulated the economy; in the last few years, real defense purchases have declined slightly and a retrenchment has begun in defense-related industries. It is being accelerated by the planned reductions in outlays agreed to last year.

It is important to clear up a common semantic problem. The terms expansion, recession, and recovery do not describe the level of economic activity, but rather the direction in which the economy is moving. There is quite a bit of confusion when economists say that the recession ended in the Spring. No one should take that for a suggestion that the economy is in good shape. All it means is that the decline in production, employment, and other indicators had ceased, and the economy had begun to pick up. To say generically that an economy is in recovery is not the same as saying that an economy is doing well.

Despite the serious problems, it is worth putting the recession into historical perspective by comparing it with the average of the experiences in other recessions. In this regard, the recent recession was relatively shallow. The civilian unemployment rate, which had been at its lowest level in 15 years, rose about half as much as it did on average in previous recessions. The fall of 1.6 percent in real gross domestic product (GDP) between the third quarter of 1990 and the first quarter of 1991 was lower than the 2.7 percent average decline in real GDP during the recessions of 1980 and 1981–82.

The substantial industrial and regional variation in economic performance that is always occurring was particularly acute in the recent recession. The real estate and auto industries were hit particularly hard. The coasts, which in the early 1980s had been called "recession proof," were hit much harder this time around. In contrast, the middle part of the country has been spared the worst of this economic episode, the major exception being the auto industry in the state of Michigan. By comparison, a decade ago, the middle part of the country was ravaged by high unemployment, as agriculture and manufacturing were hard hit, in part due to the over-valued dollar. Indeed, a major difference in this period compared to the 1980s—when the collapse in the economy's external performance pulled down GNP—is that the performance of exports has prevented the recent economic situation from becoming worse.

A year ago around this time, when we were putting together the Administration outlook, Operation Desert Shield was underway. Oil prices had gone to $40 a barrel and there was uncertainty about the timing and the nature of the resolution of the crisis in the Gulf. The Administration's outlook then was for a decline in real GNP in the fourth quarter of 1990 and the first quarter of 1991. The economy was expected to turn around in the Spring and expand at a 2½ to 3 percent annual rate in the second half of 1991. This pace was quite modest by recovery standards—during the first 18 months of other post-war recoveries, real GNP growth averaged a 6 percent annual rate, about twice what the Administration had been forecasting. The Administration's forecast also was conservative relative to that of most private analysts as well as that of the CBO, which forecast a 4 percent rate of growth for the second half of 1991. The reasons for the forecast of a quite modest recovery included problems associated with all of the following: the credit crunch and capital availability; the slower than anticipated response of the economy to declines in interest rates; the slow pace of money growth; expected retrenchment in household and corporate borrowing; the closely related problems in real estate and the financial industries; the far greater than normal fiscal drag from State and local budgets; and the absence of the usual large Keynesian Federal fiscal stimulus.

Through the third quarter, the economy evolved generally along the patterns described in the Administration forecast, tracking real growth and unemployment almost exactly, while inflation and interest rates came down even more than anticipated.

The data available thus far for the fourth quarter suggest that growth, if any, will be slight. Since mid-Summer, the economy has slowed considerably, and most major economic indicators have been relatively flat recently. In December, the so-called Blue Chip private forecasters' consensus—really their average—was for real GNP to grow at a 1.3 percent annual rate in the fourth quarter, down from the 1.9 percent prediction they had made the previous month. As I said in November, and then repeated last week to the House Ways and Means Committee, that earlier estimate was far too high; the more recent estimate is also too high.

Turning to the outlook for the next year or so, we currently are in the process of revising the Administration's forecast that will be released in conjunction with the Budget. However, my qualitative assessment is that the economy is likely to be sluggish at best for the next several months. The economy should pick up thereafter. I would expect that most private forecasts will be adjusted to follow roughly this pattern when they are revised in January.

As I always remind this Committee and others when discussing the economic outlook, economic forecasting is not a precise science. External shocks are impossible to anticipate. Consumers and firms do not always respond in the same fashion to changes in key economic variables, such as interest rates or oil prices, as they have in the past. There always is the risk of a more disappointing performance as well as the opportunity for the economy to perform better than anticipated.

Several factors pose downside risks to the economy. First, the availability of credit continues to be a problem. The Administration, under the leadership of the Treasury Department and in conjunction with banking and thrift regulators, has been working to assure that sound businesses and consumers can get needed credit. These efforts include encouraging lenders to make prudent loans and assuring that examiners perform their reviews in a balanced, sensible manner, and to make sure that treatment of U.S. banks' capital under the Basle Accord is no more stringent than that of other countries.

Second, the financial position of households remains strained. Debt burdens are high. Importantly, the collapse of real estate prices has reduced the value of homes, the single largest asset of the majority of American families. Unless this process is reversed, consumer spending is likelv to remain quite sluggish.

Third, there is a substantial State and local fiscal drag on the economy. Budgetary difficulties have caused many State and local governments to cut spending and raise taxes. The magnitude of the fiscal drag appears to be about twice as much as would be expected from changes in the aggregate economy at this stage in the business cycle. If State and local governments' budgets do not improve, this could further hamper the recovery.

Fourth, the expected beneficial effects on the economy from the decline in interest rates is occurring more slowly than might have been anticipated. In part, this appears due to the restructuring of balance sheets I discussed earlier. Also, despite increases in reserves by the Fed, money growth has been surprisingly low for some lime; see chart 3.

Finally, exports have provided a significant boost to the economy in recent quarters. There is a risk that less robust growth by our major trading partners could curtail exports.

However, there are several important factors that improve the prospects of the economy resuming its natural tendency to grow. These factors provide some upside potential to the economic outlook.

First, nominal interest rates generally are at their lowest levels in fifteen years. Although real rates may not be as low as they have been early in other recoveries, the lagged effects of lower interest rates already in the pipeline, and any additional reductions in interest rates that may occur, should help the economy as we move into next year. In addition, because their capital positions have improved greatly, banks are in a better position to lend than they have been for some time. However, I am still concerned about the low level of bank lending.

Second, with the exception of a few industries, there does not appear to be a widespread inventory imbalance that would foreshadow further cuts in production. This means that increases in domestic and foreign demand will be met largely from new production and not from drawing down existing stocks. New production will generate income, increase consumption, and beget further gains in production, employment, and income.

Third, the international competitive position of the United States has improved. After adjusting for exchange rates and relative prices of traded goods, the pattern of unit labor costs in manufacturing has been favorable relative to that of our major trading partners. Indeed, export growth helped prevent the recession from being worse.

Fourth, a particularly positive factor is the reduced inflation rate. Although there may be occasional temporary blips in, for example, the CPI due to special factors in agriculture, energy, or excise taxes, it is widely believed that underlying inflation is down and declining. The economy currently is well below capacity. Thus, during a moderate recovery, it is unlikely that resource constraints would emerge to rekindle inflationary pressures. Furthermore, there is ample room within a credible and systematic monetary policy that is designed to reduce inflation gradually to accommodate a healthy expansion during the coming year.

LONG RUN CHALLENGES FOR THE U.S. ECONOMY

The major long run challenge confronting the American economy is to increase the Nation's rate of productivity growth. Productivity growth is the foundation for improvement in the standard of living. After a quarter of a century of rapid advance in productivity following World War II, productivity growth collapsed in the period 1973 to 1981. It partially rebounded thereafter. In recent years, manufacturing productivity growth returned to internationally comparable rates. Simply put, if productivity growth does not improve, the standard of living in this country will rise too slowly to meet the expectations and desires of our population and too slowly to maintain Americans' standard of living as the world's highest.

While the United States still has the highest absolute level of productivity, other countries have had higher productivity growth in recent decades; see chart 4. In part, this is the result of Europe and Japan catching up with the United States after World War II, and a natural phenomenon of technological developments and saving differences. Today, capital stocks per worker in the United States, Germany and Japan are similar. While the United States still has the highest standard of living among industrialized nations (see chart 5), unless our rate of productivity growth increases, other countries will close the gap. Perhaps the longest peacetime economic expansion in U.S. history generated a sense of complacency about the fundamentals of economic growth and productivity.

As I said in 1989, and subsequently in the Administration's first *Economic Report of the President*—at a time when we were in the midst of the longest peacetime expansion in American history and the unemployment rate was at a 15-year low—the Nation cannot take economic growth for granted.

The Nation must choose between sound policies that will promote long-term growth, and policies that will reduce the flexibility of the economy, stunt incentives to work, save, invest, and innovate, and place the economic future at risk. These long-run challenges are so important that care should be taken to make sure that short-run policies take them into account.

To maintain the highest standard of living in the world and to set the basis for long-term growth, the Nation must meet the challenge of increasing workers' skills and providing them with more and better capital and technology with which to work. Some argue that government policies cannot affect productivity greatly, that there are many factors that the government cannot control. But sound economic policies can have an effect on productivity, enough to have an important impact on economic growth over a span of years.

The United States cannot remain the world's leading economy without the world's leading labor force. Competing in a rapidly changing international economy will require the skill to adapt to changes one cannot foresee today. The biggest problem the Nation faces in meeting this long-term challenge is the deplorable state of our elementary and secondary education system. By some measures, the U.S. spends more per pupil than any country in the world except Switzerland. But on test after test, U.S. performance doesn't measure up.

Surely, a major centerpiece of improved educational performance must be a restructured education system based on choice that generates competition, and accountability that drives performance, as called for in the President's America 2000 Program.

Long-run growth prospects also can be enhanced by raising private saving on average over the longer term. The Administration's proposals to increase private saving through Family Saving Accounts and penalty-free withdrawal from IRAs for first-time homebuyers would be important steps in this direction.

Research and development that generates new ideas, and entrepreneurship that brings capital and labor together also enhance economic growth. Reducing the tax rate on capital gains, which the President has repeatedly called for, would encourage entrepreneurial activity. This would create new products and new methods of production, and in turn generate new jobs. A capital gains differential would reduce the tax bias against equity and the overall cost of capital, thereby increasing investment.

To spur innovation, the Administration has also advocated making the research and experimentation tax credit a permanent part of the tax code, and has proposed large increases in both basic and applied research and development spending in the Federal budget. Moreover, the Administration has supported Enterprise Zone tax initiatives to encourage investment in inner cities and rural areas.

Fundamental banking reform is critical to ensuring efficient operation of credit markets. The recent bill passed by Congress is at best only a start. Important provisions in the Administration's proposal removing many unnecessary and antiquated restrictions on the banking industry are missing from the legislation. These reforms are needed to rebuild the soundness of the banking industry and enable it to be internationally competitive.

Monetary policy also has an important role to play in ensuring economic growth. Monetary policy should be credible, systematic, and consistent with achieving the maximum sustainable rate of economic growth with a low and stable inflation rate. One element of such a policy is a commitment to sustain the rate of growth of money and credit during periods of weak economic growth. It is important to recognize that a decline in interest rates during a period of soft activity may not be a sign of monetary easing, especially if the growth of money and credit has slowed.

Fiscal policy also must be designed to foster long-run growth by encouraging saving and investment. One sure and direct way to increase total national saving is to increase public saving. With the implementation of the 5-year deficit reduction package signed into law last Fall, about a half trillion dollars will be freed up for productive investment, relative to what otherwise would occur. This reduction will contribute to a lower rate of public dissaving and will reduce the cost of capital to American firms.

The size of the deficit is not all that matters. The level and composition of government spending is also important, as is the structure and level of taxation. One of the highlights of all the budgets the President has submitted since he has been in office has been a focus on both controlling the growth of government spending and, within proposed spending categories, to shift from current consumption to investment. Spending on R&D and investments in public infrastructure that pass cost-benefit tests can promote long-run growth by making the private sector more productive.

Tax policy should aim to minimize distortions to incentives to innovate, work, invest, and save. Tax reforms over the past decade have, among other things, reduced marginal tax rates, eliminated tax shelters, and indexed tax brackets. These are important developments because high marginal tax rates reduce the return to working, saving, investing, and innovating. Nevertheless, the tax system can be further improved. In my view, the major problem with the current Federal tax system lies in the taxation of capital income.

A key source of the U.S. economy's dynamism and resiliency is the flexibility it derives from reliance on markets. Of course, some markets are not perfect, and achieving certain desirable goals may require rules and regulation. But it is important to strive to keep any needed regulation from unnecessarily hampering the efficient allocation of resources and reducing the economy's flexibility.

Just as improper regulation at home can have harmful economic impacts, protection from foreign competition retards innovation, raises production costs, and decreases choices for consumers. Therefore, government policies should be aimed at opening rather than closing or segmenting markets. In this regard, it is critical that there be a successful conclusion to the Uruguay Round, in which the United States continues to play a leading role. The Administration also has important proposals to expand trade in this hemisphere—notably the Enterprise for the Americas Initiative and the historic North American Free Trade Area, which will create the largest market in the world, with 360 million consumers and a total output of over $6 trillion.

Let me re-emphasize the President has a comprehensive, integrated set of proposals to spur economic growth, including initiatives in nontraditional areas such as tort reform. These proposals are outlined in some detail in Director Darman's testimony.

PERSPECTIVES ON FISCAL POLICY

Fiscal policy encompasses all of the Government's spending, taxing, borrowing and credit policies. Fiscal policy exerts important effects on aggregate economic performance in the short run, the prospects and possibilities for economic growth in tho long run, and the allocation of resources across sectors of the economy.

There are three myths about current fiscal policy that I would like to dispel. The first myth is that the large official nominal deficit constitutes an enormous Keynesian stimulus to the economy. In fact, this is incorrect. While the $269 billion deficit last fiscal year and the prospects of a deficit this fiscal year of perhaps $100 billion larger are a legitimate concern, neither the level nor the change in the deficit constitutes a fiscal stimulus in the Keynesian sense. The large nominal deficit is due in part to a temporary bulge in deposit insurance outlays, which exceeded one percent of GNP in fiscal year 1991 and are expected to be larger in fiscal year 1992. Confidence in the financial system is extremely important to the health of the economy. Nonetheless, to a first approximation, the actual timing of outlays to make good on the previous contingent liabilities that protect insured deposits has little impact on credit markets, interest rates, and the economy.

Hence, economists usually measure the impact of deficits on the economy by the change in a standardized employment measure of the deficit net of deposit insurance, and by that measure Federal fiscal policy has been much closer to neutral.

The second myth is that any change in fiscal policy that is not deficit-neutral would generate such a large rise in interest rates that the offsetting contraction in interest-sensitive sectors would be as large as or larger than the direct stimulus. In fact, the offsetting effect could be modest. The response of the private sector to a change in fiscal policy will depend on a variety of factors, including the initial fiscal position inherited from the past and expectations concerning future fiscal policy. Obviously, in the current fiscal situation, an attempted fiscal stimulus that abandoned, or was perceived to abandon, serious discipline on the growth of future spending (and hence ultimately taxes) and/or on deficits would be likely to produce a substantial rise in interest rates. That would offset a larger portion of the direct stimulus in the short run and would leave the economy thereafter with a higher cost of capital, which would be detrimental to investment necessary for long-run growth.

Responsible stimulative policies can be enacted in a context of fiscal discipline. A well-designed reduction in the tax rate on capital gains would have clear, beneficial long-term effects on economic growth. In addition, expected lower tax rates in the future would be capitalized into the value of assets now and could stimulate the economy in the short run. The effects of neither growth nor increases in asset values are included in the standard estimates of revenue effects by Treasury or the Joint Committee on Taxation. Although it is well-known that there is a controversy about the effects they measure, the beneficial effects of a capital gains tax cut on long-term growth and asset prices suggest that this is one of the few tax cuts that will pay for itself.

Many other proposals for stimulating the economy in the short-run have recently circulated. These proposals include cutting taxes of the middle class, paid for by increasing taxes higher up the income scale, or by cuts in defense spending beyond those already underway. Whatever their other effects, such proposals are unlikely to stimulate the economy very much in the short run. Redistributing the tax burden from middle- to higher-income people could positively affect aggregate demand to the extent that middle-income people have a higher tendency to consume out of current income than do higher-income people. Although such differences may exist, they are most likely small, and consequently any potential net effect on aggregate demand of shifting taxes is likely to be small. Alternatively, paying for lower taxes overall by reducing defense expenditures, currently or in the future, also has offsetting contractionary effects, which should be taken into account. Defense spending represents a direct demand by the government for goods and services in the economy. Many firms are likely to respond to lower anticipated defense spending by reducing their labor forces now and reducing investments in plant and equipment.

The third myth is that the large current nominal dollar deficit implies that the Federal government is currently creating new large burdens on future generations. A more accurate characterization is that the fiscal stance in the last two or three years is one of rolling over previously accumulated debt. Virtually the entire deficit for the last two or three years can be accounted for by deposit insurance expenditures and net interest payments, which are most properly viewed as borrowing to finance the continuing cost of previously incurred liabilities. Although they are being recorded now, deposit insurance outlays are most appropriately considered as liabilities accrued over the previous quarter century, particularly the late 1960s and 1970s, when high inflation eroded the value of low-interest fixed-rate mortgages, which were the primary asset of savings and loans. Clearly, the problem was compounded thereafter.

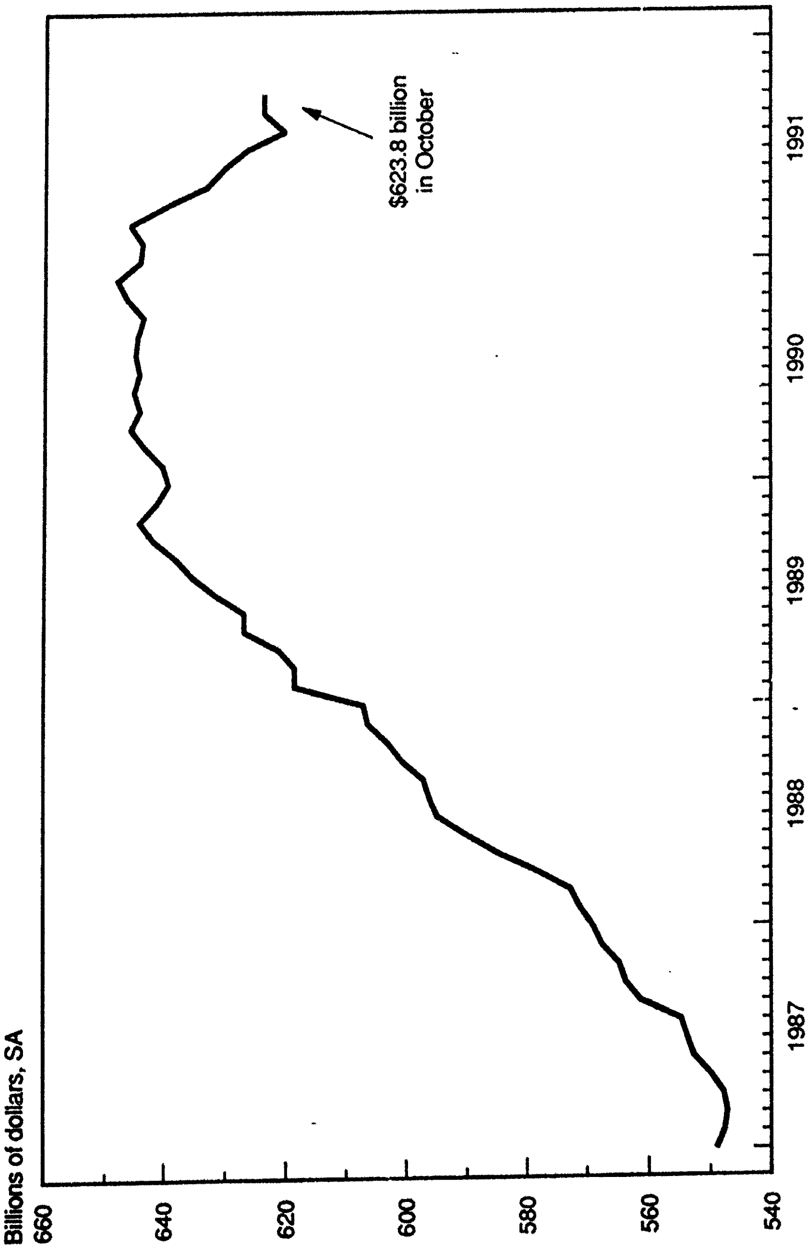
Federal net interest outlays are large and represent the carrying cost of previous borrowing. It is certainly conceptually possible that with reasonable GNP growth, the debt can be refinanced with new borrowing, while the ratio of debt to GNP declines over time. Whether to refinance debt by borrowing or to pay it off by taxation raises many issues, perhaps the most important of which is intergenerational equity. A case can be made for debt as opposed to tax finance for long-lived tangible or intangible investment, the benefits of which are shared across generations.

CONCLUSION

I have discussed the recent short-term performance of the economy, the short-term outlook, the longer-term economic challenges and opportunities confronting the Nation, and some misperceptions about fiscal policy. I have also mentioned some of the elements of, and reasoning behind, the President's economic growth agenda. I hope these remarks have been useful to the Committee, and I stand ready to answer any questions you may have. Thank you for your attention.

Chart 1

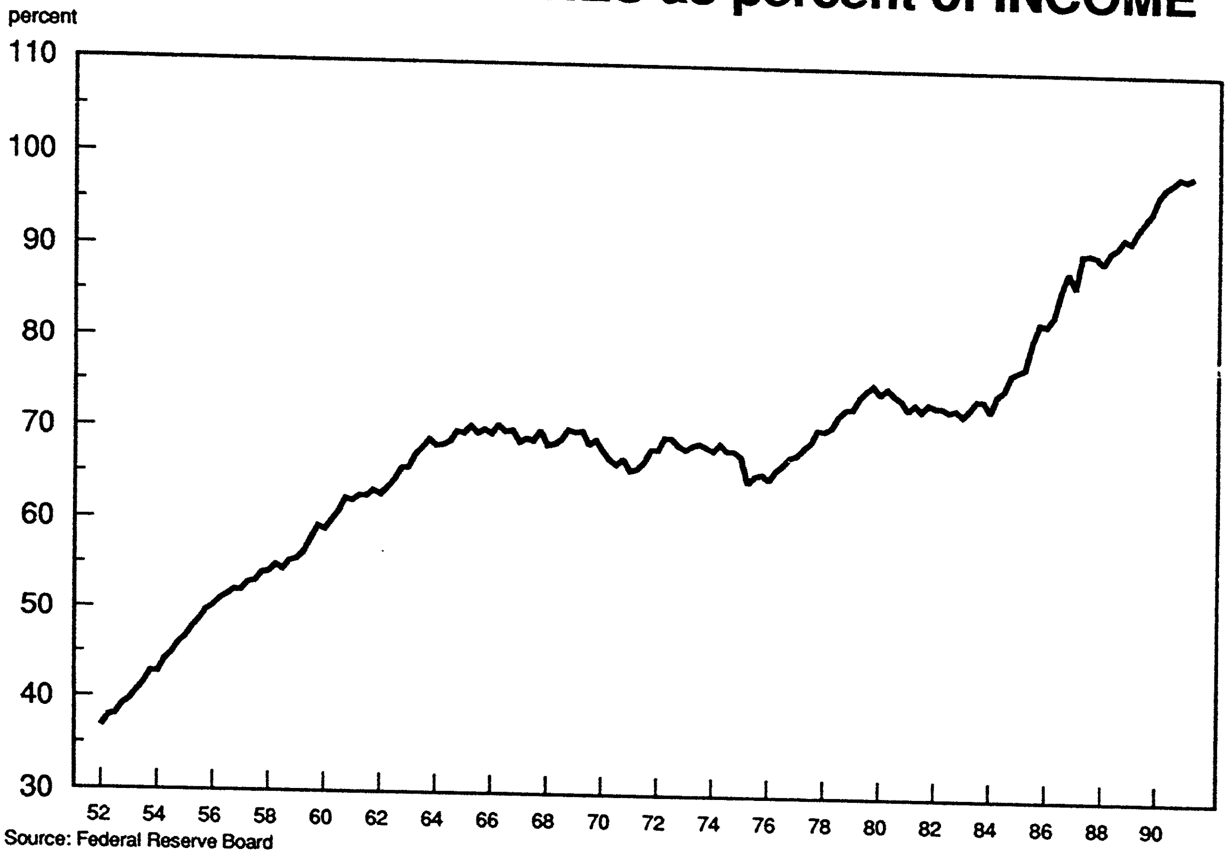
Commercial and Industrial Bank Loans



Note: Data are monthly.

Chart 2

HOUSEHOLD LIABILITIES as percent of INCOME*

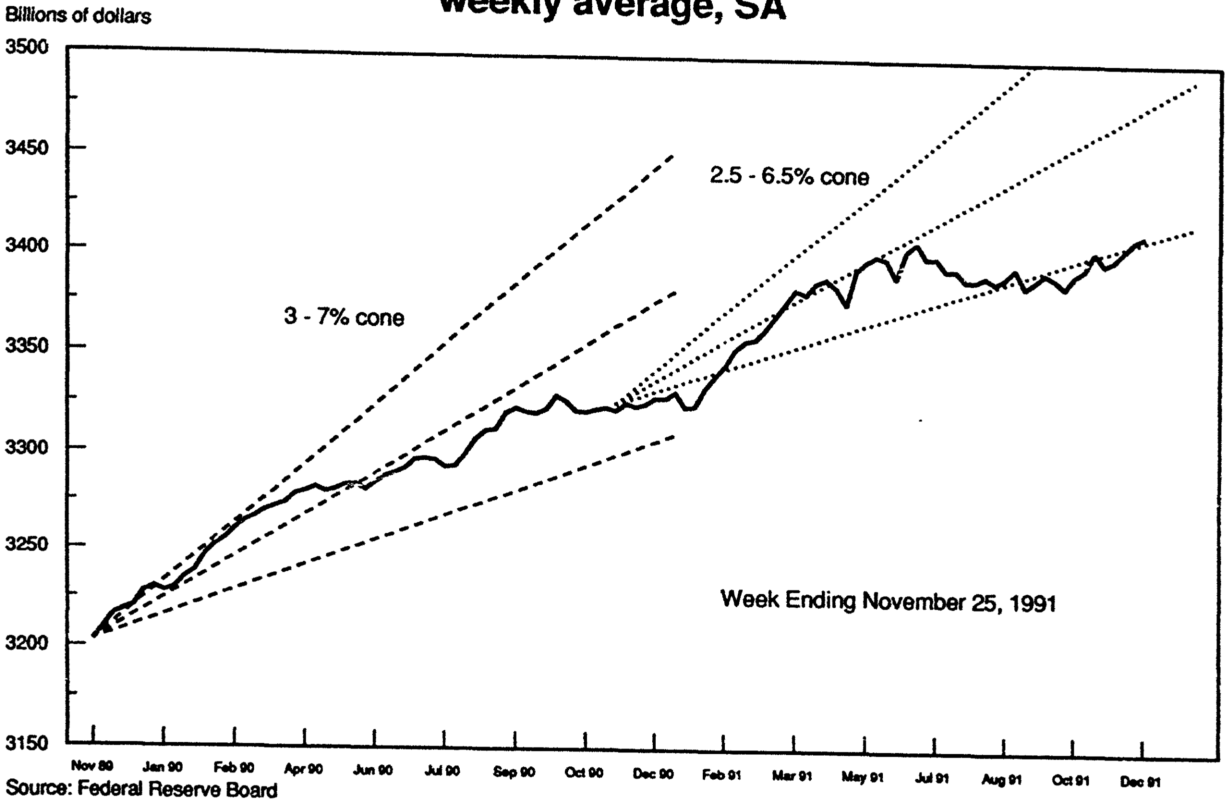


Source: Federal Reserve Board

* Disposable Personal Income

Chart 3

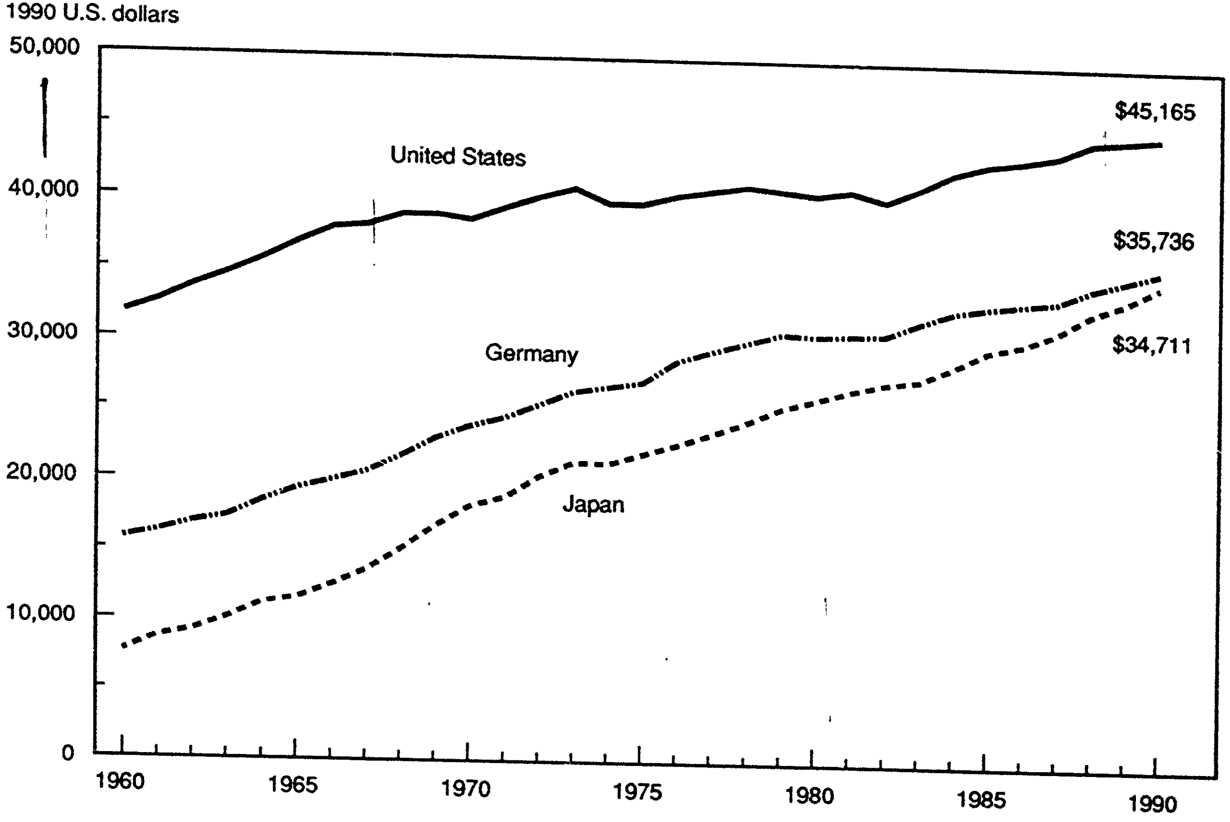
M2
weekly average, SA



Source: Federal Reserve Board

Chart 4

Productivity

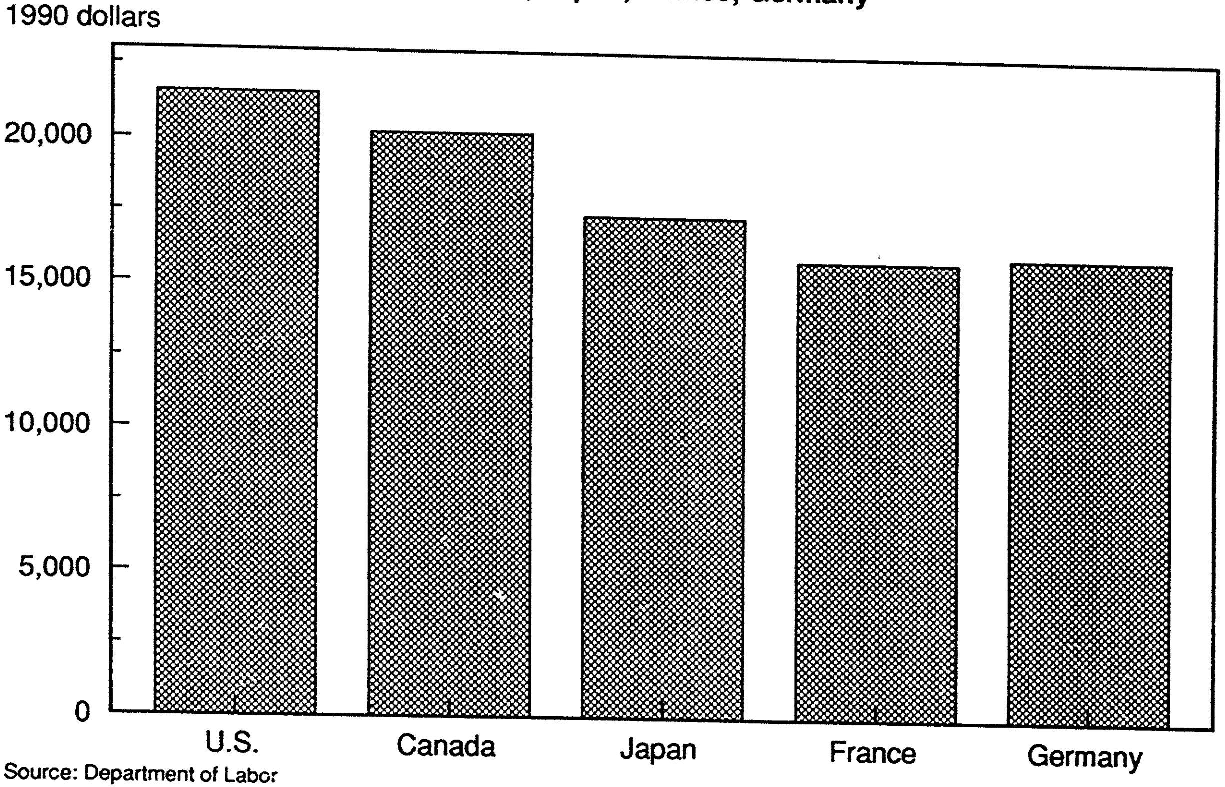


Note: Productivity is GDP per employed person.

Chart 5

GDP Per Capita, 1990

U.S., Canada, Japan, France, Germany



Source: Department of Labor

Prepared Statement of Nicholas F. Brady

Mr. Chairman and Members of the Committee: I am pleased to testify today on the state of the United States economy and the President's proposals for economic growth.

Mr. Chairman, you have not called this hearing to intensify the discord, but rather to advance the discussion about what we can agree on that will help the economy. It is an important task. There have been a number of different proposals put forward and, more importantly, fundamental differences in philosophy exist. It will not be fruitful to dwell on how we got here. We need to address the economic challenge and meet it squarely.

I believe there are two fundamental problems—one short-term and one long-term. The short-term problem is sluggish economic activity and uncertainty about the economy. For the long-term we need solutions which will promote higher growth, savings, future investment and productivity. A key problem is our low rate of national savings, which is caused by both excessive Federal deficits and inadequate private savings. The reason a low savings rate is important is that in the long run you cannot invest more than you save.

To leave the general and be specific, our task is to implement economic policies that will raise the standard of living of Americans. Between 1970 and 1990 real per capita income increased 43.1%. But this general growth trend has not been unbroken over the past 20 years. Growth will return if we adhere to certain basic criteria. The Bush Administration would suggest four guiding principles:

(1) Our goal should be to promote maximum social, political and economic progress through overall economic growth that is shared by everyone. Our solution cannot be to fight over the particulars of managing the distribution of sluggish growth. It must be to adopt measures to increase growth in the first place.

(2) We must adopt measures that create jobs and stimulate savings and investment. Jobs are what America needs. Increased savings and investment will finance productivity gains that enable a higher standard of living.

(3) The American people have sent us a message. Do not increase taxes. All that does is send more money to Washington where it is inefficiently spent.

(4) Do not take fiscal actions that increase interest rates. This makes it harder for Americans to buy homes, increases the costs of investment, and lowers the number of jobs created.

Many have asked about our current economic situation: "Where are we? Are we in a slow recovery or a double dip shallow recession?" The answer is we are in a transitional phase. The economy receded in the fourth quarter of 1990 and first quarter of 1991; emerged from the downturn and showed modest growth in the second and third quarters of 1991, and early estimates indicate it is slowing in the 4th quarter of 1991. This is not an unusual pattern for recoveries. In every one of the eight post-World War II recoveries there was a slowdown of growth in one of the quarters during the first year of the recovery.

But why are we where we are? For several reasons: we have had a war during which oil went to over $40 a barrel; we have had two and a half years of restrictive, high interest rates which have only recently abated; the country as a whole took on too much debt; and much too little has been done to create the climate for increased jobs and investment.

Now the war is over, interest rates are headed down, corporate America has turned the corner on accumulation of debt and households have made significant strides in reducing their debt burden. Now we are left with the task of providing jobs and investment. Many of the fundamentals are in place. Interest rates are at a 14 year low, inflation is under control, inventories are lean, and exports are strong.

We understand that the American people are worried and their confidence has suffered. They are worried about the value of their homes and their ability to own a home. They are worried about jobs. They are worried about the condition of financial institutions. And perhaps most of all, they are worried about the ability of the U.S. government to respond to their real concerns without dissolving into partisan warfare.

The President understands exactly the state of feelings in the country. He knows that people are worried. He has no intention of staying with the status quo. He is not satisfied with old solutions alone. He will present a program to Congress that will address these concerns head on and ask for its swift consideration.

The President said it best: "I will ask Congress to lay aside election-year politics at least long enough to enact a common-sense series of economic growth measures . . . to get the job done."

The Administration has been urging Congress to enact a program for economic growth for the last three years. While we have indicated that we would be flexible and have been prepared to negotiate with the Congress, the core elements of the tax part of that program have not varied.

Those elements are:

(1) a capital gains tax cut,
(2) permanent research and development tax incentives,
(3) incentives for first-time homeownership,
(4) incentives for savings, and
(5) incentives for job creation through all of the above and enterprise zones.

Any policy that is designed to get the economy moving again must motivate the entrepreneur. Historically, the way to job creation and growth has been the guy with an idea who tried to make it work. It is precisely that type of small business activity that restoring a capital gains tax rate differential will stimulate. However, the most important benefit would be to stimulate values in the real estate industry. Nothing could be more important for the economy.

Second, we ought to make the R&D tax credit permanent. This credit is important to the nation's ability to compete in the global marketplace and will be much more effective if made permanent.

Third, we need to assist the housing industry and, in particular, encourage first-time homebuyers. The budget proposal for penalty-free IRA withdrawals will enhance the attractiveness of deductible IRAs by making them more flexible. This increased flexibility would provide an incentive for more taxpayers to save for the purchase of their first home.

Fourth, we need to increase savings by Americans. Our proposal for family savings accounts is affordable and could be enacted quickly. FSAs would be popular because they would provide a simple tax-free way for people to save for down payments on homes, educational and medical expenses.

Fifth, we need to continue our focus on job creation. All the elements of our package have this objective.

We have made these proposals in three budgets now—and we have proposed the means to pay for them in each of these budgets. Had the Congress enacted them, I believe the economy would be stronger.

These proposals will create jobs and they will encourage long-term investment. They should be part of any credible economic growth package.

The President also has asked us to present him with other plans to stimulate the economy, as well as options for middle-income tax relief. The President shares the concern for tax relief for the middle class, but he wants to do so in a manner that does not increase the deficit, does not increase tax rates and does not impede economic growth in either the short or long-term. As the President has said, he will announce his decisions in his State of the Union address.

In this regard, proposals to increase tax rates on one group to pay for tax relief for another are not proposals for economic growth. Economists have rightly stated that such proposals are social policy, not an economic growth agenda.

With regard to the so-called tax on millionaires, let me say there has not been one proposal which does not use such a tax as a disguise to divert attention from the fact that the proposal also contains hefty increases for those well below millionaire status.

Two bipartisan achievements of this Congress that will help those who are out of work during this period of adjustment, demonstrate that when Congress and the Administration work together the country is served. I am referring to the extension of unemployment benefits to ease the burden of those whose benefits have expired and the transportation bill. That legislation will not only improve the country's infrastructure—highways, tunnels and bridges—but at the same time, according to Transportation Department estimates, will create over 600,000 additional jobs this fiscal year.

Let us not forget one important thing—the United States is a great country—our citizens, our values, our natural resources will continue to sustain our ability to be number one.

In conclusion, Mr. Chairman, I believe we must work together to address these problems. The American people deserve nothing less.

RESPONSES OF MR. BRADY TO QUESTIONS SUBMITTED BY SENATOR DASCHLE

Question No. 1. Has the Department of the Treasury estimated the impacts of declining oil prices on the U.S. economy, and, if so, could the Department share this or these analyses with the Committee? If not, would the Department prepare an analysis of the anticipated impacts of an oil price decline of $5 per barrel, and share this with the Committee? Among the considerations that should be considered are the impacts on inflation, personal income, gross domestic product, balance of trade, oil imports, oil consumption, and domestic oil production.

Answer. The Treasury Department has not estimated recently the impacts of declining oil prices on the U.S. economy. At the time of the Persian Gulf Emergency, a rough estimate was made of the effects of a sustained $5 per barrel increase in the price of crude oil. Because crude oil was selling for roughly $20 per barrel at that time, a $5 increase was about 25 percent. Assuming that the impact of a price change is symmetrical for increases and decreases, a small $5 per barrel decrease in the price of crude oil could perhaps lead to a 0.5 percent to 0.7 percent increase in real GNP. The impact on real GNP, as well as on the price level, would depend greatly on the policy stance of the Federal Reserve.

This is only a rough approximation of the impact, however. If we were to make a more formal estimate, including the impact on the several economic variables noted in your question, it probably should be done as a Troika exercise, i.e., a joint effort of Treasury, CFA and OMB.

Question No. 2. Does the Department concur with various oil industry analysts who predict a $5 per barrel decline in the world price of oil in the first two quarters?

Answer. During 1991, the world price of oil averaged somewhere between $18.50–$19.00 per barrel, down from about $22.00 per barrel in 1990. During the first two quarters of 1992, most factors point to a further weakening of prices. Any number of scenarios could be envisaged, however, that would result in either higher oil prices, or, as you indicate a sharper decline in prices. This would depend, of course, on the supply of, and demand for, crude oil.

Question No. 3. Between 1983 and 1985, the Department of Treasury advocated lower oil prices as a way to stimulate the economy. Is this still the view of your Department? What is the ideal price of oil for the U.S. economy, and for the world economy?

Answer. In the early 1980's, as you pointed out, the Department of the Treasury concluded that under the circumstances applicable at the time, lower or stable oil prices would have an overall positive impact on the economy. However, the Department has always recognized that changes in oil prices, whether upward or downward, have both costs and benefits. Lower prices would reduce business costs as well as the cost of an important expense for consumers. This could provide a boost to economic activity. At the same time, lower oil prices would cause a loss for producers and reduce domestic production; lower prices would also increase the demand for oil.

This said, we believe that the "ideal" price for oil is that which is determined by market forces. Such a price results in the most efficient allocation of scarce resources, promotes long-term price stability, and thus enhances prospects for economic growth.

PREPARED STATEMENT OF JAY BUCHERT

Mr. Chairman, members of the committee, my name is Jay Buchert I am a home builder from Cincinnati, Ohio and am President-Elect of the National Association of Home Builders. On behalf of the National Association of Home Builders (NAHB) and its 153,000 members, I congratulate you for holding this hearing and appreciate the opportunity to appear here today. At the outset, let me state that NAHB was among the first industry groups to call for the enactment of economic stimulus legislation to spur a housing led economic recovery.

I. Overview

The current nationwide recession can be characterized as no less than a depression in the housing industry. A cyclical business downturn has been exacerbated by actions taken by the Administration and Congress that were adverse to the homebuyer and home builder. The result has been a destabilization of real estate values and a "credit crunch" which have transformed the housing segment from a source of economic growth to a source of economic stagnation. Seven times since World War II the housing industry has led the U.S. economy out of recessions. This time, however, the housing industry may lead into a double dip recession. We believe that federal tax policy must contain initiatives that will remedy the depression in the housing industry. We further believe there will be no sustained economic recovery without a recovery in the housing industry. The NAHB Board of Directors developed a five point stimulus plan which will jump start the national economy.

A. Recent Housing Data

Every key housing indicator has weakened. The upswing that occurred after victory in the Persian Gulf war has not been sustained. The pertinent facts:

- We are expecting starts at the lowest level since 1945 (Exhibit 1).

- Sales of existing homes have fallen since June, retreating 12 percent during the June-October period; new home sales have shown no significant improvement since April (Exhibit 2).

- NAHB's monthly survey of builders suggests that reported home sales and housing starts will not improve in the immediate future. A November survey (based on over 400 responses) shows that an erosion of all key survey measures -- current sales, builder's sales expectations, and buyer traffic --continues (Exhibit 3). Exhibit 4 shows that the builder expectations series is a good indicator of future building permits and that permits will be coming down. The permits series, of course, is a component of the government's composite index of leading economic indicators.

- Overall job loss in November totaled 241,000. Construction employment fell by 95,000 in November (39% of total job loss) bringing the total construction job loss during the past two years to more than 682,000 (Exhibit 5). Furthermore, the unemployment rate in the construction industry rose to 16.0 percent in November (Exhibit 6).

B. Forecast for Housing and Economy

The recent pattern of housing data has forced a revision of NAHB's housing forecast for 1991 from 1,050,000 starts to 1,004,000 -- the lowest level since 1945. NAHB has also cut the 1992 forecast from 1.25 million to 1.185 million. (See bottom panel of Exhibit 7).

Weakening of the housing sector will have serious implications for the overall economy. As shown in the top panel of Exhibit 7, the single family housing component of real GDP dropped by $12.6 billion (1987 dollars) in 1991 accounting for 32 percent of the $39.1 billion drop in total GDP. The projected support provided by housing to the economy during 1992 is quite small accounting for less than 17 percent of the modest rebound in real GDP.

The fall-back in housing, together with weakening in other key sectors (including manufacturing), have turned our forecast for fourth quarter GDP growth into a decline.

Next year is the big question mark at this point. In our forecast, NAHB installed a 1.9% year-over-year increase in real GDP for 1992, with below-trend growth in the first half of the year and above-trend growth during the balance of the year. The downside risks to this forecast are considerable, and any adverse shock to the system (such as a stock market crash) could generate negatives for GDP in 1992.

It is increasingly obvious that the economic fall-back in the fourth quarter is a virtual certainty, and that some special fiscal stimulus is needed to ensure an economic upswing next year -- beyond the automatic stabilizers in the federal budget.

C. Single-Family And Homeownership Statistics

Homeownership rates among young families have fallen. The decline in homeownership began in 1980 and continued through 1989 before reversing itself slightly in 1990. The 1990 homeownership rate of 64.1 percent remains well below the 65.6 percent of 1980. The most dramatic drop in the homeownership rate during that period has been among young families who typically are first-time buyers.

The Harvard Joint Center for Housing Studies 1991 report, "State of the Nation's Housing," found that high costs continue to limit access to homeownership for many potential first-time buyers. Only those age 45 and over have shown any increase in homeownership rates since 1980. Much of that shift is attributable to changes in the distribution of income. The share of income flowing to young families has fallen despite the greater number of young families with two earners in the labor force.

The demand for single-family homes should be strong during the 1990s. Single-family starts should not be affected by the slowdown in household growth because changes in the age structure of the population will favor higher rates of homeownership, and greater demand for single-family homes.

D. Multifamily Rental Demand

The multifamily picture is less encouraging.

- Demand Growth:

An additional 350,000 multifamily units will be needed each year through the 1990s to accommodate an increased number of households and to replace existing units removed from the housing stock. Approximately 300,000 multifamily units will probably be in buildings with 5 or more units with the balance in 2 to 4 unit buildings. Most of the growth in the demand for multifamily rentals will be among moderate-, low-, and very-low income households.

The forecast demand for additional multifamily rental housing is the sum of the projected growth in multifamily renter households, the projected demand for units to replace the number that are lost on net from the available stock, and the number of vacant units needed to accommodate household growth.

- Meeting the Demand:

The Joint Center for Housing Studies of Harvard University study of the State of the Nation's Housing in 1991 concluded that "today's level of multifamily starts is well below that required to accommodate even modest projected increases in renter households--let alone allow for replacement of units demolished or otherwise removed from the inventory." Demand for multifamily housing is about 350,000 units per year and the level of multifamily starts in 1991 is only half that number.

Although there is currently an excess supply of vacant units in many areas, net additions to the rental stock from changes in the existing stock, new construction, and excess vacant units will almost certainly not be enough to meet the future demand for multifamily housing unless steps are taken soon to encourage new construction. An undersupply of multifamily rentals will cause rental markets to tighten, rents to rise, and housing cost burdens on the poor to increase. A lack of affordable rental housing could lower the rate of household formations. Some who might otherwise form renter households may be forced to double up with other families, remain in their parents' homes, and, in the worst case, end up homeless.

Since the Tax Reform Act of 1986, multifamily production has plummeted and what little production that has been taking place has been targeted towards middle- and upper-income renters. In 1985, 56 percent of all multifamily completions rented for less than $450, but by 1989 only 19 percent were so rented. This has contributed to an annual average net loss of 324,000 multifamily rentals with rents under $450 between 1985 and 1989. The loss of these units has meant greater hardships for low-income renters and has reduced the flow of existing moderate-income units into the low-income stock.

Virtually all of the limited volume of multifamily rental construction since 1986 that has been intended for low and moderate income families has been supported by the low income tax credit program -- the only remaining tax incentive for production of affordable rental housing.

II. NAHB RECOMMENDATIONS

With housing production at its lowest point since World War II, with economic indicators pointing toward a double dip recession, with a decline in employment of 241,000 in November and consumer confidence at a low point, it is obvious to us that Congress and the Administration need to act. The National Association of Home Builders urges you to enact major economic stimulus legislation.

Specifically, NAHB supports legislation that would:

- Establish a tax credit for moderate-income, first-time home buyers;
- Allow tax- and penalty-free withdrawals from IRAs and similar retirement programs for downpayments on homes;
- Permanently extend the low-income housing tax credit program;
- Permanently extend the mortgage revenue bond program for first-time homebuyers;
- Eliminate certain passive activity loss restrictions with respect to real estate professionals;
- Reduce the capital gains tax rate for investment assets including depreciable real properties.

A. First-Time Homebuyer Tax Credit

The most workable stimulant to new housing production would be a one year refundable, tax credit allowable to first-time home buyers with incomes at or below 115 percent of the local area median household income for the purchase of newly-built homes. We believe that a credit in the amount of $2,000 would add 265,000 housing starts and 500,000 jobs at a cost of $900 million.[1]. Residential investment would be increased by more than $20 billion.

- Targeting a tax credit toward the consumer purchase of housing will direct tax incentives into an area in which they are certain to have a direct and measurable economic impact by producing immediate jobs and tax revenue.

- Targeting new home buyers ensures that the credit stimulates production and minimizes the tax loss, from those who would buy existing homes.

- Targeting moderate-income, first-time home buyers:
  (1) limits the scope of the credit to a manageable number of eligible families;
  (2) provides assistance to those families who would benefit most from the program; and
  (3) induces families who might otherwise have delayed buying.

- A tax credit should be at a level sufficient enough to get first-time home buyers to buy new homes, while also providing a stimulant to move the economy out of recession.

- A refundable credit would be useable irrespective of the home buyer's tax liability and would be both equitable and efficient. Accordingly, those with the lowest incomes would receive the full benefit of the credit.

- A one-time only credit available for a one year period would induce those who might otherwise delay a home purchase to act within the year. So limited, opportunities for success would be maximized while revenue impact would be minimized.

More than one-third of the 4.5 million home transactions completed in a typical year are first-time home purchases[2]. The median income of a first-time home purchaser is $35,000. Potential first-time home buyers often can't buy a house because they lack the necessary down payment. According to two recent studies[3], 80 to 90 percent of young renters do not have enough savings to purchase a first home. Even before the recent drop in mortgage rates, these studies revealed that the lack of up-front cash was a greater barrier to ownership than the inability to afford monthly mortgage payments. The studies revealed that the inability to buy a home was especially concentrated among families and individuals with incomes below $30,000 and among those under the age of 45. Between 1980 and 1990, the home ownership rate for households under the age of 25 fell from 21 percent to 16 percent; for households between ages 25 and 29, it fell from 43 percent to 35 percent, and for households between ages 30 and 34, it fell from 61 percent to 52 percent. The young households' drop in home ownership was due in large part to the lagging income growth in these age groups. (Exhibit 8).

1. A TEMPORARY TAX CREDIT HAS BEEN USED IN THE PAST

In 1975, a 5 percent credit (up to $2,000) was offered for a limited period to all purchasers of newly built homes started before March 26, 1975.[4] The credit was intended to clear out builders' inventory and stimulate new construction. Adjusted for inflation, the 1975 $2,000 amount would be the equivalent of $4,850 in 1991. Although the credit only covered homes that had already been started before the legislation was passed, it affected 535,000 purchases.

To keep down cost, the home buyer tax credit could be restricted to families with incomes at 115 percent of local area median, with a phase out of the credit from 115 percent of local area median to 140 percent of local area median. These limits are similar to mortgage revenue bond qualifications (Exhibit 9) and encompass approximately 75 percent of all first-time home buyers and 62 percent of first-time home buyers who buy newly-built homes. If home buyer credit is applied only to newly built homes, the revenue impact would be one-fifth the amount with respect to all first-time home purchases. (Exhibit 10).

A first-time home buyer tax credit will provide a more immediate and effective stimulus to economic recovery than any other alternative stimulus proposals. It would stimulate far more spending than a tax credit or rebate with equivalent revenue impact.

B. Permanent Status for the Low Income Housing Tax Credit and Mortgage Revenue Bond program

Both the Low Income Housing Tax Credit (LIHTC) and Mortgage Revenue Bond (MRB) program should be made permanent. The LIHTC has financed the construction or rehabilitation of about 130,000 low income rental units each year, including 60,000 to 70,000 new units. MRBs support about 130,000 home purchases each year including 32,000 newly built homes.

The LIHTC is responsible for 25 percent of projected 1992 multifamily starts, more than a third of all rental multifamily starts, and virtually all the new rental units available to households with incomes under $15,000. If the LIHTC is not extended beyond June 1992, we estimate a loss of 60,000 multifamily starts each year after 1992. The reduction in multifamily starts would cost 50,000 jobs and $1.29 billion in wages in the new construction sector[5]. In the remodeling industry sector, an additional 16,500 jobs and $430 million in wages would be lost per year[6]. Permanent extension of the credit improve the efficiency of its administration and would probably result in an increase in LIHTC supported projects.

Failure to extend MRBs would cause a reduction of 16,000 to 20,500 single family housing starts and 30,000 to 35,000 fewer housing starts per year after 1993. The reduction in single family starts would cause job losses of 29,000 to 37,000 in 1993 and 54,000 to 63,000 fewer jobs per year for subsequent years. Total job loss with respect to both the LIHTC and MRB programs would be approximately 100,000 in 1993 and 120,000 per year for subsequent years.

C. Expansion of Tax-deferred Retirement Savings and use of IRA Deposits for Down Payment on a First Home

NAHB supports the proposals currently before the committee which would allow the use of IRA, and other tax-deferred retirement savings plan funds, for first home purchase. In this regard, we recommend that such use (by either the buyer, parents or grandparents of the buyer) be deemed an eligible investment of the IRA. Roughly 15 percent of potential first-time home buyers have invested in IRAs and another 9 percent have invested in 401(k) plans [7]. NAHB estimates that allowing a first-time home buyer's purchase to be a qualified investment within the plan would create 3,600 jobs and generate 8,000 additional home purchases.

D. Revise Passive Activity Loss Rules

The limitations on passive activity loss have sharply reduced real estate values. Indeed, subsequent to enactment of the PAL rules, the value levels of many properties fell by more than 20 percent, well below reproduction cost. The decline in real estate resale values has been a major factor in the number of defaulted mortgages on income-producing properties. Those declines in values have been major contributors to thrift and bank failures. Revision of the PAL limitations as to real estate would restore value to real estate. We believe that simply revising the PAL rules, by themselves, would not produce sufficient economic stimulus to spur a recovery. To be effective, PAL revision must be a part of a larger, more comprehensive tax package.

E. Capital Gains

NAHB supports reinstatement of a capital gains rate differential for real estate and other assets. More favorable capital gains treatment would not only encourage purchases of existing properties, but would also encourage investment in new construction, rehabilitation and remodeling. It would also reduce required rents on new construction. For example, taxation of capital gains at 60% of ordinary income rates would reduce new construction rental amounts by 3.4%.

Conclusion

A serious lack of economic growth exists in almost all sectors of the economy - not just housing. However, the housing market is the engine that traditionally pulls the nation out of recession.

We would urge the committee and the Congress not to pass a middle-class tax break by pa[illegible]t with an increase in taxes on upper income individuals. We agree w[illegible]irector Reischauer's statement that the economy would get "virtually no stimulative effect at all" if Congress cuts middle-class taxes and pays for that by hiking taxes on the wealthy by the same amount.

We also agree with the statements of Professor John Kenneth Galbraith and Roger Brinner that "concern for the federal deficit must be suspended" during the recession. Mr. Brinner proposed a three-step recovery plan. We agree totally with two points - lowering bond and mortgage rates and rebuilding real estate values and boosting construction. Real estate values can be boosted by enactment of a tax credit for first time home buyers and relief from the passive activity loss rules for real estate.

The National Association of Home Builders urges you to respond to the needs of our failing economy by enacting economic stimulus legislation now. NAHB looks forward to further working with you to propose and implement solutions to stimulate the Nation's economic recovery.

Thank you for this opportunity to present our recommendations.

END NOTES

1. Approximately 1,800 jobs in construction and related fields are created for every 1,000 housing starts.

2. American Housing Survey, 1989.

3. Who Can Afford to Buy a House?, Current Housing Reports H121/91-1, Bureau of the Census, and The State of the Nation's Housing 1991, Joint Center for Housing Studies of Harvard University.

4. Tax Reduction Act of 1975 (P.L. 94-12).

5. NAHB estimates updating 1981 Bureau of Labor Statistics data show that 826 jobs are created for every 1,000 additional multifamily units and $21.5 million added wages are earned per 1,000 starts.

6. The remodeling multipliers are one-third the amount of new construction. Hence, for instance, the loss of 60,000 rehabilitated units in 1993 would lead to a loss of (60) x (826) x (1/3) = 16,500 jobs and (60) x ($21.5 million) x (1/3) = $430 million in wages.

7. "Down Payments for Retirement Accounts", Housing Economics, March 1991.

Exhibit 1

STARTS AND PERMITS

Seasonally Adjusted Annual Rate

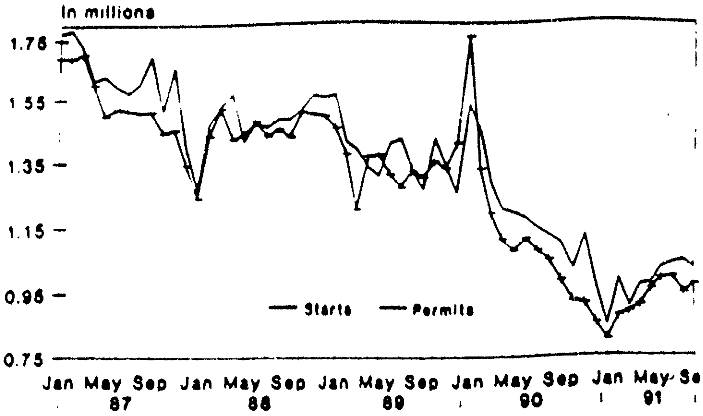
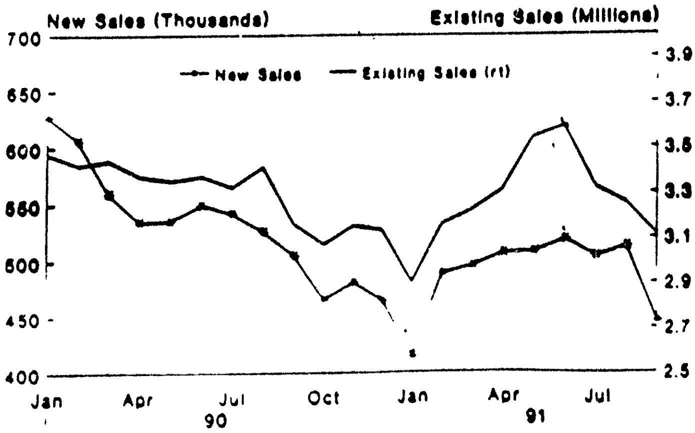


Exhibit 2

NEW AND EXISTING HOME SALES

Seasonally Adjusted Annual Rate



SALE OF NEW HOMES-PRESENT
(Percent of Respondents)

	Single Family Detached			Townhouse			Condominium		
	Good to Excellent	Fair	Poor	Good to Excellent	Fair	Poor	Good to Excellent	Fair	Poor
Nov 1991	15%	36%	49%	1%	17%	82%	3%	14%	83%
Oct 1991	12	44	44	2	23	75	2	20	78
Sep 1991	16	43	41	4	23	73	5	16	79
Aug 1991	14	45	42	5	28	67	4	17	79
Jul 1991	19	46	35	6	22	72	4	17	79
Jun 1991	21	47	32	4	27	69	6	21	73
May 1991	23	44	32	4	28	68	5	23	72
Apr 1991	27	43	30	7	28	65	8	23	68
Mar 1991	20	39	41	5	24	71	4	20	76
Feb 1991	8	36	56	2	24	74	4	19	77
Jan 1991	5	25	70	2	12	86	1	12	87
Dec 1990	5	25	67	1	14	85	1	15	84
Nov 1990	6	33	61	2	11	87	2	11	87
Oct 1990	11	32	57	4	18	78	3	21	76
Sep 1990	15	36	49	6	21	73	4	21	75
Aug 1990	15	32	53	4	23	73	4	18	78
Jul 1990	15	39	46	8	23	69	6	22	72
Jun 1990	20	43	37	6	26	68	4	24	72
May 1990	21	44	35	8	33	59	5	21	74
Apr 1990	26	44	30	9	32	59	9	23	68
Mar 1990	24	44	32	10	32	58	9	25	66
Feb 1990	24	46	30	8	29	63	9	21	70
Jan 1990	19	44	37	5	27	68	6	18	76
Dec 1989	17%	42%	41%	5%	23%	72%	4%	18%	78%
Nov 1989	20	42	38	6	29	65	7	18	75
Oct 1989	24	44	32	5	33	62	9	21	70
Sep 1989	30	43	27	14	25	61	9	20	71
Aug 1989	29	44	27	13	24	63	9	24	67
Jul 1989	29	42	29	11	29	60	10	22	68
Jun 1989	31	40	29	11	31	58	8	24	68
May 1989	28	46	26	11	25	64	8	23	69
Apr 1989	33	42	25	12	25	63	9	21	70
Mar 1989	37	40	23	11	32	57	7	24	69
Feb 1989	38	40	22	14	34	52	9	27	64
Jan 1989	34	43	23	9	33	58	8	30	62
Dec 1988	37%	34%	29%	9%	33%	58%	8%	29%	63%
Nov 1988	35	38	27	11	34	55	10	28	62
Oct 1988	22	41	37	6	32	62	21	26	53
Sep 1988	35	41	24	17	35	48	12	29	59
Aug 1988	40	41	19	20	35	45	13	28	59
Jul 1988	40	38	22	15	34	51	12	30	58
Jun 1988	36	41	23	15	29	56	10	23	67
May 1988	44	39	17	21	31	48	16	30	54
Apr 1988	43	40	17	20	37	43	18	26	56
Mar 1988	43	33	24	10	30	60	5	23	72
Feb 1988	36	39	24	15	34	51	8	29	63
Jan 1988	34	38	28	14	27	59	6	24	70
Dec 1987	29%	39%	32%	13%	38%	49%	9%	27%	64%
Nov 1987	33	43	25	12	36	52	10	33	57
Oct 1987	26	45	29	13	29	58	11	25	64
Sep 1987	37	34	29	18	31	51	12	25	63
Aug 1987	38	39	23	17	36	47	14	28	58
Jul 1987	40	40	20	21	30	49	15	24	61
Jun 1987	47	36	17	18	27	55	9	28	63
May 1987	51	30	19	24	30	46	12	24	63
Apr 1987	54	30	16	26	30	44	21	24	55
Mar 1987	57	25	18	25	33	42	15	31	54
Feb 1987	49	31	20	27	28	45	16	28	56
Jan 1987	48	35	17	16	33	51	10	27	63
Dec 1986	42%	35%	23%	13%	30%	57%	9%	25%	66%
Nov 1986	42	28	30	13	23	64	10	15	75
Oct 1986	43	34	23	19	19	62	17	21	62
Sep 1986	41	24	35	22	24	54	20	23	57
Aug 1986	44	29	27	17	26	57	16	14	70
Jul 1986	47	33	20	17	32	51	16	18	66

(con't)

November 1991

SALES OF NEW HOMES: BUILDERS' EXPECTATIONS FOR THE NEXT SIX MONTHS
(percent of respondents)

	Single Family Detached			Townhouse			Condominium		
	Good to Excellent	Fair	Poor	Good to Excellent	Fair	Poor	Good to Excellent	Fair	Poor
Nov 1991	19%	42%	39%	3%	23%	74%	4%	16%	80%
Oct 1991	18	52	30	3	32	65	3	26	71
Sep 1991	23	50	27	7	31	62	5	16	79
Aug 1991	19	54	27	5	36	59	5	23	71
Jul 1991	24	55	21	8	27	65	6	20	74
Jun 1991	28	56	16	7	34	59	6	28	66
May 1991	30	54	16	7	38	55	7	27	66
Apr 1991	33	55	12	9	37	54	11	29	60
Mar 1991	28	57	14	10	37	53	8	30	62
Feb 1991	17	55	28	5	33	62	5	26	68
Jan 1991	11	47	42	2	24	74	2	22	76
Dec 1990	9	41	50	2	24	74	2	19	79
Nov 1990	6	43	51	2	17	81	2	14	84
Oct 1990	8	41	51	3	20	77	3	21	76
Sep 1990	13	41	46	7	22	71	5	20	75
Aug 1990	14	45	41	5	25	70	5	21	74
Jul 1990	17	40	43	7	24	69	5	21	74
Jun 1990	18	51	31	7	29	64	5	26	69
May 1990	20	52	28	6	37	57	5	25	70
Apr 1990	29	50	21	9	36	55	8	28	64
Mar 1990	27	53	20	10	34	56	10	25	65
Feb 1990	30	53	17	11	33	56	11	24	65
Jan 1990	31	49	20	8	36	56	7	24	69
Dec 1989	25%	53%	22%	8%	27%	65%	6%	19%	75%
Nov 1989	22	51	27	6	34	60	8	22	70
Oct 1989	25	51	24	5	33	62	9	24	67
Sep 1989	33	48	19	12	31	57	10	25	65
Aug 1989	35	46	19	12	31	57	8	28	64
Jul 1989	29	54	17	10	36	54	7	25	68
Jun 1989	34	48	18	11	37	52	7	29	64
May 1989	31	50	19	13	29	58	9	28	63
Apr 1989	29	54	17	9	33	58	6	26	68
Mar 1989	39	45	16	12	38	50	10	26	64
Feb 1989	45	47	8	15	41	44	9	34	57
Jan 1989	40	47	13	11	38	51	11	33	56
Dec 1988	38%	45%	17%	8%	40%	52%	7%	35%	58%
Nov 1988	35	48	17	12	37	51	10	33	57
Oct 1988	23	53	24	8	39	53	20	34	46
Sep 1988	33	43	24	15	33	52	13	23	64
Aug 1988	31	47	21	14	40	46	10	33	57
Jul 1988	35	44	21	10	39	51	11	33	56
Jun 1988	30	50	20	12	29	59	8	25	67
May 1988	41	43	16	21	30	49	16	28	56
Apr 1988	43	45	12	17	40	43	15	31	54
Mar 1988	45	39	16	11	36	53	5	26	69
Feb 1988	42	41	17	17	40	43	8	34	58
Jan 1988	38	47	15	14	28	58	7	23	70
Dec 1987	28%	51%	21%	13%	43%	44%	10%	31%	59%
Nov 1987	27	56	17	9	35	55	10	28	62
Oct 1987	22	47	31	9	32	59	9	22	69
Sep 1987	33	35	31	15	31	54	12	21	66
Aug 1987	36	45	19	18	30	52	12	27	61
Jul 1987	38	46	16	20	33	47	12	27	60
Jun 1987	38	41	21	16	32	52	9	27	64
May 1987	40	43	17	17	38	45	9	28	63
Apr 1987	54	31	15	27	31	42	19	27	54
Mar 1987	56	34	10	24	34	42	13	34	53
Feb 1987	55	31	14	29	30	41	17	27	56
Jan 1987	49	40	11	15	33	52	10	29	61
Dec 1986	40%	44%	16%	13%	31%	56%	11%	22%	67%
Nov 1986	40	34	26	15	25	60	9	20	71
Oct 1986	45	36	19	17	21	62	14	21	65
Sep 1986	42	32	25	22	29	49	13	34	53
Aug 1986	41	32	27	15	28	57	14	14	72
Jul 1986	48	34	18	19	30	51	16	19	65

(con't)

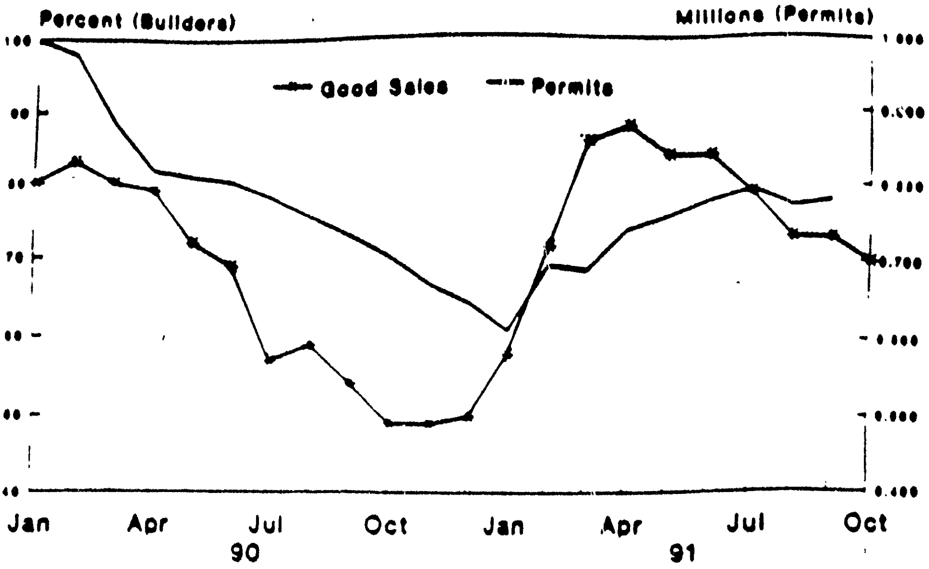
November 1991

TRAFFIC OF PROSPECTIVE BUYERS IN NEW HOMES
(percent of respondents)

	High to Very High	About Average	Low to Very Low
Nov 1991	9.5%	25.5%	64.9%
Oct 1991	9.8	27.3	63.1
Sep 1991	10.8	30.4	58.8
Aug 1991	8.0	32.5	59.5
Jul 1991	11.3	37.3	51.4
Jun 1991	15.9	38.6	45.5
May 1991	20.0	37.4	42.5
Apr 1991	22.5	42.3	35.2
Mar 1991	23.1	36.2	40.8
Feb 1991	14.2	31.4	54.5
Jan 1991	5.7	18.2	76.1
Dec 1990	3.6	17.8	78.6
Nov 1990	4.6	18.6	76.8
Oct 1990	4.7	24.2	71.1
Sep 1990	8.4	26.3	65.3
Aug 1990	7.1	27.2	65.7
Jul 1990	10.3	28.0	61.7
Jun 1990	11.8	31.9	56.3
May 1990	14.6	35.1	50.3
Apr 1990	18.8	37.5	43.7
Mar 1990	22.3	38.8	38.9
Feb 1990	21.2	41.3	37.5
Jan 1990	13.6	31.2	55.2
Dec 1989	9.7	27.1	63.2
Nov 1989	11.2	33.3	55.5
Oct 1989	11.8	35.5	52.7
Sep 1989	22.5	34.8	42.7
Aug 1989	25.3	30.3	44.4
Jul 1989	17.3	32.9	49.8
Jun 1989	20.5	35.6	43.9
May 1989	24.2	31.1	44.7
Apr 1989	23.3	36.4	40.3
Mar 1939	28.1	38.3	33.6
Feb 1989	28.1	41.5	30.3
Jan 1989	17.4	36.6	46.0
Oct 1988	18.3	41.4	40.3
Aug 1988	23.3	39.0	37.7
Jul 1988	22.6	39.4	38.0
Jun 1988	22.1	39.0	39.0
May 1988	31.2	35.9	32.9
Apr 1988	27.8	45.8	26.4
Mar 1988	29.1	41.2	29.7
Feb 1988	23.0	41.9	35.2
Jan 1988	20.3	39.9	39.9
Dec 1987	13.7%	34.4%	51.8%
Nov 1987	15.0	39.4	45.6
Oct 1987	14.0	38.7	47.3
Sep 1987	22.1	34.3	43.6
Aug 1987	19.8	45.7	34.4
Jul 1987	19.7	43.4	36.8
Jun 1987	26.5	49.9	27.6
May 1987	26.5	41.0	32.5
Apr 1987	44.9	32.1	23.0
Mar 1987	40.4	35.5	24.0
Feb 1987	37.3	37.3	25.4
Jan 1987	26.3	42.1	31.6
Aug 1986	30.1	31.6	38.3
Jul 1986	37.6	27.7	34.8
Dec 1986	22.3%	43.9%	33.8%
Nov 1986	24.1	36.5	39.3
Oct 1986	30.9	32.2	36.8
Sep 1986	27.7	40.5	31.7
Jun 1986	50.2	27.4	22.4
May 1986	55.7	23.9	20.3
Apr 1986	55.7	24.4	19.8
Mar 1986	40.8	32.1	27.0
Feb 1986	32.3	36.8	30.9
Jan 1986	24.1	42.6	33.3
Dec 1985	21.0%	34.0%	45.0%
Oct 1985	28.3	36.1	35.6
Sep 1985	18.6	40.7	40.7
Jul 1985	28.5	40.7	30.8
Jun 1985	28.6	40.6	30.8
May 1985	28.3	38.2	33.5
Apr 1985	29.9	41.4	28.7
Feb 1985	26.5%	51.6%	21.9%
Jan 1985	18.2	42.5	39.3
Nov 1984	15.0	40.5	44.5
Sep 1984	10.6	35.0	54.4
Aug 1984	10.6	34.8	54.6
Jun 1984	17.8	41.7	40.5
Mar 1984	46.8	35.3	17.9
Jan 1984	14.0	47.0	39.0
Dec 1983	36.2%	41.3%	22.5%
Nov 1983	16.3	34.1	49.6
Sep 1983	22.3	41.5	36.2
Jul 1983	28.6	33.8	37.6
Mar 1983	43.4	31.7	24.9
Dec 1982	19.4%	28.0%	52.6%
Oct 1982	13.6	28.4	58.0
Jul 1982	7.1	11.4	81.5
Jan 1982	3.3	4.8	91.9
Nov 1981	1.1%	6.9%	92.0%
May 1981	6.1	48.5	45.4
Jan 1981	1.7	10.2	88.1
Nov 1980	2.5%	15.7%	81.8%
Oct 1980	12.0	12.0	76.0
May 1980	5.0	18.0	77.0
Jan 1980	7.7	24.0	68.3
Dec 1979	7.7%	11.5%	80.8%
Oct 1979	5.7	24.9	69.4
Jun 1979	13.0	32.3	54.7
Feb 1979	14.6	54.3	31.1
Sep 1978	21.5%	51.8%	26.7%
Jun 1978	35.6	46.5	17.8
Mar 1978	35.2	44.1	10.7
Nov 1977	41.4%	46.7%	11.9%
Aug 1977	54.9	37.4	7.7
Mar 1977	48.0	41.1	10.9

Source: Builders Economic Council (BEC) Survey, NAHB Economics Division.
(Questionnaire dated September 24, 1991)

Exhibit 4
BUILDERS' SALES EXPECTATIONS AND SINGLE FAMILY PERMITS



Source: NAHB, Bureau of Census

Exhibit 5

CONSTRUCTION EMPLOYMENT

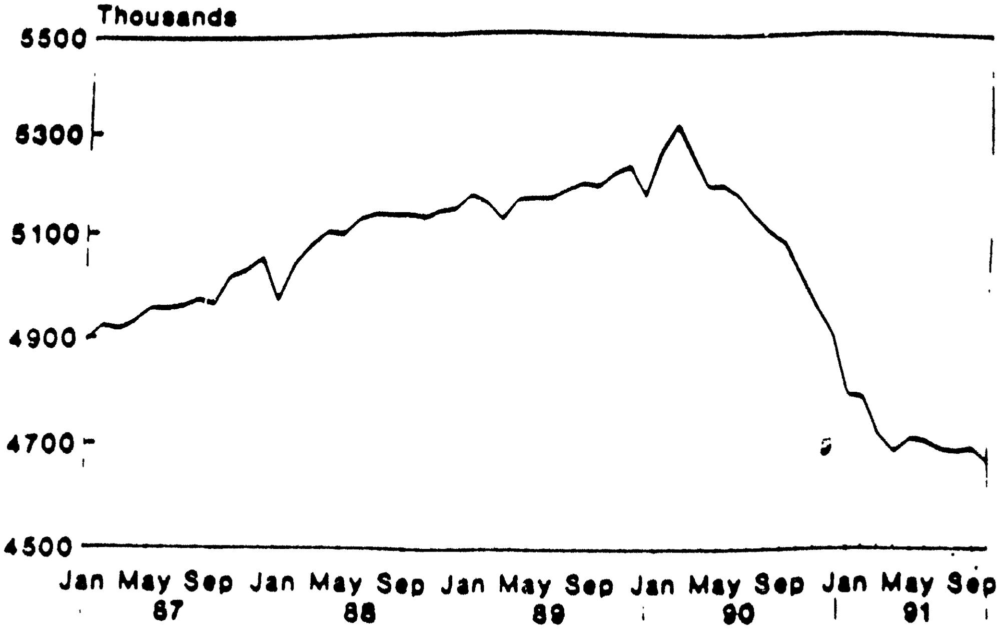
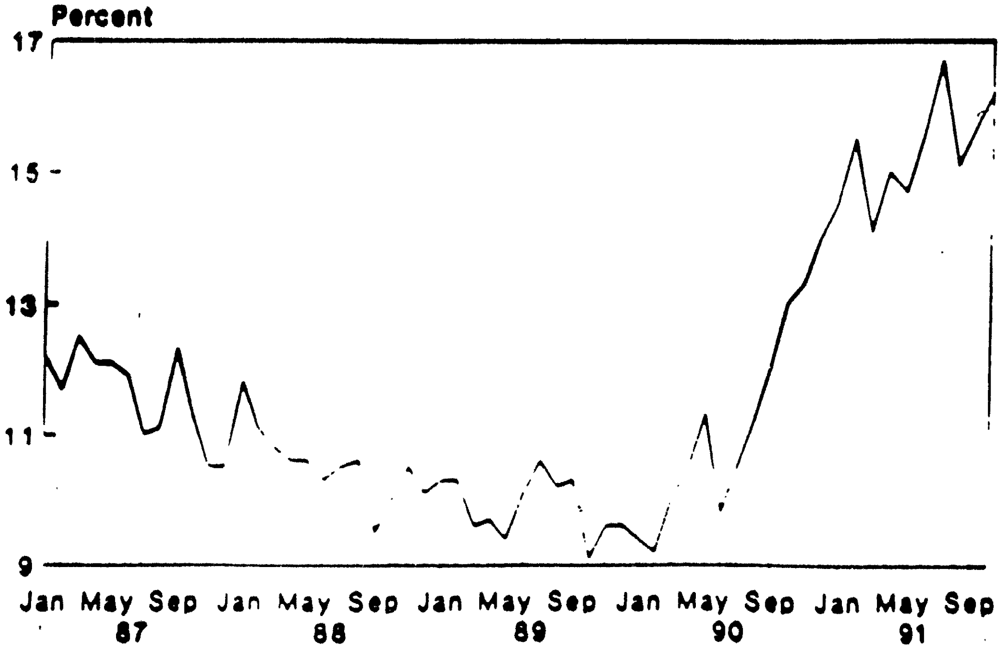


Exhibit 6

CONSTRUCTION UNEMPLOYMENT RATE



10-Dec-91

NAHB ECONOMIC FORECAST, 1991–1992

	Annual Data				1990				1991				1992			
Economic Activity	1989	1990	1991	1992	I	II	III	IV	I	II	III	IV	I	II	III	IV
Real GDP Bil.$87	4836.9	4884.9	4845.8	4937.3	4880.8	4900.3	4903.3	4855.1	4824.0	4840.7	4861.0	4857.6	4877.1	4909.0	4954.7	5008.5
% Chge AR	2.6%	1.0%	-0.8%	1.9%	1.7%	1.6%	0.2%	-3.9%	-2.5%	1.4%	1.7%	-0.3%	1.6%	2.6%	3.8%	4.4%
Resident. Fixed Inv Bil.$87	214.2	195.5	174.4	192.0	208.2	199.5	190.9	183.3	170.7	172.0	176.9	177.9	181.1	186.7	195.0	205.1
% Chge AR	-3.8%	-8.7%	-10.8%	10.1%	0.6%	-15.7%	-16.2%	-15.0%	-24.8%	3.1%	11.9%	2.2%	7.6%	13.0%	18.0%	22.2%
Single Family	107.3	96.5	83.9	99.3	106.4	100.0	93.0	86.7	77.6	78.6	88.6	90.8	92.5	95.9	101.5	107.3
Multifamily	20.6	17.4	13.4	13.8	18.2	17.7	17.0	16.6	15.8	13.9	12.6	11.5	11.8	12.6	13.9	16.9
Other	86.3	81.6	77.0	78.9	83.6	81.8	80.9	80.0	77.4	79.5	75.7	75.6	76.8	78.2	79.6	80.9
Personal Income Bil.$	4380.2	4679.8	4810.3	5068.1	4580.6	4654.7	4719.3	4764.7	4748.2	4800.2	4832.0	4860.9	4938.0	5015.9	5108.0	5210.3
% Chge AR	7.6%	6.8%	2.8%	5.4%	9.8%	6.6%	5.7%	3.9%	-1.4%	4.5%	2.7%	2.4%	6.6%	6.1%	7.6%	8.2%
Unemployment Rate - Civilian (%)	5.3%	5.5%	6.7%	6.6%	5.3%	5.3%	5.6%	5.9%	6.5%	6.8%	6.8%	6.8%	6.8%	6.7%	6.6%	6.4%
Prices – % Qrtrly Change AR																
GNP Deflator	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
PPI - Finished Goods	5.2	5.0	2.2	2.3	9.7	-0.7	6.3	11.4	-2.5	-1.1	-0.1	4.2	1.6	3.2	3.3	2.3
CPI - Urban Consumers	4.8	5.4	4.2	3.2	8.2	3.8	6.3	6.9	3.8	2.1	3.1	2.7	3.5	3.8	3.2	3.4
Interest Rates – %																
90 day Treasury Bill Rate	8.1	7.5	5.4	4.7	7.8	7.8	7.5	7.0	6.1	5.6	5.4	4.6	4.3	4.5	4.9	5.0
Constant Maturity Treasury Yields:																
One Year Maturity	8.5	7.9	5.9	4.9	8.1	8.3	7.8	7.3	6.4	6.2	5.9	4.9	4.6	4.8	5.0	5.2
Ten Year Maturity	8.5	8.5	7.9	7.3	8.4	8.7	8.7	8.4	8.0	8.1	7.9	7.4	7.2	7.2	7.3	7.3
FHLMC Commitment Rates:																
Fixed Rate Mortgages	10.3	10.1	9.3	8.6	10.1	10.3	10.1	9.9	9.5	9.5	9.3	8.7	8.5	8.5	8.6	8.7
ARMs (Index = 1 Yr Treasury)	8.8	8.4	7.1	6.5	8.5	8.5	8.4	8.1	7.6	7.3	7.1	6.5	6.2	6.4	6.6	6.7
GNMA Pass-thru Certs.: 3 Mo. Deliv.	9.7	9.6	8.7	8.0	9.5	9.8	9.6	9.4	8.9	9.0	8.7	8.1	7.9	7.9	8.0	8.1
Prime Rate	10.9	10.0	8.5	7.0	10.0	10.0	10.0	10.0	9.2	8.7	8.4	7.6	7.0	7.0	7.0	7.0
Housing Activity – 000 Units																
Total Housing Starts	1,376	1,193	1,004	1,185	1,433	1,203	1,131	1,042	915	999	1,042	1,060	1,078	1,146	1,226	1,289
Y/Y % Chge	-7.6%	-13.3%	-15.8%	18.0%	-2.1%	-11.6%	-16.1%	-22.9%	-36.1%	-17.0%	-7.9%	1.7%	17.8%	14.7%	17.7%	21.6%
Single Family	1,003	895	829	985	1,064	896	856	786	726	834	875	882	898	954	1,021	1,066
Y/Y % Chge	-7.2%	-10.8%	-7.3%	18.8%	3.7%	-10.3%	-14.7%	-20.9%	-31.8%	-6.9%	2.2%	12.2%	23.7%	14.4%	16.7%	20.9%
Multifamily	373	298	175	200	369	307	274	256	189	165	167	178	180	192	205	223
Y/Y % Chge	-8.3%	-20.1%	-41.4%	14.4%	-15.8%	-15.0%	-20.6%	-26.6%	-48.8%	-46.3%	-39.1%	-30.6%	-4.8%	16.4%	22.8%	26.3%
2 to 4 Family	55	38	36	45	43	43	32	31	31	31	39	42	42	44	45	47
5 plus Family	318	260	136	156	326	264	242	225	158	134	128	123	128	144	164	186
Total New Single Family Sales	650	535	502	587	597	539	523	470	466	510	512	519	531	563	612	642
Y/Y % Chge	-4.0%	-17.7%	-6.2%	17.0%	-6.1%	-15.8%	-24.5%	-26.9%	-21.9%	-5.3%	-2.1%	10.4%	13.9%	10.3%	19.6%	23.7%
Mobile Home Placements	203	195	169	185	202	200	200	181	174	163	175	162	170	178	191	202

Source: Forecast of Housing Activity, September 1991. Published by NAHB Economics Division.

Home Ownership Rates

			% Point
Age	1980	1990	Change
	%	%	
<25	21.3	15.7	-5.6
25-29	43.3	35.2	-8.2
30-34	61.1	51.8	-9.3
35-39	70.9	63.0	-7.8
40-44	74.2	69.9	-4.3
45-49	76.8	73.9	-3.0
50-54	78.5	76.8	-1.8
55-59	79.6	78.7	-0.9
60-64	78.8	79.8	1.0
65-69	77.3	80.0	2.7
70-74	72.7	78.4	5.7
75+	67.8	72.3	4.5
50+	75.9	77.3	1.4
<35	44.5	38.5	-6.1
35-49	73.7	68.4	-5.3
All	65.6	63.9	-1.7

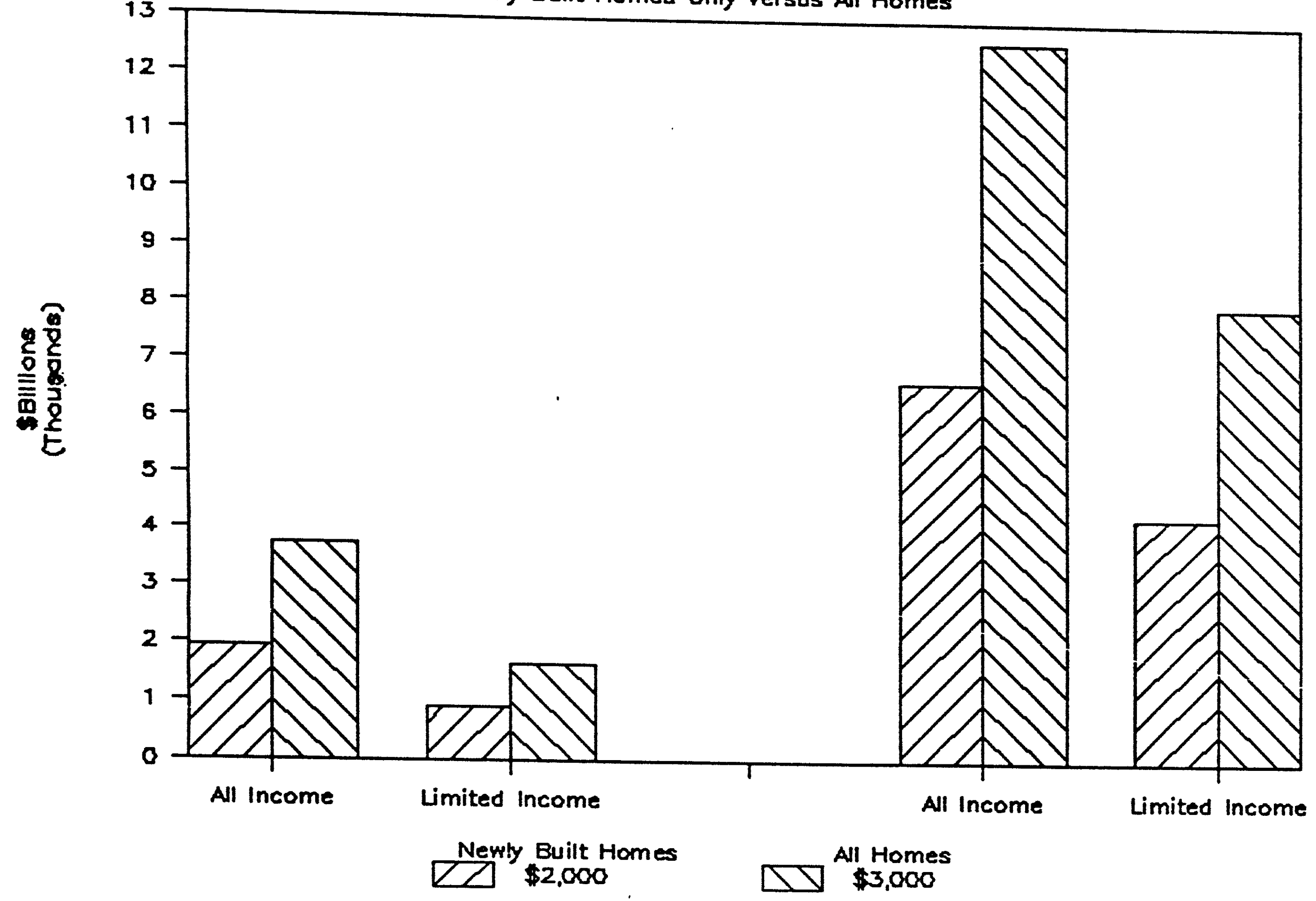
Home Buyer Credit Amount
Based On Mortgage Revenue Bond Income Limits

	Income	Credit Amounts
Below Med	<$35,000	$2,000
Median	$35,000	$2,000
115% of M	$40,250	$2,000
	$42,250	$1,543
	$44,250	$1,086
	$46,250	$629
	$48,250	$171
140% of M	$49,000	$0
	$50,000	$0

*Phase out between 115% and 140% of median is $228.50 less credit for every $1,000 of additional income.

Foregone Taxes at Various Options

Newly Built Homes Only versus All Homes



Prepared Statement of Gay Burtless[1]

Businesses, consumers, and policy makers feel growing pessimism about U.S. economic prospects. Their pessimism derives from two sources. First, the nation is suffering from an unexpectedly stubborn recession. Although the downturn has been comparatively mild, nearly a year and a half after it first began there are few signs of a strong or sustained economic recovery.

In addition, many workers and voters now recognize that their paychecks do not buy as much as they did ten or twenty years ago. The long economic expansion of the 1980s did not bring fatter paychecks and higher living standards to most workers. Instead, it brought a continuation of the slide in real wages that began in the mid 1970s. For workers in the bottom half of the earnings distribution, the slide in hourly wages actually accelerated.

Congress and the President are now considering changes in tax policy in response to the crisis in economic confidence. In framing new policies, policy makers should bear in mind the two different sources of pessimism just mentioned. It would be foolish to change tax law in a way that addresses one set of problems while at the same time making the second set of problems even worse. In particular, the country should avoid tax changes that hasten the end of the recession if they permanently enlarge the federal budget deficit. While this kind of policy could reduce our short term pain, it would cut national saving and investment in the long run, further worsening the bleak trend in wages and living standards.

In the remainder of my testimony, I emphasize long run trends rather than the short term economic situation. Two sets of questions are stressed: What has happened to average family incomes and the *distribution* of family incomes around the median? Why have these changes occurred?

Family Income Trends

Some of the gloom over the current economy is tied to the perception that the American middle class is shrinking and that its living standards are sinking. For many years, a typical American family could expect to see its real income rise from one year to the next. During the 1950s, for example, median family income adjusted for inflation rose 34 percent. In the 1960s, real median income rose another 34 percent. With incomes growing this fast, few people (and even fewer politicians) bothered to inquire very closely into the distribution of family incomes around the median: The rising tide was lifting *all* ships.

The nation's experience since the early 1970s has been much more discouraging. Income growth fell off dramatically starting in 1973, whether growth is measured in terms of average or median family income. From 1947 through 1973, median income rose nearly 2.8 percent a year; since 1973 it has grown just 0.3 percent a year.[2] *Average* family income has risen faster than that because families near the top of the income distribution have enjoyed much faster income growth than families near the middle.

[1] Senior Fellow, The Brookings Institution, Washington, D.C. The views expressed here are the author's alone and should not be ascribed to the staff or Trustees of the Brookings Institution.

[2] To calculate real incomes I have deflated incomes using the Bureau of Labor Statistics' CPI-U-X1 price deflator series for the years 1967-1989. For years before 1967, I assumed that consumer prices changed at the rate implied by the official CPI-U series. For a variety of reasons, the CPI-U series overstates the true rate of inflation -- and thus understates income growth -- between 1967 and 1983.

Trends in the rate of income growth are shown in Figure 1, where I compare income changes at selected points of the family income distribution. The lighter bars show the average rate of annual income growth between 1947 and 1973; the darker bars show annual income changes between 1973 and 1990. The five sets of bars show trends in income growth for families at five different points in the income distribution, the 20th, 40th, 60th, 80th, and 95th percentiles of annual family income. Before 1973 income growth was rapid for families everywhere in the distribution, but it was strongest for families near the middle. Since 1973, income growth has slumped everywhere in the distribution, but it has fallen most for families with low incomes. In fact, after adjusting for inflation, families at the 20th income percentile received no more income in 1990 than they did in 1973. For these families, income growth ceased in the early 1970s. The more slowly rising tide lifted the yachts, but not the tugs or rowboats.

The public is more anxious about the income distribution today than it has ever been. The reason for this is straightforward. When the size of the economic pie stops growing, every person is more concerned about the relative size of his or her own slice. And the relative size of each slice has changed markedly over the past decade. Figure 2 shows average annual income changes in two recent periods, 1973-79 and 1979-90. In the late 1970s, income growth was slow for all income groups. But at least income grew, even among families near the bottom of the distribution. Since 1979, income growth has partially recovered -- but only among families in the top quarter of the distribution. Families near the middle of the distribution continue to receive only small income gains, and families near the bottom have been losing ground. The long economic recovery of the 1980s obviously produced very unequal gains across the income distribution.

Influence of family size and composition. Some observers argue that family income statistics reflect too bleak a picture of recent economic progress. Since the late 1960s average family size has declined, so the real income needed to support an average family has fallen. In addition, a higher percentage of income is received by individuals who do not live in families. This is because the number of unattached individuals has risen faster than the number of families and because unattached individuals have enjoyed faster income growth than families.

Both objections represent valid criticisms of average or median family income growth as the *sole* yardstick of economic progress. Per capita personal income has risen faster than median and average family income since 1973. Nonetheless, per capita income rose only half as fast after 1973 as it did before that year. Moreover, the trend toward increased inequality is just as obvious in the personal income statistics as it is in the family income statistics.

Lynn Karoly, an economist at the Rand Corporation, recently tabulated trends in the distribution of personal economic well-being among individuals in the United States. She measured personal well-being as the ratio of personal or family income to the income needed to bring a person or family up to the poverty line.[3] This kind of measure permits us to see how incomes have changed over time taking account of shrinking family size and the rising fraction of Americans who live alone.

Karoly's tabulations of the distribution of personal well-being confirm the importance of the trends shown in Figures 1 and 2. First, at the midpoint of the distribution, Karoly found that the personal well-being of the median American has grown much more slowly in the past decade and a half than it did earlier. Second, she found that the *inequality* of personal well-being has risen strongly, especially since the late 1970s. While improvements in personal well-being have been sluggish in the middle of the distribution, they have been much more rapid at the top of the distribution -- and nonexistent at the bottom. In fact, personal well-being has declined at the very bottom of the distribution. The incomes of the middle class and poor are growing sluggishly or declining, while the fortunes of the affluent continue to climb. Adjustments for changing family size and composition do not fundamentally alter this picture.

[3] For example, an unrelated individual receiving income equal to three times the poverty line would have personal well-being calculated as 3.0. Each individual in a family receiving an income equal to two-and-a-half times the poverty line would have personal well-being equal to 2.5. All individuals in the population were then ranked according to their own well-being (if they were unrelated individuals) or their family's (if they were members of a family). Karoly then measured the *growth* in personal well-being over time at selected points in the distribution. See Lynn Karoly, "The Trend in Inequality Among Families, Individuals, and Workers in the United States: A Twenty-Five Year Perspective," (Santa Monica, CA: Rand, 1990).

The effects of these trends on the income distribution are documented in Table 1. Over the last twenty years the share of all income received by the richest one-fifth of families has jumped 4.0 percentage points, to 44.6 percent, while the share received by the poorest one-fifth has fallen one percentage point, to 4.6 percent. The income shares of families in the second and third quintiles also fell, reaching their lowest levels since reliable income statistics began to be collected.

Until the 1980s, inequality tended to rise in recessions and fall during economic recoveries. As in previous recessions, inequality jumped during the two recessions after 1979. But unlike previous recoveries, the 1983-89 recovery did not cause family income inequality to fall. Instead inequality rose, reaching a new post-war high.

Sources of Recent Income Trends

Income growth for families and persons near the middle of the income distribution has slowed down for one main reason: The pace of productivity improvement has declined. Figure 3 shows the relationship between productivity growth, the trend in real compensation (money wages plus fringe benefits), real hourly wages, and disposable income per household over the post-war period. The solid black bars show annual rates of growth in the quarter century before 1973. The more lightly shaded bars show annual rates of growth or decline in more recent periods ending in 1990. One of them shows trends in the period 1973-90; the other shows trends over just the last five years (1985-90).

In the early post-war period, productivity, compensation, real wages, and disposable income rose strongly and more or less at the same pace. Money wages rose a little more slowly than compensation, because fringe benefits like health insurance, pensions, and social insurance contributions grew faster than cash pay. The dramatic fall-off in productivity growth has led to an even more dramatic fall-off in compensation and wage growth. In fact, compensation and hourly wages have actually *fallen* since 1985.

Real disposable income growth has improved in the last few years for three main reasons: (1) Households are sending more workers into the labor force, and workers are earning wages for a few more hours each year; (2) Government tax revenues have not kept pace with income growth: We've had tax cuts, so transfer payments have been growing faster than taxes (as a result, disposable income is boosted more by transfer payments than it is cut by tax withholdings); and (3) Corporations have paid out an increased proportion of their earnings in the form of interest and dividends rather than retained them to finance new investments. The second and third of these trends cannot continue indefinitely in the future.

Whatever the factors that might explain the divergent trends of compensation, wages, and household disposable income, one fact should be clear: Most of the drop in the growth of compensation, wages, and income is associated with the drop in productivity growth. And contrary to some optimistic claims in the early and mid-1980s, the country has not enjoyed a rebound in productivity growth since the late 1970s, except in manufacturing. Overall productivity growth remains sluggish. The explanation for the productivity slowdown is not fully understood. Because most American families and unattached individuals rely heavily on wage earnings to support themselves, the anemic pace of wage growth has meant that living standards for most families who rely on a single paycheck have suffered. Per capita income continued to climb before the recession, notwithstanding the miserable trend in wages, mostly because the percentage of the population that is of working age and at work grew.

Single-parent households. Though inequality has grown for a number of reasons, I would like to mention four main causes. First, and least surprising, is the steady rise in the fraction of all households headed by a single parent. Since one-parent families usually have only a single adult capable of earning wages, and since that adult seldom can earn as much as the primary earner in a two-parent family, single parents will be handicapped in their struggle to earn good incomes. Indeed, the poverty rate among single-parent families has remained relatively constant (and extremely high) over the past several decades, principally because so few single parents have the capacity to earn good wages.

The swelling number of one-parent families is not a recent phenomenon, however. It was part of the American demographic scene back in the 1960s, when overall income inequality was shrinking rather than growing. In fact, the trend toward single-parent families has slowed down in the past decade as the divorce rate has stopped climbing.

Rebecca Blank, an economist at Northwestern University, recently concluded that trends in family living arrangements were comparatively insignificant in explaining trends in low-income status during the past decade.[4] Family composition trends were much more important in pushing people toward low-income status during the 1960s and 1970s than they were during the 1980s. Nonetheless, the slow growth in the number of households containing only a single potential earner tends to boost the fraction of the population at risk of becoming poor.

Growing wage inequality among men. A second source of rising inequality is the growing disparity of wages, especially among 25-64 year-old men. In many people's minds, this trend is linked to the disappearance of "good" middle-class jobs. According to a popular view, the bulk of American wage earners once worked in offices and on factory assembly lines, earning enough to feed, clothe, and shelter their families in reasonable comfort. A growing proportion now work in fast food restaurants, theme parks, and other low-paying service industries where they cannot earn enough to achieve a middle-class living standard. According to this view, instead of making real products like cars or steel, the typical modern worker flips burgers or sweeps the office floor, producing too little to justify a good wage. There are serious problems with this view, as I argue below, but it accurately captures the popular feeling that average workers have been seriously hurt by recent labor market trends.

One way to see what has happened to the distribution of wages is to calculate the trend in earnings at selected points in the earnings distribution. This calculation can be performed back through 1967 using the Census Bureau's Current Population Surveys. Figure 4 shows trends in inflation-adjusted *annual earnings* for male workers aged 25-64 at five points in the earnings distribution over the period from 1967 to 1987.[5] The graph shows annual wage gains among men during two different parts of that period, 1967-1979 and 1979-1987.

Data in the figure show clearly that inequality is rising among men. In the period 1967-79, real annual earnings among men above the 80th percentile rose 1.8 percent a year. For the worker at the 20th percentile, earnings rose just 0.4 percent a year. Real earnings growth dropped sharply for workers everywhere in the distribution from 1979 to 1987. Wages rose only 0.5 percent a year for the worker at the 95th percentile. But real earnings actually *fell* 0.9 percent a year for a worker at the 40th percentile, and 2.0 percent a year for a worker at the 20th percentile. Since reaching a peak in 1973, real annual earnings at the 20th percentile of the wage distribution have fallen 20 percent and earnings at the 40th percentile have fallen 10 percent. By contrast, real earnings at the 80th and 95th percentiles have risen 6 and 8 percent, respectively. Inequality is up, and the percentage of men whose wages place them near the middle of the earnings distribution is down.

The tidings for economically disadvantaged men are even worse than implied by the statistics shown in Figure 4. Not only have these men found it harder to earn good wages if they hold a job, they have found it increasingly difficult to find a job at all. It is true that overall unemployment moderated in the late 1980s. But for men with limited skill and education, unemployment remained well above levels the group had experienced as recently as the late 1970s. Moreover, many of these men became so discouraged by poor job prospects that they left the labor market altogether. Labor force participation rates among relatively disadvantaged men fell sharply over the 1980s in comparison with participation rates of better skilled and educated men.

Employment and earnings losses were especially severe among younger less-skilled workers. Figure 5 shows trends in the relative earnings of two broad classes of male workers, defined on the basis of their relative educational attainment. In the figure I have tabulated the ratio of annual income received by men with four or more years of college relative to the income received by men with one to four years of high school education.

For example, the darker bar for 18-24 year-old men shows that in 1978, men with a college education earned about 20 percent more than men of the same age with just a high school education. By 1987, the college earnings premium had jumped to nearly 60 percent. Among men under age 44 there was a similarly sharp rise in the payoff to a college education. The jump in the college premium did not occur because young, college-educated men were earning sharply higher wages. The wages of these men rose only moderately.

[4] Rebecca M. Blank, "Why Were Poverty Rates so High in the 1980s?" (Evanston, Il.: Northwestern University, 1991).

[5] These wage developments are examined in detail in Gary Burtless, ed., *A Future of Lousy Jobs? The Changing Distribution of U.S. Wages* (Washington, D.C.: The Brookings Institution, 1990). The data in Figure 4 end in 1987 rather than a more recent year because more recent data were not available when *A Future of Lousy Jobs?* was written.

Instead, the premium climbed because young, less-educated men were earning steadily *lower* real wages. At older ages, the college premium rose, but by a smaller amount.

This pattern of earnings change, in combination with the steady growth in the number of one-parent families, has unfortunate consequences for the living standards of U.S. children. Most young children live in families headed by an adult under 45. The lower wages of less-educated men in this age group means that the fathers of many of America's children cannot bring home as much real pay as their counterparts brought home ten or twenty years ago. As a result, child poverty remained stubbornly high over the 1980s, in spite of one of the longest economic expansions in this century.

It is likely that some of the increase in the inequality of earnings is associated with a higher payoff to tangible but hard-to-measure skills that are not recorded in Census surveys. Among men who have achieved identical schooling levels, wage inequality has grown substantially over the past two decades, and especially in the decade since 1981. For example, wage inequality is now higher than it once was among men who have graduated from high school but attained no education beyond high school. It is also higher among men with exactly four years of college education. Employers appear willing to pay their able workers sharply higher wages than they offer to less able workers who have attained the same level of schooling.

The changing industrial mix has also contributed to rising wage inequality, though the evidence suggests that this contribution has been small. Jobs in "good" industries like manufacturing are indeed disappearing. But the size of the job loss explains only a small part of the jump in wage inequality since 1979. Most of the jump is explained by rising inequality *within* U.S. industries, both in the goods-producing and service-producing sectors.

Many of the trends in male wages and employment can be explained if there has been a growing demand for skilled workers and a declining demand for the less skilled. This has occurred not so much because there has been a shift in the level or distribution of demand across different kinds of industries, but because companies and industries have attempted to change their production methods in a way that requires a more able and skilled work force. Because skilled workers remain relatively scarce, their wages have been bid up, raising the gap between them and workers with lower educational attainment.

Less skilled men have suffered from this shift in two ways. Their earnings have fallen compared with the wages received by better educated and more skilled men, and their joblessness has soared. The problem they face is not a surplus of bad jobs, as widely assumed, but a surplus of less skilled workers in a market requiring more skill than ever. Ironically, their labor market position might be improved if the economy produced *more* not fewer jobs requiring limited skill. Their wages might then be bid up and the wage gap with more skilled workers closed.

Earnings and marriage patterns among women. In contrast to developments among men, labor market trends among women have been much more encouraging. Annual earnings are up across the entire female earnings distribution, although they are rising a bit more slowly at the bottom of the distribution than they are at the top. After decades of disadvantage in the labor market, women are beginning to close the wage gap with men.

Unfortunately, the labor market gains of women have not been translated into greater equality of household income. Many of women's recent gains in employment and wages have been concentrated among women who are *married to affluent men*. This is a third development that has tended to push up family income inequality in the past decade.

In a recent analysis of women's earnings, I found that *hourly* wage rates among women in the top 20 percent of the family income distribution grew at a rate of 2-1/2 percent a year after 1979 (*see Figure 6*). Among women in the middle 20 percent of families, wage rates grew just 1/2 percent a year. Women in the bottom 20 percent of families had wage rates that *declined* nearly 1 percent a year.[6] Although these trends could mean that women in affluent families have prospered wonderfully in the job market, other information suggests that the trends mean something quite different. Women who work and earn high wage rates

[6] Readers should note that Figure 6 -- unlike Figure 4 -- ranks individuals according to their annual *family* incomes and that the hourly wage changes represent average changes within an entire income quintile. For a complete description of the calculations, readers should refer to Barry Bosworth and Gary Burtless, "Effects of Tax Reform on Labor Supply, Investment, and Saving," *Journal of Economic Perspectives*, Winter 1992 (forthcoming), which is the source of Figure 6.

are now much more likely to be members of affluent households, that is, married to well-paid spouses. As women increase their employment and earnings, this trend disproportionately tends to push up the incomes of the most affluent families, widening the gap between rich and poor.

Tax and transfer policy. When thinking about the growing disparity between rich and poor and the languishing incomes of middle class families, many journalists and policy makers conclude that changes in government tax and transfer policy must have played an important role. Since tax and transfer policy is the only factor over which politicians exercise direct control, it is naturally the focus of intense public debate.

While public policy changes contributed to growing inequality in the 1980s, careful analysis shows that government policy played a relatively minor *direct* role. The share of total income received by families in the top fifth of the income distribution rose 2.9 percentage points in the 10 years after 1979 (*see Table 1*). Tax policy played no direct role in this shift, because tax payments are ignored by the Census Bureau when it calculates the share of income received by each quintile. Transfer policy played a role, but only a minor one, because transfers represent a shall share of the income received by the top 20 percent of families. Underlying economic and demographic developments were far more important than direct government policy in explaining the swelling incomes of the affluent and the shrinking wages of the less skilled.

Rebecca Blank reached essentially that same conclusion in her recent analysis of poverty trends in the 1980s. She found that slow income growth among families near the bottom of the income distribution was primarily caused by the sluggish growth of earnings among low-income family heads when the unemployment rate fell after 1982. She concluded that earnings remained low because real hourly wage rates did not respond as they usually do when the unemployment rate falls. As we saw in Figure 6, real hourly wages *fell* during the 1980s for breadwinners in middle and low-income families. These hourly wage losses offset part or all of the income gains caused by improvements in breadwinners' employment and hours of work. Very little of the income loss sustained by low-income families occurred because of policy changes in anti-poverty programs.[7]

But even if the role of government policy was smaller than often suggested in the press or Congress, it is disgraceful that policy shifts should have played any role at all in reducing the incomes of the less affluent. Reform in public assistance programs and unemployment insurance was probably long overdue at the beginning of the 1980s. But it should have been possible to reform and improve the welfare and unemployment insurance systems without reducing the share of national income received by the poorest quarter of the population. By the standards of other industrialized nations, the share of income received by these households was already quite low at the beginning of the 1980s. Economic and demographic developments during the 1980s depressed that share still further. The federal government should have refrained from policy changes which reduced that share even more.

Policy Responses

Everyone agrees that it is desirable to hasten a strong economic recovery and to accelerate the pace of wage growth. Many would also agree that action is more urgently needed in the case of low wage workers, whose earnings have shrunk for most of the past two decades.

Tax cuts. A variety of tax proposals have been advanced to help the middle and working classes and to spur an economic expansion. By reducing the payroll or income tax burdens of working families and families with children, we could give an immediate boost to the after-tax incomes of hard-pressed families. This would reverse some of their long-term income losses and help increase personal consumption.

But while this kind of policy would help spur the economy in the short run, it cannot raise workers' real *pretax* incomes in the long run. Unless the federal government's revenue losses from a tax cut were eventually offset by an increase in other taxes, a middle-class tax cut would simply raise the federal deficit. In the long run, this policy represents a serious threat to the well-being of workers, even if it raises their net incomes today. National saving -- the share of national income that we collectively set aside for investment and future consumption -- fell sharply during the 1980s. This occurred both because of reduced private saving and because of larger federal deficits (that is, higher government *dis*saving). The reductions in national saving were translated into reduced levels of spending on capital

[7] Rebecca M. Blank, "Why Were Poverty Rates so High in the 1980s?", p. 29.

investment. Productivity growth during the late 1980s and early 1990s has almost certainly been impaired by this development.

Productivity and real wages can eventually be improved by boosting the share of national income that is devoted to investment in public works and private plant and equipment. But the capital stock can be raised over the next decade only if the nation withholds a greater percentage of national income from current consumption and devotes it instead to new investment. This can occur if the federal government eventually makes a smaller claim on the nation's pathetically depleted pool of private savings. It is hard to see how this will happen if Congress simply reduces revenues from the income or payroll tax without taking any offsetting action, such as raising taxes on some group of taxpayers.

On grounds of equity, it is certainly defensible to argue that the tax system should be reformed to shift burdens away from middle- or low-income workers and families with children. But the short-term equity gains could be offset in the intermediate and longer terms if increased government dissaving is permitted to eat up an even larger fraction of the nation's private saving. Low national saving can hold down the future wage gains available to *all* workers, including those in the middle class and on the bottom of the income distribution.

Long-run remedies. In the long run, it is unlikely that anemic wage growth and rising income disparities can be remedied solely through changes in the nation's tax and transfer system. Changes in other public policies will be needed as well.

One of the most troubling aspects of recent income trends has been the steady deterioration in the labor market position of less skilled workers, especially men. If there has been a drop in demand for unskilled labor, the obvious policy response is to improve the qualifications of less skilled workers to match the stiffer requirements of the job market. If the nation has too many unskilled workers, rather than too many bad jobs, both efficiency and equity would be served by improving the skills of workers now lodged at the bottom. In my view the most plausible policies to address this problem must involve the nation's troubled school system, especially as it affects non-college-bound youth, and the private sector's efforts to train or retrain less skilled adult workers.

It is unlikely, however, that improved schooling or private sector training will be of much benefit in the short run. One policy that offers long-term promise as well as immediate benefit in a depressed economy is a program of accelerated public works. Many of the nation's roads, bridges, mass transit systems, and airports are in need of repair, reconstruction, or expansion. Hard-pressed state and local governments are in no position to make the required investments. Federal aid to public works projects could put jobless workers to productive use, boost private consumption, and improve long-term growth prospects. Unlike a tax policy oriented toward immediate tax relief, a policy of increased public investment improves both short-term economic prospects and the long run productive capacity of the nation.

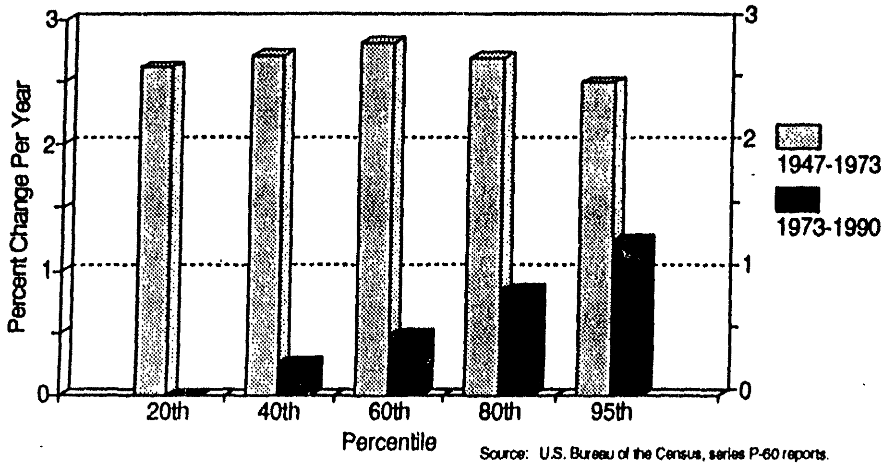
Table 1. Share of Aggregate Income Received by Each Fifth of U.S. Families, Selected Years, 1949-89

Percent

	Quintile					Top 5
Year	Bottom	Second	Middle	Fourth	Top	Percent
1949	4.5	11.9	17.3	23.5	42.7	16.9
1954	4.5	12.1	17.7	23.9	41.8	16.3
1959	4.9	12.3	17.9	23.8	41.1	15.9
1964	5.1	12.0	17.7	24.0	41.2	15.9
1969	5.6	12.4	17.7	23.7	40.6	15.6
1974	5.5	12.0	17.5	24.0	41.0	15.5
1979	5.2	11.6	17.5	24.1	41.7	15.8
1984	4.7	11.0	17.0	24.4	42.9	16.0
1989	4.6	10.6	16.5	23.7	44.6	17.9

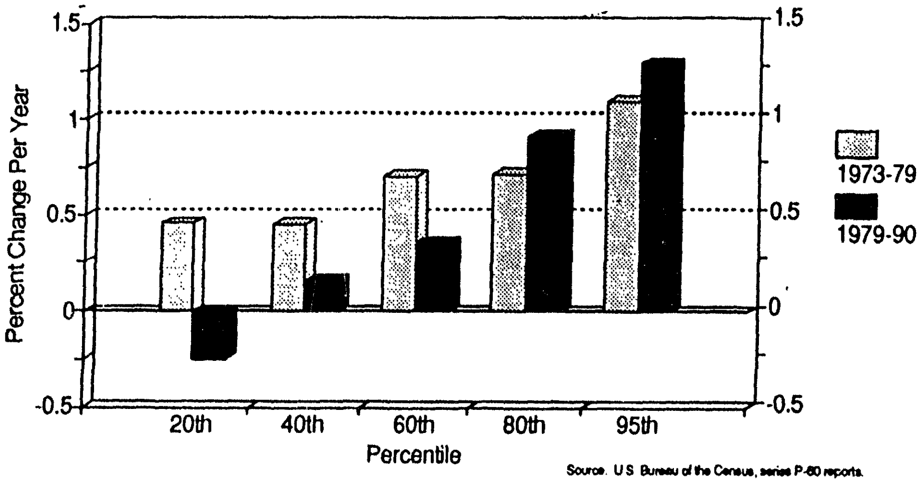
Sources: U.S. Bureau of the Census, *Money Income of Households, Families, and Persons in the United States*, series P-60, nos. 162 and 168.

Figure 1. Annual Growth of Family Income in Selected Parts of Distribution, 1947-90



Source: U.S. Bureau of the Census, series P-60 reports.

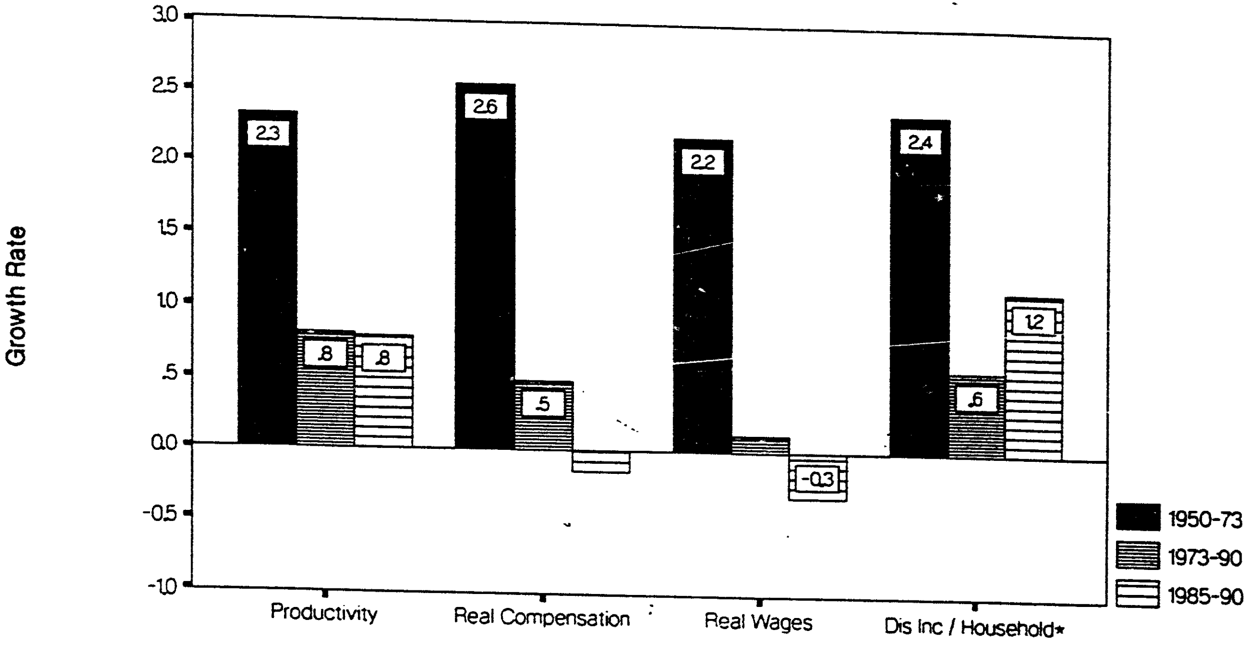
Figure 2. Annual Rate of Change in Family Income, Selected Parts of Distribution, 1973-90



Source. U S Bureau of the Census, series P-60 reports.

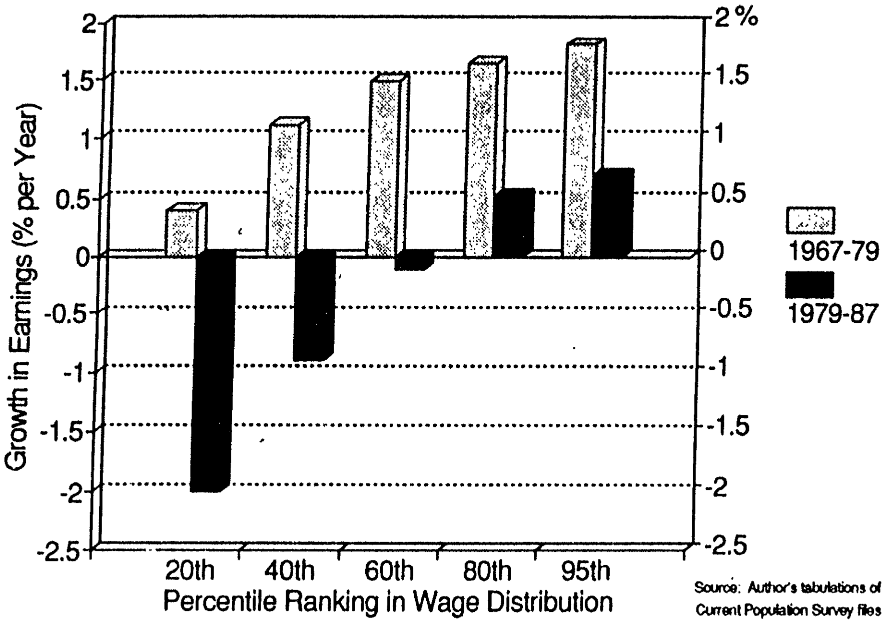
Figure 3. Compensation and Real Wages for the Private Nonfarm Economy.

Annual Percentage Rates of Change, 1950-90



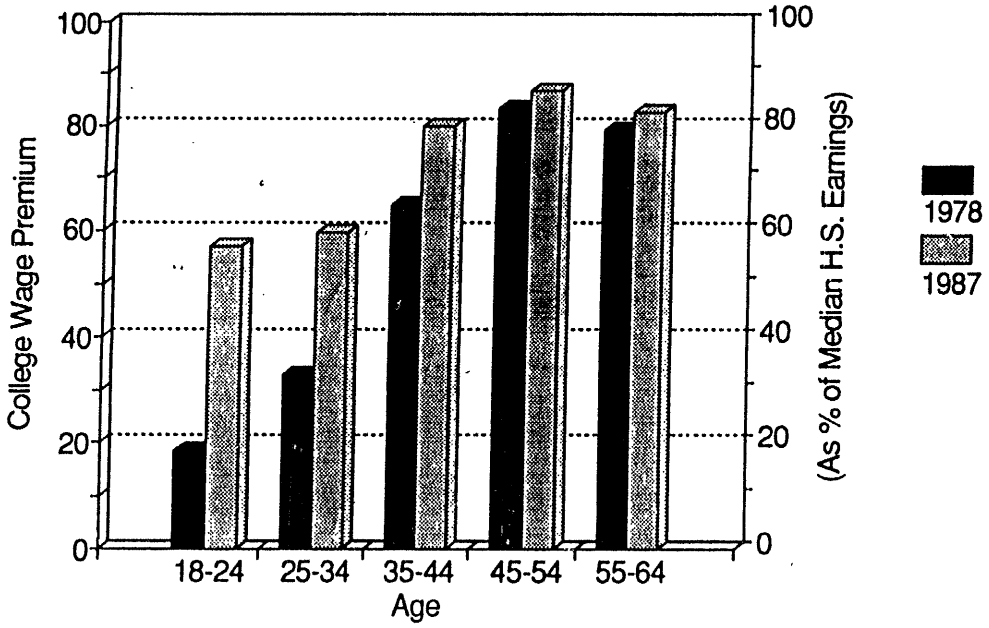
Real wages as measured by the employment cost index
*Disposable income per household 1960-73.

Figure 4. Annual Growth in Yearly Earnings of Men
Selected Parts of Distribution, 1967-87



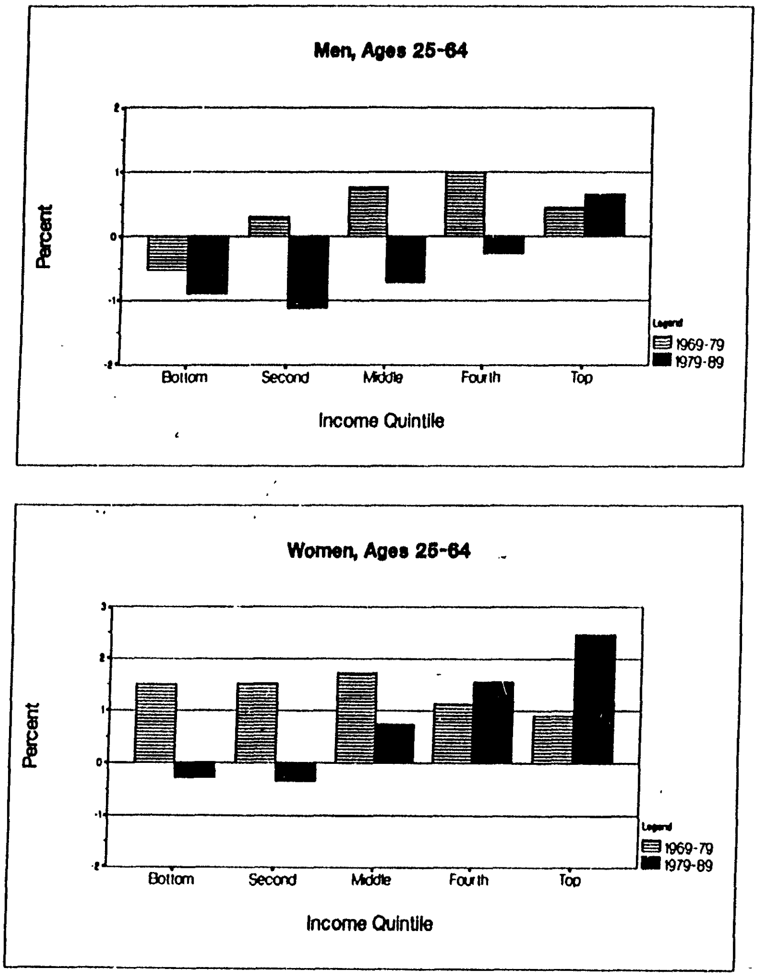
Source: Author's tabulations of March Current Population Survey files

Figure 5. Trends in the College Premium for Men 1978-1987



Source: U.S. Bureau of the Census, series P-60 reports.

Figure 6. Annual Growth in Real Hourly Earnings, By Income Quintile, 1969-79 and 1979-89



Men, Ages 25-64

Women, Ages 25-64

PREPARED STATEMENT OF SENATOR JOHN CHAFEE

Mr. Chairman, I appreciate this opportunity for the Committee to examine proposals to address our sluggish economy -- such as the Chairman's proposal to provide a $300 per child tax credit.
I strongly believe the American people have three main concerns upon which we should focus our efforts. These concerns are:

- retaining their jobs or finding new ones;
- maintaining the value of their homes; and
- keeping their health insurance and controlling rising health care costs.

I do not believe short-term tax credits or individual tax cuts will address these concerns. We must not compound our current economic problems by seeking quick fixes which have no lasting effect and which may greatly add to the Federal budget deficit.

Our goal should be to improve America's economic health and international competitiveness; boost the value of real estate; and control the costs of our health care system. The President and the Congress must work together to develop a legislative package to address these real concerns of the American people.

FIRST, to maintain and create new jobs we must:
a. establish a targeted investment tax credit;
b. index the basis of capital assets for inflation (prospectively);
c. make several of the expiring tax provisions permanent: the R&D tax credit; the moratorium on the 861-8 allocation rules; the targeted jobs tax credit; and the exclusion for employee educational assistance; and
d. repeal the luxury tax on boats.

SECOND, we need to restore the confidence of the American people in the real estate industry. To do this we must:
a. make both the mortgage revenue bond program and the low-income housing tax credit permanent;
b. allow penalty-free withdrawals from Individual Retirement Accounts for the purchase of a first-home; and
c. revise the passive loss rules as they apply to the real estate industry.

AND,THIRD, to help control the cost of health care, we must:
a. equalize the tax treatment of health insurance for all Americans by making the cost of health insurance premiums tax deductible for those who purchase health insurance whether on their own or as a self-employed individual;
b. provide health expenditures tax credit for low- and middle-income taxpayers;
c. encourage the development of group purchasing arrangements for small businesses;
d. reform health insurance practices to help small businesses;
e. encourage the development of managed care plans;
f. reform medical liability laws; and
g. encourage the use of preventive care.

I look forward to hearing the testimony of our witnesses and to working with you, Mr. Chairman, to develop a package that will include provisions to address the real concerns of Americans:

- retaining their jobs or finding new ones;
- maintaining the value of their homes; and
- keeping their health insurance and controlling rising health care costs.

Prepared Statement of Paul Cohen

Good morning, Mr. Chairman and members of the Committee. My name is Paul Cohen. I am a 51 year old husband and father of two from the Northeast section of Philadelphia. I have worked nearly my entire adult life as a supermarket department manager. I was laid off in March of this year from my job as Dairy Manager at a Thriftway Supermarket. I have been totally unable to find work since that time. I am an active member of the Philadelphia Unemployment Project, an organization of unemployed workers that represents the interests of the unemployed of the Philadelphia area.

My unemployment benefits ran out in mid September. Two months later I was forced to apply for welfare, something I never in my life dreamed I would have to do. I thank God and Senator Bentsen that the extended benefits program was passed last month and I am receiving unemployment again. But I have no idea where or when I am going to be able to find a job to support my family.

I started working for the Food Fair supermarket chain part-time in 1955 at age 15. Other than two years in the U.S. Army I worked for Food Fair for 24 years as a Dairy Manager. I made a good salary. I felt I had a job I could retire from. Food? No one ever heard of food stores going under. Everyone has to eat. I thought I had a lifetime job with a pension to retire from.

However, Food Fair got involved in rapid expansion and remodeling in the late 1970's. They bought JM Fields Discount Stores, Horn & Hardarts, Penn Fruit Supermarkets, and others. They became overextended. As rumors about problems spread, Food Fair brought the store and department managers into meetings, where they tried to blame us for their problems because we didn't minimize losses from mouldy cheese or the ends of lunchmeats or overbuying perishable items. Six months later, in 1979, with a weeks' notice, over 400 Food Fair stores closed leaving thousands of us without jobs. 98% of those stores are still functioning as supermarkets under differant names today. Food Fair was profitable. Management drove that chain under.

Since then I worked in several supermarkets, the longest in an employee-owned supermarket called O & O Market for 6 1/2 years. This store closed in 1989. All of my jobs since Food Fair were privately owned stores, not part of chains.

After the closing of O & O in 1989, I came up against the recession. One job cut my health benefits entirely. I then got a job with full benefits, managing the Dairy Department in a newly opened Thriftway Supermarket. Six weeks after I opened the Dairy Department I was laid off and replaced by a much cheaper worker. It was and is clearly an employers' market.

Here I am 51 and I had no idea how bad it would be out there. I look in the newspaper and the word supermarket has disappeared from the want ads over the past six or seven months. You need a big, big in to get a supermarket job and I can't seem to get one.

I have applied for small truck driving and delivery jobs. They want you to use your own car and the jobs turn out to be sales jobs for commission, often house to house. Sales is just not me.

I have applied for over 25 deli jobs. When I go to apply I see everyone working there is less than half my age. I don't list my wages on my resume so I don't scare the employer away. They don't call me back, but the next week I'll see the same job advertised in the neighborhood paper. They just don't want an overqualified family man who they assume needs a livable wage. You know they are right, I do need a livable wage.

I have even applied for grocery jobs at neighborhood stores stacking shelves. They get kids to do it for less than minimum wage. The big chains only hire young part timers and move them up. I applied Wednesday at a Shop-N-Bag in a middle class neighborhood in Philadelphia. They told me they were cutting back, not hiring despite it being the Christmas season.

I got a day's job in a gourmet deli recently where I worked for 12 hours. I should get at least $8.00 an hour for being an experienced counter person. The owner gave me 65 lousy dollars at the end of the day. I tried to get a job as a part-time night stock clerk at Shoprite just to get my foot in the door. They gave me extensive psychological tests besides the application and still didn't hire me.

I am scared to death. I don't know what I'm going to do at the end of February when my benefits run out again. I see no light right now. My mortgage is $550 a month. I have barely kept it up so far. I have been getting utility assistance to pay some bills but it's been tough.

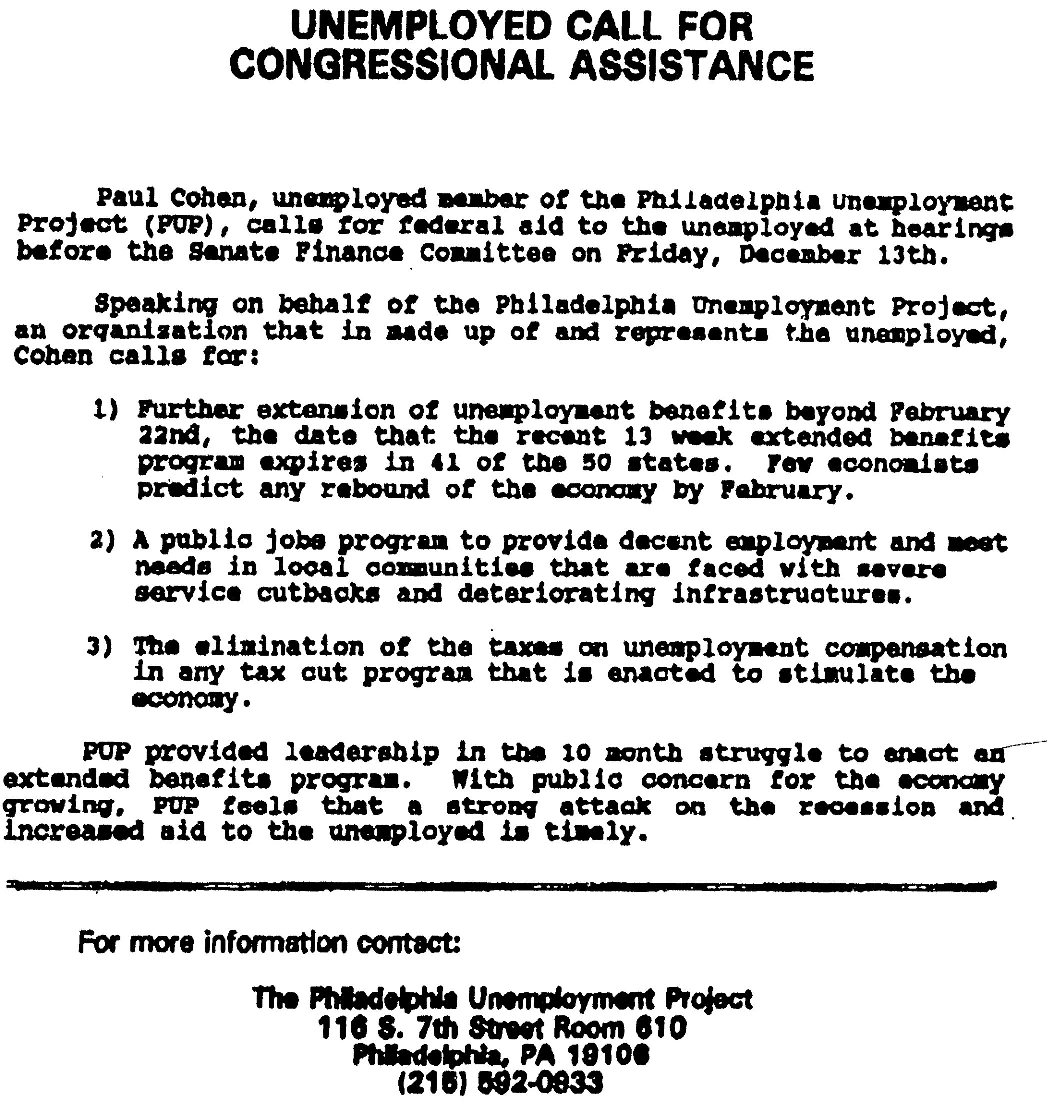
This unemployment situation has been a shock to my children. My oldest daughter, who is 9 1/2 said "We're on welfare?" during the month we were forced into that situation. My kids are insecure right now. They are very emotional since I've been out of work. We, and millions like me, need help. I need a decent job with health benefits to support my family.

My extended benefits checks will run out February 22, 1992. So will the checks of up to three million other American workers. The 13 week extension will not be enough for us, unless the economy picks up immediately. But all we see are more mass layoffs being announced in the papers. I am now speaking on behalf of the Philadelphia Unemployment Project and the millions out of work like myself. We desperately need a further extension of unemployment benefits beyond February 22nd.

Also, we need the government to consider creating a public jobs program to put us back to work and meet the needs of our community. Just yesterday a mass layoff was announced in the Women Against Abuse program in Philadelphia due to lack of funds. The Salvation Army and People Emergency Center homeless shelters are also being cut back despite tremendous need. A jobs program could employ people to provide these services and many others. We need decent jobs and there is much that needs to be done.

Finally, Mr. Chairman, as this Committee is discussing tax cuts to stimulate the economy, I would like to urge you to consider a cut in the tax on unemployment compensation. Millions of jobless Americans will have great difficulty paying taxes on their unemployment benefits. No taxes are withheld from these unemployment benefits. Any income tax return we would be eligible for will be wiped out by the tax on our benefits. If you want to help the middle class, don't forget people like me who are being pushed rapidly into poverty by this terrible recession. We will use the stimulus that comes from a tax cut on our unemployment benefits immediately. We have no choice. We have nothing else to spend.

I thank you for the opportunity to represent America's unemployed at this hearing. We have worked long and hard to build this country. Now there is no work. We are counting on you to help us. Thank you again.



UNEMPLOYED CALL FOR CONGRESSIONAL ASSISTANCE

Paul Cohen, unemployed member of the Philadelphia Unemployment Project (PUP), calls for federal aid to the unemployed at hearings before the Senate Finance Committee on Friday, December 13th.

Speaking on behalf of the Philadelphia Unemployment Project, an organization that in made up of and represents the unemployed, Cohen calls for:

1) Further extension of unemployment benefits beyond February 22nd, the date that the recent 13 week extended benefits program expires in 41 of the 50 states. Few economists predict any rebound of the economy by February.

2) A public jobs program to provide decent employment and meet needs in local communities that are faced with severe service cutbacks and deteriorating infrastructures.

3) The elimination of the taxes on unemployment compensation in any tax cut program that is enacted to stimulate the economy.

PUP provided leadership in the 10 month struggle to enact an extended benefits program. With public concern for the economy growing, PUP feels that a strong attack on the recession and increased aid to the unemployed is timely.

For more information contact:

The Philadelphia Unemployment Project
116 S. 7th Street Room 610
Philadelphia, PA 19106
(215) 592-0933

PREPARED STATEMENT OF ANNIE CUSELLA

Good morning, Senator Bentsen and Members of the Committee. I would like to thank Senator Bentsen and his staff for inviting me to speak to you today. I am from Cleveland, Ohio and work as a legal secretary at a large Cleveland law firm.

I am here today to lend support for Senator Bentsen's Super IRA proposal. I feel it is the most comprehensive package for a complete economic recovery for this country.

From 1981 to 1986 I was able to contribute to an IRA. But then they took away my right to deduct new contributions to my IRA and I had to stop contributing.

Now, I want to build a home. But I can't do it unless I can use the funds locked up in my IRA. I need the money in my IRA to cover the down payment and closing costs. Building my home would employ many people—an architect, general contractor, construction workers, electricians, plumbers. I will need new appliances—helping the steel industry. Putting people back to work will increase tax revenues and, in the long run I feel this bill will pay for itself.

In addition, there will be a built-in tax savings for me as a homeowner of between $2,000 and $4,000 just by being able to deduct the interest on my mortgage. With this tax savings I could fund a new IRA for my retirement. But only if you bring back the IRA for everyone. Right now, I have no deductions and a very substantial amount of my annual earnings is paid to the government in taxes. That makes it tough to save more for the down payment on a home and it makes it impossible for me to save more towards retirement.

But, I can't do any of this without the use of my IRA funds. I presently do not have enough money in my IRA to retire on, and at 6 percent interest maybe I never will.

On the other hand, home values in my community have been increasing from 10 to 20 percent annually in recent years. If this trend continues—and I have no doubt that it will—I cannot think of a better investment for my retirement.

The beauty of Senator Bentsen's bill is that I will be spending money to build my home, which will get people working again and, at the same time, have enough money to save towards my retirement while building equity in a home.

I have read some of the other proposals suggesting a $10,000 limit on IRA withdrawals for first home purchase. With closing costs between $5,000 and $6,000, a $10,000 withdrawal will be of little help. When you start limiting IRA withdrawals, you are setting limits on the economic recovery of this country.

I am asking you to support Senator Bentsen's proposal, and pass this legislation as soon as possible so that I can start to build my home and help put people back to work in my community and throughout the country.

Thank you.

Prepared Statement of Richard Darman

Chairman Bentsen, Majority Leader Mitchell, Republican Leader Dole, Ranking Republican Senator Packwood, and Members of the Committee:

It is a pleasure to join Treasury Secretary Brady and CEA Chairman Boskin, and to appear before the distinguished Senate Finance Committee once again.

My two colleagues have provided statements on the Administration's policies and the state of the economy. Mindful of the Committee's interest in proceeding to questions, I offer only the following introductory observations with respect to four related subjects.

(1) The President's Position: In his Thanksgiving address to the nation, and in subsequent speeches, the President has made the following points unequivocally:

(a) He is seriously concerned about the economy's sluggish growth, and about the associated human costs experienced by too many Americans. This is no time for complacency. The President is determined to take strong action to get the economy moving, to increase American jobs and American competitiveness—both for the short term, and for the long.

(b) The President has had a comprehensive agenda for growth before the Congress for this entire year. (See exhibit I.) In fact, several initiatives on this agenda have been before the Congress for almost three years. Unfortunately, Congress has not yet acted on the President's comprehensive agenda. Because the President's comprehensive agenda would increase growth (as it would have done if it had been enacted sooner), the President will continue to seek its prompt enactment.

(c) This is not to say that no more needs to be done. More does need to be done. The President is taking Administrative action independently of the Congress where this can be helpful (as, for example, in responsibly addressing the credit crunch, in accelerating the disbursement of funds under the new transportation act and other funding authorities, and in seeking to open foreign markets for U.S. exports). He is also reviewing the new legislative proposals recently advanced by others. In the coming weeks, he will decide which of these new proposals (or variations of these) merit his support. He intends to announce his further decisions and an additional action plan when the Congress has returned.

(d) The President has lamented the bitterness of this past Congressional session. He seeks to use the current cooling off period to build a foundation for prompt and effective action when Congress returns. He has said that when he gives the State of the Union address, he "will ask Congress to lay aside election-year politics at least long enough to enact a common-sense series of economic growth measures"—and that he "will ask politicians to restrain their personal ambitions at least long enough to get the job done."

(2) The Importance of Growth: The Administration has argued from the outset that measures to increase growth have needed to be enacted. This emphasis on growth-oriented measures has not always been well received. But now the painful reality of sluggish growth makes these points obvious and compelling:

(a) Growth-oriented policies are essential to "fairness." They are the key to job-creation, and to a rising standard of living for all Americans. Statistics can be marshalled to support both sides of the argument about the "fairness" of "the eighties."

But about the following, there should be no disagreement: The failure to enact growth-oriented policies is inherently unfair. It is unfair to those whose jobs are lost or at risk. It is unfair to those who depend on America's increased productivity for their own opportunity or vital support. And it is unfair to the wide range of Americans who would otherwise benefit—in countless ways from continued American primacy in an increasingly competitive world.

(b) Growth-oriented policies are also essential to deficit reduction—which itself, over the longer term, can reinforce growth. From the perspective of one who is concerned about our fiscal structure and the rising burden of debt, I must note: Growth can make a greater contribution to deficit reduction than any likely peace dividend or any likely restraint on domestic discretionary spending. (The only policy approach that can produce deficit-reduction comparable to the effects of growth is an approach that emphasizes restraint on the trillion dollars per year of so-called "mandatory" Federal spending. That spending is now out of control. Indeed, the only practicable way to bring the budget into balance is to combine mandatory spending restraint with growth-oriented policies.)

(3) The Character of Our Economic Problem: Much has been written and said about the current economic problem. I would add little here other than these two observations:

(a) The short-term problem is getting the economy out of its sputtering condition. Although the recession has been less deep than other American recessions, it has been widely evident geographically, and more "white collar" or "middle class" in its character. This is partly because it has occurred in the context of simultaneous structural adjustments in real estate, the financial sector, and the service sector generally. These adjustments have already moved somewhat toward correction. Further correction would be accelerated (and would have been accelerated) by enactment of such Presidential proposals as those for capital gains treatment, for penalty-free IRA withdrawal, and for financial service sector reform. Regardless of what additional proposals the President may offer in January, the proposals already made would help.

(b) Even if the short-term economic problem did not exist, there would be need to enact the President's comprehensive agenda for long-term growth. This agenda extends far beyond tax issues. By many measures, America remains the world's number one economic power. But to secure American primacy for the long term—and to satisfy rising domestic claims and expectations—it will be necessary to increase America's economic efficiency, productivity, and innovation. Enactment of the President's comprehensive growth agenda would help do exactly that. This was true before the downturn. It is true now. And it will remain true until the full range of problems the President has identified are responsibly addressed.

(4) The Need for a Comprehensive Agenda: There is much loose talk about the need for an "agenda." To some, this seems to mean the need for a single "fix"—the proverbial silver bullet. Unfortunately, the world is too complex for simplistic solutions (although they are often much easier to communicate). No one policy measure—whether a middle class tax benefit or preferential capital gains treatment or any other single measure—will suffice. What is needed is a comprehensive approach to growth. (This is, perhaps, what one much-mentioned Democrat may have meant by "holistic.") To the best of my knowledge, there is only one such agenda that has been developed in detail, the President's. (See the summary at exhibit I.) That agenda will be complemented by additional Presidential initiatives in the near future. But even as it stands, the President's agenda is the only detailed and truly comprehensive agenda on the table.

We are delighted to have an opportunity to discuss the President's comprehensive agenda—as well as proposals that may be useful complements to it. And we would hope that, with good will, these hearings may help accelerate Congressional action on growth-as we have long advocated.

I thank you, and look forward to your questions.

Attachments.

EXHIBIT I.—CURRENTLY OUTSTANDING ELEMENTS OF THE PRESIDENT'S GROWTH AGENDA (AS OF 12/91)

Incentive for Investment/Asset Appreciation/Entrepreneurship/Innovation

- Capital gains cut

R&D Investment (for productivity, innovation, quality of life)

- Further Federal R&D increases (to record levels)

- Applied civilian R&D investment/special cross-cutting programs
- R&D tax incentives (permanent credit, 861)

Human Capital Investment (for productivity, opportunity, competitiveness)

- New American Schools, Educational Choice, Math/Science initiative, America 2000
- Record investment in Children and Prevention
- Healthy Start, etc.
- Anti-drug abuse strategy

Service Sector Productivity Improvement

- Financial Services Reform
- Health Cost Containment

Increased Savings (to finance investment, innovation, etc.)

- IRA improvements
- Family Savings Accounts
- "Mandatory" program reform
- Strengthened Budget Enforcement Act Discipline

Legal / Regulatory Reform

- Regulatory Reform
- Tort Reform/Product Liability Reform/Malpractice Reform
- Civil Justice Reform
- Takings Reform

Increased Energy Efficiency / Reduced Vulnerability

- National Energy Strategy

International Market Expansion

- GATT
- North American Free Trade Agreement
- Enterprise for the Americas Initiative

Anti-Poverty

- All of the above, plus
- Enterprise Zones

Answer by Mr. Darman to a Question Submitted by Senator Daschle

Question. Assuming a sharp drop in the price of oil of about $5 per barrel in the second quarter of 1992, what effect would there be on government expenditures and revenues?

Answer. A reduction of $5 per barrel in the price of oil effective Q2/92 would:

- Raise the level of real GDP by about $10 billion in 1992 and by $30 billion in 1994–95.
- Add new jobs totaling 500,000 during 1992–95.
- Reduce budget outlays by a cumulative $11 billion during 1992–95.

Budget Effects of a $5/Barrel Oil Price Reduction

[Change from a base path, in $billions]

	1992	1993	1994	1995	1996
Receipts	0.5	1.2	–0.1	–2.1	–3.1
Outlays	0.4	–1.6	–4.4	–5.5	–7.0
Deficit Reduction	0.1	2.8	4.3	3.4	3.9

Prepared by Office of Management and Budget Staff

Answer by Mr. Darman to a Question Submitted by Senator Breaux

Question. In November, the President gave "enthusiastic" endorsement to the Gingrich economic growth plan and called for a vote on the package before Congress recessed for the year. That plan included a proposal to bring in revenue within the five year budget window by prepaying a portion of IRA tax liabilities through the transfer of existing IRA assets to IRA Plus accounts. In essence this is a proposal to prepay taxes at a discount in order to raise revenue in the short term. Treasury estimates it would raise about $13 billion in the next five years before losing billions more in the out years.

Is this a tax and budget concept that the Administration supports? Can we expect to see this kind of proposal in the President's budget? Do you believe this is a sound means of raising revenue or should we be concerned about the long term budget consequences of any plan to prepay taxes at a discount?

Answer. The IRA transfer, or "rollover," provision of the Gingrich economic growth plan would have negative long-term revenue consequences. Under current IRA provisions of the Internal Revenue Code, distributions from an IRA account are fully taxable. Under the proposal, taxpayers would be allowed to transfer existing IRA assets to IRA Plus accounts, and would only be taxed on the portion of the transfer that represents original contributions. However, the part of the transfer representing accumulated IRA account investment income would never be taxed, neither at the time of the transfer nor when funds are ultimately distributed from the IRA Plus account. Thus, part of the IRA distribution that would normally be taxed under current IRA provisions would permanently escape taxation under the proposal. This would effectively be a tax forgiveness that would have negative long-term revenue consequences, and would reduce revenues on a present-vain basis.

(Prepared by Treasury Department Staff)

The Administration has been urging Congress to enact a program for economic growth for the last three years. While we have indicated that we would be flexible and have been prepared to negotiate with the Congress, the core elements of the tax part of that program have not varied.

Those elements are:

(1) a capital gains tax cut,

(2) permanent research and development tax incentives,

(3) incentives for first-time homeownership,

(4) incentives for savings, and

(5) incentives for job creation through all of the above and enterprise zones.

Any policy that is designed to get the economy moving again must motivate the entrepreneur. Historically, the way to job creation and growth has been the guy with an idea who tried to make it work. It is precisely that type of small business activity that restoring a capital gains tax rate differential will stimulate. However, the most important benefit would be to stimulat3 values in the real estate industry. Nothing could be more important for the economy.

Second, we ought to make the R&D tax credit permanent. This credit is important to the nation's ability to compete in the global marketplace and will be much more effective if made permanent.

Third, we need to assist the housing industry and, in particular, encourage first-time homebuyers. The budget proposal for penalty-free IRA withdrawals will enhance the attractiveness of deductible IRAs by making them more flexible. This increased flexibility would provide an incentive for more taxpayers to save for the purchase of their first home.

Fourth, we need to increase savings by Americans. Our proposal for family savings accounts is affordable and could be enacted quickly. FSAs would be popular because they would provide a simple tax-free way for people to save for down payments on homes, educational and medical expenses.

Fifth, we need to continue our focus on job creation. All the elements of our package have this objective.

We have made these proposals in three budgets now — and we have proposed the means to pay for them in each of these budgets. Had the Congress enacted them, I believe the economy would be stronger.

These proposals will create jobs and they will encourage long-term investment. They should be part of any credible economic growth package.

Two bipartisan achievements of this Congress that will help those who are out of work during this period of adjustment, demonstrate that when Congress and the Administration work together the country is served. I am referring to the extension of unemployment benefits to ease the burden of those whose benefits have expired and the transportation bill. That legislation will not only improve the country's infrastructure — highways, tunnels and bridges — but at the same time, according to Transportation Department estimates, will create over 600,000 additional jobs this fiscal year.

Let us not forget one important thing — the United States is a great country — our citizens, our values, our natural resources will continue to sustain our ability to be number one.

In conclusion, Mr. Chairman. I believe we must work together to address these problems. The American people deserve nothing less.

INTRODUCTORY OBSERVATIONS:
THE AGENDA FOR GROWTH

Presented Before
THE HOUSE COMMITTEE ON WAYS AND MEANS
BY
RICHARD DARMAN
DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET
DECEMBER 5, 1991

Chairman Rostenkowski, Ranking Republican Congressman Archer, and Members of the Committee:

It is a pleasure to join Treasury Secretary Brady and CEA Chairman Boskin, and to appear before the distinguished Ways and Means Committee once again.

My two colleagues have provided extensive statements on the Administration's policies and the state of the economy. Mindful of these statements, and of the Committee's interest in proceeding to questions, I offer only the following introductory observations with respect to four related subjects.

(1) *The President's Position:* In his Thanksgiving address to the nation, and in subsequent speeches, the President has made the following points unequivocally:

(a) He is concerned about the economy's sluggish growth, and about the associated human costs experienced by too many Americans. This is no time for complacency. The President is determined to take strong action to get the economy moving, to increase American jobs and American competitiveness—both for the short term, and for the long.

(b) The President has had a comprehensive agenda for growth before the Congress for this entire year. (See exhibit I.) In fact, several initiatives on this agenda have been before the Congress for almost three years. Unfortunately, Congress has not yet acted on the President's comprehensive agenda. Because the President's comprehensive agenda would increase growth (as it would have done if it had been enacted sooner), the President will continue to seek its prompt enactment.

(c) This is not to say that no more needs to be done. More does need to be done. The President is taking Administrative action independently of the Congress where this can be helpful (as, for example, in responsibly addressing the credit crunch, in accelerating the disbursement of funds under the new transportation act, and in seeking to open foreign markets for U.S. exports). He is also reviewing the new legislative proposals recently advanced by others. In the coming weeks, he will decide which of these new proposals (or variations of these) have merit. He has stated that he intends to announce his further decisions and an additional action plan in January, when the Congress has returned.

(d) The President has lamented the bitterness of this past Congressional session. He seeks to use the current cooling off period to build a foundation for effective action when Congress returns. He has said that when he gives the State of the Union address, he "will ask Congress to lay aside election-year politics at least long enough to enact a common-sense series of economic growth measures"—and that he "will ask politicians to restrain their personal ambitions at least long enough to get the job done."

(2) *The Importance of Growth:* The Administration has argued from the outset that measures to increase growth have needed to be enacted. This emphasis on growth-oriented measures has not always been well received. But now the painful reality of sluggish growth makes two points obvious and compelling:

(a) Growth-oriented policies are essential to "fairness". They are the key to job-creation, and to a rising standard of living for all Americans. The failure to enact growth-oriented policies is inherently unfair. It is unfair to those whose jobs are lost or at risk. It is unfair to those who depend on America's increased productivity for their own opportunity or vital support. And the failure to enact growth-oriented policies is unfair to the wide range of

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Americans who would otherwise benefit—in countless ways—from continued American primacy in an increasingly competitive world.

(b) Growth-oriented policies are also essential to deficit reduction—which itself, over the longer term, can reinforce growth. From the perspective of one who is concerned about our fiscal structure and the rising burden of debt, I must note: Growth can make a greater contribution to deficit reduction than any likely peace dividend or any likely restraint on domestic discretionary spending. (The only policy approach that can produce deficit-reduction comparable to the effects of growth is an approach that emphasizes restraint on the trillion dollars per year of so-called "mandatory" Federal spending. That spending is now out of control. Indeed, the only practicable way to bring the budget into balance is to combine mandatory spending restraint with growth-oriented policies.)

(3) *The Character of Our Economic Problem:* Much has been written and said about the current economic problem. I would add little here other than these two observations:

(a) The *short-term* problem is getting the economy out of its sputtering condition. Although the recession has been less deep than other American recessions, it has been widely evident geographically, and more "white collar" or "middle class" in its character. This is partly because it has occurred in the context of simultaneous structural adjustments in real estate, the financial sector, and the service sector generally. These adjustments have already moved somewhat toward correction. Further correction would be accelerated (and would have been accelerated) by enactment of such Presidential proposals as those for capital gains treatment, for penalty-free IRA withdrawal, and for financial service sector reform. Regardless of what additional proposals the President may offer in January, the proposals already made would help.

(b) Even if the short-term economic problem did not exist, there would be need to enact the President's comprehensive agenda for *long-term* growth. By many measures, America remains the world's number one economic power. But to secure American primacy for the long term—and to satisfy rising domestic claims and expectations—it will be necessary to increase America's economic efficiency, productivity, and innovation. Enactment of the President's comprehensive growth agenda would help do exactly that. This was true before the downturn. It is true now. And it will remain true until the full range of problems the President has identified are responsibly addressed.

(4) *The Need for a Comprehensive Agenda:* There is much loose talk about the need for an "agenda". To some, this seems to mean the need for a single "fix"—the proverbial silver bullet. Unfortunately, the world is too complex for simplistic solutions (although they are often much easier to communicate). No one policy measure—whether a middle class tax benefit or preferential capital gains treatment or any other single measure—will suffice. What is needed is a *comprehensive* approach to growth. (This is, perhaps, what one much-mentioned Democrat may have meant by "holistic".) To the best of my knowledge, there is only one such agenda that has been developed in detail, *the President's*. (See the summary at exhibit I.) That agenda will be complemented by additional Presidential initiatives in the near future. But even as it stands, the President's agenda is the only detailed and truly comprehensive agenda on the table.

We are delighted to have an opportunity to discuss the President's comprehensive agenda—as well as proposals that may be useful complements to it. And we would hope that, with good will, these hearings may help accelerate Congressional action on growth—as we have long advocated.

I thank you, and look forward to your questions.

Attachment: Exhibit I: Currently Outstanding Elements of
the President's Growth Agenda (as of 12/91)

EXHIBIT I

CURRENTLY OUTSTANDING ELEMENTS OF THE PRESIDENT'S GROWTH AGENDA (as of 12/91)

Incentive for Investment/Asset Appreciation/Entrepreneurship/Innovation
- Capital gains cut

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- Strengthened Budget Enforcement Act Discipline

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Legal/Regulatory Reform
- Regulatory Reform
- Tort Reform/Product Liability Reform/Malpractice Reform
- Civil Justice Reform
- Takings Reform

Increased Energy Efficiency/Reduced Vulnerability
- National Energy Strategy

International Market Expansion
- GATT
- North American Free Trade Agreement
- Enterprise for the Americas Initiative

Anti-Poverty
- All of the above, plus
- Enterprise Zones

Statement of Michael J. Boskin
Chairman
President's Council of Economic Advisers
before the
Committee on Ways and Means
U.S. House of Representatives
December 5, 1991

Introduction

Thank you Chairman Rostenkowski, Ranking Member Archer, and other distinguished Members of the Committee. I am pleased to join with Secretary Brady and Director Darman in testifying before you this morning on the state of the economy and on the President's proposals for enhancing economic growth.

Economic growth is not just an abstract concept. Enhancing long-term economic growth is the key to ensuring America's future. Growth will raise our standard of living; it will create a legacy of prosperity for our children; it will ensure that we are able to afford nontraditional goods and services, such as a better environment; it will enable us to provide new employment opportunities for the labor force and those seeking upward economic and social mobility; and it will allow us to maintain our leadership role in the world.

Because growth is so important, I will focus my remarks on longer term growth prospects and challenges as well as recent developments and the short term growth outlook of the economy. As will become clear from my testimony and that of my colleagues, the President has had a comprehensive strategy for improving the Nation's long-term economic growth since the beginning of his Administration. This approach encompasses many areas of economic policy, including a fiscal policy that reduces the medium-term structural budget deficit, freeing saving to finance productive private investment, and provides tax incentives to spur entrepreneurship, saving, investment, and research and development; support of a monetary policy that is conducive to solid non-inflationary growth; banking reform to make the Nation's banking system safer, sounder, and more internationally competitive; a regulatory policy that seeks to deregulate where economically desirable, and where necessary to regulate, to do so in a manner that is minimally disruptive to the economy; and an ambitious trade policy that seeks to open markets, create jobs, and expand growth both here and abroad.

The President's policy proposals go well beyond what are thought of as traditional economic policy in the attempt to enhance productivity, for example, civil justice reform and education reform.

Recent Developments and Short-term Outlook

The economy's performance has been far from satisfactory for some time. After a period of somewhat sluggish growth, the American economy entered its ninth post-war recession in the Summer of 1990. Most private economists believe that the economy began a recovery sometime in the Spring of 1991. While the early stages of the recovery, from about May to July, were at the moderate pace we had expected, the economy has been quite sluggish for the past few months.

While I believe the economy will remain sluggish over the next few months, the foundation exists for an improved economy thereafter. Inventories generally are in check, the international competitive position has greatly improved, and nominal interest rates are low. Inflation is down and declining, leaving the Federal Reserve in better position to take necessary actions to improve the economy within the context of the overall goal of low and stable inflation.

I will turn to a more detailed discussion of the outlook in a moment. Before I do, I want to put it into perspective.

After the longest peacetime expansion in the history of the United States, the economy entered the ninth recession of the post-World War II period in the third quarter of last year. Expansions do not end on their own. Expansions end because external shocks hit the economy, policy mistakes are made, or widespread imbalances, such as an over-accumulation of inventories that must be worked off, develop in the economy.

In August of last year, an external shock occurred. The invasion of Kuwait by Iraq and the subsequent oil price spike, superimposed on an economy that already had been struggling to grow for the prior year and a half, pushed the economy into a recession. Whether there would have been a recession had there been no oil shock is impossible to know.

There were several reasons for the slow economy prior to the recession. First, there were the lingering effects of the tight monetary policy followed by the Federal Reserve in 1988 and early 1989 in an effort to engineer a so-called soft landing to ease incipient inflationary pressure. Second, there was a worldwide increase in long-term interest rates in early 1990. An important factor in this rise was the anticipated increase in the demand for capital associated with developments in Eastern Europe and the unification of Germany. Because U.S. interest rates are influenced by developments in world markets, there was upward pressure on U.S. interest rates as well.

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PREPARED STATEMENT OF SENATOR BOB DOLE

Mr. Chairman, I am pleased to see that we are taking action on these very important issues.

I believe we all agree on the objective in developing an economic growth proposal—helping the middle class and stimulating our sluggish economy so that our country ison the road to recovery.

But I hope that we don't begin the usual congressional bidding or bickering on how best to achieve that goal. Frankly, we don't have time—we need quick and decisive action.

We need to develop initiative which deal with both the short-term problem and with long-term growth.

Clearly, the Congress will have to act expeditiously—perhaps within 60 or even 30 days or reconvening, which may be unheard of around here.

In the immediate future, we need a proposal that will deliverbenefits quickly.

We need something to provide an economic stimulus—to get money into the hands of consumers, something to address the critical problem of consumer confidence.

ECONOMIC GROWTH INITIATIVE

While an economic stimulus will serve as a good first step, we all know there is no such thing as a "quick fix."

A broader economic growth package that focuses on creating jobs and increasing capital formation and investment is also critical.

Such a proposal must deliver benefits swiftly.

Again, the Congress must be challenged to approve such a proposal in a timely manner—perhaps by a date certain.

A number of proposals have been suggested and I believe many should be considered.

The president, for some time, has made several proposals to strengthen the economy.

Personally, I would like to see a carefully crafted temporary investment tax credit. It would improve the cash flow for many businesses and maybe help them through their immediate problems.

BUDGET CONSTRAINTS

Given the budget agreement—this will not be an easy task. But, I feel that we can live within the budget accord.

Without some budget discipline we could do more harm to the economy.

CONCLUSION

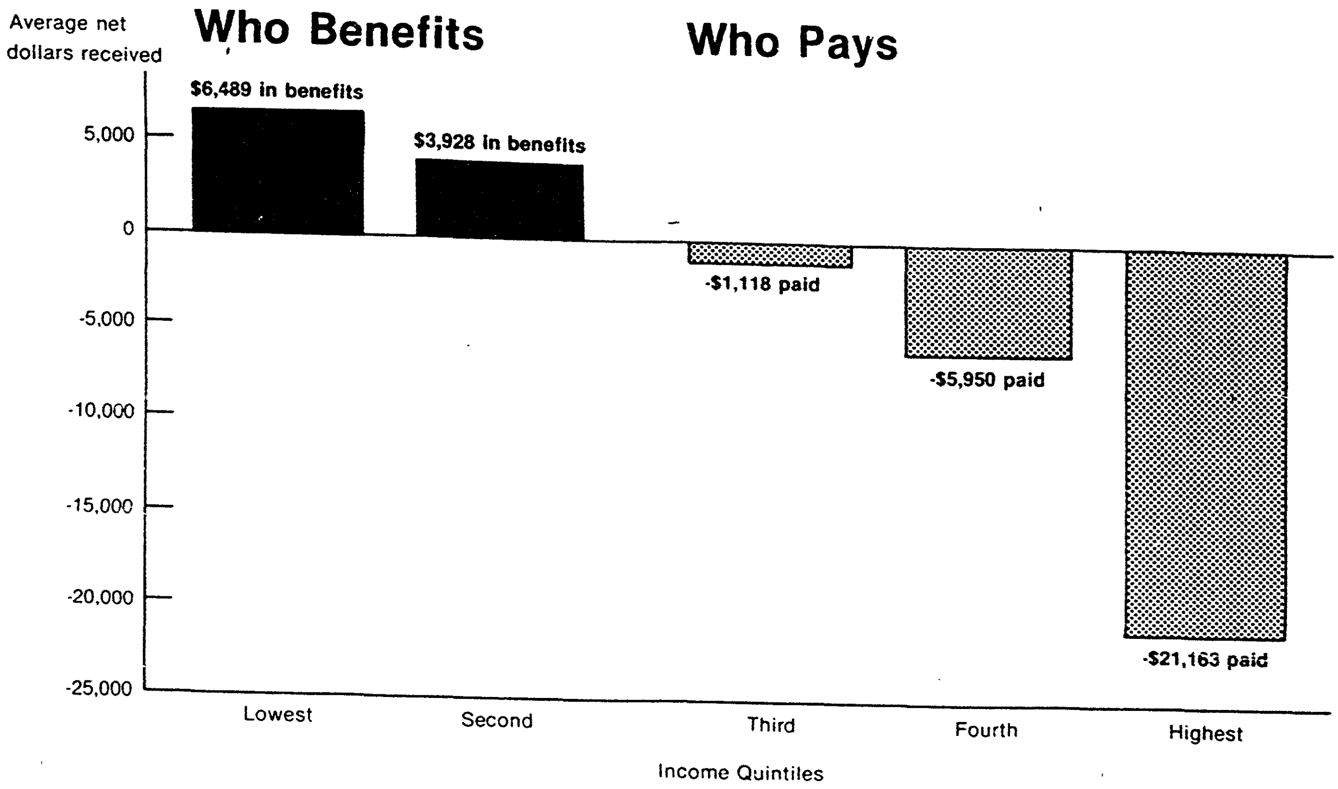
But, taxes along will not solve the problem. We can meet deadlines and we can deal with the budget agreement, but we cannot stop with tax initiatives.

We must focus on the broader picture. We need to continue our efforts at solving the credit crisis, we need banking reform, strong trade laws and tort reform.

If we were able to move on all these initiatives, I believe we would be well on our way to recovery.

Mr. Chairman, I look forward to hearing from the administration and I stand ready to work with the Congress and the President in order to come to an agreement on these important issues.

Effects of Federal Taxes & Transfers



Source: Bureau of the Census
1990

Prepared Statement of Representative Thomas J. Downey

I am pleased to have the opportunity to appear before the Senate Finance Committee today.

Before talking specifically about the Working Family Tax Relief Act, which Senator Gore has just outlined, I would like to lay the groundwork for why such a bill is greatly needed today.

Income growth has been stagnant, if not declining, for those at the bottom of the income distribution over the past decade and a half. In the early 1980s, President Reagan promised America that a rising tide would lift all boats. Yet, despite seven-and-a-half years of sustained economic growth during the 1980s, individuals in the bottom 40 percent of the income distribution experienced significant losses in income since 1977, while the richest one percent of the population faced increases in pre-tax income of more than 90 percent after adjusting for inflation. Slightly over a decade ago, the richest one percent had only about one-half the income of the poorest 100 million Americans. Today, the richest one percent of the population has more income than the poorest 100 million Americans.

The Congressional Budget Office has estimated that Federal taxes have increased by $13 billion per year for middle income families between 1977 and 1992, while taxes on the richest one percent have been lowered by $65 billion. At the same time, single parent families have been discouraged from working because of implicit marginal tax rates well above 50 percent. For every dollar they earn, the reduction in Federal benefits or tax increases exceeds 50 cents and often approaches $1.00.

Married-couple families with children, who are often not eligible for means-tested programs and who tend to rely on earnings to escape poverty, were particularly devastated by the poor performance of the economy during the 1980s. New analysis suggests that hours of work in the bottom three quintiles increased more in percentage terms than did real incomes. In fact, if women's earnings in these families had not increased, there would have been real income losses in the lowest four quintiles. No wonder the middle class feels squeezed.

Families with children have experienced the greatest income losses. Families in the lowest quintile experienced real income losses of 16 percent between 1973 and 1989. Individuals in families with children accounted for 75 percent of the total increase in the number of poor persons between 1979 and 1989.

Throughout the last decade, Republican Administrations have relied on supply-side economics and its trickle-down theories to boost economic growth, raise the incomes of working families at the bottom as well as the top of the income distribution, create jobs, and reduce the budget deficit. But what we have received instead is the political equivalent of water running up hill. Current trends indicate that this trickle-down approach has failed. The Federal Government is now 2.4 trillion dollars in debt. As a resultl there is no open coffer from which to spend on social programs.

The Gore/Downey bill is part of a broader plan to reduce child poverty and to provide income support outside the welfare system to poor and middle-class families with children. Implicit in our efforts are the overriding goals to reward work and to promote parental responsibility.

Our first step began with a major overhaul of the welfare system in 1988. The JOBS component of the Family Support Act emphasizes the mutual responsibility of the government to provide support to families who fall below the poverty threshold and, in return, the obligation of these families to obtain the education and training necessary to become self-sufficient. Work and training programs for welfare recipients have been found both to be cost-effective and to yield modest but significant increases in employment and earnings for a segment of the welfare population.

One of the most important non-welfare initiatives to pass into law in recent years is a major expansion of the earned income tax credit. In the budget reconciliation bill for fiscal year 1991, Congress recognized the growing problem of the working poor, and expanded significantly this refundable credit that supplements the earnings of low-income families with children. By 1994, all working families with children earning less than $24,000 will be eligible for at least some benefits. Families earning between $8,000 and $13,000 will be eligible for a benefit of up to $2,400. With the EITC expansions, working-poor families will have more support in choosing work over welfare, and welfare families will have more incentive to enter the labor force.

The Gore/Downey bill eases the tax burden for 35 million American families with children by replacing the personal exemption with a refundable, $800 child tax credit for children under the age of 18. The credit, unlike the personal exemption, provides equal benefits to families at all income levels. The bill also expands the EITC and further adjusts the credit by family size.

Overall, the proposal cuts taxes for working families with children with incomes between $10,000 and $75,000 by more than $20 billion per year. Federal taxes would fall 8.1 percent for a four-person family with income between $35,000 and $50,000.

There are a number of aspects of the Gore-Downey bill that are particularly important and I would like to spend a few moments talking about them in detail. First, the child credit is refundable, with a minimum credit of $400 or 20 percent of earned income phased in for families outside of the tax system. I cannot place enough emphasis on the importance of refundability. A nonrefundable credit would fail to include a fourth of the children in the country, including the 20 percent of children who live below poverty. Additionally, some 45 percent of Hispanic children and 50 percent of black children would receive no benefit unless the credit is refundable. The refundable credit proposed by Senator Gore and myself would remove more than 600,000 families from poverty.

Second, while the tax credits cost more than $90 billion over five years, the bill has been paid for through an increase in the top rate and a surtax on incomes above $200,000. Only six million families in the top 10 percent of the income distribution will face a tax increase. Significant tax increases will only be felt by the richest one percent of the population.

Any tax relief for the middle class must be paid for through tax increases at the top of the income distribution. The gap between the rich and the poor have continued to widen and have reached their widest point in more than 40 years. number of tax relief proposals look to cuts in defense spending to raise the necessary revenues. This is the easy way out. We should adhere to the principles of the budget act—that defense savings, to the extent that they actually materialize, should be spent on other discretionary programs such as increases in Head Start and WIC, and improvements in public infrastructure. If non-defense discretionary programs are simply adjusted for inflation, defense spending must decline by $68 billion in fiscal years 1994 and 1995 just to meet the budget agreement. I readily agree that defense spending can be drastically reduced and, to the extent that we can cut defense spending more than the budget agreement assumes, that we need public investment to stimulate economic growth.

Third, credits are inherently more progressive than exemptions, providing a greater value to those with lower rather than higher incomes. The Gore/Downey bill was designed to actually increase work incentives and to make work a more viable alternative to welfare. Furthermore, it is necessary to dispel any myths that the child tax credits provide an incentive for mothers to have more children. Numerous studies have shown that there is no evidence that child allowances, used widely throughout the world, induce higher birth rates.

Finally, although we have made great strides in expanding the EITC in recent years, it is essential that we continue to help working poor families that are doing their best to stay afloat. Despite recent increases in the EITC, families at the bottom have lost substantially in real terms. In addition, middle income families have only stayed ahead because the female spouse has been forced to work harder to make up for the decline in male wages.

In addition to the refundable tax credit, I will soon introduce child support legislation that will move us even closer to ensuring parental responsibility and rewarding work. The legislation will have two major components. The first set of proposals will enhance the establishment and enforcement of child support awards. The second will provide an assured child support benefit to children at any income level when the noncustodial parent fails to pay what he owes, and an improved collection system to ensure that he pays if he can.

The refundable tax credit of the Gore/Downey bill is a major step in the right direction. The credit can provide a meaningful and much-needed tax cut to middle-income families with children and supply low-income families with incentives to work their way out of poverty. I urge my colleagues to support a refundable child tax credit that is paid for through taxes on the wealthy.

PREPARED STATEMENT OF SENATOR DAVE DURENBERGER

Mr. Chairman, I am grateful that the committee is having this opportunity to prepare for the extension of a number of extremely important tax provisions due to expire at the end of this year. Like many of my colleagues, I am very hopeful that we can act on these important issues before they lapse in just six weeks.

I would also be remiss if I did not express to my friend from Missouri, Senator Danforth, my particular appreciation for the commitment which he has made to extending these provisions for another year. The leadership which he has demonstrated in this herculean effort has been remarkable.

The significance of the legislation which the Committee is considering today goes well beyond the goal of Congress disposing of another piece of legislation before adjournment. Renewing several of these items will help to offer an element of stability to the lives of the individuals who benefit, both directly and indirectly from these programs. Our efforts to pass this legislation reinforce our commitment to these people and these ideas for offering assistance.

One issue which has been of particular importance to me is the health insurance deduction for the self-employed. While I would prefer that this modest benefit to America's farmers and small business people be increased to a 100 percent deduction, as well as be made permanent, I stand firmly behind any effort which can be made to help these individuals provide health insurance for themselves and their families. I will not give up in my effort to provide a complete deduction for the health insurance costs of the smallest businesses in American until it is equal to the benefit enjoyed by the country's largest corporations.

I am also pleased that we are endeavoring to extend the mortgage revenue bond program.

The mortgage revenue bond program has worked well for assisting families of modest incomes to achieve the American dream of owning their own homes. As the country continues to work its way out of a recession, it is also important to underscore the value of this program for providing jobs. It is wholly appropriate that we considering extending this provision close on the heals of extended unemployment benefits legislation. This is the type of program which will put people back to work or will permit the planning to go forward for new housing projects in the new year.

In a more direct way, the targeted jobs tax credit is particularly important for the employment of many Americans. Through this program, individuals in the targeted groups are able to gain valuable work experience while contributing to the nation's workforce. In my state of Minnesota, there are several major businesses which have made strong commitments to employ workers from these targeted groups. This tax credit has ensured that these businesses, and others like them, are able to employ many people who would otherwise have great difficulty finding gainful employment.

The one unfortunate drawback of this program, like all of the others we are discussing, is that it has been subject to annual extension. The result, Mr. Chairman, is that these people, who have a particularly hard time finding employment, are subject to the whims of the Congressional schedule and questions over annual extension of this valuable program.

Also of great value are two programs which go to the heart of a theme which has been floating around throughout this recession, and for many years, and that is the idea of competitiveness. Few people would suggest that the United States suffers from less ingenuity than our competitors or that our workers are poorly educated and less dedicated than in other nations. There are, however, two programs in this bill which would ensure that these concerns never come to pass.

The research and development tax credit guarantees that U.S. corporations are not at a competitive disadvantage to businesses in other nations. It is designed to encourage innovation and the development of new technologies, despite research costs which can be astounding, but who results are immeasurable. Through the tax credit, American businesses are able to conduct research without the constraining demand that it be applied to some solely commercial purpose which will yield a sufficient short-term return.

A provision which also seeks to ensure that the United States is never at a competitive disadvantage to other nations is the employer-provided educational assistance benefit. This program, which permits employers to contribute to the continuing education of their workers without imposing a discouraging tax burden on their employee, helps workers to improve themselves by offering them an chance to improve existing skills or to acquire new ones. This provision, in my judgment, represents the long-term view which is all-too-often ignored by the government, businesses, or workers in favor of the immediate return. I wholeheartedly support extension of this valuable program.

Mr. Chairman, I commend you for your leadership in working to assure that these 12 expiring provisions do not live up to their name. I hope that the full Senate will join the Committee in demonstrating its commitment to the continued success of these programs and the importance of stability in the lives of the people who benefit from them.

PREPARED STATEMENT OF SENATOR AL GORE

Mr. Chairman and members of the Committee, thank you for this opportunity to testify. I know I join many others both here in Congress and across our country in applauding your decision to focus on such an important issue and to take action to move this debate forward.

Mr. Chairman, I want to particularly acknowledge the contribution you personally have made and the leadership you have shown with a specific proposal for tax relief for middle income Americans. And, I want to acknowledge the work of Sen. Bradley and Sen. Rockefeller, also on this Committee, on other proposals that aim at the same goal.

My colleague, Congressman Downey, and I offer a different plan but share your commitment to providing meaningful tax relief to middle income American families who are facing unbearable financial pressures. The need for action is clear to everyone, it seems, but the White House, which may be the only place in America where the recession is over.

Across our country, to millions of Americans and their families, the recession is as real as a mortgage that can't be paid, a doctor's bill not covered by insurance, and college tuition beyond the family budget.

We're on the wrong track and the American people know it. In one recent national survey, 56 percent said the economy is getting worse, not better, and that unemployment worries them more than crime or even drugs. Just last week, in a new survey of American families, 87 percent said they have a harder time making ends meet. Now imagine the people behind the numbers. You know them, they are our constituents. Whether in Texas or Tennessee, New York or Oregon, they're telling us the same thing.

Here in Washington, the pundits say it's political pressure that's forcing all this tax cut talk. But get beyond the Capitol, to millions of homes across our country, to millions of families and the pressure to cut taxes for middle income American families comes from middle income American families. They don't need an economist to tell them times are tough. They're having trouble telling the difference between recession and recovery. They're still worried about pink slips that come with two bullets: one takes out their paychecks, the other takes out their health insurance.

The rich are getting richer while the rest of us pay the bills. Sixty percent of Americans have less after-tax income today than they did in 1977, according to a Citizens for Tax Justice study. Those who earn about $30,000 a year—and it's important to remember that median family income in the U.S. is about $35,000—these families lost nearly 10 percent in after tax income since 1977. At the same-time, those with incomes of more than $600,000 saw their after tax income increase by 136 percent since 1977, according to the same study.

President Bush says we ought to be giving more to those taxpayers at the top, to the richest Americans. The panic in the White House today means somebody there must have stuck his head out the window and gotten a whiff of what's really going on in America. And, belatedly, they seem to have realized that the White House doesn't have a clue about what needs to be done.

My colleague, Congressman Downey, and I believe tax relief for middle income families should come from a tax credit of $800 per child, replacing and increasing the value of the existing personal exemption. For working poor families, the tax credit for children would be refundable, and the Earned Income Tax Credit would be expanded. For some middle income and working poor families this will more than double the value of the personal exemption. For a family of four earning $40,000, it would mean a $910 tax cut.

The Gore-Downey Working Family Tax Relief Act would cut taxes by more than $20 billion a year for 134 million Americans, some 35 million American families. It presents an innovative approach that makes current tax rates more progressive and meets the pay-as-you test of existing budget agreements.

Since we first introduced our legislation in May, support has grown for this basic idea of a tax credit for children, most notably, Mr. Chairman, in your own proposal. And, we welcome that support and that commitment. We believe strongly that the best way to provide real tax relief to middle income families is by providing a tax credit for children that will increase the value of the personal exemption.

If all we do is increase the personal exemption, we send the money away from those families with children who need it most. With this approach, the higher your income, the greater the benefit. And, if we provide a tax credit but fail to make it refundable or fail to expand the Earned Income Tax Credit, we're refusing to help those working poor families who are struggling to stay on the job and off welfare.

The Gore-Downey bill pays for itself by increasing taxes on the very wealthiest taxpayers. This isn't because we want to soak the rich. It is because we want to give middle income taxpayers a break, for a change, without worsening our budget deficit. Other proposals offer other means of payment and those plans ought to get a close look, as long as we don't lose sight of where we're heading. But we can't pay for tax cuts with defense cuts if we're going to use those defense cuts for other priorities.

Cutting capital gains taxes—unless those cuts are carefully targeted to encourage only truly long-term investments—means moving further down the wrong track: toward another tax cut for the wealthiest one percent of Americans, more money for those who already have it, and a deeper recession for those already suffering. A recent analysis shows that six-digit salary earners would receive more than 80 percent of the capital gains tax cut benefit. And that's the key difference that the White House is trying to bury.

Mr. Chairman, our proposals for middle income tax relief may be different, but our goals are the same. In this debate, it's important to keep those goals clearly in view.

The White House talks about tax cuts without talking about whose taxes they'll cut. They dust off an old plan and hope no one notices it's another tax cut for the rich. Democrats are offering detailed proposals for tax relief for middle income families with children, real help for Americans who need help because for the last 12 years, Reagan-Bush tax policies have been emptying their pockets.

Today's hearing represents an important first step for these middle income American families because it represents a commitment to these families, not to the rich, and not to the big corporations, but to average Americans who for too long, have gone to their pocketbooks and found more disappointment than hope.

Mr. Chairman, I look forward to working with you, with the Finance Committee, and with all my colleagues on this issue. In the course of the debate on these proposals and others, the differences will be examined and weighed. Each bill offers innovative approaches. But I cannot say strongly enough that it is the similarities among these bills that is most impressive. If we're going to make progress, if we're serious about providing tax relief for middle income families who need it, then, it is on these shared goals that we must focus and move forward.

Thank you.

Prepared Statement of Senator Charles E. Grassley

[November 26, 1991]

Mr. Chairman: I greatly appreciate your convening today's hearing on the extremely important issue of middle income tax cuts. I also commend you for your leadership in this area.

Looking at the witness list, except for Secretary Kemp and Senator Specter, one could get the impression that only democrats are interested in family tax cuts and have initiatives on the table.

Well, a number of us in Congress, including Republicans, have offered proposals to accomplish tax fairness for families. Some of us Republicans have been trying to make new middle income tax cuts a priority for over a year. My only regret is that we haven't been able to achieve these *family tax cuts before now.* Being the minority party in Congress, combined with the help of a reluctant White House, hasn't necessarily helped our cause. Nevertheless, once this hearing is over, I have little doubt we'll only be hearing about democratic initiatives.

However, I would note that Senator Coat's legislation doubling the dependent exemption isn't even on the list for consideration as reflected in the Joint Tax Committee's briefing materials. This is legislation that, I believe, has been in this committee since the last Congress.

Despite the administration's missteps on this issue, I highly commend Secretary Kemp for bucking White House insiders and carrying on the torch of Republican tax cuts. I can only hope that the administration will see the light and get back out in front of this growing movement.

As I have stated, despite the lack of press attention, a number of us Republicans have been trying for at least a year to get family tax cut proposals on the table. Last April, as a member of the budget committee, I offered an amendment to the budget resolution recognizing the need for Congress to pass tax cuts for families. This amendment overwhelmingly passed 18 to 1 in the committee.

Last may, I introduced the "emergency tax relief for families" legislation, which is comprised of a package of two bills. The first bill, S. 1013, would expand the young child tax credit up to 500 dollars to families with adjusted gross income of under 50,000 dollars and with children under five years old. Congressman Frank

Wolf is the sponsor of the companion bill in the House. Currently, this credit is tied to the earned income tax credit and is only available to families with an AGI under 21,000 dollars and with children under one year old. In addition, the maximum credit is only around 350 dollars.

My second bill, S. 1014 would increase the dependent exemption from the current 2,150 dollars to 7000 dollars by the year 2000. This is approximately what the exemption would be if it had kept up with inflation. The nearly 5000 dollar loss due to inflation underscores the growing unfairness to families reflected in the tax code.

I joined with Senator Coats and Congressman Wolf, who over a year ago, took the lead in the Congress in pushing tax fairness for families. I creasing the dependent exemption seemed to be the easiest way to address the problem since this mechanism was in place and well known. In addition, these exemptions are phased out for higher income families, *so the wealthy do not benefit from them.* However, a major shortcoming in this approach is the fact that low-income working families with no taxable income would not be helped with just an increase in the dependent exemption, which is not refundable.

I, therefore, introduced an increase and modification in the young child tax credit, which is—refundable, and will help low-income families.

It's very encouraging to see that others have begun to recognize the need to provide direct tax relief for families, rather than more spending for bloated bureaucracies. I commend my colleagues for their attempt to finally cut taxes, which some of us have been pushing for a long time. There are a number of proposals on the table now, and each one of them deserves consideration.

Of course, now that nearly everyone finally agrees that families need tax relief, the hurdle we face at this point is how to pay for it. The Chairman has suggested using cuts in the military budget, using the so-called peace dividend. In my own view, defense cuts certainly need to be part of the mix, but it seems more reasonable to combine both defense and domestic spending cuts to pay for family tax relief. There'sjust no more cost-effective way of helping families and children than through direct tax assistance.

Now that there is strong support and momentum in both Houses of Congress and on both sides of the isle for family tax fairness, I'm very encouraged that we're going to finally see some results. I look forward to working with you, Mr. Chairman, and other colleagues in accomplishing this very important goal.

Prepared Statement of Senator Orrin G. Hatch

[November 26, 1991]

Mr. Chairman, I applaud the efforts of my colleagues to relieve some of the tax burden facing the families of America and commend you for holding these hearings on this critical issue.

Like all of us here, I am concerned with the condition of our economy. As we come out of this recession, it remains sluggish and unresponsive. A real need exists for some sort of economic stimulus to encourage growth and job creation.

I am also very concerned about the financial condition of the American family. Over the last several years, families with children have experienced decreasing incomes and increasing taxes. The families of America are our greatest resource. Families with young children, including many in my home state of Utah, are struggling to make ends meet. They need our help. We must be concerned with their plight and do everything we can to help them.

Several of my colleagues, have introduced legislation to offer tax relief to the families of America. I generally support these efforts.

The tax credits for children contained in several of the bills will get some tax relief to those who need it the most—the families of America with children. However, while tax credits for children offer many advantages, I believe we must also consider increasing the dependency deduction, which would also give tax relief to those families who are supporting other dependents such as aging parents.

I fully support the universal IRA deduction and penalty free withdrawals for education, medical expenses, and home purchases contained in the Chairman's legislation. This bill encourages saving and empowers the families of America to attain the American dream. The national savings rate is an important part of the economy and increasing it is a critical part of any effective economic or tax relief package.

At least one proposal pays for tax relief by raising taxes. While well-intentioned, this will not help the families of America. By removing incentives for those responsible for the majority of the investment and job creation that occurs, we are hurting the entire nation. I will not raise marginal tax rates just to say I support the family.

While these proposals are a step in the right direction and give some relief to American families, they will not turn the economy around. A tax credit may give the American family a boost in the amount of money available for consumer spending, but it isn't going to help those who are worried about finding or keeping their jobs. We need to offer legislation with strong incentives to help create jobs and strengthen the economy.

The proposals to cut payroll taxes would stimulate economic growth and encourage job creation by putting money into employers' and employees' pockets that could be used for new investment and jobs. While I support this idea, I feel that we need to go further and enact some tax incentives such as a permanent R&D credit and lower capital gains tax rate.

The only way to truly help the families of America in the long-run is to encourage investment and provide incentives to stimulate the economy. Only through growth and deficit reduction can our economy recover, giving the American family long-term relief. Therefore, our number one priority must be economic growth and deficit reduction.

Mr. Chairman, I see that we have a distinguished list of witnesses testifying on this important subject today. I look forward to hearing their views on the various proposals to provide tax relief to the American family.

Thank you Mr. Chairman.

Prepared Statement of Lacy H. Hunt

THE LONGEST POST-1930'S RECESSION

The U.S. economy faces significant difficulties. There is a presumption that when the economy goes into recession we know what to expect: a rough year, declining corporate profits, and people out of work. But after a year, the pain begins to subside. Unfortunately, the current situation may be much more serious. By November, the current downturn had already lasted for 17 months, one month longer than the recessions of 1974–75 and 1981–82. In fact, this contraction has been longer than any downturn since the Great Depression. Before this slump ends, the length will be similar to the 22+ months duration of the six longest economic contractions since 1854. Although the magnitude of this contraction is relativel" mild so far, this may change as more complete and revised statistical evidence becomes available, and as results for the final quarter of this year and the first half of 1992 are tabulated.

AUTOS AND HOUSES—INSUFFICIENT GAINS TO PROPEL RECOVERY

To place this in perspective, I want to start by looking at the two so-called point industries: housing and automobiles. These sectors have typically led the transition from one phase of economic activity to another. Thus far, neither housing starts nor automobile sales have gained enough to lay the foundation for recovery.

Last month housing starts were about 5% lower than when the recession started in the summer of last year (the second vertically-shaded section of Graph 1). At the end of the 1981–82 recession, housing starts were almost 32% higher than when the recession started (the first vertically-shaded area of Graph 1). Automobile sales exhibit a very similar pattern (Graph 2). Sales last month were about 15% lower than when the recession started. This is also not encouraging since by the end of the 1981–82 recession, automobile sales were almost 11% higher than when the recession began.

A WORLDWIDE BUSINESS SLOWDOWN

One of the most unrecognized yet potentially far reaching developments is an unprecedented worldwide monetary deceleration. In the last four quarters, the increase in money supply for the G7 countries (the U.S., Japan, Germany, Italy, France, the U.K. and Canada) was about 3.1%. In the 1980's, G7 monetary growth was around 8%, and since then, the rate of global monetary expansion has been cut by more than one half. Since 1970, when this series was created, G7 monetary growth has never been slower. Slower monetary growth is particularly noticeable in Japan and the U.K. In the last twelve months, the growth of M2 plus CD's in Japan was the lowest on record for a series that goes back to the late 1960's. As a result of this severe contraction in global monetary growth, the prospects for U.S. exports are discouraging.

Reflecting developments in the latter part of the 1980's that continued into the early part of this decade, the role of exports in the total U.S. economy became considerably more important. A tremendous accumulation in U.S. exports in the late

1980's raised their share from about 10% of our GNP in 1985 to around 16% of GNP in the third quarter of this year. As a consequence of this advance, exports were four times more important than the housing and automotive sectors combined. Due to a worldwide slowdown caused by the huge decline in monetary growth, exports have begun to erode. This means that faltering domestic sectors must pick up the slack, a prospect that does not appear realistic at present.

LOWER SHORT-TERM INTEREST RATES, A LIMITED ECONOMIC STIMULUS

Short-term interest rates, which are frequently cited as a positive element in the business outlook, are at virtually the lowest levels of the past twenty years. However, in real terms, the thirty-year Treasury bond yield in October was slightly in excess of 5%, much higher than the long-term average of 2.62% and much higher than the 2.32% average in the fourth quarter of 1990 (Graph 5). Except for the 1981–82 recession, when monetary growth surged sharply, and the Reagan income tax cuts took effect, the real yield on the thirty-year Treasury bond was lower in all of the recessions since 1960. Although the Federal funds rate is very low in nominal terms, the real rate in October was 2.3%, slightly above the long-term average of about 2% (Graph 6). In real terms, the Federal funds rate fell into negative territory in three of the last four recessions and came very close in the recession of 1960. The high short and long-term real interest rates reflect three considerations: first, the key inflation-adjusted money supply measures are highly restrictive; second, an unprecedented credit contraction is gripping the country in spite of the intentions of the Federal Reserve; and third, the Federal budget deficit for the current fiscal year appears to be in the $400 billion range, or about 7% of GNP, the highest for any peacetime period (Graph 7).

SEVERE MONETARY AND CREDIT CONTRACTIONS

The real money supply, regardless of how it is measured, is not strong enough to lead us out of the current recession. On Graph 8, the M2 money stock (solid line), the M3 money stock (middle line), and M4, or total liquidity (checkered line), are adjusted for inflation and plotted through September/October. M2 is about 3.5% below the peaks of the late 1980's. The loss in monetary growth that occurred over the last several years has not been recouped, and real M2 in October is no higher than it was six years ago. The performance of real M2 during the 1981–82 recession was completely different. The low point in real M2 money balances actually occurred in the first month of the recession, July 1981. The recession ended sixteen months later. By March 1983, the entire decline in real money balances, which was a precursor to the recessions of the early 1980's, had been reversed. Former Fed Chairman Paul Volcker engineered a double-digit increase in money balances and restored the erosion of money that had occurred.

Real M3 and real M4 offer even less encouragement than real M2. The real M3 money stock in October was almost 7% below the peak of the late 1980's, and unchanged since 1986. By the end of the 1981–82 recession, the real M3 money stock was at a new all-time peak. In September, the broadest of the money figures, real M4, was also at its lowest level since 1986.

Some complain that the money aggregates are biased by the shift into bond and stock mutual funds, which are not included by definition in M2 through M4. However, if this shift was a material development, total domestic nonfinancial debt, the broadest of all U.S. credit measures, which totaled $10.8 trillion in September, would have shown more growth than it has. In the past four quarters, this key aggregate rose by only 4.8%, he lowest year-over-year rise in the 40-year history of this series (Graph 9).

HIGHER TAXES, A CAUSE OF THE ONGOING RECESSION

Tax policy is not supporting monetary policy. Taxes paid by individuals and families, at all levels—Federal (including Social Security), state and local—recently absorbed a record share of household income. Reflecting increases at the Federal level, as well as 36 different state governments and many localities, taxes have reduced consumers' discretionary spending power by $50 billion this year. This is significantly different than what typically happens during a time of economic distress. Never in the past have we started a recovery with the personal tax rate this high and rising. There was always a partnership between monetary and fiscal policy. The Federal Reserve was not asked to do the entire job of economic stabilization. Instead of getting help from the tax authorities, the Federal Reserve now has the double job of stabilizing the economy and offsetting the contractionary effects of the tax increases.

The failure of monetary policy to get into gear, combined with higher tax rates, explains the weakness in the labor markets. In November, payroll employment was at the same level originally reached slightly over two years ago (Graph 10). The latest reading for the broader household employment measure was essentially unchanged from levels reached almost three years ago. With employment opportunities declining, people are unlikely to buy more cars, appliances, and over-the-counter items. We simply do not have the basis for a sustainable recovery until employment turns higher.

DEBT—A MAJOR STRUCTURAL PROBLEM

Some experts say that we can get spending up if we can get people to borrow more money. The use of debt as a propellant of economic activity, in my opinion, is an unlikely outcome. Since the U.S. could be on the verge of an unprecedented period of deleveraging, we must now learn to grow without reliance on debt, and try to decrease debt in relation to the level of economic activity. Graph 11, tracks total debt of all components of the U.S. economy relative to GNP from 1920 to the present, including Federal, state and local government, corporate, household, and financial debt from every sector of the U.S. economy. GNP, of course, reflects our cumulative ability to finance debt.

Thus far in 1991, debt is almost two and a half times greater than GNP, and almost 60% higher than our long-term average (horizontal line). The only time the ratio was greater was in the 1930's. Theoretically, for individuals and businesses, when debt rises repeatedly relative to income, defaults should move higher. The ratio of business failures, in billions of dollars, to GNP, which is the hidden impediment to future economic performance, has surged to a record (Graph 12). Failures, although not a component of the national income and product accounts, are nevertheless at work, eroding the underpinnings of the economy. Since 1961, business failures, on average, have been approximately 0.3% of GNP. Last year business failures were 1.2% of GNP. Complete numbers for 1991 are not yet available, but the figure will be higher. This is a tremendous obstacle that almost every financial institution in the country is familiar with. The U.S. is massively overleveraged. An examination of the individual sectors shows that each lacks the capacity for additional borrowing.

The high level of total household debt as a percentage of disposable income is a major constraint on consumer borrowing. From 1966–1977, this ratio centered around 68% (Graph 13). The long-term historical average is just under 75%. Thus far this year, total debt, including mortgage and consumer borrowings of all types, is about 94% of disposable income. Much of this went for homes along the Northeast corridor and in California, which are now worth at least 25% less than they were at the peaks of the late 1980's. With consumers mired in debt, the ability to take on enough additional debt to finance a recovery is lacking.

In the corporate sector, total debt was 20.8 times greater than operating after-tax profits in the first half of this year (Graph 14). This was virtually an all-time high. During the 1981–82 recession, this debt ratio never hit these high levels. However, that was a different situation, because at that time the prime rate was around 20%. By 1986, the prime rate was in single digits. Mr. Volcker aggressively relieved the pressure on the corporate sector. Three years ago, in the second quarter of 1988, the prime rate was 11.5%. In the second quarter of this year, the prime rate was 8.5%. Interest rates fell 300 basis points, but the debt burden remained essentially unchanged. The lower rates were not enough to relieve the pressure in the corporate sector because the debt load was simply too heavy.

Perhaps the worst example of overborrowing was in commercial construction, as illustrated by Graph 15, the office vacancy rate. Recently, about 18% of office space was available for rent, or unused. The latest numbers, which are for the first six months of this year, are slightly encouraging since the recent high was 19%. Unfortunately, the number one user of office space in the United States, occupying twice as much rented space as the next industry, is banking, which is merging, consolidating, and downsizing. As banks release unneeded space, vacancies may begin to creep higher again. At the prior historical peak in 1974, about 14% of commercial space was empty. Six years were needed to eliminate that oversupply. If we could fill 1% of the oversupply per year, which is optimistic at best, with the space being thrown back on the market by banks (and possibly later by insurance companies), eight years would be required in order to pare the vacancy rate to 10%. No significant office construction is likely until the very end of this decade at this rate. When the 1981–82 recession started, the vacancy rate was about 7%. One of the main outlets of the Volcker monetary expansion was the financing of office buildings. That is not viable now, not with rents falling and unutilized capacity so high. This situation significantly detracts from potential GNP, not just in 1992, but for years into the future.

The other side of the overleveraged economy is represented by commercial banks. Over the last ten years, equity capital grew 125%, however, at the same time, loans outstanding jumped 174% (columns 1 and 2, Graph 16). Consequently, the ratio of loans to capital deteriorated from 8:1 to 10:1. More recent (although incomplete) statistics indicate a further erosion. Ultimately, a bank's ability to lend, and to take the incumbent risks in so doing, depends on their equity base.

OVERVIEW OF THE ECONOMIC OUTLOOK

In summary, the economy faces very serious difficulties. The problems are not merely cyclical, but are deep-seeded and structural. Consumer confidence in November has been lower in only two other months since 1970. Confidence is not down due to whim, but to these very serious underlying problems. Real gross domestic product should decline this quarter and in the first quarter (Graph 17). A further small drop in the second quarter of 1992 should not be ruled out. The best that can be anticipated for the second half of next year is a poor recovery, followed by a very unsatisfactory pattern in 1993.

IDEAS TO BOOST THE ECONOMY WITHOUT ENLARGING THE BUDGET DEFICIT

Four steps, which require no legislation, may be taken almost immediately to deal with the widespread and continuing economic stresses. One is fiscal and the others represent a forceful effort to lower long-term interest rates. If adopted, these steps would not further increase, and might even reduce, this year's record budget deficit.

First, on the fiscal side, the administration could transfer a substantial portion of the more than 700,000 U.S. troops located at military bases in Western Europe, Asia, and elsewhere to bases within the United States. Already, there are long-term plans to substantially reduce U.S. troops in these areas in view of the diminished international political tensions. This is not a proposal to remove all of these troops immediately, nor could that even be accomplished. Some troops would be needed to repare the various weapon systems for eventual shipment back to the United States, and several global hot spots still remain. This proposal would directly and psychologically benefit the U.S. economy.

For example, a shift of 300,000, or 40%, of the foreign-based military personnel to various locations in the United States, if feasible and consistent with our other national objectives, would have a significant, positive effect on the U.S. economy. On the surface, this step would not seem to be a highly material development, since this figure only constitutes about 0.25% of total employment of 117 million. If 10,000 military personnel, along with their dependents, were sent to 30 different domestic locations, the impact on those regions would be highly significant. Merchants in Army, Air Force, and Navy towns have long come to understand the implications for retail spending when major units are moving into or out of their local bases. If these 300,000 personnel earn an average of $25,000 a year (including salaries, food and housing allowances), an additional $7.5 billion of buying power would be injected into the U.S. economy.

Troops and their families brought back to the United States would spend their salaries here for food, clothing, housing, and virtually all other items in the typical market basket. By shifting this spending back to the domestic economy, there would be a multiplier effect as well. With spending for such a wide variety of different domestic items going up, spending might rise by at least another 85% as these expenditures ripple through the economy, generating jobs and profits. Thus, the total economic effect could be almost $14 billion. While this figure seems relatively small for an economy with a $4.9 trillion real GDP, spending of this sum in the U.S. economy could have eliminated almost 40% of the net drop in real GDP reported for the last four quarters. But, the actual economic effect could well be greater than $14 billion. Other costs of maintaining these troops are also incurred since foreign bases must have educational, medical, PX, and a variety of other services, along with expenses for transportation, rent, repair, telephone, utilities, and other miscellaneous items. Hence, other additional spending might be redirected into the U.S. economy.

If the repositioning of overseas troops went well, ultimately more than 300,000 troops could be returned home, with the net economic benefit to the U.S., and to the individual localities even higher. Restationing troops in the U.S. that ultimately will be mustered out of the services over the next several years would also be beneficial. With the U.S. labor markets very tight, military people will need as much time as possible to find private jobs, a task that would be made easier if they are searching from within the U.S. borders.

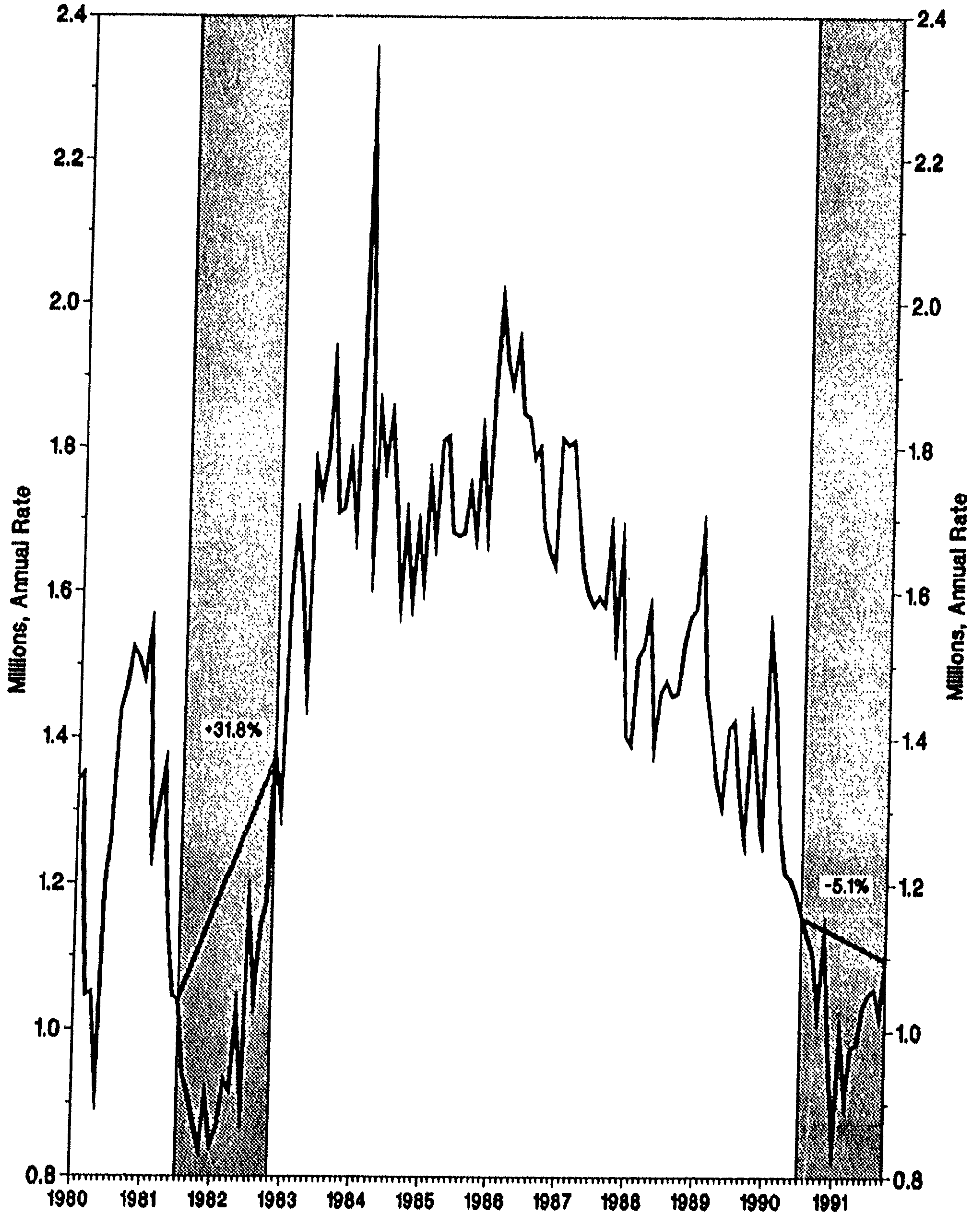
The second short-term solution is for the Treasury to dramatically curtail or even suspend issuing 30-year bonds until the economic crisis is over. Based on the recent issuance rate of $12 billion per quarter, the Treasury would offer about $50 billion of new 30-year bonds over the next twelve months. Such a heavy supply would absorb a substantial percentage of the long-term capital that is likely to be created over this period. Already in 1991, the heavy volume of 30-year bond issues has been difficult for the capital markets to absorb. In fact, the spread between short-term rates, which are heavily influenced by Federal Reserve policy, and long-term rates has widened to an unprecedented level. Stubbornly high long-term rates have blocked the economy's ability to restructure the enormous level of debt.

No other G7 government raises as much money by issuing debt instruments with longer than a 10 year maturity, and there is no law which says our government must. Substituting future Treasury securities of 5 years maturity or under for 30-year bonds would free up long-term capital in the private sector. This would allow firms to refinance heavy debt, and homeowners to refinance mortgages with lower cost loans; a very important factor for an economy which is so highly leveraged. The average maturity of the Federal debt recently stood at about six years, higher than the long-term average of just over four years and well above the two-year and five-month maturity that prevailed at the end of 1975. By shifting financing of the Treasury's deficit into shorter maturity ranges, there would also be cost savings to the government, since short-term rates are considerably below long-term rates. One final point: to the extent the huge Federal budget deficit reflects cyclical economic difficulties, selling long-term bonds does not make good economic sense.

Third, in order to assure that this "Operation Twist" maneuver is more successful than the one of the early 1960's, the force of the intent to lower long-term rates should be accentuated by an ancillary move at the Fed. In conjunction with this change by the Treasury, the Federal Reserve should simultaneously announce that they will begin shifting a portion of their approximately $260 billion portfolio of U.S. Treasury securities from the short-term bill area into longer-term coupons. At the end of the third quarter, less than 10% of the Fed's portfolio was in Treasury securities with a maturity of more than ten years. If the Treasury were to shift $1–2 billion a month, this would provide substantial liquidity to the long-term bond market, and a year hence, the Federal Reserve's holdings of long-term Treasury securities would still only comprise 20% of their total portfolio. This too would have no adverse budget impact, but would increase the earnings of the Federal Reserve, marginally reducing the budget deficit. This change could lead the Fed to adopt modern portfolio management techniques.

Fourth, the Fed should abandon gradualism in order to prevent the upward pressure on short-term rates that the proposed shift in debt financing and portfolio management might cause. With short-term rates more heavily influenced by actions of the Federal Reserve, the Fed should use all the tools at its disposal to boost money supply aggregates into the middle of their target ranges. This would supply enough money to hold steady, if not lower, short-term rates, while bond yields are being reduced.

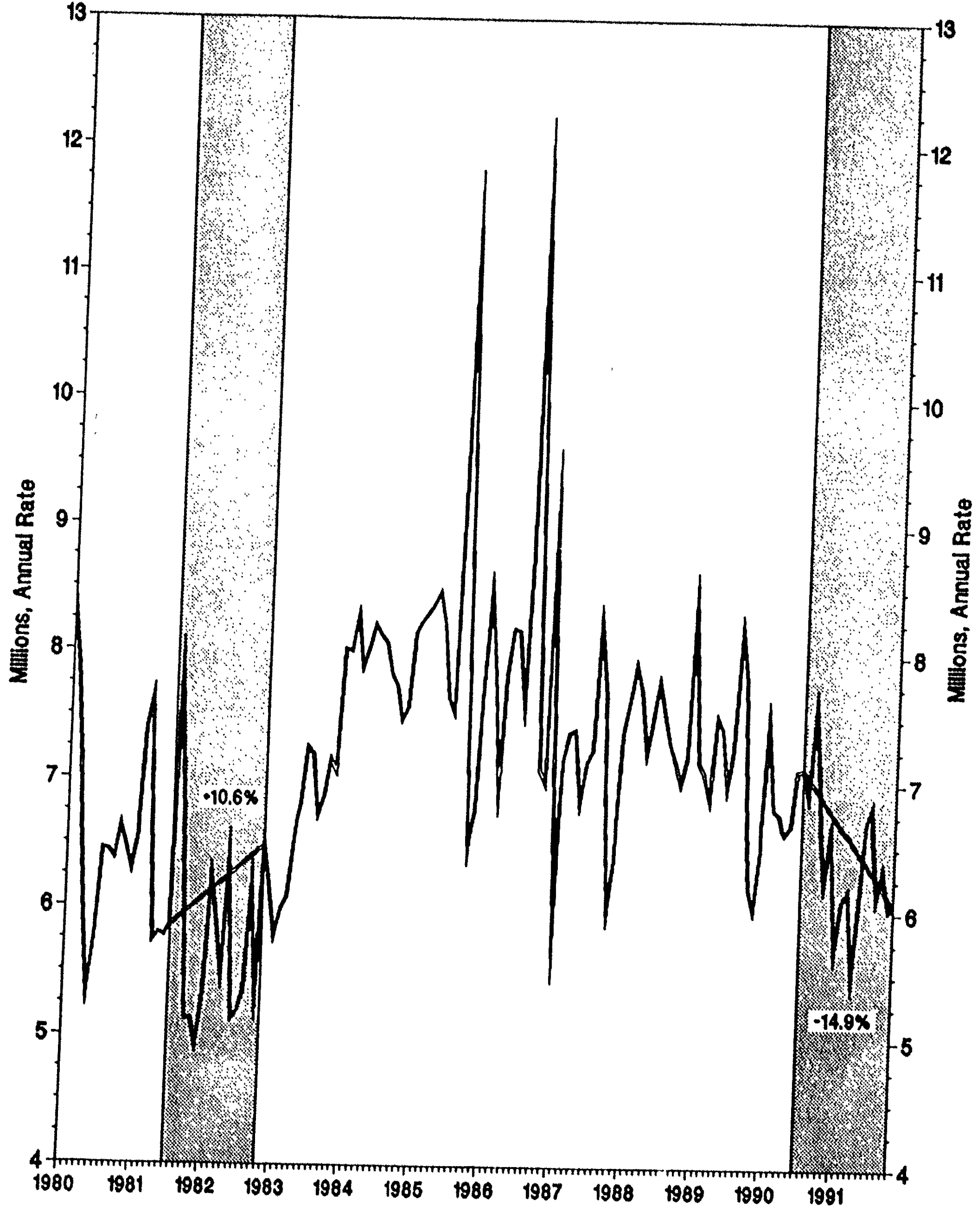
Housing Starts



HSBC Group Economics Dept. USA

Source: Bureau of the Census

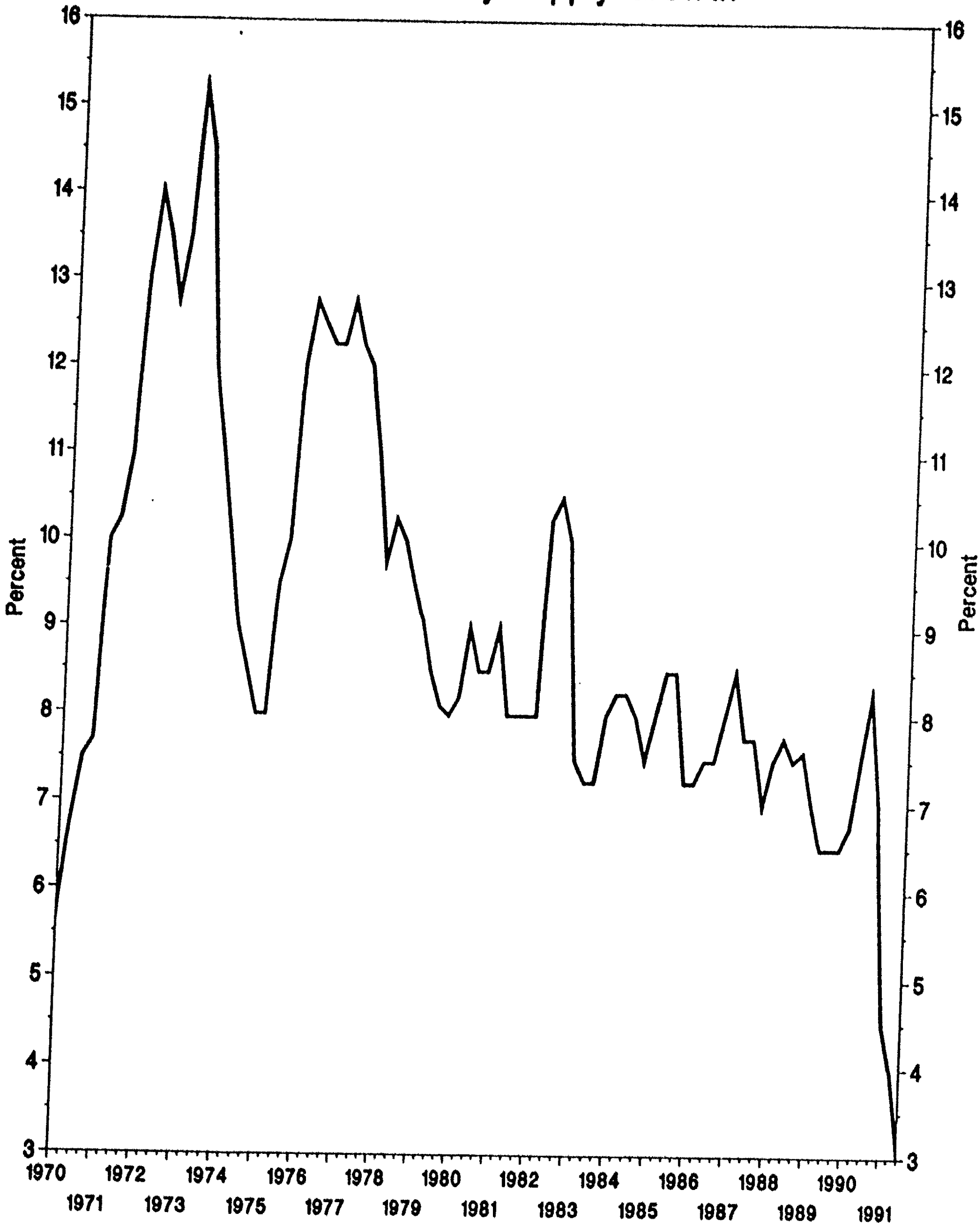
Domestic Car Sales



HSBC Group Economics Dept, USA

Source: US Department of Commerce

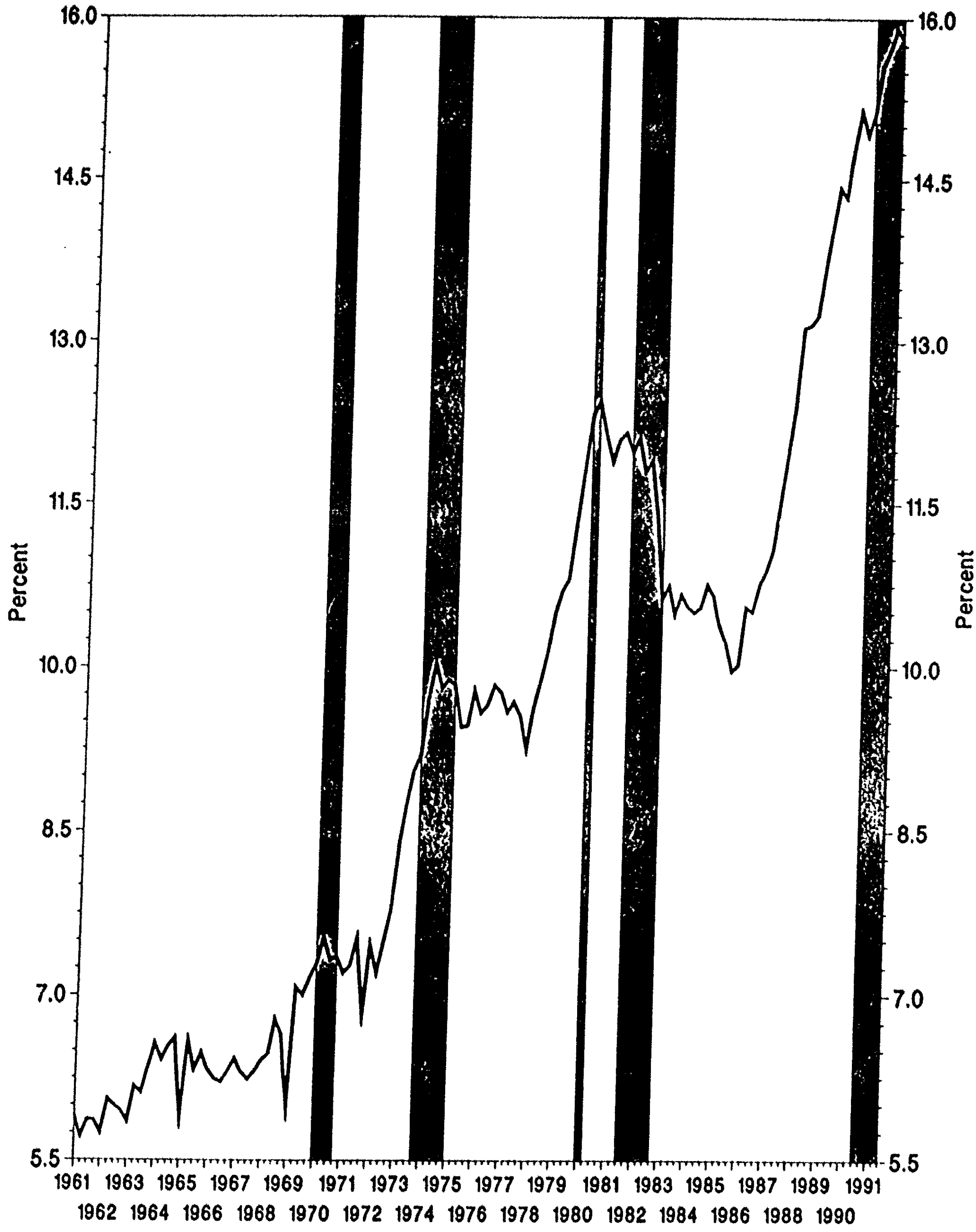
Global Money Supply Growth



HSBC Group Economics Dept, USA

Source: OECD

Exports Surge to Record Share of GNP

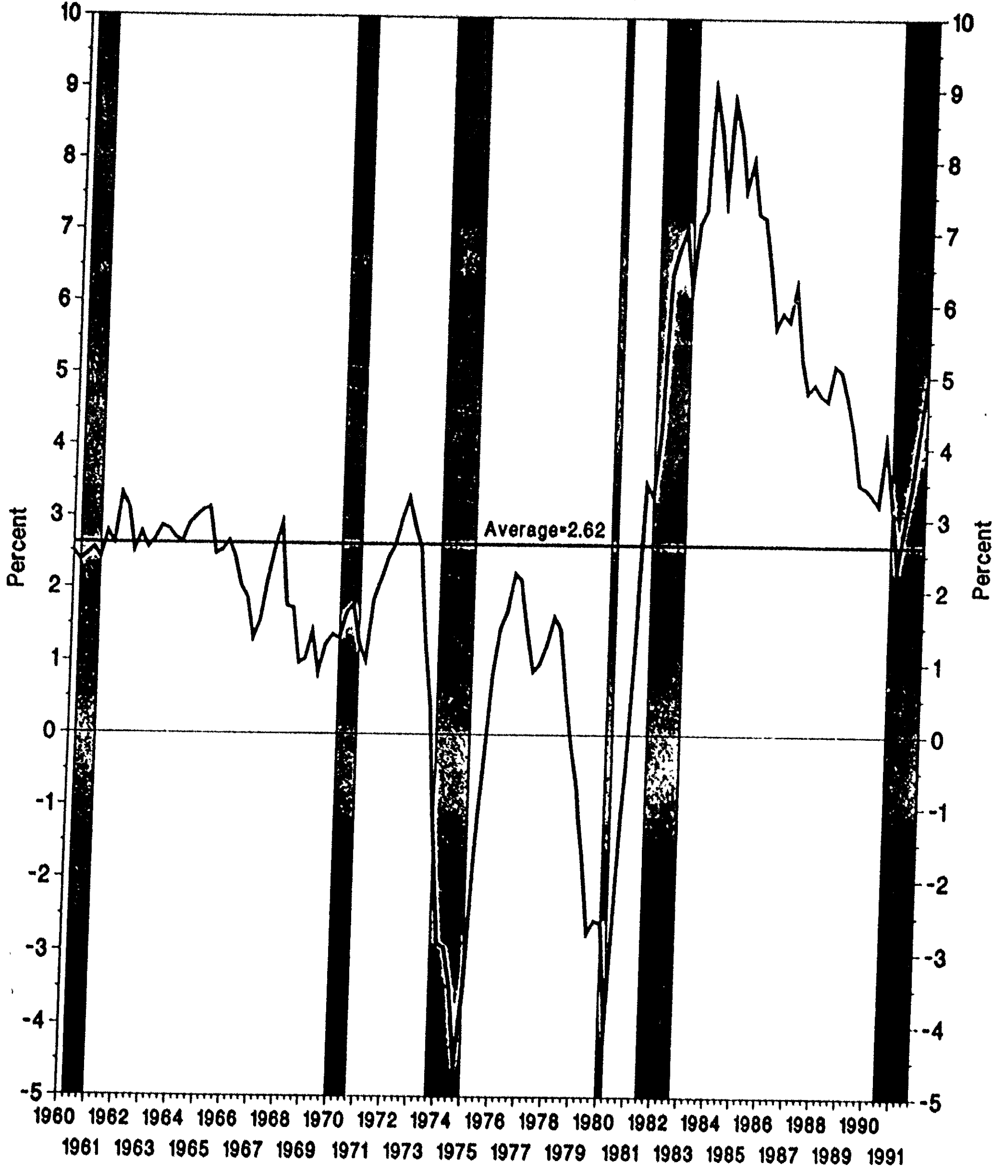


HSBC Group Economics Dept, USA

Source: US Department of Commerce

• Real Bond Yield*

Bond Yield less Year-over-year CPI

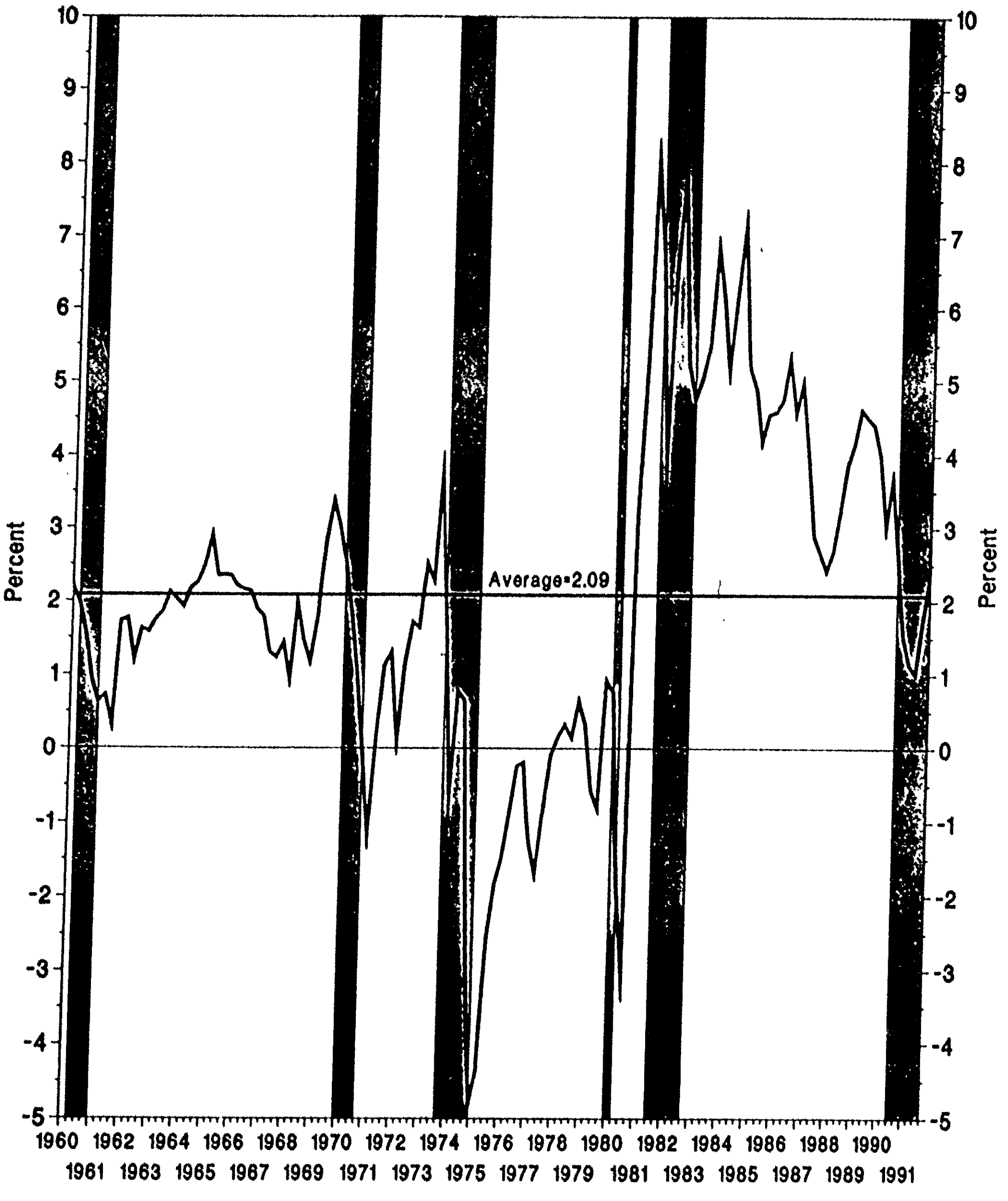


HSBC Group Economics Dept, USA
*Bond Yield: '60-'76, 10-yr note;
'77-'91, 30-yr bond.

Source: Federal Reserve
Fourth quarter 1991 is October only.

Real Federal Funds Rate

Federal Funds less Year-over-year CPI



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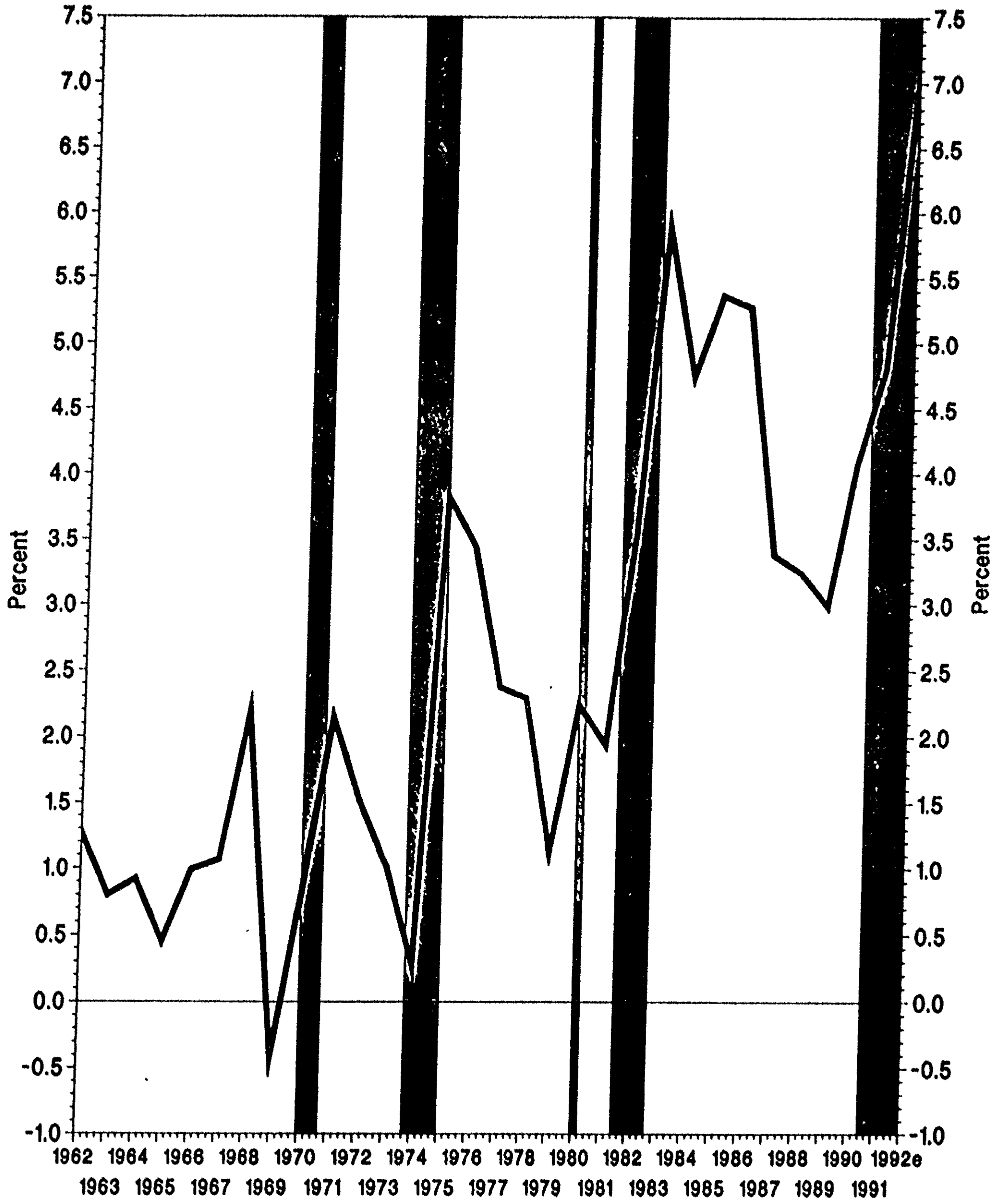
Source: Federal Reserve
Fourth quarter 1991 is October only.

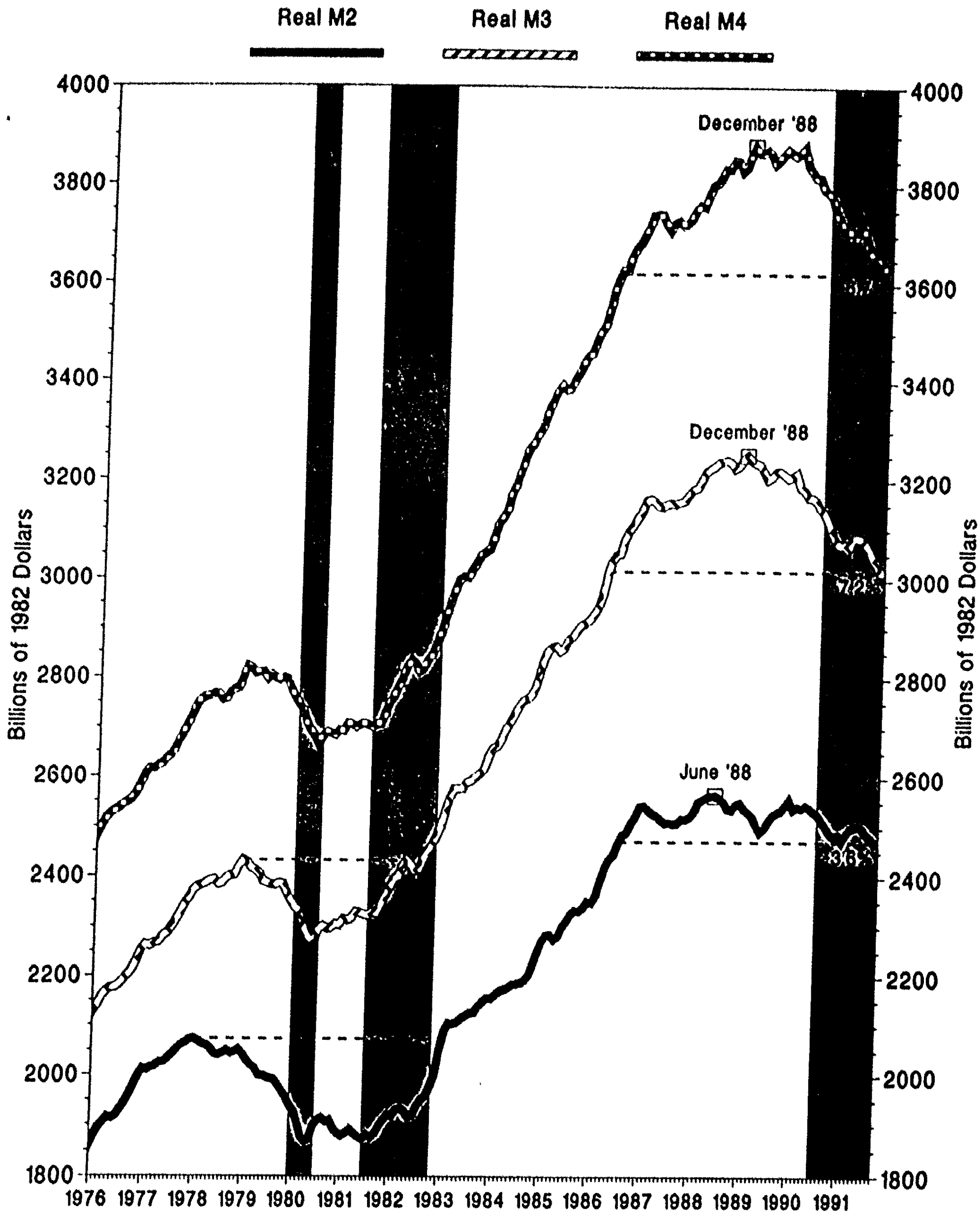
Federal Budget Deficit as a Percent of GNP



HSBC Group Economics Dept, USA
Ratio equals fiscal year budget
deficit divided by fiscal year GNP.

Source: US Department of Commerce

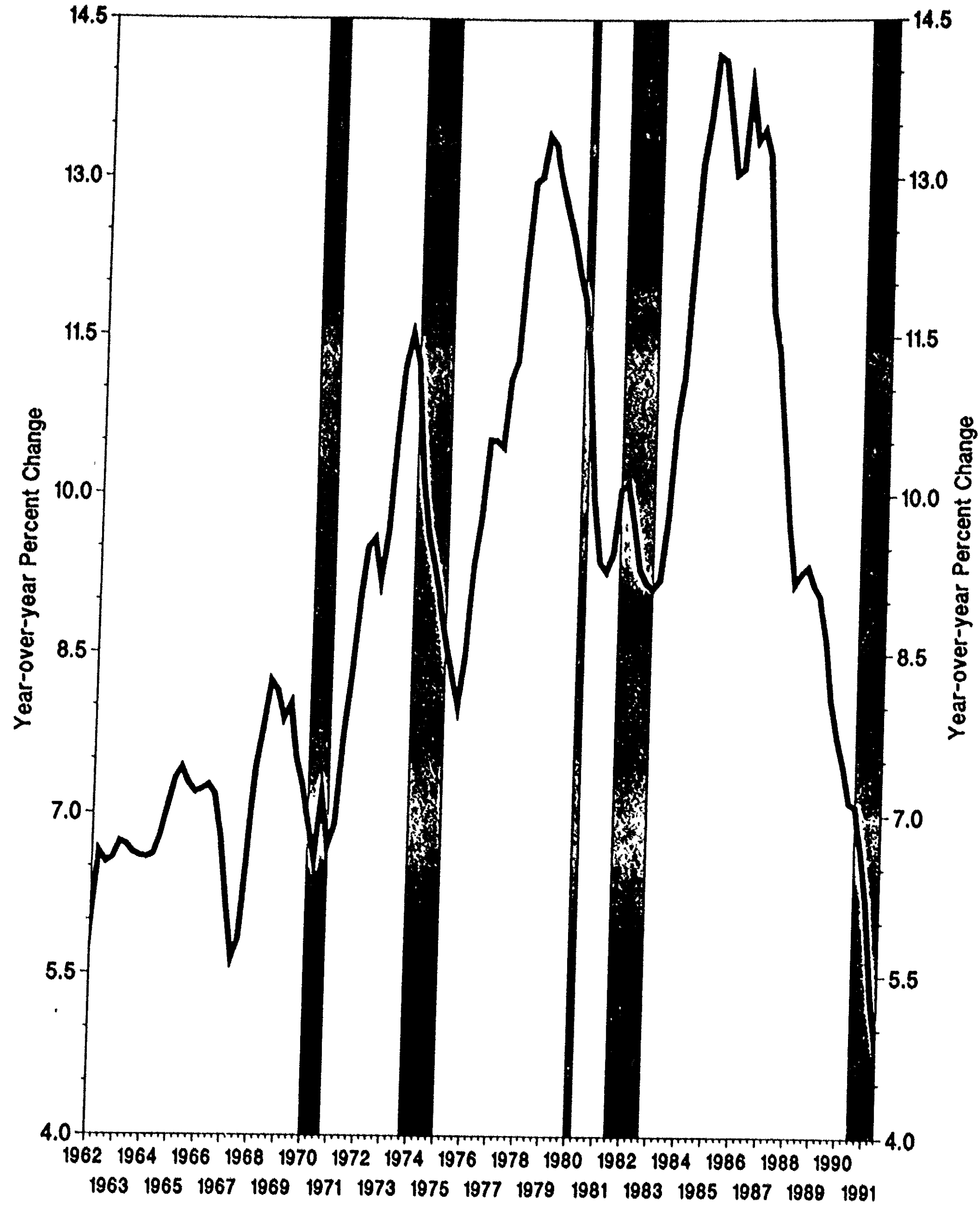
Real M2, M3, and M4



HSBC Group Economics Dept, USA

Source: Federal Reserve Bank

Total Domestic Nonfinancial Debt



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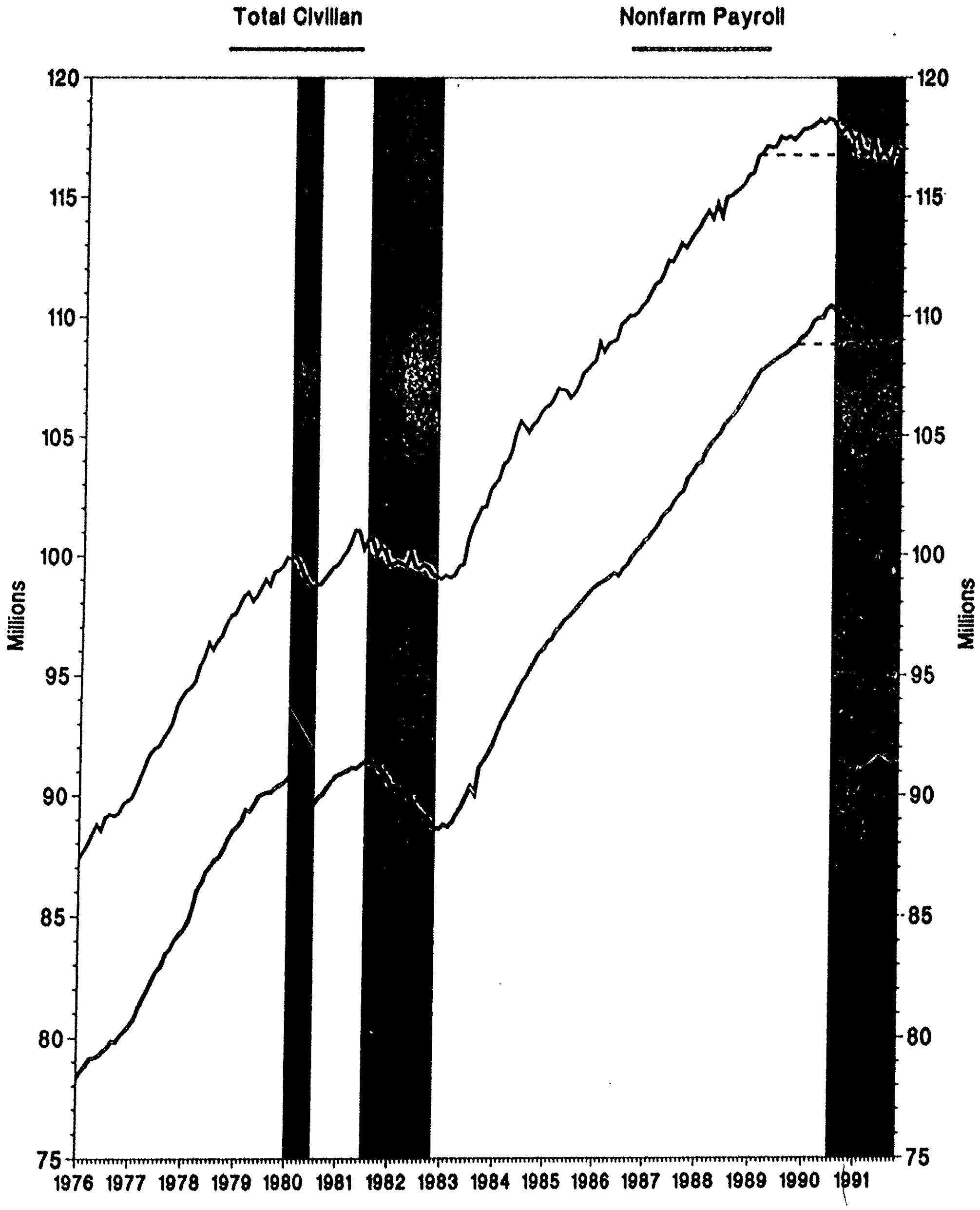
Source: Federal Reserve Bank

Total Civilian & Nonfarm Payroll Employment



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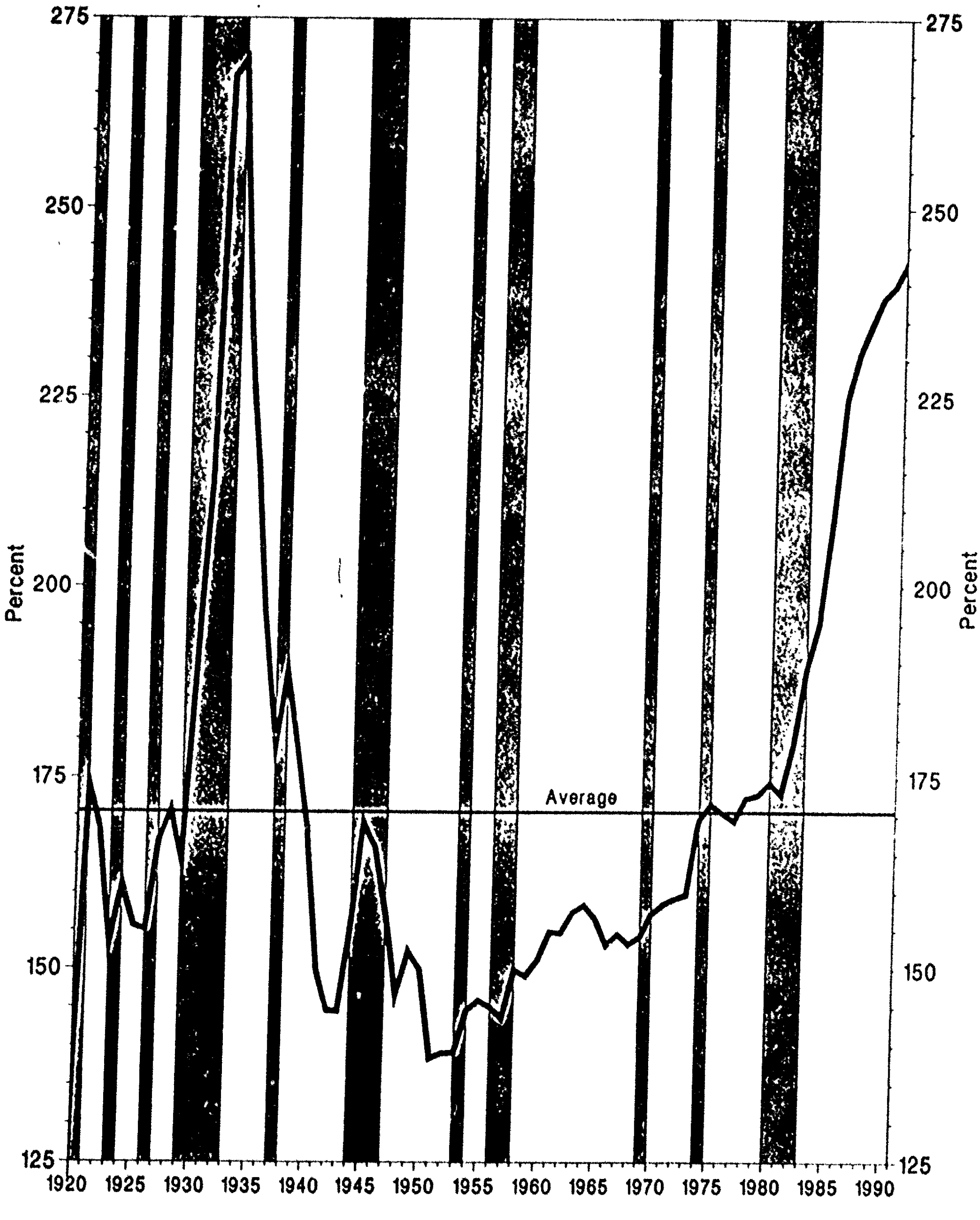
Source: US Department of Commerce

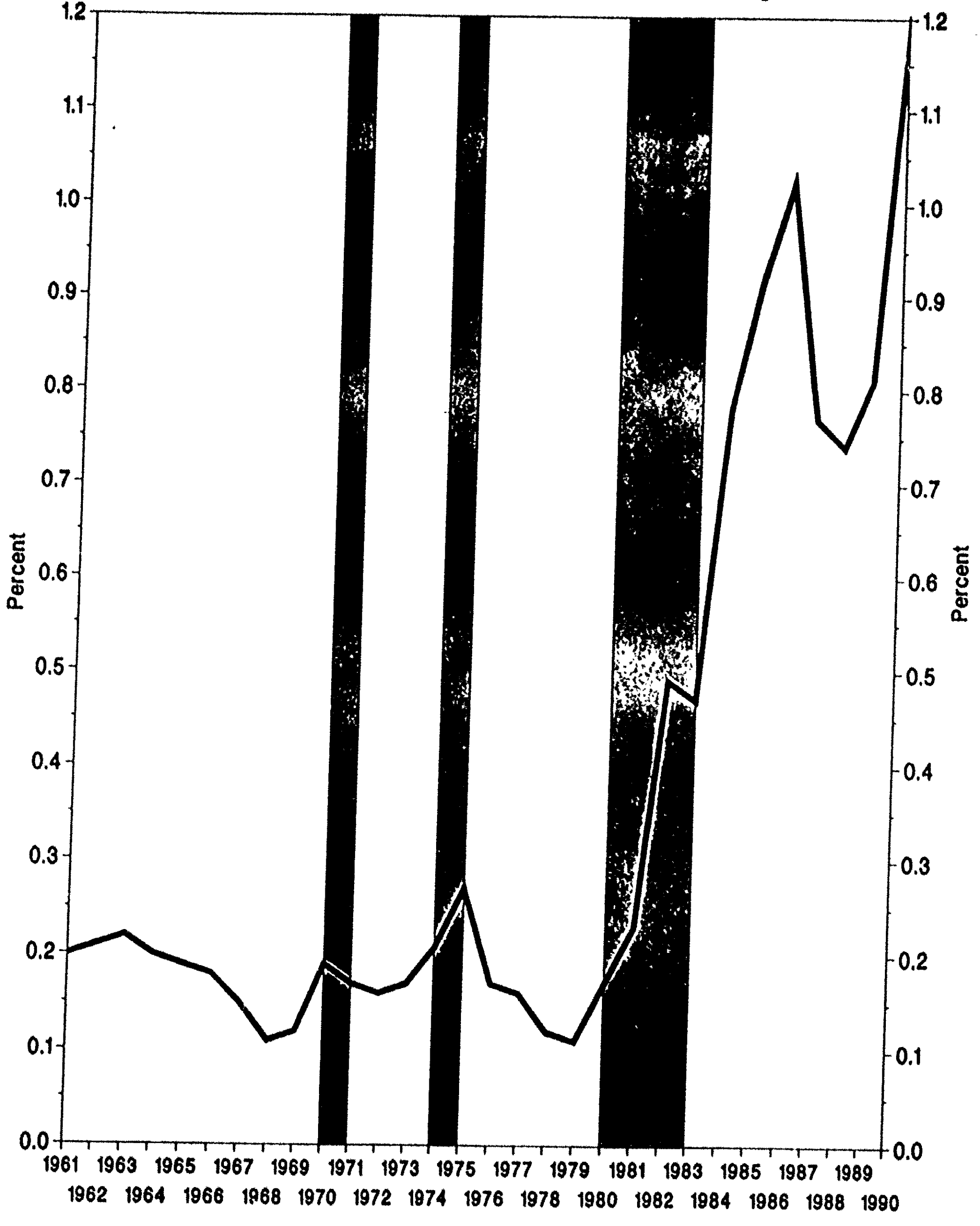
Total Debt as a Percent of GNP



HSBC Group Economics Dept, USA
1991 is 1st qtr only at an annual rate

Source: US Department of Commerce

Business Failures Soar to Record Percentage of GNP



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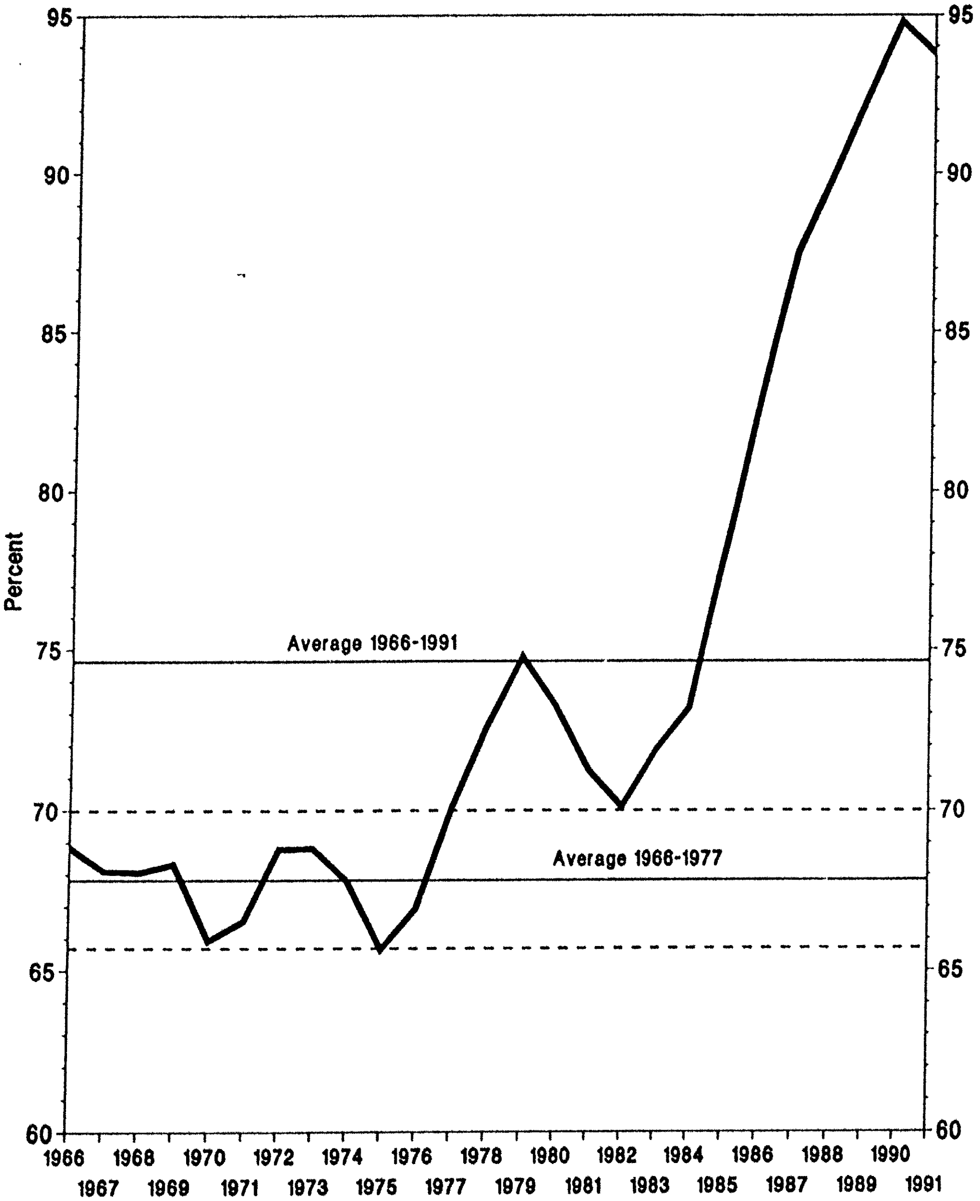
Source: Survey of Current Business

Total Household Debt as a Percent of Disposable Personal Income



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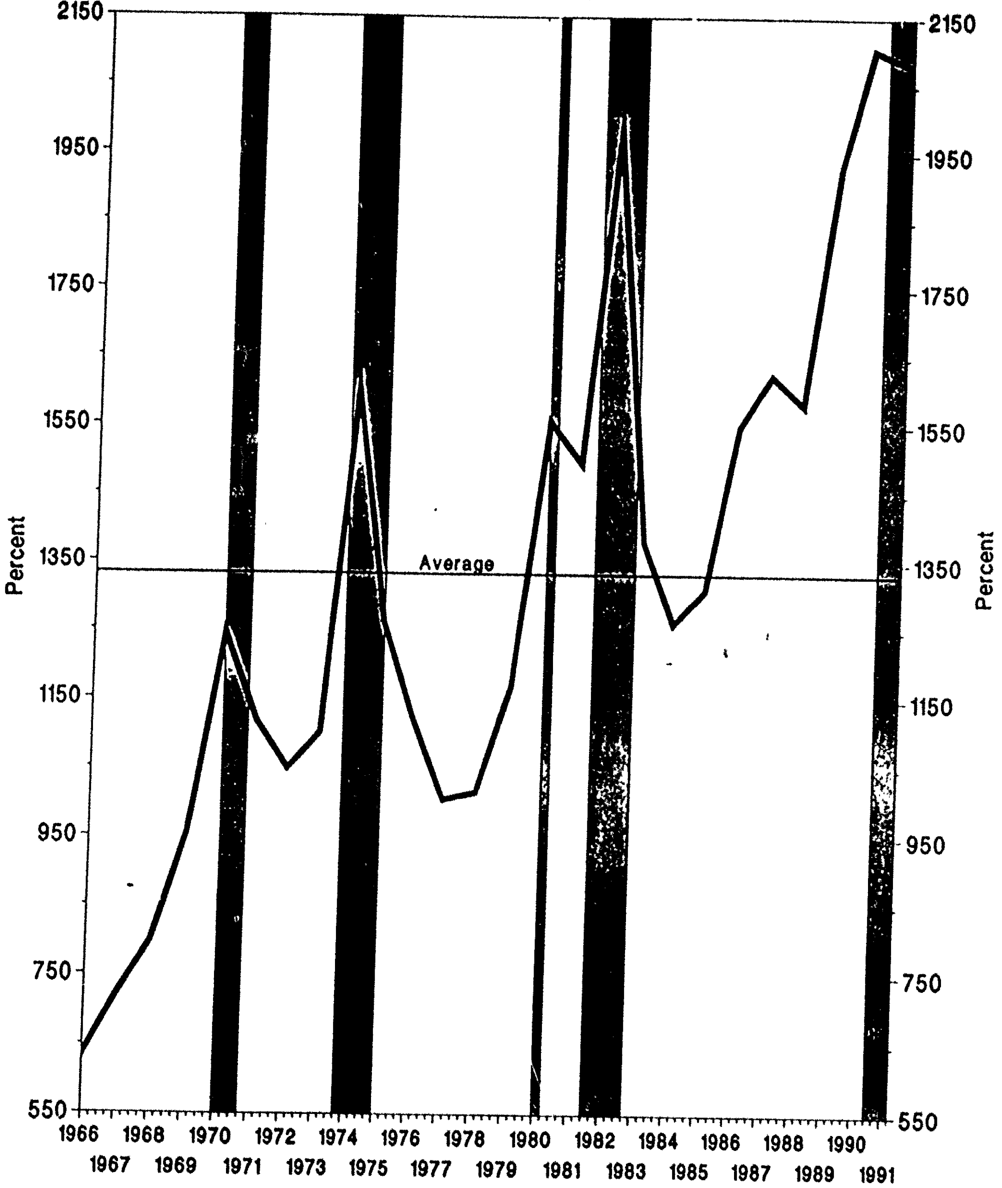
Sources: US Dept of Commerce & the Fed

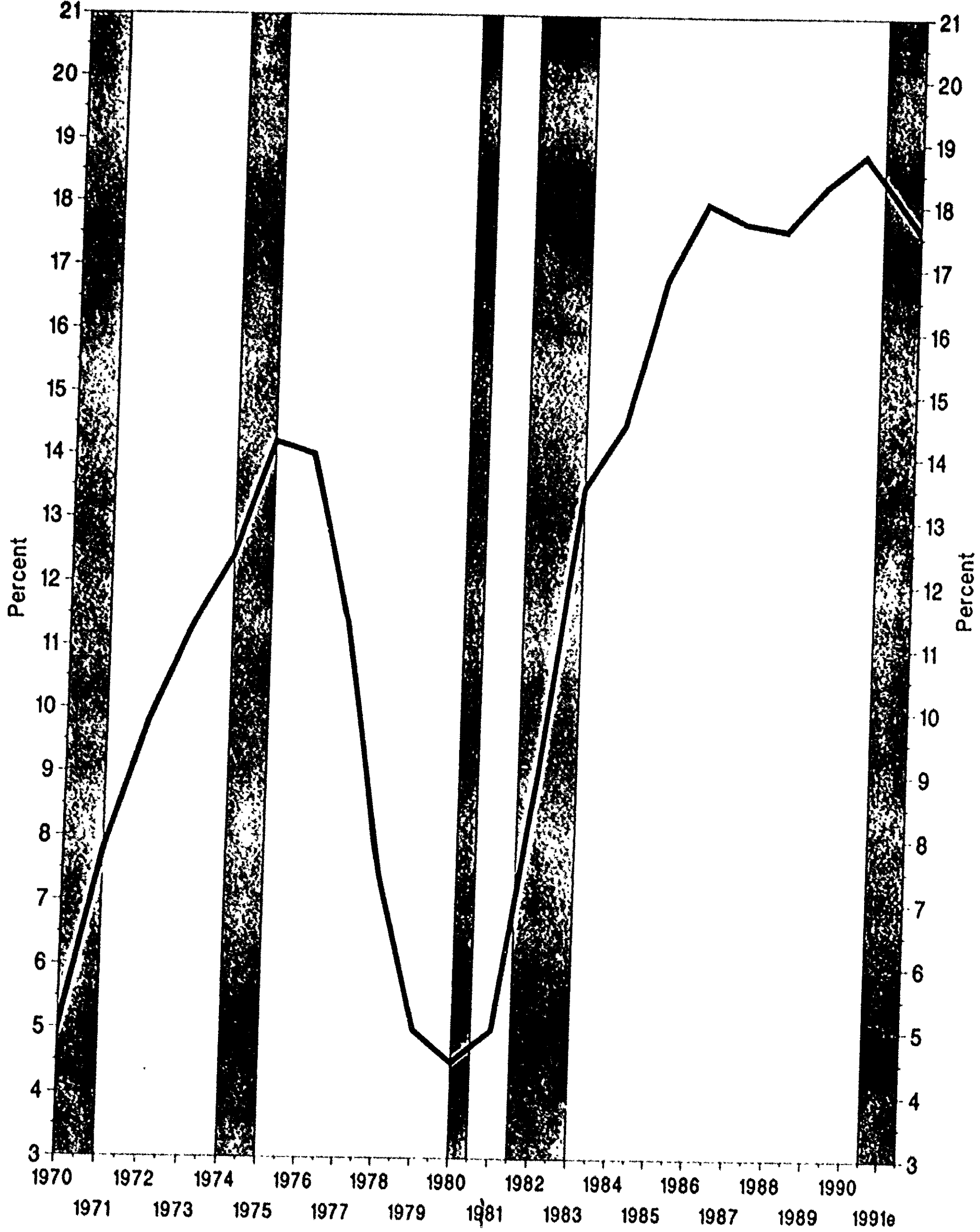
Ratio: Total Business Debt to Corporate Profits After Tax*



HSBC Group Economics Dept, USA
*Corporate profits after tax includes inventory valuation adjustment and capital consumption adjustment.

Sources: US Dept of Commerce & the Fed
1991 is 1st and 2nd quarters only.

Office Vacancy Rate



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Sources: HSBC and Torto Wheaton

Total Equity Capital at Commercial Banks and

Total Loans Outstanding

	(1)	(2)	(3)
End Of Year	Equity Capital	Loans Outstanding	Ratio of Loans to Capital
1979	$97.2 bil.	$763.2 bil.	8 to 1
1989.	$204.7 bil.	$2,01,1.9 bil.	10 to 1
Change	$121.9 bil.	$1,330.6 bil.	
Percent change	125.4%	174.3%	

HSBC Group Economics Department, USA

Sources: Federal Reserve Bank and FDIC

HONGKONG AND SHANGHAI BANKING CORP LTD
ECONOMETRIC MODEL DEC 10, 1991 FORECAST PAGE 1
BASE LINE FORECAST

	1991		1992				1993					
	QTR 3	QTR 4	QTR 1	QTR 2	QTR 3	QTR 4	QTR 1	QTR 2	QTR 3	1990	1991	1992
	ECONOMIC AND MONETARY INDICATORS (ANN PERCENT CHANGES)											
1.GDP, 1987$	1.7	-1.2	-1.3	.0	1.8	1.3	1.4	1.4	1.9	1.0	-.9	.1
2.FINAL SALES 1987$	-.9	-1.5	-.3	-.8	1.0	.9	1.1	1.1	1.9	1.7	-.6	-.4
3.CONSUMPTION, 1987$	2.3	-.6	.0	1.2	1.1	1.1	1.8	1.2	1.3	1.2	-.2	.7
4.BUS FIXED INVEST 1987$	-3.6	-8.1	-2.8	-1.7	.8	3.8	3.1	4.8	6.2	1.2	-6.9	-2.9
5.GOVT PURCH,1987$	-3.8	.4	-2.5	-.1	1.0	-2.3	-1.4	.5	1.0	3.2	1.1	-1.1
6.RESIDENTIAL INV 1987$	11.9	6.5	7.5	2.2	6.0	3.1	2.0	1.1	1.6	-8.7	-10.6	6.1
7.INDUSTRIAL PROD	6.5	-2.8	-3.2	7.0	7.2	.5	.6	6.5	8.8	1.0	-2.1	1.8
8.DISP INCOME 1987$	.1	-.5	-1.4	-.4	.4	.5	.4	.9	1.4	2.0	-.2	-.3
9.CORP PROFITS A TAX	16.7	-14.2	-10.8	7.2	11.8	8.7	6.2	10.1	9.0	5.5	2.3	-1.5
10.CPI: ALL URBAN	3.2	3.1	2.6	3.1	3.4	3.1	2.9	3.5	2.5	5.4	4.2	3.0
11.PPI: FIN GOODS	-.2	2.0	-1.0	1.9	.2	3.6	.0	2.4	.0	4.9	2.1	.7
12.CONSUMPTION DEFLATOR	2.7	2.5	2.4	2.8	3.1	3.0	2.9	3.0	2.5	5.1	4.0	2.7
13.PRODUCTIVITY 1977=100	1.8	.8	.4	.4	.6	.4	.4	.4	.4	-.2	.2	.6
14.M1	7.0	8.5	7.1	7.2	5.8	6.1	5.6	5.3	4.8	3.7	5.7	7.2
15.M2	-.3	1.3	2.9	6.0	4.2	5.1	4.1	4.1	3.1	5.2	2.8	3.2
16.M3	-2.4	-.2	.5	3.2	2.2	3.2	2.7	3.1	2.2	2.5	1.5	1.0
17.MONETARY BASE	6.0	7.2	5.0	5.3	5.2	5.1	5.1	5.0	4.9	7.2	9.3	5.6
18.C&I LOANS+NONFIN PAPER	-7.9	-3.9	-10.0	-11.5	-3.2	-.8	.2	.0	4.5	5.1	-2.2	-7.4
	MAJOR ECONOMIC INDICATORS											
19.TOTAL UNEMP. RATE	6.7	6.9	7.3	7.2	7.3	7.3	7.2	7.0	6.8	5.4	6.7	7.3
20.HOUSING STARTS	1.04	1.10	1.13	1.15	1.17	1.18	1.18	1.21	1.24	1.20	1.01	1.16
21.MOTOR VEHICLE SALES	12.6	11.5	11.4	11.3	11.5	11.6	11.8	11.8	12.1	13.5	11.9	11.4
22.AUTO SALES, TOTAL	8.7	8.1	8.0	7.9	8.0	8.1	8.3	8.3	8.6	9.5	8.4	8.0
23.AUTO SALES, DOMESTIC	6.4	5.9	5.8	5.7	5.8	5.9	6.0	6.1	6.4	6.9	6.1	5.8
24.INVNT INVEST 1987$	.4	3.4	-8.6	1.5	11.8	17.1	20.8	24.5	23.9	.2	-14.8	5.4
25.NET EXPORTS G&S 1987$	-32.2	-37.7	-35.0	-52.7	-56.1	-55.3	-58.0	-62.0	-59.8	-51.5	-25.1	-49.8
26.GOVT SURPLUS/DEF,UNI	-91.3	-96.8	-112.8	-77.7	-117.6	-82.9	-100.8	-64.8	-104.7	-220.5	-268.7	-404.9*
	MONEY AND BOND YIELDS											
27.FEDERAL FUNDS RATE	5.64	4.80	4.01	3.89	3.84	3.57	3.41	3.61	3.81	8.10	5.68	3.83
28.REAL FED FUNDS RATE	2.46	1.74	1.42	.84	.41	.52	.49	.14	1.27	2.70	1.45	.87
29.PRIME COMM.BANK RATE	8.40	7.68	6.91	6.61	6.54	6.40	6.21	6.36	6.55	10.01	8.48	6.62
30.PRIM.89 DAY CD(NYCB)	5.70	5.02	4.32	4.08	3.94	3.91	3.82	3.79	3.80	8.15	5.86	4.06
31.3 MO COMM PAPER	5.78	5.00	4.19	3.90	3.71	3.67	3.54	3.49	3.48	8.06	5.87	3.87
32.3 MO TREASURY BILL	5.41	4.71	4.00	3.75	3.59	3.55	3.44	3.40	3.39	7.51	5.44	3.72
33.3 YR GOVT SEC	6.89	5.96	5.24	5.03	4.82	4.78	4.59	4.54	4.47	8.25	6.84	4.97
34.5 YR GOVT SEC	7.49	6.66	6.03	5.84	5.65	5.63	5.46	5.42	5.33	8.37	7.39	5.79
35.10 YR GOVT SEC	7.94	7.42	7.02	6.94	6.87	6.94	6.91	6.98	6.98	8.55	7.88	6.94
36.30 YR GOVT SEC	8.18	7.85	7.51	7.42	7.31	7.37	7.45	7.57	7.52	8.61	8.14	7.40

* INDICATES VALUE IS FOR FISCAL YEAR

PREPARED STATEMENT OF SENATOR ROBERT W. KASTEN, JR.

The U.S. economy is stalled. A historic eight year boom was wrecked by tax increases and re-regulation. As a result, over 1.5 million Americans have lost. their jobs in a recession that could have been avoided. The key now is to get America back on track with a strong economic growth and family tax relief package that will unleash entrepreneurial capitalism, generate higher living standards, and create new and better jobs for millions of Americans. Implementing an economic recovery package should be the top priority of Congress and the Administration.

I have joined with Representative Vin Weber of Minnesota in introducing the Economic Growth and Family Tax Freedom Act of 1991 (S. 1920, H.R. 3744). This package offers the best plan to revive the stalled economy, sustain long term growth, and reduce the heavy tax burden on middle class families.

An economic recovery package should do more than provide a temporary stimulus to the economy. It should also put into place tax policies that will. sustain long term economic growth. America's prosperity is threatened by slow economic growth. Our post World War II growth path is 3 percent real growth 'in GNP per year—when we fall below that it means lost jobs, lost output and lost family income. The economy has been.growing at well below that level for the last two years, and even if the economy turns around and grows at the Office of Management and Budget's projected 2.5 percent per year, it will mean 9 million fewer jobs by 1996, relative to the normal post war growth path. Clearly, this "growth gap" must be eliminated.

The Kasten-Weber proposal is designed to eliminate the growth gap with a six point plan that includes middle class tax relief in the form of tax credits for working families with children, a reduction in the capital gains tax, a speed up of depreciation for business equipment and machinery, expanded IRAs, reform in the tax treatment of real estate, and enterprise zones.

FAMILY TAX RELIEF

Our proposal provides for middle class tax relief by reducing the heavy tax burden on working families. Kasten-Weber provides a $300 tax credit for each child age 6–18, and $1,000 tax credit for each child under age 6. This credit is available only for working families, and can be used only to the extent of income tax and payroll tax liability.

The middle class family has been squeezed particularly hard by the increasing burden of taxes. The Tax Foundation reports that the typical family now works until May 8, of each year just to make enough to pay the tax bill. The declining value of the dependent exemption is largely responsible for the heavy tax burden on families. If the dependent exemption shielded from taxation the same proportion of annual income in 1991 as it did in 1948, a family today would be able to exempt nearly $8,000 per child instead of the current $2,150 exempted under the dependent exemption. Our tax credit is designed to address this dramatic decline in the value of the dependent exemption.

CAPITAL GAINS TAX REDUCTION

A capital gains tax reduction will create jobs and restore fairness. Our proposal slashes the capital gains tax from 28 percent to 15 percent and provides for a 7.5 percent rate for those in the lower tax bracket. This is coupled with indexing to ensure that savers and investors are not taxed on gains that are due solely to inflation. In addition, the legislation provides for a complete elimination of the capital gains tax on the sale of a principal residence.

Most other growth packages introduced in Congress either contain no capital gains tax cut or watered down versions of the proposal that will do little to stimulate the level of investment necessary to create new ventures and new jobs. By contrast, a 15 percent rate is estimated to create up to 2.5 million new jobs over 5 years. It will also bring the U.S. into line with the other leading capitalist economies, many of which have no tax at all on capital gains.

In addition to creating jobs our capital gains proposal would restore fairness to farmers, small business owners, and senior citizens. Each of these taxpayers suffer particular hardship due to the lack of capital gains tax indexing under the present system. A farmer selling his farm after 30 years work pays a 28 percent federal capital gains tax on gains that are due almost entirely to inflation. Similarly, senior citizens, who account for 26 percent of all sales of capital assets, are taxed at full capital gains tax rates on retirement savings that have been eroded by years of inflation.

The following example demonstrates just how unfair the current tax system is. A retired senior citizen who bought stock in the S&P 500 index in 1970 for $1,000 could sell that investment for $4,580 in 1991. This looks like a healthy gain of $3,580. However, after adjusting for 21 years of inflation, the gain is worth only $1,130, and after paying the full 28 percent capital gains tax his profit is only $128. This small profit will be more than wiped out by state capital gains taxes. This demonstrates why including an inflation indexing component in any capital gains proposal is so important. Without it millions of Americans are cheated out of their savings by a tax code that taxes them on phantom gains due solely to inflation.

In addition to helping our citizens, the government will also benefit from lower capital gains taxes. Economist Allan Sinai estimates that the growth impact of a 15 percent capital gains rate will result in a $40 billion revenue increase for the Federal government over 5 years. Former Treasury Department economists Gary and Aldona Robbins have calculated a 5 year revenue gain of $63.5 billion.

IMPROVED DEPRECIATION FOR MACHINERY AND CAPITAL EQUIPMENT

The Kasten-Weber proposal reforms the current system of tax depreciation. In order for American industry to remain competitive, the tax treatment of equipment and machinery purchases needs improvement. When machinery is purchased it cannot be immediately written off, but must be deducted over a number of years. The value of this deduction is eroded by inflation and the time value of money. Our proposal addresses this erosion by indexing depreciation schedules so that the value of each year's deduction keeps pace with inflation and the cost of funds.

In addition, our package eliminates the disincentive for capital investment which results from the Alternative Minimum Tax (AMT) treatment of depreciation. Presently, any depreciation in excess of straight line depreciation is included as an adjustment under the AMT, increasing the tax liability of companies that pay under the AMT and actually punishing capital intensive companies. At a time when our international competitors are encouraging capital investment, the U.S. is doing the opposite. The current AMT treatment of depreciation even discourages companies from making important investments in pollution control machinery. We eliminate this disastrous policy by completely phasing out the corporate AMT depreciation adjustment by the year 2000.

REAL ESTATE REVITALIZATION

One reason the economy is performing poorly is the depressed value of real estate. The Tax Reform Act of 1986 contributed to this decline in values by increasing the capital gains tax and imposing unfair passive loss restrictions on real estate. Investment in rental real estate was singled out during Tax Reform and defined as "passive" investment regardless of whether a taxpayer materially participates in the activity. Generally, no losses from this passive activity can be used to offset other income.

Our legislation changes this by providing the same treatment under passive loss rules for those engaged in the real estate business as those engaged in any other type of business. The taxpayer would be allowed to establish that he or she materially participates in the rental activity, thereby improving the tax treatment of their business activity. By increasing the value of real estate, this reform will have the beneficial side effect of reducing the cost of the S&L bailout.

SAVING INCENTIVES THROUGH EXPANSION OF IRA'S

The Kasten-Weber package encourages long term saving by establishing IRA-Plus accounts. This will permit individuals to make non-deductible contributions to IRA's where the interest accumulates, compounds and is distributed tax free. The proposal allows for the use of up to 25 percent of the account for education, the downpayment on first time home purchases, and certain medical expenses.

ENTERPRISE ZONES

Finally, the legislation creates Enterprise Zones which target business investment and job creation in economically depressed urban and rural areas. Enterprise Zones offer special tax incentives to companies that locate and create jobs in economically depressed areas. The zone tax incentives .would include an employee tax credit, elimination of the capital gains tax on zone investments and real property, and stock expensing. Enterprise Zones have been successfully implemented in dozens of states. The addition of federal tax incentives would provide a major boost to these programs.

CONCLUSION

How will we pay for these tax incentives? The big reason for today's record budget deficit is the decline in tax revenues due to the recession. Get the economy moving again with growth incentives, and tax revenues will rise. Using the Congressional Budget Offices's "rules of thumb," if our tax cut plan raises the rate of growth just one percentage point per year over today's forecast, the cumulative deficit reduction would add up to $258 billion by 1996 (see chart). Adding Senator Bentsen's nearly $70 billion "peace dividend" from a 5 percent lower U.S. defense profile would put the budget deficit on a permanent downward path. Even more deficit reduction could be achieved by a 4 percent growth cap on domestic spending. This would result in $306 billion in deficit reduction over 5 years.

Many "growth" packages have been introduced in Congress in the last several months. Unfortunately, few of these provide for the type of comprehensive tax reform that is necessary to sustain long term economic growth. Several tax plans are not tax cuts at all, but merely offset tax credits with higher tax brackets. These plans attempt to redistribute wealth, not create it. Others simply do not contain enough tax reduction to make a significant difference to the average taxpayer. The Kasten-Weber proposal provides both substantial middle income tax relief and the growth provisions that are necessary to rebuild the economy.

DEFICIT REDUCTION WITH ONE PERCENTAGE POINT GREATER REAL GNP GROWTH

	1992	1993	1994	1995	1996
NEW REVENUES	$7	$23	$40	$60	$80
SPENDING SAVINGS	$1	$4	$8	$14	$21
DEFICIT REDUCTION	$8	$26	$48	$74	$102
CUMULATIVE DEFICIT REDUCTION	$8	$34	$82	$156	$258

SOURCE: CONGRESSIONAL BUDGET OFFICE

SLIDE 21

"A Proposal for Economic Growth and Family Tax Freedom"

by

U.S. Senator Bob Kasten (R-WI)
U.S. Representative Vin Weber (R-MN)

PRO-FAMILY TAX RELIEF

- $300 non-refundable tax credit for children age 6 - 18.
- $1000 non-refundable tax credit for children under age 6.

PRO-GROWTH TAX INCENTIVES

CAPITAL GAINS

- 15% top rate, 7.5% for lower bracket individuals
- 15% for corporations
- Indexed for inflation
- One year holding period
- 0% tax on sale of principal residence

NEUTRAL COST RECOVERY SYSTEM

- Time value of money plus inflation
- Present value equivalent to expensing

IRA-PLUS

- Non-deductible IRA contributions tax free at withdrawal
- Penalty-free IRA withdrawal for home purchase, education, and medical expenses

PASSIVE LOSS

- Passive loss relief to material participants in real estate

ENTERPRISE ZONES

PREPARED STATEMENT OF SECRETARY JACK KEMP

Mr. Chairman and members of the Committee, thank you for this opportunity to discuss economic and tax policy initiatives that will stimulate growth and create jobs and opportunity for all Americans.

It has been almost three decades since this country first declared "unconditional war on poverty." In that time, poverty has become entrenched as never before in this country, ending its steady decline from 30 percent after the Second World War to 12 percent in 1968. Since the upsurge of social welfare programs—which have doubled as a share of Gross National Product (GNP)—that progress against poverty has stopped. There is no denying the noble intentions of the Great Society, but since the mid- 1960s, we have spent $2.6 trillion on a war on poverty—and poverty appears to be winning.

I would be remiss if I did not point out that poverty numbers are deeply distorted by the fact that the Census Bureau does not count in-kind welfare payments, such as food stamps, housing and Medicaid, and a significant portion of AFDC. In fact, the Census misses over $11,000 in benefits per household, according to Warren Brookes.

But the poverty numbers also don't reflect the critical consequences of the breakdown of the traditional American family, as increasing numbers of Americans in poverty are in one-parent homes with no one working at all. In fact, in 1959 28 percent of poor families were headed by women. Last year, 62 percent were headed by single mothers. Nearly all welfare programs today subsidize that type of family, which actually promotes a rising poverty rate.

If one steps back and examines some of the orthodox notions about fighting poverty, one can see why they have not succeeded, and indeed why we have created more poverty.

How do countries cause poverty? What policies and principles destroy the economy and cities and make people dependent on government? Let me offer some suggestions:

- Impose steeply graduated tax rates on labor and capital, leave them unindexed as well, and then allow inflation to push people into ever higher tax brackets that are confiscatory.
- Reward welfare at a higher level than working.
- Tax the entrepreneur who succeeds in the legal economy—while permitting the underground and untaxed economy to flourish.
- Reward people who stay in public housing more than those who want to move up and out into private housing and homeownership.
- Give a greater reward to the family that breaks up, rather than to the family that stays together and remains intact.
- Encourage debt and spending rather than saving, investing and risk taking.
- Finally, destroy the link between effort and reward.

Mr. Chairman, we have effectively created two economies in this country. One economy—the mainstream economy—is democratic capitalist, market oriented, entrepreneurial, and based on private property. It offers incentives for working families and rewards work and investment, productivity and saving. Indeed, incentives abound for productive economic and social behavior.

It was this economy, triggered by the income tax rate cuts in 1981, that generated 21.5 million new jobs, more than four million new businesses including record increases in the number of minority businesses, relatively low inflation, and a higher standard of living for most people. This economy created more jobs in the last decade than all of Europe, Canada and Japan combined. The GNP grew by a third and revenues increased by 40 percent. And according to the U.S. Treasury, federal income taxes paid by the top one percent of taxpayers surged by more than 80 percent from 1981 to 1987. In 1980, the wealthiest five percent of Americans paid 35 percent of income taxes, and after the tax cut they paid 46 percent, and the top 50 percent of earners accounted for 95 percent of total income collections.

But there is another economy—a second economy that is similar in many respects to Third World or Eastern European socialist economies. It functions in a fashion opposite to the democratic capitalist economy, indeed it is neither capitalist nor democratic. It predominates in the pockets of poverty throughout urban and rural America. This economy has barriers to productive social activity, and a virtual absence of economic incentives, rewards or private property. It denies black, Hispanic and other minority men and women entry into the economic mainstream as much as Jim Crowism did after the Civil War. It stresses dependency over independence; subsistence over self-sufficiency, and literally has eliminated the link between effort and the reward for produce human activity.

The irony is that the second economy was born of drive to help the poor, alleviate suffering and provide a basic social safety net. The results were a counterproductive economy and a counter-intuitive welfare system aimed at perpetuating poverty, instead of the springboard to prosperity that was the hallmark of the American dream.

Mr. Chairman, the 1980s were a decade of renewal and opportunity. But not for everybody. This is the worst of times for people who can't afford to buy their first home; for people without jobs, who are homeless, who are trapped by drug addiction, who are living in despair. I believe, Mr. Chairman, that the most important way this nation can combat despair, poverty and hopelessness is to use the tools of democracy, homeownership and entrepreneurial capitalism as a ladder for upward mobility.

Let me outline some ideas for a national agenda to help low-income people and our nation find the keys that will help unlock the shackles on growth, hope and opportunity. Many of these items are contained in the President's growth and empowerment agenda, and many are supported by members of Congress on both sides of the aisle:

- Eliminate the capital gains tax in distressed urban and rural communities that we would designate as Enterprise Zones, to help expand ownership of business and create new jobs.
- Use housing policy to expand homeownership opportunities for low-income and minority families through resident management, urban homesteading and privatization of public housing and other properties; increase the use of tenant-based assistance; and implement self-sufficiency programs to promote greater choice, dignity and asset accumulation.
- Eliminate the excessive tax rates on persons trying to leave welfare and take jobs. Today, those who attempt to leave welfare face the highest marginal income tax in the United States.
- Encourage homeownership by allowing first-time homebuyers to use their IRAs for downpayments, without tax penalty.
- Increase the supply of affordable housing for minorities and the poor by extending the low income housing tax credit (LIHTC).
- Foster quality education by expanding educational choice through magnet schools, tuition tax credits, educational vouchers and family choice.
- Enact a pro-family tax cut to give families more after-tax income in order to reduce financial pressures, to help families keep more of their resources to take care of their children, and to help them break free of government assistance."
- Cut the capital gains tax rate to launch a new decade of economic growth, capital formation and job creation.

Let me address some of these issues in more detail.

First, Enterprise Zones. We need to greenline for success those areas of our country that have been redlined for failure. President Bush has again asked Congress to establish 50 Enterprise Zones in which the capital gains tax would be eliminated completely. Enterprise Zones have proved themselves at the state level through they are just a glimmer of what could be achieved with the power of Federal initiatives. Enterprise Zones would directly benefit those who need the basic commodities of an economy: Jobs and a steady income. Enterprise Zones would create rungs on the ladder of opportunity for those residents who are below the poverty line.

Second, is a radical new direction in housing and welfare policy. When I became Secretary of HUD, I made a commitment to wage war on poverty by using the resources of the Department to expand homeownership and affordable housing opportunities; to empower the poor through resident management and urban homesteading; to fight homelessness; and to create jobs and economic development. These activities are at the very heart of HUD's historic mission to fight poverty. But Mr. Chairman, this Department and the Bush Administration have intended from the outset not to be const ained by the traditional means of fighting poverty that have become grossly ineffici nt and that have placed low-income families on a treadmill of endless poverty and dependence.

We clearly recognize the need to provide basic shelter assistance to the millions of families who live in substandard housing, are faced with homelessness, or who pay large portions of their modest incomes for rent. However, this Administration does not buy the argument that poverty is a permanent or perpetual condition. We have proposed programs and budgets intended to redirect housing policy back to the poor and low-income families who are the intended beneficiaries of HUD programs, with the goal of ending poverty and dependence.

To an extent, we have had the cooperation of Congress in this effort Congress authorized the Administration's HOPE Grants proposal to enable low-income families and tenants to become homeowners with a stake in their communities. HOPE is intended to break the cycle of poverty, dependence and despair that has entrapped low-income families, and to replace it with access to assets, private property and opportunity.

The most successful asset-based anti-poverty program in American history got underway a hundred years before the Great Society. It was Abraham Lincoln's Homestead Act of 1962. Homeownership is the classic path to the American dream. The median net worth of homeowners in 1984 was 30 times that of renters. Homeownership is a fundamental building block of prosperity in America. It is no different for the poor than for the middle class.

Congress also approved the Administration's Shelter Plus Care initiative to expand community-based mental health facilities, drug abuse treatment, job training and day care to help the long-term homeless get the shelter and support services they need to re-enter the mainstream economy. It also approved the Administration's Family Self-Sufficiency program to link Section 8 and public housing assistance with job training, education and other assistance to provide residents with opportunities for upward mobility.

Unfortunately, the promise of some of these new directions in housing was not matched by the performance of Congress in appropriating the funds for them. Because Congress approved only 40 percent of the authorized amount, we will have to settle for great deal less that we had hoped, the opportunity for homeownership will be delayed or denied for thousands of low income families, and we will have greater difficulty meeting our of 1 million new homeowners by 1992 Congress also funded both the Shelter Plus Care program at a small fraction of the Administration's request.

At the same time Congress chose to protect the status quo. It ignored the evidence that housing vouchers and certificates will meet the affordability requirements of most families with "worst case" housing needs and at the same time give low-income families greater choice of where to live. Instead, it funded public housing new construction, which will create one-half as many units of housing as a comparable amount of tenant-based rental assistance. It even waived the matching requirement for the new HOME program, which was intended to provide a preference for more efficient tenant-based assistance and light rehabilitation over new construction. Congress even stripped the Department of its ability to implement rules that would have stopped the awarding of public housing operating subsidies to inefficient public housing authorities for the maintenance of vacant public housing units.

Third, we must help welfare recipients move to economic independence. If a woman on welfare in New York with two children, or a father who is unemployed takes a job, their income goes down. The startling fact in America today is that the highest marginal tax rates are being paid not by the rich, but by welfare mothers and unemployed fathers who want to take a job. In most cities, a welfare mother with two children would have to earn $18,000 to $20,000 in a private sector job to earn the equivalent of the average tax-free welfare payment.

But the loss of income is not the only barrier. According to the *Wall Street Journal* when a woman in Milwaukee, Grace Capetillo, accumulates a small savings account as a nest egg to help send her daughter to college, she is legally guilty of "welfare fraud," and faces a $15,000 fine. Tell me how it's possible to run a welfare system which tells people that if you work and produce and invest your time and your talent and your energy, you're going to me worse off. There is no link between effort and reward. People who come off welfare should not face higher marginal tax rates than the wealthiest of our citizens. Savings and assets should not be penalized but encouraged.

Other initiatives. The President's "Excellence in Education" Act which makes choice among public and private schools the centerpiece of improving America's education, has not been passed by Congress. But I believe this Committee should look closely at choice in education for inner city schools where poor people are far too often trapped in second rate schools.

The President's empowerment agenda also includes IRAs for first time homebuyers to help young families accumulate savings for downpayments on their first homes. It includes more authority for states to experiment in welfare reform at the state level, such as Governor Tommy Thompson in Wisconsin.

Last, Capital Gains. Mr. Chairman, I read an interesting column by David Broder in Sunday's *Washington Post* concerning the serious budget shortfalls being faced by states from Maine to California. States governments everywhere are running out of money and are proposing drastic cuts in state services—employee layoffs, reductions in aid to education and aid to local governments, and abolition of state agencies. The states responded to low revenues by raising taxes, and when the economy did not respond, they were forced either to cut services or raise taxes again.

The culprit in the Broder piece is, of course, the Federal government, the failure of whose economic policies has crippled the capacity of state and local governments to meet their responsibilities.

Mr. Chairman, budget deficits are a clear indicator of slow economic growth, and the Federal government is to be blamed for that. But the answer to the problem of slow growth of the economy, at the most fundamental level, is not finger pointing but an action that will unleash the pent up forces of our economy, namely a reduction in the capital gains tax.

Mr. Chairman, one reason for supporting a capital gains tax cut is that such a cut would benefit the states. This is not a revelation. The capital gains tax is effectively a transaction tax which can be avoided by not transacting. This is called the "lock-in" effect, and as a result of the 1986 Tax Reform Act, capital gains have been treated as ordinary income. The tax is effectively the highest it has ever been for almost all Americans, and because of the inflation of the last 20 years, many of the capital gains are not real. One part of the problem for government finance is that the lock-in cuts the tax flow.

The other part of the problem is that high capital gains taxes reduce the value of all capital assets—stocks and bonds, commercial real estate and residential property. Assets that must face a prohibitive capital gains rate are worth less than those facing a lower rate, such as the 15 percent rate proposed by the President. The rise in property values would increase revenue streams to even the smallest school district and unlock and increase the value of capital assets.

Mr. Chairman, it was not Jack Kemp or Ronald Reagan or George Bush—but President John F. Kennedy—who said almost 30 years ago: "It is a paradoxical truth that tax rates are too high today and tax revenues are too low—and the soundest way to raise revenues in the long run is to cut rates now."

Assets, as well as income, are the key to escaping poverty. Only assets appreciate over time, providing a cushion during hard times and a foundation for risk-taking. Assets become a catalyst for entrepreneurship and new wealth. The entrepreneur who uses his talent, intellect and labor to provide a new product or service is the primary source of economic growth and wealth creation in this country. Instead of seeking to redirect the way wealth is distributed, we must create the conditions that create wealth in the first place.

The most important thing we can do to help those in poverty help themselves is to reduce the cost and increase the flow of capital. You cannot create new employees without first creating new employers. The tax on capital is a tax on the ability of Americans to create new wealth. Stifling tax rates on capital gains have driven up the cost of capital to the point where we have a "capitalistic economy with no capital." The Administration sees it as a tax on innovation, risk-taking and job creation, and thus as a tax on the poor, the jobless and the future of the nation.

Under the current capital gains tax we will have to continue to settle for a meager 1 or 2 percent growth in the economy each year, at a time when we need a decade of 4 or 5 percent annual growth.

Experience and common sense show us that an expanding economy increases income to the government, as well as providing opportunity and a better life for our people. Government revenues steadily increased in the 1980s, and there is no reason to stop there. Even sustained, modest 4 percent increases in economic growth will double the size of the economy to $10 trillion during the next decade and sharply increase revenues which will be available to develop infrastructure and help educate our children, and reduce the deficit. The alternative, Mr. Chairman, is the loss of jobs alone is simply unacceptable.

From 1978 to 1986, when the capital gains tax rate was incrementally reduced from 49 to 20 percent, investment seed capital—the lifeblood for the entrepreneur—increased almost a hundred-fold. At the same time, Federal revenue from capital gains nearly quadrupled from the jump in economic activity. Moreover, the number of black-owned businesses soared during this golden age of venture capital, increasing by more than a third in just four years. Blacks, Hispanics and other minorities have the most to gain from a capital gains tax cut because they have most of their capital gains ahead of them.

Abraham Lincoln said in a speech more than 130 years ago: "I don't believe in a law to prevent a man from getting rich; it would do more harm than good. We wish to allow the humblest man an equal chance to get rich with everyone else. When one starts poor, as most do in the race of life, free society is such that he knows he can better his condition; He knows that there is no fixed condition of labor, for his whole life. I want every man to have the chance, and I believe a black man is entitled to it—in which he can better his condition—when he can look forward and hope to be a hired laborer this year and next, work for himself afterward, and finally hire men to work for him. That is the true system."

There are not enough minority businessmen and women in America, despite the large increases of the 1980s—80 percent for Hispanic businesses, 60 percent for Asians and nearly 50 percent for Black-owned businesses—there are today less than 500,000 black-owned businesses and not enough Hispanic-owned businesses. John Jacob's speech on the "State of Black America in 1989" stated that there were only about 300,000 Black entrepreneurs in 1982, about 2 percent of all small businesses. And Black Americans, which comprise 13 percent of the population, own only one-half of one percent of the Nation's $29 trillion of capital stock. There are 14.1 million small businesses in America, and we want minority business people to have the same opportunity to realize their dreams as other Americans in the free-enterprise system have. Our goal should be no less than to double the number of minority-owned businesses by the end of this decade.

It was surprising to some that when the President and I visited the Cochran Gardens Tenant Management Corporation in St. Louis in May, the President was applauded when he called for a reduction in the capital gains rate. But the people of Cochran Gardens have a far better understanding of what it takes to succeed in the free market than those who have never known what it's like to be locked out, kept down, and held hostage by the second economy. The understood the President's message, because they know who will benefit from lower capital gains taxes.

Taken together, all of these pieces represent an ambitious agenda and a new direction in domestic policy that can empower the poor and expand opportunity.

In the last meeting of the President's Task Force on Economic Empowerment and Opportunity, we considered ideas that should take us even further. I'm happy to see that many Congressmen agree with me that we need to change our welfare system towards self sufficiency, work, and business development. In this regard, the Task Force is considering alternatives that might allow persons on AFDC and other federal subsidy programs to accumulate assets and achieve greater self-sufficiency.

At HUD we are also looking at some dramatic new changes in public housing. The *Wall Street Journal* recently wrote of the enormous problems in public housing; the bureaucratized system of distressed PHAs, excessive staffs, and huge subsidies to the tune of $5 billion per year with little to show for the money. Bob Woodson has called it "the silent scandal" and issued a study of management abuses in public housing.

HUD is going to address these problems aggressively with some radical changes to create what we call "perestroika in public housing"—building on our HOPE program. The times we are looking at will help bring choice, competition, and competence into public housing.

Finally, I would be remiss is I didn't point out the good work which many are doing on the right and the left on pro-family tax policy. The National Commission on Children suggested a higher children's tax credit or exemption. Senator Bentsen has made a positive proposal on the children's tax credit. The Heritage Foundation, American Enterprise Institute, and the Progressive Policy Institute have all recommended variations of this idea. The Republican Platform has recommended higher exemptions for families for more than 8 years. But the principle is a sound one—allow families to keep more of their own income to raise children, to pay for health care, to pay for college education, and the need for government support will drop accordingly.

I've attached a chart on the family exemption demonstrating that the exemption would be worth over $7,000 today had it kept up with rates of inflation and income growth in the post World War II period. It seems to me that this is not only something which is important from a fairness standpoint, but by bolstering the family structure our nation's social and economic fabric would be strengthened.

Mr. Chairman, I also see positive signs that Congress is beginning to take seriously both the importance of stimulating growth and creating jobs and opportunity through improvements in the tax code. Members on both sides of the aisle from Phil Gramm, Bob Kasten, Lloyd Bentsen, and Pat Moynihan in the Senate, and from Newt Gingrich and Vin Weber to Tom Downey and Charlie Rangel in the House have introduced tax cutting bills that deserve serious attention.

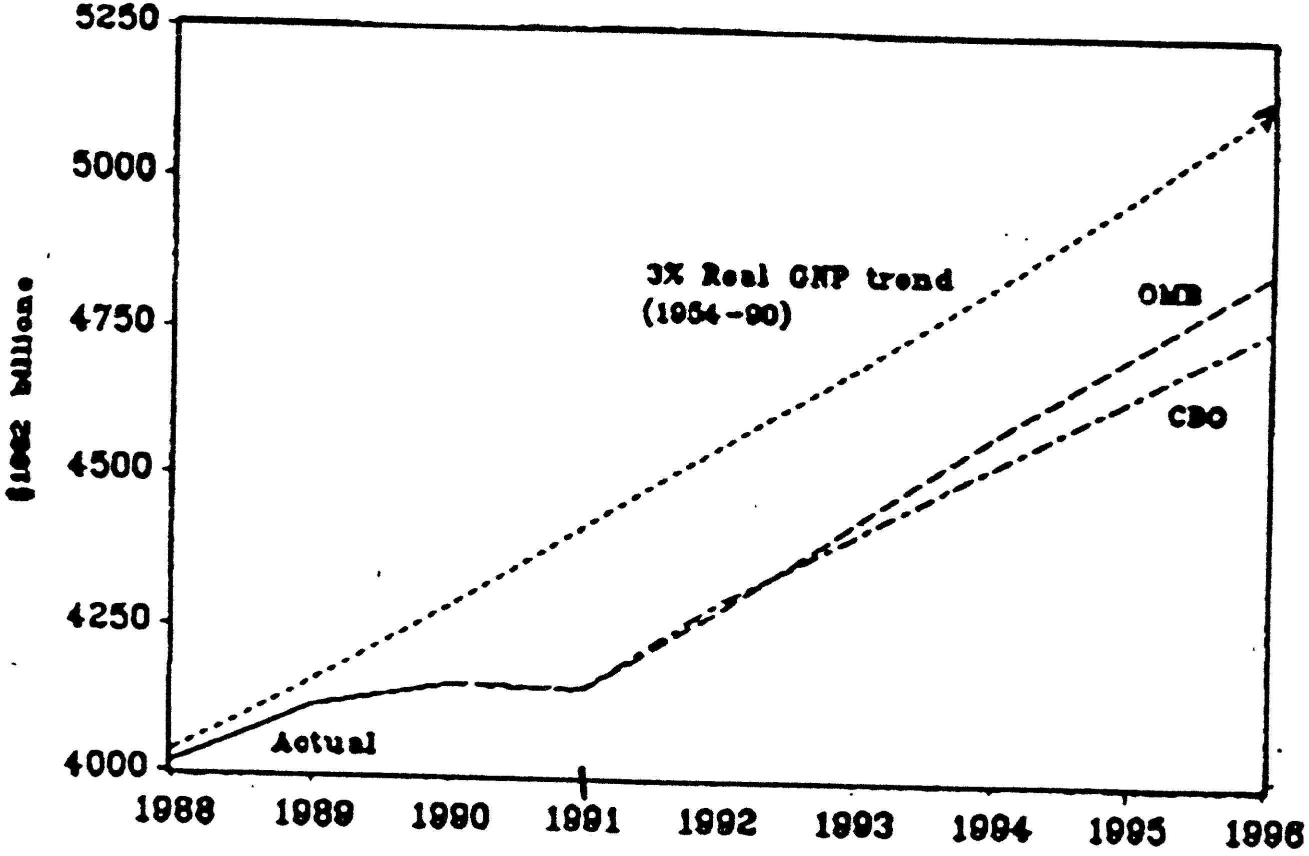
Just as important, however, is the fact that members on a bipartisan basis are beginning to question the ability of the current welfare system to encourage initiative and reward work and responsibility. I want to commend Vin Weber and members of the House Wednesday Group for examining this issue in depth. But I want to give special mention to a Democratic Congressman from the Mississippi Delta, Mike Espy, who happens to be a rising young leader in the Black Caucus. He has made a particular commitment to providing incentives for the accumulation of assets as the route to opportunity and economic independence. I mention Mike Espy not just because he led a group of 66 House Democrats who supported increased HOPE funding, but because he speak from the heart about a wide range of new approaches—like microenterprises and self-employment—to helping those who are poor, because the old ways simply don't work.

The Congressman said recently: ". . . it's time we adopted policies which help the poor move from dependency—to independence. It's time we adopted programs which help them move from subsistence—to self-sufficiency. It's time we stopped merely giving people fish, and taught them how to fish, and helped them get a rod and a reel." He went on to say that he learned as a child growing up in the Mississippi Delta that he who controls your home, controls your life.

Let me make it clear that one does not judge success in fighting poverty by the number of people we are able to assist, but by the number that have moved out of poverty—those who have access to housing and homeownership, jobs and opportunity. The premise behind Enterprise Zones, HOPE, capital gains tax reduction and the whole range of "empowerment strategies is that where life liberty and the pursuit of happiness are concerned, all Americans—rich and poor—are equally endowed to be architects of their own self-creation. We have a moral and political obligation to use democratic capitalism to fight poverty, and we can win that war.

I know there is a debate over the timing of new tax and economic growth initiatives. In my view—and I am speaking for myself as chairman of the President's Economic Empowerment and Opportunity Task Force, as Secretary of HUD and as a former colleague of yours who is deeply concerned about increases in unemployment and poverty, the decline in the value of residential and commercial real estate values, the slowdown in housing starts and the dramatic rise in barriers to affordable housing—the hour is late. I urge the Congress to move expeditiously to put jobs, growth, hope and equality of opportunity back into our national economy and to engage in radical perestroika of our inner city welfare economy. I pledge the cooperation of every member of this Administration to work with you to that end.

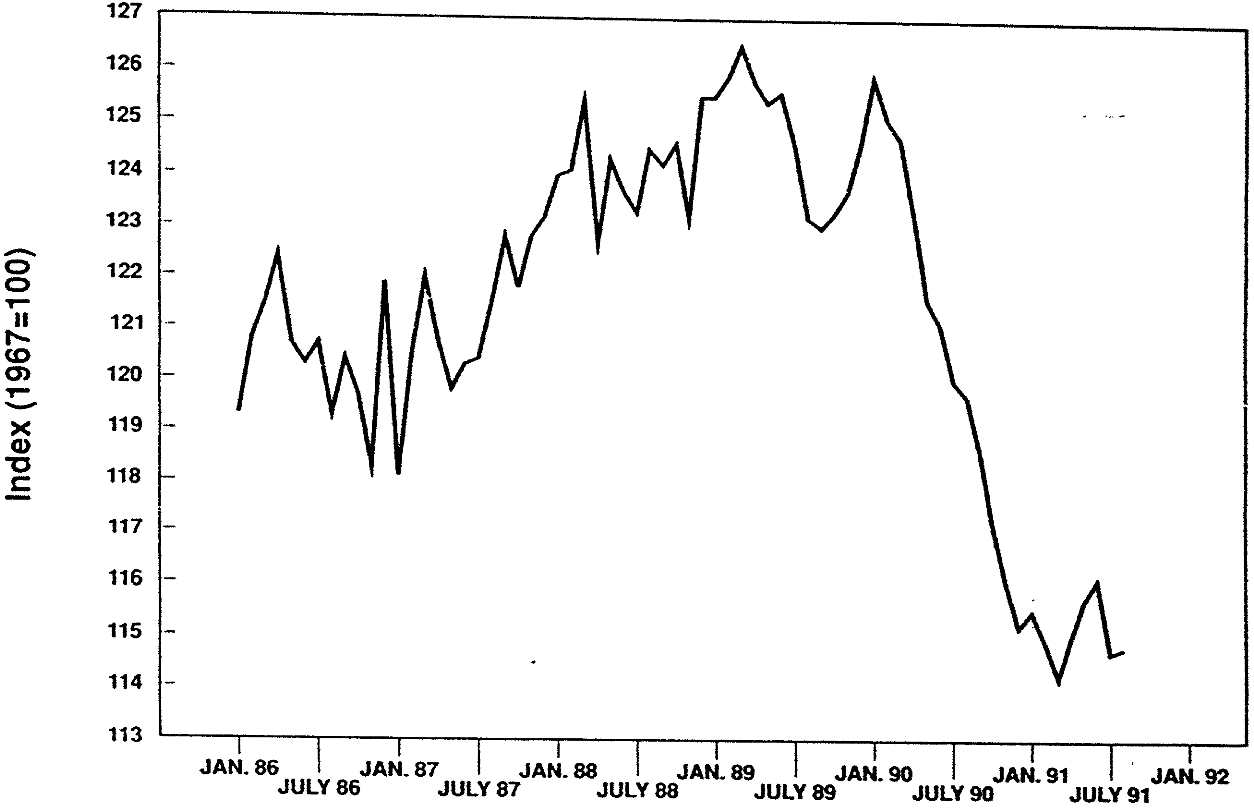
REAL GNP, TREND & OMB/CBO PROJECTIONS



Source: Bear Stearns

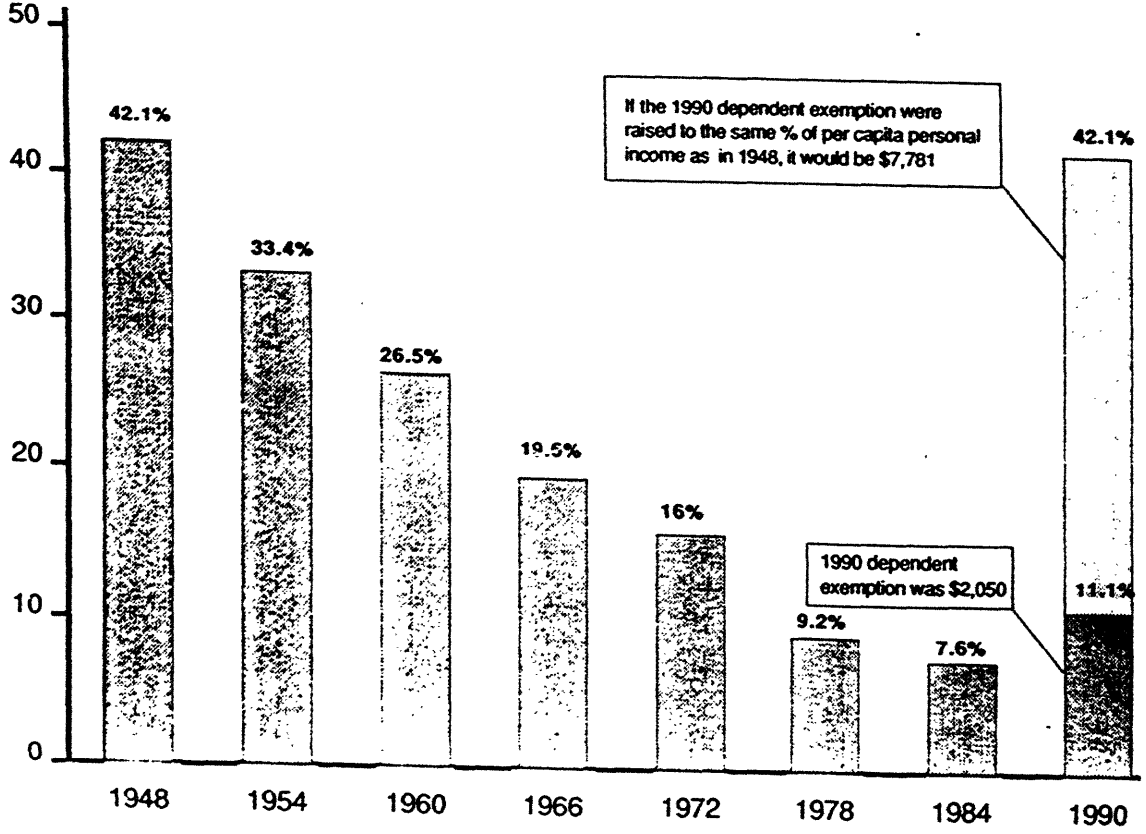
Index of Net Business Formation

Monthly



Source: Bureau of Economic Analysis

Dependent Exemption as a Percent of Per Capita Personal Income, 1948-1990



If the 1990 dependent exemption were raised to the same % of per capita personal income as in 1948, it would be $7,781

1990 dependent exemption was $2,050

Source: Urban Institute

PREPARED STATEMENT OF ANDREW KOHUT

Today my testimony will describe the so called "Middle class financial crunch" as it is revealed through nationwide opinion surveys conducted by the Times Mirror Center for the People and the Press—of which I am the Director of Surveys.

In 1987 the Times Mirror company began a program of nationwide surveys designed to monitor the political, social and economic values of the American public. Benchmark measures were established so as to be able to observe changes in the basic public attitudes, values and dispositions that underlie political choices and policy attitudes. Since its inception, the program has been extremely useful in identifying shifts in the public's mood and changes in its condition over the past four years.

During this period we have found a consistency of change in two areas: a steady increase in the level of financial pressure experienced by the average citizen and a rising tide of disenchantment with the political and economic system. My remarks today will concentrate on economic and financial pressures that people report to us, but obviously it is hard to discuss this fully without touching on the impact it is having on the public's trust and confidence in political and financial institutions.

Today, the American public describes its economic condition quite differently than it did in the Spring of 1987, when the first Times Mirror public opinion soundings were made. Although the stock market crash had occurred only months earlier, a 48% to 20% plurality of Americans said they were better off, not worse off than five years ago. A 63% majority described themselves as pretty well satisfied with their personal finances, and only 43% said they often did not have enough money to make ends meet.

This is not to say that the public was unaffected by the stock market crash or that people were unaware of major economic problems that beset the country. Indeed, surveys in the late 1980s underscored the extent to which people's assessments of their own financial situation were far more optimistic than the appraisals the public made about the national economy. For example, in late January of 1989 as the Bush administration began, only 25% expected that financial conditions in the country would be better next year, yet as many as 54% expected their own personal financial situation to improve over the course of the next year.

In light of the attitudes that people expressed at that time about the seriousness of the budget deficit, the S&L Crisis and economic competitiveness, we described the public's undaunted personal financial optimism as representing a "don't worry be happy" attitude. We wrote at the time that six years of recovery seemed to be having an almost anesthetizing effect on public opinion. Feelings about the deficit, our trade problems, the growing crisis in the banking industry seemed to have little effect on the public's mood or disposition to deal with these problems.

But that was then, and this is now, and today people are both unhappy and worried. In each of our annual surveys we have found somewhat more evidence of increased financial pressure.

- The percentage of people saying they are satisfied with their finances fell from 63% in 1987, to 58% in 1990, and then to 56% in our most recent survey.
- The percentage of people saying they often don't have enough money to make ends meet rose from 43% in 1987 to 47% in 1990 to 51% in the current survey.

In response to a frequently posed bottom line question, we found more people saying that compared to four years ago, they are worse off financially now (43%), than say they are better off today (40%). In turn, the percentage of people who say they are satisfied with the way things are going in the country has fallen to 34%. This fundamental indicator of public confidence in the state of the nation had not been this low since pre-Reagan economic recovery days.

Clearly, people in all demographic groups have been affected by worsening economic conditions over the past four years. However, people in middle income and lower income categories show larger increases in financial pressure than do more affluent people. For example, only 22% of people in the highest income quintile in our survey (those with annual family incomes of $50,000 or more) said they often don't have enough money to make ends meet. Four years ago that figure was almost identical (20%) among a comparable slice of the public.

In contrast, among middle and lower income groups the percentage saying they often don't have enough money to make ends meet rose from 49% in 1987, to 59% in 1991. Similarly, the decline in feeling satisfied with one's personal financial situation between 1987 and 1990 is more apparent among poorer people and middle income people than it is among affluent Americans.

I might add that the term middle income crunch is a bit of a misnomer. People in the lowest income categories are being crunched to a considerably greater degree than middle income people. While 53% of people earning between $15,000 and

$49,999 annually say they often don't have enough money to make ends meet, no fewer than 77% of people who earn less say they often can't make ends meet.

Our trend analysis also shows that although blacks continue to rate their own financial situation far worse than do whites, dissatisfaction with one's financial position has grown more among whites than among blacks. In 1987, 39% of blacks said they were satisfied with their finances, compared to an almost identical 38% in the current survey. Among whites the percentage satisfied fell from 67% to 59% over the four year period.

These differences notwithstanding, the vast majority of Americans in all income and racial groups focus on economic or financial issues, when we ask the public to cite the most important problems facing them in their own lives. The basic problem of making ends meet is cited by 25%; 18% mention the condition of the economy or the recession; 13% mention jobs and unemployment, specifically. Significant percentages also mention the cost of healthcare (6%) and taxes (8%). A net total of 65% mention some economic problem or issue in response to this question.

When the question is asked in terms of priorities for the President, the public answers are of the same tone. Times Mirror's respondents most often said that reducing unemployment should be the President's top priority (25%), followed by improving the quality of education (22%), improving healthcare (18%) and reforming the US banking and financial industry (12%).

As you might imagine, the fear of unemployment reaches many more people than are actually unemployed at the present time. Five percent of our November sampling said that someone in their household was currently unemployed, but another 27% said there was a "high" chance that within the next year some in the household would lose their job. Among people with family income of under $20,000, 8% reported someone out of work. However, as many as 35% were fearful of unemployment within the next year. By way of comparison, this percentage was 21% among people from households with annual family income of $50,000 or more.

As difficult a problem as unemployment is for the country and for many Americans personally, a 52% majority said they worry more about rising prices than the chances of unemployment (39%). When we ask people about the costs that they find most difficult to afford, three concerns predominate: healthcare, housing and higher education. Thirty-one percent say that the cost of healthcare is most burdensome to them, 19% cite housing and 18% the costs of a college education. There is a clear generational difference in emphasis between the three. Among people over fifty concern for health care costs dominates, almost to the exclusion of the other two concerns. Among people under 30 years of age there is less concern about health care cost and much more concern about the cost of housing and paying for higher education. Middle age people divide their cost concerns about equally between housing, health care and higher education.

People with incomes of less than $30,000 cite the cost of healthcare as more burdensome than do affluent people. On the other hand, people earning $30,000 or more per year more often report difficulty affording the costs of higher education, while people earning less than $20,000 are much more likely than others to say they have trouble affording food, clothing and other expenses.

Not too surprisingly in light of these concerns and trends, our survey found the public voicing a strong desire that the government take a more activist role in dealing with the problems they face. A lopsided 61% majority favor using the peace dividend for spending on major domestic problems such as health, education and the environment, rather than using it to reduce the deficit (27%) or for a tax cut (10%).

Over eight in ten (84%) agree with the statement that the government should play a more active role in improving the health care, housing and education for middle income families. As many as 52% of the people questioned say they completely agree with that statement. The survey also finds an almost equal level of support for the idea that the government should play an active role in improving things for *lower income people*—88% totally agree and 53% completely agree with this idea.

As the level of financial pressure on Americans has increased feelings of futility and disenchantment with the system have grown. The percentage of people feeling that the government is really run for the benefit of the people was 57% in 1987. It slipped to 52% in 1990, and to 48% in our current poll. The percentage of people feeling that the rich get richer and the poor get poorer has risen from 74% to 80% during this period. More dramatically, the percentage of Americans who agree that hard work offers little guarantee of success was only 29% in 1987. It rose to 36% by 1990 and stands at 44% in 1991—a 15% point increase in four years.

We at the Times Mirror Center have a special perspective on the results of this question having asked it of 13,000 Europeans in survey that covered the largest countries of Western Europe and most former Soviet bloc countries. We were struck by the extent to which Americans were distinguished from Europeans, both East and West, in feelings about the value of hard work and other indicators of personal empowerment. In Russia and in most Eastern European countries large majorities of dispirited publics feel that hard work does not lead to success. However, even in Western Europe the British, French and German publics did not match Americans in the extent to which this public feels that hard work does pay off. Obviously, the margin between Americ~an and European attitudes has been significantly reduced given the growing discontent that we have observed.

Appended is a copy of the results of the survey described.

APPENDIX

Q. 5c What is the most important problem facing you in your life these days?

25	Finances/Money/Making ends meet
18	Economy/Recession
13	Jobs/Unemployment
8	Have no pressing problems
8	Taxes
6	Cost of health care/Insurance/Drugs

Q. 6 In general, are you satisfied or dissatisfied with the way things are going in the U.S. at this time?

		May 1990	Jan. 1989	Oct 1988	May 1988	Jan. 1988
34	Satisfied	41	45	56	41	39
61	Dissatisfied	54	50	40	54	55
5	Don't know	5	5	4	5	6
100		100	100	100	100	100

Q. 6a As I read from a list, tell me which ONE of the following eight items is the most important thing for the President to do in the future?

Q. 6b Which should be the President's second highest priority? (REREAD LIST)

Reduce unemployment

25	Highest
20	Second

Improve the quality of education

22	Highest
16	Second

Improve healthcare

18	Highest
20	Second

Reform the U.S. banking and financial industry

12	Highest
14	Second

* Only the top 4 answers are shown.

Q. 7 Thinking about your own situation, compared to four years ago, would you say that you are better off financially today or worse off financially today?

		May 1987 [1]
40	Better off	48
43	Worse off	20
16	Same (VOL)	31
1	Don't know (VOL)	1
100		100

[1] In 1987 the questioned was asked, "Compared to five years ago, would you say you are better off financially, worse off financially, or about the same?"

Q. 8 Now looking ahead, do you expect that at this time next year you will be financially better off than now, or worse off than now?

		May 1990	Jan. 1989	May 1988	Jan. 1988
49	Better	44	54	54	48

		May 1990	Jan. 1989	May 1988	Jan. 1988
26	Worse	24	15	10	18
17	Same (VOL)	27	28	31	30
8	Don't know (VOL)	5	3	5	6
100		100	100	100	100

Q. 8a What do you personally worry about more—that prices will go up, or that you or a family member will become unemployed?

52	Prices
39	Unemployment
7	Neither (VOL)
2	Don't know (VOL)
100	

Q. 9 Do you think the chances are high, low or almost zero that some time in the next 12 months an adult in your family will be out of work and actively looking for a job?

27	High
28	Low
30	Almost zero
5	Someone out of work now (VOL)
6	Retired (VOL)
4	Don't know/No answer
100	

Q. 10 Which one of the following do you have the most difficulty affording?

19	The cost of housing
9	The cost of an automobile
11	The cost of food, clothing and other regular expenses
31	The cost of health care
7	The cost of retirement or,
18	The cost of a college education
4	None (VOL)
1	Don't know (VOL)
100	

Q. 12 I am going to read some statements that candidates may be making next year in the election campaign. For each statement tell me whether you completely agree with it, mostly agree with it, mostly disagree with it or completely disagree with it. The first one is . . .

	Completely Agree	Mostly Agree	Mostly Disagree	Completely Disagree	Don't Know
FORM 1					
h. Government should play an active role in improving healthcare, housing and education for middle income families	52	32	10	4	2=100
FORM 2					
h. Government should play an active role in improving healthcare, housing and education for lower income families	53	35	7	4	1=100

Q. 15 If it turns out that less money will be spent on defense than in the past because of reduced tensions between the U.S. and the Soviet Union, which ONE of the following should we do with the money we save on defense? (READ LIST)

10	Use it for a tax cut
27	Use it to reduce the budget deficit, or

61 Use it for increased spending on domestic programs such as health, education and the environment
2 Don't know

SURVEY METHODOLOGY

The survey results are based on telephone interviews conducted among a nationally representative sample of 2,020 adults, 18 years of age or older, during the period of October 31–November 10, 1991. For results based on the total sample, one can say with 95% confidence that the error attributable to sampling and other random effects is plus or minus 2 percentage points.

	1987	1990	1991
The government is really run for the benefit of all the people			
Agree	57	52	48
Disagree	39	45	50
Don't know	4	3	2
Total	100	100	100
Hard work offers little guarantee of success			
Agree	29	36	44
Disagree	68	63	54
Don't know	3	1	2
Total	100	100	100
It's true that the rich get richer and the poor get poorer			
Agree	74	78	80
Disagree	22	19	18
Don't know	4	3	2
Total	100	100	100
I often don't have enough money to make ends meet			
Agree	43	47	51
Disagree	55	52	48
Don't know	2	1	1
Total	100	100	100
I'm pretty well satisfied with the way things are going for me financially			
Agree	63	58	56
Disagree	35	41	42
Don't know	2	1	2
Total	100	100	100

Prepared Statement of Senator Carl Levin

Mr. Chairman: The various proposals which have been offered to cut taxes as a means of stimulating the economy share a common flaw that could prove detrimental both to getting us out of the current recession and to achieving long term economic growth.

My message to the Committee is simple: What Washington—the President and the Congress—must focus on is legislation which will foster confidence in our economic future. That is not synonymous with enacting tax cuts. Putting most, or even all, of our eggs in the tax cut basket may not hatch a recovery over the next few months and could leave our economy fragile and cracked for years to come.

If, to avoid creating a net increase in the budget deficit, proposed tax cut packages also include other tax increases or spending cuts, which could otherwise be used to reduce the deficit, then these tax cuts will make it more difficult to achieve the deficit reduction that is essential to getting our fiscal house in order. We have already made that mistake once. Let's not do it again. In the 1986 Tax Reform Act, the opportunity for deficit reduction was sacrificed to the desire to cut taxes for some people and to streamline the tax code. Putting aside whether the 1986 Act was successful on its own terms (and, I do not think that it was), today's even larger deficits make it even more ill-advised to follow that course of action again. The steady determination to deal with our debt ridden economic weakness will go far more in the direction of revitalizing the American economy and reinvigorating the American consumer than will the offer of tax cuts. Those tax cuts would add relatively little to the purchasing power of an individual, but would add to the public's sense of drift and politics as usual in Washington.

I am not saying that balancing the budget in a time of recession is the answer to our present difficulties—difficulties which are no more apparent anywhere else in the country than in my home state of Michigan, where unemployment is nearing 10%. However, taking a few, firm steps to bring our budgetary situation under control will send out the signal that the federal government, both as an example and as a major economic force, recognizes that the huge deficits of the 1980's are unsustainable and must be corrected. Deficit reduction measures would also send important messages to the financial markets and the Federal Reserve Board that interest rates could be lowered without running the risk of igniting inflation.

I am concerned that a $300 per family tax cut would increase the deficit while not significantly altering the spending patterns of someone who is afraid on a personal level that unemployment and not prosperity is just around the corner. People who are afraid of losing their jobs are not going to take on the commitment of a car loan or a home mortgage just because a small tax cut has made it a little bit easier to make the downpayment. To the contrary, a tax cut—or even, as we saw a few weeks ago, just the talk of a tax cut—could send a shiver through the financial markets and result in an upward spike in interest rates.

The President and the Congress are presented with a dilemma. But, this dilemma could also be an opportunity. The public is rightfully upset with the economic news it sees on television and with the economic reality it experiences every day. When confronted with this situation, no one wants to take a "wait and see attitude." I certainly do not. I believe that action is necessary. But, the action we must take is to restore confidence. That will truly make the federal government an agent of recovery, both from the current recession and from the more profound economic doldrums into which we have fallen. I believe that such action calls not for focusing on tax cuts, but on finally getting serious about deficit reduction. Action to get our own economic house in order would do more to stimulate confidence and end the recession than would a politics as usual tax cut.

PREPARED STATEMENT OF WILLIAM R. MATTOX, JR.

Mr. Chairman, I want to thank you for the opportunity to address your committee today about the need for tax relief targeted to middle-income families with children. Today's hearing attests to the leadership you have provided in promoting pro-child tax relief. sincerely hope that the discussions here today will lead to the adoption of a major tax bill designed to strengthen the economic health and autonomy of middle-income families with children.

Mr. Chairman, just about everyone these days seems to have a plan designed to offer middle-income tax relief of one kind or another. While the Family Research Council is encouraged by the growing interest in pro-family tax relief, we recognize that all middle-income tax relief plans are not created equal. Thus, as the committee continues its consideration of legislation designed to reduce the tax burden of middle-income taxpayers, we urge you to give your greatest attention to these four objectives:

1. *Focus on the Family.* The sluggish performance of the American economy in recent months has generated considerable public attention and concern. This attention and concern are well founded: many Americans have lost their jobs, and many others are having trouble making ends meet.

Lest anyone be mistaken, however, America is facing more than just an economic recession. For at least the last 25 years, our nation has been mired in a "family recession," and the steady decline in family stability and well-being means that many children have lost their fathers and many others are lacking a healthy home life.

Even if the "family recession" had no bearing on the serious social and economic problems facing our country, it would be right and appropriate for public policymakers to seek to shore up the economic autonomy of families with children through tax cuts targeted to parents. Families, after all, face a federal tax burden that is unusually high by historical standards. In 1948, for example, federal income and payroll taxes claimed just two percent of the annual earnings of a median-income family of four. Today, federal taxes siphon 24 percent of a median family's annual income.

Since the "family recession" is directly and inextricably linked (both as a cause and an effect) to the current social and economic problems facing our nation, it is all the more important that any tax cuts adopted in this Congress give serious attention to the needs of families with children. Neglecting such concerns in a headlong pursuit of some economic "quick fix" could prove to be penny wise, but pound foolish. Indeed, the long-term health of our economy and our society depend greatly on a dramatic upswing in our nation's leading family indicators.

To be sure, pro-family tax cuts alone cannot pull our nation out of its family recession. Economic pressure is but one dimension of the current family problem; other aspects—particularly those which are moral or cultural in nature—are at least as important. But pro-family tax cuts are nevertheless very significant because such relief would allow parents to regain some of the economic independence and autonomy that have been lost in recent years to other institutions, including the state. Put another way, pro-family tax relief would help empower families to carry out those vital functions—such as the rearing of children—which they are uniquely equipped to perform.

Thus, pro-family tax relief should be the centerpiece of any middle-income tax relief plan. It should be the engine driving tax reform. Accordingly, Senators should:

- favor plans which tie tax relief to the presence and number of children over those (such as the Rostenkowski adults-only income tax credit bill and the Moynihan payroll tax cut bill) which treat families with children no differently than yuppies with poodles;
- adopt changes in the Earned Income Tax Credit which would eliminate the tax code's current bias against low-income married couples with children;
- expand the current Young Child Tax Credit (as Senator Grassley has proposed) to address, among other things, the tax code's "parenting penalty;" and
- make certain that increases in pro-child tax benefits take effect immediately (rather than after the economy grows a certain amount, as Gramm and Gingrich have proposed) and that cuts are permanent (not scheduled to expire in two years, as the Rostenkowski bill has proposed).

2. *Don't Scrimp on Children.* The fact that so many recent tax bills include provisions designed to reduce the tax burden on families with children attests to the growing consensus among conservatives and liberals, Democrats and Republicans, that middle-income parents are overtaxed. While there is reason to be encouraged by this growing consensus, there is reason to be concerned that most of the major proposals that have been advanced thus far fail to grasp the severity of the problem.

Eugene Steuerle, a former Reagan Treasury official who now serves as a fellow at the Urban Institute, has calculated that if the tax exemption for children had been properly adjusted since 1948, the exemption would now be $8,200 rather than $2,150. This means that if Congress were to provide a median-income family today the same per-child tax benefits offered in 1948, the current tax exemption would need to be quadrupled or a new tax credit worth nearly $1,000 per child would need to be created. None of the proposals currently before the Congress offers such relief. Most do not even come close.

Thus, as the pro-child tax relief agenda moves forward, more ambitious proposals need to emerge. Sure, Ebenezer Scrooge would object to a new $1,000 tax credit for children—but America's overtaxed families certainly would not.

3. *Limit Tax Relief to Taxpayers.* Curiously, several prominent proposals promising "middle-income tax relief" (including the Rockefeller and Gore-Downey plans) make little or no distinction between welfare recipients and taxpayers with children. They offer refundable tax credits to all families, including low-income, child-present households where the household head is not married, gainfully employed, or receiving child support.

There is reason to believe this provision of "free money" (cash transfer payments unrelated to one's marital or employment status) does passive harm to middle-income taxpayers who must pay higher taxes to subsidize out-of-wedlock childbearing. Moreover, there is reason to believe this "free money" does active harm to those individuals who "benefit" from a system which seems unconcerned about whether children are born in wedlock or whether household heads are attempting to become economically self-sufficient.

Even if one believes greater cash assistance to welfare recipients is warranted, it is disingenuous to use the banner of "middle-income tax relief" to secure this result. Not only is a "bait-and-switch" strategy of this kind dishonest, but it threatens to sabotage legitimate efforts to reduce the tax burden of families with children.

Limiting tax relief to taxpayers is good policy and honest politics. Within the context of the current debate, Senators should steer clear of any refundable tax credit for children that extends assistance to families beyond their current income and payroll tax liability.

4. *Don't Hold Pro-Child Tax Relief Hostage.* The growing consensus on pro-child tax relief suggests that legislation in this Congress is indeed possible. (A pro-family tax bill offered by Congressman Frank Wolf, for example, has garnered more than 250 House cosponsors, including more than 100 Members from each party.)

Unfortunately, the debate over tax relief for families often breaks down over sub-issues, such as how the revenue lost would be recouped or whether economic growth incentives (such as a cut in the capital gains tax or an expansion of Individual Retirement Accounts) should be included in the mix. Clearly, these are not insignificant questions. They deserve serious Congressional consideration.

There is a serious danger, however, that pro-child tax relief could be held hostage in the process, that the contentious debate and partisan posturing over sub-issues could prevent passage of a vigorous pro-family tax cut. While the Family Research Council has some strong opinions about how these sub-issues should be resolved—for example, we strongly support efforts to recoup lost revenues through restraints on domestic spending—we do not want differences on these sub-issues to kill passage of a pro-family tax bill. Accordingly, we urge the Congress to work through these differences and pass a pro-family tax bill providing at least $ 1,000 in per-child tax savings.

Mr. Chairman, I want to thank you once again for the opportunity to testify before your committee today. I am submitting for the record some supporting materials which outline our views on tax issues in greater detail, and would be happy to respond to any questions you or your colleagues might have for me at this time.

Attachment.

Spelling Relief: T-a-x C-u-t-s

COMMENTARY

Efforts to reduce the income tax burden faced by families with children got a big boost last week when the chairmen of the House and Senate tax-writing committees introduced separate bills designed to target relief to middle-income taxpayers.

The bills offered by Sen. Lloyd Bentsen (D-Texas) and Rep. Dan Rostenkowski (D-Ill.) give testimony to the groundswell of public support for pro-family tax relief set off earlier by Rep. Frank Wolf (R-Va.) and Sen. Dan Coats (R-Ind.). Wolf and Coats introduced legislation in March to double the tax exemption for children. More than 250 House members now support the Wolf-Coats measure.

In addition, the Bentsen and Rostenkowski bills increase the likelihood that some sort of middle-income tax relief will be adopted soon after Congress resumes business in January.

While the Bentsen and Rostenkowski plans bear a superficial resemblance to one another, the real drama lies in the details, which reflect stark differences in the way each approaches middle-income tax relief. The Bentsen plan is an unabashedly pro-family measure. It recognizes that families with children have borne a disproportionate share of income tax increases during the last four decades. Accordingly, it targets relief to parents through a new $300-per-child tax credit.

Much like the Wolf-Coats measure, the Bentsen plan would limit tax relief to taxpayers. It would not offer the new tax credit to welfare recipients who have no tax liability. In addition, Bentsen would not "soak the rich" to fund his tax plan. Instead, the $72 billion in revenue lost over five years would be recaptured through cost savings in defense and domestic spending programs.

Yuppies and poodles

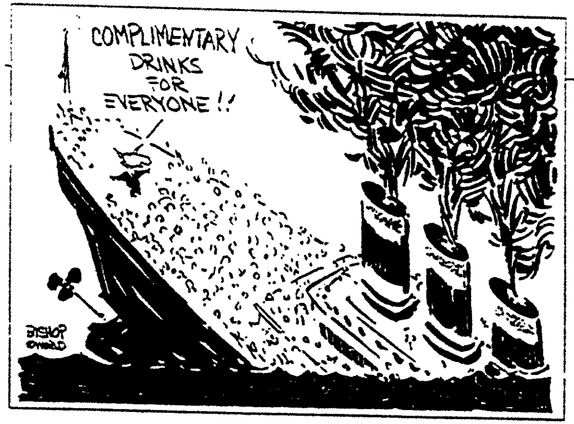
The Rostenkowski plan shows no similar appreciation for the principles that have guided most of the pro-family tax relief debate over the last year. For starters, the bill neglects children. It offers a new tax credit worth up to $200 per adult, but nothing per child.

As such, the Rostenkowski plan treats parents with children no differently from yuppies with poodles.

In addition, the Rostenkowski proposal offers "dime-store" tax relief. For a median-income family of four, it offers less relief than any other major proposal, falling as much as $954 below the tax savings proposed by the National Commission on Children earlier this year.

The Rostenkowski plan also offers only temporary relief. The new $200 per adult tax credit would be available for two years only. After 1993, the credit would cease to exist but the tax increases designed to pay for the credit would remain. It not only fails to cut excessive government spending in the short term, but it sets in motion a scheme that is likely to lead to more wasteful spending in the long term.

While Bentsen and Rostenkowski have touched off a new round of debate about tax relief for middle-income taxpayers, President Bush remains on the sidelines, concerned that tax cuts could jeopardize the future of the five-year budget accord reached with Congress last year.



Not only has the president failed to step into the pro-family tax cut arena, but he has also resisted pressure from some high-level Republicans—including housing secretary Jack Kemp, Georgia congressman Newt Gingrich, and Texas Sen. Phil Gramm—to push for an economic growth tax package designed to boost the economy.

If and when Bush decides to put forward a tax relief plan, it will be interesting to see whether pro-family tax relief measures constitute the plan's centerpiece or serve as a mere adornment. Pro-child tax relief is more popular politically than cutting the capital gains tax rate. Pro-family leaders believe insufficient attention to the need to target relief to parents with children will cost the president important votes, and will help perpetuate America's protracted "family recession."

Indeed, apart from the human suffering involved in family decline, the link between family breakdown and lower economic productivity causes many pro-family economists to wonder whether the nation's long-term economic problems can be addressed absent significant attention to strengthening families with children.

Should the administration squander this opportunity to champion a dramatic increase in pro-child tax benefits, it would not be easily overlooked. After all, the GOP has spent much of the Reagan-Bush years trumpeting the need for increased per-child benefits. A 1986 White House working group on the family advocated raising the tax exemption for children, a call echoed in the 1988 Republican Party platform.

As Congress moves closer to a showdown on tax cuts, Bush's credibility is clearly on the line.

Will President Bush remain on the sidelines? Will he pursue an economic growth package that largely ignores the family? Or will he stand and deliver a long-awaited—and long-overdue—increase in pro-child tax benefits? —WILLIAM R. MATTOX JR.

WORLD July 13, 1991

Children's Report Turning Washington Upside Down

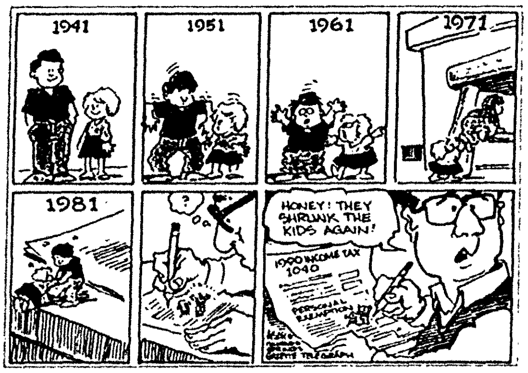
Strange things are happening in Washington these days. The world—or at least the debate on family issues—is upside down.

To understand the peculiar goings-on, one has to go back to 1988 when Congress passed legislation to create a National Commission on Children. At the time, most observers did not believe a bipartisan ad hoc commission would be able to produce a consensus document that would bridge the deep divisions on family policy that have separated liberals and conservatives for years.

But last month, the commission defied skeptics and produced a document that won unanimous approval frcm conservative and liberal commissioners even though it challenged some "politically correct" view of family life.

For example, the commission argued that children fare best when they are raised in a home with their father and mother. That may not seem like a big deal to most Americans, but it was no small achievement for the liberal-dominated commission, which drew two-thirds of its members from appointments by the congressional Democratic leadership.

Not only was the commission's stance on two-parent families antithetical to conventional liberal doctrine, but its most significant policy recommendation—a dramatic increase in pro-child tax benefits available to parents—was torn right out of the conservatives' playbook. Pro-family conservatives have long argued that federal taxes claim too much of the family dollar. During the Reagan administration, we succeeded in doubling the tax exemption for dependents, and a 1986 White House Working Group that I chaired called for further increased in pro-child tax benefits. (If the dependent tax exemption had kept pace with inflation since 1948, it would now be worth more than $8,200 instead of just $2,150.)



Accordingly, the 1988 Republican Party platform included a plank urging a dramatic increase in the dependent exemption, and George Bush's presidential campaign gave high-profile attention to his proposal to create a $1,000 tax credit for young children as an alternative to a liberal day care proposal that discriminated against families that care for their own children.

One might think the Bush White House would have reacted to the commission's call for pro-child tax relief by rejoicing that liberals had finally awakened and conceded a conservative truth· that high taxes on America's families have made it difficult for many parents to carry out their family responsibilities.

But these are strange days in Washington. Rather than trumpet the commission's proposed $1,000 tax credit, the Bush White House pooh-poohed the commission's plan, voicing concern that the federal government needed the money more than parents The response pleased green-eye-shaded GOP accountants and status-quo Rockefeller Republicans. But it outraged pro-family conservatives who have long suspected that pro-family rhetoric from this White House was mere lip service.

It also gave Democrats the opportunity to seize the "pro-family" and "anti-tax" mantles that Ronald Reagan used to bring many middle-class families into the GOP fold. Indeed, Sen. Jay Rockefeller (D-W. Va.), commission chairman, plans to make this one of the key themes of his 1992 presidential bid.

What's going on here? Lest anyone be mistaken, Sen. Rockefeller has not become a pro-family traditionalist. While the most significant elements of the commission's 700-page report are conservative, buried within it are a number of nostrums—like distributing condoms to unwed teens and increasing funds for government-run day care—which liberals hope to legitimate in this "consensus" document.

But Rockefeller's decision to embrace long-held conservative positions on pro-child tax relief, two-parent families, and parental choice in education reflects the fact that many Democrats are tired of losing the White House, and that they are increasingly convinced that the liberal "family" agenda lacks broad-based mainstream appeal. Rep. George Miller (D-Calif.) admits this in the May/June issue of *Mother Jones* magazine.

"I spent eight years getting the child-care bill passed in Congress, and at its zenith, there was never a child-care movement in the country," Miller said. "There was a coalition of child-advocacy groups, and a few large international unions that put up hundreds of thousands of dollars, and we created the mind of the leadership of the Congress that there was a child-care movement—but there was *nobody* riding me."

Apparently, Miller and company snookered more than the Democratic leadership in Congress. While Rockefeller was putting the finishing touches on his tax relief plan in June, President Bush was visiting a day care center in Atlanta to trumpet the administration's support for day care.

Apparently, the president's public relations staff has been paying more attention to liberal-media stories about day care than to reams of recent poll data which show that parents are unenthusiastic about leaving their children in day care and are increasingly concerned about the lack of time they have available for their children. For example, a recent survey by the Mass Mutual Insurance Co. found that Americans believe "parents having less time to spend with their families" is the single most significant reason for the family's decline in our society.

Apparently, these poll results have convinced some Democrats that it is time to change their tune

The Rockefeller Democrats' new music—and the Bush administration's cacophony on pro-child tax relief—have turned the family policy world upside down. Hold on to your hats, folks. If this is a foretaste of 1992 presidential politics, we could be in for a pretty wild ride.

—Gary L. Bauer

A PUBLICATION OF THE FAMILY RESEARCH COUNCIL

Family

Tax Fairness for Families

A New Call for Pro-Child Tax Relief

Politicians kiss babies. They give speeches about the importance of family values. They plaster photos of their well-scrubbed families on political campaign literature

But if the treatment of families with children in the U.S. tax code is any indication, our nation's elected officials have, at best, a passive indifference to children and, at worst, a *kinderfeindlichkeit* (German for "hostility to children").

The federal tax code is riddled with a variety of anti-family biases, inequities, and quirks. Some penalize rich kids. Others disadvantage poor kids. Almost all shortchange middle-income children, especially those with parents who strike a good balance between meeting work and family responsibilities.

As a consequence, it is possible for some couples earning $100,000 to receive $8 in child-based tax savings for every $1 claimed by some median-income families.[1] Likewise, it is possible for some low-income mothers with out-of-wedlock children to receive $5 in tax-related cash transfers for every $1 claimed by some median-income married couples with children.[2] (And this does not even take into consideration food stamps, AFDC, nutrition benefits, day care assistance, Pell grants, and other government services for the poor.)

Despite all of the talk these days about tax "fairness," official Washington has devoted little attention to five serious inequities in the tax treatment of families: (1) the bias against children; (2) the bias against middle-income families; (3) the bias against parental childrearing; (4) the bias against low-income, two-parent families; and (5) the bias against simplicity. Each of these problems bears closer examination.

The tax code today views children more as a consumption item than a socially beneficial private investment.

The Bias Against Children

You can get a bigger tax break for breeding racehorses than raising children, Rep. Patricia Schroeder is fond of saying.[3] And the clever-tongued chairwoman of the House Select Committee on Children, Youth & Families is right.

Indeed, from an historical perspective, the tax code today views children more as a consumption item (like, say, a speedboat, a Persian rug, or a case of Chardonnay) than a socially beneficial private investment (like, say, an Individual Retirement Account or the United Negro College Fund).[4]

For example, federal income and payroll (combined employer-employee) taxes in 1948 claimed just two percent of the annual income of a median-income family of four. Today, federal income and payroll taxes claim 24 percent of the annual income of a median-income family. In addition, state and local taxes, on average, siphon another eight cents from every family dollar.[5]

Moreover, the income tax burden on a median income family of four has risen 150 percent since the mid-1950s, while remaining fairly constant for childless couples and single taxpayers.[6]

The erosion in the value of the tax exemption for dependents is the primary reason for this dramatic increase. The dependent exemption is the tax code's chief mechanism for adjusting tax liability to account for differences in family size. It is the tax code's way of acknowledging that raising children is both socially desirable and expensive.

If the exemption shielded from taxation the same proportion of annual income in 1991 as it did in 1948, a median-income family today would be able to exempt approximately $8,000 per dependent child.[7] Instead, it can shield only $2,150.

While the growing tax bias against children can be seen in the failure of the dependent tax exemption to keep pace with wage and price inflation, the payroll (or Social Security) tax treatment of families with children offers yet another illustration of this bias. Under the current payroll tax, all employees pay the same rate, but not all taxpayers make an equal contribution to the Social Security system. The reason is quite simple. Social Security's survival depends on contributions of two kinds: (1) money to support today's retirees; and (2) children (future workers) to support tomorrow's retirees. Thus, individuals without children make a single contribution to the Social Security system while families with children make a double contribution.

Given the magnitude of the bias against children, it is difficult to justify yet another tax bill which places a higher priority on reducing tax rates than on increasing pro-child tax benefits.

Nevertheless, no adjustment is made in the payroll tax to recognize the double contribution of parents. As a result, some analysts like Allan Carlson of the Rockford Institute have pointed out that the Social Security system provides an incentive for young adults to eschew childrearing and "live it up" today on the money that might otherwise go to support children, knowing that upon retirement, they will be able to live off of Social Security and other old-age benefits financed by other people's children.[8]

The existing payroll tax bias against families with children should give pause to those attracted to proposals to reduce the FICA rate. Because such proposals do not differentiate between taxpayers with children and those without, across-the-board payroll tax cuts offer a childless, two-earner couple earning $100,000 a year *three times* the tax savings available to a median-income family of four.

Moreover, any tax package featuring as its centerpiece an across-the-board payroll tax rate cut merely echoes the tax cutting priorities found in the last two major tax reduction bills—the 1981 Reagan tax cuts and the 1986 tax reform act. While each of these bills modestly improved the tax treatment of families with children (the dependent exemption was indexed for inflation in 1981 and virtually doubled in 1986), both had as their central feature a reduction in marginal tax rates. Given this fact, and (especially) the magnitude of the bias against children, it is difficult to justify yet another tax bill which places a higher priority on reducing tax rates than on increasing pro-child tax benefits.

The Bias Against Middle-Income Children

Suppose four married couples—one low-income, one middle-income, one upper-middle income, and one upper-income—give birth to a child this year. When they go to file their taxes, each couple claims the $2,150 dependent tax exemption for their new child. Thus, each receives tax benefits of equal value. Right? Not exactly.

Family

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PUBLISHER
Gary L. Bauer

EDITOR
William R. Mattox, Jr.

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Family Research Council
700 Thirteenth Street, N.W.
Suite 500
Washington, D.C. 20005
(202) 393-2100

A tax exemption, like a tax deduction, is designed to reduce the amount of one's income subject to taxation. Since families with different incomes are taxed at different rates under a progressive income tax system, the actual value of a $2,150 exemption varies by tax bracket. Thus, a $2,150 exemption generates $667 in actual tax savings to upper-income families in the 31 percent tax bracket, $602 in tax savings to upper-middle-income families in the 28 percent tax bracket, and $323 to middle- and lower-income families in the 15 percent tax bracket.

High taxes on parents seriously undermine family autonomy, leaving many parents vulnerable to becoming dependent on government programs that supplant family functions and discourage economic self-sufficiency.

The fact that a tax exemption produces uneven tax savings depending on one's tax bracket would not be a terribly serious problem if, as in 1913 when the income tax was created, exemptions were high enough to free all but the wealthiest Americans from income tax liability entirely. Nor would it be a terribly serious problem if, as in 1948, high tax exemptions and low payroll rates left the average family with a modest overall tax burden.

The disparate impact of tax exemptions is now a serious problem because high taxes on parents—due to the erosion of the dependent exemption, the dramatic increase in the payroll tax, and the growth in state and local taxes—seriously undermine family autonomy, leaving many families vulnerable to becoming dependent on government programs (welfare, day care, etc.) that supplant family functions and discourage economic self-sufficiency.

To offset the disparity in tax benefits, Congress has, in recent years, provided tax benefits to low-income families with children through the Earned Income Tax Credit. These benefits, which in 1991 offer families as much as $1,600 for the first child, are limited to families with incomes below $22,000. Thus, a child born to a middle-income family has a significantly lower "tax value" than one born to richer or poorer parents.

The Bias Against Parental Childrearing

Crazy as it may seem, the tax code penalizes parents for spending time with their children by narrowly linking certain tax benefits to day care expenses. In fact, the Dependent Care Tax Credit (DCTC) and employer-provided Dependent Care Assistance Plans (DCAPs) are constructed in such a way that the more time a child spends in day care (and, therefore, the higher the family's day care expenses), the greater the tax benefits.

Although growing economic and cultural pressures make it difficult for some parents to spend as much time with children as they would like, tying tax benefits to day care expenses makes matters worse. It penalizes parents for seeking to maximize the amount of care they provide their children by redistributing income from families that make little or no use of paid day care to those who make extensive use of such services.

Not only does this "parenting penalty" adversely affect families with a non-employed mother at home, but it also shortchanges two-earner and single-parent families that seek to minimize their use of paid substitute care by working from home, working part-time, utilizing unpaid care by a relative, or staggering employment schedules so that at least one parent is at home to care for children.

Moreover, this bias against parental childrearing is especially egregious in view of the fact that day care users earning $100,000 a year can claim tax benefits worth up to $1,925 for one child, while non-users earning $25,000 a year receive no child care tax benefit. Zero.

Tying tax benefits to day care expenses is often justified as a means of recognizing that day care users have less "ability to pay" taxes since part of their income is absorbed by day care expenses.

This argument appears reasonable until one considers that it could be used to justify a tax break for just about any expense. A taxpayer who eats at restaurants or calls out to Domino's could argue that he has less "ability to pay" taxes than a family that prepares its own meals. Moreover, a taxpayer who pays someone to cut his grass could argue that he has less "ability to pay" than a family that mows its own lawn.

Indeed, *in extremis*, this reasoning could be used to justify tax breaks for people who hire housekeepers, butlers, gardeners, interior designers, and chauffeurs—since there are some people who perform these services for themselves.

Day care tax credit proponents are quick to point out, however, that day care costs are unlike other expenses, that day care is an employment-related expense that workers with children incur to produce income. According to this reasoning, tax breaks for day care are justified in the same way that tax breaks for other business-related expenses are justified.

A child born to a middle-income family has a significantly lower 'tax value' than one born to richer or poorer parents.

Whatever merit this argument might have is undermined by the fact that the Dependent Care Tax Credit permits taxpayers to write off between 20 and 30 percent of their day care expenses even though many recipients are in the 15 percent tax bracket. In other words, the DCTC is clearly designed to offer a cash subsidy rather than a tax deduction for employment-related expenses.

Moreover, day care tax breaks bear little resemblance to other tax-deductible employment expenses because they can be claimed by taxpayers who are not self-employed. If all employment-related expenses worked like day care, all wage earners would be entitled to generous tax write-offs for commuting costs, lunch bills, and ordinary business attire expenses. No such tax breaks currently exist, and the only apparent justification for creating such credits would be if some larger social goal were attained by favoring say, expensive commutes over walking or biking to work.

Likewise, linking tax benefits to day care expenses would be legitimate only if paid day care were indisputably better for young children than unpaid care by family members. But the current debate among child development experts is not over whether non-familial group day care has an overall positive effect on child development; it is instead over whether, or to what extent, day care has an overall negative effect on children's physical health, social development, and psychological well-being.

Accordingly, tax benefits which favor day care over parental care should be replaced by benefits available to all families with young children. This would make it more affordable for families to devote greater portions of their time to the important task of raising children and would recognize that there is great social benefit to private investments of parental time with children.

The Biás Against Low-Income, Two-Parent Families

Under current law, the wage supplement offered to low-income families with children through the Earned Income Tax Credit does not distinguish between married-couple and single-parent households. Consequently, a two-parent, one-child family receives no greater wage supplement than a one-parent, one-child family.

This policy fails to acknowledge the importance of promoting two-parent families. It fails to acknowledge the fact that children fare best when they have the opportunity to grow up in a two-parent home.

In addition, this policy fails to recognize that you get more of what you subsidize and less of what you tax. No doubt part of the reason for the increase in single-parent families in poverty in recent years is because current government policies facilitate divorce and out-of-wedlock childbearing. Likewise, the growing economic vulnerability of many intact, middle-income families with children is no doubt related, at least in part, to the growing tax burden faced by such families.

There is merit to offering wage supplements to low-income families with children, but these supplements should recognize that marriage fosters economic self-sufficiency. Indeed, 35 percent of those leaving AFDC do so because of marriage. This makes marriage the number one escape route from poverty and welfare dependency—a remarkable fact given current government disincentives to marry.[9]

Thus, "wedfare" policies which eliminate economic penalties for marriage among the poor are justifiable for both social and economic reasons.

The Bias Against Simplicity

Not only has the value of pro-child tax benefits eroded in recent years, but the increasing complexity of the tax code deters some families from claiming all of the tax benefits to which they are entitled. This is particularly true for low-income families, who often have a difficult time calculating their DCTC and EITC benefits.[10]

Moreover, several recent proposed increases in the dependent exemption have called for limiting increases in

A CLOSER LOOK

Five Principles to Guide Pro-Child Tax Relief

Just as there are five major anti-family inequities in the current tax code, there are five major principles that should guide pro-child tax relief efforts.

1. *Recognize the unique social value of children, by restoring to their 1948 value tax benefits keyed to the presence and number of children.*
2. *Recognize the worth and dignity of every child by providing to all families per child tax benefits of equal value which would be applied against federal income and payroll taxes.*
3. *Recognize the importance of parental time with children by replacing tax benefits narrowly linked to day care expenses with universal tax benefits available to all families with young children.*
4. *Recognize the superiority of two-parent families by structuring low-income family wage supplements to discourage divorce and illegitimacy.*
5. *Recognize the virtues of tax clarity and simplicity by distinguishing between tax benefits and wage-based cash transfers and by seeking to make pro-child tax mechanisms more "user friendly."*

the exemption to taxpayers in certain income ranges. While such income limitations are usually motivated by legitimate concerns about vertical equity, restricting exemption increases on the basis of income opens up a Pandora's Box that further threatens the exemption's elegant simplicity and near-universal reach.

In addition, income limitations—like the 1990 budget agreement's phase-out of the exemption for taxpayers with annual incomes above $150,000—pose a serious horizontal equity problem since a family of four at any given income level has higher basic living expenses (and, therefore, less ability to pay taxes) than a bachelor with an identical income.

Incremental Steps or Major Overhaul?

In addressing the five major anti-family biases in the tax code, Congress could expand the dependent exemption (to address the bias against children), move the EITC's Supplemental Young Child Tax Credit up the age and income scales (to address the biases against middle-income families, parental childrearing, and simplicity), and create a spousal EITC benefit (to address the bias against low-income, two-parent families). Congressman Frank Wolf and Senators Dan Coats and Charles Grassley have shown impressive leadership in spurring congressional consideration of such issues.

While there is tremendous merit to addressing existing tax inequities in an incremental fashion, there is also merit to exploring a complete overhaul of the income tax treatment of families with children that would consolidate all existing tax relief mechanisms directed to families with children (the dependent exemption, the Dependent Care Tax Credit, Dependent Care Assistance Plans, and the Earned Income Tax Credit) into a single tax credit.

The Family Research Council, in conjunction with the staff of the Heritage Foundation, has developed such a plan. Our proposal, the Tax Freedom for Families Plan, would offer a per-child tax credit worth $1800 for preschool children and $1200 for children ages 6 and up. This credit, which would be refundable up to the combined employer-employee level of the payroll tax, is superior to an across-the-board cut in the payroll tax because it targets assistance to the taxpayers that need help most—families with children. In fact, the Tax Freedom for Families Plan would increase pro-child tax benefits to a level roughly equivalent to that provided in 1948. Importantly, all taxpayers with children would receive these per-child benefits, regardless of income level or child care arrangement.

Tax benefits which favor day care over parental care should be replaced by benefits available to all families with young children.

In addition to this tax credit, the Family Tax Freedom Plan includes a Family Wage Supplement that works much like the existing EITC in that it offers cash benefits to low-income wage earners with children who have little or no income and payroll tax liability. This wage supplement would add up to 10 cents to every dollar earned for taxpayers with one child, an additional 5 cents on the dollar for families with two or more children, and an additional 5 cents on the dollar for two-parent families.

Thus, the Family Wage Supplement, unlike some child allowance plans, links cash benefits to responsible behavior (marriage, employment), thereby eliminating the existing bias against low-income two-parent families. It avoids the negative unintended consequences of a guaranteed minimum income plan, and separates tax relief mechanisms from wage supplement mechanisms. This is a significant advantage over the existing EITC which blurs the critical distinction between taxpaying families receiving tax benefits and non-taxpaying income-earners receiving wage-based cash assistance. Certainly, both groups are deserving of assistance, but both should not be treated the same. For example, limitations on family size (both the EITC and the proposed Family Wage Supplement currently cut off benefits after two children) are justifiable for cash transfer recipients who are not yet self-sufficient, but are inappropriate for low-income taxpaying families.

The Right Priorities

Obviously, providing incremental tax benefits to families with children would require a reassessment of existing budgetary priorities. Essentially, there are three options: (1) allow the lost revenue to add to the federal budget deficit; (2) offset the lost revenue with increased taxes; or (3) offset the lost revenue with reductions in the growth of federal spending.

Apart from being politically unrealistic, the first option is unappealing because deficit spending transfers societal economic obligations to future generations. Such transfers are economically unwise and morally disturbing—especially when one considers that some of the societal debt is being run up by those who forego childrearing and, therefore, leave the debt for other people's children to pay.

The second option is also unappealing because virtually all tax increases would hit at least some of the intended recipients of pro-child tax benefits. Thus, pro-child tax cuts financed by new tax increases would give with one hand and take away with the other.

The final option, cuts in federal spending—or at least reduc-

ET CETERA, ET CETERA

IRA Changes?

One other set of changes policymakers should consider making is to broaden the use of Individual Retirement Accounts (IRAs) so that taxpayers can make penalty-free withdrawals to cover major housing, education, and health expenses. Broadening the use of IRAs would be particularly helpful to families with children since their savings priorities often differ at various stages in the life cycle.

For many young and middle-aged families, saving to buy a home and to pay for their children's college education are higher priorities than saving for retirement. Moreover, at every stage in the life cycle, parents have less incentive than non-parents to save for retirement since parents know that if they become needy after retirement, they may be able to lean on their adult children for financial support.

While broadening the use of IRAs is attractive, broadening the eligibility of Individual Retirement Accounts is considerably less so—primarily because the beneficiaries of any such expansion would be upper-middle- and upper-income taxpayers. Given the need to target tax cuts primarily to middle-income families with children, the only expansion of IRA eligibility that policymakers should consider now is an expansion of the IRA benefits available to families with a non-employed spouse. Such couples can currently claim a maximum benefit of only $2,250 even though two-earner couples can claim up to $4,000. Leveling the playing field at $4,000 for all families would recognize the important contribution that non-employed spouses make to the income production of employed spouses—an acknowledgment commonly made in divorce settlements.

tions in the growth of federal spending—is clearly the most attractive, especially since allowing parents to keep more of the money they earn reduces the need for government services that replace family functions.

Wage supplements should recognize that marriage fosters self-sufficiency and that children fare best when they have the opportunity to grow up in a two-parent home.

Several spending reduction proposals are worthy of consideration. Limiting the growth in federal spending to five percent a year would generate an estimated $65 billion in annual budget savings—enough to cover the entire cost of the Tax Freedom for Families Plan outlined above.[11] Reducing government overhead expenses (travel, utilities, supplies, etc.) by ten percent would save an estimated $27 billion a year, enough to bump the universal tax credit thresholds up to $2,000 for preschool children and $1,500 for children age 6 and up. This additional relief would recognize that the cost of raising children has risen faster than the general inflation rate in recent years.[12]

It should be pointed out that since some families would use the increased buying power (gained through pro-child tax benefits) to purchase goods and services, tax relief targeted to parents could have a significant stimulative effect on the economy. This in no way suggests that pro-child tax relief is the most efficient means of fostering short-term economic growth. But stimulating the economy is not now and never should be the only objective of tax policy. While there is certainly reason to be concerned about several recent quarters of economic decline, there is even more reason to be concerned about a quarter-century of family decline. Just as policymakers should give attention to tax policies designed to help us out of our economic recession, they should give considerable attention to tax policies designed to help us out of our family recession.

Clearly, passage of a major pro-child tax relief bill should be a top priority for leaders in the Congress and the Administration. Tax fairness for families can and should unite Democrats and Republicans, liberals and conservatives, feminists and traditionalists.

Whether policymakers pursue an incremental strategy or a complete tax overhaul, a significant increase in pro-child tax benefits is long overdue.

Policymakers should give considerable attention to tax policies designed to help us out of our family recession.

Rather than concocting new ways to raid the family pocketbook, it is time for our nation's elected officials to find ways to let parents keep more of the money they earn and to let them make their own decisions about how best to balance their work and childrearing responsibilities. Fairer tax laws—and, more importantly, stronger families—are apt to be the result.

—*William R. Mattox, Jr.*

ENDNOTES

[1] *The 8 to 1 comparison is based on a married couple with a combined income of $100,000 in which one parent claims a $5,000 DCAP (salary reduction plan to cover day care expenses) through his/her employment. Combined with the $2,150 dependent exemption, this means the couple is able to shield $7,150 from income taxation and $5,000 from payroll taxation for their one child. This yields over $2,500 in tax savings, roughly eight times the tax savings available through the dependent exemption to a median income family with one child ($323).*

[2] *The 5 to 1 comparison is based on the fact that a low-income single mother with a young child can receive more than $1,600 in tax benefits through the Earned Income Tax Credit—roughly five times the amount available through the dependent exemption to a median-income family with one child ($323)*

[3] *Pat Schroeder, Champion of the Great American Family, (New York: Random House), 1989, p. 142.*

[4] *I am in no way suggesting that children have no greater intrinsic worth than IRAs. I am merely pointing out that children, like IRAs or charitable contributions, are a private investment that pays social dividends.*

[5] *Elaine Kamarck and William Galston, Putting Children First: A Progressive Family Policy for the 1990s, The Progressive Policy Institute, September 27, 1990.*

[6] *Robert Rector, "The Family Tax Freedom Plan," Backgrounder, The Heritage Foundation, May, 1991.*

[7] *Eugene Steuerle, Testimony before the Select Committee on Children, Youth and Families, U.S. House of Representatives, Washington, D.C., April 15, 1991.*

[8] *Allan Carlson, "The Time Bomb Within Social Security," Persuasion at Work, The Rockford Institute, September, 1985.*

[9] *Spencer Rich, "The Many Unknowns of Child Poverty," The Washington Post, March 5, 1991.*

[10] *Spencer Rich, "For Working Poor, a Tough Program to Figure," The Washington Post, August 14, 1990.*

[11] *Robert Rector, op cit.*

[12] *William R. Mattox, Jr. "The Parent Trap: So Many Bills, So Little Time," Policy Review, The Heritage Foundation, Winter, 1991.*

A FINAL WORD

Time is Money; Money is Time

The erosion in pro-child tax benefits has not only affected family pocketbooks, it has also affected family lifestyles. As federal taxes have risen, families with children have devoted more of their time to paid employment and less to raising children.

In fact, the amount of time parents spend with their children has dropped roughly 40 percent since 1965.[1] This decline is the source of significant public concern. According to a recent poll, Americans believe "parents having less time to spend with their families" is the single most important reason for the family's decline in our society.[2]

While increasing tax benefits keyed to the presence and number of children should be the primary focus of any effort to make the tax code more "family friendly," there is also reason to consider other tax changes that would help parents better meet their childrearing and income-producing responsibilities. For example, easing restrictions on the tax deductibility of home office expenses would make it easier for more parents to work for pay from home.

Two such restrictions need particular attention:

- **The Exclusive Use Rule.** Under current law, a taxpayer cannot write off home office expenses unless home office space is used exclusively for income-producing purposes. In other words, overhead expenses for a room that doubles as an office and a guest bedroom cannot be claimed. This stipulation is particularly burdensome to families with children because they have greater demands on household space than do, say, bachelors living at home.

As federal taxes have risen, families with children have devoted more of their time to paid employment and less to raising children.

- **The Employer's Convenience Rule.** Under current law, a home-based employee cannot write off home office expenses unless he or she works from home at the explicit convenience of his or her employer. This restriction denies benefits to individuals who work from home not so much for their employer's convenience but for their family's convenience.

In easing these restrictions, policymakers may want to consider waiving these requirements only for taxpayers with children. Such a provision would limit the lost-revenue impact of these changes and would acknowledge that the social benefits associated with home-based employment are greatest for taxpayers with children.

Of course, encouraging more home-based employment is not just good family policy. It is also good energy policy because it reduces gasoline consumption associated with commuting, good environmental policy since it decreases automotive air pollution, good transportation policy because it curbs the need for more roads and bridges, good foreign policy because it reduces our dependence on foreign oil, and good anti-crime policy since it deters daytime home burglaries.

[1] *William R. Mattox, Jr. "The Family Time Famine," Family Policy, The Family Research Council, Vol. 3, No. 1, 1990.*

[2] *MassMutal American Family Values Study, Mellman & Lazarus, Inc., Washington, D.C., October, 1989.*

Family Research Council
A Division of Focus on the Family

700 Thirteenth Street, N.W.
Suite 500
Washington, D.C. 20005

Alert

FAMILY
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Gary L. Bauer
President

THREE CHEERS FOR THE BENTSEN PRO-CHILD TAX CUT

If Senator Lloyd Bentsen (D-TX) has his way, the overtaxed American family may soon get some much-needed relief! The Senate Finance Committee Chairman recently unveiled a proposal which would allow taxpayers to subtract $300 from their federal income tax bill for each child in their family. This $300 per-child tax credit would reduce significantly the federal income tax liability of parents, thereby relieving families of some of the economic pressures they have been forced to shoulder in recent years.

The Bentsen plan deserves high marks for three reasons:

1. It focuses on the family. Unlike other tax-cutting initiatives currently under consideration, the centerpiece of the Bentsen plan is a sizeable increase in pro-child tax benefits. Since the most dramatic shift in tax policy during the last four decades has been the shift towards higher and higher taxes for families with children, this long-overdue focus on the family is most appropriate.

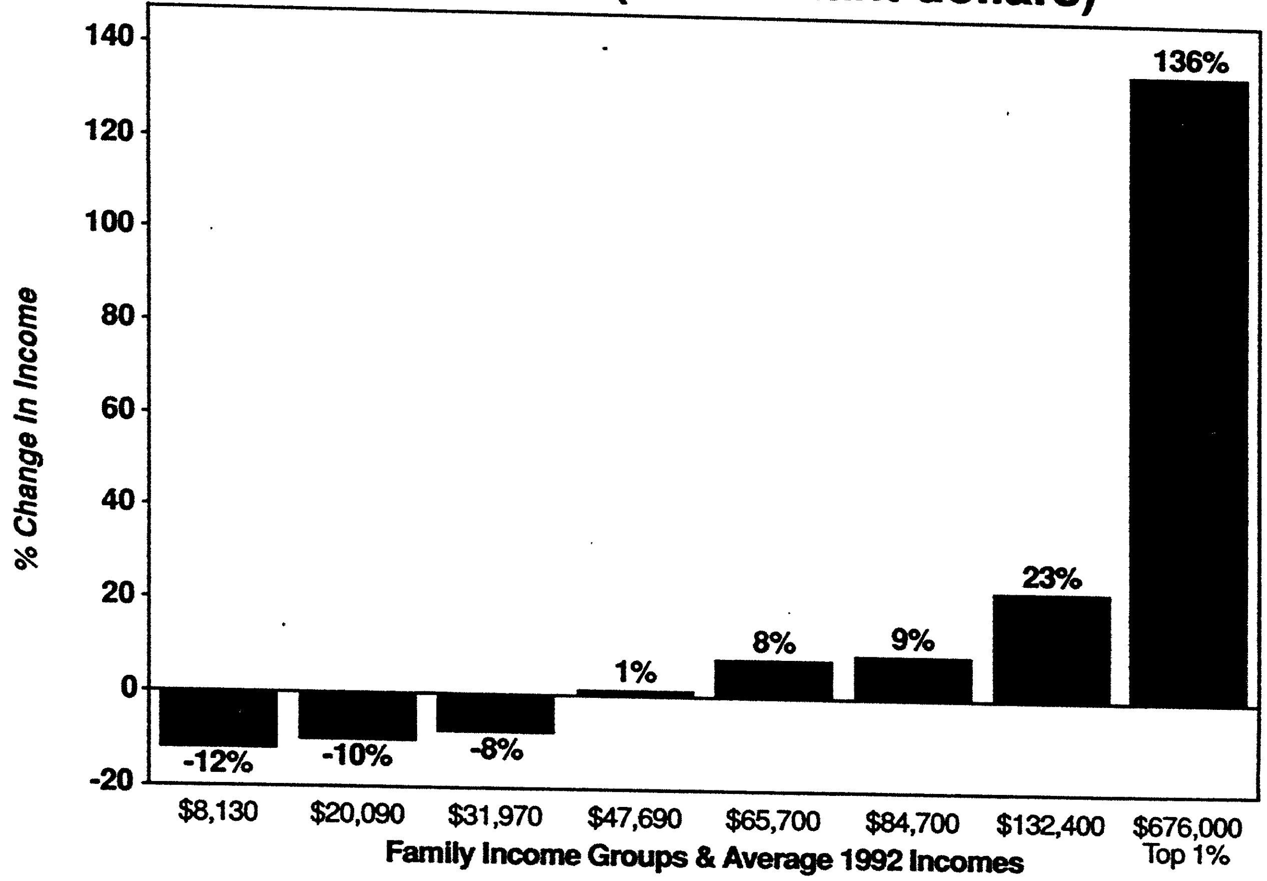
2. It remembers the middle class. Unlike other proposed tax credits for children, the Bentsen plan is not a bait-and-switch proposal designed to secure greater cash assistance for welfare recipients in the name of tax relief for middle-income taxpaying families. Since the credit is non-refundable, Bentsen offers *tax* relief only to *tax*-payers. This is good policy -- and honest politics.

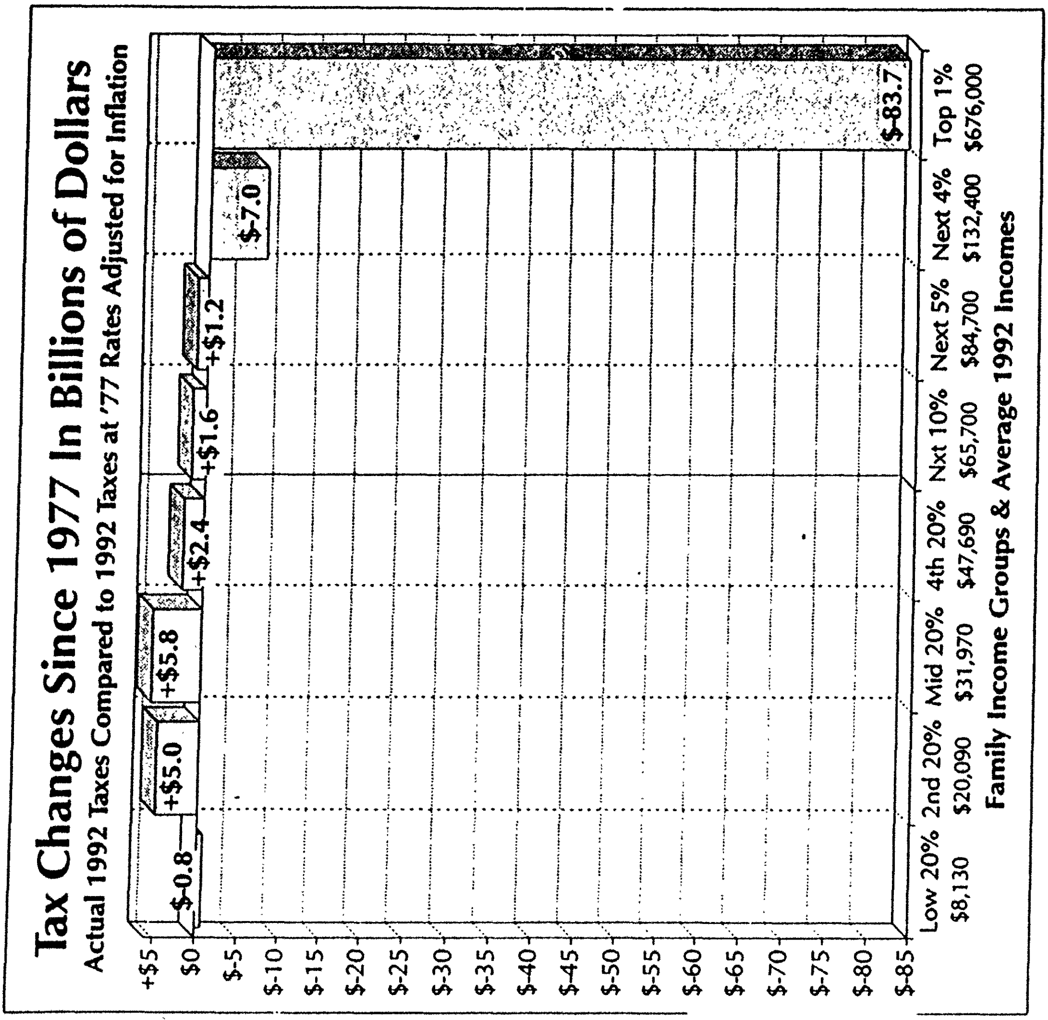
3. It does not rob Peter to pay Paul. Unlike schemes which raise taxes on some in order to lower them for others, the Bentsen plan uses the "Peace Dividend" to finance pro-child tax relief. As such, it recognizes that the most appropriate way to fund tax relief for families with children is by reducing the size of government.

America's overtaxed parents need relief. The Bentsen plan is an excellent first step towards easing the tax burden on families. It deserves bipartisan support.

700
Thirteenth St., NW
Suite 500
Washington, DC
20005
(202) 393-2100
FAX (202) 393-2134

% Changes in Average Family Incomes After Taxes from 1977 to 1992 (in constant dollars)





Prepared Statement of Senator Daniel Patrick Moynihan

In fiscal year 2000, the Social Security system will take in half-a-trillion dollars. It will need only two-thirds of this to pay benefits. The balance, $166 billion, will be invested in Treasury bonds to help to finance that year's budget deficit, estimated to be, under CBO baseline projections, $435 billion.

I believe that the public will think it a scandal if our fiscal policy and Social Security financing arrangements are allowed to get to that point. And rightly so. As with the savings and loan mess, voters will want to know who was asleep at the switch when the trend could and should have been corrected.

In this light, I find it rather startling to review our fiscal circumstances and some of the proposed tax measures. Basically, we have an overfunded Social Security system and a huge structural budget deficit. Proposals to cut income taxes would not change the immediate situation or the projected trends.

The Social Security surplus will be $63 billion this year. The amount of this yearly surplus will double in five years and triple in ten. These surpluses will add to an accumulated trust fund reserve that is already equal to a year's worth of benefits and is projected to reach the unimaginable sum of $8 trillion by the year 2025.

Meanwhile, in the general fund—that is, the federal budget exclusive of the Social Security trust funds—we have budget deficits even bigger than the Social Security surpluses. The general fund deficit will be $425 billion this year, ease down to $252 billion by 1996, and rise back to the current level before the end of the decade.

What to do? Logic would seem to dictate that the solution to this puzzle is to lower Social Security taxes and go back to work on general fund revenues and spending. But instead we hear proposals to, of all things, reduce general fund revenues—i.e., income taxes. Now consider, even if such tax cuts are financed with income tax increases on the rich, or reductions in general fund spending, the general fund deficit would remain the same. We would merely be back in the same position that we are in now—the same Social Security surpluses, the same general fund deficits.

I have proposed that we cut Social Security taxes and reduce the general fund deficit with defense and other spending cuts. This, it seems to me, has several advantages over other tax cut proposals.

First and foremost, it would reduce the size of the Social Security surpluses to what is needed to pay benefits and maintain a safe reserve of a year-and-a-half's worth of benefits. This would improve the integrity of both our Social Security finances and fiscal policy as we would no longer be relying on the Social Security tax to fund an increasingly larger part of the budget deficit.

Second, the spending cuts would alleviate the problem of the structural budget deficit, which is the gap between general fund revenues and general fund outlays. This sounds so simple that I am almost embarrassed to say it. Yet it bears repeating that proposals to finance income tax cuts with spending cuts would not improve the structural budget deficit, but only leave it the same.

Third, a reduction in Social Security taxes would improve the progressivity of our current fiscal and budgetary arrangements. The federal tax burden was more regressive in 1990 than in 1980. Over the decade, income taxes were cut, but payroll taxes steadily increased. For the top 20 percent of taxpayers this meant a tax cut, but for the lower 80 percent this meant a tax increase—because payroll taxes are a larger component of their total tax burden. Indeed, 71 percent of households now pay more in payroll taxes than in income taxes (up from 54 percent in 1977). We increasingly rely on the regressive payroll tax to fund general government. In the 1980s, the share of federal revenues coming from payroll taxes increased 21 percent, while the share from individual and corporate income taxes dropped 9 percent. Another income tax cut would not curb our growing reliance on the regressive payroll tax, and may indeed exacerbate it.

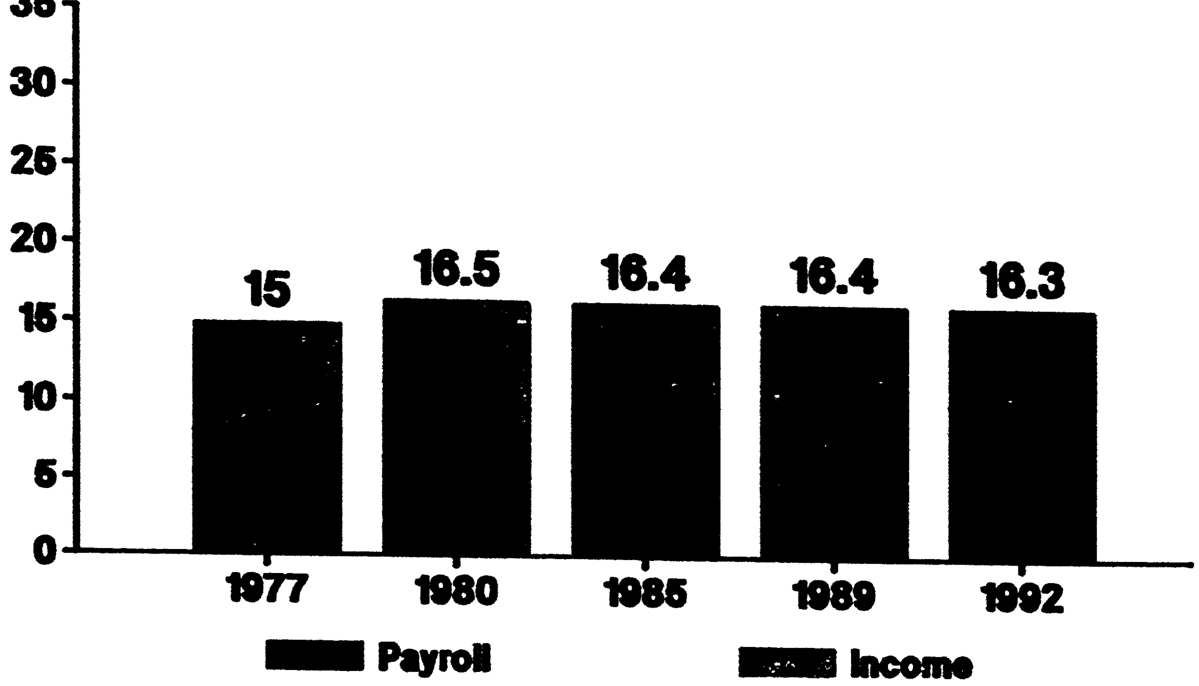
Fourth, a Social Security tax cut would directly address the issue of the increased tax burden on the middle class. Rising payroll taxes in the 1980s were the cause of this increased burden. Other tax cuts are of course aimed at the middle class. But if we want to ease the middle class tax burden, it would seem to make some sense to attack the problem at its source—high payroll taxes.

Finally, a Social Security tax cut is the broadest-based tax cut. It is not targeted to families with children, which account for about one-third of households. It is a tax cut for everyone with a job; Lord knows, the average worker could use it. Average weekly earnings in 1990 were lower than they were in 1960. But more, it is a tax cut for every employer. This would make more money available to businesses for investment, including investment in what economists call human capital. Which is to say it would create jobs. A million jobs, according to one estimate. The benefits of this broad-based tax cut are apparent from who supports it: both the AFL-CIO and the U.S. Chamber of Commerce.

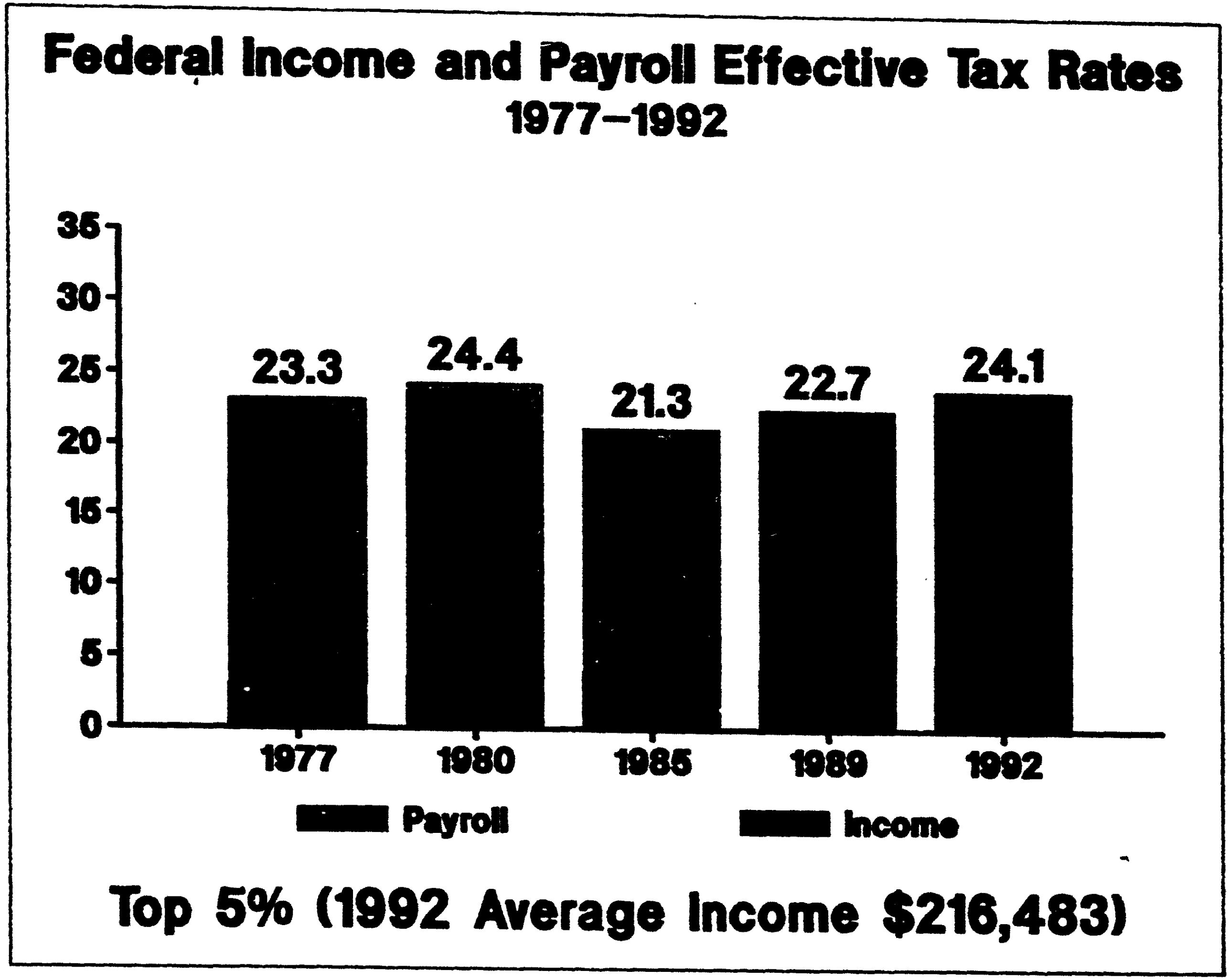
I said in January of this year that a Social Security tax cut would stimulate the economy and help us out of this recession. It may be too late for that now. At any rate, that is not the main issue. It would have been a bonus had we acted sooner. The main issue is integrity. Integrity in the financing of the Social Security system. Integrity in our tax structure. Integrity in the way we govern.

I urged a Social Security tax cut two years ago, before middle class tax cuts became popular. I would say now that if we are going to cut any tax, it must be the Social Security tax. A Social Security tax cut achieves the same objectives as any other middle class tax cut. And much, much more.

Federal Income and Payroll Effective Tax Rates
1977–1992



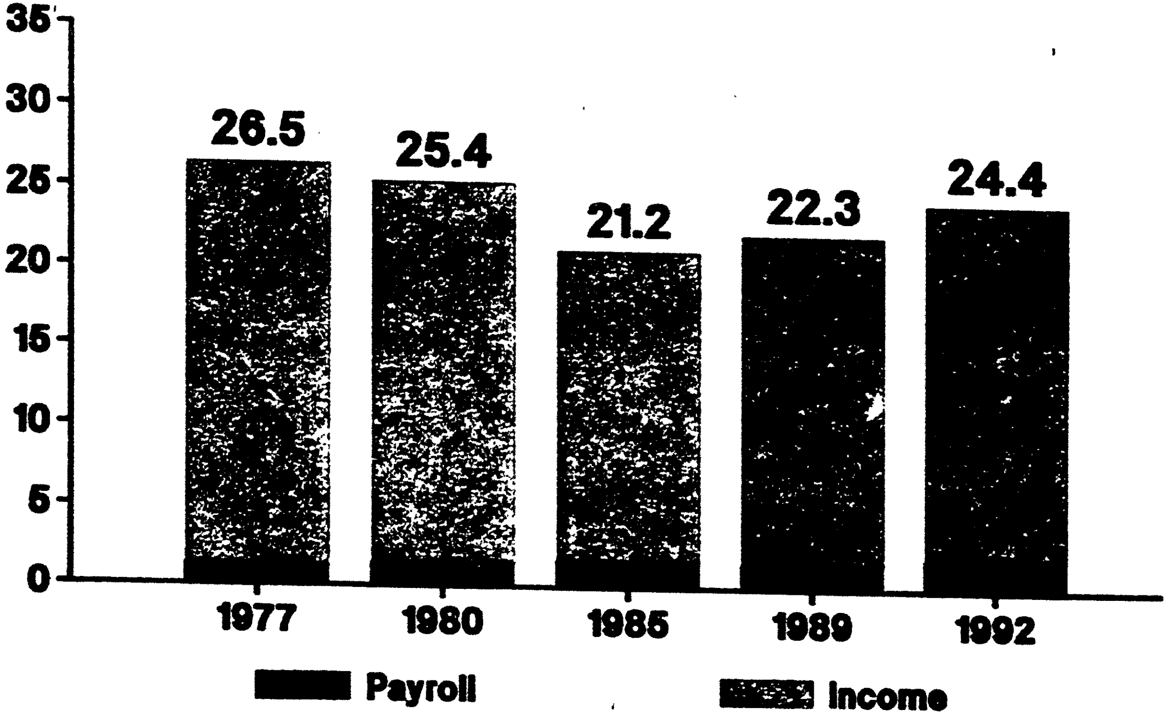
Middle Quintile (1992 Average Income $31,973)



Federal Income and Payroll Effective Tax Rates
1977–1992

Top 5% (1992 Average Income $216,483)

Federal Income and Payroll Effective Tax Rates
1977–1992



Top 1% (1992 Average Income $566,674)

AVERAGE WEEKLY EARNINGS

(for production and nonsupervisory workers, in 1982 dollars)

1960	$261.92
1970	$298.08
1980	$274.65
1990	$259.98

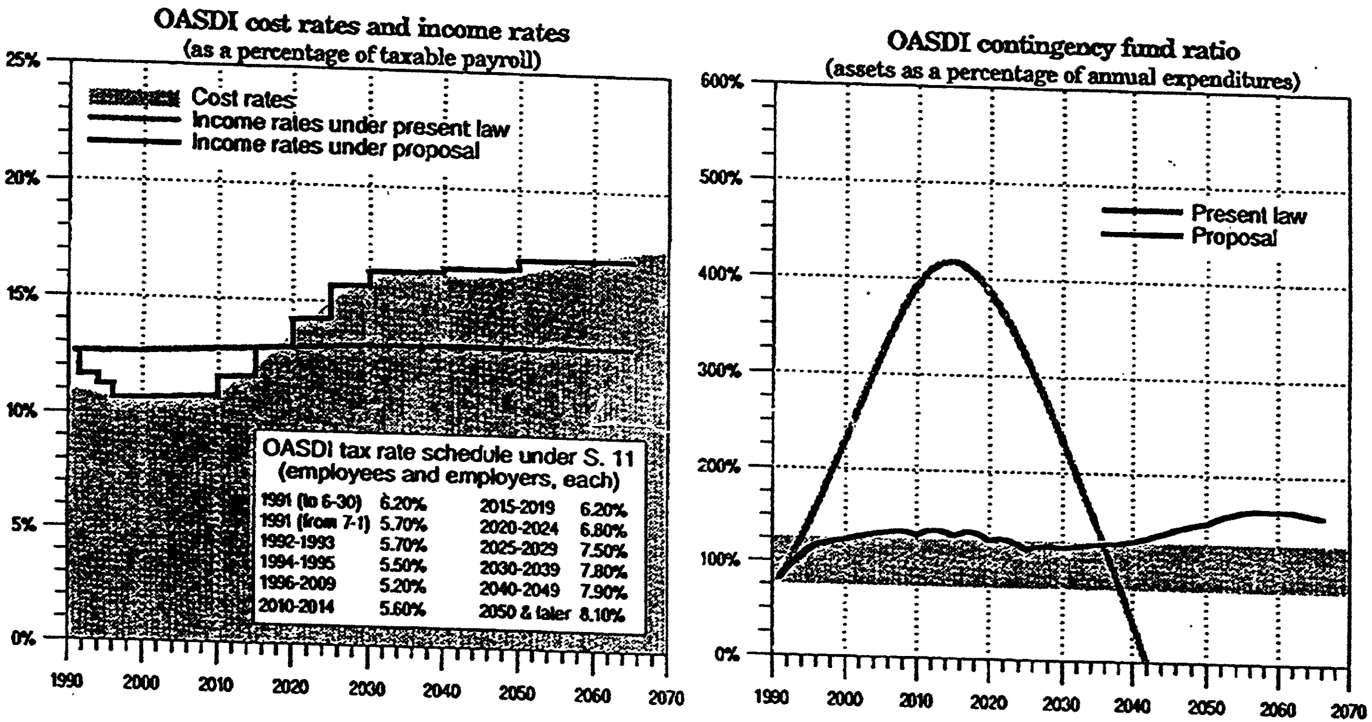
Source: U.S. Department of Labor, Bureau of Labor Statistics.

REAL MEDIAN FAMILY INCOME, 1973 - 1990
(in 1990 dollars)

1973	$35,474
1974	$34,205
1975	$33,328
1976	$34,359
1977	$34,528
1978	$35,361
1979	$35,262
1980	$33,346
1981	$32,190
1982	$31,738
1983	$32,378
1984	$33,251
1985	$33,689
1986	$35,129
1987	$35,632
1988	$35,565
1989	$36,062
1990	$35,353

Source: U.S. Department of Commerce, Bureau of the Census, Money Income of Households, Families, and Persons in the United States: 1990, 1991, Table C, p.9

Projected OASDI Financial Operations Under S. 11, as Introduced



OASDI cost rates and income rates
(as a percentage of taxable payroll)

OASDI tax rate schedule under S. 11
(employees and employers, each)

1991 (to 6-30)	6.20%	2015-2019	6.20%
1991 (from 7-1)	5.70%	2020-2024	6.80%
1992-1993	5.70%	2025-2029	7.50%
1994-1995	5.50%	2030-2039	7.80%
1996-2009	5.20%	2040-2049	7.90%
2010-2014	5.60%	2050 & later	8.10%

OASDI contingency fund ratio
(assets as a percentage of annual expenditures)

600%
500%
400%
300%
200%
100%
0%
Present law
Proposal
1990
2000
2010
2020
2030
2040
2050
2060
2070

Office of the Actuary
Social Security Administration
October 30, 1991

Prepared Statement of Kevin Phillips

My name is Kevin Phillips. I am the publisher of the American Political Report and the author of "The Politics of Rich and Poor." I appreciate this chance to make a brief statement on the question of the so-called middle-class squeeze and what to do about it.

This is an issue which I suspect Americans will be discussing for the rest of the decade, but I'd like to begin by suggesting that the term "middle-class squeeze" isn1t adequate. It's become worse than a squeeze. You don't get David Duke politics out of squeezes; you get David Duke politics out of traumas.

But let me use my short time here to make some observations and perhaps a few recommendations.

The first simply involves the degree of middle-class alienation. It's high—and for a number of very good reasons. For years now, middle-class voters have distrusted liberal politicians for favoring welfare recipients, government employees, minorities and cultural fringes. Now they also blame conservative politicians for favoring the rich, big business and Wall Street and caring more about capital gains and bond markets than about unemployment lines. And while this has been going on, they worry, the American Dream has started to crumble, and we're losing our markets, our jobs and our future to Japan, Germany and a whole bunch of Third World countries with workers who get a dollar fifty an hour.

This didn't happen overnight, it's not going to be solved overnight, and I've seen polls in which voters dismiss any likely 1992 Congressional action on taxes as a "gimmick." Producing quickie legislation that justifies that cynicism would be a mistake.

To be more specific, equity and solvency in federal fiscal policy isn't going to be achieved by small-caliber tinkering. That wouldn't begin to deal with the tax unfairness to the middle class that's developed over the last forty-five years. The problem is too large, too central. One useful way to approach this is to look at what's happened to the combined federal tax burden of the median income family since, say, 1948. Well, back in 1948, the median income family, with two kids and $3000 a year, didn't have to pay income tax, and the Social Security tax was peanuts—1 percent. Maybe excise taxes added another 1 percent. By 1960, the federal tax burden on the median family would have been in the 16 percent range. For 1990, however, the Tax Foundation says the average family paid 28 percent of its income in federal taxes. All these numbers include the employer's share of Social Security.

By contrast, let's look at a million-dollar-earner's family. According to official Census Bureau data cited in the Statistical History of the United States, the effective income tax rate alone for a million-dollar family of four was as follows: in 1948, 77 percent; in 1960, 86 percent. Of course, there were loopholes, but it's easy to find stories from the 1950s of executives howling because they paid sixty or seventy percent. Now let's jump ahead to 1990. What was the effective combined federal tax rate for million-dollar earners? Twenty-eight or 29 percent? Something in there. In other words, what we've seen since the 1950s is a near-convergence of the effective federal tax rate in a mid-to-upper-twenties range that, on one hand, is at an all time, brutal high for the average family, and on the other hand, is around its lowest point in sixty years for the million-dollar family.

What makes things even worse, of course, is that during the 1980s so many new burdens were shoved out to the states that taxes at that level have gone up—rapidly—and these hit the poor and middle-class harder than they hit the rich.

In my opinion, any attempt to deal with this unfairness to the middle class by mere tinkering would miss the mark. Full-scale reform seems necessary, probably involving four, five or six progressive brackets. People who make hundreds of millions like Michael Milken did should pay a much higher marginal rate than average families—and also a much higher rate than $200,000 a year families. At the same time, exemptions for children should be increased, FICA taxes should be cut, and perhaps some kind of broad consumption tax can come in as a revenue-raiser if fairness is restored in the income tax-FICA equation.

Let me turn now to two other problems. The first involves poor federal statistics which probably underestimate the severe problems this economic downturn is causing the middle class. Let's start with the Consumer Price Index. Even if it's accurate on an overall basis, for middle class families it probably underweights the effect of the steep increases people have been feeling in college or school tuition, day care, cable TV charges, auto insurance, water bills, government fees and the like. And if that's true, then the middle-class disposable-income situation is worse than it seems. Albert Sindlinger, a consumer polltaker based in Pennsylvania, says that right now, he finds consumers estimating the cost of living—including taxes, as well as these other things—at fully 14 percent! Unemployment data also seems misleading, given that people aren't counted if they've stopped looking for work, if they've got part time jobs, or if they say they're self-employed consultants or something. All of this minimizes problems that need to be faced squarely.

Finally, this is the first downturn since World War Two in which the middle class has to face a new fear: disappearing private sector safety nets. So far, at least, federal deposit insurance has protected accounts at banks and S&Ls that fail, but there's no such national backstopping for insurance policies, annuities, many pensions and post-retirement guarantees of health insurance coverage. Not only do insurance companies and regular corporations render obligations worthless by failing, but even relatively healthy companies are embracing Darwinian tactics either to survive or to maximize their profits.

In short, ordinary Americans have a lot to worry about—and their legitimate worries are clearly affecting the economy. Obviously, not all of these problems come under the jurisdiction of this committee, though, and besides which, it's hard to see how any quick, easy legislation could restore confidence—or even provide very much additional purchasing power. What I think this committee could do, however, is combine some small downpayment to the middle class with a two-fold larger commitment. The first part of that commitment could be to develop a genuine tax reform instead of the fumbled version of 1986, and the second could involve some large-scale effort to identify and deal with what's happening to both middle-class purchasing power and the average family's private-sector safety net.

I appreciate this chance to raise these points. I wish I could offer more useful advice—or that I could identify some magic public policy bullet, but I don't think there is one.

As for the politics of how the larger economy and the middle class have come unglued, it should be the key battleground next year—and perhaps a good bit longer than that.

Thank you.

Prepared Statement of Robert D. Reischauer

Mr. Chairman, I appreciate the opportunity to appear today before the committee to discuss how families with children are doing in relation to other families and to comment on Title I of the "Tax Fairness and Savings Incentive Act of 1991" (S. 1921). My testimony today will focus on how the income and tax situations of families with children compare with those of other families, and how these situations have changed over the past decade and one-half.[1]

A number of conclusions arise from this analysis. Three of the most striking are:

- Average family income, adjusted for family size, is lower for families with children than for other types of families. Furthermore, between 1977 and 1989, average pretax income for families with children grew very little, less than 10 percent after controlling for inflation.
- Rates of income growth varied markedly for families with children at different points in the income distribution. Between 1977 and 1989, the average pretax income for families with children in the bottom three income quintiles was virtually unchanged, while the average pretax income for families in the highest income quintile increased by more than 25 percent.
- Effective individual income tax rates—the percentage of pretax income paid in individual income taxes—are projected to be lower in 1992 than they were in 1977 for families with children in all income quintiles except the highest. Increases in payroll taxes, however, are projected to offset the decline in individual income taxes for families with children in all but the lowest income quintile, causing total federal effective tax rates to be slightly higher in 1992 than they were in 1977 for middle- and upper-income families with children.

[1] Families are divided into three groups for purposes of this analysis: families with a related child under age 18; childless families with both the head and spouse, if any, under age 65; and childless families with the head or spouse age 65 or older. Individuals not living with relatives are treated as one-person families, so families include the entire noninstitutionalized population. To compensate for differences in family size and changes in consumer prices, CBO used adjusted family income, which is a measure of incomes relative to the appropriate poverty thresholds of the Bureau of the Census. Income consists of all cash income, including realized capital gains, plus employers' share of payroll taxes and corporate income taxes imputed to individuals. Federal taxes include individual and corporate income taxes, payroll taxes, and excise taxes.

PRETAX INCOMES

In 1989, about one-third of all families had children. These families contained more than 55 percent of all people. In 1989, families with children had lower average pretax income, adjusted for family size, than other types of families (see Figure 1). While the average income for families with children was less than four times the poverty level, the average income for nonelderly childless families was more than five times the poverty level, and the average income for elderly families was more than four and one-half times the poverty level.

Between 1977 and 1989, the average pretax family income for families with children grew by less than 10 percent, as did the average pretax income of nonelderly childless families. In contrast, average pretax family income for elderly families grew by more than 30 percent during the same period.

Average incomes grew at different rates during the 12-year period. After declining between 1977 and 1980, average pretax income for families with children and for nonelderly childless families grew by slightly more than 1 percent a year during the 1980s. Average pretax income of elderly families grew steadily over the period, although all the growth in income between 1977 and 1980 was among high-income families. While the average pretax income of elderly families, adjusted for family size, was below that of families with children in 1977, by 1989 it was about 20 percent higher.

The change in average pretax income of families with children varied widely at different points in the income distribution (see Figure 2). Average pretax income was virtually unchanged between 1977 and 1989 for families in the bottom three income quintiles, rose slightly for families in the next-to-highest income quintile, and grew by more than 25 percent for families in the highest income quintile.

The change in average pretax income for nonelderly childless families at different points in the income distribution was similar to that for families with children. The only significant growth in average income was for families in the highest income quintile. In contrast, average pretax family income grew for elderly families at all points in the distribution, but here too the highest income families experienced the greatest income growth.

Changes in earnings dominated overall changes in income for nonelderly families. More than 90 percent of nonelderly families received at least some income from earnings, and earnings accounted for 85 percent of their total family income. Earnings in constant dollars dropped during the late 1970s, particularly for low-income families, as rapid inflation eroded wage rates. Between 1980 and 1985, overall average earnings rose slightly, though the gains were concentrated in the upper part of the income distribution as the 1980 and the 1981–82 recessions and a bout of double-digit inflation depressed average real earnings for nonelderly families in the bottom three quintiles. Earnings gains in the latter 1980s were spread over all parts of the income distribution and were sufficient to yield a small rise in overall average earnings during the entire 1977–1989 period. For families in the bottom three quintiles, however, the small gains between 1985 and 1989 were not enough to offset earlier declines, and average earnings in constant dollars for those families was lower in 1989 than in 1977.

TAXES OF FAMILIES WITH CHILDREN

Overall, families with children are projected to pay about 10 percent of their incomes in federal individual income taxes in 1992, not much different than their effective tax rate in 1977 (see Figure 3).[2] This percentage is less than the 12 to 13 percent effective rate projected for childless nonelderly families. The difference results in large part because the tax code includes preferences for families with children such as the Earned Income Tax Credit (EITC), the Dependent Care Credit, and dependent exemptions.

Changes in effective individual income tax rates vary for families at different points in the income distribution (see Figure 4). Families with children in the lowest income quintile receive a subsidy, on average, rather than pay a tax, through the refundable earned income tax credit. This subsidy has become larger as a result of the expansions made in the EITC in both the Tax Reform Act of 1986 and Omnibus Budget Reconciliation Act of 1990. Families with children will receive average credit refunds in 1992 equal to about 6 percent of their pretax incomes. Because low-income families without children do not qualify for the EITC, they will face slightly positive income tax rates.

[2] The complete change in effective federal tax rates is best measured using projections through 1992, by which time most provisions of the Omnibus Budget Reconciliation Act of 1990 will be fully phased in.

Families with children in the middle three quintiles will face effective income tax rates in 1992 that are projected to be lower than the rates they faced in 1977. The biggest drop is projected for families with children in the second quintile, some of whom will benefit from the expanded EITC. At the top end of the income distribution, families with children are projected to pay virtually the same percentage of pretax income in individual income taxes in 1992 as families paid in 1977. Effective individual income tax rates have risen steadily since 1985 as the elimination of various tax preferences has offset the large rate decreases of the early 1980s.

Since 1977, total federal effective tax rates have increased slightly for families with children and for nonelderly childless families (see Figure 5). Only low-income families with children will face lower total effective tax rates in 1992 than similar families faced in 1977 (see Figure 6). For those families, tax reductions since 1985 have more than offset the increases they experienced during the early 1980s. Although the increase in total effective tax rates for middle- and upper-income families with children is small, on average their taxes are projected to be a slightly higher percent of income in 1992 than they were for similar families in 1977.

The increase in total effective tax rates has been primarily the result of rising payroll taxes. The Social Security tax rate has risen from a combined 11.7 percent of taxable earnings on employers and employees in 1977 to the current 15.3 percent, while the limit on taxable earnings has been increased by about half after adjusting for inflation. As a result, the effective social insurance tax rate for families with children—including both Social Security and unemployment insurance taxes—is projected to rise from 7 percent of income in 1977 to about 10 percent of income in 1992. (The effective social insurance tax rate is less than the combined Social Security tax rate because not all income is subject to Social Security taxes.) One justification for the EITC is that it offsets payroll taxes for low-income families. While increases in the EITC have offset the impact of payroll tax increases for low-income families with children, nonelderly families without children have faced similar increases in payroll taxes, but have not benefitted from the EITC. All families who pay payroll taxes, however, benefit from the social insurance programs that the taxes fund.

AFTER-TAX INCOMES

Changes in after-tax income reflect the combined effects of changes in pretax income and changes in effective tax rates. Average pretax income of families with children, adjusted for inflation and changes in family size, has grown little since 1977. Although effective individual income taxes have fallen for all but the highest-income families with children during the same period, increases in effective payroll tax rates have reversed those changes for families with children in the middle of the income distribution. As a result, average adjusted after-tax incomes have grown by slightly less than average pretax incomes for families with children.

CBO estimates that average after-tax income for families with children, when adjusted for inflation and family size, will be 4 percent higher in 1992 than it was in 1977. Although the last actual data for 1989 showed an 8 percent increase in after-tax income, that increase will be cut in half because the recent recession and a small increase in effective tax rates between 1989 and 1992 will cause a small drop in after-tax income between 1989 and 1992. As with pretax income, all of the gains in average after-tax income for families with children so far have been concentrated among higher-income families.

HELPING MIDDLE-INCOME FAMILIES

Permanent solutions to the problem of little or no income growth for middle- and low-income families must address the causes of low pretax incomes, which include the limited earnings capacity of many and their willingness and ability to work. Specific policies aimed at strengthening education, job training, employment opportunities, and assistance obtaining and keeping jobs, including child care, may be effective in the long run.

As shorter-term solutions, a number of tax proposals have been offered to help middle-income families with children. Among these is the "Tax Fairness and Savings Incentive Act of 1991" (S. 1921), sponsored by Senator Bentsen and other members of the committee. The bill includes a nonrefundable credit of $300 for each child under the age of 19. The credit would cut taxes for the average family with children by $367 in 1992 and would raise their after-tax income by 1 percent (see Table 1). After-tax income of families with children in the second and third income quintiles would rise by over 1.5 percent. Because the credit is not refundable, families in the lowest income quintile would see little change in their after-tax incomes.

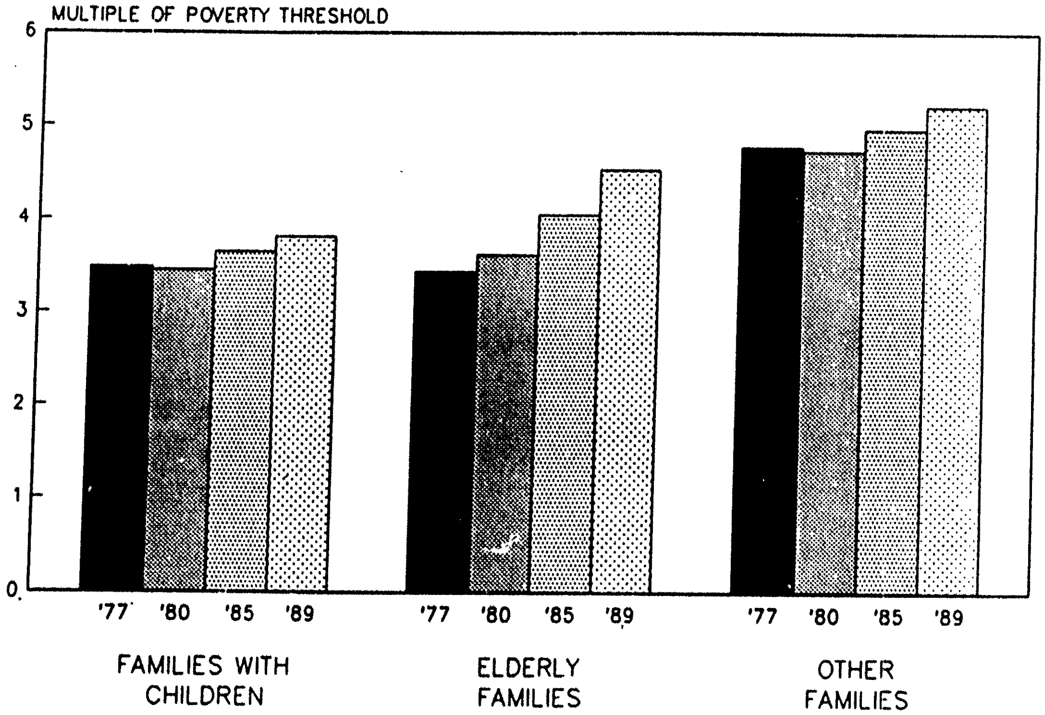
As noted earlier, however, those families have benefitted significantly in recent years from increases in the EITC.

Table 1.—EFFECT OF A NONREFUNDABLE TAX CREDIT OF $300 PER CHILD FOR FAMILIES WITH CHILDREN BY INCOME QUINTILE, 1992

Income Level	Average Change in Taxes (in dollars)	Percentage Change in After-Tax Income
Lowest Quintile	−16	0.2
Second Quintile	−433	1.9
Middle Quintile	−535	1.6
Fourth Quintile	−488	1.0
Highest Quintile	−454	0.4
All families	−367	1.0

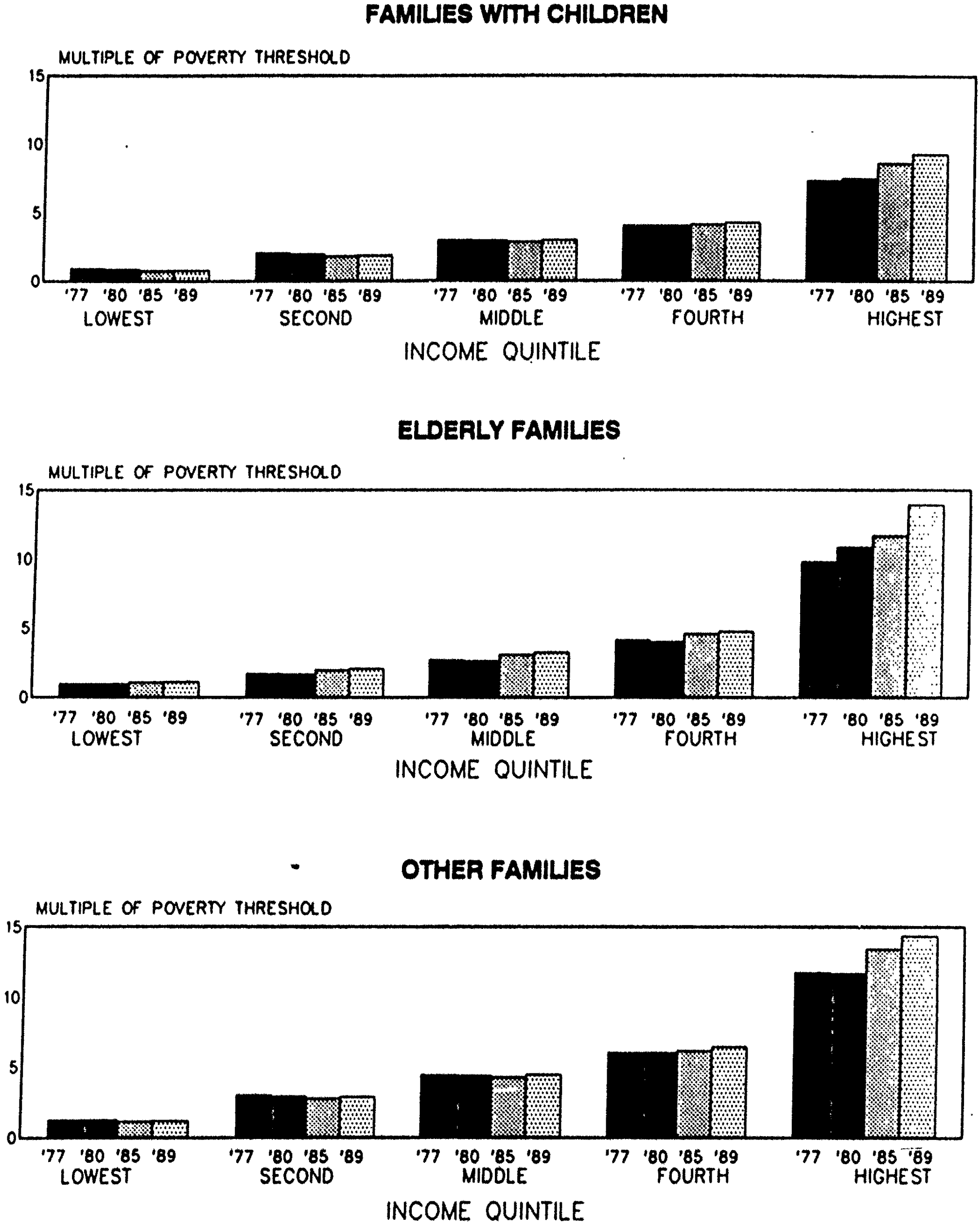
SOURCE: Congressional Budget Office tax simulations.

FIGURE 1. AVERAGE PRETAX FAMILY INCOMES AS MULTIPLE OF POVERTY THRESHOLD, 1977-1989



SOURCE: Congressional Budget Office tax simulation model.

FIGURE 2. AVERAGE PRETAX INCOMES BY INCOME QUINTILE, 1977-1989



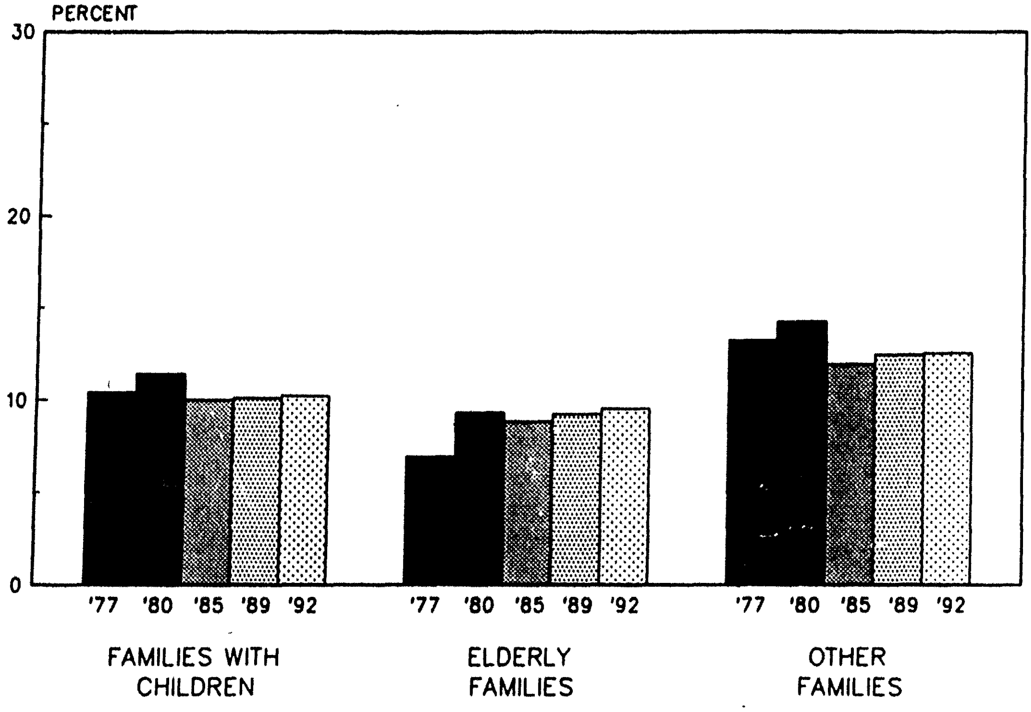
FAMILIES WITH CHILDREN

ELDERLY FAMILIES

OTHER FAMILIES

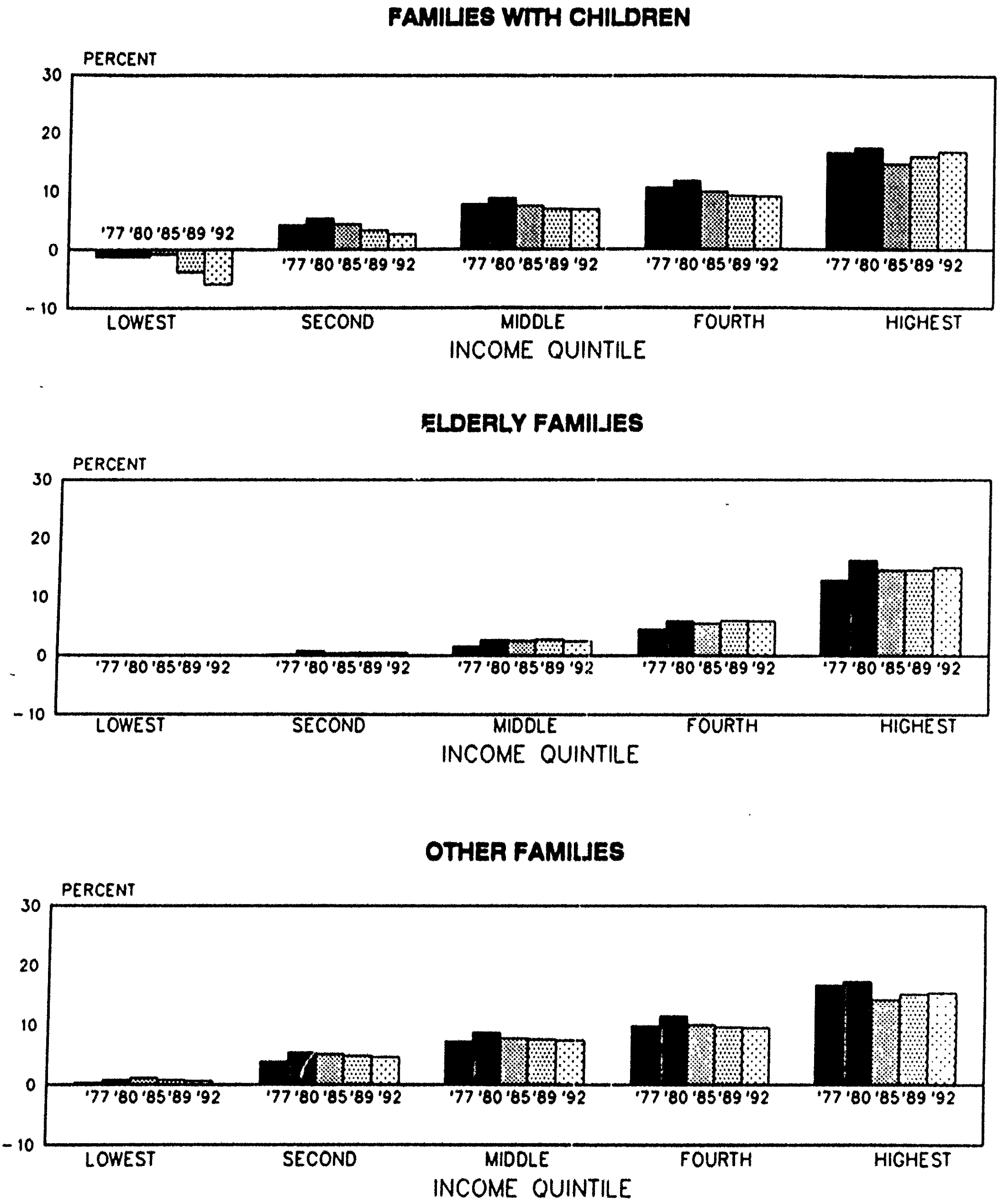
SOURCE: Congressional Budget Office tax simulation model.
NOTE: Income quintiles are for specific type of family.

FIGURE 3. AVERAGE EFFECTIVE FEDERAL INDIVIDUAL INCOME TAX RATES, 1977-1992



SOURCE: Congressional Budget Office tax simulation model.

FIGURE 4. EFFECTIVE FEDERAL INDIVIDUAL INCOME TAX RATES BY INCOME QUINTILE, 1977-1992



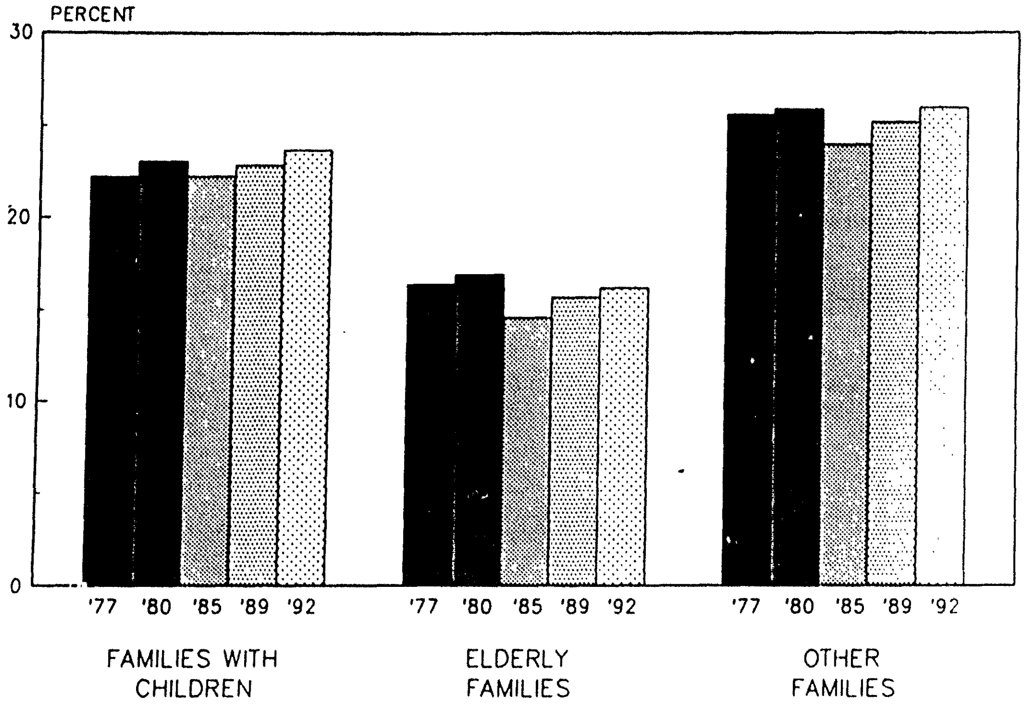
FAMILIES WITH CHILDREN

ELDERLY FAMILIES

OTHER FAMILIES

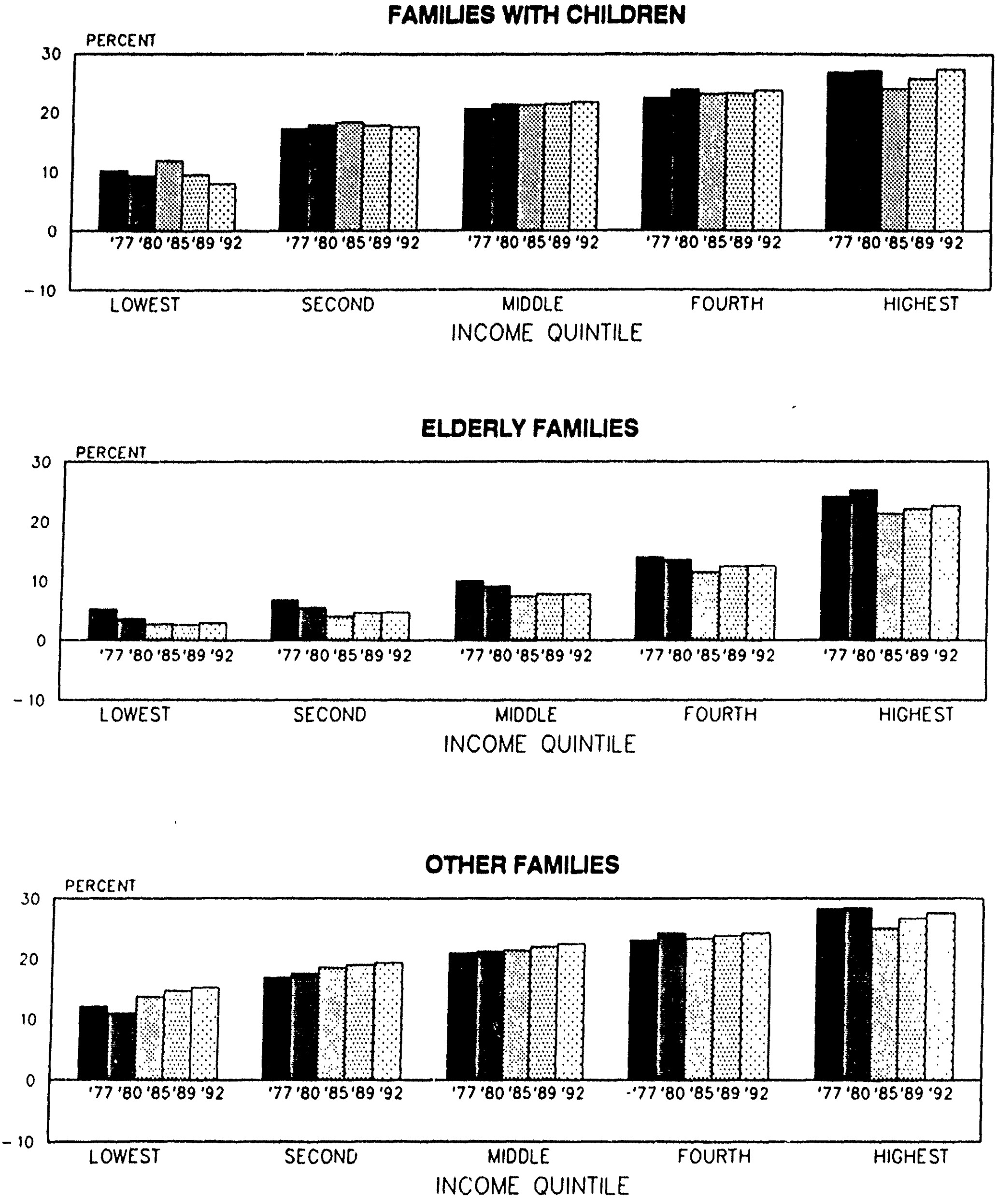
SOURCE: Congressional Budget Office tax simulation model.
NOTE: Income quintiles are for all families.

FIGURE 5. AVERAGE TOTAL EFFECTIVE FEDERAL TAX RATES, 1977-1992



SOURCE: Congressional Budget Office tax simulation model.

FIGURE 6. TOTAL EFFECTIVE FEDERAL TAX RATES BY INCOME QUINTILE, 1977-1992



FAMILIES WITH CHILDREN

ELDERLY FAMILIES

OTHER FAMILIES

SOURCE: Congressional Budget Office tax simulation model.
NOTE: Income quintiles are for all families.

PREPARED STATEMENT OF SENATOR JOHN D. ROCKEFELLER IV

I appreciate this opportunity to address the committee as it considers a proposal to revise the federal income tax code to address the economic needs of middle-income American families.

Over the past two and a half years, it has been my great pleasure to serve as chairman of the National Commission on Children. In the course of our deliberations, we took a long hard look at the economic needs of families raising children, and we considered an array of options to reduce childhood poverty and relieve the growing financial pressures that plague so many middle-income families. On June 24 of this year, we released our report, presenting a bold blueprint for a national children and families policy. As its center is a comprehensive income security plan that includes a $1,000 refundable child tax credit to replace the personal exemption for dependent children. Today, I would like to share with you our thinking about this important new idea.

Families raising children have been the big economic losers of the past decade. Today children are the poorest Americans—one in five lives in a family whose income is below the federal poverty level. Many of these families are poor even though at least one parent is employed. Many others get by only because both parents have gone to work. In a recent national survey of parents and children conducted by the National Commission on Children, more than half of low-income parents polled said they worry all the time that their incomes will not meet their family's expenses.

Yet it's not only poor families that are worried. Middle-income families are hurting as well.

Over the past decade, the average family either lost income or barely stayed even. Their wages stagnated, while the costs of housing, feeding, and clothing children, health care and a college education all skyrocketed.

Over the past several months, several proposals to provide tax credits to families raising children have surfaced, including Senator Bentsen's bill which is before this committee. Tax fairness has become the issue of the day.

But we have been talking of lower taxes for a dozen years, while taxes went up for all but a handful of our wealthiest families. In 1970, working families with children paid 14% of their income in taxes. Today, almost a quarter of their income is taxed away. This legacy of unfairness is one of the scandals of a decade of misguided economic policy.

What we should have learned is that we need to ask the same questions about tax policy as we do about expenditures: Which Americans are most affected? What is best for the country? Out of many pressing needs, what is the higher priority? How can we have an immediate impact, and a positive, long-term effect?

As we move ahead to craft a fairer tax structure, we must strive to shape a public policy that both addresses urgent short-term economic needs—helping families and jump-starting the economy—*and* also recognizes the equally urgent need to invest in America's future and its people over the long-term.

Based on the work of the National Commission on Children, I argue strongly that children and their families *must* be one of our top priorities; and that this priority must be extended to *all* of America's children. Thus, a tax credit for families must be *refundable.* That is, it must ensure a basic level of income support to *all* families with children—including those who do not earn enough to pay taxes.

For poor families a refundable tax credit provides badly needed income assistance without the stigma of welfare and without limitations on work and earned income. It is cash they need to meet their children's basic needs. For low-income working families, it may well be the essential boost they need to continue to choose work over welfare. For middle-income families it is a tax cut that allows them to keep most of what they earn to offset the rising costs of raising children. And for all families a refundable tax credit says that, as a society, we value the job of raising children—all children.

It does not discourage two-parent families from forming and staying together. Nor does it penalize single parents who are struggling to raise their children against enormous odds. It is equally available to families in which both parents work and families in which one parent remains at home to care for children.

To limit the credit to families that earn enough to owe taxes would deny basic income security to at least a quarter of all American children. Disproportionately, minority children would be left out. Roughly half of all African American children and 45 percent of all Hispanic children would not benefit. Perhaps more distressing, an estimated 20 percent of children whose parents get up and go to work each day would be ineligible. Families with a parent who works' full-time, full-year at minimum wage would be left out. So would families with one full-time and one half-time worker, both earning low wages. If we establish a child tax credit that is not refundable, the clear message to these families will be that they are not as important, not as deserving—that our measure of worth is not how hard you work, but how much money you make.

For those critics who say that Congress addressed the needs of the working poor last year by expanding the Earned Income Tax Credit, I say, it was a good first step. But you and I both know that as a mechanism for fighting poverty, the EITC alone is not enough. At its current level, it only raises the minimum wage by about 50 cents per hour—from $4.25 to $4.75. For a family of four with one full-time worker to escape poverty1 that worker must earn at least $7.00 per hour.

Moreover, at the same time that we expanded the Earned Income Tax Credit last year, we also increased the regressive gasoline tax and other excise taxes. In effect, we gave with one hand and we took back with the other.

As a matter of principle, I believe that a child tax credit must be equally available to every family in America. In economic terms, children are a "public good." Today's children are tomorrow's parents, employees, and citizens. Every American reaps the benefits—or bears the costs—of how well parents do the job of raising their children. We simply can't afford to leave any child behind.

If our goal is to make all families strong, stable, and self-reliant, then we must begin now to build a system of income support that encourages all families, including low-income families, to become a part of the social and economic mainstream of this nation. We must address their economic needs in a way that reinforces hard work, strong families, individual responsibility, and economic independence—the core values on which this nation was built.

Out tendency to stigmatize and separate poor families is counterproductive. Our welfare system is fundamentally anti-family and anti-work. It discourages hope and individual initiative. And it fosters dependency. Yet, if we deny low-income families the same basic income assistance we would provide to middle-income families, we leave them little alternative but to continue to rely on welfare.

Right now, this nation faces a great economic challenge. Our economy is weak—consumers aren't buying; businesses aren't investing; banks aren't loaning; and the trade deficit is once again on the rise. Conventional wisdom and economic theory suggest that a tax cut is one way to stimulate spending. But overdue attention to middle-class concerns should not be an excuse to further divide middle-income families from poor families.

The tax credit is an idea whose time has come. But it absolutely must be a *refundable credit.* Only this will simultaneously provide badly needed tax relief to the nation's middle income taxpayers, nudge our ailing economy, and begin to establish a new national human resource strategy linking the agenda of economic development to our broad social agenda.

The misguided economic policies of a dozen years will not be overcome with a magic wand. But we must seize the opportunity to invest in the human capital of our nation, and to make *every* child a critical part of our economic program.

PREPARED STATEMENT OF SENATOR WILLIAM V. ROTH, JR.

Thank you, Mr. Chairman. I appreciate your leadership and the fact that we are holding these important hearings. Whether Congress likes it or not, when it comes to taxes, America is rebelling—from California to Connecticut; from New Mexico to New Jersey. Like the central character in the movie "Network," Americans are mad as hell, and they're not going to take it anymore!

Frankly, I don't blame them. Last year, this Congress passed the largest tax increase in history. It totalled some $18 billion in the first year alone. On top of that, state taxes increased $17 billion. Together, these increases took more than $35 billion out of the economy. Is it any wonder, with well over 19 percent of our gross national product tied up in taxes, why this recession has only been prolonged? Without a doubt, there is a tremendous impact Congress and the White House can have on improving America's immediate economy and its competitive future.

And it all begins with tax cuts.

There is no way our country can be taxed into prosperity. Statistics prove that for every dollar Congress increases taxes, it increases spending by $1.59. That's why we have the deficits today. The plain and simple fact is: Congress cannot control spending. Those who say otherwise—those who say its not Congress's inability to control spending—I dare them to go home this Thanksgiving and to tell their constituents that the reason we have a $300-billion-plus deficit is because Americans aren't paying enough taxes. They know it's not true.

That's why I'm encouraged by the legislation that Senator Bentsen and I have introduced. It represents a good beginning, and I applaud the chairman for his leadership.

Likewise, I have introduced my own plan—S. 1865—to offer even a more broad-based tax cut, one that would affect not only families with children under 18, but all Americans (with the exception of those earning more than a million dollars in taxable income). Under my legislation, individual tax rates would be reduced to four new brackets: 12–25–28 and 31 percent. A family of four earning $35,000 would save $792 in federal income taxes, a 20 percent cut in the rate they pay today. A family of four earning $75,000 would save about $1,992, or fourteen percent. These tax rate cuts would be paid for by reducing the defense budget by $130 billion and other government spending by $30 billion over five years.

In short, my plan includes:

- A three percent tax rate reduction for all Americans with less than a million dollars in taxable income;
- A Super IRA;
- An incremental investment tax credit; and,
- A lifting of the Social Security earnings test.

I ask that a copy of my proposal—S. 1865—be inserted into the record of these proceeding, together with the CBO distribution analysis.

There are numerous proposals from members of both parties to reduce taxes. They are worthy of close attention by this committee. But let's make sure they are real solutions, not simply political rhetoric dressed up for re-election. Rhetoric got our economy into this mess. Real reform will get it out. I believe that even if Congress has to stay here until Christmas, it would be worth it if both sides of this aisle could come together to cut taxes in a meaningful and economically productive way.

Attachments.

II

102D CONGRESS
1ST SESSION

S. 1865

To amended the Internal Revenue Code of 1986 to provide for a reduction in individual income tax rates, a new individual retirement account and an incremental investment tax credit.

IN THE SENATE OF THE UNITED STATES

OCTOBER 24 (legislative day, SEPTEMBER 19), 1991

Mr. ROTH introduced the following bill; which was read twice and referred to the Committee on Finance

A BILL

To amended the Internal Revenue Code of 1986 to provide for a reduction in individual income tax rates, a new individual retirement account and an incremental investment tax credit.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; AMENDMENT OF 1986 CODE.

(a) SHORT TITLE.—This Act may be cited as the "Defense Tax Rebate Act".

(b) AMENDMENT OF 1986 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1986.

TITLE I—INDIVIDUAL INCOME TAX PROVISIONS

SEC. 101. RATE REDUCTIONS.

(a) GENERAL RULE.—Subsections (a) through (e) of section 1 (relating to tax imposed on individuals) are amended to read as follows:

"(a) MARRIED INDIVIDUALS FILING JOINT RETURNS AND SURVIVING SPOUSES.—There is hereby imposed on the taxable income of—

"(1) every married individual (as defined in section 7703) who makes a single return jointly with his spouse under section 6013, and

"(2) every surviving spouse (as defined in section 2(a)), a tax determined in accordance with the following table:

"If taxable income is:	The tax is:
Not over $34,000	12% of taxable income.
Over $34,000 but not over $82,150.	$4,080, plus 25% of the excess over $34,000.
Over $82,150 but not over $1,000,000.	$16,117.50, plus 28% of the excess over $82.150.
Over $1,000,000	$273,115.5, plus 31% of the excess over $1,000,000.

"(b) HEADS OF HOUSEHOLDS.—There is hereby imposed on the taxable income of every head of household (as defined in section 2(b)) a tax determined in accordance with the following table:

“If taxable income is:	The tax is:
Not over 27,300	12% of taxable income.
Over $27,300 but not over $70,450.	$3,276, plus 25% of the excess over $27,300.
Over $70,450, but not over $1,000,000.	$14,063.50, plus 28% of the excess over $70,450.
Over $1,000,000	$275,247.50, plus 31% of the excess over $1,000,000.

“(c) Unmarried Individual (Other Than Surviving Spouses and Heads of Households).—There is hereby imposed on the taxable income of every individual (other than a surviving spouse as defined in section 2(a) or the head of a household as defined as in section 2(b)) who is not a married individual (as defined in section (7703) a tax determined in accordance with the following table:

“If taxable income is:	The tax is:
Not over $20,350	12% of taxable income.
Over $20,350 but not over $49,300.	$2,442, plus 25% of the excess over $20,350.
Over $49,300 but not over $1,000,000..	$9,679.50, plus 28% of the excess over $49,300.
Over $1,000,000	$275,875.50, plus 31% of the excess over $1,000,000.

“(d) Married Individuals Filing Separate Returns.—There is hereby imposed on the taxable income of every married individual (as defined in section 7703) who does not make a single return jointly with his spouse under section 6013, a tax determined in accordance with the following table:

“If taxable income is:	The tax is:
Not over $17,000	12% of taxable income.

"If taxable income is:	The tax is:
Over $17,000 but not over $41,075.	$2,040, plus 25% of the excess over $17,000.
Over $41,075 but not over $1,000,000.	$8,058.75, plus 28% of the excess over $41,075.
Over $1,000,000	$276,557.75, plus 31% of the excess over $1,000,000.

"(e) ESTATE AND TRUSTS.—There is hereby imposed on the taxable income of—

"(1) every estate, and

"(2) every trust,

taxable under this subsection a tax determined in accordance with the following table:

"If taxable income is:	The tax is:
Not over $5,450	12% of taxable income.
Over $5,450 but not over $13,500	$654, plus 25% of the excess over $5,450.
Over $13,500 but not over $1,000,000.	$2,666.50, plus. 28% of the excess over $13,500.".

(b) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1991, except that the tax tables added by such amendments—

(1) shall be adjusted under section 1(f) of the Internal Revenue Code of 1986 (relating to inflation adjustments); and

(2) shall be adjusted under section 1(k) of such Code (relating to phase-in of tables) as added by section 102.

SEC. 102. PHASE-IN OF RATE REDUCTIONS.

(a) GENERAL RULE.—Section 1 is amended by adding at the end thereof the following new subsection:

"(k) TAX RATES FOR YEARS BEGINNING IN 1992 THROUGH 1996.—

"(1) IN GENERAL.—In the case of taxable years beginning in 1992 through 1996, each time the Secretary prescribes tables under subsection (f) for taxable years beginning in such calendar years, the Secretary shall—

"(A) adjust the 12, 25 and 28 percent rates of tax applicable to each rate bracket by substituting for each the precentage determined as if—

"(i) the substitute percentage in effect for the preceding calendar year were in effect for the portion of such taxable year preceding October 1 of the calendar year; and

"(ii) the substitute percentage for the calendar year were in effect for the portion of such taxable year on and after October 1 of the calendar year, and

"(B) adjust the amounts setting forth the tax to the extent necessary to reflect the adjustments in the rates of tax under subparagraph (A).

"(2) SUBSTITUTE PERCENTAGES.—For purposes of paragraph (1), the substitute percentage shall be determined as follows:

"(A) In the case of the 12 percent rate of tax, the substitute percentage is:

"1992	14.5
1993	14
1994	13.5
1995	13
1996	12.5

"(B) In the case of the 25 percent rate of tax, the substitute percentage is:

"1992	27.5
1993	27
1994	26.5
1995	26
1996	25.5

"(C) In the case of the 28 percent rate of tax, the substitute percentage is:

"1992	30.5
1993	30
1994	29.5
1995	29.0
1996	28.5

(b) EFFECTIVE DATE.—The amendment made by this section shall apply to taxable years beginning after December 31, 1991.

SEC. 103. WITHHOLDING TABLES.

Section 3402(a) is amended by adding at the end thereof the following new paragraph:

"(4) CHANGES MADE BY THE DEFENSE TAX REBATE ACT.—Notwithstanding the provisions of this subsection, the Secretary shall modify the tables and procedures under paragraph (1) to reflect the amendments made by sections 101 and 102 of the Defense Tax Rebate Act and such modifications shall take effect on October 1 of calendar years 1991 through 1995 as if there were a ½ percentage point reduction in the applicable rates of tax on each such date.".

TITLE II—RETIREMENT SAVINGS INCENTIVES

Subtitle A—Restoration of IRA Deduction

SEC. 201. RESTORATION OF IRA DEDUCTION.

(a) IN GENERAL.—Section 219 (relating to deduction for retirement savings) is amended by striking subsection (g) and by redesignating subsection (h) as subsection (g).

(b) TECHNICAL AND CONFORMING AMENDMENTS.—

(1) Subsection (f) of section 219 is amended by striking paragraph (7).

(2) Paragraph (5) of section 408(d) is amended by striking the last sentence.

(3) Section 408(o) is amended by adding at the end thereof the following new paragraph:

"(5) TERMINATION.—This subsection shall not apply to any designated nondeductible contribution for any taxable year beginning after December 31, 1991.".

(4) Subsection (b) of section 4973 is amended by striking the last sentence.

(c) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1991.

SEC. 202. INFLATION ADJUSTMENT FOR DEDUCTIBLE AMOUNT.

(a) IN GENERAL.—Section 219, as amended by section 201, is amended by redesignating subsection (g) as subsection (h) and by inserting after subsection (f) the following new subsection:

"(g) COST-OF-LIVING ADJUSTMENTS.—

"(1) IN GENERAL.—If this subsection applies to any calendar year, then each applicable dollar amount for any taxable year beginning in the adjustment period for such calendar year shall be equal to the sum of—

"(A) such applicable dollar amount for taxable years beginning in such calendar year, plus

"(B) $500.

"(2) YEARS TO WHICH SUBSECTION APPLIES.—This subsection shall apply to any calendar year if the excess (if any) of—

"(A) $2,000, increased by the cost-of-living adjustment for such calendar year, over

"(B) the applicable dollar amount in effect under subsection (b)(1)(A) for such calendar year,

is equal to or greater than $500.

"(3) COST-OF-LIVING ADJUSTMENT.—For purposes of this subsection—

"(A) IN GENERAL.—The cost-of-living adjustment for any calendar year is the percentage (if any) by which—

"(i) the CPI for such calendar year, exceeds

"(ii) the CPI for 1991.

"(B) CPI FOR ANY CALENDAR YEAR.—The CPI for any calendar year shall be determined in the same manner as under section 1(f)(4).

"(4) APPLICABLE DOLLAR AMOUNT.—For purposes of this subsection, the term 'applicable dollar amount' means the dollar amount in effect under any of the following provisions.

"(A) Subsection (b)(1)(A).

"(B) Subsection (c)(2)(A)(i).

"(C) The last sentence of subsection (c)(2).

"(5) ADJUSTMENT PERIOD.—For purposes of this subsection, the term 'adjustment period' means, with respect to any calendar year to which this subsection applies, the period—

"(A) beginning on the 1st day of the calendar year following such calendar year, and

"(B) ending on the last day of the next calendar year to which this subsection applies.".

(b) CONFORMING AMENDMENTS.—

(1) Section 408(a)(1) is amended by striking "in excess of $2,000 on behalf of any individual" and inserting "on behalf of any individual in excess of the amount in effect for such taxable year under section 219(b)(1)(A)".

(2) Section 408(b)(2)(B) is amended by striking "$2,000" and inserting "the dollar amount in effect under section 219(b)(1)(A)".

(3) Section 408(j) is amended by striking "$2,000".

Subtitle B—Nondeductible Tax-Free IRAs

SEC. 211. ESTABLISHMENT OF NONDEDUCTIBLE TAX-FREE INDIVIDUAL RETIREMENT ACCOUNTS.

(a) IN GENERAL.—Subpart A of part I of subchapter D of chapter 1 (relating to pension, profit-sharing, stock bonus plans, etc.) is amended by inserting after section 408 the following new section:

"SEC. 408A. SPECIAL INDIVIDUAL RETIREMENT ACCOUNTS.

"(a) GENERAL RULE.—Except as provided in this section, a special individual retirement account shall be treated for purposes of this title in the same manner as an individual retirement plan.

"(b) SPECIAL INDIVIDUAL RETIREMENT ACCOUNT.—For purposes of this title, the term 'special individual retirement account' means an individual retirement plan which is designated at the time of establishment of the plan as a special individual retirement account.

"(c) TREATMENT OF CONTRIBUTIONS.—

"(1) NO DEDUCTION ALLOWED.—No deduction shall be allowed under section 219 for a contribution to a special individual retirement account.

"(2) CONTRIBUTION LIMIT.—The aggregate amount of contributions for any taxable year to all special individual retirement accounts maintained for the benefit of an individual shall not exceed the excess (if any) of—

"(A) the maximum amount allowable as a deduction under section 219 with respect to such individual for such taxable year, over

"(B) the amount so allowed.

"(3) SPECIAL RULES FOR QUALIFIED TRANSFERS.—

"(A) IN GENERAL.—No rollover contribution may be made to a special individual retirement account unless it is a qualified transfer.

"(B) LIMIT NOT TO APPLY.—The limitation under paragraph (2) shall not apply to a qualified transfer to a special individual retirement account.

"(d) TAX TREATMENT OF DISTRIBUTIONS.—

"(1) IN GENERAL.—Except as provided in this subsection, any amount paid or distributed out of a special individual retirement account shall not be included in the gross income of the distributee.

"(2) EXCEPTION FOR EARNINGS ON CONTRIBUTIONS HELD LESS THAN 5 YEARS.—

"(A) IN GENERAL.—Any amount distributed out of a special individual retirement account which consists of earnings allocable to contributions made to the account during 5-year period ending on the day before such distribution shall be included in the gross income of the distributee for the taxable year in which the distribution occurs.

"(B) CROSS REFERENCE.—

"For additional tax for early withdrawal, see section 72(t).

"(C) ORDERING RULE.—

"(i) FIRST-IN, FIRST-OUT RULE.—Distributions from a special individual retirement account shall be treated as having been made—

"(I) first from the earliest contribution (and earnings allocable thereto) remaining in the account at the time of the distribution, and

"(II) then from other contributions (and earnings allocable thereto) in the order in which made.

"(ii) ALLOCATIONS BETWEEN CONTRIBUTIONS AND EARNINGS.—Any portion of a distribution allocated to a contribution (and earnings allocable thereto) shall be treated as allocated first to the earnings and then to the contribution.

"(iii) ALLOCATIONS OF EARNINGS.—Earnings shall be allocated to a contribution in such manner as the Secretary may by regulations prescribe.

"(iv) CONTRIBUTIONS IN SAME YEAR.—Under regulations, all contributions made during the same taxable year may be treated as 1 contribution for purposes of this subparagraph.

"(3) QUALIFIED TRANSFER.—

"(A) IN GENERAL.—Paragraph (2) shall not apply to any distribution which is transferred in a qualified transfer to another special individual retirement account.

"(B) CONTRIBUTION PERIOD.—For purposes of paragraph (2), the special individual retirement account to which any contributions are transferred from another special individual retirement account shall be treated as having held such contributions during any period such contributions were held (or are treated as held under this subparagraph) by the account from which transferred.".

"(4) SPECIAL RULES RELATING TO CERTAIN TRANSFERS.—

"(A) IN GENERAL.—Notwithstanding any other provision of law, in the case of a qualified transfer to a special individual retirement account from an individual retirement plan which is not a special individual retirement account—

"(i) there shall be included in gross income any amount which, but for the qualified transfer, would be includible in gross income, but

"(ii) section 72(t) shall not apply to such amount.

"(B) TIME FOR INCLUSION.—In the case of any qualified transfer which occurs before January 1, 1994, any amount includible in gross income under subparagraph (A) with respect to such contribution shall be includible ratably over the 4-taxable year period beginning in the taxable year in which the amount was paid or distributed out of the individual retirement plan.

"(e) QUALIFIED TRANSFER.—For purposes of this section, the term 'qualified transfer' means a transfer to a special individual retirement account from another such account or from an individual retirement plan but only if the requirements of subparagraphs (A) and (B) of section 408(d((3) are met with respect to such transfer (determined after application of section 408(d)(3)(D)).".

(b) EARLY WITHDRAWAL PENALTY.—Section 72(t), as amended by section 301(c), is amended by adding at the end thereof the following new paragraph:

"(8) RULES RELATING TO SPECIAL INDIVIDUAL RETIREMENT ACCOUNTS.—In the case of a special individual retirement account under section 408A—

"(A) this subsection shall only apply to distributions out of such account which consist of earnings allocable to contributions made to the account during the 5-year period ending on the day before such distribution, and

"(B) paragraph (2)(A)(i) shall not apply to any distribution described in subparagraph (A).".

(c) EXCESS CONTRIBUTIONS.—Section 4973(b) is amended by adding at the end thereof the following new sentence: "For purposes of paragraphs (1)(B) and (2)(C), the amount allowable as a deduction under section 219 shall be computed without regard to section 408A.".

(d) CONFORMING AMENDMENT.—The table of sections for subpart A of part I of subchapter D of chapter 1 is amended by inserting after the item relating to section 408 the following new item:

"Sec. 408A. Special individual retirement accounts.".

(e) EFFECTIVE DATE.—The amendments made by this section shall apply to taxable years beginning after December 31, 1991.

TITLE III—PENALTY-FREE DISTRIBUTIONS

SEC. 301. DISTRIBUTIONS FROM CERTAIN PLANS MAY BE USED WITHOUT PENALTY TO PURCHASE FIRST HOMES OR TO PAY HIGHER EDUCATION OR FINANCIALLY DEVASTATING MEDICAL EXPENSES.

(a) IN GENERAL.—Paragraph (2) of section 72(t) (relating to exceptions to 10-percent additional tax on early distributions from qualified retirement plans) is amended by adding at the end thereof the following new subparagraph.

"(D) DISTRIBUTIONS FROM CERTAIN PLANS FOR FIRST HOME PURCHASES OR EDUCATIONAL EXPENSES.—Distributions to an individual from an individual retirement plan, or from amounts attributable to employer contributions made pursuant to elective deferrals described in subparagraph (A) or (C) of section 402(g)(3) or section 501(c)(18)(D)(iii)—

"(i) which are qualified first-time home-buyer distributions (as defined in paragraph (6)); or

"(ii) to the extent such distributions do not exceed the qualified higher education expenses (as defined in paragraph (7)) of the taxpayer for the taxable year."

(b) FINANCIALLY DEVASTATING MEDICAL EXPENSES.—Section 72(t)(3)(A) is amended by striking "(B),".

(c) DEFINITIONS.—Section 72(t) is amended by adding at the end thereof the following new paragraphs:

"(6) QUALIFIED FIRST-TIME HOMEBUYER DISTRIBUTION.—For purposes of paragraph (2)(D)(i)—

"(A) IN GENERAL.—The term 'qualified first-time homebuyer distribution' means any payment or distribution received by an individual to the extent such payment or distribution is used by the individual before the close of the 60th day after the day on which such payment or distribution is received to pay qualified acquisition costs with respect to a principal residence of a first-time homebuyer who is such individual or the child or grandchild of such individual.

"(B) QUALIFIED ACQUISITION COSTS.—For purposes of this paragraph, the term 'qualified acquisition costs' means the costs of acquiring, constructing, or reconstructing a residence. Such terms includes any usual or reasonable settlement, financing, or other closing costs.

"(C) FIRST-TIME HOMEBUYER; OTHER DEFINITIONS.—For purposes of this paragraph—

"(i) FIRST-TIME HOMEBUYER.—The term 'first-time homebuyer' means any individual if such individual (and if married, such individual's spouse) had no present ownership interest in a principal residence during the 2-year period ending on the date of acquisition of the principal residence to which this paragraph applies.

"(ii) PRINCIPAL RESIDENCE.—The term 'principal residence' has the same meaning as when used in section 1034.

"(iii) DATE OF ACQUISITION.—The term "date of acquisition' means the date—

"(I) on which a binding contract to acquire the principal residence to which subparagraph (A) applies is entered into, or

"(II) on which construction or reconstruction of such a principal residence is commenced.

"(D) SPECIAL RULE WHERE DELAY IN ACQUISITION.—If—

"(i) any amount is paid or distributed from an individual retirement plan to an individual for purposes of being used as provided in subparagraph (A), and

"(ii) by reason of a delay in the acquisition of the residence, the requirements of subparagraph (A) cannot be met,

the amount so paid or distributed may be paid into an individual retirement plan as provided in section 408(d)(3)(A)(i) without regard to section 408(d)(3)(B), and, if so paid such other plan, such amount shall not be taken into account in determining whether section 408(d)(3)(A)(i) applies to any other amount.

"(7) QUALIFIED HIGHER EDUCATION EXPENSES.—For purposes of paragraph (2)(D)(ii)—

"(A) IN GENERAL.—The term 'qualified higher education expenses' means tuition, fees, books, supplies, and equipment required for the enrollment of attendance of—

"(i) the taxpayer,

"(ii) the taxpayer's spouse, or

"(iii) the taxpayer's child (as defined in section 151(c)(3)) or grandchild,

at an eligible educational institution (as defined in section 135(c)(3)).

"(B) COORDINATION WITH SAVINGS BOND PROVISIONS.—The amount of qualified higher educational expenses for any taxable year shall be reduced by any amount excludable from gross income under section 135.".

(d) CONFORMING AMENDMENTS.—

(1) Section 401(k)(2)(B)(i) is amended by striking "or" at the end of subclause (III), by striking "and" at the end of subclause (IV) and inserting "or", and by inserting after subclause (IV) the following new subclause:

"(V) the date on which qualified first-time homebuyer distributions (as defined in section 72(t)(6)) or distributions for qualified higher education expenses (as defined in section 72(t)(7)) are made, and".

(2) Section 403(b)(11) is amended by striking "or" at the end of subparagraph (A), by striking the period at the end of subparagraph (B) and inserting ", or" and by inserting after subparagraph (B) the following new subparagraph:

"(C) for qualified first-time homebuyer distributions (as defined in section 72(t)(6)) or for the payment of qualified higher education expenses (as defined in section 72(t)(7)).".

(e) EFFECTIVE DATE.—The amendmpnt made by this section shall apply to payments and distributions after the date of the enactment of this Act.

TITLE IV—INCREMENTAL INVESTMENT TAX CREDIT

SEC. 401. INVESTMENT CREDIT FOR NEW MANUFACTURING AND OTHER PRODUCTION EQUIPMENT.

(a) ALLOWANCE OF CREDIT.—Section 46 of the Internal Revenue Code of 1986 (relating to amount of investment credit) is amended by striking "and" at the end of paragraph (2), by striking the period at the end of paragraph (3) and inserting ", and", and by adding at the end thereof the following new paragraph:

"(4) the manufacturing and other productive equipment credit."

(b) AMOUNT OF CREDIT.—Section 48 of such Code is amended by adding at the end thereof the following new subsection:

"(c) MANUFACTURING AND OTHER PRODUCTIVE EQUIPMENT CREDIT.—

"(1) IN GENERAL.—For purposes of section 46, the manufacturing and other productive equipment credit for any taxable year is an amount equal to 10 percent of the excess (if any) of—

"(A) the aggregate bases of qualified manufacturing and productive equipment properties placed in service during such taxable year, over

"(B) the base amount.

"(2) QUALIFIED MANUFACTURING AND PRODUCTIVE EQUIPMENT PROPERTY.—For purposes of this subsection—

"(A) IN GENERAL.—The term 'qualified manufacturing and productive equipment property' means any property—

"(i) which is used as an integral part of the manufacture or production of tangible personal property, "(ii) which is tangible property to which section 168 applies,

"(iii) which is section 1245 property (as defined in section 1245(a)(3)), and

"(iv)(I) the construction, reconstruction, or erection of which is completed by the taxpayer, or

"(II) which is acquired by the taxpayer if the original use of such property commences with the taxpayer.

"(B) SPECIAL RULE FOR COMPUTER SOFTWARE.—In the case of any computer software which is used to control or monitor a manufacturing or production process and with respect to which depreciation (or amortization in lieu of depreciation) is allowable, such software shall be treated as qualified manufacturing and productive equipment property.

"(3) BASE AMOUNT.—For purposes of paragraph (1)(B)—

"(A) IN GENERAL.—The term 'base amount' means the product of—

"(i) the fixed-base percentage, and

"(ii) the average annual gross receipts of the taxpayer for the 4 taxable years preceding the taxable year for which the credit is being determined (hereafter in this subsection referred to as the 'credit year').

"(B) MINIMUM BASE AMOUNT.—In no event shall the base amount be less than 50 percent of the amount determined under paragraph (1)(A).

"(C) FIXED-BASE PERCENTAGE.—

"(i) IN GENERAL.—The fixed-base percentage is the percentage which the aggregate amounts described in paragraph (1)(A) for taxable years beginning after December 31, 1986, and before January 1, 1992, is of the aggregate gross receipts of the taxpayer for such taxable years.

"(ii) ROUNDING.—The percentages determined under clause (i) shall be rounded to the nearest 1/100 of 1 percent.

"(D) OTHER RULES.—Rules similar to the rules of paragraphs (4) and (5) of section 41(c) shall apply for purposes of this paragraph.

"(4) COORDINATION WITH OTHER CREDITS.—This subsection shall not apply to any poverty to which the energy credit or rehabilitation credit would apply unless the taxpayer elects to waive the application of such credit to such property.

"(5) CERTAIN PROGRESS EXPENDITURE RULES MADE APPLICABLE.—Rules similar to rules of subsection (c)(4) and (d) of section 46 (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990) shall apply for purposes of this subsection.".

(c) TECHNICAL AMENDMENTS.—

(1) Clause (ii) of section 49(a)(1)(C) of such Code is amended by inserting "or qualified manufacturing and productive equipment property" after "energy property".

(2) Subparagraph (E) of section 50(a)(2) of such Code is amended by inserting "or 48(c)(5)" before the period at the end thereof.

(3) Paragraph (5) of section 50(a) of such Code is amended by adding at the end thereof the following new subparagraph.

"(D) SPECIAL RULES FOR CERTAIN PROPERTY.—In the case of any qualified manufacturing and productive equipment property which is 3-year property (within the meaning of section 168(e))—

"(i) the percentage set forth in clause (ii) of the table contained in paragraph (1)(B) shall be 66 percent,

"(ii) the percentage set forth in clause (iii) of such table shall be 33 percent, and

"(iii) clauses (iv) and (v) of such table shall not apply."

(4)(A) The section heading for section 48 of such Code is amended to read as follows:

"SEC. 48. OTHER CREDITS."

(B) The table of sections for subpart E of part IV of subchapter A of chapter 1 of such Code is amended by striking the item relating to section 48 and inserting the following:

"Sec. 48. Other credits."

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to—

(1) property acquired by the taxpayer after December 31, 1991, and

(2) property the construction, reconstruction, or erection of which is completed by the taxpayer after December 31, 1991, but to the extent of the basis thereof attributable to construction, reconstruction, or erection after such date.

TITLE V—REPEAL OF THE EARNINGS TEST

SEC. 501. LIBERALIZATION OF EARNINGS TEST OVER THE PERIOD 1992–1996 FOR INDIVIDUALS WHO HAVE ATTAINED RETIREMENT AGE.

(a) IN GENERAL.—Effective with respect to taxable years ending after 1991, subparagraph (D) of section 203(f)(8) of the Social Security Act is amended to read as follows:

> "(D) Notwithstanding any other provision of this subsection, the exempt amount which is applicable to an individual who has attained retirement age (as defined in section 216(l) before the close of the taxable year involved shall be increased by $3,000 in each taxable year over the exempt amount for the previous taxable year, beginning with any taxable year ending after 1991 and before 1993.".

(b) CONFORMING AMENDMENT.—The second sentence of section 223(d)(4) of such Act is amended by striking out "which is applicable to individuals described in subparagraph (D) thereof" and inserting in lieu thereof "which would be applicable to individuals who have attained retirement age (as defined in section 216(l) without regard to any increase in such amount resulting from a law enacted in 1991".

SEC. 502. REPEAL OF EARNINGS TEST IN 1997 FOR INDIVIDUALS WHO HAVE ATTAINED RETIREMENT AGE.

Effective with respect to taxable years ending after 1996—

(1) clause (B) in the third sentence of section 203(f)(1) of the Social Security Act is amended by striking out "age seventy" and inserting in lieu thereof "retirement age (as defined in section 216))"; and (2) section 203(f)(3) of such Act is amended—

(A) by striking out "33½ percent" and all that follows through "other individual" and inserting in lieu thereof "50 percent of his earnings for such year in excess of the product of the application exempt amount as determined under paragraph (8)", and

(B) by striking out "age 70" and inserting in lieu thereof "retirement age (as defined in section 216(1))".

SEC. 503. CONFORMING AND RELATED AMENDMENTS.

Effective with respect to taxable years ending after 1996—

(1) Section 203(c)(1) of the Social Security Act is amended by striking out "is under the age of seventy" and inserting in lieu thereof "is under retirement age (as defined in section 216(1));

(2) the last sentence of subsection (c) of section 203 of such Act is amended by striking out "nor shall any deduction" and all that follows and inserting in lieu thereof "nor shall any deduction be made under this subsection from any widow's or widower's insurance benefit if the widow, surviving divorced wife, widower, or surviving divorced husband involved became entitled to such benefit prior to attaining age 60.";

(3) paragraphs (1)(A) and (2) of section 203(d) of such Act are each amended by striking out "under the age of seventy" and inserting in lieu thereof "under retirement age (as defined in section 216(1))";

(4) section 203(f)(1) of such Act is amended by striking out clause (D) and inserting in lieu thereof the following: "(D) for which such individual is entitled to widow's or widower's insurance benefits if such individual became so entitled prior to attaining age 60, or";

(5) subparagraph (D) of section 203(f)(5) of such Act is amended—

(A) by striking out "(D) In the case of" and all that follows down through "(ii) an individual" and inserting in lieu thereof the following: "(D) An individual";

(B) by striking out "became entitled to such benefits" and all that follows and inserting in lieu thereof "became entitled to such benefits, there shall be excluded from gross income any such other income."; and

(C) by shifting such subparagraph as so amended to the left to the extent necessary to align its left margin with that of subparagraphs (A) through (C) of such section;

(6) section 203(f)(8)(A) of such Act is amended by. striking out "the new exempt amounts (separately stated for individuals described in subparagraph (D) and for other individuals) which are to be applicable" and inserting in lieu thereof "the new exempt amount which is to be applicable";

(7) section 203(f)(8)(B) of such Act is amended—

(A) by striking out all that precedes clause (i) and inserting in lieu thereof the following:

"(B) The exempt amount which is applicable for each month of a par:icular taxable year shall be whichever of the followin'g is the larger—";

(B) by striking out "corresponding" in clause (i); and

(C) by striking out "an exempt amount" in the matter following c:ause (ii) and inserting in lieu thereof "the exempt amount";

(8) section 203(f)(8)(D) of such Act (as amended by section 1(a) of this Act) is repealed;

(9) section 203(f)(9) of such Act is repealed;

(10) section 203(h)(1)(A) of such Act is amended by striking out "age 70" each place it appears and inserting in lieu thereof "retirement age (as defined in section 216(l))";

(11) section 203(j) of such Act is amended to read as follows:

"Attainment of Retirement Age

"(j) For purposes of this section—

"(1) an individual shall be considered as having attained retirement age (as defined in section 216(l)) during the entire month in which he attains such age; and

"(2) the term 'retirement age (as defined in section 216(1))', with respect to any individual entitled to monthly insurance benefits under section 202, means the retirement age (as so defined) which is applicable in the case of old-age insurance benefits, regardless of whether or not the particular benefits to which the individual is entitled (or the only such benefits) are old-age insurance benefits.";

(12) section 202(w)(2)(B)(ii) of such Act is amended—

(A) by striking out "either"; and

(B) by striking out "or suffered deductions under section 203(b) or 203(c) in amounts equal to the amount of such benefit"; and

(13) the second sentence of section 223(d)(4) of such Act (as amended by section 1(b) of this Act) is further amended by striking out "without regard to any increase in such amount resulting from a law enacted in 1991" and inserting in lieu thereof "but for the liberalization and repeal of the earnings test for such individuals in 1992".

SEC. 504. ACCELERATION OF 8 PERCENT DELAYED RETIREMENT CREDIT.

Effective with respect to taxable years ending after 1991, paragraph (6) of section 202(w) of the Social Security Act is amended—

(1) by striking out "2005" in subparagraph (C) and inserting in lieu thereof "1993"; and

(2) by striking out "2004" in subparagraph (D) and inserting in lieu thereof "1992".

TITLE VI—EMERGENCY UNEMPLOYMENT COMPENSATION

SEC. 601. FEDERAL-STATE AGREEMENTS.

(a) IN GENERAL.—Any State which desires to do so may enter into and participate in an agreement under this title with the Secretary of Labor (hereafter in this title referred to as the "Secretary"). Any State which is a party to an agreement under this title may, upon providing 30 days written notice to the Secretary, terminate such agreement.

(b) PROVISIONS OF AGREEMENT.—Any agreement under subsection (a) shall provide that the State agency of the State will make payments of emergency unemployment compensation—

(1) to individuals who—

(A) have exhausted all rights to regular compensation under the State law;

(B) have no rights to compensation (including both regular compensation and extended compensation) with respect to a week under such law or any other State unemployment compensation law or to compensation under any other Federal law (and are not paid or entitled to be paid any additional compensation under any State or Federal law); and

(C) are not receiving compensation with respect to such week under the unemployment compensation law of Canada; and

(2) for any week of unemployment which begins in the individual's period of eligibility (as defined in section 106(2)).

(c) EXHAUSTION OF BENEFITS.—For purposes of subsection (b)(1)(A), an individual shall be deemed to have exhausted such individual's rights to regular compensation under a State law when—

(1) no payments of regular compensation can be made under such law because such individual has received all regular compensation available to such individual based on employment or wages during such individual's base period; or

(2) such individual's rights to such compensation have been terminated by reason of the expiration of the benefit year with respect to which such rights existed.

(d) WEEKLY BENEFIT AMOUNT.—For purposes of any agreement under this title—

(1) the amount of emergency unemployment compensation which shall be payable to any individual for any week of total unemployment shall be equal to the amount of the regular compensation (including dependent's allowances) payable to such individual during such individual's benefit year under the State law for a week of total unemployment;

(2) the terms and conditions of the State law which apply to claims for extended compensation and to the payment thereof shall apply to claims for emergency unemployment compensation and the payment thereof, except where inconsistent with the provisions of this title, or with the regulations or operating instructions of the Secretary promulgated to carry out this title; and

(3) the maximum amount of emergency unemployment compensation payable to any individual for whom an account is established under section 102 shall not exceed the amount established in such account for such individual.

SEC. 602. EMERGENCY UNEMPLOYMENT COMPENSATION ACCOUNT.

(a) IN GENERAL.—Any agreement under this title shall provide that the State will establish, for each eligible individual who files an application for emergency unemployment compensation, an emergency unemployment compensation account with respect to such individual's benefit year.

(b) AMOUNT IN ACCOUNT.—

(1) IN GENERAL.—The amount established in an account under subsection (a) shall be equal to the lesser of—

(A) 100 percent of the total amount of regular compensation (including dependents' allowances) payable to the individual with respect to the benefit year (as determined under the State law) on the basis of which the individual most recently received regular compensation, or

(B) the applicable limit times the individual's average weekly benefit amount for the benefit year.

(2) APPLICABLE LIMIT.—For purposes of this section—

(A) IN GENERAL.—Except as provided in this paragraph, the applicable limit shall be determined under the following table:

In the case of weeks beginning during a:	The applicable limit is:
5-percent period	10
Other period	7

(B) APPLICABLE LIMIT NOT REDUCED.—An individual's applicable limit for any week shall in no event be less than the highest applicable limit in effect for any prior week for which emergency unemployment compensation was payable to the individual from the account involved.

(C) INCREASE IN APPLICABLE LIMIT.—If the applicable limit in effect for any week is higher than the applicable limit for any prior week, the applicable limit shall be the higher applicable limit, reduced (but not below zero) by the number of prior weeks for which emergency unemployment compensation was paid to the individual from the account involved.

(3) REDUCTION FOR EXTENDED BENEFITS.—The amount in an account under paragraph (1) shall be reduced (but not below zero) by the aggregate amount of extended compensation (if any) received by such individual relating to the same benefit year under the Federal-State Extended Unemployment Compensation Act of 1970.

(4) WEEKLY BENEFIT AMOUNT.—For purposes of this subsection, an individual's weekly benefit amount for any week is the amount of regular compensation (including dependents' allowances) under the State law payable to such individual for such week for total unemployment.

(c) DETERMINATION OF PERIODS.—

(1) IN GENERAL.—For purposes of this section, the terms "5-percent period" and "other period" mean, with respect to any State, the period which—

(A) begins with the third week after the first week for which the applicable trigger is on, and

(B) ends with the third week after the first week for which the applicable trigger is off.

(2) APPLICABLE TRIGGER.—In the case of a 5-percent period or other period, as the case may be, the applicable trigger is on for any week with respect to any such period if the adjusted rate of insured unemployment in the State for the period consisting of such week and the immediately preceding 12 weeks falls within the applicable range.

(3) APPLICABLE RANGE.—For purposes of this subsection, the applicable range is as follows:

In the case of a:	**The applicable range is:**
5-percent period	A rate equal to or exceeding 5 percent.
Other period	A rate less than 5 percent.

(4) SPECIAL RULES FOR DETERMINING PERIODS.—

(A) MINIMUM PERIOD.—Except as provided in subparagraph (B), if for any week beginning after October 5, 1991, a 5-percent period or other period, as the case may be, is triggered on with respect to such State, such period shall last for not less than 13 weeks.

(B) EXCEPTION IF APPLICABLE RANGE INCREASES.—If, but for subparagraph (A), another period with a higher applicable range would be in effect for a State, such other period shall be in effect without regard to subparagraph (A).

(5) NOTIFICATION BY SECRETARY.—When a determination has been made that a 5-percent period or other period is beginning or ending with respect to a State, the Secretary shall cause notice of such determination to be published in the Federal Register.

(d) EFFECTIVE DATE.—

(1) IN GENERAL.—Except as provided in paragraphs (2) and (3), no emergency unemployment

compensation shall be payable to any individual under this title for any week—

(A) beginning before the later of—

(i) October 6, 1991, or

(ii) the first week following the week in which an agreement under this title is entered into, or

(B) beginning after July 4, 1992.

(2) TRANSITION.—In the case of an individual who is receiving emergency unemployment compensation for a week which includes July 4, 1992, such compensation shall continue to be payable to such individual in accordance with subsection (b) for any week beginning in a period of consecutive weeks for each of which the individual meets the eligibility requirements of this title.

(3) REACHBACK PROVISIONS.—

(A) IN GENERAL.—If—

(i) any individual exhausted such individual's rights to regular compensation (or extended compensation) under the State law after February 28, 1991, and before the first week following October 5, 1991 (or, if later, the week following the week in which the agreement under this title is entered into), and

(ii) a 5-percent period, as described in subsection (c), is in effect with respect to the State for the first week following October 5, 1991,

such individual shall be entitled to emergency unemployment compensation under this title in the same manner as if such individual's benefit year ended no earlier than the last day of such following week.

(B) LIMITATION OF BENEFITS.—In the case of an individual who has exhausted such individual's rights to both regular and extended compensation, any emergency unemployment compensation payable under subparagraph (A) shall be reduced in accordance with subsection (b)(3).

SEC. 603. PAYMENTS TO STATES HAVING AGREEMENTS FOR THE PAYMENT OF EMERGENCY UNEMPLOYMENT COMPENSATION.

(a) GENERAL RULE.—There shall be paid to each State which has entered into an agreement under this title an amount equal to 100 percent of the emergency unemployment compensation paid to individuals by the State pursuant to such agreement.

(b) TREATMENT OF REIMBURSABLE COMPENSATION.—No payment shall be made to any State under this section in respect of compensation to the extent the State is entitled to reimbursement in respect of such compensation under the provisions of any Federal law other than this title or chapter 85 of title 5, United States Code. A State shall not be entitled to any reimbursement under such chapter 85 in respect of any compensation to the extent the State is entitled to reimbursement under this title in respect of such compensation.

(c) DETERMINATION OF AMOUNT.—Sums payable to any State by reason of such State having an agreement under this title shall be payable, either in advance or by way of reimbursement (as may be determined by the Secretary), in such amounts as the Secretary estimates the State will be entitled to receive under this title for each calendar month, reduced or increased, as the case may be, by any amount by which the Secretary finds that his estimates for any prior calendar month were greater or less than the amounts which should have been paid to the State. Such estimates may be made on the basis of such statistical, sampling, or other method as may be agreed upon by the Secretary and the State agency of the State involved.

SEC. 604. FINANCING PROVISIONS.

(a) IN GENERAL.—Funds in the extended unemployment compensation account (as established by section 905 of the Social Security Act) of the Unemployment Trust Fund shall be used for the making of payments to States having agreements entered into under this title.

(b) CERTIFICATION.—The Secretary shall from time to time certify to the Secretary of the Treasury for payment to each State the sums payable to such State under this title. The Secretary of the Treasury, prior to audit of settlement by the General Accounting Office, shall make payments to the State in accordance with such certification, by transfers from the extended unemployment co፧pensation account (as established by section 905 of the Social Security Act) to the account of such State in the Unemployment Trust Fund.

(c) ASSISTANCE TO STATES.—There are hereby authorized to be appropriated without fiscal year limitation, such funds as may be necessary for purposes of assisting States (as provided in title III of the Social Security Act) in meeting the costs of administration of agreements under this title.

SEC. 605. FRAUD AND OVERPAYMENTS.

(a) IN GENERAL.—If an individual knowingly has made, or caused to be made by another, a false statement or representation of a material fact, or knowingly has failed, or caused another to fail, to disclose a material fact, and as a result of such false statement or representation or of such nondisclosure such individual has received an amount of emergency unemployment compensation under this title to which he was not entitled, such individual—

(1) shall be ineligible for further emergency unemployment compensation under this title in accordance with the provisions of the applicable State unemployment compensation law relating to fraud in connection with a claim for unemployment compensation; and

(2) shall be subject to prosecution under section 1001 of title 18, United States Code.

(b) REPAYMENT.—In the case of an individual who has received amounts of emergency unemployment compensation under this title to which he was not entitled, the State shall require such individual to repay the amounts of such emergency unemployment compensation to the State agency, except that the State agency may waive such repayment if it determines that—

(1) the payment of such emergency unemployment compensation was without fault on the part of any such individual, and

(2) such repayment would be contrary to equity and good conscience.

(c) RECOVERY BY STATE AGENCY.—

(1) IN GENERAL.—The State agency may recover the amount to be repaid, or any part thereof, by deductions from any emergency unemployment compensation payable to such individual under this title or from any unemployment compensation payable to such individual under any Federal unemployment compensation law administered by the State agency or under any other Federal law administered by the State agency which provides for the payment of any assistance or allowance with respect to any week of unemployment, during the 3-year period after the date such individual received the payment of the emergency unemployment compensation to which he was not entitled, except that no single deduction may exceed 50 percent of the weekly benefit amount from which such deduction is made.

(2) OPPORTUNITY FOR HEARING.—No repayment shall be required, and no deduction shall be made, until a determination has been made, notice

thereof and an opportunity for a fair hearing has been given to the individual, and the determination has become final.

(d) REVIEW.—Any determination by a State agency under this section shall be subject to review in the same manner and to the same extent as determinations under the State unemployment compensation law, and only in that manner and to that extent.

SEC. 606. DEFINITIONS.

For purposes of this title:

(1) IN GENERAL.—The terms "compensation", "regular compensation", "extended compensation", "additional compensation", "benefit year", "base period", "State", "State agency", "State law", and "week" have the meanings given such terms under section 205 of the Federal-State Extended Unemployment Compensation Act of 1970.

(2) ELIGIBILITY PERIOD.—An individual's eligibility period shall consist of the weeks in the individual's benefit year which begin in a 5-percent period or other period under this title and, if the individual's benefit year ends within any such period, any weeks thereafter which begin in any such period. In no event shall an individual's period of eligibility include any weeks after the 39th week after the end

of the benefit year for which the individual exhausted his rights to regular compensation or extended compensation.

(3) ADJUSTED RATE OF INSURED UNEMPLOYMENT.—The adjusted rate of insured unemployment shall be determined in the same manner as the rate of insured unemployment is determined under section 203 of the Federal-State Extended Unemployment Compensation Act of 1970, except that the total number of individuals exhausting rights to regular compensation for the most recent three months for which data are available shall be included in such determination in the same manner as the average weekly number of individuals filing claims for regular compensation.

SEC. 607. PAYMENTS OF UNEMPLOYMENT COMPENSATION TO FORMER MEMBERS OF THE ARMED FORCES.

(a) REDUCTION IN LENGTH OF REQUIRED ACTIVE DUTY FOR DESERT STORM RESERVISTS.—Section 8521 of title 5, United States Code, is amended by adding at the end thereof the following new subsection:

"(d)(1) In the case of a member of the armed forces who served on active duty in the Persian Gulf area of operations in connection with Operation Desert Storm, paragraph (1) of subsection (a) shall be applied by substituting '90 days' for '180 days'.

"(2) For purposes of paragraph (1), the term 'Operation Desert Storm' has the meaning given the term in section 3(1) of Public Law 102–25 (105 Stat. 77).".

(b) LIMITATIONS ON UNEMPLOYMENT COMPENSATION.—Subsection (a)(1) of section 8521 of title 5, United States Code, is amended by striking subparagraphs (A) and (B) and inserting the following new subparagraphs:

"(A) The individual was—

"(i) involuntarily separated from the armed forces, or

"(ii) separated from the armed forces after being retained on active duty pursuant to section 673C or 676 of title 10, United States Code.

"(B) The paragraph does not apply in the case of a dismissal, dishonorable discharge, or bad conduct discharge adjudged by a court martial or a discharge under other than honorable conditions (as defined in regulations prescribed by the Secretary of the military department concerned).".

(c) CONFORMING AMENDMENT.—Subsection (c) of section 8521 of such title is hereby repealed.

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to weeks of unemployment beginning on or after October 5, 1991.

TITLE VII—GUARANTEED STUDENT LOANS

SEC. 701. CREDIT CHECKS; COSIGNERS.

(a) IN GENERAL.—Section 427(a)(2)(A) of the Higher Education Act of 1965 (20 U.S.C. 1001 et seq.), hereafter in this title referred as "the Act", is amended to read as follows:

"(A) is made without security and without endorsement, except that prior to making a loan insurable by the Secretary under this part a lender shall—

"(i) obtain a credit report, from at least one national credit bureau organization, with respect to a loan applicant who will be at least 21 years of age as of July 1 of the award year for which assistance is being sought, for which the lender may charge the applicant an amount not to exceed the lesser of $25 or the actual cost of obtaining the credit report; and "(ii) require an applicant of the age specified in clause (i) who, in the judgment of the lender in accordance with the regulations of the Secretary, has an adverse credit history, to obtain a credit worthy cosigner in order to obtain the loan, provided that, for purposes of this clause, an insufficient or nonexistent credit history may not be considered to be an adverse credit history;".

(b) CONFORMING AMENDMENT.—Section 428(b)(1) of the Act is amended—

(1) in subparagraph (U), by striking "and" at the end thereof;

(2) in subparagraph (V), by striking the period at the end thereof and inserting a semicolon and "and"; and

(3) by adding at the end thereof the following new subparagraph:

"(W) provides that prior to making a loan made, insured, or guaranteed under this part (other than a loan made in accordance with section 428C), a lender shall—

"(i) obtain a credit report, from at least one national credit bureau organization, with respect to a loan applicant who will be at least 21 years of age as of July 1 of the award year for which assistance is being sought, for which the lender may charge the applicant an amount not to exceed the lesser of $25 or the actual cost of obtaining the credit report; and

"(ii) require an applicant of the age specified in clause (i) who, in the judgment of the lender in accordance with the regulations of the Secretary, has an adverse credit history, to obtain a credit worthy cosigner in order to obtain the loan, provided that, for purposes of this clause, an insufficient or nonexistent credit history may not be considered to be an adverse credit history.".

SEC. 702. BORROWER INFORMATION.

(a) In General.—Section 427 of the Act is amended by adding at the end thereof the following new subsection:

"(d) Borrower Information.—The lender shall obtain the borrower's driver's license number, if any, at the time of application for the loan.".

(b) Conforming Amendment.—Section 428 of the Act is amended—

(1) in subsection (a)(2)(A)—

(A) in clause (i)(I), by striking out "and" at the end thereof;

(B) in clause (ii), by striking out the period at the end thereof and inserting in lieu thereof a semicolon and "and"; and

(C) by adding at the end thereof the following new clause:

"(iii) have provided to the lender at the time of application for a loan made, insured, or guaranteed under this part, the student's driver's number, if any.".

SEC. 703. ADDITIONAL BORROWER INFORMATION.

Section 485(b) of the Act is amended—

(1) by striking the subsection heading and inserting "EXIT COUNSELING FOR BORROWERS; BORROWER INFORMATION.—"; and

(2) by adding at the end thereof the following:

"Each eligible institution shall require that the borrower of a loan made under part B, part D, or part E submit to the institution, during the exit interview required by this subsection, the borrower's expected permanent address after leaving the institution, regardless of the reason for leaving; the name and address of the borrower's expected employer after leaving the institution; and the address of the borrower's next of kin. In the case of a loan made under part B, the institution shall then submit this information to the holder of the loan.".

SEC. 704. CONFESSION OF JUDGMENT.

Section 428(b)(1) of the Act is further amended—

(1) in subparagraph (V), by striking "and" at the end thereof;

(2) in subparagraph (W), by striking the period at the end thereof and inserting a semicolon and "and"; and

(3) by adding at the end thereof the following new subparagraph:

"(X) provides that the lender shall obtain, as part of the note or written agreement evidencing the loan, the borrower's authorization for entry of judgment against the borrower in the event of default.".

SEC. 705. WAGE GARNISHMENT.

(a) IN GENERAL.—Part G of title IV of the Act is amended by inserting immediately following section 488 the following new section:

"WAGE GARNISHMENT REQUIREMENT

"SEC. 488A. (a) GARNISHMENT REQUIREMENT.—Notwithstanding any provision of State law, a guaranty agency, or the Secretary in the case of loans made, insured or guaranteed under this title that are held by the Secretary, may garnish the disposable pay of an individual to collect the amount owed by the individual, if he or she is not currently making required repayment under a repayment agreement with the Secretary, or, in the case of a loan guaranteed under part B on which the guaranty agency received reimbursement from the Secretary under section 428(c), with the guaranty agency holding the loan, as appropriate, provided that—

"(1) the amount deducted for any pay period may not exceed 10 percent of disposable pay, except that a greater percentage may be deducted with the written consent of the individual involved;

"(2) the individual shall be provided written notice, sent by mail to the individual's last known address, a minimum of 30 days prior to the initiation of proceedings, from the guaranty agency or the Secretary, as appropriate, informing such individual of the nature and amount of the loan obligation to be collected, the intention of the guaranty agency or the Secretary, as appropriate, to initiate proceedings to collect the debt through deductions from pay, and an explanation of the rights of the individual under this section;

"(3) the individual shall be provided an opportunity to inspect and copy records relating to the debt;

"(4) the individual shall be provided an opportunity to enter into a written agreement with the guaranty agency or the Secretary, under terms agreeable to the Secretary, or the head of the guaranty agency or his designee, as appropriate, to establish a schedule for the repayment of the debt;

"(5) the individual shall be provided an opportunity for a hearing in accordance with subsection (b) on the determination of the Secretary or the guaranty agency, as appropriate, concerning the existence or the amount of the debt, and, in the case of an individual whose repayment schedule is established other than by written agreement pursuant to paragraph (4), concerning the terms of the repayment schedule;

"(6) the employer shall pay to the Secretary or the guaranty agency as directed in the withholding order issued in this action, and shall be liable for, and the Secretary or the guaranty agency, as appropriate, may sue the employer in a State or Federal court of competent jurisdiction to recover, any amount that such employer fails to withhold from wages due an employee following receipt of such employer of notice of the withholding order, plus attorney's fees, costs, and, in the court's discretion, punitive damages, but such employer shall not be required to vary the normal pay and disbursement cycles in order to comply with this paragraph; and

"(7) an employer may not discharge from employment, refuse to employ, or take disciplinary action against an individual subject to wage withholding in accordance with this section by reason of the fact that the individual's wages have been subject to garnishment under this section, and such individual may sue in a State or Federal court of competent jurisdiction any employer who takes such action. The court shall award attorney's fees to a prevailing employee and, in its discretion, may order reinstatement of the individual, award punitive damages and back pay to the employee, or order such other remedy as may be reasonably necessary.

"(b) HEARING REQUIREMENTS.—A hearing described in subsection (a)(5) shall be provided prior to issuance of a garnishment order if the individual, on or before the 15th day following the mailing of the notice described in subsection (a)(2), and in accordance with such procedures as the Secretary or the head of the guaranty agency, as appropriate, may prescribe, files a petition requesting such a hearing. If the individual does not file a petition requesting a hearing prior to such date, the Secretary or the guaranty agency, as appropriate, shall provide the individual a hearing under subsection (a)(5) upon request, but such hearing need not be provided prior to issuance of a garnishment order. A hearing under subsection (a)(5) may not be conducted by an individual under the supervision or control of the head of the guaranty agency, except that nothing in this sentence shall be construed to prohibit the appointment of an administrative law judge. The hearing official shall issue a final decision at the earliest practicable date, but not later than 60 days after the filing of the petition requesting the hearing.

"(c) NOTICE REQUIREMENTS.—The notice to the employer of the withholding order shall contain only such information as may be necessary for the employer to comply with the withholding order.

"(d) DEFINITION.—For the purpose of this section, the term 'disposable pay' means that part of the compensation of any individual remaining after the deduction of any amounts required by law to be withheld.".

(b) CONFORMING AMENDMENTS.—

(1) Section 428E of the Act is repealed.

(2) Section 428(c)(6) of the Act is amended by striking subparagraph (D).

SEC. 706. DATA MATCHING.

Part G of title IV of the Act is further amended by inserting immediately following section 489 the following new section:

"DATA MATCHING

"SEC. 489A. (a)(1) The Secretary is authorized to obtain information from the files and records maintained by any of the departments, agencies, or instrumentalities of the United States concerning the most recent address of an individual obligated on a loan held by the Secretary or a loan made in accordance with part B of this title held by a guaranty agency, or an individual owing a refund of an overpayment of a grant awarded under this title, and the name and address of such individual's employer, if the Secretary determines that such information is needed to enforce the loan or collect the overpayment.

"(2) The Secretary is authorized to provide the information described in paragraph (1) to a guaranty agency holding a loan made under part B of this title on which such individual is obligated.

"(b)(1) Notwithstanding any other provision of law, whenever the head of any department, agency, or instrumentality of the United States receives a request from the Secretary for information authorized under this section, such individual or his designee shall promptly cause a search to be made of the records of the agency to determine whether the information requested is contained in those records.

"(2)(A) If such information is found, the individual shall, in conformance with the provisions of the Privacy Act of 1974, as amended, immediately transmit such information to the Secretary, except that if disclosure of this information would contravene national policy or security interests of the United States, or the confidentiality of census data, the individual shall immediately so notify the Secretary and shall not transmit the information.

"(B) If no such information is found, the individual shall immediately so notify the Secretary.

"(3)(A) The reasonable costs incurred by any such agency of the United States in providing any such information to the Secretary shall be reimbursed by the Secretary, and retained by the agency.

"(B) Whenever such information is furnished to a guaranty agency, that agency shall be charged a fee to be used to reimburse the Secretary for the expense of providing such information.

TITLE VIII—ELECTROMAGNETIC SPECTRUM FUNCTION

SEC. 801. SHORT TITLE.

This title may be cited as the "Emerging Telecommunications Technologies Act of 1991".

SEC. 802. FINDINGS.

The Congress finds that—

(1) spectrum is a valuable natural resource;

(2) it is in the national interest that this resource be used more efficiently;

(3) the spectrum below 6 gigahertz (GHz) is becoming increasingly congested, and, as a result entities that develop innovative new spectrum-based services are finding it difficult to bring these services to the marketplace;

(4) scarcity of assignable frequencies can and will—

(A) impede the development and commercialization of new spectrum-based products and services;

(B) reduce the capacity and efficiency of the United States telecommunications system; and

(C) adversely affect the productive capacity and international competitiveness of the United States economy;

(5) the United States Government presently lacks explicit authority to use excess radiocommunications capacity to satisfy non-United States Government requirements;

(6) more efficient use of the spectrum can provide the resources for increased economic returns;

(7) many commercial users derive significant economic benefits from their spectrum licenses, both through the income they earn from their use of the spectrum and the returns they realize upon transfer of their licenses to third parties; but under current procedures, the United States public does not sufficiently share in their benefits;

(8) many United States Government functions and responsibilities depend heavily on the use of the radio spectrum, involve unique applications, and are performed in the broad national and public interest;

(9) competitive bidding for spectrum can yield significant benefits for the United States economy by increasing the efficiency of spectrum allocations, assignment, and use; and for United States tax-

payers by producing substantial revenues for the United States Treasury; and

(10) the Secretary, the President, and the Commission should be directed to take appropriate steps to foster the more efficient use of this valuable national resource, including the reallocation of a target amount of 200 megahertz (MHz) of spectrum from United States Government use under section 305 of the Communications Act to non-United States Government use pursuant to other provisions of the Communications Act and the implementation of competitive bidding procedures by the Commission for some new assignments of the spectrum.

SEC. 803. NATIONAL SPECTRUM PLANNING.

(a) PLANNING ACTIVITIES.—The Secretary and the Chairman of the Commission shall, at least twice each year, conduct joint spectrum planning meetings with respect to the following issues—

(1) future spectrum needs;

(2) the spectrum allocation actions necessary to accommodate those needs, including consideration of innovation and marketplace developments that may affect the relative efficiencies of different portions of the spectrum; and

(3) actions necessary to promote the efficient use of the spectrum, including proven spectrum management techniques to promote increased shared use of the spectrum as a means of increasing non-United States Government access; and innovation in spectrum utilization including means of providing incentives for spectrum users to develop innovative services and technologies.

(b) REPORTS.—The Secretary and the Chairman of the Commission shall submit a joint annual report to the President on the joint spectrum planning meetings conducted under subsection (a) and any recommendations for action developed in such meetings.

(c) OPEN PROCESS.—The Secretary and the Commission will conduct an open process under this section to ensure the full consideration and exchange of views among any interested entities, including all private, public, commercial, and governmental interests.

SEC. 804. IDENTIFICATION OF REALLOCABLE FREQUENCIES.

(a) IDENTIFICATION REQUIRED.—The Secretary shall prepare and submit to the President the reports required by subsection (d) to identify bands of frequencies that—

(1) are allocated on a primary basis for United States Government use and eligible for licensing pursuant to section 305(a) of the Communications Act;

(2) are not required for the present or identifiable future needs of the United States Government;

(3) can feasibly be made available during the next 15 years after enactment of this title for use under the provisions of the Communications Act for non-United States Government uses;

(4) will not result in costs to the Federal Government that are excessive in relation to the benefits that may be obtained from the potential non-United States Government uses; and

(5) are likely to have significant value for non-United States Government uses under the Communications Act.

(b) AMOUNT OF SPECTRUM RECOMMENDED.—

(1) IN GENERAL.—The Secretary shall recommend as a goal for reallocation, for use by non-United States Government stations, bands of frequencies constituting a target amount of 200 MHz, that are located below 6 GHz, and that meet the criteria specified in paragraphs (1) through (5) of subsection (a). If the Secretary identifies (as meeting

such criteria) bands of frequencies totalling more than 200 MHz, the Secretary shall identify and recommend for reallocation those bands (totalling not less than 200 MHz) that are likely to have the greatest potential for non-United States Government uses under the Communications Act.

(2) MIXED USES PERMITTED TO BE COUNTED.—Bands of frequencies which the Secretary recommends be partially retained for use by United States Government stations, but which are also recommended to be allocated and made available under the Communications Act for use by non-United States Government stations, may be counted toward the target 200 MHz of spectrum required by paragraph (1) of this subsection, except that—

(A) the bands of frequencies counted under this paragraph may not count toward more than one-half of the amount targeted by paragraph (1) of this subsection;

(B) a band of frequencies may not be counted under this paragraph unless the assignments of the band to United States Government stations under section 305 of the Communications Act are limited by geographic area, by time, or by other means so as to guarantee that the potential use to be made by which United States Government stations is substantially less (as measured by geographic area, time, or otherwise) than the potential United States Government use to be made; and

(C) the operational sharing permitted under this paragraph shall be subject to procedures which the Commission and the Department of Commerce shall establish and implement to ensure against harmful interference.

(c) CRITERIA FOR IDENTIFICATION.—

(1) NEEDS OF THE UNITED STATES GOVERNMENT.—In determining whether a band of frequencies meets the criteria specified in subsection (a)(2), the Secretary shall—

(A) consider whether the band of frequencies is used to provide a communications service that is or could be available from a commercial provider;

(B) seek to promote—

(i) the maximum practicable reliance on commercially available substitutes;

(ii) the sharing of frequencies (as permitted under subsection (b)(2));

(iii) the development and use of new communication technologies; and

(iv) the use of nonradiating communications systems where practicable;

(C) seek to avoid—

(i) serious degradation of United States Government services and operations;

(ii) excessive costs to the United States Government and civilian users of such Government services; and

(iii) identification of any bands for reallocation that are likely to be subject to substitution for the reasons specified in section 405(b)(2) (A) through (C); and

(D) exempt power marketing administrations and the Tennessee Valley Authority from any reallocation procedures.

(2) FEASIBILITY OF USE.—In determining whether a frequency band meets the criteria specified in subsection (a)(3), the Secretary shall—

(A) assume such frequencies will be assigned by the Commission under section 303 of the Communications Act over the course of fifteen years after the enactment of this title;

(B) assume reasonable rates of scientific progress and growth of demand for telecommunications services;

(C) determine the extent to which the reallocation or reassignment will relieve actual or potential scarcity of frequencies available for non-United States Government use;

(D) seek to include frequencies which can be used to stimulate the development of new technologies; and

(E) consider the cost to reestablish United States Government services displaced by the reallocation of spectrum during the fifteen year period.

(3) COSTS TO THE UNITED STATES GOVERNMENT.—In determining whether a frequency band meets the criteria specified in subsection (a)(4), the Secretary shall consider—

(A) the costs to the United States Government of reaccommodating its services in order to make spectrum available for non-United States Government use, including the incremental costs directly attributable to the loss of the use of the frequency band; and

(B) the benefits that could be obtained from reallocating such spectrum to non-United States Government users, including the value of such spectrum in promoting—

(i) the delivery of improved service to the public;

(ii) the introduction of new services; and

(iii) the development of new communications technologies.

(4) NON-UNITED STATES GOVERNMENT USE.—In determining whether a band of frequencies meets the criteria specified in subsection (a)(5), the Secretary shall consider—

(A) the extent to which equipment is commercially available that is capable of utilizing the band; and

(B) the proximity of frequencies that are already assigned for non-United States Government use.

(d) PROCEDURE FOR IDENTIFICATION OF REALLOCABLE BANDS OF FREQUENCIES.—

(1) SUBMISSION OF REPORTS TO THE PRESIDENT TO IDENTIFY AN INITIAL 50 MHZ TO BE MADE AVAILABLE IMMEDIATELY FOR REALLOCATION, AND

TO PROVIDE PRELIMINARY AND FINAL REPORTS ON ADDITIONAL FREQUENCIES TO BE REALLOCATED.—

(A) Within 3 months after the date of the enactment of this title, the Secretary shall prepare and submit to the President a report which specifically identifies an initial 50 MHz of spectrum that are located below 3 GHz, to be made available for reallocation to the Federal Communications Commission upon issuance of this report, and to be distributed by the Commission pursuant to competitive bidding procedures.

(B) The Department of Commerce shall make available to thu Federal Communications Commission 50 MHz as identified in subparagraph (a) of electromagnetic spectrum for allocation of land-mobile or land-mobile-satellite services. Notwithstanding section 553 of the Administrative Procedure Act and title III of the Communications Act, the Federal Communications Commission shall allocate such spectrum and conduct competitive bidding procedures to complete the assignment of such spectrum in a manner which ensures that the proceeds from such bidding are received by the

Federal Government no later than September 30, 1992. From such proceeds, Federal agencies displaced by this transfer of the electromagnetic spectrum to the Federal Communications Commission shall be reimbursed for reasonable costs directly attributable to such displacement. The Department of Commerce shall determine the amount of, and arrange for, such reimbursement. Amounts to agencies shall be available subject to appropriation Acts.

(C) Within 12 months after the date of the enactment of this title, the Secretary shall prepare and submit to the President a preliminary report to identify reallocable bands of frequencies meeting the criteria established by this section.

(D) Within 24 months after the date of enactment of this title, the Secretary shall prepare and submit to the President a final report which identifies the target 200 MHz for reallocation (which shall encompass the initial 50 MHz previously designated under subparagraph (A)).

(E) The President shall publish the reports required by this section in the Federal Register.

(2) CONVENING OF PRIVATE SECTOR ADVISORY COMMITTEE.—Not later than 12 months after the enactment of this title, the Secretary shall convene a private sector advisory committee to—

(A) review the bands of frequencies identi-/fied in the preliminary report required by paragraph (1)(C);

(B) advise the Secretary with respect to—

(i) the bands of frequencies which should be included in the final report required by paragraph (1)(D); and

(ii) the effective dates which should be established under subsection (e) with respect to such frequencies;

(C) receives public comment on the Secretary's preliminary and final reports under this subsection; and

(D) prepare and submit the report required by paragraph (4).

The private sector advisory committee shall meet at least quarterly until each of the actions required by section 405(a) have taken place.

(3) COMPOSITION OF COMMITTEE; CHAIRMAN.—The private sector adviser committee shall include—

(A) the Chairman of the Commission, and the Secretary, or their designated representatives, and two other representatives from two different United States Government agencies that are spectrum users, other than the Department of Commerce, as such agencies may be designated by the Secretary; and

(B) Persons who are representative of—

(i) manufacturers of spectrum-dependent telecommunications equipment;

(ii) commercial users;

(iii) other users of the electromagnetic spectrum; and

(iv) other interested members of the public who are knowledgeable about the uses of the electromagnetic spectrum to be chosen by the Secretary.

A majority of the members of the committee shall be members described in subparagraph (B), and one of such members shall be designated as chairman by the Secretary.

(4) RECOMMENDATIONS OF SPECTRUM ALLOCATION PROCEDURES.—The private sector advisory committee shall, not later than 12 months after its formation, submit to the Secretary, the Commission,

the Committee on Energy and Commerce of the House of Representatives, and the Committee on Commerce, Science and Transportation of the Senate, such recommendations as the committee considers appropriate for the reform of the process of allocating the electromagnetic spectrum between United States Government users and non-United States Government users, and any dissenting views thereon.

(e) TIMETABLE FOR REALLOCATION AND LIMITATION.—The Secretary shall, as part of the final report required by subsection (d)(1)(D), include a timetable for the effective dates by which the President shall, within 15 years after enactment of this title, withdraw or limit assignments on frequencies specified in the report. The recommended effective dates shall—

(1) permit the earliest possible reallocation of the frequency bands, taking into account the requirements of section 406(a);

(2) be based on the useful remaining life of equipment that has been purchased or contracted for to operate on identified frequencies;

(3) be based on the need to coordinate frequency use with other nations; and

(4) avoid the imposition of incremental costs on the United States Government directly attributable

to the loss of the use of frequencies or the changing to different frequencies that are excessive in relation to the benefits that may be obtained from non-United States Government uses of the reassigned frequencies.

SEC. 805. WITHDRAWAL OF ASSIGNMENT TO UNITED STATES GOVERNMENT STATIONS.

(a) IN GENERAL.—The President shall—

(1) within 3 months after receipt of the Secretary's report under section 402(d)(1)(A), withdraw or limit the assignment to a United States Government station of any frequency on the initial 50 MHz which that report recommends for immediate reallocation;

(2) with respect to other frequencies recommended for reallocation by the Secretary's report in section 404(d)(1)(D), by the effective dates recommended pursuant to section 404(e) (except as provided in subsection (b)(4) of this section), withdraw or limit the assignment to a United States Government station of any frequency which that report recommends be reallocated or available for mixed use on such effective dates;

(3) assign or reassign other frequencies to United States Government stations as necessary to

adjust to such withdrawal or limitation of assignments; and

(4) publish in the Federal Register a notice and description of the actions taken under this subsection.

(b) EXCEPTIONS.—

(1) AUTHORITY TO SUBSTITUTE.—If the President determines that a circumstance described in section 405(b)(2) exits, the President—

(A) may, within 1 month after receipt of the Secretary's report under section 404(d)(1)(A), and within 6 months after receipt of the Secretary's report under section 404(d)(1)(D), substitute an alternative frequency or band of frequencies for the frequency or band that is subject to such determination and withdraw (or limit) the assignment of that alternative frequency or band in the manner required by subsection (a); and

(B) shall publish in the Federal Register a statement of the reasons for taking the action described in subparagraph (A).

(2) GROUNDS FOR SUBSTITUTION.—For purposes of paragraph (1), the following circumstances are described in this paragraph:

(A) The reassignment would seriously jeopardize the national security interests of the United States.

(B) The frequency proposed for reassignment is uniquely suited to meeting important United States Government needs.

(C) The reassignment would seriously jeopardize public health or safety.

(D) The reassignment will result in incremental costs to the United States Government that are excessive in relation to the benefits that may be obtained from non-United States Government uses of the reassigned frequency.

(4) CRITERIA FOR SUBSTITUTED FREQUENCIES.—For purposes of paragraph (1), a frequency may not be substituted for a frequency identified by the final report of the Secretary under section 404(d)(1)(D) unless the substituted frequency also meets each of the criteria specified by section 404(a).

(3) DELAYS IN IMPLEMENTATION.—If the President determines that any action cannot be completed by the effective dates recommended by the Secretary pursuant to section 404(e), or that such an action by such date would result in a frequency

being unused as a consequence of the Commission's plan under section 406, the President may—

(A) withdraw or limit the assignment to United States Government stations on a later date that is consistent with such plan, by providing notice to that effect in the Federal Register, including the reason that withdrawal at a later date is required; or

(B) substitute alternative frequencies pursuant to the provisions of this subsection.

(c) COSTS OF WITHDRAWING FREQUENCIES ASSIGNED TO THE UNITED STATES GOVERNMENT; APPROPRIATIONS AUTHORIZED.—Any United States Government licensee, or non-United States Government entity operating on behalf of a United States Government licensee, that is displaced from a frequency pursuant to this section may be reimbursed not more than the incremental costs it incurs, in such amounts as provided in advance in appropriation Acts, that are directly attributable to the loss of the use of the frequency pursuant to this section. The estimates of these costs shall be prepared by the affected agency, in consultation with the Department of Commerce.

(d) There are authorized to be appropriated to the affected licensee agencies such sums as may be necessary to carry out the purposes of this section.

SEC. 806. DISTRIBUTION OF FREQUENCIES BY THE COMMISSION.

(a) PLANS SUBMITTED.—

(1) With respect to the initial 50 MHz to be reallocated from United States Government to non-United States Government use under section 404(d)(1)(A), not later than 6 months after enactment of this title, the Commission shall complete a public notice and comment proceeding regarding the allocation of this spectrum and shall form a plan to assign such spectrum pursuant to competitive bidding procedures, pursuant to section 408, during fiscal years 1994 through 1996.

(2) With respect to the remaining spectrum to be reallocated from United States Government to non-United States Government use under section 404(e), not later than 2 years after issuance of the report required by section 404(d)(1)(D), the Commission shall complete a public notice and comment proceeding; and the Commission shall, after consultation with the Secretary, prepare and submit to the President a plan for the distribution under the

Communications Act of the frequency bands reallocated pursuant to the requirements of this title. Such plan shall—

(A) not propose the immediate distribution of all such frequencies, but, taking into account the timetable recommended by the Secretary pursuant to section 404(e), shall propose—

(i) gradually to distribute the frequencies remaining, after making the reservation required by subparagraph (ii), over the course of a 10-year period beginning on the date of submission of such plan; and

(ii) to reserve a significant portion of such frequencies for. distribution beginning after the end of such 10-year period;

(B) contain appropriate provisions to ensure—

(i) the availability of frequencies for new technologies and services in accordance with the policies of section 7 of the Communications Act (47 U.S.C. 157); and

(ii) the availability of frequencies to stimulate the development of such technologies; and

(C) not prevent the Commission from allocating bands of frequencies for specific uses in future rulemaking proceedings.

(b) AMENDMENT TO THE COMMUNICATIONS ACT.—Section 303 of the Communications Act is amended by adding at the end thereof the following new subsection:

"(u) Have authority to assign the frequencies reallocated from United States Government use to non-United States Government use pursuant to the Emerging Telecommunications Technologies Act of 1991, except that any such assignment shall expressly be made subject to the right of the President to reclaim such frequencies under the provisions of section 407 of the Emerging Telecommunications Technologies Act of 1991.".

SEC. 807. AUTHORITY TO RECLAIM REASSIGNED FREQUENCIES.

(a) AUTHORITY OF PRESIDENT.—The President may reclaim reallocated frequencies for reassignment to United States Government stations in accordance with this section.

(b) PROCEDURE FOR RECLAIMING FREQUENCIES.—

(1) UNASSIGNED FREQUENCIES.—If the frequencies to be reclaimed have not been assigned by the Commission, the President may reclaim them based on the grounds described in section 405(b)(2).

(2) ASSIGNED FREQUENCIES.—If the frequencies to be reclaimed have been assigned by the Commission, the President may reclaim them based on the grounds described in section 405(b)(2), except that the notification required by section 405(b)(1) shall include—

(A) a timetable to accommodate an orderly transition for licensees to obtain new frequencies and equipment necessary for their utilization; and

(B) an estimate of the cost of displacing the licensees.

(c) COSTS OF RECLAIMING FREQUENCIES.—Any non-United States Government licensee that is displaced from a frequency pursuant to this section shall be reimbursed the incremental costs it incurs that are directly attributable to the loss of the use of the frequency pursuant to this section.

(d) EFFECT ON OTHER LAW.—Nothing in this section shall be construed to limit or otherwise affect the authority of the President under section 706 of the Communications Act (47 U.S.C. 606).

SEC. 808. COMPETITIVE BIDDING.

(a) COMPETITIVE BIDDING AUTHORIZED.—Section 309 of the Communications Act is amended by adding the following new subsection:

"(j)(1)(A) The Commission shall use competitive bidding for awarding all initial licenses or new construction permits, including licenses and permits for spectrum reallocated for non-United States Government use pursuant to the Emerging Telecommunications Technologies Act of 1991, subject to the exclusions listed in paragraph (2).

"(B) The Commission shall require potential bidders to file a first-stage application indicating an intent to participate in the competitive bidding process and containing such other information as the Commission finds necessary. After conducting the bidding, the Commission shall require the winning bidder to submit a second-stage application. Upon determining that such application is acceptable for filing and that the applicant is qualified pursuant to subparagraph (C), the Commission shall grant a permit or license.

"(C) No construction permit or license shall be granted to an applicant selected pursuant to subparagraph (B) unless the Commission determines that such applicant is qualified pursuant to section 308(b) and subsection (a) of this section, on the basis of the information contained in the first- and second-stage applications submitted under subparagraph (B).

"(D) Each participant in the competitive bidding process is subject to the schedule of changes contained in section 8 of this Act.

"(E) The Commission shall have the authority in awarding construction permits or licenses under competitive bidding procedures to (i) define the geographic and frequency limitations and technical requirements, if any, of such permits or licenses; (ii) establish minimum acceptable competitive bids; and (iii) establish other appropriate conditions on such permits and licenses that will serve the public interest.

"(F) The Commission, in designing the competitive bidding procedures under this subsection, shall study and include procedures—

"(i) to ensure bidding access for small and rural companies,

"(ii) if appropriate, to extend the holding period for winning bidders awarded permits or licenses, and

"(iii) to expand review and enforcement requirements to ensure that winning bidders continue to meet their obligations under this Act.

"(G) The Commission shall, within 6 months after enactment of the Emerging Telecommunications Technologies Act of 1991, following public notice and comment proceedings, adopt rules establishing competitive bidding procedures under this subsection, including the method of bidding and the basis for payment (such as flat fees, fixed or variable royalties, combinations of flat fees and royalties, or other reasonable forms of payment); and a plan for applying such competitive bidding procedures to the initial 50 MHz reallocated from United States Government to non-United States Government use under section 404(d)(1)(A) of the Emerging Telecommunications Technologies Act of 1991, to be distributed during the fiscal years 1994 through 1996.

"(2) Competitive bidding shall not apply to—

"(A) license renewals;

"(B) the United States Government and State or local government entities;

"(C) amateur operator services, over-the-air terrestrial radio and television broadcast services, public safety services, and radio astronomy services;

"(D) private radio end-user licenses, such as Specialized Mobile Radio Service (SMRS), maritime, and aeronautical end-user licenses;

"(E) any license grant to a non-United States Government licensee being moved from its current frequency assignment to a different one by the Commission in order to implement the goals and objectives underlying the Emerging Telecommunications Technologies Act of 1991;

"(F) any other service, class of services, or assignments that the Commission determines, after conducting public comment and notice proceedings, should be exempt from competitive bidding because of public interest factors warranting an exemption; and

"(G) small businesses, as defined in section 3(a)(1) of the Small Business Act.

"(3) In implementing this subsection, the Commission shall ensure that current and future rural telecommunications needs are met and that existing rural licensees and their subscribers are not adversely affected.

"(4) Monies received from competitive bidding pursuant to this subsection shall be deposited in the general fund of the United States Treasury.".

(b) RANDOM SELECTION NOT TO APPLY WHEN COMPETITIVE BIDDING REQUIRED.—Section 309(i)(1) of the Communications Act is amended by striking the period after the word "selection" and inserting ", except in instances where competitive bidding procedures are required under subsection (j).".

(c) SPECTRUM ALLOCATION DECISIONS.—Section 303 of the Communications Act is amended by adding the following new subsection:

"(v) In making spectrum allocation decisions among services that are subject to competitive bidding, the Commission is authorized to consider as one factor among others taken into account in making its determination, the relative economic values and other public interest benefits of the proposed uses as reflected in the potential revenues that would be collected under its competitive bidding procedures.".

SEC. 809. DEFINITIONS.

As used in this title:

(1) The term "allocation" means an entry in the National Table of Frequency Allocations of a given frequency band for the purpose of its use by one or more radiocommunications services.

(2) The term "assignment" means an authorization given by the Commission or the United States Government for a radio station to use a radio frequency or radio frequency channel.

(3) The term "Commission" means the Federal Communications Commission.

(4) The term "Communication Act" means the Communications Act of 1934 (47 U.S.C. 151 et seq.).

(5) The term "Secretary" means the Secretary of Commerce.

TITLE IX—REPEAL RECREATIONAL VESSEL USER FEE

SEC. 901. RECREATIONAL BOAT TAX REPEAL.

(a) Section 2110 of title 46, United States Code, is amended—

(1) by repealing subsection (b);

(2) in subsection (c), by striking "subsections (a) and (b)," and inserting "this section,"; and

(3) by redesignating subsections (c) through (i) as subsections (b) through (h), respectively.

TITLE X—REDUCTION IN DISCRETIONARY SPENDING

SEC. 1001. CHANGES IN DISCRETIONARY CAPS.

(a) CHANGES IN SPENDING.—Subsections 601(a)(2)(C) through 601(a)(2)(E) of title VI of the Congressional Budget Act of 1974 are amended to read as follows:

"(C) with respect to fiscal year 1993—

(i) for the defense category: $265,147,000,000 in new budget authority and $265,966,000,000 in outlays;

(ii) for the international category: $21,400,000,000 in new budget authority and $19,600,000,000 in outlays; and

(iii) for the domestic category: $197,119,000,000 in new budget authority and $220,380,000,000 in outlays;"

"(D) with respect to fiscal year 1994, for the discretionary category: $476,950,000,000 in new budget authority and $499,360,000,000 in outlays; and

"(E) with respect to fiscal year 1995, for the discretionary category: $479,930,000,000 in new budget authority and $501,350,000,000 in outlays;

as adjusted in strict conformance with section 251 of the Balanced Budget and Emergency Deficit Control Act of 1985.".

O

Fact Sheet
ROTH "JOG America" Plan
October 24, 1991

- 3% Individual Income Tax Rate Reductions

  --Individual tax rates would be reduced to four new brackets. They would be the 12%, 25%, 28% and 31% brackets.

  --Those Americans in the lowest tax bracket, would receive the greatest cut of approximately twenty percent. Those in the higher brackets would receive a lesser cut of about ten percent of their income taxes.

  --For a family of four earning $35,000, this would be a tax cut of $792, or twenty percent.

  --For a family of four earning $75,000, this would be a tax cut of $1,992, or fourteen percent.

- Bentsen-Roth IRA

  --All Americans would be eligible for the fully deductible $2,000 IRA, currently available only to people not covered by a pension plan and with individual income under $25,000 or family income of $40,000.

  --The $2,000 limit on contributions would be indexed for inflation.

  --Taxpayers would have the option of getting a deduction when the money is deposited or forgoing an immediate deduction and not paying taxes on the money as it is withdrawn after a minimum waiting period of five years.

  --Young couples, or their parents or grandparents on their behalf, could make penalty-free withdrawals to pay for a first home.

  --Students, or their parents or grandparents on their behalf, could make penalty-free withdrawals to pay for college tuition.

  --Americans with medical expenses for themselves or for their dependents that are more than 7.5 percent of their income could make penalty-free withdrawals to help cover their costs.

  --Taxpayers could "rollover" money from their old IRA or qualified plan and deposit it into a "back-end" IRA if they pay the taxes on the earnings and previously deducted contributions. No penalty will apply and taxes on the withdrawal can be paid out of funds from the IRA account. When the funds are later withdrawn, after a five year waiting period, all proceeds including earnings will be tax-free.

- Incremental Investment Tax Credit

  --The amount of the credit is ten percent of the increased investment in "qualified manufacturing and productive equipment" property.

  --For a business which has a "base amount" of $8,000 and purchases $15,000 of manufacturing equipment in one year, the credit would be equal to $700.

- Repeal of the Boat User Fee

  --Would repeal the boat user fee passed as part of the 1990 Budget Act.

- Repeal of the Earnings Test

  --The bill would repeal the earnings test on social security, which reduces benefits for those earning more than $9,700 between the ages of 65 and 72.

- Defense Cut

  --9.5% cut over a five year period totalling $130 billion.

- Extend Unemployment Insurance

  --Would extend benefits for at least 7 weeks to workers who have lost their jobs during the recession.

- Intelligence Agency Cuts

  --A $500 million cut in each of the five years.

- Agriculture Subsidies

  --Reduce farm credits to those with off-farm income of over $125,000; increase farmer responsibility for crop insurance premium payments; increase user fees for recreation and grain inspection and establish fees for agricultural marketing; continue shift from direct to guaranteed loans in Rural Electrification Administration.

- Student Loan Enforcement

  -- Allow the IRS to reduce the amount of a taxpayer's refund equal to the amount the taxpayer owes on a defaulted student loan.

- Power Marketing Loans

  --Revise the level and schedule of PMAs' debt repayments to the Federal government and require PMAs' to pay current market interest rates on their debt.

- Medicare

  --Implement Medicare secondary payor reform (S.365); refine Durable Medical equipment/oxygen payment methods, in part to reflect increased use of less-expensive oxygen delivery services; include payment for certain post-hospital services in medicare hospital payment; place medicare hospital update on January 1 cycle; pay a uniform rate for medicare covered outpatient services, whether performed in doctors' office or outpatient departments.

- Spectrum Fee

  --Replace the allocation of radio spectrum with a system of competitive bidding for all future communications use.

- Postal Service Subsidies

  --Require the Postal Service to pay a larger share of the costs for health benefits and COLA's for post 1971 retired postal employees and their survivors.

- Federal Civilian Personnel Hiring Limitation

  --This hiring limitation equals a 10% reduction in the non-postal employee work force over five years, without RIFs. Reduction is achieved through limiting replacements for retirements and quits.

SENATOR WM. V. ROTH, JR. "JOG AMERICA" PLAN

October 24, 1991

ITEM	FY 1992	FY 1993	FY 1994	FY 1995	FY 1996	1992-1996
REVENUE ITEMS						
Bentsen-Roth IRA (S.612) (1)	($0.60)	($3.10)	($3.70)	($4.50)	($5.20)	($17.10)
Rollover of Deductible IRA into Back-end IRA (2)	$1.20	$2.00	$1.30	$1.10	$0.40	$6.00
Rate Reduction to 12%, 25%, 28% & 31% (2)	($0.30)	($9.10)	($20.30)	($32.70)	($43.90)	($106.30)
Incremental Investment Tax Credit (S.1831) (3)	($4.53)	($4.97)	($5.96)	($6.25)	($6.85)	($28.57)
Repeal Boat User Fee (4)	($0.13)	($0.14)	($0.14)	($0.15)	($0.16)	($0.72)
Repeal Earnings Test Under Social Security (S.10) (3)	($0.45)	($0.91)	($1.22)	($1.49)	($1.73)	($5.80)
SUBTOTAL OF REVENUE LOSSES	($4.81)	($16.21)	($30.03)	($44.00)	($57.44)	($152.49)
SPENDING ITEMS						
Potential Defense Cuts (detail attached--9.5% Defense Cut) (3)	$0.07	$26.72	$32.35	$34.64	$36.42	$130.20
Intelligence Agency Cuts (3)	$0.50	$0.50	$0.50	$0.50	$0.50	$2.50
Unemployment (10/7 weeks--Dole, Domenici, Roth) (4)	($2.69)	$0.00	$0.00	$0.00	$0.00	($2.69)
Agriculture Subsidies (5)	$0.00	$0.21	$0.38	$0.40	$0.40	$1.39
Student Loan Enforcement (4)	$0.86	$0.07	$0.08	$0.08	$0.08	$1.17
Power Marketing Loans (5)	$0.38	$0.38	$0.41	$0.42	$0.40	$1.99
Postal Subsidies (5)	$0.00	$0.20	$0.20	$0.20	$0.20	$0.80
Medicare (5)	$0.00	$0.78	$1.15	$1.59	$1.78	$5.30
Medicare Secondary Payor (3)	$0.40	$0.65	$0.65	$0.65	$0.65	$3.00
Spectrum Fee (4)	$1.90	$0.00	$0.00	$0.00	$0.00	$1.90
Civilian Personnel Limits (3)	$0.00	$1.82	$3.59	$5.31	$6.99	$17.71
Employee Productivity Bonus Plan (3)	($0.50)	($0.50)	($0.50)	($0.50)	($0.50)	($2.50)
SUBTOTAL OF CUTS	$0.92	$30.83	$38.81	$43.29	$46.92	$160.77
TOTAL	($3.89)	$14.62	$8.78	($0.71)	($10.52)	$8.28

(1) Treasury Estimate from 1990
(2) Joint Tax Estimate from 1990 or 1991
(3) Staff Estimate
(4) Congressional Budget Office Estimate
(5) President's FY 1992 Budget

POTENTIAL DEFENSE SAVINGS FOR FISCAL YEARS 1992-96
KEY POINTS

- CUT 9.5 % OF FIVE YEAR SPENDING TOTAL, AS CURRENTLY PLANNED

- SAVINGS COME FROM RIGHT-SIZING DEFENSE MANAGEMENT, REDUCING ACQUISITION EXPENDITURES ON WEAPONS DESIGNED FOR USE AGAINST THE WARSAW PACT, AND REMOVAL OF SPENDING ITEMS THAT DO NOT HAVE A VALID MILITARY REQUIREMENT (I.E. PORK BARREL PROJECTS)

- FORCE STRUCTURE ELEMENTS (NUMBERS OF ARMORED DIVISIONS, TACTICAL FIGHTER WINGS, CARRIER BATTLE GROUPS) ARE RELATIVELY UNCHANGED. NON-NUCLEAR READINESS IS MAINTAINED OR INCREASED.

- ESTIMATES REFLECT LIKELY OUTLAY SAVINGS, MAY NEED TO BE ADJUSTED TO REFLECT ARMED SERVICES CONFERENCE REPORT.

POTENTIAL DEFENSE SAVINGS
FISCAL YEARS 1992 - 1996

(Note: numbers may change slightly as a result of FY 1992 Defense Appropriations Conference Report)

	FISCAL YEAR					
	1992	1993	1994	1995	1996	TOTAL
SAVINGS GOAL		9.10	20.30	32.70	43.90	106.00
	POTENTIAL SAVINGS					
POTENTIAL SOURCES OF SAVINGS	0.57	27.22	32.85	35.14	36.92	132.71
I. EFFECIENCY OF OPERATIONS: RIGHT-SIZING DOD						
• REDUCE RATIO OF NON-COMBAT TO COMBAT PERSONNEL BY 25% TO ABOUT 6.5:1 (CUT 5% OF MILITARY PERSONNEL BUDGET)		3.87	3.49	3.15	2.84	13.35
• ACCELERATE GOLDWATER-NICHOLS REFORMS BY CONSOLIDATING DUPICATIVE SERVICE HEADQUARTERS' STAFFS WITH UNIFIED AND SPECIFIED COMMAND STAFFS (CUT 5% OF TOTAL DOD PERSONNEL, PLUS HEADQUARTERS OPERATIONS COSTS)		5.42	5.75	5.75	5.75	22.67
• RE-ORIENT TRAINING AND OPERATIONS TO COINCIDE WITH CYCLES OF THEATER CONTINGENCIES (CUT OPS & SUPPT)		0.30	0.50	0.75	0.75	2.30
II. TERMINATE NEW WEAPONS ACQUISITION PROGRAMS AIMED AT WARSAW PACT THREAT						
PROCUREMENT (EXAMPLE PROGRAM CHANGES)						
• B-2 (TERMINATE)		3.50	4.20	4.60	4.60	16.90
• SSN-21 SEAWOLF (TERMINATE, FOCUS ON NEXT GENERATION & SSN-688)		1.60	1.60	1.60	1.60	6.39
• DDG-51 AEGIS (CUT PLANNED BUY 50%)		1.70	2.10	1.70	2.10	7.60
• ADATS (TERMINATE DIVAD FOLLOW-ON)		0.10	0.40	0.30	0.30	1.10
• C-17 AIRCRAFT (CUT PLANNED BUY)		2.00	2.10	2.10	2.00	8.20
• F-16 C & D (TERMINATE AND UPGRADE EXISTING F-16 As & Bs)		1.00	1.00			2.00
• D-5 TRIDENT II MISSILE(CUT REMAINING BUY 50%)		0.80	0.85	0.85	0.85	3.35
• NUCLEAR TIPPED TOMAHAWK (CUT PLANNED BUY)	0.07	0.07	0.07	0.07	0.00	0.28
• REDUCED NUCLEAR WARHEAD PRODUCTION AND TESTING (IN LINE WITH NUCLEAR WEAPONS CUTS)		1.00	2.00	2.50	3.00	8.50
RESEARCH, DEVELOPMENT, TESTING & EVALUATION						

• ARMORED SYSTEMS MODERNIZATION (REDUCE INVESTMENT IN ARMORED FOLLOW-ON SYSTEMS, CONTINUE TO UPDATE ARMORED VEHICLE FLEET PER CBO RECOMMENDATION)		0.33	0.49	0.46	0.33	1.61
III. REDUCE OVERSEAS TROOP DEPLOYMENTS IN LINE WITH REDUCED SOVIET ADVENTURISM						
• REDUCE TROOPS DEPLOYED TO EUROPE BY 33% TO 100,000 (CUT 50,000 @ $40K/MANYR)	WITHDRAWAL=	10	15	15	10	
		0.80	1.90	3.25	4.00	9.95
• REDUCE TROOPS DEPLOYED TO KOREA BY 1 BRIGADE (10% CUT IN EXPENDITURES = 8,000 TROOPS @$35K/MANYR)	WITHDRAWAL=	1	3	3	1	
		0.14	0.39	0.65	0.78	1.95
• 8% REDUCTION IN CARRIER BATTLE GROUPS, SUPPORT SHIPS (PART OF CBO RECOMMENDATION)		0.70	0.90	1.10	1.70	4.40
IV. REDUCE STRATEGIC NUCLEAR OPERATIONS COSTS PER PRESIDENT'S SEPTEMBER SPEECH AND SOVIET CUTS (10% CUT IN $48.2B ANNUAL STRATEGIC NUCLEAR EXPENDITURES)		2.41	3.62	4.82	4.82	15.67
V. REDUCE INTELLIGENCE EXPENDITURES TO REFLECT POST-WARSAW PACT ERA	0.50	0.50	0.50	0.50	0.50	2.50
VI. REDUCE PORK-BARREL PROJECTS & ITEMS WITHOUT CURRENT MILITARY REQUIREMENT		1.00	1.00	1.00	1.00	4.00

DISTRIBUTIONAL EFFECT OF OPTION AT 1992 INCOME LEVELS, USING JULY 1991 ASSUMPTIONS

CUT INCOME TAX RATES FROM 15/28/31 TO 12/25/28 EXC MILLIONAIRES

	INDIV INCOME TAX			INC AFTER FED TAXES	
	AVG	CHANGE	%CHANGE	AVG	% CHANGE
FAMILIES BY ADJUSTED FAMILY INCOME					
ALL FAMILIES					
FIRST	-315.	-8.	- 2.5	7607.	0.1
SECOND	316.	-148.	-46.7	16821.	0.9
THIRD	1755.	-414.	-23.6	25936.	1.6
FOURTH	3813.	-827.	-21.7	36726.	2.3
FIFTH	16817.	-2094.	-12.5	79659.	2.6
ALL QUINTILES	4545.	-703.	-15.5	32930.	2.1
TOP 10	26575.	-2845.	-10.7	110086.	2.6
TOP 5	41862.	-3840.	-9.2	156017.	2.5
TOP 1	126818.	-8050.	-6.3	403396.	2.0
81-90%	6961.	-1336.	-19.2	48924.	2.7
91-95%	11071.	-1836.	-16.6	63503.	2.9
96-99%	21375.	-2825.	-13.2	96363.	2.9
FAMILIES W. CHILDREN					
FIRST	-783.	-9.	- 1.1	10024.	0.1
SECOND	97.	-231.	-237.9	22806.	1.0
THIRD	2262.	-608.	-26.9	34247.	1.8
FOURTH	4671.	-1100.	-23.6	47374.	2.3
81-90%	8830.	-1689.	-19.1	64016.	2.6
TOP 10	39102.	-3799.	-9.7	148187.	2.6
ALL QUINTILES	4257.	-751.	-17.6	36753.	2.0
FAM W. HEAD 65+					
FIRST	1.	0.	-35.2	7170.	0.0
SECOND	70.	-17.	-24.7	14739.	0.1
THIRD	624.	-127.	-20.3	23734.	0.5
FOURTH	2284.	-464.	-20.3	34332.	1.4
81-90%	5144.	-1009.	-19.6	47289.	2.1
TOP 10	28636.	-2699.	-9.4	130269.	2.1
ALL QUINTILES	3513.	-428.	-12.2	31066.	1.4
OTHER FAMILIES					
FIRST	27.	-12.	-44.6	5061.	0.2
SECOND	686.	-151.	-22.0	12371.	1.2
THIRD	1883.	-388.	-20.6	19711.	2.0
FOURTH	3748.	-763.	-20.3	29997.	2.5
81-90%	6654.	-1274.	-19.1	43228.	2.9
TOP 10	21927.	-2579.	-11.8	91948.	2.8
ALL QUINTILES	5221.	-790.	-15.1	30894.	2.6
FAMILIES BY DOLLAR INCOME (MEASURED AFTER CORPORATE & EMPLOYER PAYROLL TAXES)					
LESS THAN $10,000	-90.	-10.	-11.3	5757.	0.2
$10,000-$20,000	178.	-108.	-60.6	13727.	0.8
$20,000-$30,000	1276.	-318.	-25.0	21773.	1.5
$30,000-$40,000	2649.	-580.	-21.9	29870.	1.9
$40,000-$50,000	3969.	-828.	-20.9	37539.	2.2
$50,000-$75,000	6223.	-1278.	-20.5	49898.	2.6
$75,000-$100,000	11127.	-1892.	-17.0	68800.	2.7
$100,000-$200,000	20887.	-2839.	-13.6	102085.	2.8
$200,000 OR MORE	119517.	-8012.	-6.7	382845.	2.1
ALL INCOMES	4545.	-703.	-15.5	32930.	2.1

SOURCE: CBO STAFF SIMULATION OF OPTION. DO NOT RELEASE WITHOUT PERMISSION.

[SUBMITTED BY SENATOR ROTH]

GOVERNMENT POLICY AND PERSONAL RETIREMENT SAVING

[By Steven Venti and David A. Wise*]

Incentives to save for retirement have been an important component of government tax policy since the Revenue Act of 1942 made employer pension contributions tax-deductible. Since that time, pension funds have grown enormously. Private firm pension assets increased from $13 billion in 1950 to $1,836 billion in 1989.[1] But only about half of the workforce is covered by a pension plan and thus benefit from this inducement to employers to save for their employees' retirement. To address this inequity and to provide a retirement saving incentive for employees not covered by pension plans, the Individual Retirement Account was introduced in 1974. Under this plan, employees without an employer-provided pension plan could put up to $1,500 each year in an IRA account. The contribution was tax-deductible and the return on the balance accumulated tax free. Taxes were paid on withdrawal. The non-employed spouse of an employee could contribute up to $250 per year. The self-employed were covered by Keogh plans introduced in 1962. The Economic Recovery Tax Act of 1981 extended the IRA to all employees beginning in 1982. In addition, the contribution limit, that was increased to $1,750 in 1977, was raised to $2,000.

The 1981 legislation sparked a wave of promotion of IRAs by banks and other financial institutions. IRA (and Keogh) assets grew from $39 billion in 1981 to almost ½ trillion by 1989.[2] By 1989, IRAs assets were equal to 27 percent of firm pension plan assets, an increase from only 4 percent in 1981. About 30 percent of households had IRA accounts by 1986. After firm pension plans, IRAs seemed destined to become the principle form of saving for retirement. IRAs are the focus of this paper. More recently there has been an explosion in 401(k) plans that do not have income restrictions and have higher contribution limits.

Largely because of their tax cost, IRAs were a major topic of discussion preceding the Tax Reform Act of 1986. The original "Treasury I" plan proposed that the annual contribution limit be raised to $2,500 and that the spousal contribution be raised from the $250 to $2,500 as well. The Senate Finance Committee proposed that the existing plan be eliminated. The compromise solution left the existing plan intact for families with incomes less than $40,000 and for single persons with incomes less than $25,000, and for all persons not covered by a firm pension plan. For those with a pension plan, the tax deduction of the contribution was phased out between $40,000 and $50,000 for families and between $25,000 and $35,000 for single persons. Even persons with incomes above these limits could contribute to an IRA without the tax deduction and the returns accumulated tax free, with the tax to be paid on withdrawal.

The Tax Reform Act of 1986 eliminated the tax deduction for about 15 percent of the 1985 contributors and partially restricted the deduction for another 12 percent.[3] But, both the number of contributors and the amount contributed fell much more than these figures would suggest. The total amount deducted dropped from $37.8 billion to $14.1 billion, a 62.8 percent decline.[4] This "overreaction" is at least in part attributable to widespread misunderstanding of the legislation (often reported at the time to have eliminated IRAs) and to the marked decline in the promotion of IRAs.: Indeed, a recent survey revealed that about half of all persons eligible for an IRA deduction following the 1986 legislation mistakenly believed they were no longer eligible.[5]

The debate surrounding the 1986 legislation raised questions about the distribution of accounts by income and about the net saving effect of the accounts.[6] The latter question has led to the most extensive empirical research. An early paper by

* We are grateful to Art Kennickell for providing a cleaned version of the SCF data set (Avery and Kennickell [1988]). Some of the CES and SIPP data were made available by the Inter-University Consortium for Political and Social Research. We are grateful to Jonathan Skinner and to Jim Poterba for their comments on earlier drafts of the paper. Financial support was provided by the National Institute on Aging, grant number PO1 AG05842–06.

[1] Including government pension funds the total was $2,786 billion in 1989.

[2] See Piacentini and Cerino [1990].

[3] See EBRI [1986].

[4] The percent of tax returns showing an IRA deduction fell from 15.1 percent in 1986 to 6.8 percent in 1987, a 55.0 percent decline.

[5] *IRA Reporter*, vol. 6, no. 9, September 30, 1988.

[6] The proponents of the original 1974 IRA legislation emphasized the savings inducement for persons not covered by private pension plans. But whether this goal has been met has received little recent attention. We found in earlier work (Venti and Wise [1988]) that it was not. After controlling for individual attributes like age and income, we found that persons without pension plans are no more likely than persons with pensions to contribute to an IRA account.

Hubbard [1984] using a 1979 survey conducted for the President's Commission on Pension Policy suggested that IRAs stimulated new saving prior to 1982. He found that contributions to IRAs and Keoghs, unlike "saving" through private pensions or Social Security, increase household net worth, given permanent income and other household characteristics. In a series of papers based on the 1983 Survey of Consumer Finances, the Survey of Income and Participation, and the Consumer Expenditure Surveys, Venti and Wise (1986, 1987, 1990a, 1991a) concluded that additional IRA contributions represented "new" saving for the most part. Feenberg and Skinner (1989), using a 1980 to 1984 panel of taxpayers, found that IRA contributors increased their saving over time by more than noncontributors even after controlling for initial wealth. They were unable to find substitution of IRA for non-IRA saving. Gale and Scholz (1990), based on the 1986 Survey of Consumer Finances, concludes that most IRA saving is not new saving, but rather represents saving that would otherwise have occurred in other forms. Joines and Manegold (1991), using a taxpayer panel, offer a middle ground estimate. All of the studies agree that about 30 to 35 cents of each dollar put in an IRA account is funded by reducing taxes. The various Venti and Wise estimates suggest that 45 to 66 cents of each dollar comes from reducing consumption expenditure, the Feenberg and Skinner estimates imply that about two-thirds comes from reduced consumption, the Gale and Scholz estimates are from –2 to 25 cents, and the Joines and Manegold "best guess" is 30.5 cents.

The goal of this paper is not to review these studies, although such an endeavor would certainly be worthwhile. Instead, we present in a simple format the basic patterns of IRA and non-IRA saving behavior, without the constraints imposed by the more formal models—some of which are rather complex.

The paper begins with a review of the level of personal saving in the United States and a discussion of the distribution of IRA accounts by age and income. The data suggest that at least 40 percent of households would have opened an IRA account over the course of their lives under the pre-1986 legislation. At least 60 percent of households with incomes above $30,000 would have opened accounts. Evidence on the saving effects of IRAs is presented in sections II through IV. The exposition is primarily graphical. Although the analysis is non-technical, by considering several types of data we attempt to account for factors like individual propensity to save, that may confound the interpretation of the data. We find that the data provide little support for the possibility that IRAs had no net saving effect. Finally, we comment on the simple theoretical model that has led some observers to conclude that IRAs had no saving effect. We conclude that this simple model does not capture some of the prominent features of IRA saving and thus that its implications are unlikely to be valid. In particular, the assumption that IRA saving and other saving are treated by actual decision makers as perfect substitutes is inconsistent with the empirical evidence.

I. BACKGROUND

Most of the data discussed below pertain to IRA contributions, IRA asset balances, and non-IRA asset balances. The data are from three sources: the Consumer Expenditure Surveys (CESs) for 1980 through 1989, the Survey of Income and Program Participation (SIPP) for 1985 through 1987, and the Survey of Consumer Finance (SCF) for 1983 and 1986. Although much of the data in the three surveys is overlapping, the exact coverage and definitions differ among the surveys. The CES data span the period before and after the IRA program. They provide data on non-IRA asset balances and on IRA contributions in each year, but not on IRA balances. Both the SIPP and the SCF provide detailed information on non-IRA asset balances and IRA balances, but not on IRA contributions. The household is the unit of analysis for the CES and the SCF data; the SIPP data allow analysis based on both household and family units. The family is the more appropriate unit because it corresponds to the typical IRS tax filing unit. For comparability, however, we present household data in most instances. For all of the analyses in this paper a household or family is excluded if either the respondent or the spouse Of the respondent is self-employed. The self-employed had access to Keogh plans with very different contribution limits than IRAs. In most cases IRAs were not a feasible option for the self-employed. Elimination of the self-employed also minimizes a potential complication that arises because two of the surveys (the CESs and the 1986 SCF) ask respondents for combined IRA and Keogh balances. Some details of each of the data sets is presented in an appendix.

A. Low Personal Saving in the United States

On the eve of retirement the typical American family has only about $6,600 in financial assets. Personal saving in the United States has declined substantially as a fraction of personal income since the early 1950s and a large proportion of families reach retirement age with little or no personal saving. Personal saving declined from between 3 and 6 percent of disposable private income in the 1950s to around 1 percent in the early 1980s, based on computations made by Summers and Carroll [1987].[7] These numbers are adjusted for inflation and exclude saving by employers through defined benefit pension plans.[8] Without the inflation adjustment, the downward trend begins only after 1973.

Aggregate saving rates of course reflect the wealth accumulation of all households, some of whom save very large amounts. Micro data show that a large fraction of families have almost no personal saving. Based on the recent Survey of Income and Program Participation (SIPP), we [1991b] computed the composition of total wealth for all households in 1984. The results are summarized in figure 1. The amounts reflect median wealth by asset category.[9] It is clear that most families approach retirement age with very little personal saving other than housing equity. Among households with heads aged 60 to 65, median liquid wealth is only $6,600; the median value of housing equity is $43,000.[10] The majority of families rely heavily on Social Security benefits for support after retirement, and to a much more limited extent on the saving that is done for them by employers through defined benefit pension plans.[11]

B. IRA Assets and The Distribution of Accounts by Age and Income

The explosion of IRA saving after the 1981 legislation can be judged by comparing assets in IRA accounts to firm pension fund assets, reflecting the retirement saving by firms for their employees. The aggregate data are graphed in figures 2a and 2b. Assets in IRA (and Keogh) accounts were only about 4 percent as large as pension fund assets in 1981.[12] By 1989, accumulation of personal saving in IRA accounts amounted to $493.7 billion and was almost 27 percent as large as pension fund assets. Without the precipitous decline in IRA contributions after the 1986 bill, IRA assets would apparently have continued to grow.

At the individual level, the importance of IRAs for contributing households grew rapidly as well. The median ratio of IRA to other financial assets (excluding stocks and bonds) increased from essentially zero in 1980 to 0.75 in 1986, for households with accounts in 1986. If stocks and bonds are included, the ratio was 0.46. Most households without IRA saving in 1986 were essentially non-savers, like the majority of American households (as discussed above). The median level of their financial assets was about $1,500 in 1986. As the discussion below will show, a large fraction of IRA savers also saved very little before the advent of the IRA program.

The realization that a large fraction of Americans don't save at all is important in assessing the impact of the IRA program. The data presented below suggest to us that IRA savers increased their total saving substantially after 1982. Many were saving very little before they began to contribute to an IRA. But many households didn't save before and still don't. A significant proportion of these non-savers will have low lifetime incomes and Social Security retirement benefits will replace a large fraction of their annual pre-retirement earnings. They may expect to maintain their pre-retirement standard of living with no personal saving and may never save through an IRA account.

But a large fraction of households with modest lifetime incomes would have been IRA savers under the pre-1986 legislation. The percent of households with IRA accounts in 1986 ranged from close to zero for young households with very low incomes to over 70 percent among older households with high incomes, as shown in

[7] Many other studies using different definitions of saving have reported a similar downward trend. See for example, Bosworth, Burtless, and Sabelhaus [1991].

[8] The National Income Accounts include firm contributions to defined benefit pension plans under "personal saving." Inflation adjusted saving is measured saving, minus the inflation rate (the GNP deflator) times net interest bearing assets.

[9] Thus the component medians do not sum to the median of total wealth.

[10] Liquid wealth is broadly defined to include interest earning assets held in banks and other institutions, mortgages held, money owed from sale of businesses, U.S. Savings Bonds, and checking accounts, equity in stocks and mutual fund shares, less unsecured debt. Other wealth includes net equity in vehicles, business equity, and real estate equity (other than owned home).

[11] The SIPP data allow estimation of the value of Social Security and pension plan benefits only after the payments are received. Thus wealth in the form of Social Security and pensions is only recorded for persons who have begun to receive the payments. The median of Social Security and pension wealth combined is $113,400 (the median of Social Security wealth is $83,700 and the median of pension wealth $11,200); the median of housing wealth is $38,000 and the median of liquid financial assets is only $10,000, for households with heads age 65 to 70.

[12] The data are reported in Piacentini and Cerino [1990] and include IRA and Keogh assets together. It is apparent, however, that in the later years the vast majority of the assets are in IRA accounts.

figure 3.[13] Like other saving, IRA saving increases with age and income. Over 50 percent of households with annual income above $20,000 would have opened an IRA account before they retired, based on the 1986 participation rate of households with heads 55 to 65 and income over $20,000. About 60 percent in this age bracket with incomes over $30,000 had accounts and 65 percent of those with incomes over $40,000.[14] Thus relative to other saving, IRA saving is very widespread.

IRAs are sometimes portrayed as held by only a few and concentrated among the wealthy. About 60 percent of 1986 IRA accounts and 50 percent of IRA assets were held by households with incomes less than $50,000.[15] Only 34 percent of non-IRA financial assets are held by households with incomes less than $50,000.[16] Over one quarter of all households had accounts in 1986.[17] And, a large fraction of families that did not have accounts in 1986 would have had accounts before they retired. Thus, it may be more accurate to say that IRAs are widespread among potential savers.

II. IRA SAVING VERSUS OTHER SAVING: 1980 TO 1989

If IRA saving substituted for other saving, one might have expected the proportion of persons saving in other forms to decline as the proportion saving through IRAs increased. In figures 4a and 4b are graphed the proportion of households contributing to an IRA in each year and the proportion of households with positive saving in non-IRA assets. (Figure 4a includes and figure 4b excludes stocks and bonds.) The graphs show that between 1980 and 1989 there was essentially no change in the proportion of households with non-IRA financial asset saving. The proportion making IRA contributions grew from 3 percent to 20 percent and then declined to 10 percent after the 1986 legislation.

Although we would expect the proportion of households with other saving to decline—if there were widespread substitution of IRA for other saving—it could be that even if IRA savers reduced other saving, most would still have some saving in other forms. In this case, the proportion with positive non-IRA saving would not change much. Thus we turn to consideration of the change in saving balances.

III. CHANGE IN IRA VERSUS NON-IRA ASSET BALANCES

We consider in this section whether the data appear consistent with the possibility that IRA contributions represented no addition to total saving, but only a reshuffling of existing asset balances a switching of new saving from non-IRA to IRA accounts. The analysis is based on the relationship between the change in non-IRA financial asset balances as IRA balances increased. In particular, we ask whether non-IRA balances declined, as the substitution (or reshuffling) hypothesis suggests. There are two ways that substitution could occur: one is that existing pre-1982 assets were *transferred* into IRAs in subsequent years. The other is that beginning in 1982 *new saving* was in the form of IRAs instead of non-IRA financial assets; IRA saving *displaced* non-IRA saving.

Three versions of the change in non-IRA balances are discussed. The first is based on the balances of respondents to successive Consumer Expenditure Surveys between 1980 and 1988. The second uses the same data but adjusts for the change in the attributes of contributor respondents to successive CES surveys. In both instances, the comparison is based on the balances of the random samples interviewed in successive surveys; the same respondents are not followed from year to year. The third version compares the balances of the same respondents interviewed through the Survey of Consumer Finances in 1983 and 1986. The goal is to judge whether the increase in IRA balances was accompanied by a transfer of assets from non-IRA accounts or by a reduction in new saving in non-IRA assets.

[13] Figure 3 is based on SIPP data. Over 80 percent of older high-income households contributed, according to SCF data.

[14] Based on SIPP data. Based on SCF data, 65 percent, 70 percent, and 77 percent, respectively, of households in this age group had accounts.

[15] *Families* with income less than $50,000 held 76 percent of the accounts and 66 percent of the balances, according to SIPP data. The family data corresponds more closely to an IRS tax unit than the household data.

[16] Based on SCF data.

[17] 26.1 percent based on SIPP and 29.7 based on SCF.

A. IRA versus Non-IRA Asset Balances: CES Data, 1980 to 1988.

Each quarter the Consumer Expenditure Survey obtains information on a new random sample of households.[18] Thus each survey represents a snapshot of households in that quarter. Data is obtained on income, assets, and other household characteristics. The average age of the head of the respondent households was about 46 in each of our quarterly samples. We have combined data from the quarterly surveys to obtain annual averages.[19] These data are merged with IRA balances obtained from the SIPP (1985 to 1987).

The median IRA balance of contributors was about $1,700 in 1982.[20] By 1986 the median had increased to almost $8,000, and over one-quarter of households had IRA accounts. What happened to other financial asset balances over this time period?

Recall the two substitution possibilities: transfers and displacement of new saving. If IRA balances were accumulated by making repeated *transfers* from other accounts, the balances in other accounts should have declined as the IRA balances increased. If IRA saving *displaced* non-IRA saving after 1982—so that post-1982 respondents had begun to save in IRA accounts instead of in other accounts—the typical 1986 respondent with an IRA account should have had less money in other assets than the typical 1982 respondent. That is, *even if no transfers were made from existing 1982 balances,* if *new saving* by households after 1982 were in the form of IRAs instead of other assets, the accumulated balance in other assets should have been lower for households surveyed in 1986 than for households surveyed in 1982. This is because the typical 1986 respondent would have accumulated less saving in other accounts in the previous four years than the typical 1982 respondent would have accumulated over the four years prior to 1982. For example, suppose that in 1982 the typical 46 year old had been saving $2,000 per year in bank accounts for the past four years. That person would have accumulated $8,000 in bank accounts by 1982 (ignoring interest accumulation). If after 1982 IRA saving completely replaced other saving, the typical 46 year old in 1986 would have saved $2,000 a year between 1983 and 1986 in an IRA but nothing in other accounts. The person who was 46 years old in 1986 would have $8,000 in an IRA account but nothing in the regular bank account. IRA balances would simply have replaced other balances. Total assets of the 1986 46 year old would be the same as the total assets of the 1982 46 year old.

The data are shown in figures 5a and 5b. The graphs show that there was no systematic decline in the non-IRA balances of contributors as their IRA balances increased. These data show the assets of the *typical household in different years—not the change over time for the same household.* Thus, if there were no change in saving behavior, no change in returns on assets, and no change in household income, balances would be expected to be approximately the same over this time period. But nominal balances might be expected to rise as nominal income grows.

Figure 5a shows that by 1986, the median IRA balance was about the same as the median balance in other financial assets and was higher than pre-1982 balances in other financial assets (excluding stocks and bonds).

The total financial assets of 1982 respondent contributors (including IRAs but excluding stocks and bonds from other assets) was about $9,427.[21] A direct comparison with the total 1986 balance is not possible because the CES data do not provide the IRA balance. Thus the combined totals are not shown in the figures. But non-IRA asset balances based on SIPP data are essentially the same as the CES balances and the totals, including IRA balances, based on SIPP data should be close to the total assets of CES respondents. Based on this assumption, the total assets of 1986 contributor respondents was were percent greater than the total assets of 1982 contributor respondents, $17,900 versus $9,427. The increase between 1980 and 1986 was 248 percent.

Similar trends are revealed in figure 5b that includes stocks and bonds in non-IRA assets. The total financial assets of contributor respondents, including stocks

[18] More precisely, a new panel is started each quarter and households in each panel are surveyed 5 times (each quarter) over the following 15 months. Only households with heads 18 to 65 are included in this analysis and households with a self-employed member are excluded.

[19] All quarterly surveys conducted in a calendar year are included in the annual average for that year. This means, for example, that the percent of households making IRA contributions in a year will not match the IRS figure for the percentage of tax returns showing an IRA contribution for a tax year.

[20] The median contribution in 1982, based on CES data.

[21] Assuming that the 1982 household IRA balance was equal to the 1982 IRA contribution.

and bonds, increased by 71 percent, $21,650 versus $12,660, between 1982 and 1986 and by 214 percent between 1980 and 1986.[22]

In summary: non-IRA assets of respondents to successive CES surveys did not decline as IRA assets increased between 1982 and 1986. Instead, non-IRA assets increased as well. Total assets of 1986 respondent contributors were much larger than the assets of respondents at the outset of or prior to the IRA program. It is apparent that IRA contributions were not funded by withdrawing funds from pre-1982 assets. Indeed, 1986 IRA balances were larger than pre-1982 non-IRA assets. It also seems apparent from the data that the typical IRA contributor was not accustomed to accumulating assets at an annual rate equal to the typical IRA contribution. In addition, the data suggest that the new IRA saving of contributors did not replace saving that otherwise would have gone into non-IRA assets. Assets in both forms were larger in 1986 than in 1982. Total assets were very much larger in 1986.

B. IRA versus Non-IRA Balances of Like Groups: CES Data, 1980 to 1988

In the preceding section, the assets of the typical contributor respondent in a year such as 1986 were compared to the assets of the typical contributor respondent in an earlier year such as 1982, at the outset of the IRA program. The respondents to each CES represent a random sample of the population in that year. But the characteristics of families who were making IRA contributions may have changed over time. In particular, pre-1982 contributors did not have employer-provided pension plans and the: non-IRA assets of these contributors may have differed from the assets of the much larger group that began to contribute after the 1982 legislation.

To correct for this ambiguity, we consider the non-IRA assets of more closely equivalent households. Instead, for example, of comparing the assets of the typical 1986 respondent contributor to the assets of the typical 1980 respondent contributor, we ask for the assets in 1980 of households who were "like" the households who made IRA contributions in 1986. In 1980 most of the like households were not eligible for an IRA. But by defining "like" groups, the 1980 and 1986 assets of "comparable" households can be compared. The groups are comparable except that the 1986 respondents had had the opportunity to make IRA contributions for several years, while the 1980 respondents had not.

To identify groups of "contributor-like" households, 1985–86 contributors are used to define the "contributor group." The 1985–86 data are used to predict the probability that a household with given income and age of head contributes to an IRA account. For example, about 68 percent of households with heads aged 55 to 65 and income over $50,000 contributed to an IRA account; about 45 percent of those aged 45 to 55 with incomes between $30,000 and $50,000 contributed. Based on the 1985–86 proportions, 68 percent of the 1980 households in the 55 to 65 age range with income over $50,000 are randomly assigned to the "contributor-like" group, and so forth for other groups. In practice the probabilities are calculated for 16 age-income categories. An adjustment is then made for the "individual saving effect" reflected in the higher non-IRA assets of persons within each group who have IRAs.[23]

Comparisons similar to those in the previous section can now be made. They are shown in figures 6a and 6b for the years 1980 through 1988 and in figures 6c and 6d for 1980 and 1986 only. The conclusions are much the same as those based on the unadjusted data, graphed in figures 5a and 5b.

It is easiest to consider first the comparison between 1980 and 1986, shown in figure 6c and 6d. The data are summarized below:

[22] The median asset balances appear to be unusually high in 1982. (See figure 4a.) On the other hand, the new 1982 contributors may have had asset levels that differed from those of earlier contributors, who did not have firm provided pensions.

[23] The adjustment is based on the difference between the non-IRA assets of an actual contributor and the assets of a randomly predicted contributor in the same age and income cell. It is the ratio of the median assets of observed contributors to the median of predicted contributors within each of the 1985–86 age-income cells. Non-IRA assets of the like group in other years is obtained by first using the contributor probabilities described in the text to identify the like group, then calculating actual non-IRA assets for this group, and then applying the adjustment ratio. Separate calculations are made for the contributor and non-contributor groups. Income is converted to 1986 dollars using the income growth observed in the CESs.

CES-SIPP SUMMARY[24]

Contributor Status and Asset	Respondents in: 1980	Respondents in: 1986	Percent change
Excluding Stocks and Bonds			
Contributor-like:			
Non-IRA assets	4635	7816	68.6
IRA assets	0	7800	....
Total assets	4635	17900	286.2
Non-contributor-like:			
Total Assets	508	752	48.0
Including Stocks and Bonds			
Contributor-like:			
Non-IRA assets	6238	12547	101.1
IRA assets	0	7800	....
Total assets	6238	21650	247.1
Non-Contributor-like:			
Total Assets	523	781	49.3

The 1980 IRA balance of contributor-like respondent households was close to zero. By 1986 the median had increased to $7,800. Contributor-like 1980 respondents had a median of $4,635 in non-IRA financial assets, as shown in figure 6c (excluding stocks and bonds). The 1986 respondents had a median of $7,816 in non-IRA assets, an increase of 69 percent.[25] In addition to the increase in non-IRA assets, the 1986 contributors had an additional $7,800 in IRA assets. Total financial assets of contributor-like respondents increased from about $4,635 in 1980 to about $17,900 in 1986, an increase of 286 percent.[26] Comparable data are shown in figure 6d, with stocks and bonds included in non-IRA financial assets. In this case, the increase in total assets between 1980 and 1986 was 247 percent.

Is it likely that without the IRA program the assets of like households would have nearly tripled over this period?

There are at least two reasons why non-IRA assets might have increased over this time period. One is that nominal income increased and nominal saving might have increased as well. The other is that changes in the rate of return on financial assets may have changed. The increase in median income between 1980 and 1986 was 48 percent, much less than the increase in total financial assets—286 percent excluding and 247 percent including stocks and bonds. Indeed the income increase was less than the increase in non-IRA financial assets—69.6 percent excluding and 101.1 percent including stocks and bonds. Assets may also have increased because of capital gains in the stock market.[27] But the financial assets of most savers are not in stocks. Indeed, the increase in non-IRA assets excluding stocks and bonds was not much greater than the increase when they are included, suggesting that stock market capital gains is not the explanation.

It may be that non-IRA balances should be considered relative to the overall increase in financial assets for all respondents. The trend in financial assets for the

[24] The 1986 IRA and total asset balances are from SIPP. Median 1986 non-IRA assets based on the CES and the SIPP are virtually the same ($8,050 versus $8,040 excluding and $11,500 versus $12,200 including stocks and bonds).

[25] In years for which the assets of "contributor-like" respondents can be compared to the assets of actual contributors the correspondence is typically close. For example, the median non-IRA assets (excluding stocks and bonds) of actual 1983 respondents was $5,500; the predicted assets of "contributor-like" respondents was $5,472. The implication we draw is that the correspondence would also be close for 1980, for example, when the correspondence can not be seen because there were few contributors then. It also means that the conclusions using 1986 as a base would have been essentially the same if 1983 had been used as a base. For example, if 1983 were used as the base, the natural comparison would have been to ask if 1986 "contributor-like" respondents saved less in non-IRA assets than would have been predicted based on the distribution of assets of contributors by age and income in 1983. The answer would be no; they saved about the same, plus they accumulated a substantial balance in IRA accounts.

[26] Again, based on the match between SIPP and CES median asset balances in 1986, as discussed in the previous section.

[27] The Standard and Poor stock market index more than doubled between 1982 and 1986. The expected increase in financial asset balances would be much less than this because only a small proportion of asset holders have significant equity in the stock market.

non-contributor-like group is also shown in the figures. The increase between 1980 and 1986 was 48 percent, much less than the percent increase for contributors.

What about the return on commercial bank accounts, where the bulk of most households' financial assets are held? Average time and saving deposit rates in commercial banks in the years preceding 1980, 1982, 1983, and 1986 are shown below.[28] The data for 1983 are included in anticipation of the same issue that will be raised with respect to the data in the next section.

AVERAGE OVER THE PRECEDING

Ending in	Three years	Four years	Five years	Six years
1980	7.53	7.02	6.72	6.59
1982	10.28	9.58	8.87	8.31
1983	10.07	9.82	9.35	8.80
1986	7.84	7.99	8.48	8.95

The rate of return in the years preceding 1986 was somewhat higher than the rate in the years preceding 1980, but the differences are not large enough to explain the large increase in financial assets. Even the increase in non-IRA financial assets seems large relative to the increase that might have been expected based on 1980 non-IRA assets.

Based on these data, it seems to us very unlikely that IRA saving replaced non-IRA; that there was no gain in net saving. Again, it is apparent from the low 1980 asset balances of contributor-like households ($4,635) that before the advent of IRAs the typical contributor-like household had not been accumulating financial assets at an annual rate close to an IRA contribution, typically $2,000 or $4,000 in 1986.[29] It is also clear that the increase in IRA balances was not funded by withdrawing funds from pre-1982 balances, which were substantially smaller than the $7,800 put into IRA accounts.

Data for these two years but including stocks and bonds are shown in figure 6d. The data for all years from 1980 to 1988 (figures 6a and 6b) reveal the same trends as the two-year comparison.

The adjusted CES data discussed in this section provide an informal picture very comparable to the results of the formal analysis in Venti and Wise (1990a], that was also based on these same CES data. Indeed a general test of the behavioral validity of the model used in that analysis was to predict the saving behavior of households in the pre-IRA period, using model estimates based on post-1982 data. In effect, with reference to figure 6, the model predicted quite accurately the low non-IRA saving in 1980, based on estimates in later years when total saving (including both IRA and non-IRA saving) was much higher. That is, the model predicted well what saving would be if the IRA limit were set to zero.

C. IRA versus Non-IRA Balances: SCF Data, 1983 to 1986.

The discussion in the previous section is based on the comparison of the asset balances of the *different* respondents to successive surveys, before and after the general availability of IRAs. In that case, asset balances may have increased between the surveys because of income growth, but age did not change systematically (the average age was about 46 in each year). An alternative to comparing different household samples in different years is to compare the balances of the same households over time. In this case, asset balances may as they age, and possibly because of income growth as well.

Such a comparison can be made using the 1983 and 1986 SCF data. We begin with respondents to the 1986 survey. Only households aged 24 to 65 are included in the analysis and households with self-employed members are excluded. Non-IRA and IRA median balances for this group in 1983 and 1986, are shown in figures 7a through 7d, by 1986 IRA contributor status. Stocks and bonds are excluded from 7a and 7c an included in 7b and 7c. Figures 7c and 7d are the same as 7a and 7b except that they include data for total assets of contributors—including both IRA and non-IRA balances—and show the change in assets between 1983 and 1986. The data are reproduced below:

[28] The rates are from the Savings Institutions Sourcebook, U.S. League of Savings Institutions.

[29] The mean was $2,308.

SCF SUMMARY

Contributor Status and Asset	Year		Percent change
	1983	1986	
Excluding Stocks and Bonds			
Contributors in 1986:			
Non-IRA assets	6360	9209	44.8
IRA assets	1000	7000	600.0
Total assets	8900	20000	125.7
Non-Contributors			
Total assets	600	900	50.0
Including Stocks and Bonds			
Contributors in 1986:			
Non-IRA assets	9400	13500	43.6
IRA assets	1000	7000	600.0
Total assets	12075	24000	98.8
Non-contributors			
Total assets	729	1000	37.2

Again, the non-IRA assets of contributors did not decline as IRA assets increased between 1983 and 1986, on the contrary, they increased substantially. The median 1983 non-IRA asset balance (excluding stocks and bonds) of households with IRA accounts in 1986 was $6,360. Clearly, prior to 1983, this group had not been accumulating assets at the rate of the typical IRA contribution. And clearly the $6,000 increase in IRA balances (from $1,000 in 1983 to $7,000 in 1986) was not funded by transferring funds from the 1983 balance in non-IRA accounts, $6,360.

Without the IRA program, what increase in this 1983 non-IRA asset balance would be expected over the next 3 years? In fact the observed 44.8 percent increase was equivalent to an annual growth rate of over 13 percent. The increase in all assets combined—including IRAs—was in fact much greater than this. IRA assets also grew, by $6,000. The median of total assets more than doubled, increasing by $ 11,100 from $8,900 to $20,000.

Without IRA contributions, would the 1983 balance of $6,360 have been expected to increase by almost threefold, to $20,000, by 1986?

As discussed in the previous section, the increase in total assets may be determined in part by income growth and the increase in age, and the data could be confounded by differences in economic trends prior to the two dates—differences in rates of return. The increase in non-IRA assets between 1983 and 1986 is apparently not the result of the growth in stock values over this period. The percentage increase in non-IRA assets was about the same when stocks and bonds are excluded as when they are included.

Assets may have been expected to increase with age and income. We have controlled for these effects by predicting 1986 assets based on the distribution of contributor assets by age and income in 1983. Adjusting for the 3-year age increase and the income increase between 1983 and 1986, the balance would have been expected to increase by about 25 percent, excluding stocks and bonds, and about 31 percent including stocks and bonds. Including IRA contributions the actual increase was almost 126 percent excluding stocks and bonds and almost 100 percent including stocks and bonds. Commercial bank rates in the years preceding 1986 were lower than the rates preceding 1983, as shown in the previous section. The asset growth cannot be explained by unusually high rates of return.

Thus, judging from the SCF data, it seems to us unlikely that the IRA contributions simply substituted for saving that would have occurred anyway. In particular, that inference seems implausible based on the information available in 1983. And again, based on the 1983 balance of $6,360 the 1986 contributors prior to 1983 had not been accustomed to saving nearly as much as they saved over the next three years.

Comparison of the SCF with the CES summary tabulation in the previous section shows that the two data sets yield essentially the same implications.

There is one possible, although we believe improbable, scenario that cannot be addressed directly with any of these data: Were the IRA contributors the people who, for reasons not apparent in 1983, were going to increase their saving dramatically over the next 3 years? The dramatic increase in asset balances cannot be explained by a sudden increase in income. The median increase in income for 1986 contributors was only 15.7 percent over the entire period, 1983 to 1986. Were these then households whose saving behavior was about to change dramatically, independent of the new IRA option? Did the change in saving behavior just happen to coincide with the advent of the IRA? On its face, this possibility seems an improbable explanation. Of course it is also possible that promotion of the IRA program spurred households to save more in other forms as well, which is consistent with the large increase in non-IRA saving. Or, the consideration of retirement needs in conjunction with IRA saving may have induced more saving in other forms. This possibility is consistent with evidence on the relationship between personal saving and firm pension plan saving, reviewed in Shefrin and Thaler [1986].

V. CHANGE IN OTHER SAVING WITH CHANGE IN IRA STATUS

If non-IRA saving is reduced when IRA saving is increased, then when a household that was not contributing begins to contribute that household should reduce non-IRA saving. Likewise, when a household that was contributing stops contributing, non-IRA saving should increase. The SIPP panel data allow calculation of the change in non-IRA saving when IRA contributor status changes. This simple calculation controls directly for changes in saving behavior across families since it is based on changes over time for the same families.[30]

Table 1 shows that there is a small reduction ($377.4) in non-IRA bank account financial asset saving for new contributors and a small increase ($148.6) for households that stop contributing. But the changes are only a small fraction of the typical IRA contribution, about $2,300.

Estimates incorporating all non-IRA financial assets—bank accounts, bonds, and stocks—are shown in table 2. These data also reveal that the change in non-IRA saving is much less than the typical IRA contribution. Although these data suggest some substitution, none of the estimates is statistically significant. In particular, the hypothesis that there is no change in non-IRA saving with change in IRA contributor status cannot be rejected.

V. LIMITATIONS OF THE THEORY

Many expressed views on the saving effects of IRA are not based on empirical evidence but are speculations based on simple theoretical reasoning.[31] In some important respects, however, the empirical evidence is inconsistent with the predictions and the assumption embedded in the "theory-based" speculations. Although these models may provide some insight into how people should behave in a narrow financial sense, the predictions offer a poor description of how the public actually responded to the IRA program. Indeed, the assumptions are inconsistent with basic facts about IRA contributors and IRA saving. Moreover, the assumptions underlying the speculations virtually preclude any saving effect of IRAs. A more complete model must recognize the broader economic and psychological channels through which an aggressively promoted tax-advantaged savings plans may stimulate saving. Thus having presented the data, we emphasize the limitations of judgments based on restrictive assumptions about saving behavior that are embedded in the simple economic model. In our view it is important to determine from the data which assumptions are most consistent with the saving decisions of real people.

A. The Simple Model.

The theoretical model underlying several recent judgments is what Burman et al. (1990) call the "traditional approach" and what Gravelle calls the "conventional view." In this mo4el, there is only one form of saving. Thus the assumption is that households treat IRA saving and other saving as perfectly fungible. Except for the tax advantage, a dollar saved in an IRA is no different than a dollar saved in another form. And, the "tax-price" difference is the *only* means by which the IRA program is permitted to affect individual behavior; IRAs simply provide a higher return on the one and only form of saving.

From this characterization of saving behavior, it is a short stride to the conclusion that IRAs will not stimulate saving. Burman et al. state the case:

> If saving is motivated by life-cycle consumption choices, two conditions must be satisfied if IRAs are to stimulate private saving. IRAs must change the after-tax return to the additional dollar saved for a significant number of savers and private saving must respond to such changes. The task is

[30] The calculations and the data set are explained in detail in Venti and Wise [1990b].

[31] For an extreme view, see Gravelle [1989, 1991].

then to determine whether both of these conditions are likely to be met. (p. 266)

Of course, if one assumes that IRAs and other saving are perfect substitutes, that only the marginal after-tax return matters, and that IRA savers were saving above the IRA limit, then there will be no change in the after-tax return on the next dollar saved and no change in saving. Furthermore, since the general consensus is that saving is not very responsive to the after-tax return, the boost to saving will be negligible even among those who were not saving above the IRA limit prior to the IRA program. Thus, following this simple model, the case against the saving effectiveness of IRAs can be closed without looking at the data.

More generally, there are four assumptions embedded in the simple theoretical framework that has been used by some to evaluate the saving effects of IRAs: The first is that most IRA contributors were already saving more than the IRA limit prior to the advent of the IRA program. (A related assumption is that the typical IRA saver had large accumulated financial asset balances that could easily be transferred to an IRA account.) The second is that the program inducement to save operates entirely through the after-tax rate of return. The IRA tax advantage encourages saving by increasing the return on saving, up to the IRA limit. But a household that is already saving more than the limit doesn't benefit from the higher rate of return on an additional dollar saved. The third, and most important assumption, is that IRA saving and other forms of saving are treated by savers as perfect substitutes. The fourth, and related to the third, is that the promotion of IRA saving had no effect on their use.

B. The Evidence

We will consider these assumptions in turn, although it is not always possible to neatly separate them. In particular, it is not always clear whether an example should be thought of as contradicting the perfect substitutes assumption or the assumption that only the rate of return matters. Nonetheless, we have found it convenient to separate them in the discussion. The simple model does not explain several prominent features of IRA saving, let alone their saving effects, a much more complicated issue.

1. Contributors Were Saving More than the IRA Limit

From the data discussed above, it seems apparent that the typical IRA contributor, a prior to the advent of the IRA program, had not been saving nearly as much as the typical IRA contribution. Nor did the typical contributor fund IRA contributions by drawing down pre-1982 non-IRA financial asset balances. Both the CES and the SCF summary tabulations and figures 6c and 7a, for example, show this clearly.

2. Only the After-Tax Rate of Return Matters

Much of IRA saving behavior is inconsistent with saving decisions based solely on the rate of return. First, if only the rate of return is considered, strictly financial calculations show no difference between a "front-loaded" IRA—with an up-front tax deduction but payment of tax on withdrawal from the IRA account, and the "back loaded" version -with payment of taxes on the contribution but no tax payment when the funds are withdrawn (if tax rates don't change). But the evidence is that real people prefer the up-front deduction. The here and now tax saving takes precedence over the long-term equivalence calculation. The United Kingdom experience with the Personal Equity Plan (PEP) provides evidence of the difference as viewed by savers. The U.K. plan is patterned after the U.S. IRA but contributions are made on an after-tax basis, with no taxes paid when funds are withdrawn. Unlike the U.S. experience, financial institutions have found it difficult to attract contributions to the U.K. plan.

Second, the narrow rate of return analysis suggests that consumers can benefit by using tax-deductible borrowing (home equity loans in particular) to finance IRA contributions (Kotlikoff [1990]). However, the empirical evidence suggests that this effect is either nonexistent or very small (Manchester and Poterba [1989], Skinner [1991], Venti and Wise [1991a].

Third, after the Tax Reform Act of 1986, households that were no longer eligible for the up-front tax deduction could still benefit from tax free compounding of the return. The dramatic drop in IRA contributions following the reform is inconsistent with saving decisions based strictly on the rate of return. This drop can be explained by neither changes in eligibility nor changes in marginal tax rates (Long [1990]). Instead, the response suggests that the up front deduction itself is important. It's apparently what gets peoples' attention.

3. People Treat IRA and Other Saving As Perfect Substitutes

To begin, consider the implications of these three assumptions: (1) IRA contributors would save more than the IRA limit in the absence of the IRA option, (2) only the after-tax rate of return matters, and (3) real people treat IRA and other saving as perfect substitutes. Based on these assumptions, the introduction of IRAs may even reduce saving. The reasoning is that if saving is subsidized—by reducing the consumption that must be given up today to save for tomorrow—a saver can give up less today and still have the same income to spend 'tomorrow. (A "target saver," for example, could save less today and still reach target asset accumulation at retirement.) Thus even less may be saved today. But this reasoning breaks down if all forms of saving are not perfect substitutes in the minds of the *real people* who make saving decisions.

Consider this example: I devote 2 percent of my earnings to a bank saving account and 98 percent to other things. A new subsidized saving vehicle is introduced—there is a sale on this type of saving—and it is heavily promoted as a means of assuring my financial well-being after retirement. If the old and the new types of saving are perfect substitutes, and the promotion has no effect on saving, new saving is likely to be financed by reducing old bank account saving. But if savers view the two types of vehicles as different accounts, like the mental accounts suggested by Shefrin and Thaler [1988] and Thaler [1990] for example, new saving may be financed by reducing the 98 percent of income devoted to other things rather than by reducing the 2 percent of income devoted to bank account saving. The standard marginal arguments don't hold if people think of the two forms of saving as different. This could be true even without the promotion; it would be more pronounced to the extent that the promotion is effective, as discussed below. Thus even people who would otherwise save more than the IRA limit may increase their total saving with the "sale on IRA saving."

There are obvious reasons why IRAs and other saving are not perfect substitutes in theory. In particular, there is a penalty on withdrawal of IRA assets before age 59½. They are less liquid. Thus persons who want to save for the short run may not want to use the IRA mechanism.[32] But, more important, what is the empirical evidence on substitutability?

Data for persons over 59½ demonstrate the limitation of the perfect substitutes assumption. Persons over age 59½ are able to take IRA deductions but do not face any penalty for withdrawal of IRA funds. In terms of availability and liquidity, IRAs for this age group are barely distinguishable from other forms of saving. The one difference is the higher after-tax rate of return available through the IRA account, apparently making the IRA unambiguously "better" than a conventional saving account. Yet even most persons over 59½ don't have IRA accounts. The empirical fact is at odds with the implication of the perfect substitutability assumption, suggesting that there is more to the IRA program than the simple "tax-price" subsidy of a simple form of saving, the characterization at the heart of the simple model.

More general data for all age groups also reject the extreme perfect substitutes view. If all forms of saving were perfect substitutes, all savers would save first in the IRA form and only save in other forms if they saved more than the IRA limit. But a large fraction of persons that don't make IRA contributions saves in other forms.

Another empirical regularity also suggests that the traditional model mischaracterizes the IRA as a perfect substitute for other saving. IRA contributions, unlike other saving, are bunched in the month preceding the filing of tax returns. If the distinction between IRAs and other saving is solely the tax advantage, then investors should open these accounts some fifteen months earlier to take advantage of the higher return on IRA accounts. That they do not behave this way suggests a behavioral motivation other than or in addition to the rate of return.

4. The Promotion of IRAs Had No Effect on Their Use

Different modes of saving may be *treated by real people* as distinct goods for several reasons discussed below. Whatever these reasons may be, to the extent that the promotion of IRAs is successful, the promotion may magnify the distinctions between modes of saving and indeed may help to create them. The greater the promotional success, the more IRA saving may be distinguished by savers from other forms of saving. In particular the widespread promotion that accompanied the IRA program in the 1982–86 period may have served in part to distinguish IRA saving

[32] The studies by Joines and Manegold [1991] and Gale and Scholz [1990] relax the perfect substitutability assumption by explicitly incorporating the withdrawal penalty in a three-period theoretical model. Their theoretical predictions of the saving effects of IRAs are ambiguous.

from other forms of saving. The simple theory leaves no role for the effect of advertising and other forms of promotion on IRA saving.

Although it is difficult to assess quantitatively the psychological and informational role played by the promotion, the direction of the effect seems clear. The IRA fanfare psychologically earmarked IRAs for retirement, possibly tending to limit the substitutability of IRAs for funds saved in other "mental accounts." A goal of the promotion was to make families more aware of the need to adequately save for retirement. Many may have concluded that a special account for retirement saving was a good way to foster behavior that would not otherwise be adhered to. The "sale" on this type of saving, of course, made the idea especially appealing. Indeed the illiquidity of IRAs may be considered an advantage by many; it may help to ensure behavior that would not otherwise be followed. It may be a means of self-control. Thought of in this way, IRA saving may have promoted greater saving in other forms as well. The effect may be similar to the "recognition effect" advanced by Cagan [1965] to explain the empirical finding that pension coverage was associated with higher levels of saving (see also Katona [1965]). Thus the promotion of saving accounts dedicated to particular uses may both limit substitution between accounts and increase investor awareness of the need to save for specific goals.

Several aspects of the public response to IRAs in the 1982–86 period suggest to us that the fanfare accompanying IRAs was an important ingredient of their success. First, the bunching of IRA contributions during the media blitz preceding April 15 each year suggests that contributors are responsive to promotion. As Summers [1986] noted, IRAs, much like insurance, may be sold not bought. Apparently the public was an easy sell at tax time. For a typical taxpayer, the last minute choice between writing a $800 check to the IRS or opening a $2,000 IRA may have been too alluring to pass up.

A second indication of the role of promotion is provided by Feenberg and Skinner [1989] who found that a large number of households were "falsely constrained"—they contributed exactly $2,000 when they were eligible to contribute more. Although transaction costs associated with opening a spousal account provide one explanation for this behavior, it is likely that the promotion, in which the amount $2,000 figured prominently, played a key role.

Third, investor behavior following the Tax Reform Act of 1986 provides an indication of promotional effects. As emphasized above, IRA contributions fell by much more than would be predicted given the changes in eligibility rules. This "over-reaction" is at least in part attributable to widespread misunderstanding of the legislation (often reported at the time to have eliminated IRAs) and to the marked decline in the promotion of IRAs. Indeed, a recent survey revealed that about half of all persons eligible for an IRA deduction following the 1986 legislation mistakenly believed they were no longer eligible.[33]

The emphasis here on the promotion and the "psychology of saving" that it may have engendered doesn't mean that the tax-advantage was unimportant. Surely it was critical to the success of the program. However, it seems apparent that the promotion and fanfare played a critical role in parlaying the tax' break into IRA contributions. The simple economic models that do not recognize this are likely to be blinded to an important explanation of the public response. Thus it seems to us that a complete understanding of the effects of the IRA program must capture substantially more than the limited reasoning embodied in the simple model.

C. What Makes IRAs Different?

If individuals behave as if all forms of saving are not perfect substitutes, what fosters the behavioral distinctions? We believe that the advertising plays a role. But any answer to this question is speculative. Although the simple model is at odds with prominent features of IRA saving and, in particular, the perfect substitutes assumption cannot be supported by the data, the source of the distinction between different forms of saving is not as clear. A possible explanation is provided by individual motives for saving and possibly the "psychology of saving."

Personal motives for saving suggest compartmentalization. If IRAs are held for different purposes than conventional accounts, then substitution possibilities may be limited from the perspective of many savers. For instance, assets accumulated for short-term goals such as a down-payment on a home or a child's education may be unaffected by the introduction of an IRA promoting saving for retirement. How much of conventional saving is closely related to IRA saving? Stated reasons for saving may provide a rough indication. Avery, Elliehausen, and Gustafson [1986] tabulated responses to the following question from the 1983 Survey of Consumer Finances: "People have different reasons for saving. What are your (family's) most im-

[33] See *IRA Reporter*, vol. 6, no. 9, September 30, 1988.

portant reasons for saving? Anything else?" Results are summarized by age and income in Table 3. At all income levels the precautionary motive ("emergencies") dominates retirement as a motive for saving. And only at ages above 55 does retirement dominate "emergencies." Even in this age group only half say they are saving for retirement. While such evidence is only suggestive, it indicates that much of non-IRA saving may be viewed as an imperfect substitute for IRA saving which is narrowly targeted for retirement.

Further evidence on motives for saving is provided by the asset holdings of families on the eve of retirement. The data in figure 1 suggest that the typical family saves little for retirement in the form of financial assets. For example, the median household financial asset balance including stocks and bonds was $6,600 in 1984 for households with head age 55–65. The family median is less than $3,700 (Venti and Wise [1991a]). Thus it appears that, for most families, the level of non-IRA financial asset saving destined to finance consumption in retirement is low. For the *typical* family it is thus unlikely that a new IRA contribution would substitute for funds that were previously targeted for retirement.

Shefrin and Thaler [1988] and Thaler [1990] have addressed these and other empirical regularities that they find inconsistent with the traditional life-cycle theory of saving. They argue that some of the limitations of the traditional theory can be overcome by modifications making the model more behaviorally realistic. One of their suggestions is to recognize that all forms of saving are not treated as fungible—individuals may have a system of "mental accounts" in which they save for various purposes. Some of these accounts may, by choice, be easily spent (e.g. checking). As a means of precommitment or self-control other accounts may be viewed as inaccessible. Shefrin and Thaler place pensions in the latter category. Apparently an IRA would also be viewed as inaccessible, according to their view. For many individuals the ability to place some saving "off-limits" may actually be a desirable attribute. To the extent that "mental accounts" reflect individual saving behavior, they would tend to limit substitution between funds saved for different uses.

D. Formal Analysis of the Perfect Substitutes Assumption

How individuals in fact behave is an empirical question that can not be answered by theory alone. Our approach in earlier formal analyses has been to test statistically whether IRAs and other forms of saving are treated as different, without trying to quantify the importance of—or even identify—the possible reasons. We have developed and estimated an econometric specification that encompasses both possibilities—permitting flexible substitution. In particular, a special case of the specification is the prefect substitutes possibility. This constraint is strongly rejected by the data.[34]

Even less extreme substitution implies that other saving should increase once the IRA limit has been reached. But this pattern is not observed in the data that we have analyzed, suggesting little substitution.[35]

As emphasized above, the simple theory leaves no role for the effect of advertising and other forms of promotion on IRA saving. While it is difficult to quantify the effect of advertising, we are convinced that the promotion played an important role in establishing the popularity of IRAs. To the extent that the promotion is successful, it would tend to show up in our formal analysis as a preference for IRA saving over other forms of saving and as a rejection of the perfect substitutes assumption, as the data indicate.

To find that IRAs and other saving are not perfect substitutes is not anomalous but instead is consistent with other empirical findings on saving behavior. For example, one might expect that persons with firm pension plans would have lower balances in personal financial assets than persons without firm plans, controlling for personal attributes like age and income. It might be presumed that the firm pension benefits would substitute for personal saving. But the data don't show this. On the contrary, there is a tendency for those with firm pensions to have higher personal financial asset balances. The evidence is reviewed in Shefrin and Thaler [1988]. What the data do seem to suggest, however, is that firm pensions reduce earnings by inducing earlier departure from the labor force. Instead of pension benefits substituting for personal saving, they may instead—by inducing earlier retirement—substitute for personal earnings, as emphasized in Lumsdaine and Wise [1990].

Closer to the IRA issue itself, it was presumed that IRAs would be more likely to be opened by persons without private pension plans, controlling for personal attributes like income, age, and other financial asset balances. But the data don't

[34] See Venti and Wise [1986, 1987, 1990a, 1991a].

[35] See Venti and Wise [1991a].

show this tendency either; again, the IRA doesn't appear to be a substitute for firm pension plans.[36]

We find that the simple model—that is the basis for much of the skepticism about the saving effect of IRAs—provides a poor description of actual IRA saving behavior. Simple economic theory provides an incomplete guide to saving behavior in other instances as well. Thus it should not be surprising if it were misleading in this instance. The primary tool of the simple theory is the rate of return. But the empirical evidence on balance shows little relationship between saving and observed rates of return.[37] Other factors apparently swamp whatever the effect of the return on new saving may be.[38]Personal saving rates vary dramatically among countries but standard theory doesn't explain why. A plausible explanation is that habits, cultural norms, "taste" for saving, the psychology of saving, vary from country to country but are not incorporated in standard models.

Thus there is considerable motivation to look more broadly for explanations of saving behavior. Relaxation of the restrictive assumptions of the simple model is a start.

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[36] See Venti and Wise [1988].

[37] See Bovenberg [1989], for example.

[38] It is even difficult to demonstrate a convincing relationship between rather wide ranging individual tax rates and contributions to tax-deferred saving accounts, controlling for income, age, and other tax filer characteristics. Feenberg and Skinner [1989] conclude that there is a positive relationship between marginal tax rates and IRA contributions, based on U.S. tax returns. Long [1990] also concludes that the relationship is positive. But Wise [1984] finds that the conclusion is extremely sensitive to the functional form used in the statistical analysis. Indeed, using precise marginal tax rates calculated from tax returns, he finds no relationship between individual marginal tax rates and contributions to Registered Retirement Saving Programs in Canada, controlling for income and other tax filer attributes, and using a specification that fits the data best. The evidence in Venti and Wise (1988] suggests that the marginal tax rate may be associated with whether a household contributes to an IRA suggests little relationship to the amount of the contribution.

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DATA APPENDIX

Three sources of data were used to prepare tables and graphs in the text. Each data source and the principal adjustments that were made prior to calculation are described in this appendix.

1. *Survey of Income and Program Participation (SIPP).* The SIPP is a large ongoing survey of the American population principally designed to collect data on the income and participation in government transfer programs. It is organized by annual panels, with each panel consisting of eight or nine interview waves administered at four month intervals. Most of the SIPP data used here come from wave 7 of the 1984 panel (administered September-December 1985), wave 7 of the 1985 panel (January to April 1987), and wave 7 of the 1986 panel (January to April 1988). In the text tables and figures these three sources are referred to as 1985, 1986, and 1987 data respectively because they are closest to year-end balances in those years. However it is clear that for each panel the responses used may be as many as four months "off" from being year-end figures—as many as four months early in 1985 and four months late in 1986 and 1987. In all cases the IRA and other financial asset data pertain to assets owned by the reference person and the spouse; assets owned by other members of the household are excluded.

Financial assets including stocks and bonds includes Regular (passbook) saving accounts, money market deposit accounts, certificates of deposit or other saving certificates, NOW or other interest bearing saving accounts, money market funds, U.S. Government securities, municipal or corporate bonds, other interest earning assets, and noninterest bearing checking accounts. The category *financial assets including stocks and bonds* also includes the market value of stocks and mutual funds (less debt or margin account) and the face value of U.S. savings bonds. Note that the former category, despite its title, contains some bonds. This arises because we were unable to separate out bonds from other interest earning assets in the SIPP and we wanted to keep the names of asset groupings consistent with the categories derived from the other data sources.

2. *Survey of Consumer Finances (SCF).* The SCF is a panel survey first administered between February and July 1983. A subsample of the original sample were reinterviewed between June and September of 1986. The 1983 SCF is much smaller than the SIPP but contains more detail on financial assets. The 1986 reinterview contains less detail. In both 1983 and 1986 the special high-income sample is used. Details on the 1983 and 1986 SCF are available in Avery and Kennickell [1988a, 1988b].

Financial assets excluding stocks and bonds includes checking, statement savings, passbook, share, draft, and other saving accounts; money market accounts, and certificates of deposit. The category *financial assets including stocks and bonds* also includes stocks and all holdings of bonds including U.S. saving bonds.

3. *Consumer Expenditure Surveys (CES).* The CES is a quarterly panel survey used to obtain information on household expenditure patterns. Households enrolled in a quarter are followed for five quarters. We use CES data for all quarters from 1980:1 through 1989:1. For the calculations in this paper, we have combined all four quarterly reports into a single annual average. Thus, for example, the CES asset figure for 1983 will include balances reported for all 12 months in 1983. For this reason, and possibly others as well, annual figures obtained from the CES may differ from figures based on the other two sources, and from tax year data reported by the IRS.

Financial assets excluding stocks and bonds includes saving accounts in banks, savings and loans, credit unions, and similar accounts; checking accounts, brokerage accounts, and other similar accounts; and U.S. savings bonds. The category *financial assets including stocks and bonds* also includes securities such as stocks, mutual funds, private bonds, government bonds, or treasury notes.

A key objective was to obtain from each data source a sample representative of the "IRA-eligible" U.S. population. The following steps are common to each source of data:

- Households in which the head or reference person is age 65 or older are deleted. The minimum age is determined by the availability of data for each source. In the CESs the minimum age of a household head is 18. In the SIPP the minimum age is 21. In the SCF the minimum age of a household head is 25.
- Households in which the respondent or spouse of the respondent is self-employed are excluded. The self-employed had access to Keogh plans with contribution limits very different from the IRA limits. Elimination of the self-employed also minimizes a potential complication hat arises because two of the surveys (the CESs and the 1986 SCF) ask respondents for combined IRA and Keogh balances.
- SIPP and SCF are weighted to represent the national population. The CES is weighted to represent the national urban population.

Figure 1. Median Asset Balance
By Age and Type of Asset

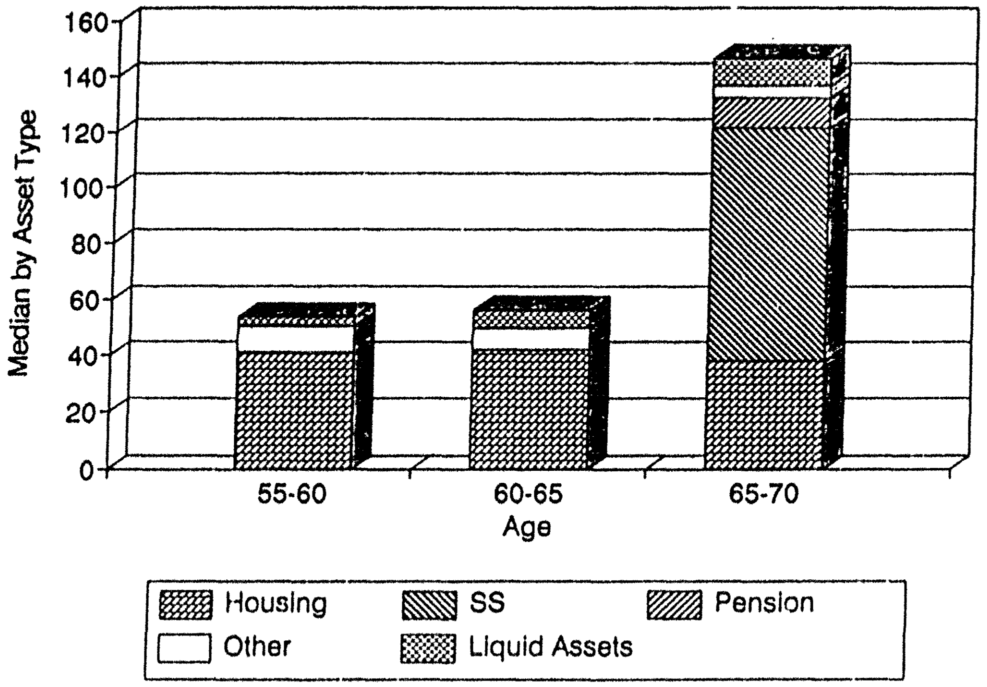


Figure 2a. Private Pension vs IRA&Keogh

Total Assets

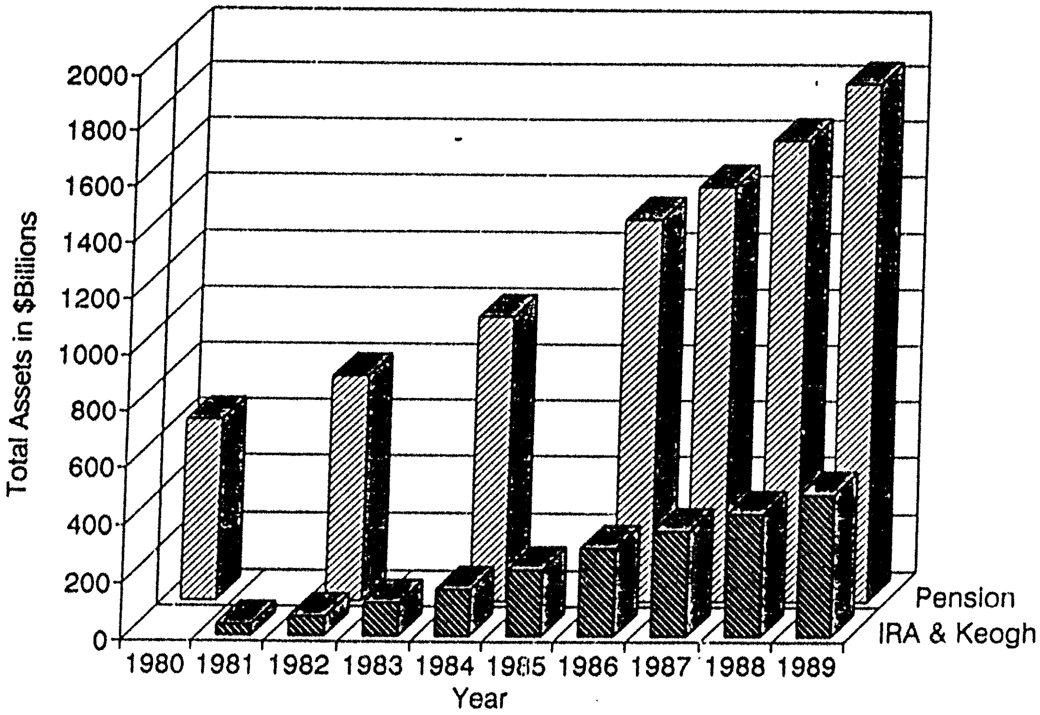


Figure 2b. Private Pension vs IRA&Keogh
Ration of Total Assets

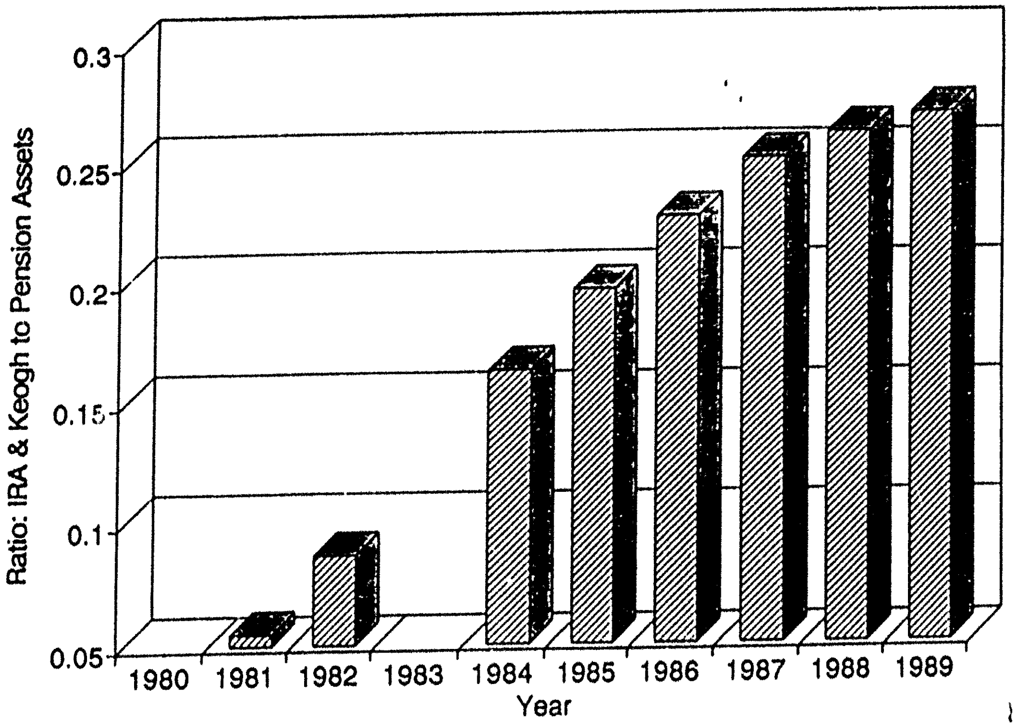


Figure 3. Percent With IRA Accounts
Households, by Income and Age, 1986

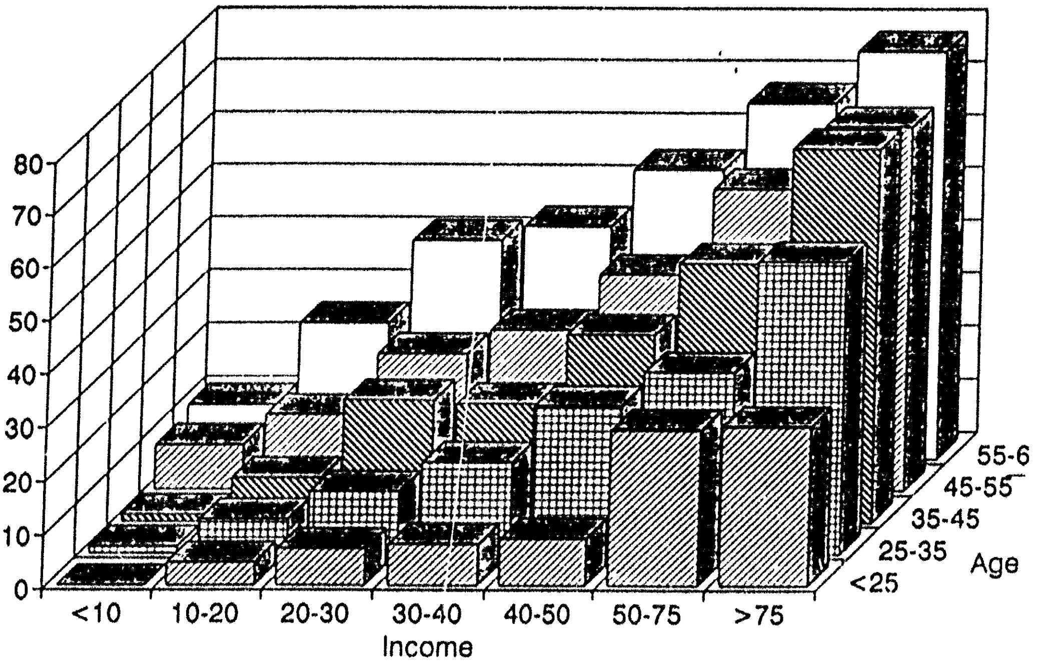


Figure 4a. IRA vs Non-IRA Saving
1980-1989, Incl Stocks & Bonds

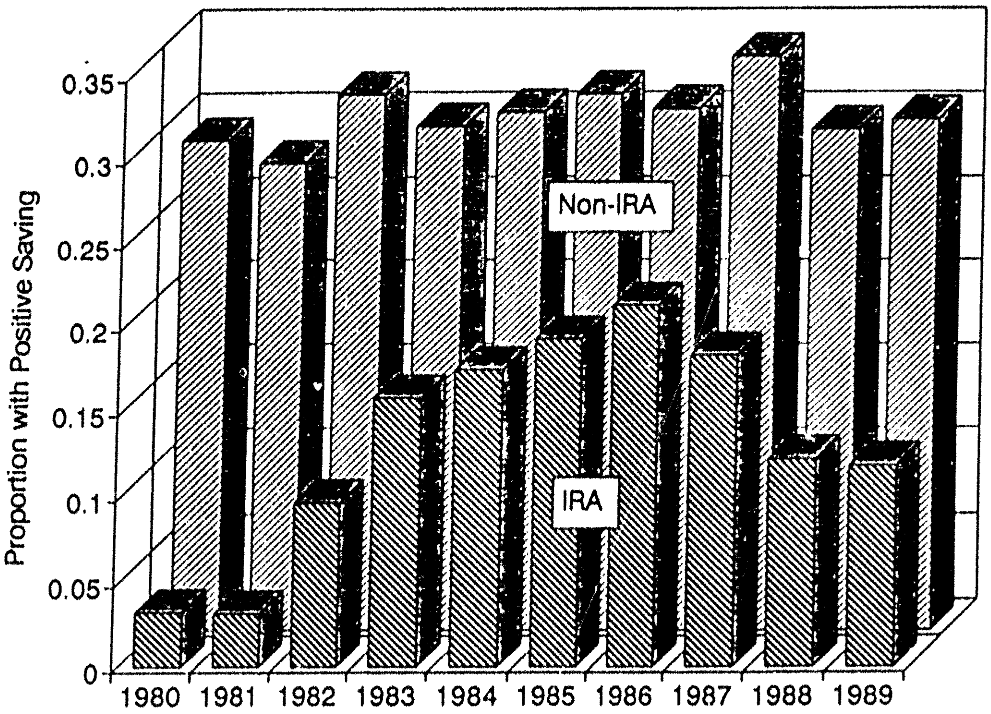


Figure 4b. IRA vs Non-IRA Saving

1980-1989, Excl Stocks & Bonds

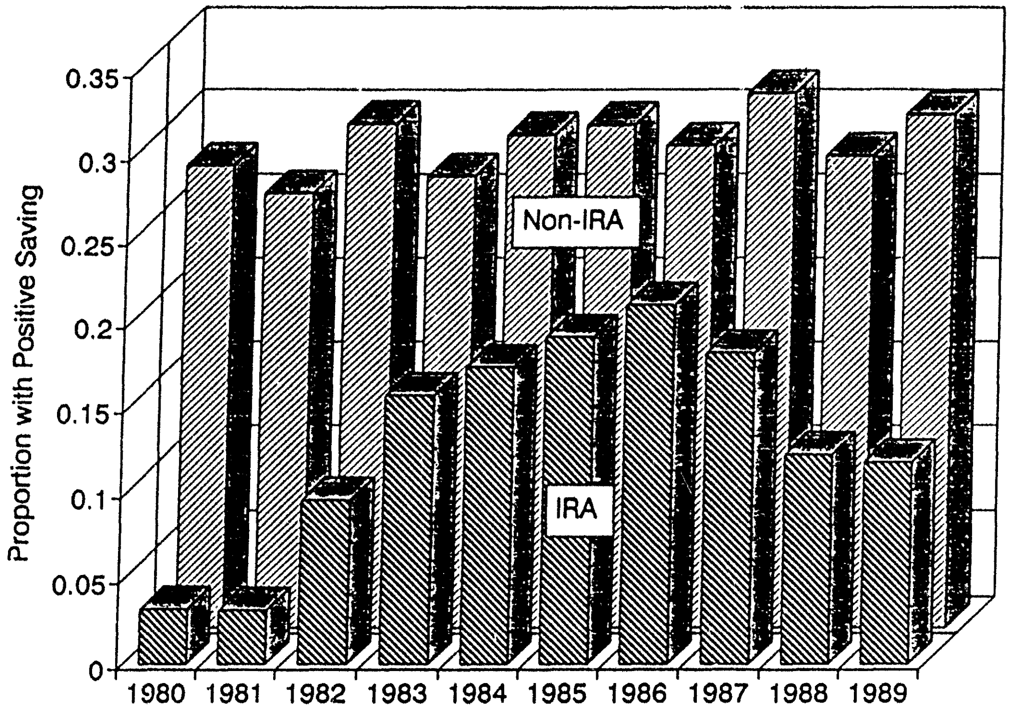


Fig 5a. IRA vs Non-IRA Asset Balances
By IRA Contributor Status, Excl S&B

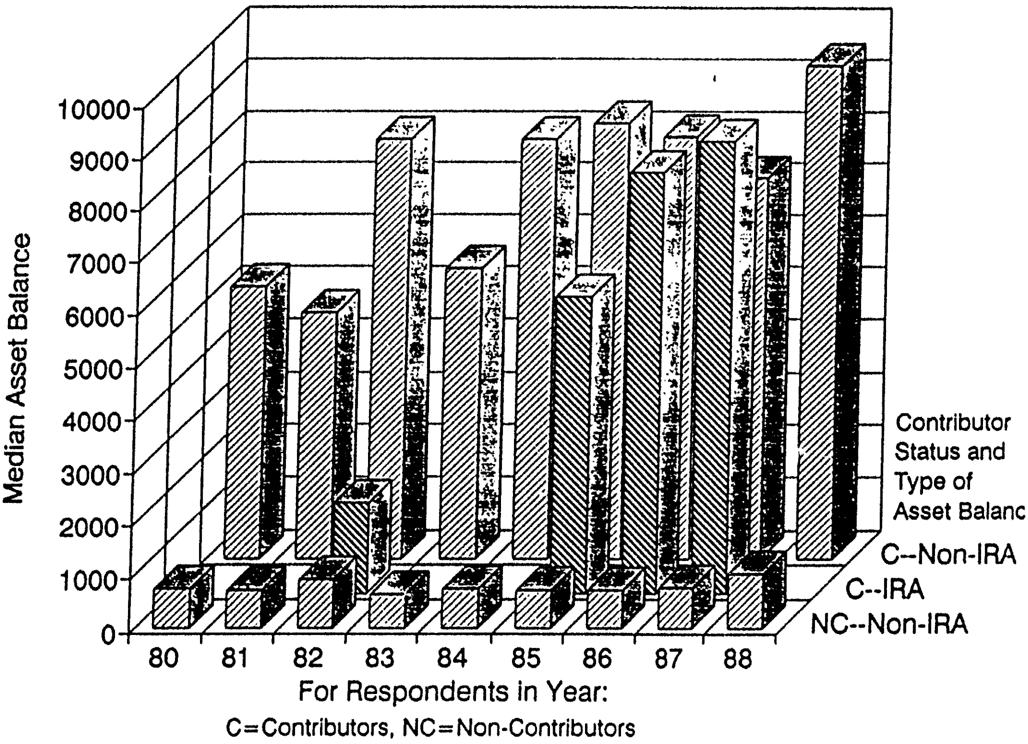


Fig 5b. IRA vs Non-IRA Asset Balances
By IRA Contributor Status, Incl S&B

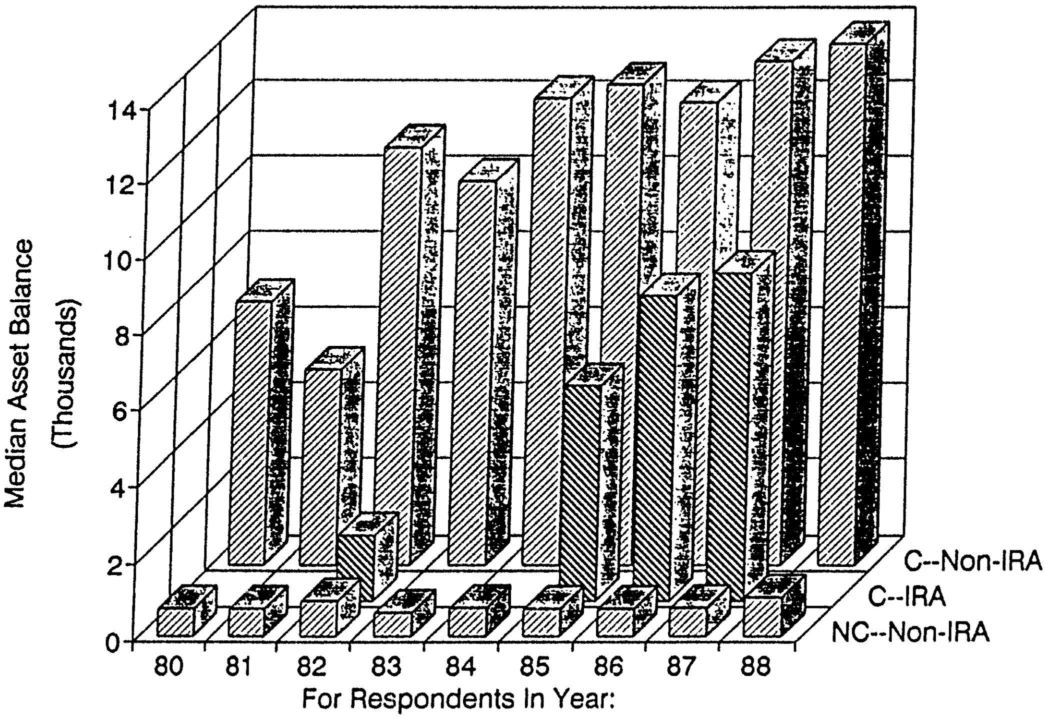


Figure 6a. IRA vs Non-IRA Balances
For Like Groups, Excl S&B

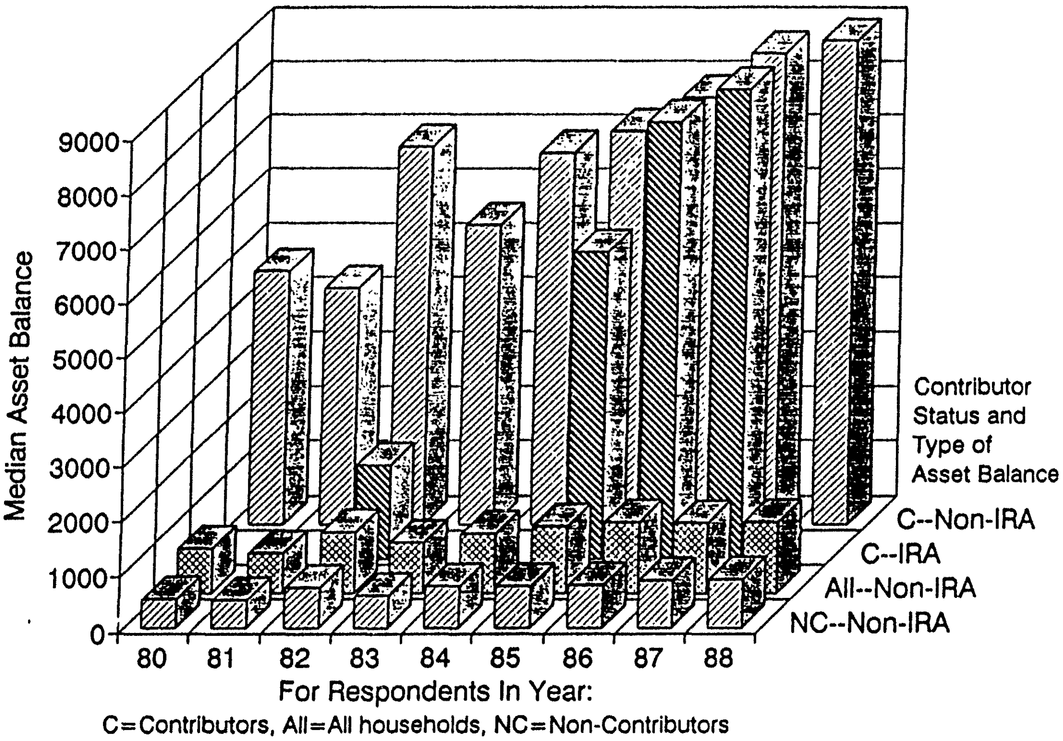


Figure 6b. IRA vs Non-IRA Balances

For Like Groups, Incl S&B

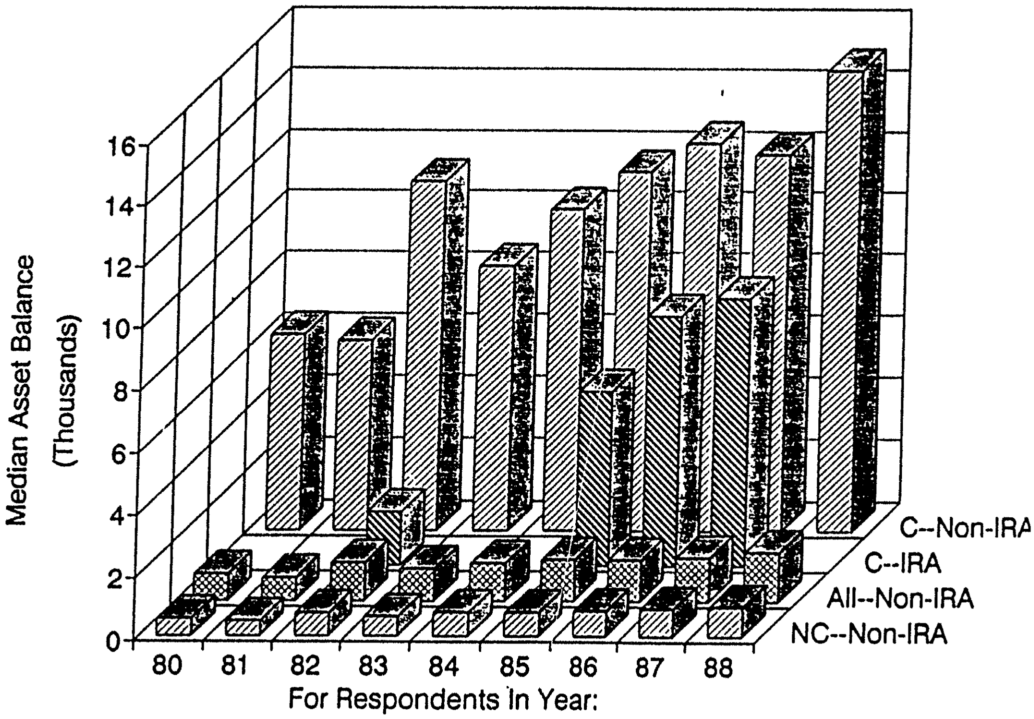
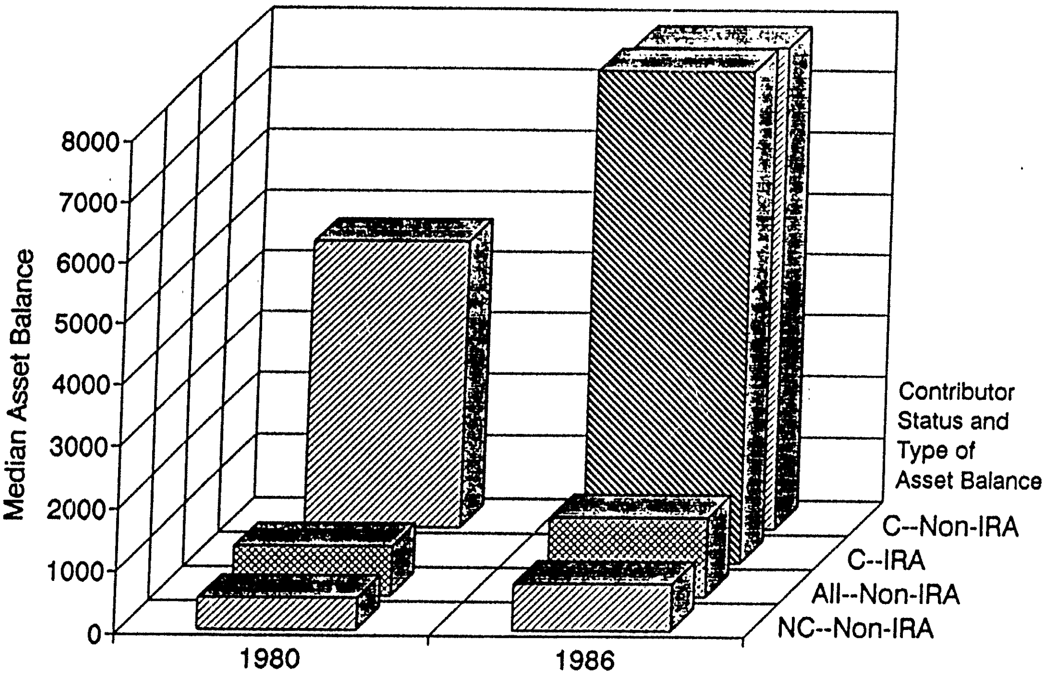


Figure 6c. IRA vs Non-IRA Balances
For Like Groups, Excl S&B



C=Contributors, All=All Households, NC=Non-Contributors

Figure 6d. IRA vs Non-IRA Balances
For Like Groups, Incl S&B

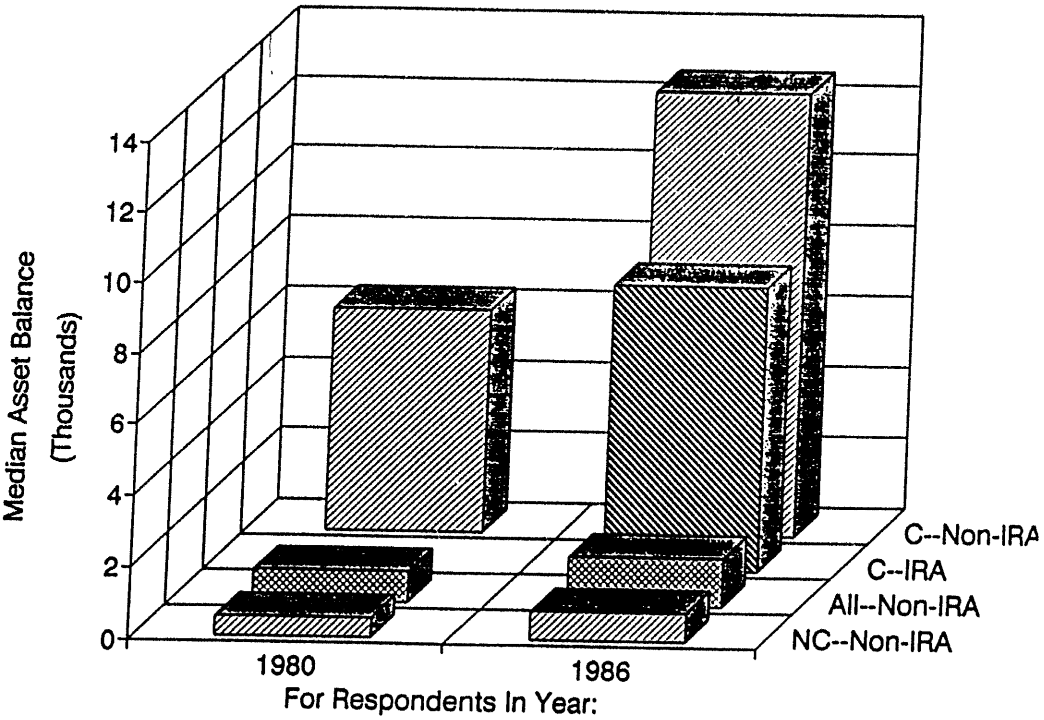
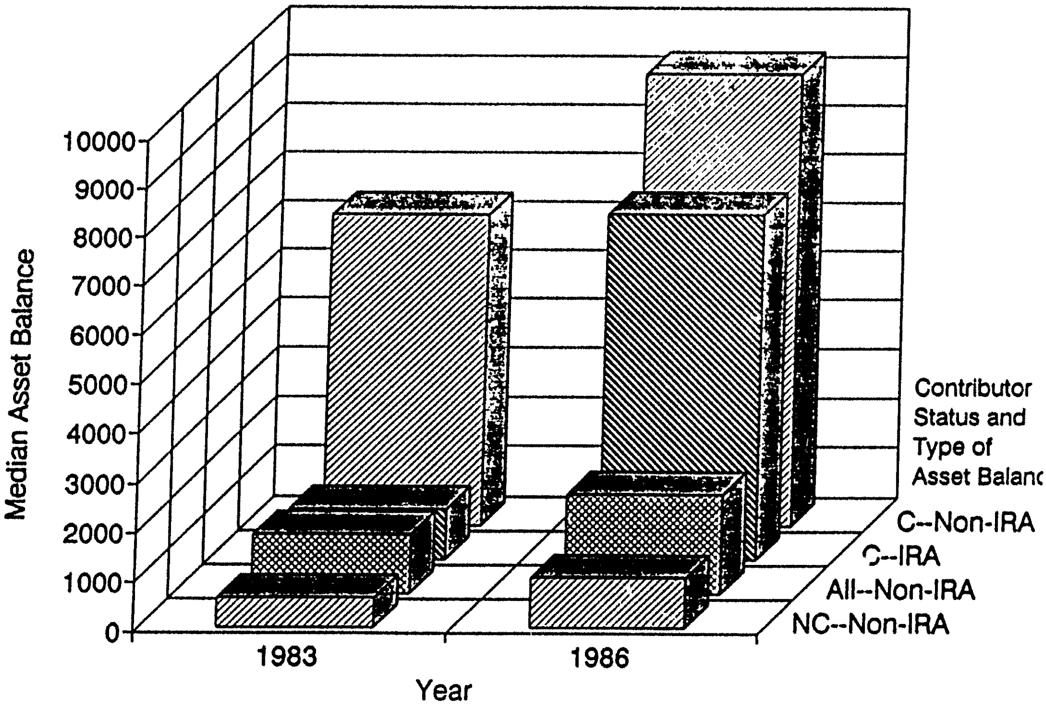


Figure 7a. IRA vs Non-IRA Balances
SCF 1986 Respondents, Excl S&B



C=Contributors, All=All Households, NC=Non-Contributors

Figure 7b. IRA vs Non-IRA Balances
SCF 1986 Respondents, Incl S&B

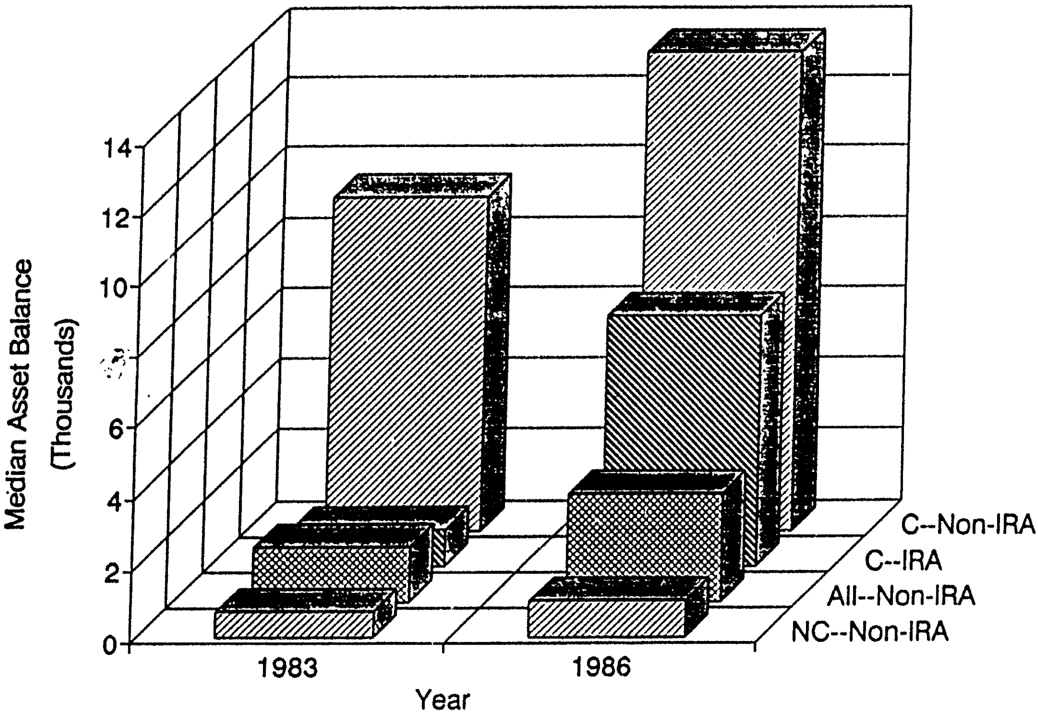
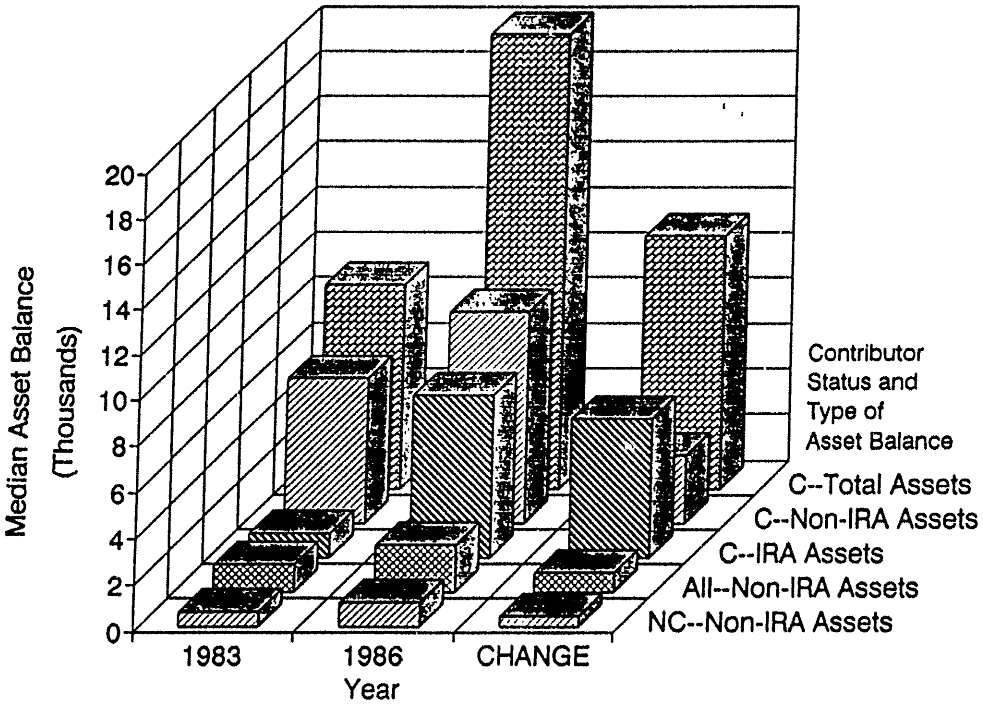


Figure 7c. IRA vs Non-IRA Balances

SCF 1986 Respondents, Excl S&B



C=Contributors, All=All households, NC=Non-Contributors

Figure 7d. IRA vs Non-IRA Balances
SCF 1986 Respondents, Incl S&B

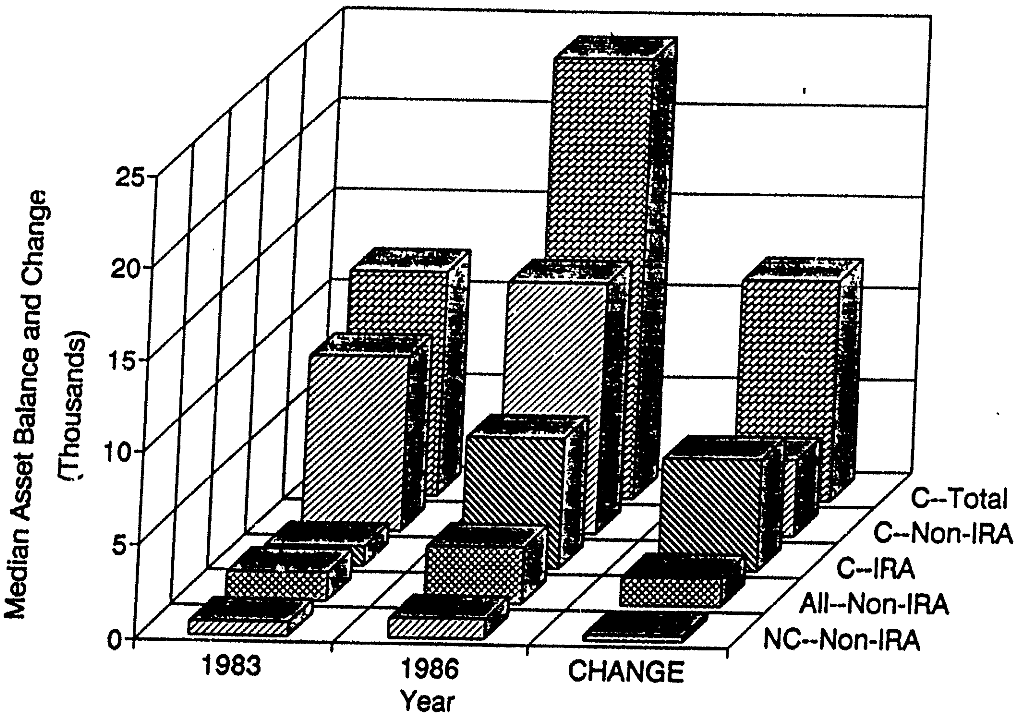


Table 1
Change In Non-IRA Saving
When IRA Contributor Status Changes
Bank Accounts

	1985 Non-Contributor	1985 Contributor
1984 Non-Contributor	-64.6 (61.4)	-377.4 (248.7)
1984 Contributor	148.6 (317.0)	-470.3 (182.7)

F = 2.565

Table 2
Change In Non-IRA Saving
When IRA Contributor Status Changes
Bank Accounts, Bonds, & Stocks

	1985 Non-Contributor	1985 Contributor
1984 Non-Contributor	89.4 (102.1)	-193.5 (413.6)
1984 Contributor	630.3 (527.2)	-186.2 (303.9)

F = 2.565

Table 3. Purposes of Saving, Families with Head in Labor Force,
by Family Income and Age of Head.
(percent of families in each group mentioning purpose)

	Purpose						
	Emergencies	Retirement	Education	Purchase Home	Purchase Durables	Travel	Expenses
Family Income							
< $10,000	49.5	10.5	20.7	6.9	18.4	6.9	12.7
$10,000-19,999	53.8	18.0	16.0	10.2	15.7	10.9	7.3
$20,000-29,999	58.6	22.5	16.3	10.8	13.8	11.2	5.3
$30,000-49,999	48.8	30.9	21.7	8.8	14.3	11.4	5.1
$50,000 or more	50.9	37.8	23.4	4.3	11.1	10.8	4.9
Age of head							
Less than 25	52.5	4.9	16.2	16.1	24.2	12.0	10.2
25-34	55.6	8.8	18.6	15.3	18.5	8.9	7.2
35-44	55.4	20.7	26.4	7.6	13.9	12.6	5.4
45-54	52.4	35.9	18.2	3.1	11.5	10.0	5.2
55-64	44.5	52.0	11.1	1.9	8.2	10.9	7.3
65 and over	39.6	44.3	9.8	*	7.2	5.3	12.7

Source: Robert Avery, Gregory Elliehausen, and Thomas Gustafson, "Pensions and Social Security in Household Portfolios: Evidence from the 1983 Survey of Consumer Finances", in F. Gerald Adams and Susan Wachter (ed.), Savings and Capital Formation, 1986.

PREPARED STATEMENT OF ALLEN SINAI*

The U.S. economy has failed to recover from the recession that began in July 1990 and has been performing dismally since the second quarter of 1989.

What is the state of the economy and its prospects? Why has there been no recovery? What should be done to put the economy back on a growth path that is balanced with respect to short- and long-run considerations, to sustain noninflationary growth, improve the competitiveness of the United States, and to raise the standard-of-living for all Americans?

State of the Economy and Prospects

At the current time, there is no recovery from the recession in the United States economy. It increasingly appears there may never have been any meaningful recovery. Worse, whether the economy recovered or not, it may now be entering a secondary downwave.

Recent data, surveys, The Boston Company Economic Advisors, Inc. (TBCEA) models, screening and filtering systems, anecdotal evidence, and the underlying fundamentals suggest that nothing much is happening in the economy, although seeds of some growth later have been sewn and some potentially promising trends for the longer-run are beginning to take shape.

Cyclically, the economy peaked in July 1990, and has been in a recession-like situation since then. The causes included the typical cyclical factors of a bumping of activity against capacity and a tight labor market, both sources of accelerating inflation. For a time, tighter monetary policy occurred in response, raising the cost of borrowing, increasing debt service burdens, worsening already deteriorated balance sheet positions and liquidity, and reducing purchasing power. Business profits came under pressure and cutbacks ensued. In turn, incomes grew more slowly, further restraining private sector spending. In the fourth quarter of 1990, a negative external shock occurred--the Gulf Crisis and Iraq confrontation. As a consequence, a near doubling of crude oil prices raised inflation and interest rates, depressed consumer confidence, and so intensified the downturn of the economy.

Subsequently, with the successful conclusion of the Gulf War, interest rates dropped, inflation eased, confidence was restored and the economy snapped back, with most monthly data rising in May through August and Gross Domestic Product (GDP) up in the second and third quarters.

But, the factors that lifted the economy in May to August--an upward burst of consumer spending, increased production and some restocking of inventories, a little hiring, and improved residential construction--now are mostly fading. The momentum of the economy is negative. Poor jobs prospects, weak real income growth, softening consumption, a flattening of production and now some cutbacks, continued restructuring and layoffs, a spotty orders picture, a continuing squeeze on profits, rising joblessness, and rapidly deteriorating confidence are pushing the economy lower.

The failure of lower interest rates to provide any lift to the economy one year after a decided turn toward aggressively easier monetary policy is disconcerting. In recent years, the lags between monetary ease and a better economy most often have been six to twelve months.

Uncertainty over Washington's ability to diagnose and handle the cyclical and secular problems of the U.S. economy is hurting confidence. Surveys of consumer sentiment by the Conference Board and University of Michigan, small business surveys by the National Federation of Independent Business and American Express, Associated Press Surveys, and WSJ/NBC polls all show a deterioration.

*President and Chief Economist, The Boston Company Economic Advisors, Inc.; Adjunct Professor, Lemberg Program in International Economics and Finance, Brandeis University, Waltham, Massachusetts.

As things now stand, the economy looks to be in an extended recession. A slow recovery next year, not really a very satisfactory one, a long standing view of TBCEA, now appears subject to greater risk unless additional monetary easing and fiscal help are forthcoming.

Growth in Gross Domestic Product (GDP) is expected flat to down in the fourth quarter, with much of the same in store for the first quarter of 1992. GDP is a poor summary indicator of things these days, however, all along in the past few years understating the severity of this episode, which, in many ways, has been the most punishing and difficult downturn in the postwar era.

About 65% of states still are in recession--led by the Northeast, Mid-Atlantic, South Atlantic, parts of the Far West, East and West South Central states, a portion of the Midwest, and some of the Northwest. The goods-producing sectors--Manufacturing, Mining and Construction are weakening, flat or in recession. Much of The Services Economy is in recession or flat in activity. Only Health Care and Finance are expanding nicely. Agriculture and exports, both for goods and services, are solid. But, a new round of economic weakness overseas, in Western Europe and in Japan, threatens the export side of the U.S. economy, adding yet another risk to an already long list of downside possibilities. Canada and the U.K. have only begun to recover, but in a halting way. Latin America is doing better, especially Mexico.

Looking ahead, the earliest meaningful upturn that might occur now looks put off until at least March or April, and probably will be contingent on further easing by the Federal Reserve and some fiscal help from Washington.

About a 1-1/2% to 2% pace of growth is expected between the fourth quarter of 1991 and the fourth quarter of 1992, but with any upturn not really in place until the second half of the year.

Such an expectation is based on more help from monetary and fiscal policy, minimal positive growth in consumption spending, which has a trend of about 1% per annum in real terms, a tilt up in residential construction, sustained growth in exports, and inventory rebuilding.

The unemployment rate likely will rise to 7% or a little more. It would be almost 10% if not for the unusually low labor force growth that has been occurring, just 0.4% over the past year or about one-third what might be expected on demographic trends for the 1990s.

Inflation should be in the 2-1/2% to 3% range, a positive and encouraging result, certainly no impediment to some additional monetary stimulus and fiscal support.

The federal budget deficit is estimated at $357 billion, a little over 6% of GDP. But, despite this large deficit, fiscal policy actually has been restrictive, with taxes raised in 1991, to rise more in 1992 and federal government spending cut back, in real terms. Anywhere from $80 billion to $110 billion of the deficit is from thrift bailout and FDIC funding and $50 billion to $60 billion is from the revenue shortfall of a chronically weak economy and the extra costs of financing the bigger deficit. Ex- the thrift bailout costs, on a structural or full employment budget basis, the federal budget has restrained the economy and will also do so in 1992 if there is no fiscal stimulus forthcoming from Washington.

This recession-like episode is now in its 17th month, exceeding the 1973-75 and 1981-82 episodes of 16 months each, the previous longest downturns in the post-World War II era.

But, the recession itself is only one page of an even bigger story, a long period of subpar, chronically depressed, difficult, weak and puny economic activity, in an economy that appears in a "state of squeeze," a kind of "mid-life crisis" of adjustment and restructuring, hopefully to set the stage for healthy expansion later on. The transition has been and is painfully difficult, and filled with considerable downside risks that could alter the prospects for a sustained, noninflationary expansion in the longer-run.

Since 1989, the U.S. economy has been in a "growth recession," rising far below its already anemic potential rate of growth of about 2% per annum.

The dismal performance of the economy, 0.5% growth per annum since the end of 1988, and 10 consecutive quarters of less than potential growth, while not so steep and sharp as the declines in the recessions of 1980 and 1981-82, in its own way has been just as severe and punishing.

Even after some sort of recovery is in place, serious questions remain over how the economy can sustain the kind of growth needed for healthy expansion, achieving a sustainable, noninflationary rate of growth in production, incomes, profits, and jobs that can provide for all of our citizens.

Despite the numerous difficulties and problems that exist, there are pluses that should be recognized. Inflation is much lower and shows signs of a sustained low rate. Interest rates have fallen to levels not seen since the early 1970s. Breakeven points have been lowered across corporate America. U.S. business is more competitive, domestically and overseas. The international scene should permit systematic reductions in defense spending in coming years and free up some funds for allocation to unmet national needs. A lower dollar and sharply reduced cost of capital are helping the U.S. to be more competitive internationally. A restructuring of debt and reliquefication of balance sheets across most sectors is in process. Companies are stressing quality, service, and looking toward market signals for guidance more than ever before. Awareness of short-run and longer-run economic, sociological and societal national problems is much greater and more sensitized than in a long time.

The first step in fixing problems is recognizing that there are problems. The country and Washington now seem more focussed on the cyclical and long-run problems of the U.S. economy. No easy solutions or quick cures exist, but the recognition and beginning of a focussed attempt to make things better is a healthy step. While much work remains to be done, and while the difficulties of transition will remain to squeeze American consumers and businesses, the transition to better times probably has begun.

A successful transition will require attention and actions from Washington. The U.S. economy never really has recovered through spontaneous combustion, almost always requiring an external impulse to set the internal propagation mechanisms spiraling economic activity higher. The current episode is likely no exception.

The forecast of TBCEA for the rest of 1991 and 1992 is presented in Table 2, where the performance of the economy since 1989 also is indicated.

Without additional monetary easing and a modest dose of fiscal stimulus, the growth path for 1992 would be estimated at flat to up a percentage point, with a 1-in-4 chance of extended recession through the year.

Why No Recovery and Such Subpar Performance?

There are cyclical and secular reasons for the poor performance of the U.S. economy since 1989.

It is important to understand the fundamentals of why there has been no meaningful recovery and such slow growth over the longer-run in order to help in deciding what, if anything, to do.

There are unusual, atypical forces at work this time that are contributing to the current situation and prospects. Some of them are new, some cyclical, some secular or long-run.

First, despite a huge and rising federal budget deficit, fiscal policy actually has been restrictive. This is new and unusual, since in all postwar recessions a combination of monetary ease and fiscal stimulus, the latter more-or-less, have been used to revive the economy. Restraint also is set for the longer-run, with federal government spending on a downward course, in real terms, for the next few years. This is a consequence of the Omnibus Budget Reconciliation Act of 1990 (OBRA).

Trying to balance the federal budget deficit is of critical importance for the long-run, a means by which resources can be released and reallocated to the private sector and to saving. But, as a cyclical matter a tight fiscal policy has been applied in recession. This has never occurred in the postwar era.

Table 3 shows that on the federal level, taxes were raised by $17.6 billion in fiscal year 1991. Another $12.3 billion has been set for 1992, although the recent extension of tax breaks due to expire on January 1 will prevent $3.2 billion of tax increases from occurring.

Because of large deficits at the state level and balanced budget requirements, another $15 billion of tax increases was levied on July 1, 1991. These were concentrated in about 15 states.

Thus, in total, U.S. households and business saw a near $33 billion tax increase in 1991, a year of recession. In 1992, with another $7.5 billion of tax hikes expected at the state and local government level, the total increase will be about $17 billion.

Spending on defense, in real terms, ex-Iraq War costs, has been moving lower, programmed to decline, on average, 3.4% per annum through 1995, also by OBRA.

Caps on the international and nondefense nonentitlements categories limit another 16% of federal outlays, including transfers. The OBRA legislation "pay-as-you-go" provision in the Budget Enforcement Act has had a restraining effect.

Only in the recessions of 1957-1958 and 1960-61 was no fiscal stimulus applied to help restore expansion in the U.S. economy. In 1962, large tax cuts had to be used to move the economy higher after a long period of slack growth that was, in part, due to the earlier fiscal drag.

The lesson of the past year is that the policy mix of monetary ease and fiscal restraint, at least in the first year of application, has produced essentially nothing for growth of the economy.

How, it might be asked, can fiscal restraint be in place when so large a federal budget deficit exists, with all of its problems and the rapid pace of growth in debt and debt service at the federal government level?

A distinction between the federal budget deficit and impact of the budget on the economy must be made. Taking out the thrift bailout and FDIC outlays, accounting for the revenue shortfalls from a weak economy and allowing for extra expenditures from a less than fully employed economy, a better way of assessing the impact of the budget on the economy, structural or full employment budget calculations, shows fiscal restraint to be in place.

Table 4 shows the calculations of TBCEA on this basis, the "full employment budget" or the "structural" budget deficit. It should be noted that fiscal restraint, measured as the change in the full employment budget deficit ex-thrift bailout, occurred in 1991 and will do so again in 1992. Even admitting some potential for error in the calculations, it can be inferred that no help has come to the economy from the fiscal side. The estimated fiscal drag in 1992 is approximately $41.3 billion.

The large federal budget deficit does create a greater supply of securities, tending to raise interest rates. But, the thrift bailout costs have no positive spending impact. Indeed, the effect is negative through the increases of supply on interest rates. There is no spending stimulus occurring to offset whatever negative effect the greater supply of securities might have in keeping long-term interest rates up.

Second, a new secular force relates to demographics and housing. Less growth in the labor force has appeared as a consequence of the aging population, with fewer families in the age groups that typically buy first homes. Only 19.5% of the population now lies in the 25-to-34 year age group, the lowest proportion in 20 years, the group where most first-time homebuying occurs. In the 1970s and 1980s, the percent of households in this age group ranged from 21% to 23.1%.

Third, the excesses of the 1980s have come home to roost, in part a cyclical phenomenon of stock adjustments, but also as part of a necessity for long-run adjustment.

Strong spending, a lot of borrowing in the U.S. and abroad, little saving, much debt accumulation, and rising debt service all occurred as a consequence of the fast-paced economy of the 1980s. Massive purchases of cars and houses by households, an overbuilding of nonresidential and commercial real estate, and growing interest and repayment burdens were some of the excesses that eventually had to be corrected. The process of correction, stock adjustments in physical consumer durable goods, office buildings, debt across all sectors and at various levels of government, necessarily is accompanied by less growth and higher unemployment in the shorter-term.

Fourth, and related to the 1980s excesses, debt, debt service and balance sheet shocks have been extensive, moreso than typically due to so much overextension.

A wave of failures, bankruptcies, delinquencies and restructuring following the excessive speculation, aggressive spending and borrowing of the 1980s, and leveraging of American businesses has occurred. The stretching of leverage throughout the economy was so great as to require a long period of retrenchment and adjustment.

Fifth, a financial institutions fallout, unlike any other period since the 1930s, has been pervasive. The extent of the troubles for thrifts and commercial banks are new to the postwar era and probably long-run in nature. Failures of thrifts and the difficulties of commercial banks, lower valuation on the asset value of collateral, and tougher regulatory requirements have prevented easier Federal Reserve policy from being transmitted through credit into spending. The credit channel has not been functioning well, preventing spending from picking up.

Sixth, international competition is now a major factor, new compared with the situation 5, 10 or 15 years ago. Much greater competition from foreign companies exists now than ever before, both overseas and here in the United States. Because of this, markets essentially have shrunk for many U.S. companies.

Seventh, a long squeeze on the profits of business has been in place, mostly cyclical but longer-run in nature because of the restructuring and repositioning that must go on. The profits squeeze has led to a wave of cost-cutting and attempts to control labor costs, which are reverberating through the rest of the economy in a negative way.

Eighth, a major change in consumer attitude and behavior has emerged. Households are retrenching in spending and in debt accumulation. This tends to be short-run or cyclical in nature, although once occurring can last for quite awhile.

The household sector, squeezed on income and now exceedingly concerned over job prospects, is radically altering behavior. Spending and borrowing are out! Saving and paying off debt is in! Consumer patterns of behavior will be very different from the 1980s for some time.

Ninth, real estate difficulties have put this industry in a depression-like situation. Overbuilding, overbuying, oversubsidization, overleverage and a speculative boom have been followed by busts in real estate--commercial, residential, and development. The Tax Reform Act of 1986 revised and limited real estate subsidies, and contributed to the downturn. Real estate affects more than just its own industry, through the fallout on banks, thrifts, insurance companies, the net worth of households, possibly even pension funds, and the cost to government of the bailout and support of depository institutions failures.

Finally, the potential growth or supply-side of the economy, a long-run factor, is setting a much lower limit for the economy and is limiting the potential for both short- and long-run growth.

The limit on potential supply or output can be seen to have become more constraining in recent years. Table 5 shows the estimated change in potential economic growth over the last 30 years, using an elaborate model of potential GNP developed at TBCEA. The current figure is 1.8% per annum, compared with well over 3% a year in 1961 to 1975 and a 2-1/2% to 3% range in 1975-85.

In this framework, factors such as the quantity and quality of labor including educational achievement, capital stock growth and embodied technology, the financial system, infrastructure, research and development, energy, efficiency and entrepreneurship are considered and assessed quantitatively.

Another way to estimate potential growth is to add labor force growth to output per manhour, 1.3% per year as estimated by the Bureau of Labor Statistics (BLS) for 1990-2005 and about 1% near- to intermediate- term for growth in output per manhour. However, this calculation of about 2% to 2-1/2% growth in potential output is only a rough proxy, since so many factors affect productivity.

The problems of the speed limit set by potential supply are multiple in nature.

First, growth in the standard-of-living of all Americans, in real terms, is limited to no more than the low rate of growth, on average, of potential output. Compared with U.S. history and relative to other countries, the relative decline in the U.S. standard-of-living is cause for great concern.

Second, with potential supply growing by only about 2% per annum, the ability of the economy to sustain a strong pace of noninflationary growth is hampered. Even if demand management policies could be designed to pump up economic growth, a reignition of inflation might quickly arise. Then, the Federal Reserve would tighten monetary policy, interest rates would rise, and the economy's actual rate of growth would tumble again. The rate of growth in potential output acts as a straightjacket, constraining actual growth, limiting sales and revenues, weakening incomes, and producing a negative profits environment for the U.S. economy.

The ability to compete internationally also is harmed by the limited growth potential of the U.S. economy. Sustained and strong noninflationary growth can pay high dividends in providing funds for investments in all sorts of things, as well as a better standard-of-living for all.

Also, countries that can grow more at lower rates of inflation often exhibit stronger currencies, in turn increasing the standard-of-living and international purchasing power of an individual country.

No world power has maintained its status with greatly limited productive potential.

There are a number of positive trends in place, unfortunately dwarfed by the long list of negatives that exist. Inflation rates have moved sharply lower and probably permanently so. Cutting debt and debt service is now a major thrust of the business sector. Consumers are spending less and trying to save more. The problem is that there is not enough income to permit any big increase of saving. There is a declining role for government, especially on the defense side, which has previously claimed too many of our resources. Cost-cutting and lowering breakeven points is a big wave in American business, with efficiency, stress on quality and productivity beginning to emerge--certainly healthy for the long-run.

Many of these positives are an outgrowth of the squeeze that comes from the difficult adjustments that are occurring.

But, in order to reach the long-run, the economy must get through the short-run.

The U.S. economy does not grow by spontaneous combustion. Incomes, jobs, profits and productivity and potential growth are exerting a stranglehold.

All of these negative factors have quantitative effects that are hard to judge and to estimate, since so many of them are new in this episode. How they play out will determine how the economy does--short- and long-run.

Policy Options, Actions and Perspectives--What to Do?

The economy's failure to recover from the recession is promoting lower inflation and a discipline and austerity that has its potential benefits. The trouble is that the costs have become prohibitive.

The problem of no recovery is a triad--a lack of jobs, incomes, and profits--in any order desired.

Without actions to raise income and jobs; jobs, income, spending and profits; profits, jobs and incomes, part or all of this triad; the dynamics of the situation and potential negative side effects of weakness could complicate and make worse the prospects over the long-ruh.

"Jump-starting" the economy means an external impulse to the system to set off the internal mechanisms of expansion. This is typically done through monetary or fiscal policies. At the current time, a number of negative external impulses are buffeting the economy.

Any measures taken must do double-duty--helping to lift the economy near-term to reduce the costs of longer-run improvement, while setting a solid basis and framework for a higher and sustainable noninflationary growth path for the rest of the decade. Policies used should be designed to accomplish both tasks.

A single policy is not enough. A package of measures is required--both monetary and fiscal. The fiscal stimulus should be modest, $20 billion to $50 billion.

For all purposes, a low profile of interest rates is preferable. So long as inflation is under control, easier money and a lower interest rate profile should have very beneficial effects. To keep inflation under control, in the long-run the potential supply of the economy must be increased through faster productivity growth. Then, demand-management can seek a balanced path of demand with supply.

Quick, decisive, large doses of additional monetary ease are indicated. Reductions of interest rates have done little so far because of weak demands for borrowing, relatively small declines in many consumer-related lending rates, and the many negative co-factors that exist.

o There should be two additional one-half percentage point reductions in short-term interest rates and a lowering of reserve requirements for the banking system.

o The economy needs a National Clearing House to match solid credits with financial institutions who can and will lend--a FNMA-like institution.

o The regulators must find ways to ease or stretch out the way loan losses are being written off by commercial banks and prevent the costs of lending from being so high that banks do not want to lend. One way is a more gradual approach to the new risk-adjusted capital adequacy requirements, phasing them in over time. Or, the pace of write-downs at banks can be slowed down.

To offset the fiscal restraint that is in place, a quick fiscal stimulus program is desirable.

Designing a fiscal stimulus program is complicated for several reasons. One, deciding on the amount and composition is difficult. Two, issues of permanent versus temporary fiscal stimulus must be dealt with. Three, how to finance the fiscal stimulus, especially given the Budget Enforcement Act, is yet another issue. Long-run fiscal discipline is essential for the economy and to permit a sustained low profile of interest rates. But, complete reliance on financing any fiscal stimulus on a pay-as-you-go basis could severely limit the impact of the program. Fourth, there has been and may be negative effects on the financial markets of any program of fiscal stimulus. This is to be considered. Fifth, there are, of course, many political crosscurrents that can make agreement difficult in Congress.

The ingredients of any fiscal package are five.

One, a modest dose of stimulus of about $20 billion to $50 billion would pretty much offset the fiscal restraint for 1992 and, depending on how financed, provide stimulus to the economy.

Two, if possible, financing should be done within the Budget Agreement in order to maintain the fiscal discipline that has started. But, even more important is a clear commitment of Congress and the Administration to reallocating resources out of government into the private sector and to reducing the full employment budget deficit toward balance. If such a commitment could be structured without a law on the budget, that would be preferable.

Three, any fiscal stimulus should be evaluated and measured in its totality, and be designed and assessed as a package, ex-ante and ex-post.

Four, a balance must be struck, with measures designed to gently and permanently lift the economy over the next year or so, and, at the same time push out the frontier of potential output.

Fifth, measures should be permanent, since known temporary or uncertain changes tend to have a limited impact.

Last year's budget agreement actually is a kind of straightjacket for the current situation, with few loopholes and tremendous inflexibility in the year at a time process that is enforced.

Another possibility is for Congress and the Administration to mix-and-match, financing partially through the Budget Agreement, partially outside of it. Yet another possibility is to program a series of additional reductions in defense spending, probably $50 billion would be feasible, over a five year period, using the proceeds now to reduce the deficit, increase spending, and lower taxes. Finally, if all of the above are too difficult or the economy does poorly, the Budget Enforcement Act must be jettisoned, but not the desire to continue on a path of fiscal responsibility.

One possible package is a combination of tax reductions and increased spending, standard macroeconomic medicine.

Sized at $20 billion to $50 billion, the fiscal package would be from 0.3% to nearly 1% of GDP, well below the average 1-1/2% of GNP of fiscal stimulus used across other recession episodes.

Some 70% could be from tax reductions--a combination of lower taxes for middle and low income families, capital gains tax reduction, and investment tax credits.

30% could come from spending or increased transfers, designed and targeted for improvements in infrastructure repair and building, education programs, or jobs benefit relief.

Tax relief for families up to $75,000 of income could take the form of small income tax rate reductions, 15% to 14% and 28% to 27%, tax credits for dependents, or small cuts in social security taxes. The latter constitutes the second largest source of federal tax receipts now and is a very regressive tax. These changes could range from $10 billion to $20 billion of tax reductions.

This sized package would not swell the budget deficit much and actually return some of the initial cost through additional receipts out of increased economic growth.

The economy would get a lift in the near-term to intermediate-run and increased income, spending, profits and jobs would stimulate more capital formation.

The capital gains tax reduction would stimulate growth and employment over the intermediate- to long-term, enhancing capital formation and possibly potential output, perhaps helping to permit some extra tax receipts by unlocking unrealized capital gains.

The equity or fairness dimension of capital gains tax reduction would be offset by the tax cuts for low and middle income families.

A reasonable capital gains tax reduction policy would involve indexing for inflation and a sliding scale for holding periods that provided lower capital gains the longer a capital gains eligible asset was held. Some distinctions could be made on assets available or to help real estate a bigger capital gains differential might be applied.

Investment tax credits have been an effective device in raising the path of equipment spending compared with what might have occurred otherwise, raising capital formation and productivity. The lagged effects have tended to be concentrated in years two to four after the investment tax credits have been levied.

The net economic impact of any such fiscal program would depend on the component measures and also the financing.

If fully financed within the Budget Agreement, through reductions in spending elsewhere or increases in taxes, for example, on higher income families, the net impact on spending, capital formation, productivity growth, and potential output would be significantly lower. However, if financed in this way, the size of the package could be increased to calibrate the net impact on the economy.

Another way to achieve a positive effect on the economy through fiscal stimulus would be to mix-and-match the financing, some within the Budget Agreement and some outside.

Yet another way would be to program reductions in defense spending over the next five years of $50 billion or so, certainly feasible in the context of the current international scene. Savings from future reductions in defense could be used now, displacing spending from the future to the present, and raising the path of growth between now and the future time when the shift of defense spending away from then would be having a restrictive effect.

Yet other means of financing involve funneling funds from the federal government to states or localities for targeted spending on infrastructure repair, then issuing tax-free infrastructure bonds with earmarked proceeds for these projects.

Funding of targeted projects or targeted tax incentives can be achieved by modest subsidies on new types of financial instruments that induce a reallocation of savings by investors to the higher aftertax returns on such instruments.

The combination of monetary easing and fiscal stimulus indicated here suggests roughly about 1 to 1-1/2 percentage points of additional economic growth over the next year or two. Lags could be long, since the easier money and income tax cuts might be used for saving and debt reduction before being spent. The net rise in the budget deficit would be about $15 billion to $35 billion.

Any investment tax credits could be set to target particular kinds of capital expenditures or be allowed only if spending on equipment were demonstrated to be above what might have occurred otherwise.

To limit the potential negative effects on interest rates of the fiscal stimulus, the Treasury should restructure its financing, using more short-dated Treasury securities and issuing fewer long-term U.S. Government bonds and notes. The reduced supply would marginally reduce long-term interest rates. The switch in the composition of Treasury financing would reduce debt service charges.

Financial Market Impacts--Fiscal Policy Stimulus Effects

How much negative impact any fiscal policy stimulus might have on long-term interest rates is of considerable interest.

In the 1980s, active increases in spending and large reductions in taxes over a long period of time raised interest rates higher than otherwise would have occurred on expectations and financing effects.

Would a similar result occur now? On just the discussion of fiscal stimulus a month or so ago, fixed income markets became quite nervous and sold off in the long-term U.S. Government bond market.

The market fear is "budget-busting" or runaway fiscal irresponsibility, once the process of cutting taxes and increasing spending gets underway.

By sticking within the Budget Agreement, temporarily deviating from it, mixing-and-matching the financing, or in some way making clear a strong commitment to a gradual balancing of the budget, the potential negative effects on interest of any fiscal stimulus would be mitigated.

However, there is some question as to whether long-term interest rates would sustain a rise on a modest program of fiscal stimulus.

The overall 1-1/2% to 2-1/2% growth rate that might be achieved on the combination of monetary ease and fiscal stimulus indicated here is probably an outside bound on the potential impact.

The main determinant of long-term interest rates is inflation. The kind of fiscal stimulus embodied in $20 billion to $50 billion of tax reductions and spending increases in a $5.6 trillion economy does not seem as if it should be large.

Even if long-term interest rates spiked up as much as one-half percentage point on such a program, the net result still would be more income, jobs and profits, although less so than if long-term interest rates did not rise.

Simulations with the Sinai-Boston Macroeconometric Model of the U.S. Economy show that the aggregate demand stimulus of easier money and fiscal stimulus, especially in the context of prior fiscal restraint, more than swamps the negative effect of higher interest rates on spending to produce a net improvement in GDP, production, incomes, spending, and employment.

While correct to be concerned over runaway fiscal irresponsibility, the notion that the kind of programs being envisioned in Washington would spike interest rates up and swamp any stimulative effect is not supported in economic theory nor empirical research.

Table 1
U.S. Economic Performance: 1988 to 1991

	1991F	1990	1989	1988
Real Economic Growth (% Chg., QIV to QIV)	-0.1	-0.1	1.7	3.3
Real Disposable Income (% Chg., QIV to QIV)	0.3	1.0	1.4	3.2
Nonfarm Payroll Employment (Chg., Mils. of Persons, QIV to QIV)	-0.932	0.770	2.252	3.254
S&P500 Earnings (Annual Pct. Chg.)	-13.2	-7.0	-3.6	36.0

F-The Boston Company Economic Advisors, Inc. forecast.

Allen Sinai, Chief Economist

THE BOSTON COMPANY
Boston Safe Deposit and Trust Company

Economic Advisors, Inc.
(Boston – New York – London – Tokyo)

U. S. Economic Forecast

December 11, 1991

Forecast of the U.S. Economy and Financial Markets
(Probability of 0.65)

	Quarters						Years			
	1991:1	1991:2	1991:3	1991:4	1992:1	1992:2	1989	1990	1991	1992
Gross Domestic Product – 1987 Dollars	4824.0	4840.7	4861.0	4850.6	4843.0	4861.0	4836.9	4884.9	4844.1	4884.3
Annual Rate of Change	−2.5	1.4	1.7	−0.9	−0.6	1.5	2.5	1.0	−0.8	0.8
Percent Change Year Ago	−1.2	−1.2	−0.9	−0.1	0.4	0.4	1.7	−0.1	−0.1	1.7
Consumption	3241.1	3252.4	3270.6	3265.4	3262.4	3276.1	3223.1	3262.6	3257.4	3285.5
Annual Rate of Change	−1.3	1.4	2.3	−0.6	−0.4	1.7	1.9	1.2	−0.2	0.9
Business Fixed Investment	519.1	514.8	510.2	505.0	500.2	499.6	542.4	548.8	512.3	500.7
Annual Rate of Change	−17.4	−3.3	−3.5	−4.0	−3.7	−0.5	2.2	1.2	−6.6	−2.3
Residential Construction	170.7	172.0	176.9	181.8	183.1	184.2	214.2	195.5	175.4	185.0
Inventory Investment	−32.8	−30.4	0.4	−5.8	−7.8	−5.0	32.6	0.2	−17.1	−3.3
Net Exports	−18.6	−12.3	−32.3	−27.8	−23.8	−27.8	−75.7	−51.3	−22.8	−30.6
Federal Government	391.7	392.7	384.1	380.6	376.2	379.2	375.0	380.9	387.3	388.1
Annual Rate of Change	9.9	1.0	−8.5	−3.6	−4.5	3.2	−0.6	1.6	1.7	0.2
State and Local Government	552.7	551.7	551.0	551.3	552.7	554.7	525.3	548.2	551.7	558.9
Annual Rate of Change	−1.9	−0.7	−0.5	0.2	1.0	1.5	3.1	4.4	0.6	1.3
Industrial Production (1987=1.000)	1.059	1.066	1.080	1.079	1.076	1.085	1.081	1.092	1.071	1.091
Annual Rate of Change	−9.1	2.5	5.7	−0.5	−1.1	3.2	2.6	1.0	−1.9	1.9
Housing Starts (Mils. Units)	0.915	0.998	1.042	1.098	1.127	1.239	1.387	1.203	1.013	1.227
Auto Sales – Total (Mils. Units)	8.2	8.5	8.8	8.3	8.6	8.8	9.9	9.5	8.4	8.9
Unemployment Rate – Civilian (%)	6.5	6.8	6.8	6.8	6.9	7.0	5.3	5.5	6.7	6.9
Federal Budget Surplus										
Unified (Quarterly Rate, NSA, FY)	−65.6	−25.7	−91.7	−91.6	−94.6	−76.1	−153.3	−220.5	−268.7	−356.7
Implicit Price Deflator (%CH)	5.0	3.1	2.1	2.3	2.6	3.1	4.4	4.2	3.7	2.6
CPI – All Urban (%CH)	3.5	2.1	3.0	2.2	2.4	3.0	4.8	5.4	4.2	2.6
PPI – Finished Goods (%CH)	−2.3	−0.5	−0.7	3.8	2.6	2.9	5.2	4.9	2.2	2.4
Hourly Compensation (%CH)	4.2	4.6	3.5	3.3	3.3	3.1	3.4	3.9	4.2	3.2
Trade – Weighted Exchange Rate	0.827	0.877	0.876	0.841	0.813	0.803	0.913	0.866	0.855	0.819
Annual Rate of Change	5.2	26.5	−0.4	−15.1	−12.7	−4.8	3.7	−5.1	−1.2	−4.2
Merchandise Trade Balance (Bils. $'s)	−67.8	−52.3	−77.1	−67.3	−68.0	−83.0	−109.4	−101.7	−66.1	−82.6
Corporate Profits Aftertax (Bils. $'s)	189.7	182.7	189.9	183.6	187.2	193.2	206.6	197.0	186.5	200.7
Percent Change Year Ago	−4.7	−5.7	−3.3	−7.7	−1.3	5.7	−1.9	−4.6	−5.3	7.6
Adjusted Profits Aftertax (Bils. $'s)	182.9	180.0	176.1	187.6	191.2	197.2	213.7	183.7	181.6	204.7
Percent Change Year Ago	−9.8	−10.8	9.4	11.0	4.5	9.5	6.2	−14.1	−1.1	12.7
Real Disposable Income (Bils. 87$'s Est.)	3514.9	3537.4	3538.9	3551.2	3568.0	3588.3	3471.1	3538.3	3535.6	3599.7
Annual Rate of Change	−1.6	2.6	0.2	1.4	1.9	2.3	2.0	1.9	−0.1	1.8
Personal Saving Rate (%)	5.1	5.5	5.0	5.5	6.0	6.1	4.6	5.1	5.3	6.2
M2 (Bils. $'s)	3353.8	3393.5	3389.0	3410.0	3438.0	3469.1	3203.2	3325.3	3410.0	3533.3
Annual Rate of Change	3.5	4.8	−0.5	2.5	3.3	3.7	4.6	3.8	2.5	3.6
Prime Rate (%)	9.17	8.67	8.40	7.57	6.67	6.50	10.87	10.01	8.45	6.65
Federal Funds Rate (%)	6.52	5.85	5.68	4.87	4.01	4.04	9.22	8.12	5.73	4.22
3 – Month Treasury Bills (%)	6.02	5.56	5.38	4.62	3.89	3.96	8.11	7.50	5.40	4.15
10 – Year Treasury Note (%)	8.00	8.13	7.92	7.39	6.95	6.85	8.49	8.53	7.86	6.98
30 – Year Treasury Bond (%)	8.19	8.31	8.17	7.87	7.47	7.30	8.44	8.59	8.14	7.46
New AAA – Equiv. Corporate Bonds (%)	8.89	8.91	8.76	8.43	7.92	7.78	9.38	9.43	8.75	7.93
Bond Buyer Index (%)	7.03	7.03	6.90	6.70	6.53	6.47	7.23	7.27	6.92	6.54
S&P 500 Index of Common Stocks	354.12	379.10	385.51	382.41	371.39	378.16	322.87	334.44	375.29	397.02
Annual Rate of Change	56.5	31.3	6.9	−3.2	−11.0	7.5	21.5	3.6	12.2	5.8
Earnings Per Share – S&P 500 ($)	5.14	4.77	3.86	4.75	5.08	5.26	22.95	21.34	18.52	'21.03
Percent Change Year Ago	−7.2	−21.4	−27.6	8.0	−1.2	10.3	−3.6	−7.0	−13.2	13.6
Price – Earnings Ratio – S&P 500	17.2	19.9	25.0	20.1	18.3	18.0	14.1	15.7	20.3	18.9

Table 3
Tax Increases and Sources--1991-93

	Levels			Incremental		
Fiscal Year	1991	1992	1993	1991	1992	1993
Federal-Total	17.6	29.9	27.5	17.6	12.3*	-2.4
Personal Taxes	2.2	5.3	5.4	2.2	3.1	0.1
Changes in Rates	0.8	2.3	2.5	0.8	1.5	0.2
Phase-Out of Exemption	1.0	2.0	2.2	1.0	1.0	0.2
Limit on Deductions	0.5	3.7	4.1	0.5	3.2	0.4
Increased Earned Income Tax Credit		-1.5	-2.1	0.0	-1.5	-0.6
Child Health Insurance Credit		-1.1	-1.2	0.0	-1.1	-0.1
Corporate Taxes	1.5	0.4	0.9	1.5	-1.1	0.5
Amortize Insurance Policy Deferred Tuition Expenses	1.4	1.7	1.7	1.4	0.3	0.0
Adopt Retiree Health Provision	0.5	0.2	0.1	0.5	-0.3	-0.1
Increase Rate on Tax Underpayments	1.5	0.1	0.1	1.5	-1.4	0.0
Extend Expiring Tax Breaks	-2.2	-1.5	-0.8	-2.2	0.7	0.7
Excise Taxes	9.8	13.5	14.8	9.8	3.7	1.3
Raise Motor Fuel Tax five cents	4.4	5.2	5.1	4.4	0.8	-0.1
Extend Telephone Tax	1.6	2.6	2.8	1.6	1.0	0.2
Extend and Raise Airport Tax	1.4	2.3	2.5	1.4	0.9	0.2
Raise Alcohol Taxes	1.3	1.9	1.5	1.3	0.6	-0.4
Raise Tobacco Taxes	0.5	0.7	1.5	0.5	0.2	0.8
Social Insurance	4.1	11.0	6.2	4.1	6.9	-4.8
Raise Medicare Cap to $125,000	1.8	5.7	6.1	1.8	3.9	0.4
Extend Social Security to Some State and Local Workers	0.4	2.0	2.1	0.4	1.6	0.1
Extend Unemployment Tax	0.8	1.1	1.1	0.8	0.3	0.0
Adopt Payroll Tax Deposit Stabilization	1.0	2.2	-3.1	1.0	1.2	-5.3
State-Total				10.3	15.0	7.3
Sales				2.5	3.8	2.8
Personal Income				2.9	5.4	2.3
Corporate Income				1.4	1.4	0.5
Cigarette/Tobacco				0.5	0.2	0.2
Motor Fuels				1.4	0.6	0.3
Alcohol				0.2	0.2	0.2
Other				1.4	3.2	1.1
California				1.5	5.7	--
Connecticut				0.0	1.1	--
Florida				0.9	0.3	--
Illinois				0.0	0.1	--
Massachusetts				1.2	-0.2	--
New Jersey				2.3	-0.0	--
New York				1.7	0.8	--
North Carolina				0.2	0.6	--
Pennsylvania				0.0	3.0	--
Texas				0.5	1.0	--

Source: Office of Management and Budget, TBCEA.

*Since reduced $3.2 billion by extension.

Table 4
Structural Budget Deficit Estimates*

	Structural Budget Deficit Ex-Deposit Insurance and Excluding the Gulf War			
Years	Deficit (Bils. $'s)	Chg. (Bils. $'s)	Deficit (Pct. of GNP)	Chg. (Pct. of GNP)
1965	-2.7	0.1	-0.4	0.0
1966	-10.5	-7.7	-1.5	-1.1
1967	-20.5	-10.0	-2.7	-1.2
1968	-20.9	-0.4	-2.5	0.1
1969	-5.0	15.9	-0.6	2.0
1970	-8.7	-3.7	-0.9	-0.3
1971	-15.9	-7.2	-1.5	-0.6
1972	-21.8	-5.8	-1.9	-0.4
1973	-20.0	1.7	-1.6	0.3
1974	-4.7	15.4	-0.3	1.2
1975	-23.0	-18.3	-1.4	-1.1
1976	-22.6	0.3	-1.3	0.1
1977	-20.7	2.0	-1.0	0.2
1978	-24.1	-3.4	-1.1	-0.1
1979	-6.6	17.6	-0.3	0.8
1980	-23.2	-16.6	-0.8	-0.6
1981	-22.1	1.8	-0.7	0.1
1982	-43.2	-21.1	-1.3	-0.6
1983	-70.2	-35.0	-2.2	-0.9
1984	-104.6	-26.5	-2.7	-0.6
1985	-134.6	-29.8	-3.3	-0.6
1986	-157.3	-22.9	-3.7	-0.4
1987	-122.2	35.1	-2.7	1.0
1988	-135.8	-13.6	-2.9	-0.1
1989	-136.2	-0.3	-2.7	0.2
1990	-139.3	-3.2	-2.6	0.1
1991	-137.9	1.4	-2.4	0.7
1992	-96.6	41.3	-1.6	0.8
1993	-94.2	2.4	-1.5	0.1
1994	-63.7	30.5	-1.0	0.5
1995	-42.6	21.1	-0.6	0.4

*Source: The Boston Company Economic Advisors, Inc.

Table 5
Potential Growth (GNP) of the United States

Years	Average Per Annum Growth Rate (%)
1961-65	3.4
1965-70	3.4
1970-75	3.5
1975-80	2.9
1980-85	2.4
1985-90	2.3
1991-95F	1.8

Source: The Boston Company Economic Advisors, Inc.

Prepared Statement of John Steinbruner

I am pleased and honored to appear before the Senate Finance Committee. My testimony is based on a monograph *Decisions for Defense* that I have written jointly with William W. Kaufmann. It was published in September by the Brookings Institution. My remarks are also derived from testimony presented to the Legislation and National Security Subcommittee of the House Government Operations committee on November 6, 1991 and to the House Budget Committee on September 26, 1991. My remarks represent solely my own judgment. I do not attempt to represent any other individual or institution.

I understand you are considering legislation to provide for a five percent reduction in the total defense outlays from fiscal year 1993 through 1997. According to our calculations at Brookings, the administration's budget for national defense (050) is expected to produce a total of $1470.4 billion in current dollar outlays for this period of time, so a reduction of the 5% over this five year period would produce a total savings of $73.5 billion. My purpose is to assess what the security consequences of such a reduction might be.

Administration officials and defense planners are inclined to believe, of course, that any reduction in the defense expenditures they have requested would produce a commensurate reduction in overall security. Though there is no accepted output measure of overall national security, they talk as if an output measure of this sort would be forced to decline by at least 5% and perhaps more if the input resources are reduced by that amount. Implicitly this is a claim that defense reserves are being used with perfect efficiency or at any rate with the maximum degree of efficiency that can reasonably be obtained. To accept this claim is to admit a stark trade-off with all competing policy objectives and to pose the uncomfortable problem of accepting some decline in national security in order to pursue other values.

In my own judgment the current use of United States defense resources is nowhere near the limits of reasonably achievable efficiency. With sufficient discipline in defense planning, it is possible to exact resources from the defense budget substantively exceeding the amount of $73.5 billion over five years without any meaningful reduction in national security. In fact with sufficient wisdom in redesigning national security policy a distinct improvement can probably be achieved as resources are diverted.

There are two basic methods for achieving these improvements in defense efficiency. The first is to match force levels to plausible mission requirements more exactly than is currently being done. The second is to develop a more comprehensive regulation of general military deployments that would make mission requirements more predictable and less demanding. Both approaches can and should be pursued.

Realistically each approach probably requires a longer period of time than five years to be fully developed and implemented. U.S. defense programs have considerable inertia associated with the processes of technical design and personnel training. If changes are imposed too suddenly or are concentrated in too short a period time, the resulting turbulence and disruption can wipe out any gain in efficiency. If one imagines, however, the systematic development of these two types of efficiency over a 10 year period, substantial savings can be achieved by the end of that period. Within the first five years, a 5% reduction could certainly be achieved.

Specifically, a more judicious matching of force levels and mission requirements under prevailing international conditions could save $405.9 billion in current dollar outlays over 10 years ($308.9 billion in outlays of constant 1992 dollars). In terms of budget authority the corresponding figures are $469 billion current dollars and $364.6 constant 1992 dollars. For the five year period FY 1993–1997, the respective savings for this program would be $88.1 billion in current dollar outlays and $120.8 in budget authority. These savings meet the suggested target.

Similarly the development of a cooperative security arrangement that would regulate threats comprehensively and reduce the uncertainties that drive current defense planning could save $569.9 billion in current dollar outlays over 10 years ($437.8 billion in constant 1992 dollars) and $647.7 billion in current dollar budget authority ($505.5 billion in constant 1992 dollars). The FY 1993–1997 savings in current dollars for this form of efficiency would be $140.1 billion in outlays and $181.6 in budget authority. These savings are more than double the savings target.

Let me explain these figures by elaborating these two forms of efficiency and by contrasting them with current defense planning assumptions.

THE CURRENT BUDGET

The defense budget totals embodied in the Budget Enforcement Act of 1990 provide for an appreciable reduction of the U.S. military establishment from the base that existed when the legislation was enacted. Measured in constant 1992 dollars the defense budget is scheduled to decline under the administration's plan from $327.6 billion in 1990 to $256.8 billion in 1596. This represents a 21.7% reduction over that period, but that is asserted by the administration to be the maximum that the new circumstances will prudently allow. Despite the acknowledged fact that the Soviet Union no longer presents a plausible threat of deliberate aggression, the core planning assumptions that were developed over forty years to deal with such a threat are continued in the projected budget. U.S. nuclear forces are maintaining the capacity to deter a major strategic opponent on a scale not meaningfully different from the standards of the past two decades. The recently announced removal of tactical nuclear weapons will not affect that capability. In addition U.S. conventional forces are being preserved at a level sufficient to respond within a few weeks, unilaterally if necessary, to any threat that might arise anywhere in the world. The traditional objectives of deterrence and containment remain the central organizing missions of U.S. forces under the administration's defense plan.

THE MAJOR OPTIONS

A more efficient matching of force levels and mission requirements would simply adjust to a greater extent than has yet been done to the new circumstances of security. Whatever happens to the Soviet military establishment it is extremely unlikely to develop anything like the capacity for sudden massive aggression against U.S. allies that has provided the focus of U.S. defense planning for past forty years. And there are no plausible opponents to substitute for the traditional Soviet threat. No potentially hostile military establishment could conduct massive aggression against U.S. allies without extensive time-consuming preparations. The necessary preparations would give ample warning and ample time for countervailing preparations. Moreover, reliable allies do have substantial military assets of their own, some portion of which would be available in any contingency threatening enough to motivate U.S. military actions.

In the absence of opposing military forces that have the inherent capability to conduct sudden and massive aggression and in the presence of many friends to help resist it, the level of U.S. forces can be safely reduced below those provided in the administration's budget. It is in fact prudent to do so. A military establishment that appears to be larger then circumstances require undermines international acceptance of its operations and domestic support for its financing.

The second option involves a more fundamental revision of security policy. It would extend beyond the traditional deterrent threat and the preparations for defeating an attempted invasion to set limits on military deployments. Those limits would be designed to prevent invasion forces from being assembled in the first place. By means of cooperative regulation, the size of all military establishments would be held to a common international standard that would enable secure defense of national territory but would deny the capacity to conduct a major ground offensive against another country. This would be supplemented by regulations governing the location and movement of forces and by rules of disclosure and supplementary monitoring to prevent secret preparation of offensive operations. With the active cooperation of the major military establishments—notably the five permanent members of the UN security council plus Germany and Japan—such an arrangement could create international security conditions that would substantially remove uncertainty and would allow offensive inclinations to be controlled long before it came to the point of actual fighting.

Such an arrangement is analogous to preventive medicine; and, for diseases of the sort that produce security problems, prevention promises to be far more effective and far more efficient than emergency treatment. With the dissolution of ideological divisions that once precluded it, cooperative security has become a feasible option, and it is clearly in the interest of the United States to attempt to develop it. Should the attempt fail, U.S. security could continue to rely on traditional collective security in its more efficient form. Cooperative security involves different principles and is more demanding but is not fundamentally incompatible with collective security. If prevention fails, direct resistance by an organized coalition would remain possible.

BUDGET IMPLICATIONS

The extent to which these two options and the different types of efficiency they promise would allow reductions in the U.S. defense budget is a matter of judgment. There is bound t0 be a range of opinions on the subject. Table 1 presents an illustrative estimate as to how U.S. forces and their annual budget requirements might evolve under these two options. The illustration is intended to reflect what a mainstream consensus judgment might ultimately prove to be after these options were subjected to the extensive debate that would necessarily accompany their acceptance as basic U.S. security policy. Assuming that consensus judgment would choose to be prudent and gradual in implementing force structure and fundamental policy provisions of this magnitude, the differences between these two options and the administration's budget are relatively modest within the current defense planning horizon which extends only to 1996, although as noted these savings exceed the target this committee is currently considering. In a longer, ten-year perspective, however, the differences are quite substantial.

Table 2 summarizes the financial implications of these choices and provides the basis for the savings estimates I have presented. Its calculations assume that the administration's defense budget would be held constant through 2001 and it compares each of the two options to this base.

However the exact judgments might be made, it is quite apparent that major savings can be achieved by introducing improved efficiency in defense planning and it is therefore reasonable to expect and demand an improved security outcome as resources are directed from the defense effort to other purposes. The $75 billion dollars that this committee's contemplated legislation proposes to extract from national defense portions of the budget should not damage U.S. national security, and it might help stimulate an improvement that is available with more appropriate planning. Moreover, that amount will not exhaust the potential for reasonable defense savings.

I hope these observations are helpful to your deliberations. I append some supplementary tables on the force structures and annual budget allocations associated with the official defense plan and the options I have mentioned.

Table 1.—DEFENSE BUDGET AUTHORITY (051) BY MAJOR FORCES FISCAL YEARS, BILLIONS OF 1992 DOLLARS

	Administration		Collective Security I		Cooperative Security I	
	1990	1996	1996	2001	1996	2001
Major forces:						
Strategic nuclear	48.2	39.0	32.7	23.6	30.6	14.7
Theater nuclear	2.4	1.5	0.9	....	0.9	....
Ground (Army & USMC)[1]	86.8	56.7	54.0	30.1	50.6	30.1
Land-based tactical air[2]	63.5	43.9	49.1	43.9	46.0	32.0
Naval (including carriers)	83.0	70.0	55.9	39.0	52.8	39.0
Airlift and sealift[3]	13.4	13.4	13.4	13.4	13.4	13.4
Nat'l intelligence & communications	19.2	19.2	19.2	19.2	19.2	17.6
Total (051)	316.5	243.7	225.2	169.2	213.5	146.8
			Force Size and Composition			
Strategic nuclear:						
ICBMs	1,000	550	493	100	300	100
Bombers	301	181	153	41	144	40
SLBMs	656	432	384	432	384	240
Theater nuclear (warheads)	4,625	2,500	2,000	....	2,000	....
Ground (division equivalents)	44	22	[2][3]23	15	[2][3]22	15
Land-based tactical air (wings)	41	30	[1][3]33	30	32	21
Naval (ships & submarines)	502	417	331	247	327	247
Airlift	861	861	861	861	861	861
Sealift	285	285	285	285	285	285

[1] Includes reserve as well as active-duty forces.

[2] Includes Marine air wings.

[3] Airlift includes inter-theater as well as intra-theater; sealift includes 68 ,active, 96 ready reserve, and 121 national defense reserve ships.

Table 2.—NATIONAL DEFENSE BUDGET (050) TEN YEAR COSTS FOR MAJOR OPTIONS

[Billions of current dollars]

	Total 10 year costs		10 year savings 1992–2001		5 year savings 1993–1997		Annual savings after 2001
	Budget authority	Outlays	Budget authority	Outlays	Budget authority	Outlays	Budget authority
Administration's Budget continued through 2001	3144.0	3107.2	....	....	....	....	....
Traditional Collective Security	2675.0	2701.3	469.0	405.9	120.8	88.1	111.3
New Cooperative Security Policy	2496.3	2537.3	647.7	569.9	180.9	140.1	142.9
			Billions of 1992 dollars				
Administration's Budget continued through 2001	2645.7	2613.7	....	....	....	....	....
Traditional Collective Security	2281.1	2304.8	364.6	308.9	105.0	69.9	78.9
New Cooperative Security Policy	2140.2	2175.9	505.5	437.8	156.8	114.9	101.3

Table 3.—ANNUAL COST OF PREPARING FOR STANDARD MILITARY MISSIONS

[Defense budget authority (051) in billions of 1992 dollars]

Standard mission	Administration's budget 1990	Administration's budget 1996	Traditional collective security 2001	New cooperative security 2001
Strategic nuclear deterrence	48.2	41.8	23.6	14.7
Tactical nuclear deterrence	2.4	0.5	....	....
Non-nuclear defense total:	246.7	181.2	126.4	114.5
of which				
(a) Northern Norway	16.7	12.2	....	....
(b) Central Europe	90.3	44.0	31.1	17.4
(c) Mediterranean	7.6	7.6	3.8	3.8
(d) Atlantic Sea Lanes	21.7	21.7	4.8	9.1
(e) Middle East/Persian Gulf	64.5	55.1	29.0	45.9
(f) South Korea	19.0	17.3	20.9	7.7
(g) Pacific Sea Lanes	14.7	14.7	4.8	13.0
(h) Alaska	1.4	1.0	5.1	3.0
(i) Panama & Caribbean	3.2	3.2	....	1.2
(j) Continental U.S.	7.6	4.4	26.9	13.4
National Intelligence & Communication	19.2	19.2	19.2	17.6
Total	316.5	242.7	169.2	146.8

Table 4.—NATIONAL DEFENSE BUDGETS (050) FISCAL YEARS, BILLIONS OF CURRENT DOLLARS[1]

Fiscal years	Administration budget extrapolated[2]	Budget Authority					
		Collective security I[3]	Collective security II[4]	Cooperative security I[3]	Cooperative security II[4]	Collective security III[5]	Cooperative security III[5]
1992	290.8	290.8	281.9	290.8	275.7	290.8	290.8
1993	290.9	290.9	278.3	290.9	289.0	288.2	282.1
1994	291.9	280.6	274.7	280.6	281.9	278.0	272.0
1995	296.1	272.4	271.2	270.3	265.3	268.0	262.1
1996	297.8	273.9	267.7	260.3	247.8	269.5	252.5

Table 4.—NATIONAL DEFENSE BUDGETS (050) FISCAL YEARS, BILLIONS OF CURRENT DOLLARS[1]—Continued

Fiscal years	Administration budget extrapolated[2]	Budget Authority					
		Collective security I[3]	Collective security II[4]	Cooperative security I[3]	Cooperative security II[4]	Collective security III[5]	Cooperative security III[5]
1997	309.7	269.2	264.3	251.6	241.9	264.9	235.8
1998	322.1	264.5	260.9	243.1	235.9	260.3	230.3
1999	335.0	281.0	257.6	238.0	230.4	256.9	228.8
2000	348.4	255.5	254.2	227.0	224.7	251.4	222.5
2001	362.3	251.0	251.0	219.4	219.4	251.0	219.4
Total BA	3,144.0	2,709.8	2,661.8	2,570.0	2,642.0	2,675.0	2,496.3
Difference from Administration budget	....	434.2	482.2	574.0	682.0	469.0	647.7

Fiscal year	Administration budget extrapolated	Outlays					
		Collective security I	Collective security II	Cooperative security I	Cooperative security II	Collective security III	Cooperative security III
1992	295.2	295.2	293.5	295.2	286.1	295.2	295.2
1993	292.0	292.0	288.2	292.0	276.0	289.9	285.5
1994	286.7	282.6	283.1	282.6	265.9	280.2	276.0
1995	288.6	274.1	278.0	272.2	256.9	271.7	265.8
1996	298.2	275.7	273.0	262.0	248.7	273.5	255.9
1997	304.9	269.2	268.1	253.0	241.9	267.0	247.1
1998	317.1	263.6	263.3	244.0	235.2	261.5	238.3
1999	329.8	260.4	258.2	237.0	229.9	258.7	231.8
2000	343.0	256.3	253.6	229.1	225.3	254.6	224.1
2001	356.7	249.0	249.0	217.6	217.6	249.0	217.6
Total outlays ...	3,107.2	2,718.1	2,708.0	2,584.7	2,483.5	2,701.3	2,537.3
Difference from Administration budget	....	389.1	399.2	522.5	623.7	405.9	589.9

[1] Assumed annual Inflation (BA): 1992=1.00, 1993=1.0397, 1994=1.0379, 1995=1.0385, 1996=1.0368, 1997=1.04, 1998=1.04, 1999=1.04, 2000=1.04, 2001=1.04; Assumed annual Inflation (Outlays): 1992=1.00, 1993=1.0403, 1994=1.0388, 1995=1.0371, 1996=1.0361, 1997=1.04, 1998=1.04, 1999=1.04, 2000=1.04, 2001=1.04

[2] Assumption is that, in real terms, the national defense budget to remain flat.

[3] Assumption is that the Budget Enforcement Act is upheld and that real declines do not begin until 1994.

[4] Assumption is that the Budget Enforcement Act is changed and that real declines begin in 1992.

[5] Assumption is that the Budget Enforcement Act is changed and that real declines begin in 1993.

Table 5.—NATIONAL DEFENSE BUDGET (050) BILLIONS OF 1992 DOLLARS

Fiscal years	Administration budget extrapolated	National defense budget authority					
		Collective security I[1]	Collective security II[2]	Cooperative security I[1]	Cooperative security II[2]	Collective security III[3]	Cooperative security III[3]
1992	290.8	290.8	281.9	290.8	275.7	290.8	290.8
1993	279.8	279.8	267.7	279.8	258.7	275.3	271.3
1994	270.5	260.0	254.6	260.0	242.7	255.8	252.1
1995	263.8	243.5	242.4	241.6	228.2	239.6	234.3
1996	256.8	236.2	230.8	224.5	213.7	232.4	217.7
1997	256.8	223.2	219.1	201.6	200.6	219.6	195.5
1998	256.8	210.9	208.0	188.9	188.1	207.5	183.6
1999	256.8	200.1	197.5	180.9	176.6	196.9	175.4
2000	256.8	188.3	187.4	169.1	165.6	185.3	164.0
2001	256.8	177.9	177.9	155.5	155.5	177.9	155.5
Total BA	2,645.7	2,310.7	2,267.3	2,192.7	2,105.4	2,281.1	2,140.2
Difference from Administration budget	....	–335.0	–378.4	–453.0	–540.3	–364.0	505.5

Fiscal years	Administration budget extrapolated	National defense outlays					
		Collective security I	Collective security II	Cooperative security I	Cooperative security II	Collective security III	Cooperative security III
1992	295.2	295.2	293.5	295.2	288.1	295.2	295.2
1993	280.7	280.7	277.0	280.7	265.3	278.5	274.6
1994	265.3	261.5	262.0	261.5	246.0	259.7	255.8
1995	257.5	244.6	248.0	242.9	229.2	242.9	237.6
1996	252.5	237.4	235.1	225.6	214.1	235.5	220.7
1997	252.5	222.9	222.0	209.5	200.3	221.4	204.9
1998	252.5	209.9	209.9	194.3	187.3	208.5	190.0
1999	252.5	199.6	197.9	181.7	176.2	198.3	177.7
2000	252.5	188.9	186.9	168.9	166.1	187.7	165.2
2001	252.5	176.5	176.5	154.2	154.2	176.5	154.2
Total outlays ...	2,613.7	2,317.2	2,308.5	2,214.5	2,124.8	2,304.8	2,175.9
Difference from Administration budget	....	–296.5	–305.2	–399.2	–488.9	308.9	437.8

[1] Reductions from Administration budget begin in 1994.
[2] Reductions from Administration budget begin in 1992.
[3] Reductions from Administration budget begin in 1993.

Prepared Statement of James D. Weill

Mr. Chairman, I am James D. Weill, General Counsel of the Children's Defense Fund (CDF). CDF appreciates this opportunity to testify on the very important tax and income issues and proposals facing this Committee and the Nation.

I. INTRODUCTION

As a result of your leadership and through the actions of this Committee, important improvements in a number of programs crucial to the well-being of America's children are now the law. Children are directly benefiting from recent expansions in Medicaid eligibility, passage of the child care legislation last year, and the improvements in the earned income tax credit. These programs have helped both poor and middle income children and families. We applaud your leadership in introducing S. 4, the "Child Welfare and Preventive Services Act," and look forward to passage of child welfare legislation in the second session of the 102nd Congress. The National Commission on Children that you were so instrumental in creating produced an important consensus document on the next steps to take for America's children. In part because of that report, a rare opportunity exists to address the needs of children: both conservatives and liberals agree that families with children are hurting economically, that even an end to the recession will only alleviate part of the pain, and that another important way to help families with children is to enact a child credit. Both middle class and poor families have been battered by economic changes of the last two decades, a battering exacerbated both by the recession and by the increased taxes on them while the rich have received expanded tax benefits and increased their wealth. Families with children have been hit the hardest.

II. AS S. 1921 RECOGNIZES, A CHILDREN'S TAX CREDIT IS THE BEST WAY TO PROVIDE SUPPORT TO AMERICA'S FAMILIES AND TAX RELIEF FOR THE MIDDLE CLASS

The bill that you have introduced, Mr. Chairman, is on the right track: it focuses on families with children and establishes a child credit. This approach is fundamental to assuring that the focus is on those most in need: middle and lower income families with children.

The current personal exemption should be replaced with a substantial refundable child credit, like the one proposed by the National Commission on Children. Short of that, efforts to give families tax relief should focus on creating such a credit, rather than expanding the exemption. The personal exemption is most valuable to those who have the least need for it: those in the highest income levels. An increased personal exemption would give the greatest benefits to upper-income families, shortchange the struggling middle class, and completely ignore the plight of those families whose incomes are too meager to place them on the federal income tax rolls. For example, each $1,000 increase in the personal exemption is worth $310 to a taxpayer in the 31 percent bracket (e.g., married couples with two children and annual incomes above $110,000 in 1992) but only $150 to a taxpayer in the 15 percent bracket (e.g., married couples with two children and annual incomes between $15,000 and $51,000 in 1992). In the longer run, CDF hopes that the nation will move from an exemption to a credit in order to improve tax equity. A refundable child credit in the range of $1,200 to $1,300 for each family member younger than 18 would provide a tax benefit roughly equal to the original 1948 value of the exemption. (The National Commission on Children proposes a $1,000 child credit.) In order to reduce the cost of such a change and to assure that the tax benefit is targeted where it is most needed—on children in middle and low income families—the credit could be gradually phased out for very high-income families. This year and next year, it is important that the Congress help meet the immediate economic plight of middle income and lower income families with children by taking a significant step down the children's tax credit path. This Committee's leadership is needed to assure that both the Congress and the public understand the critical difference between a children's credit and the personal exemption; that a refundable child credit is targeted to middle and lower income families with children and will mean real dollars for these families.

It is encouraging that Congress seems prepared to seize opportunity to refocus tax policy upon those in the middle and lower income groups. Numerous proposals, including those from Senator Gore and Representative Downey, Senator Bradley, yourself and the National Commission on Children, would create a child credit. The Commission and Gore-Downey also go the next step: they eliminate the personal exemption as well and increase the amount of the child credit.

The next few months will produce substantial debate over how large the credit should be, who should get it, and how it should be financed. We would urge the Committee to take two steps to assure that the children's tax credit be available to all families with children that need it and not harm the nation's ability to continue to fund other programs for children in the years ahead.

III. IT IS CRITICAL TO MIDDLE AND LOWER INCOME CHILDREN AND THEIR FAMILIES THAT THE CHILDREN'S TAX CREDIT BE REFUNDABLE

First, it is crucial that the credit be refundable. If it is not refundable, approximately 25% of all children, in both middle and low income families, will not benefit at all. Among children who are Black or Hispanic, nearly 50% would not benefit. The greatest concentrations of children who would receive no credit are in the South and Southwest. Millions more children will not receive the full benefit of the credit if it is not refundable. In total, close to one-third of all children, the very neediest children in middle and low income families, will not receive anything or will receive only a partial credit if it is not refundable.

The majority of these families are working families: millions of the parents in them work long hours at low wages, $4.25, $5.00, $7.00, $9.00 an hour; others work part-time or are only able to secure employment for portions of each year. Failure to make the credit refundable simply compounds the problems these families and their children are having in paying the rent, meeting basic needs, and paying for health care and post-secondary education.

IV. TAX CHANGES SHOULD BE FINANCED WITH TAX REVENUES

We are also concerned that in the present budget situation financing a tax change with a cut in defense spending will make it impossible for the government to maintain, much less increase, the funding for key domestic programs, including programs crucial to children, such as Head Start, WIC, maternal and child health, and the childhood immunization programs. Unless cuts in defense spending are made available for these programs, it is very likely that these critically needed, cost effective programs will suffer severe cuts in the years immediately ahead because of the budget caps. Therefore, these tax changes for families with children should be paid for with tax revenues.

CONCLUSION

Again, Mr. Chairman, we appreciate your successes and those of your colleagues on this Committee on behalf of America's children and their families. As you know, much more remains to be done. The next key step toward assuring families economic stability is a refundable children's tax credit. We are pleased that S. 1921 includes a children's credit and urge you to make the credit refundable.

We look forward to working with you and your staff on these very important proposals. Thank you.

PREPARED STATEMENT OF VICKI L. YANCEY

Good morning, and thank you for inviting me here to speak today. My name is Vicki Lynn Yancey. I am an analyst with a major consulting firm here in the Washington, D.C. area. I am 34 years old, college educated, and married with two elementary school children. I consider myself an average middle-class representative, and it is of the middle class that I would like to speak.

Like much of our middle class, I was brought up with the American dream. Both of my parents were the children of immigrants. Neither went to college, yet during the 1960's my father bought a house and raised five children in New Jersey on his salary as a welder. My mother stayed at home. They budgeted their money carefully and did without luxuries, but all five of us grew up in a secure, middle-class environment.

Four of the five children went on to college. My parents' expectation was that we would continue the tradition of having a better life than the generation before. My siblings and I tell the story of American life in the 80's and 90's:

My sister in Atlanta is married with two children, has a college degree and works full time to help support the family income. She would love to be home while her children are young, but they cannot pay their mortgage without her salary.

My two youngest brothers finished college last year and are living at home, trying to find work during a recession. One who had found work was recently laid off.

My third brother, following in my father's footsteps, chose not to go to college and insisted that his wife stay at home. They have two children and want to have a large family. They also live in a small apartment in a very poor area and depend on money from my father to get by. A middle-class lifestyle? Not possible.

As for me, despite the fact that my husband has an MBA, we learned it was virtually impossible for a family of four to live a middle-class existence in the Washington area on one salary. Everything we had been brought up to believe proved obsolete, as we struggled to make ends meet and were unable to buy a home.

I have worked for several large firms in this area, and I can not recall a time over the last ten years when I have not been around working mothers. Even during my tenure as an at-home mother, for instance, I tried to make ends meet by caring for other women's children. I was also one of many working mothers in the military. I have known many, many professional women with children over the years, and I have yet to meet one who is completely happy and content to be in the workplace, who doesn't feel stressed, or guilty, and many have said they would like to be home if they could. I pay the price, and my children pay the price, because we want our children to grow up with the comfort and security of a middle-class upbringing.

This is how it is in the real world. It makes me angry when I hear people say that the middle class hasn't changed, who deny the reality that is all around them. While the experts argue over statistics, my high school friend works at Shop Rite and laments the time it takes away from her young daughter. This is not the legacy I want to hand down to my children. Indeed, I wonder what life will be like for my children's generation, when the expectation is that they will be unable to attain what their parents had. When two paychecks are not enough, then what? A whole generation of men and women who have already been required to grow up in a daycare environment will have even less to give to their own children.

My spouse and I would like to be in a position to help our children when they start out on their own- if we can. However, if progressive legislation does not reverse the decline within the middle class, this will become increasingly difficult. At this time, my husband and I have no savings, a home that has decreased in value, and we wonder where we will get the money to send our children to college. Diving deeply into debt in our middle age is a very unappealing possibility.

The middle class is burdened not only with soaring college bills, but also with expensive health care and the growing responsibility for aging parents. As a good example, my mother suffered a brain tumor seven years ago and has been comatose since the operation. The medical bills have been almost beyond comprehension. Half of everything my father has worked for will be turned over to the state for medical bills upon his death. I do not expect him to help me financially; to the contrary, many people of my generation will soon be looking for ways to help their aging parents, as well as their own children.

The middle class desperately needs relief. The world has changed a great deal since the 1960's. Our health care policy costs us $2200 dollars per year, assuming no one gets sick. Day care for two children costs us the equivalent of a second mortgage, and we do not have the luxury of extended family nearby to help out as my parents did. Senator Bentsen's tax-cut proposals reflect a sound, common-sense approach that I can understand and appreciate. It is an exciting thought that, should these proposals be enacted, perhaps my husband and I could invest in our first IRA. With that investment, we could begin the process of ensuring our future, including our children's education.

I ask that the Committee not be deterred by criticism that the proposal does not help childless couples. Childless couples are not as financially hard-hit as a group as those who are trying to raise a family. With a family comes not only the increased economic burdens but also the unending trauma of women torn between work and children. Some women may chose work, some may chose home, but the key is that the choice should be there. For many middle-class women, there is no longer a choice, except perhaps the choice to remain childless.

I hurt for my brother, who is trying to do what he believes is right for his family, because he cannot give his children all they deserve. I sympathize with the plight of women whose heart tells them to be home with their young children, but whose budget tells them otherwise. And I worry about a country that seems to be consumed with a monetary tug-of-war between the rich and the poor, while the middle class is left to shift for itself.

Even to a layman like myself, Senator Bentsen's proposals seem best designed to provide relief to the millions of middle-class families who need it most. People like my brother, who are considering another child, may feel more confident in having one. Those people who are looking for free money will find it is not contained in this proposal. Most importantly, it sends a clear and strong signal to people like myself that the hard-working middle class are no longer being discounted.

Thank you again for this extraordinary opportunity to address the United States Senate.

COMMUNICATIONS

STATEMENT OF THE A. PHILIP RANDOLPH INSTITUTE

On behalf of the A. Philip Randolph Institute (APRI), the labor movement's organization for over two and one-half million black trade unionists in the United States, I appreciate the opportunity to submit testimony to the Committee on various proposals to provide middle-class tax relief, economic growth, and tax equity and fairness.

Over the past decade, working men and women, and black Americans disproportionately, have been forced to assume more and more of the federal and state tax burden. Working and black Americans are paying higher taxes while the wealthy and large corporations receive substantial federal and state tax breaks and giveaways. It is wrong that the people least able to pay, low-and middle-income workers and black families, have had to assume a greater portion of the tax burden in the United States. While the wealthy received tax breaks and loopholes, the working class paid for it through higher payroll taxes and increased excise taxes—the most regressive of all taxes. It is time to balance the scales of tax fairness in this country.

Working people and black Americans always have been willing to pay their fair share to fund vital government services and programs. But the federal, state and local tax policies of the past decade have forced black, low- and middle-income workers to carry the load while wealthy Americans and large corporations receive a free ride.

APRI supports fair and progressive tax policy based on the ability to pay. We believe that those who earn the most should pay the most in taxes. APRI urges the Committee to avoid unfair revenue raising measures, such as increasing sales and consumer excise taxes. These taxes are inherently regressive. They take a greater proportion of income from the black, poor and low- and middle-income families than from the rich. We need an equitable, fiscally-responsible program which will ease the burden of working people, both white and black, in this country.

APRI applauds the efforts of Congress to find a fair and equitable solution for providing middle-class tax relief so desperately needed. However tax relief comes at a price, and it must be paid for fairly and honestly by rolling back some of the huge Reagan-era tax cuts now enjoyed by the very wealthy.

APRI urges Congress to adopt a middle-income tax relief program based on progressive taxation and economic justice. We urge the members of the Committee to stand up to the loophole lobby, reject costly new tax-shelter gimmicks and unite behind a responsible, revenue-neutral middle-class tax cut plan next year. It is time for Americals wealthy to pay their freight for the free ride they have received over the past decade, while contributing to this country's growing tax problem and current recession.

STATEMENT OF THE COALITION FOR LABOR UNION WOMEN

As president of the Coalition for Labor Union Women (CLUW), a national organization of 20,000 members representing 7.5 million union working women in the United States, I appreciate the opportunity to submit testimony to the U.S. Senate Committee on Finance on various proposals to provide middle-class tax relief, tax equity and fairness and economic growth.

The story of America during the past two decades has been the story of three families—one rich and getting richer; one that is middle-class, with husbands and wives running harder and working more just to stay in place; and one that is struggling, headed by a woman, and falling further and further behind. It is this last family type, which is becoming more and more the norm for children in the United States today, that deserves the specific attention of tax policymakers.

Working women have a huge stake in the direction of federal tax policy. Indeed, a fair tax system can make a huge and positive difference in the prospects of struggling families with children. An unfair tax system can drive these same families deeper into poverty and desperation, and can further isolate them from the mainstream of American life.

Among the most unfair tax for women is the consumer excise tax. In our 1990 study, Women and Children First: An Analysis of Trends in Federal Tax Policy, we found that a family headed by a single mother pays from five to fourteen times as large a share of its income as does a family earning close to $100,000 a year for excise taxes on gasoline, telephone service and tobacco products.

Excise taxes hit those people hardest who have the least ability to pay, making them one of the most regressive taxes today. Lower-income families and families with children are hit particularly hard. In essence, women wind up paying significantly more than their fair share of the bill for federal excise taxes. This is not fair. We urge Congress to continue to look to progressive tax reform to provide middle-income tax relief. We need an equitable, fiscally-responsible program which will ease the burden on working women in this country.

CLUW applauds the efforts of Congress to find a fair and equitable solution for providing the middle-class tax relief that is so desperately needed. Tax relief comes at a price, however, and it must be paid for fairly and honestly by rolling back some of the huge Reagan-era tax cuts now enjoyed by the very wealthy, and by moving away from regressive excise taxes.

The Coalition of Labor Union Women urges Congress to adopt a middle-income tax relief program based on progressive taxation and economic justice. We urge the members of the Committee to stand up to the loophole lobby, reject costly new tax-shelter gimmicks and unite behind a responsible, revenue-neutral middle-class tax cut plan next year. It is time for America's wealthy to pay for the free ride they have received over the past decade, and contribute more equitably to this country's growing tax problem and the current recession.

Statement of the Federation Against Inequitable and Regressive Taxation

Mr. Chairman and Members of the Committee:

On behalf of the Federation Against Inequitable and Regressive Taxation (FAIRTAX), I urge you to repeal the so-called "luxury tax" on all products as part of legislation to provide middle-class tax relief, tax equity and fairness, and economic growth. FAIRTAX is comprised of American dealers of BMW, Ferrari, Jaguar, Mercedes-Benz, Porsche, and Rolls-Royce automobiles. Through my own small business, I offer Porsche, Jaguar, and Audi automobiles for sale. Unfortunately, I have felt first hand the devastating impact of the luxury tax. So have the 23 employees (constituting 22 percent of our staff) I have been forced to lay off since the tax went into effect at the beginning of the year.

Clearly, the luxury tax has failed miserably in achieving its apparently intended goal of "soaking the rich." All it has done is add to the deficit and hurt small businesses and working men and women and their families across the country. We believe the evidence is overwhelming that the luxury tax--not the recession--has been principally responsible for the reduced sales of high-line vehicles that have led to widespread losses and layoffs in our industry.

We therefore urge you to repeal the luxury tax on all products before it inflicts any more damage on the economy, hurts any more families, or causes any further increase in the federal deficit or state treasury losses.

To help you appreciate the impact the tax is having on the automobile sector, I have included with my statement the Executive Summary of an independent study prepared by Temple, Barker & Sloane, Inc., a general management consulting and market research firm with two decades of experience in the automobile and transportation sectors. The Temple, Barker & Sloane study concluded:

- The tax would cause at least a 20 percent permanent drop in demand for vehicles priced over $30,000, with the burden falling most heavily on European makes;

- A 20 percent decline would represent at least $1.3 billion in lost sales for high-line dealerships in 1991 alone;

- At least 3,320 employees in these dealerships and at the ports will lose their jobs as dealerships close across the country and manufacturers cut back on the number of employees they can keep gainfully employed; and

- The federal government and state governments will lose at least $135.5 million in 1991 just as a result of the impact of the tax on high-line automobile dealerships. These losses include lost customs duties ($22.5 million), lost federal income tax revenues ($26.0 million), lost gas guzzler tax revenues ($22.5 million), and lost state sales tax revenues ($64.5 million).

These estimates were clearly conservative because they did not include other costs to the federal government, such as the cost of "loss carryback" refunds or increased unemployment benefits payments.

State governments in particular will continue to feel the pain of reduced sales tax revenues as long as the luxury tax continues to discourage sales. According to estimates prepared by Temple, Barker & Sloane this summer, Texas will lose $5.6 million in 1991 alone. Other states will be hard hit as well: Florida ($10 million), New York ($8.1 million), New Jersey ($7.4 million), Pennsylvania ($6.6 million), Massachusetts ($5.0 million), Ohio ($3.3 million), California ($2.4 million), Maryland ($2.4 million), and Tennessee ($2.4 million).

Workers in these states also will be hard hit as high-line automobile sales continue to be depressed by the luxury tax. The top ten job losers in 1991 will be: California (459.3), Florida (319.6), New York (293.8), New Jersey (252.6), Pennsylvania (251.8), Texas (234.8), Massachusetts (183.9), Illinois (178.4), Ohio (170.3), and North Carolina (131.3).

With sales data now available for the first eleven months of the year, there can no longer be any question that the luxury tax--not the recession--is responsible for a severe drop in demand. The evidence is threefold. First, through the first eleven months of this year sales of European high-line automobiles hit by the tax fell 31.3 percent below sales for the same period last year. In contrast, the market for all passenger vehicles for this period was only off by 11.9 percent--a difference of 19.4 percentage points, which demonstrates that the Temple, Barker & Sloane estimate was on the mark. To put these sales figures in perspective, during the first eleven months of 1990 sales of high-line cars outperformed the market. Whereas high-line sales dipped by only 1.0 percent, the entire market was off by 5.3 percent during the first eleven months of the year. Then, during December 1990, sales of high-line cars increased by 43.9 percent as consumers raced to beat imposition of the tax, while overall sales increased by a mere 1.6 percent. Clearly, the luxury tax has had a profound impact on the market.

Second, the severe drop in sales of high-line vehicles cannot be attributed to a sudden market shift away from European nameplates. Sales of the BMW 3-series and the Mercedes-Benz 190 series, for example, have outperformed the overall market since the beginning of the year. In short, vehicles below the $30,000 threshhold are selling better than those above it--further evidence that the luxury tax is distorting purchasing decisions.

Finally, I don't know a single dealer in the country who has not been told by potential customers that they will not buy a new vehicle because of the luxury tax. Many are delaying purchasing decisions; others are buying previously owned vehicles; and others are insisting the dealer or manufacturer absorb the tax. The impact on dealerships has been the same: reduced new car sales, reduced profits, and increased layoffs.

Ironically, there have been winners as a result of the luxury tax--Japanese high-line manufacturers. Since their vehicles generally carry much lower sticker prices, the luxury tax represents a significantly smaller monetary burden on buyers and is more affordable for dealers to pay if necessary to make a sale. As Representatives Gary Ackerman, Wayne Owens, and Dick Swett recently pointed out in a "Dear Colleague" letter, "the new tax appears to have had the perverse effect of helping the Japanese capture the luxury car market in the United States.... [T]he Japanese are increasing sales at a time when the entire car market is off by 10.7 percent and Detroit has just announced it is sharply cutting back production plans for the remainder of the year."

The Temple, Barker & Sloane study and the recent sales data confirm what dealers know only too well: The American public is refusing to be saddled with another tax. They generally have stopped buying our cars, as well as boats, small airplanes, jewelry, and furs. Those who are buying our vehicles generally are doing so only when the manufacturer or the dealer agrees to foot the bill for the tax. Dealers cannot remain in business very long paying a tax that is greater than the profit on a sale. We believe it is essential for Congress to repeal this terrible tax before any more Americans are hurt and the budget deficit grows any larger.

Beyond saving jobs, there are at least three additional reasons for repealing the tax. First, by acting quickly our government can eliminate a significant fiscal drain on the federal treasury. According to the Treasury Department, first quarter sales figures were 30 percent below projected sales. Preliminary second quarter data suggest the tax eventually may meet expectations. But these data do not capture the overall fiscal impact of the tax.

Let me tell you about the fiscal effect of the impact of the tax on our dealership's business. Despite having reduced our fixed expenses by 30 percent in the first ten months of 1991 (as compared to the first ten months of last year), our new car sales revenue is down by 49.9 percent and our new car sales operating gross profit is down by 54 percent. Our total sales revenue (which includes used-cars sales) are off 29.9 percent and operating gross profit is down by 21.8 percent. Why? Because prospective customers have been scared away by the prospect of having to pay the tax on new cars. And others don't want to look stupid to their peers by agreeing to pay the tax. Moreover, sales of previously owned cars have not been sufficient to offset our sizeable new car sale losses. As a result, our dealership will be deep in the red this year.

This will have a significant impact on the Treasury Department. Our CPAs tell us that because we have been profitable during the past 3 years we will be able to "carry back" our 1991 losses as deductions against prior year profits. Under longstanding provisions of the Internal Revenue Code, like other businesses suddenly confronted with losses after years of profitability, we will be able to apply for a refund of tax dollars previously paid to the Internal Revenue Service. As much as we will be helped with the refund, we would much prefer not to be getting one--after all, we are only getting it because we will lose so much money this year. Dealers across the country like me will be carrying back their losses as well, creating a Treasury liability likely to run in the tens of millions of dollars. I can't believe Congress considered--let alone estimated the fiscal impact of--this drain on the Treasury in enacting the luxury tax.

Moreover, as I mentioned earlier, we already have been forced to lay off 23 employees (constituting 22 percent of our staff). They have lost income on which taxes would have been paid. If the tax remains in place much longer, we will have to let additional people go. Why should they and their families have to suffer? And why should the Congress permit this injustice to continue? As every day passes, the fiscal burden of the tax only increases.

Perhaps the Committee can draw a lesson from the Australian experience with luxury taxes. In January 1990, the Australian federal government had enacted a new luxury tax on automobiles with the hope of raising approximately $A 100 million in additional revenue. After one year of operation, however, the law had led to revenue losses projected to reach $A 260 million annually. Faced with widespread job losses, dealership closings, and mounting revenue shortfalls, on March 12, 1991 the Australian federal government rescinded the legislation.

Let me offer an additional reason for repealing the tax. The existence of the tax has led a number of state legislatures to consider imposing their own luxury taxes. To date, legislation has been introduced in California, Connecticut, Kansas, Minnesota, Nebraska, Nevada, and North Carolina. Fortunately, not one of these bills has been enacted into law. As long as the federal law remains on the books, however, state legislatures will continue to make the unfortunate assumption that this form of taxation raises revenue painlessly. In fact, the imposition of state taxes on top of the federal tax could be the final crippling blow to many retailers and their employees. It is essential for Congress to signal to the states that luxury taxes don't work as advertised.

Finally, Congress should repeal the luxury tax because it violates our international obligations under the General Agreement on Tariffs and Trade. The tax violates Article III by taxing imports more heavily than like domestic products and by improperly attempting to afford protection to a domestic industry. In addition, it violates Article I by denying the European Community a previously negotiated trade benefit by discriminating against European models in favor of Japanese models that sell for less than the threshhold. With this Committee having lent its considerable weight to spur the Uruguay Round, we think it important for the Committee to signal that it is prepared to eliminate the luxury tax as part of our overall commitment to achieve a good GATT agreement.

Mr. Chairman, given the harm this terrible tax continues to cause to small businesses and families throughout the country, we urge you to join with your colleagues in enacting repeal legislation as quickly as possible as part of tax cut legislation recommended by the Committee.

Thank you.

STATEMENT OF CRAIG G. GOODMAN[*]

The Impact of U.S. Tax Policy on Competition in the Global Economy

As the election year approaches, both parties have begun another round of debates over budget deficits, trade deficits, foreign competition, income redistribution and how to use a "peace dividend" to increase economic activity during 1992. At the core of these debates is U.S. tax policy. Unlike prior debates, however, there is now a growing body of quantitative analysis which permits informed policy-makers to measure the impact of U.S. policies on real-world investment behavior, and the creation and measurement of new wealth for U.S. society.

The results of this research hold significant implications for the United States and its ability to compete in the global economy. Until now, U.S. tax and economic policies have relied on relatively static macro-economic models and rhetoric to "predict" America's response to any given set of policy proposals. As the U.S. falls further behind in the quest for new markets and a higher standard of living, it is becoming painfully clear that any new world economic order demands a far more dynamic approach to policymaking.

Presented in graphic form on the pages that follow are economic analyses of the impacts of U.S. tax policies on U.S.-based companies competing in the global economy. The results strongly suggest that merely reshuffling spending priorities or slightly shifting relative tax burdens according to voting potentials will not necessarily increase America's economic well-being or its standard of living over the long-term.

The combination of what many see as continued U.S. profligacy, ever-increasing private and public debt loads, embarrassingly-low savings rates, and tax policies which punish capital formation, could easily foreshadow undesirable consequences. Much is already known about America's public and private consumption rates, its spending habits, its savings rates and, of course, its debt loads. However, new microeconomic research allows us to see the dynamic real-world impacts of America's tax policies.[1]

The following article incorporates this research to offer insight on how to reverse America's declining share of global wealth. In sum, the U. S. form of capitalism can no longer afford to impose tax penalties on capital seeking to create new jobs, new wealth and new economic opportunities for U.S. citizens and U.S.-based business enterprises.[**]

I
The History of U.S. Capital Taxation Policies

Historically, U.S. tax policies affecting capital have held a revered place in the foundations of American democracy.[2] The 18th Century outcry against taxation without representation can be traced forward directly as the basis for the 20th Century Constitutional prohibition against taxing capital. However, when America shifted its budgetary reliance on excise taxes and import fees to income-based taxation, a "vexed question"[3] became how to distinguish *income* from *capital.* This has been no minor feat, particularly when the answer depends (among other things) on whether the capital is depreciating or depleting, tangible or intangible. The Supreme Court has wrestled with this question repeatedly. Yet, from the start it was clear that the question was primarily legal, with significant economic implications.[4]

[*] Craig G. Goodman served as director of oil policy, and as the Director of the Office of Energy Tax Policy within the U.S. Department of Energy under the Reagan and Bush Administrations. Mr. Goodman currently is Vice President of Mitchell Energy Corporation in The Woodlands, Texas. Prior to government service, Mr. Goodman was senior counsel and director of energy and tax policy for the Independent Petroleum Association of America. Mr. Goodman is a member of the Bars of the States of Texas, Florida, and Washington, D.C. and is admitted to practice before the United States Supreme Court.

[**] This article addresses taxes on capital and income generated from capital, not the taxation of *capital gains.*

Regardless of the circumstance or type, it has always been clear that taxing capital is not only unconstitutional, but also is contrary to many of the basic precepts of U.S.-styled free-market democracy. The Constitutional prohibition against taxing capital is deeply rooted in the American notion of private property rights and the inherent distrust the founding fathers had of political factions arising that could tax property existing disproportionately in states having only minority representation in the "lower-house of Congress".[5] This Constitutional safeguard reflects America's disdain for taxation without representation.

Interestingly, this basic principle of 18th and 19th Century American-styled capitalism is also an important part of late 20th Century global capitalism. The research presented below indicates that the United States has not only lost sight of the roots of its prosperity, but that its competition has studied well the U.S. formula for success and is capturing large portions of America's historical share of global wealth.

In the past, other countries modeled their tax codes around that of the United States because of its sheer economic power. In the last three decades, however, America's stature in the world economy has declined dramatically.

After decades of being the world's largest lender of capital, the United States is now the world's largest debtor nation. The United States has gone from an unparalleled economic superpower with a 40% share of the world's total production, to one of several regional economic powers fiercely competing for market share. In the process, the U.S. has lost more than 28% of its global-market share. During the same time, the U.S. share of the world's total direct investment declined 38% as foreign direct investment in the United States increased thirty-fold (3000%).[6]

Over the last five years alone, the U.S. has borrowed over $100 billion annually just to finance its trade deficit, the majority of which is related to the importation of crude oil and foreign automobiles; the two industries that were synonymous with U.S. prosperity, and its preeminent standard-of-living in the first half of the 20th Century.

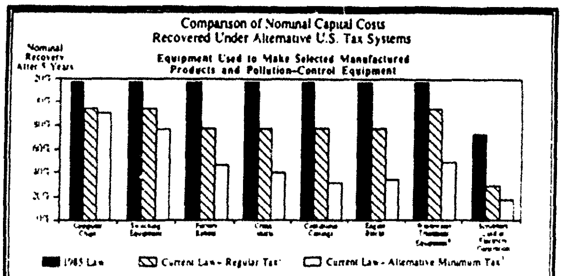
During this period of marked decline in U.S. global economic stature, other trends also emerged. The U.S. economy became more reliant on consumption of all types, and the foreign production of cars, crude oil, and, more recently, high-tech products have captured ever increasing shares of the U.S. and world markets. Not surprising, this period is marked also by a substantial shift in America's tax burden onto productive capital and income generated from capital, thereby freeing up more personal income, after taxes, for added consumption. "Tax equity and efficiency" may sound like taxation without representation, but as shown below, certain impacts of current U.S. tax policies are neither equitable nor efficient.

II
Recent Changes
in
U.S. Capital Policies

Over the last twenty years, political concerns about tax *equity* and *efficiency* have motivated a reform of the U.S. system of income taxation. This reform has taken the form of slower capital-cost recoveries in the regular tax code and the creation of a new form of taxation called the alternative minimum tax (AMT). Contrary to traditional principles of income taxation, at the margin, the incidence of this new tax falls directly on capital itself rather than solely on the income generated from that capital. In the process, the various tax reform acts between 1969 and 1986 have increased substantially the economic impact of U.S. taxation on virtually all capital investments, and particularly on high-risk depleting capital investments such as petroleum.[7]

In response to the OPEC embargoes and price spikes of the 1970s, the United States repealed time-honored rules allowing recovery of sufficient funds to replace reserves for more than 70% of all proven domestic petroleum assets. The U.S. definition of *taxable income* which now includes drilling costs and asset depletion, represents a major departure from the historical structure of the U.S. system of income taxation as well as from its constitutional underpinnings. As a result, in the U.S. tax code today, a long-term AMT petroleum taxpayer is no longer guaranteed a return *of*, much less a return *on*, new drilling capital.[8]

The following chart presents a side-by-side comparison of the pre- and post-tax-reform systems of capital and capital-income taxation in the United States for a variety of significant capital investments. As shown, the ability of U.S-based taxpayers to recover capital invested in virtually any type of depreciating asset has deteriorated significantly in the last five years.



Notes: Nominal capital costs recovered after five years measure the speed at which a firm is able to recover its capital expenditures. Under 1985 law in the U.S., the combination of depreciation and the investment tax credit resulted in a nominal recovery of 116.5 percent of capital expenditures after five years.

1985 law refers to the federal tax code provisions for capital cost recovery on December 31, 1985, of the Economic Tax Recovery Act of 1981 as modified by TEFRA (1982) and DRA (1984).

Current law-regular tax refers to the capital cost recovery provisions of the Tax Reform Act of 1986. The calculations assume the investing firm incurs the regular marginal corporate tax rate of 34 percent.

Current law-alternative minimum tax refers to the capital cost recovery provisions of the Tax Reform Act of 1986 for firms incurring the alternative minimum tax adjusted current earnings rule. The calculations assume the firm stays on the minimum tax.

*Pollution-control equipment used in manufacturing chemicals and allied products.

Source: Coopers and Lybrand, Economic Effects of Corporate Alternative Minimum Tax, ACCF Center for Policy Research, September 1991.

When capital recovery periods lengthen, as has occurred, the cost of new investment capital increases and the after-tax return on that capital declines. Additionally, as shown in the section dealing with depleting capital, as the tax code stretches out the time it takes to recover capital, both the costs and the risks associated with that capital increase significantly. Moreover, the longer capital is at risk, the increased costs of U.S. policies are even more significant in determining whether such capital is competitively employed.

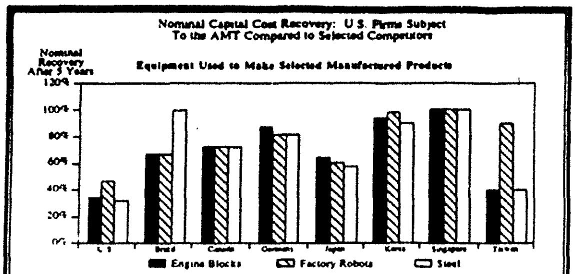
As shown, the United States is one of the more hostile environments in the world in which to be headquartered and to invest new capital. As is also shown, U.S.-based companies are at significant competitive disadvantages when doing business anywhere in the world. Consequently, capital invested by U.S.-based corporations both domestically and internationally will cost more and return less than capital similarly invested by companies based in virtually all of our major trading partners.[9] Today, the majority of U.S depleting assets and 40% of U.S. depreciating assets are subject to these new policies.[10]

Research presented below suggests strongly that revising U.S. capital policies can increase U.S. social wealth, its job base, its economic activity and ultimately increase federal tax revenues as well. This research also suggests strongly that such revisions could help the United States to compete more successfully, and to create and bring home a greater share of new wealth from the global marketplace.

III
U.S. Taxation
of
Depreciating Capital

Capital and capital-income tax policies in the United States are now controlled primarily by the provisions of the Tax Reform Act of 1986. As shown above, these policies lengthened considerably the period in which a U.S.-based taxpayer can recover the capital needed to generate income, jobs and social wealth. Consequently, there is growing concern as to whether current tax and capital policies can or will foster the type of economic growth and prosperity American culture has come to expect.

The following is a chart of the time it takes to recover capital invested in the U.S. automotive, steel and robotics industries compared to seven of our major trading partners. This chart demonstrates persuasively that U.S.-based taxpayers investing in new depreciating capital assets are at a significant competitive disadvantage both domestically and internationally.[11] Foreign tax regimes have nothing remotely similar to the AMT and generally allow significantly more favorable returns *of* and *on* new capital invested under their respective tax regimes.



Nominal Capital Cost Recovery: U.S. Firms Subject To the AMT Compared to Selected Competitors

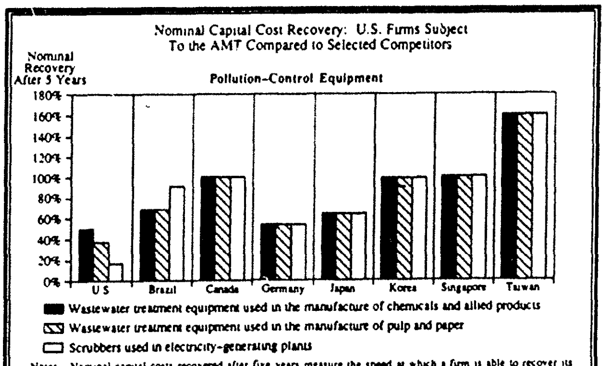
Notes: Nominal capital costs recovered after five years measure the speed at which a firm is able to recover its capital expenditures. U.S. firms are assumed to pay the alternative minimum tax (AMT) throughout the class life of the asset. The alternative minimum tax refers to the capital cost recovery provisions of the Tax Reform Act of 1986 for firms incurring the alternative minimum tax adjusted current earnings rule. The calculations assume the firm stays on the AMT. None of the competitor countries has an AMT similar to that of the United States.

Source: Cornick and Godshaw, *Economic Effects of Corporate Alternative Minimum Tax*, ACCF Center for Policy Research, September 1991

As shown, U.S. capital recovery policies present major disincentives for firms located in the United States to invest in these three significant asset categories. Capital invested in equipment to manufacture steel, engine blocks or robots under the tax regimes of any of the other countries shown, will cost less and return more than it would in the United States. In five years, an auto-maker in Germany can recover over twice as much of its investment than its U.S. competition. Similar results occur in Japan and Canada. With a 3% investment tax credit available in Korea, the results of an automotive investment are far more competitive than in the United States. Singapore even more aggressively pursues capital formation by offering a three-year capital recovery period.

A U.S.-based automotive, steel or high-tech company subject to the AMT is at a significant disadvantage when compared with its foreign competition. U.S. firms competing in foreign countries are further penalized by U.S. foreign tax laws[12] which essentially impose a surcharge, not borne by foreign competitors, in amounts of 4% to 10%.[13]

Interestingly, as the United States has become increasingly concerned about the quality of its environment, it has simultaneously imposed significant tax disincentives on capital invested in equipment used to clean-up the environment. Compared with Taiwan, Singapore, Korea, Canada and Brazil, environmental investments in the United States are not a competitive use of capital. The Taiwan government allows a complete return *of* and a 60% return *on* environmental investments, while a U.S.-based company subject to the AMT can only recover 17.5% *of* its capital invested in new scrubbers, and less than 50% *of* its capital invested in new wastewater treatment equipment, after five years.[14] The following chart provides a graphic comparison of the relative returns *of* and returns *on* depreciating capital used to enhance environmental quality in the United States and seven of its major trading partners.



Nominal Capital Cost Recovery: U.S. Firms Subject To the AMT Compared to Selected Competitors

Notes: Nominal capital costs recovered after five years measure the speed at which a firm is able to recover its capital expenditures. U.S. firms are assumed to pay the alternative minimum tax (AMT) throughout the class life of the asset. The alternative minimum tax refers to the capital cost recovery provisions of the Tax Reform Act of 1986 for firms incurring the alternative minimum tax adjusted current earnings rule. The calculations assume the firm stays on the AMT. None of the competitor countries has an AMT similar to that of the United States.

Source: Cornick and Godshaw, *Economic Effects of Corporate Alternative Minimum Tax*, ACCF Center for Policy Research, September 1991

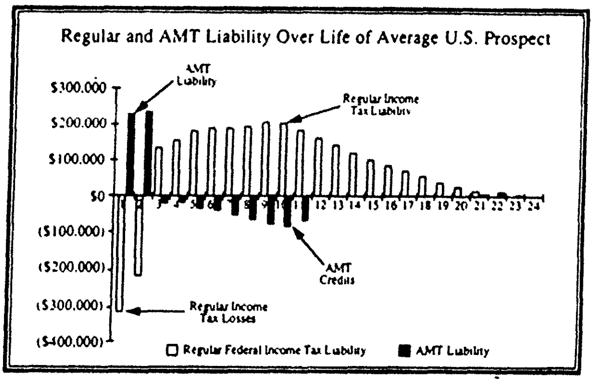
In each asset category shown, the U.S. yields the worst results. Yet, depreciating capital is only part of the story. The impact of U.S. policies on depleting capital is also significant.

IV
U.S. Taxation
of
Depleting Capital

Capital used to maintain, enhance and replace America's depleting reserves of petroleum also has been affected greatly by changing U.S. capital policies. According to pre-tax reform Joint Tax Committee studies, no other industry contributes as much either to the wealth of nations or to U.S. and foreign treasuries as the U.S. petroleum industry.[15]

Today, over 50% of U.S.-based petroleum taxpayers pay both regular and AMT, yet compete against other taxpayers that pay only regular taxes or foreign-based taxpayers only partially subject to U.S. taxation. Additionally, high-risk depleting capital is more negatively affected by the impact of the U.S. take system than low-risk-depreciating capital because of the effects of risk and the fact that virtually every major expenditure that is required for a U.S.-based petroleum taxpayer to stay in business is considered *taxable income* for AMT purposes.

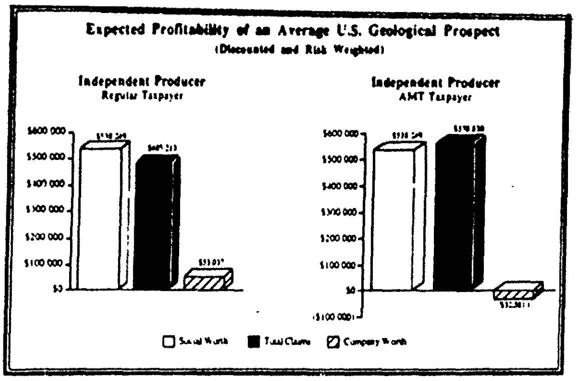
The following chart demonstrates the difference in timing between the regular and AMT systems of U.S. capital taxation. Shown are the regular U.S. income tax liability and the added burden of the AMT on the statistically average U.S. geological prospect.



As can be seen, AMT liability occurs during the first two years because the taxpayer is investing capital in new drilling over this period. For regular tax purposes, drilling costs are treated as ordinary and necessary business expenses. For AMT purposes, however, a substantial portion of this capital is treated as *taxable income.*

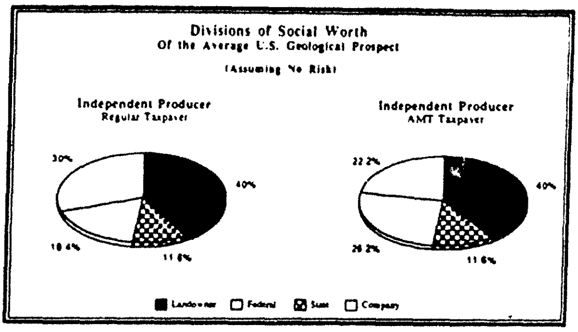
As also shown, an AMT taxpayer takes approximately 11 years to recover the tax paid on the capital used to replace depleting U.S. petroleum assets. Contrary to the intent of law, recovery of the up-front AMT payment is not guaranteed. Only if a taxpayer eventually becomes profitable enough to pay regular taxes is a credit provided to recover the up-front AMT tax on this capital.[16] Under this structure a U.S.-based taxpayer lends the federal government money, interest free, by paying *income* taxes before *income* is earned, and gets paid back only if sufficiently profitable in the future.[17] For most U.S.-based petroleum taxpayers, AMT credits are not available or are unusable, and the AMT thus becomes a direct tax on the capital invested to maintain and replace America's depleting petroleum capital.

Today, a regular U.S. taxpayer exploring for crude oil in the United States can expect a profit in an amount that is almost identical to the expected loss of a competing AMT taxpayer on the exact same investment. Shown below is a side-by-side comparison of the expected after-tax economics of an identical investment made by competing taxpayers.

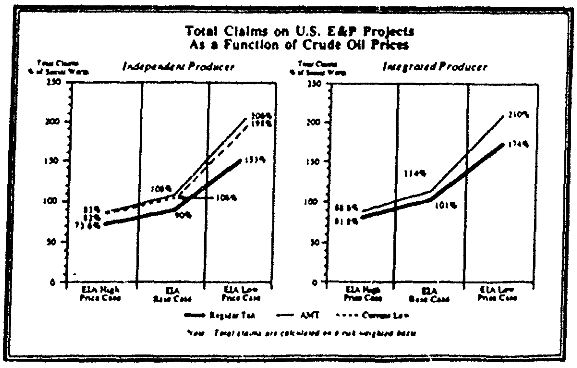


The revenues generated by this investment, if undertaken, would be divided in the manner shown in the following pie chart. As shown, when a taxpayer moves from a regular tax position to an AMT position, this capital investment is rendered unprofitable because the federal government's share of the net revenues generated from the capital increases over forty percent, from 18% to 26%.

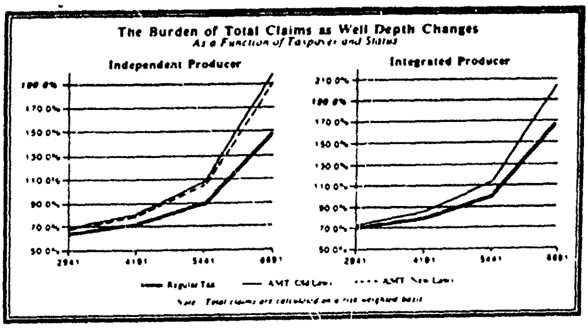
Principles of tax neutrality require that the underlying economics of a project not be affected differentially by the tax code. However, both the bar and pie charts show that different U.S.-based taxpayers are treated very differently.[18] Under current U.S. tax policies, after-tax economics of new capital investments do not approach similarity until investments become far more profitable. In essence, on the margin, the U.S. tax system rewards more-profitable taxpayers and penalizes less-profitable competitors, on the exact same investment.



The following chart shows that as crude oil prices decline, the percentage of the net revenues taken by the U.S. tax and fiscal system increases dramatically for every type of U.S.-based taxpayer. The chart also shows that at any given price level, the after-tax return to a U.S.-based AMT taxpayer will always be lower than the return to a regular taxpayer, on the exact same investment. As can be seen, U.S.-based taxpayers subject to the AMT can no longer make a competitive rate of return on the statistically average U.S. geological prospect.



The next chart demonstrates the economic impact of the U.S. take system as the costs of production rise. When a U.S.-based taxpayer is forced to explore deeper for new petroleum assets, the impact of both the AMT and regular systems increases dramatically. At relatively shallow depths, U.S. take exceeds the expected social wealth that would be generated from an average U.S. geological prospect, thus rendering it unprofitable. The same regressive economic impacts occur when either revenues or profitability decline.[19]



These policies have contributed to a marked decline in U.S. crude oil production. Since the Tax Reform Act of 1986, crude oil production in the United States has declined over 1.7 million barrels per day, despite interim price increases of more than 100 percent. This lost production alone equates to a measurable loss in wealth to U.S. society, before multiplier effects, of $160 billion to $250 billion, a loss in federal and state revenues of more than $50 billion, plus hundreds of billions of dollars in S&L-related losses, trade deficits, increased military spending and economic multiplier effects.[20]

Since the OPEC-controlled price collapse of 1986, virtually every major non-OPEC producer of crude oil except the United States has reduced the economic impact of its take system on new petroleum investments.[21] Over the same period, the U.S. foreign tax code has compounded the disparities by severely limiting the ability of U.S.-based firms to recover capital invested anywhere in the world.

Recent comparative analyses of the U.S. petroleum take system demonstrate that identical extraction investments earn higher after-tax returns elsewhere. At virtually every level of geological risk and at any level of crude oil prices, an oil and gas investment in the United Kingdom will yield its investor a higher after-tax return than a similar investment would in the United States, solely because of the structure and operation of the U.S. take system.[22] Similar results were also found in Canada.[23] Immediately after the collapse, unlike the United States, Canada provided cash grants for new drilling expenses, implemented tax and royalty holidays and numerous other take reductions to avoid damage to its natural resource base.

Recommendations to Improve the Competitiveness of U.S. Tax Policy

Competition comes in many forms and forums. The competitiveness of a tax and fiscal system is measured by its impact on the risk-weighted, after-tax, rate of return on capital invested domestically or internationally by businesses headquartered within its boundaries. Capital is a scarce resource that theoretically has no national boundaries and pledges its allegiance solely to a risk-weighted, after-tax rate of return.

On the margin, after the underlying economics of an investment are computed, government take policies will basically determine whether capital is competitively employed. To eliminate completely the anti-competitive impacts of the U.S. tax code on both domestic and international investments would require a significant restructuring of U.S. capital and income taxation. Essentially, it would require a uniform, low-rate, tax structure which allows immediate and complete cost recoveries without a distinction between expenditures for labor or capital and without a distinction between debt or equity sources of funds.

In the absence of a complete restructuring, shortening recovery periods for new investments in both depletable and depreciable assets for both regular and AMT taxpayers will help. This will lower the costs and risks of new capital investments made by U.S.-based taxpayers. Second, existing tax credits should be available equally to either regular or AMT taxpayers, and at a minimum, AMT credits should be useable against any subsequent tax liability. These changes will promote equity, efficiency and neutrality within the existing system. These changes also will generate substantial new economic activity and create substantially more wealth to the federal treasury and U.S. society than it would cost in lost tax revenues.[24]

Such a tax structure would substantially reduce the time it takes a U.S.-based taxpayer to recover capital invested productively anywhere in the world. The federal government can improve expected economics of new capital investments at virtually no "real" cost. As demonstrated above, by moving the tax from the investment capital to the project's income, the project becomes marginally profitable, thereby yielding disproportionately greater increments of wealth to U.S. society.[25]

Conclusion

There is clearly a new world economic order. The United States must compete for new capital, new jobs, new markets and for its share of global wealth in an increasingly regionalized global economy. U.S.-based companies compete against foreign companies and their governments. Unlike the Unites States, which traditionally has relied on relatively free-market principles, its new competition is more experienced at integrating social and economic policies with underlying tax policies. Competing for new jobs, new wealth, increased capital flows, surplus trade balances and an affluent standard of living should be the object and purpose of future U.S. capital, tax and economic policies.

Taxing capital, and raising taxes as prices, revenues and profits fall and as the costs of production increase are clearly contrary to the basic precepts of U.S. income and capital tax policies. To replenish its resource, asset and job base, investments to maintain, enhance and replace America's depleting and depreciating capital must be competitive with other investments.

Until U.S policies change to reflect the intense competition for capital, jobs and economic prosperity within the global marketplace, the United States will continue liquidating it's proven resource base, and exporting its standard of living to competitor countries that foster capital formation and new wealth creation. New capital recovery policies should allow U.S.-based taxpayers to earn competitive, risk-weighted, after-tax returns *of* and *on* both depletable and depreciable capital. Such policies can increase U.S. social wealth, economic activity, employment, income tax collections and improve our product-related trade balances at a very low marginal social cost.

ENDNOTES

[1] **Impacts of U.S. tax reform on investments in depreciable assets:** *Economic Report of the President*, January 1989 (Washington, D.C.: U.S. Government Printing Office), p.92; *An Analysis of the Alternative Minimum Tax: Equity, Efficiency, and Incentive Effects*, A. Lyon, 1991; *AMT Depreciation: How Bad is Bad*, S. Corrick and G. Godshaw, *Economic Effects of The Corporate Alternative Minimum Tax*, American Council for Capital Formation Center for Policy Research, September 1991; *Approaches to Efficient Capital Taxation: Leveling the Playing Field vs. Living by the Golden Rule*, Goulder and Thalmann, National Bureau of Economic Research Working Paper #3559, December 1990; *Tax Neutrality and Intangible Capital*, Fullerton and Lyon, National Bureau of Economic Research Working Paper #2430, November 1987. **Impacts of U.S. tax reform on investments in depletable assets:** *The Microeconomic Impact of the U.S. Tax System on Domestic Petroleum Extraction, A Quantitative Analysis of the Post-Tax Reform System of Take in the United States*, Goodman, Gordon and Youngblood, 1990; *The Impact of the Omnibus Budget Reconciliation Act of 1990 on Investments in Domestic Petroleum Extraction*, C. Goodman, 1991.

[2] For a more detailed discussion See *U.S. Petroleum Income Taxation: 1890-1990*, C. Goodman, Oil and Gas Tax Quarterly, vol. xxxix, Nos. 2, 3 and 4 (Dec. 1990, March 1991, and June 1991).

[3] *Stratton Independence, Ltd. v. Howbert*, 231 U.S. 399, 422 (1913).

4. *Ibid.*, at 417. See *Burnet v. Logan*, 283 U.S. 404 (1931), wherein the Supreme Court enunciated the *return of capital* doctrine as follows: *"In order to determine whether there has been gain or loss, [income] and the amount of the gain, if any, we must withdraw from the gross proceeds an amount sufficient to restore the capital value that existed at the commencement of the period under consideration."*

5. See *Pollock v. Farmers' Loan & Trust Co.*, 158 U.S. 601, at 621-622, *"they retained this security by providing that direct taxation and representation in the lower house of Congress should be adjusted on the same measure."*

6. See *U.S. International Tax Policy for a Global Economy*, Price Waterhouse, 1991.

7. See *The Microeconomic Impact of the U.S. Tax System on Domestic Petroleum Extraction, A Quantitative Analysis of the Post-Tax Reform System of Take in the United States, supra.* See also *U.S. Tax Policies Distorting Economics of Exploration, Development Ventures*, Oil & Gas Journal October 7, 1991, at page 58.

8. See charts on pages 8 and 9 *infra*. See also *U.S. Petroleum Income Taxation: 1890-1990*, March 1991 and June 1991 and *The Impact of Current Tax Policy on U.S. Energy Production*, C. Goodman, *Economic Effects of The Corporate Alternative Minimum Tax*, American Council for Capital Formation Center for Policy Research, September 1991.

9. See Notes 1, 6 and 8, *supra*. See also *AMT Depreciation: How Bad is Bad, supra.*

10. *Ibid.*, See also *An Analysis of the Alternative Minimum Tax: Equity, Efficiency, and Incentive Effects, supra.*

11. See *AMT Depreciation: How Bad is Bad*, S. Corrick and G. Godshaw, *Economic Effects of The Corporate Alternative Minimum Tax*, American Council for Capital Formation Center for Policy Research, September 1991. See also *The International Competitiveness of the U.S. Petroleum Licensing System*, R. Gordon, 1988; *U.S. and Canadian Tax and Fiscal Treatment of Oil and Gas Production*, C. Goodman, Working Paper, U.S. Department of Energy, May 1989; *Taxation Effects on the Competitiveness of U.S. Oil and Gas Investments: Promoting Stability in the 1990's*, Flaim, Gordon and Hemphill, 1989; *U.S. International Tax Policy for a Global Economy*, Price Waterhouse, 1991.

12. The most onerous domestic impacts of the U.S. tax code occur because of the conflicting structure of the regular and the alternative tax systems and because of overly complicated and restrictive capital and non-capital investment cost-recovery provisions. Additional anti-competitive impacts are created internationally by higher taxes on capital and income from capital, artificial allocation rules, foreign and domestic "ring-fence" and exploration-loss-recapture rules, and rules which effectively bar cost recoveries or tax certain income twice. Each of these structural impacts increases both the costs and risks for U.S.-based taxpayers to do business anywhere in the world.

13. *U.S. International Tax Policy for a Global Economy, supra.*

14. For recent analysis of the macroeconomic impacts of U.S. environmental policies See D. Jorgenson and P. Wilcoxen, *U.S. Environmental Policy and Economic Growth: How Do We Fare?*, The Impact of Environmental Legislation on U.S. Economic Growth, Investment, and Capital Costs, American Council for Capital Formation Center for Policy Research, September 12, 1991. For microeconomic analysis of the impact of U.S. tax laws on environmental investments See *AMT Depreciation: How Bad is Bad*, S. Corrick and G. Godshaw, *supra.*, and J. McCallum, *Economic Effects of The Corporate Alternative Minimum Tax*, supra.

15. See attachment.

16. See chart on page 7, *infra*.

17. The chart on page 7 assumes that the taxpayer is profitable enough to pay regular income taxes starting in year three of the project.

18. Each of the charts on pages 8 through 10 demonstrate the difference in the after-tax value of the exact same investment to different taxpayers.

19. See *The Microeconomic Impact of the U.S. Tax System on Domestic Petroleum Extraction, A Quantitative Analysis of the Post-Tax Reform System of Take in the United States, supra.* See also *U.S. Tax Policies Distorting Economics of Exploration, Development Ventures, supra.*

20. *Ibid.*

21. *See generally* notes 1, 8 and 11, *supra.*

22. *Taxation Effects on the Competitiveness of U.S. Oil and Gas Investments: Promoting Stability in the 1990's, supra.*

23. *U.S. and Canadian Tax and Fiscal Treatment of Oil and Gas Production*, Working Paper, U.S. Department of Energy, *supra*. The Province of Alberta Canada has recently anounced additional take reductions in the form of tax and royalty holidays.

24. For example, if U.S. tax policy renders the statistically average U.S. geological prospect marginally economic to an AMT taxpayer (75% of the domestic industry), the prospect would generate over $12.5 million in "actual" new wealth to U.S. society, of which $2.5 million would go to the federal treasury, and $1 million would go to the state treasury. Yet, this does not occur because the investor faces an expected loss solely because of the impact of the AMT. See chart on page 8. In expected terms, even at high social discount rates the payback to society is over fifteen times the cost. For more detailed quantitative microeconomic analyses of the U.S. take system generally. See *The Microeconomic Impact of the U.S. Tax System on Domestic Petroleum Extraction, A Quantitative Analysis of the Post-Tax Reform System of Take in the United States, supra.*

25. This is demonstrated graphically in the charts on pages 7 and 8.

Global Income Taxes Paid by Industries Sampled in 1983

(Thousands of Dollars)

	U S income before tax	Foreign income before tax	Worldwide income before tax	Current U S tax expense	Current foreign tax expense	Current worldwide tax expense
Aerospace	3,287,418	373,107	3,660,525	459,337	201,611	660,948
Beverages	1,688,161	577,327	2,265,488	316,120	301,673	617,793
Broadcasting	1,081,109	209,552	1,290,661	199,818	79,957	279,775
Chemicals	1,164,100	3,416,300	4,580,400	(11,100)	2,433,900	2,422,800
Computers and office equipment	6,842,475	4,972,408	11,814,883	1,396,917	2,702,044	4,098,961
Construction	59,386	195,035	254,421	429	74,134	74,563
Electronics and appliances	3,952,658	1,482,062	5,434,720	290,863	598,646	889,509
Financial institutions	2,862,830	3,460,057	6,322,887	182,040	1,354,023	1,536,063
Food processors	3,810,004	1,309,634	5,119,638	987,286	511,118	1,498,404
Glass and concrete	605,401	180,435	785,836	105,754	85,754	191,479
Instruments	2,256,478	659,639	2,916,117	739,600	330,291	1,069,891
Insurance	1,755,975	48,800	1,804,775	174,398	58,491	232,889
Investment companies	979,855	680,650	1,660,505	91,478	137,383	228,861
Metal manufacturing	(1,341,203)	16,600	(1,324,603)	25,396	40,300	65,696
Metal products	286,113	318,686	604,799	43,296	133,960	177,256
Mining	(485,812)	145,328	(340,484)	(18,861)	70,961	52,100
Motor vehicles	5,759,186	1,281,402	7,040,588	202,308	527,330	729,638
Paper and wood products	759,318	118,263	877,581	(3,846)	66,917	63,071
Petroleum	19,255,861	22,171,133	41,426,994	4,094,087	13,303,397	17,397,484
Pharmaceuticals	2,301,842	1,549,400	3,851,242	626,033	608,331	1,234,364
Retailing	5,067,076	288,367	5,355,443	1,015,447	125,630	1,141,077
Rubber	618,089	283,821	901,910	121,366	194,260	315,626
Soaps and cosmetics	2,027,044	513,380	2,540,424	720,699	266,857	987,556
Telecommunications	11,072,260	127,117	11,199,377	530,913	96,978	627,891
Tobacco	3,083,254	539,760	3,623,014	1,041,548	150,751	1,192,299
Transportation						
Airlines	(272,024)	169,123	(102,901)	(58,828)	4,464	(54,364)
Railroads	2,164,765		2,164,765	71,899		71,899
Trucking	1,283,557	7,824	1,291,381	442,768	4,278	447,046
Utilities (electric and gas)	7,158,433		7,158,433	505,298		505,298
Wholesalers	947,776	9,200	956,976	329,472	13,806	343,278
Total Sample, All Companies	90,031,387	45,104,410	135,135,797	15,021,935	24,477,216	39,499,151

Source Joint Committee Print JSC-40-84, Nov 28, 1984

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J. Mitchell Bean

David Goodman
Director,
Management Advisory Services

December 16, 1991

Senate Finance Committee
Dirksen Building
Room 205
Washington, D.C. 20510-6200

Gentlemen:

I understand your Committee is considering re-establishment of the investment tax credit. I believe that is an excellent incentive to an economic recovery.

As a CPA for 30 years primarily dealing with closely held companies, I observed that the investment tax credit was an incentive for expansion and starting new businesses. Without the ITC, one client would not have started a cruise boat business in the 1980's which eventually built 10 boats throughout the country employing over 2,000 people.

I recommend that the investment tax credit be re-established, particularly for small businesses.

Very truly yours,

GOODMAN & COMPANY

Robert I. Low

/llc

Statement of the International Council of Shopping Centers

I. INTRODUCTION

I am Norman M. Kranzdorf, President of The Kranzco Group, Conshohocken, Pennsylvania, a developer and manager of shopping centers, and I am presenting this statement to the Committee as Chairman of the Tax Policy Committee of the International Council of Shopping Centers.

The International Council of Shopping ("ICSC") is the trade association of the shopping center industry. Members of ICSC, consisting of shopping center developers, retailers, investors, managers, and others having a professional or business interest in the shopping center industry, are engaged in the day-to-day activities of designing, planning, constructing, managing, financing, developing, leasing, and owning shopping centers and their retail stores. ICSC has approximately 25,000 members, and the approximately 23,000 members located in the United States represent a majority of the shopping centers in this country. ICSC's Government Relations office is located at 1199 North Fairfax Street, Suite 204, Alexandria, Virginia 22314–1437, (703) 549–7404, and it is headquartered at 665 Fifth Avenue, 11th Floor, New York, New York.

In order to deal with the current and long term problems of the economy, the Congress must address the problems currently troubling real estate, many of which were created by the changes in the tax code in 1986. Real estate is the Nation's greatest tangible resource, and the dramatic decrease in real estate values, both residential and commercial, that has resulted from the tax changes of the 1980s has had a devastating effect on personal wealth, the financial system, the revenues of the federal, state, and local governments, and federal spending to protect financial institutions and their depositors.

ICSC believes that immediate action to implement the tax changes discussed below is a necessary and vital step to restoring growth in the economy.

II. THE TAX REFORM ACT OF 1986

A. The Law Prior to the 1986 Act

Prior the Tax Reform Act of 1986 ("1986 Act"), in general no limitations were placed on the use of deductions or losses from one activity to offset income from another activity. Therefore, taxpayers could offset losses from investments in rental real estate against income from real estate activities and from non-real estate activities, including wages and investment portfolio income.

Capital gains were taxed at a preferential rate, there was no recapture f depreciation deductions taken under the straight line method for commercial real estate, and the depreciable life of commercial real estate was set at nineteen years.

B. The 1986 Act

The Tax Reform Act of 1986 made many changes in the tax law affecting investments in real estate. The aims of the 1986 Act were to "restore the trust of the American people in the income tax system and lead the Nation's economy into greater productivity" by creating a fairer, more efficient, and simpler tax system for individuals.

While the 1986 Act provided some salutary benefits to the real estate industry—including the end of tax sheltering as a motivation for real estate investment—in many respects it went too far in its impact on real estate.

As a result of the 1986 Act and of market forces and other legislation enacted to deal with problems arising therefrom, real estate values have plummeted, there has been a significant restructuring of real property ownership, and a dramatic growth in the number of bankruptcies and workout agreements for distressed properties. These changes obviously affected developers and owners, but they also have seriously damaged the financial institutions that provide debt and equity capital for real estate development and acquisition, forced them to shrink their loan portfolios and investments, greatly restricted the rollover of existing loans on healthy real estate, and seriously limited new lending for all types of businesses. In addition, the 1986 Act played a substantial role in creating the current immense real estate holdings of the financial institutions and of the RTC and other federal government agencies.

The provisions of the 1986 Act of most concern to our industry are those that have fundamentally changed the way real property is developed, owned, and operated by distorting investment decisions through rules that unfairly discriminate against real estate.

The most serious of these is the per se passive treatment of all rental real estate activities which subjects rental real estate to restrictions not imposed on any other trade or business activity.

Also, the depreciable life allowable for commercial real estate was increased by more than sixty percent (60%), and the tax on capital gains was increased to that applicable to ordinary income.

III. THE PASSIVE ACTIVITY LOSS LIMITATIONS

A. The Provisions

The passive loss provisions of the 1986 Act (Section 469 of the Code) limit the deduction of losses from passive activities to the amount of income or gain from passive activities, and, thus, prevent passive losses from being offset against active income or investment portfolio income. A passive activity is generally defined as a trade or business in which a taxpayer does not "materially participate," except that all rental activities, including rental real estate activities, are classified as passive activities without regard to the participation of the taxpayer. To materially participate in non-rental activities, a taxpayer must be "involved in the operations of the activity on a basis that is regular, continuous, and substantial."

In addition, there is a special rule which allows persons who "actively participate" in rental real estate activities to offset up to "$25,000 in losses from such activities against all income. This exemption phases out at incomes between $100,000 and $150,000 (with higher limits for low-income housing). Active participation requires at least a 10 percent interest (which is not a limited partnership interest) in the property and participation in the form of making significant management decisions.

In 1988, the Treasury issued 266 pages of regulations defining "material participation" under the passive loss rules. This definition is stated in terms of the number of hours the taxpayer spends on an activity (500 and 100 hours are sufficient depending upon the situation), and includes references to the taxpayer's participation in prior years and the extent of participation of other taxpayers in the activity. In 1989, the treasury issued an additional 195 pages of regulations defining what constitutes and "activity" under the passive loss rules and many pages of further regulations have been promised and are due.

B. Impact on Real Estate and the Economy

For those actively engaged in the real estate business, the most severe disadvantage of the passive loss rules is that they create an unnatural and quite unfair division within real estate trades and businesses that severs rental real estate from all other real estate undertakings, such as development, management, etc. This is because all rental activities are conclusively considered passive by Section 469, whereas all other activities are only considered passive if the taxpayer does not materially participate in them.

Thus, as a result of the 1986 Act, those who develop, construct, rent, manage, lease, and sell real property find that their rental real estate activities normally produce only passive income or loss, while their other real estate activities produce active income or loss if they materially participate in them, but passive income or loss if they do not. (In this regard, the Proposed Regulations promulgated by the Internal Revenue Service, in as broad a spectrum of circumstances as possible, seek to compel those in real estate to treat virtually all non-rental activity income as active, rather than passive income.) Since passive losses cannot normally be deducted against active and portfolio income, this discriminatory treatment of real estate creates an untenable and unjustified tax result, one that taxpayers conducting other kinds of trades and businesses do not face.

The passive loss rules fail to recognize that rental properties may produce actual out-of-pocket losses and may suffer severe reductions in value. Unlike all other business activity losses, passive losses may not be offset against active income. This results in tax treatment that is contrary to economic reality. Despite the fact that the real estate developer-owner-operator invests large sums of capital, may guarantee a significant amount of loans, is truly at risk for these amounts, and works on a full-time basis on a project, he is treated as a mere investor. In effect, the real estate developer-owner-operator with a property operating at a loss, which always is so in a startup and which is not uncommon when the economy is slow (as is abundantly clear today) must provide equity to the property from after tax dollars to offset the losses. This situation is not justified on any tax or economic policy basis and is not necessary to prevent tax shelters.

Because of these defects, the passive loss rules exacerbate the financial institution crisis by inhibiting the work-out of distressed properties that produce losses that may not be offset against active real estate or other income.

The real estate industry has always been cyclical, but in the past the ability of skilled developer-owner-operators to see distressed properties through hard times and to acquire and work-out the distressed properties of others has mitigated the costs to the financial institutions and investors involved and to the economy in general. The operation of the passive loss rules and the resulting impact of the dramatic drop of real estate values on financial institutions has made the down part of this cycle much deeper than usual.

Unfortunately, the passive loss rules as applied to persons in the real estate business limit their traditional role in the self-correcting process of the real estate cycle. The passive loss rules simultaneously encourage defaults by owners unable to fund losses from after tax dollars and discourage the purchase of troubled properties by real estate developer-owner-operators who are unable to fund the continuing losses of these properties during a work-out period because they are unable to offset these losses against their real estate income. This drives down property values in many markets, further accelerates the negative spiral of the crisis of the banks, insurance companies, and other financial institutions, intensifies the credit crunch, and requires the infusion of billions of dollars of public money into the financial institutions and real estate.

C. The Solution to the Passive Loss Problem

To rectify the inequitable and substantial economic impact of the passive loss rules on real estate, the financial system, and the public treasury, ICSC supports the legislation amending the passive loss rules introduced in the Senate by Senator David Boren (D-Okla.) (S. 1257) and in the House by Congressman Michael A. Andrews (D-Tex.) and William M. Thomas (R-Calif.) (H.R. 1414).

This legislation provides that, with respect to taxable years beginning after December 31, 1991, the rental real property operations, undertakings, and activities of an individual "engaged in the real property business" will be treated, for purposes of Section 469, in the same manner as the non-rental trade or business operations, undertakings, and activities of such an individual. Under this approach, once an individual is considered "engaged in the real property business," such individual must in addition materially participate with respect to an activity if the individual is to have active income or loss from it.

An individual is treated as "engaged in the real property business" if the individual spends at least 50 percent of his or her working time in real property operations and spends more than 500 hours during the taxable year in real property operations. This concept involves two straightforward definitions. The first is that "real property operations" means any real property development, redevelopment, construction, conversion, rental, management, leasing, and similar operations. The second is that "working time" means any time spent as an employee, sole proprietor, S corporation shareholder, partner in a partnership or beneficiary of a trust or estate.

A closely held C corporation will be considered "engaged in the real property business" if one of two alternative criteria regarding the activity of the owners and.employees is met.

Only those actively engaged in the real estate business will benefit from the legislation and it merely places them on the same plane as those in other trades or businesses. Those outside of the real estate industry who attempt to use rental real estate as a means of sheltering income from their true trades or businesses, as indicated by where they spend their working time, will receive no benefit from the legislation.

The proposed legislation will have the immediate impact of reducing federal expenditures to resolve the problems of the financial institutions and the distressed real estate held by them and the federal government. This would be accomplished by making it possible, as current law does not, for real estate professionals to carry-out their traditional role of mitigating the costs of the real estate down cycle by acquiring distressed properties from such institutions, the Resolution Trust Corporation, and private entities and by then carrying such distressed properties and those that they already hold until they are turned around. As a result, real estate markets and prices will be stabilized earlier and at higher levels.

In determining the cost of the legislation, if any, to the federal government, these major reductions in federal expenditures must be set off against the estimated revenue loss of the legislation. The accounting firm of Peat, Marwick and Main two years ago estimated the revenue loss of the legislation over 5 years as $2.3 billion, and recently the Joint Committee on Taxation made a "preliminary" estimate of a revenue loss of $5 billion over 5 years from the legislation.

We believe that the Committee, and the Congress, should pass this legislation as quickly as possible in order to rectify, at least prospectively, the inequities and the damage to the economy and the public treasury of the passive loss provisions of the 1986 Act. IV. Capital Gains

A. Law Prior to the 1986 Act

Prior to 1987, assets such as corporate stocks and bonds, land, and depreciable property used in a trade or business, were accorded special "capital gain" treatment on disposition, which resulted in a tax rate lower than the ordinary income tax rate.

From 1921 to 1987, noncorporate capital gains were taxed at reduced rates. From 1942 to 1987, land and depreciable real property used in a trade or business were accorded net capital gain and ordinary loss treatment. From 1921 to 1942, a maximum 12.5 percent tax rate was prescribed for capital gains. From 1942 to 1986, the basic structure of the capital gains tax was an exclusion of a portion of the gain from income (50 percent from 1946 to 1978 and 60 percent from 1978 to 1986) with a tax rate lower than the ordinary income rate applied to the nonexcluded portion of the capital gain.

B. 1986 Act and the Budget Agreement

The Tax Reform Act of 1986 repealed the capital gains tax preference for all assets. Thus, all gains were taxed at the same rates as ordinary income.

However, even so, rules regarding capital gains, such as Section 1250 dealing with recapture, were left on the books in case a capital gains differential was reinstituted.

As part of last year's budget agreement, a top rate of 31% was instituted for ordinary income, but the top rate for capital gains was left at 28%.

C. Preferential Treatment for Capital Gains

1. Proposal and Guidelines

ICSC believes that Congress should act to restore significant preferential tax treatment for capital gains as soon as possible in order to restore the depleted value of real estate, to improve long-term productivity, and to improve the Nation's competitiveness (most of our competitors do not tax, or impose a very low tax, on capital gains). There are many different ways to address this problem, as the various proposals by members of Congress and the Administration indicate, but ICSC believes that any solution to the capital gains problem should be based on the following principles:

a. Capital gains from capital assets such as real estate should be taxed at a lower rate than ordinary income.

b. Capital gains relief should not require full recapture of depreciation for real estate.

c. There should be no discrimination between new and existing property.

d. There should be no discrimination between corporate and non-corporate taxpayers.

2. Reasons

a. Lower Rate of Tax on Capital Gains

Because of inflation, each year that passes since the 1986 Act increases the distortion of investment patterns, especially for assets held for long periods of time, such as real estate. Even low rates of inflation mean that individuals who sell capital assets at a nominal profit are paying tax on a "fictional" element of profit represented by inflation.

In addition, the "penalty" of paying ordinary rates on the gain from the sale of property "locks-in" real estate investments and impairs the free alienability of real estate. This prevents real property from employment in its highest and best use, which is vital to the functioning of an efficient economy and to improving productivity.

Moreover, when gain, both real and inflationary, that has accumulated over several years is taxed in one year, "bunching" occurs. This pushes the income of the taxpayer, including the income that otherwise would have been taxed at a lower tax rate, into a higher tax bracket in that year. The "bunching" problem typically is more severe for assets such as real estate that are usually held for a long time because more years of accumulated gain are taxed in one year.

b. No Full Recapture of Depreciation for Real Estate

Capital gains relief should not require full recapture of depreciation for real estate. In the past, Congress has never required the recapture of depreciation deductions taken for real property under the straight-line method. This is because the relatively long period of time that real property is typically held assures that much or all of the gain above the adjusted basis remaining after cost recovery by the straight-line method is attributable to inflation, to changes in general economic conditions, and to changes in the neighborhood of the property rather than to an absence of deterioration in the real value of the property. It is fair to say that the depreciation allowances under current depreciation lives for real estate are less than economic depreciation (the loss of the market value of physical assets through use and obsolescence) for most real estate, especially with the increasing obsolescence resulting from competition and the demand for modern, technologically efficient buildings.

c. New and Existing Property Should Be Treated the Same

New property should be treated the same as existing property because all of the reasons supporting preferential capital gains treatment apply equally to new and existing property. It makes no sense and would be unfair to tax all prior years inflationary gains at ordinary income rates for existing property, but tax such gains for new property at lower rates.

d. Corporate and Noncorporate Property Should Be Treated the Same

Property held by corporations should be treated the same as property held by individuals, since the reasons supporting preferential tax treatment for capital gains apply without regard to the legal form of the entity holding the property.

V. CONCLUSION

ICSC urges the Committee and the Congress to act promptly to implement the tax changes suggested above

STATEMENT OF THE JEWELRY COORDINATING COMMITTEE

When an industry is in crisis, as is the jewelry industry today, it comes together in common cause. The imposition of a Federal luxury tax on jewelry precipitated the crisis, and the industry response was the formation of the Jewelry Coordinating Committee, a non-incorporated membership organization comprised of all of the leading trade associations within the U.S. jewelry industry. The membership includes the following:

- **American Gem Society**, Los Angeles, CA — A North American association of 1,500 retailers and 144 manufacturer/wholesalers of fine jewelry. Members are required to maintain high ethical standards and strong gemological knowledge. Titleholders must be tested and certified annually.
- **American Gem Trade Association**, Dallas, TX — Represents more than 500 direct importers, miners, cutters, and manufacturers of colored gemstones in the U.S.
- **American Watch Association**, Washington, DC — A national association of 45 U.S. companies representing major watch brands.
- **California Jewelers Association**, Los Angeles, CA.
- **Cultured Pearl Association of America**, New York, NY — A national association representing cultured pearl importers and wholesalers to promote cultured pearl jewelry and fair trade practices in the U.S.
- **Diamond Council of America** — A national, not-for-profit educational foundation serving more than 2,000 retail jewelry stores in the U.S.
- **Diamond Manufacturers & Importers Association** — A NY-based organization representing 2,000 members.
- **Jewelers of America, Inc.**, New York, NY — A national association representing more than 12,000 specialty retail jewelry firms operating over 20,000 outlets in all 50 states.
- **The Gold Institute**, Alexandria, VA — A non-profit trade association founded in 1976 that represents miners, refiners, fabricators, and wholesalers. The institute has 80 corporate members in 15 nations, and its members account for 85 percent of U.S. gold production.
- **The Jewelers Board of Trade**, Providence, RI — A not-for-profit trade association which provides its 3,200 members with credit reporting and collection services on 40,000 jewelry operations in the U.S.
- **Manufacturing Jewelers & Silversmiths of America, Inc.**, Providence, RI — A national organization representing more than 2,300 manufacturers of jewelry and suppliers to the industry operating in all 50 states.
- **National Association of Catalog Showroom Merchandisers**, East Northport, NY — A national trade association representing catalog showroom discount retailers operating close to one thousand (1,000) stores. The industry does approximately $7 billion in annual sales in a wide variety of brand name products, with a large percentage of sales in jewelry.

The Jewelry Coordinating Committee wishes to submit the following comments regarding legislation to lead the country out of the current economic doldrums. We believe that repeal of the excise tax on luxury items is essential and will contribute to the relief of our industry, which is mired in the worst sales decline in recent history. Even in the midst of the Christmas selling season, which is traditionally our industry's brightest time, there is little to cheer our members. We are not certain how many of our members will be around next year, but we can confirm that the number of store closings will be staggering.

We strongly opposed the imposition of the luxury tax on jewelry last year because we believed the tax hurts nearly everyone but the rich. Symbols may have their place in political compromises, but when it can be shown that the symbolic reason is not being served by the legislation, as in this case, then we submit it is the wiser course of action to acknowledge that a mistake has been made, however well-intentioned the reason for its use.

No one is being served by this tax. Certainly not the U.S. Treasury, which may have a revenue loser on its hands; certainly not the thousands of workers who have lost their jobs; and, certainly not the risk takers in the affected industries whose livelihoods have been placed in real jeopardy. And, we must ask, to what end does the tax serve the nation? It is, we must conclude, a failed political symbol. We appeal to you to support S. 1261 and repeal the luxury tax before greater harm is done to our economy.

First, the mere imposition of the tax has had a significant impact on jewelry sales. Not only does it reduce interest in the purchase of items subject to the tax, but consumer perception is that there is now a tax on all jewelry, and this hurts sales across the board. In retailing, perception is a powerful influence. Whether a luxury tax affects their purchase or not, the consumer will be hesitant if there is an excise tax. The jewelry industry is already suffering under current economic conditions. This tax unquestionably makes a bad situation worse. The jewelry industry lived with a "temporary" excise tax for 22 years until its repeal in 1965; we know only too well the negative impact this tax can have on our business. Obviously, the jewelry industry did everything possible to stop the enactment of a patently discriminatory tax, which was neither the subject of Congressional hearings nor extended legislative debate.

Second, the early evidence and the unmistakable data trends show that the luxury tax is not working to improve distributional tax effects. As this Committee has been shown, there is every reason to believe that the luxury tax is a revenue-losing and a job-losing phenomena. Although it is difficult to prove a negative, we are convinced the lost sales, with the full economic ramifications associated with lost opportunities, will exceed by many times any revenue collected by this tax. This is an unconscionable result that will inevitably diminish the integrity of the tax system. We cannot, nor should we, allow it to happen. As trustees of the American economic system, we ask that our elected leaders do the possibly politically difficult but very necessary task and support repeal of this tax.

Third, the rules necessary to administer this tax are cumbersome and unwieldy. Both compliance and enforcement are made difficult by the legislative language adopted by Congress. While there are a host of problems, one particular problem created by the law has virtually guaranteed the failure of the law. In a recent IRS hearing on the subject, held on April 29, one witness aptly referred to the luxury excise tax as a "tax on honesty," which only penalizes those jewelers and customers who choose to comply with this burdensome law.

The law requires a retail jeweler to pay the tax on the entire fair market value of an item whenever the customer furnishes the materials for the item. What is referred to as "the grandmother's ring" problem is illustrated by the circumstances when a grandchild inherits a diamond ring with a current market value of $20,000 and the grandchild wishes to have the diamond reset in a modern setting of $1,000. Under the law, the luxury tax on this transaction would be $1,100. The tax exceeds the value of the underlying service transaction — a very unfair result.

The grandmother's ring, of course is not the only example. It is hard to explain to a customer who bought a $15,000 diamond ring after January 1, 1991 and paid a $500 tax, that he must pay a second tax because his wife wants him to have the ring reset as a diamond pendant necklace. Women frequently have diamond engagement rings remounted after a number of years of marriage. Likewise, as in the grandmother's ring example, grandchildren often inherit grandmothers' rings, bracelets, and pendants and have them remounted in more modern settings. We would like to believe Congress did not contemplate inclusion of one of the most common transactions in retail jewelry stores within the term "production." We know the IRS has received hundreds of letters from retail jewelers on this law. We would like to share with you only one letter. It was written by two customers in California to a retail jeweler, Roger Marks. We believe it illustrates the impact of these rules on the general public:

"3/17/91

To Whom It May Concern:

My boyfriend and I are planing on getting married this year. We have been searching for just the right ring. Last week my grandmother told us that she was giving us her engagement ring, which was given to her by my grandfather in the late 1920s. We were very surprised, I couldn't believe I was getting such a beautiful ring. We started looking for just the right setting that would compliment her diamonds. We went to Roger's Jewelers and found the perfect setting. After picking out the setting, I was told by Rob Roberson, manager of Roger's, that there is a new luxury tax law we need to be aware of. As of January 1st, 1991 you have to pay 10 percent of any luxury item over $10,000. Rob showed us the information in writing. We were appalled that we have to pay tax on my diamonds that were a gift from my grandmother. This is a gift both of us will cherish for many years. Why should we have to pay tax to the government when we didn't buy anything? This new law is wrong; we feel we are being taken advantage of by the government again!!

Sincerely,

Jodi Antelman and Ely Albalos"

The bottom line is we must repeal this ineffective tax. When Congress repealed an earlier excise tax on jewelry in 1965, the Ways and Means Committee noted such taxes were a source of undesirable discrimination. The Committee stated: "These selective excise taxes tend to reduce sales and therefore reduce income and jobs in industries that produce the taxed goods. In these ways, selective excise taxation results in arbitrary and undesirable distortion in allocation of resources and in this manner interferes with the free play of our competitive market."

Recently, firms in our industries have collected petitions signed by their employees, expressing concern over this tax. We have received several thousand of these petitions, representing perhaps 65,000 or more employees. On October 1, the leadership of our industry came to Washington and presented them to you and your colleagues.

Finally, while our comments today focus on the excise tax, please count us among those urging you to act quickly to enact an economic recovery package. We see the devastating impact of the current situation each day in our industry. Just as the perception of a luxury tax has dampened all jewelry sales, the perception of a sour economy has become solidly entrenched in the minds of the consumer. It will now take affirmative action to restore confidence. We urge you to repeal the luxury tax as soon as possible.

/L1942B

Statement of the Labor Council for Latin American Advancement

The Labor Council for Latin American Advancement (LCLAA) speaks for 1.4 million Hispanic workers in the United States and Puerto Rico who are affiliated with AFL-CIO international unions. As national president of LCLAA, I appreciate the opportunity to submit testimony to the U.S. Senate Committee on Finance on various proposals to provide middle-class tax relief, economic growth, and tax equity and fairness.

The tax policy of the 1980's was extremely unfair for working-class Hispanics. Congress has been financing the government largely on the backs of those who are least able to pay, including low- and middle-income Hispanic workers. Since 1977, after-tax incomes for families earning approximately $32,000 per year have fallen by eight percent. Families earning approximately $8,130 per year -- a large number of them Hispanic households -- have seen their average after-tax income fall by 12 percent during the same period. In contrast, the wealthiest one percent of American families have seen their after-tax incomes rise by a staggering 136 percent since 1977. Basically, the rich went to the party in the 80's, while the rest of us are still waiting for our invitations.

How did this happen? It's easy to understand when you take a close look at the failure of supply-side economics. From 1965 to 1970 the wealthiest Americans paid approximately 70 percent of their total income in federal income taxes. In 1981, the first year of the Reagan tax cuts, that rate was slashed to 50 percent. In 1991, the Congress cut the rate to 31 percent. Meanwhile, working people, those who make approximately $32,000 per year, are paying $280 more in taxes per year, while the wealthiest one percent are saving approximately $83,450 in yearly taxes.

It is wrong that the people least able to pay, low- and middle-income workers, have had to assume a greater portion of the tax burden in the United States. While the wealthy received tax breaks and loopholes, the working class paid for it through higher payroll taxes and increased consumer excise taxes -- the most regressive of all taxes. It is time to balance the scales of tax fairness in this country.

LCLAA applauds the efforts of Congress to find a fair and equitable solution for providing middle-class tax relief so desperately needed. However tax relief comes at a price, and it must be paid for fairly and honestly by rolling back some of the huge, Reagan-era tax cuts now enjoyed by the very wealthy.

We urge Congress to continue to look to progressive tax reform to provide middle-income tax relief. We need a new, fiscally-responsible program which will ease the burden of low- and middle-income Hispanic working people in this country.

Hispanic working families are struggling to keep their heads above water. They are responsible, dedicated and hard-working Americans and should not be forced to carry an unfair tax burden. The economic policies of the last decade have damaged their well-being, but not their spirit. They are willing to pay their fair share, and demand the wealthy pay theirs.

The Labor Council for Latin American Advancement urges Congress to adopt a middle-income tax relief program based on progressive taxation and economic justice. We urge the members of the Committee to stand up to the loophole lobby, reject costly new tax-shelter gimmicks and unite behind a responsible, revenue-neutral middle-class tax cut plan next year. It is time for America's wealthy to pay their freight for the free ride they have received over the past decade, while contributing to this country's growing tax problem and the current recession.

STATEMENT OF PROFESSOR EDWARD RENSHAW[1]

AN ECONOMIST'S "LAG" IS THE POLITICIAN'S NIGHTMARE OR IMPROVING THE EFFECTIVENESS OF MONETARY AND FISCAL POLICY BY REDUCING THE LAGS

The payroll employment recession—which began in June 1990, registered an anemic recovery from May to September, and plunged almost to a new low in November—will soon have the distinction of being the most protracted employment recession in the post World War II period. The previous record was the 17 month decline from July 1981 to December 1982 when more than three percent of the employees on nonagricultural payrolls lost their jobs.

The possibility that employment recessions, instead of getting shorter and easier to cure, are actually getting more protracted and difficult to get out of makes it appropriate to reexamine some of the more talked about remedies for recessions with a view to improving their timeliness and effectiveness. Most textbooks in macroeconomics devote several pages to the problem of lags in monetary and fiscal policy but do not pay much attention to how they might be shortened. This is unfortunate since the economist's lag, in the words of former Secretary of State George P. Schultz, "may be a politician's catastrophe."

One type of fiscal policy with a relatively high multiplier that has been tarnished by the image of a long implementation lag is investment in public works. The expenditure lag may be quite long for new projects that must be debated, planned, subject to extensive hearings, approved, budgeted and gradually implemented. There are many well established programs for funding the repair and construction of roads and other types of social infrastructure, however, with a backlog of projects that have already been started and could be accelerated. Most state and local governments also have some projects which have been approved and could be started fairly quickly if the money were available.

In 1937 John Maynard Keynes noted that, "Public works even of doubtful utility may pay for themselves over and over again at a time of severe unemployment, if only from the diminished cost of relief expenditures." Not to have an in place mechanism for accelerating spending on social infrastructure during economic recessions is stupid since history would suggest that voters do hold incumbents responsible for what happens to the economy.

Since the election of Herbert Hoover in 1928 no political party has been able to retain control of the White House if there was a recessionary decline in economic activity (as defined by the National Bureau of Economic Research) in the presidential election year or a recession that over lapped the preceding year. Hoover in 1932, Nixon in 1960, Ford in 1976 and Carter in 1980 were all victimized by economic recessions of varying duration and intensity.

The perception of very long lags for public works has caused many economists to favor recessionary tax cuts to stimulate economic recovery. The problem with unrestricted tax cuts is the possibility of a very small multiplier effect. Nobel Laureate Robert Solow has suggested that a temporary one dollar tax cut "is likely to generate only 30 to 40 cents of additional consumer spending." This can be contrasted to an increase in total spending of perhaps $2 for each one dollar of expenditure on public works.

Tax cuts, on the other hand, could have a high multiplier if they were conditional upon actual expenditure by consumers for big ticked items. There have been several occasions in the last decade when the auto industry was able to get rid of excess inventory without tipping the US economy into another recession by offering factory rebates of a temporary nature to persons who were willing to invest in a new car.

Expenditure by consumers for motor vehicles and parts in 1987 dollars declined by more than 21 percent from the third quarter of 1989 to the second quarter 1991. A tax credit of say $1,000 for every new American built car that is sold in 1992 would cost the Federal government less than $10 billion and by helping to revive an industry that is depressing consumer confidence and economic activity in other industries might actually pay for itself in increased tax revenues in a year or two.

It has been suggested that first time home buyers should be allowed to make penalty free withdrawals from their IRAs. If these withdrawals were limited to recessionary periods when real GNP is growing at a below average rate, or unemployment is excessively high, it would help to stabilize the US economy and might even reduce the federal budget deficit since most first time home buyers would have to

[1] Professor Renshaw is the author of "Deferred Income Accounts," *Challenge*, September 1980; "Presidential Elections and the Federal Reserve's Interest Rate Reaction Function," with Emery Trahan *Journal of Policy Modeling*, 1990; "A Keynesian View of the US Budget and Trade Deficits," *Public Finance*, 1990; "It's Time Again to Heed Keynes," *Times Union*, November 17, 1991 and *The Forecaster's Almanac* to be published by Business One Irwin in March 1992.

borrow far more than they withdraw to finance the purchase or the construction of a first home. Any loss in federal tax revenue, in any event, would be at the expense of future tax collections.

THE PROBLEM OF MONETARY LAGS

The Fed can lower short term interest rates almost instantly. Financial innovations such as checkable deposits that pay market rates of interest and money market mutual funds, however, may have reduced the effectiveness of lower interest rates at stimulating an economic recovery.

Between December 1990 and September 1991 personal interest income declined by $20.1 billion dollars on a seasonally adjusted annualized basis. During the same period of time the interest paid by consumers to business enterprises only declined by $2.6 billion. This erosion of consuming power has helped to stall the recovery of industrial production and payroll employment which began in April 1991 and might turn out to be the straw which tipped the U. S. economy into a prolonged recession.

Lower interest rates are suppose to stimulate borrowing and investment. Since the September 1990 peak in industrial production, however, commercial and industrial loans outstanding have been reduced by almost $40 billion on an seasonally adjusted annualized basis. Consumer installment credit outstanding has also been reduced by about $10 billion dollars. The reduction in credit outstanding is partly the result of a fit of over borrowing and lending during the 1980s which has bankrupted many developers and left the United States with a more fragile and risk averse banking system.

It may also be related to a shrinkage of loanable funds in response to relatively higher yields on long term bonds, foreign securities and some types of common stock. During the five month interval from April to September 1991, M–2 declined by more than ten billion dollars and the broader monetary aggregate M–3 by almost 45 billion. A fear of deposit losses may be keeping many banks from making loans to credit worthy customers.

If savings trickle out of the banking system in response to higher returns on other types of financial assets and many consumers and business enterprises that depend on bank credit are unable to borrow, there is a haunting possibility that lower interest rates might have a negative effect on investment as well as consumption.

To counter the possibility that conventional monetary policy might not be as effective at stimulating an economic recovery as it use to be I believe that the Federal Reserve should be allowed to make long term loans to member banks during economic recessions.

Banks are now required to keep more than $50 billion of required reserves on deposit at the Fed. As of September 1991 member bank borrowing only amounted to $645 million compared to almost $3 billion in September 1989. If the Fed were encouraged to manage its own lending in a contra cyclical manner it would help to reverse the downward trend in the supply of loanable funds and might revive investment spending enough to get the US economy moving upward again.

In 1752 the philosopher and economist David Hume noted, "It is no manner of consequence, with regard to the domestic happiness of a state, whether money be in a greater or less quantity. The good policy of the magistrate consists only in keeping it, if possible, still increasing; because by that means he keeps alive the spirit of industry in a nation."

The best way for the Fed to accomplish this time honored objective, I believe, is to assure commercial banks that if they do make more loans to business enterprises for investment purposes and deposits continue to flow out of the banking system in response to higher returns on other types of financial assets, it will provide what ever credit is necessary from its discount window to keep the broader monetary aggregates from trending downward.

ROBERT A.WARWICK
10018 Contessa Drive
Glen Allen, Virginia 23060

December 4, 1991

Mr. Wayne Hosier
U.S. Senate Committee on Finance
Washington, D.C. 20510

Re: Tax Relief for Middle Income Families

Dear Mr. Hosier:

I submit the following in response to the Committee's invitation for written statements to be included in the record of the hearing held on November 26. For the record, during the past 18 years, I have been a lawyer heavily involved in tax matters and am currently employed as Tax Counsel for a major corporation. The views expressed herein, however, are my own and not necessarily those of my employer.

The focus on tax relief for middle income families offers the opportunity to encourage taxpayers to increase productive activity and boost the economy out of its doldrums. Unfortunately, the plans advanced thus far fail to seize this opportunity. These plans tend to emphasize obvious and conventional approaches, typically increasing deductions, exclusions or credits of one kind or another. But by offering benefits tied to the taxpayer's current activities, these plans do nothing to reward the increased effort needed to boost the economy. Furthermore, some of plans seek to pay for themselves by increasing marginal rates; in so doing they discourage productive effort and exacerbate present economic difficulties.

Common sense -- as well as experience -- tells us that the way to encourage middle income -- as well as other -- taxpayers to increase their productive efforts is to reduce marginal rates. Although marginal rate reductions are often spurned as a give-away to the "wealthy", properly structured rate reductions, paid for through broadening and expansion of the tax base, can target tax reductions toward middle (and lower) income families.

Specifically, the Committee should consider:

i) Reducing the current 15%, 28% and (nominal) 31% marginal rates to 10%, 20% and 25%, respectively and eliminating all "back door" rate increases (i.e. phaseouts).

ii) Broadening the tax base by imposing the reduced rates directly on adjusted gross income (AGI) and, to prevent lower and middle income taxpayers from being subjected to the highest rates, raising the break points to $50,000 and $100,000 (indexed as under current law) for a joint return with similar increases for other categories of taxpayers.

iii) Allowing taxpayers to claim a credit, equivalent to the value of the taxpayer's personal exemptions and itemized or standard deductions at the lowest rate (for example, a credit of $215 or 10% of $2,150 would be substituted for the current personal exemption) but limiting the credit on any return to an amount equal to the break point between the 10% and 20% rates ($5,000 -- equivalent to $50,000 in deductions and personal exemptions -- for a joint return).

In connection with these changes, the Committee should also consider:

iv) Taxing long term capital gains separately from ordinary income, either at a flat rate of 10% or a dual rate with gains up to $25,000 per year taxed at 7.5% and gains in excess of that amount taxed at 15%, so that middle income taxpayers with extraordinary gains are not pushed into higher brackets and allowing excess capital losses to be carried back for two years and carried over indefinitely.

v) Eliminating the alternative minimum tax on individuals and bringing abusive tax preferences into AGI.

Taxpayers with AGI of $50,000 or less would benefit substantially from this approach: they would suffer no tax increase as a result of substituting the credit for their personal exemptions and deductions but would benefit from the reduced rates. Middle income taxpayers with AGI over $50,000, especially those with relatively small deductions would also see reductions, although in percentage terms less than those with AGI of $50,000 or less. And, because they will retain a larger proportion of any increased income, these taxpayers will be encouraged to work, save and invest.

For upper income taxpayers, who generally are able to shelter greater amounts of income, the benefits of the lower rates will be overcome by the loss of deductions, resulting in higher tax bills. However, the opportunity to keep a larger proportion of increases in income should encourage even these taxpayers to increase their productive efforts.

A few examples comparing income taxes under current law and this proposal are attached. Although somewhat simplified, these examples show that this proposal substantially reduces income taxes for middle income taxpayers while increasing -- often substantially -- taxes paid by upper income taxpayers on current income.

This proposal even results in an income tax that is more progressive than the present tax. The proposed top rate is 2.5 times the lowest rate and 20% higher than the middle rate, as opposed to a current top rate that is just over twice the lowest rate and only about 11% higher than the middle rate. And, by capping tax benefits and applying them against the bottom rate instead of the top rate, the proposal insures that taxpayers with higher incomes will actually pay the highest rates.

Little, if any, consideration has been given to reducing marginal rates as a means of relieving the tax burden on middle income families. Yet rate reduction, unlike the more conventional plans being advanced, offers middle income families not just lower taxes in their present circumstances but also incentives to work, save and invest. The marginal rate reduction approach deserves the Committee's serious consideration.

I would be happy to respond to any questions the Committee or staff might have regarding this proposal. Feel free to contact me at (804) 281-4607.

Respectfully submitted,

Robert A. Warwick

Robert A. Warwick

Enc.

CURRENT LAW VS. PROPOSAL (1991 Rates)

Family of Four Filing Joint Return

	Middle Income Taxpayers				
Adjusted Gross Income	35.000	50,000	75.000	90,000	100,000
Pers. Ex. & Deductions	13.770	17.500	25,000	30,000	35,000
Taxable Income	21,230	32.500	50,000	60,000	65,000
Income Tax (Present Law)	3.185	4.875	9.580	12,380	13,780
Tax pre- Credit(Proposed)	3,500	5 000	10.000	13,000	15,000
Credit	1.377	1.750	2,500	3,000	3.500
Income Tax (Proposed)	2,123	3.250	7.500	10.000	11,500
Savings Under Proposal	1.062	1,625	2.080	2,380	2,280

	Upper Income Taxpayers				
Adjusted Gross Income	250.000	500.000	750.000	1.000,000	3,000,000
Itemized Deductions	85,000	170.000	250.000	350.000	1,000,000
Deduction Phasseout	4,500	12,000	19.500	27,000	87,000
Net Itemized Deductions	80,500	158.000	230,500	323.000	913,000
Pers. Ex. (inc. Phaseout)	1.720	0	0	0	0
Taxable Income (Current)	167.780	342,000	519,500	677,000	2,087,000
Income Tax (Current Law)	45,127	99,136	154,161	202,986	640,086
Tax pre-Credit (Proposed)	52,500	115,000	177,500	240,000	740,000
Credit	5,000	5,000	5.000	5,000	5,000
Income Tax (Proposed)	47,500	110,000	172,500	235.000	735,000
Savings Under Proposal	(2,373)	(10.865)	(18,340)	(32,015)	(94,915)

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