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PRESIDENT'S ECONOMIC PLAN

HEARINGS

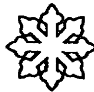
BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

FEBRUARY 24, MARCH 24 AND 25, 1993



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PRESIDENT'S ECONOMIC PLAN

WEDNESDAY, FEBRUARY 24, 1993

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

The hearing was convened, pursuant to notice, at 10:02 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Daniel Patrick Moynihan (chairman of the committee) presiding.

Also present: Senators Baucus, Boren, Bradley, Mitchell, Riegle, Rockefeller, Daschle, Breaux, Conrad, Packwood, Dole, Roth, Danforth, Chafee, Durenberger, Grassley, Hatch, and Wallop.

[The press release announcing the hearing follows:]

[Press Release No. H-2, February 22, 1993]

TREASURY SECRETARY BENTSEN TO TESTIFY ON THE PRESIDENT'S ECONOMIC PLAN

Sen. Daniel Patrick Moynihan (D.-N.Y.), Chairman of the Senate Committee on Finance, announced today that the Committee will hold a hearing on the economic plan the President announced in his State of the Union address. The Secretary of the Treasury, Lloyd Bentsen, will be the only witness at the hearing.

The hearing will begin at *10:00 a.m. on Wednesday, February 24 in room SD-215, Dirksen Senate Office Building.*

The President has proposed a three-part plan for raising the living standards of all Americans. First, he has proposed a $30 billion stimulus package to create jobs. Second, in order to increase both public and private investment in the country, the President is proposing a $160 billion investment plan. Finally, he is proposing the largest deficit reduction package in U.S. history—almost $500 billion over 4 years to secure long-term economic growth.

"The objective of the hearing is to provide the Committee an opportunity to assess the President's economic plan," Senator Moynihan said. "We are delighted that our former colleague, Secretary Bentsen—the chief economic spokesperson for the administration—will testify on all aspects of the economic plan."

Senator Moynihan has also requested written comments from the public on the President's economic plan. Additional hearings on the economic plan will be held in the future.

The President's economic plan is described in *A Vision of Change for America,* available from the Government Printing Office.

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

The CHAIRMAN. A very good morning to our most distinguished guests who have the distinction of appearing in our newly refurbished quarters.

I can tell you that these lights will be dimmed in the course of a week or so. And you can see the zodiac up there by which we may define our future from time to time.

Could I say that at the end of the Secretary's appearance, we will have the opportunity to report out the Emergency Unemployment

Compensation Amendments which we heard of from Secretary Reich last week. I would hope that members might stay on hand so a quorum would be present.

Now, this is a very special moment. It is the first appearance, in his capacity as Secretary of the Treasury, of our former chairman and our most esteemed friend, Senator Bentsen. He is here to discuss the President's economic proposal.

And if I may begin on a bipartisan note for which this committee is well and deservingly renowned, I would note that an article appears in the New York Times this morning, by Herb Stein, who was a most able Chairman of the Council of Economic Advisers under President Nixon, which is headed, "Let's Work with Clinton's Plan.".

He begins with the statement that Bill Clinton's economic program is probably the most far-reaching effort ever made by a President to control the Federal budget deficit. "In light of the challenge and opportunity facing him and the country, it is somewhat disappointing still that the plan is the only place we have to start. And it needs support."

I think on that note, I will turn to my friend and sometime chairman, Senator Packwood.

OPENING STATEMENT OF HON. BOB PACKWOOD, A U.S. SENATOR FROM OREGON

Senator PACKWOOD. I want to give the Secretary all of the time we can this morning, Mr. Chairman.

The CHAIRMAN. Senator Bradley.

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

Senator BRADLEY. Mr. Chairman, if this is the precedent being set by the chairman and ranking member, I will make just a few comments.

I do not think we have a choice. I think the President has given us a very important package. Deficit reduction is essential for our children's future. It is essential for higher-living standards.

And it is incumbent upon us that if there are any changes offered, I in this package that the amount of money in deficit reduction cannot go below where we are now.

That has got to be a principle under which we operate. If somebody has a better idea for this or that, they ought to offer it. Not that this package is perfect, but it is certainly a major step in the right direction. And I believe it deserves our strong support to the extent that we can give it.

The CHAIRMAN. Senator Dole.

OPENING STATEMENT OF HON. ROBERT DOLE, A U.S. SENATOR FROM KANSAS

Senator DOLE. Mr. Chairman, thank you very much. And it is a pleasure to have Secretary Bentsen here.

I would just like to have my statement be put into the record and just touch on a few points.

Secretary Bentsen, I have a meeting with Prime Minister Major in a few moments. And perhaps we will be able to come back for questions and, if not, submit questions to the Secretary.

I think there is always a problem whenever any President sends up any budget package. I think we all agree with the underlying premise that we need to create jobs, let the economy grow, attack the deficit, and deal with the deficit.

And this is the committee where most of those decisions are made. The tough decisions are going to be made right here in this committee. And it seems to me that we have opportunities as well as the tough decisions coming up.

But as I look at the plan—and if it's not accurate, Mr. Secretary, I can correct it, but it looks like $360 billion in tax increases.

I have a little chart here. I will just hold it up here. What we are trying to show here is that 63 percent of this package is taxes. If you add in the user fees, it even makes it higher. The user fees tend to be taxes for most people.

And then, you have the interest savings, 13 percent, that nobody does anything about. Spending is about 18 percent of the package, but that is primarily defense.

So 63 percent goes for a net tax increase totalling $293 billion, then, the 18 percent net spending cuts that come out of defense.

And I think if you take a look at President Clinton's plan, it actually increases domestic spending over inflation over the next 5-year period.

I note in the morning papers that there has been a change in strategy, that we are going to have a vote on the budget resolution before we vote on the stimulus package so that members can say they voted to restrain spending before they voted to spend more money.

In my State of Kansas, the phone calls are now nine to one against the package.

They started off about even. There has been a steady erosion because people have gotten more facts, the farmers on the energy tax and other people on taxes generally.

Plus, a lot of people who may not pay increased taxes have discovered they are going to pay more in consumer prices. So indirectly, they are going to have a tax because they are going to pay more for their prices because of higher energy taxes and higher taxes on corporations and higher taxes on individual proprietors or partners on Subchapter S.

All these people who make $100,000 or $115,000 are not just individuals out there. The money comes from their business, businessmen and women. So it seems to me that we got some challenges.

And the question that I would ask is, whether or not we are going to follow the recovery or increase the recovery?

I think it is fair to say that the public can support a number of provisions in the package, whether it is a permanent R&D credit, capital gains, or enterprise zones. Those have gone through here before.

And I know that there has been a challenge to say, "Well, what's the Republican plan? Well, we don't think we ought to stifle debate on the Clinton plan this early. It's only been out a week."

We do not want to stifle debate on the President's plan. He did get elected President. And we certainly do not want to get in the way of some good vigorous debate on his package. Otherwise, I think it would be unfair to the American people just to talk about the future without talking about specifics.

One thing that we have talked about is that we say, "Well, the Republicans are for to eliminate all the spending and all the tax breaks." That is $245 billion. That is a pretty good start. That has been recommended by some, and up to the plan that produces the same amount of debt reduction as the Clinton Plan, and roughly one-third of the tax. So that might be a place to get started for anybody.

And again, I do not want to stifle debate on the President's plan. I think he deserves to have his plan debated and debated specifically, not just in generalities about the concept. So we appreciate the fact that you can give us answers to all of these questions.

And I will either be submitting questions or asking questions later.

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

The CHAIRMAN. Thank you, Senator Dole.

Senator Mitchell.

OPENING STATEMENT OF HON. GEORGE J. MITCHELL, A U.S. SENATOR FROM MAINE

Senator MITCHELL. Mr. Chairman, thank you very much for your courtesy and that of my colleagues to permit me to proceed out of order.

I will not be able to stay for the hearing. The Republican leader and I are hosting a reception for Prime Minister Major. He will have to leave shortly.

But I wanted to come to welcome Secretary Bentsen to the committee and congratulate him for his assistance to President Clinton in developing the President's economic program.

It is a program for job creation, for long-term economic growth, and serious deficit reduction. And it is a welcome plan for the Nation that is being very well received by the American people.

They recognize that the economic future of our country requires that we work together, deal directly and honestly with the serious problems that confront our country.

The President's program is also being well received in the financial markets where long-term interest rates have come down to their lowest levels in many years.

The market is reacting favorably to the President's determination to deal seriously with the Federal budget deficit. This will have a favorable effect on the cost of capital, thereby facilitating increased capital investment by business.

The overall focus of the President's program to reduce the Federal budget deficit while redirecting national economic spending away from consumption and toward investment is in the long-term interest of the economy.

All proposed spending and tax changes considered by the Congress should be evaluated by that standard.

The Senate Finance Committee has a major task in the weeks ahead, as we review the President's plan. At a minimum, we must achieve at least as much deficit reduction as proposed by the President.

To those who are critical of the President's plan, I think a healthy debate is appropriate and desirable, but obviously, those who are critical should offer constructive and specific alternatives of their own.

I think it is not enough merely to criticize an existing plan or proposed plan without coming up with specific and constructive alternatives.

Working together, Democrats and Republicans, I hope that we can come up with a program that will gain the support of the Congress and will persuade the American people that we, like the President, are determined to deal with the deficit and to lay the foundation for sustained economic growth and job creation in the years ahead.

Mr. Chairman, I thank you very much.

The CHAIRMAN. Thank you, Senator Mitchell.

Senator Baucus.

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

Senator BAUCUS. Thank you, Mr. Chairman.

I appreciate you calling this hearing today to give us a chance to address the President's package. I also appreciate the opportunity to visit with our former colleague and former chairman of the committee, Secretary Bentsen.

Welcome back Mr. Secretary.

Last Wednesday evening the President made a courageous speech. He is the first President in 12 years to propose measures that seriously address the deficit.

These problems will not be easy to solve. President Clinton has taken a bold first step. He is doing the right thing.

I look forward to working with the President, Secretary Bentsen, and the rest of the administration, in uplifting the economy and attacking the deficit.

The positive response of the American people to the President's package is illustrated by the initial reaction of the financial markets. A reduction in long-term interest rates has enhanced the flow of much needed capital into the economy.

I commend the President for compiling a package that represents the fulfillment of many of his most important campaign commitments.

In particular, the income tax changes really are targeted only at the very wealthy, there is an increase in funding for America's infrastructure, and there are badly needed incentives for investment in small business.

I firmly believe that Montanans and all Americans should do their fair share to get America's economy back on track, but no one should have to do more than their fair share.

It is with this theme in mind that I raise concern about the potential for disproportionate impact of two general items in the President's package. First, I am concerned about the effect of the

energy tax proposals on the west as a whole, and specifically on industries, such as sub-bituminous coal and aluminum production.

Second, the proposals to increase grazing fees, to implement a 12.5 percent gross royalty on hard rock mining, and the phase-out of below cost timber sales in our National forests, in fact, threaten thousands of jobs in Montana, as well as the possible elimination of those industries in the State.

I recognize that the package represents a first step. I am encouraged by suggestions by Secretary Bentsen and other members of the administration that there may have to be some adjustments made in order to address fairness and international competitiveness issues. I look forward to working with the administration to resolve these issues.

The CHAIRMAN. Thank you, Senator Baucus.

Senator Roth.

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

Senator ROTH. Thank you, Mr. Chairman.

It is indeed a pleasure to welcome you here Mr. Chairman and Mr. Secretary.

I congratulate you and the President for coming up with what the President has described as a serious plan. Like any comprehensive program, it does, in my judgment, raise a number of serious questions.

And while our economic indicators are now showing some signs of strength, I think, we can all agree that a principal problem is the question of job creation. And very frankly, I am concerned. I am concerned as to what increasing taxes some $300 billion will do to that recovery and the creation of jobs.

I might point out that Newsweek in a recent article pointed out that these tax increases proposed by the administration are going to particularly hit hard in New England, Alaska, California, Delaware, and Maryland.

I wonder if this is the way to go, when the recovery is moving nicely, although not as strongly as we would want.

Now, I think history shows that the deficit is not the result of Americans being under-taxed. Federal spending has consistently outpaced revenue $150 to $300 billion each year. I think the problem is that for every dollar of increased taxes, Congress has spent $1.59.

Mr. Secretary, I find people back home insisting that spending cuts should be made before we consider any tax increases.

And one of my concerns is that if you look at the President's proposal, in the first 4 years in his first term, you will find that total discretionary spending goes up every year.

I do not think that answers what concerns the American people. As I said, they are concerned about the fact that the program does not appear to be doing enough with respect to spending cuts.

As I say, this shows that in the first term there are no cuts in the President's proposal with respect to discretionary spending, no net cut.

Finally, let me say, Mr. Secretary, I think the President has rightly challenged Members of Congress to come up with their own

proposals. I would just like to make it clear that in 1990, I introduced what I called my "Jog America" plan, meaning jobs, opportunity and growth.

And I spelled out in detail where I thought $160 billion worth of cuts could be made. We are in the process of trying to update that.

But it does seem to me that the real problem we face, the key question is, how do we create jobs and growth? And from that standpoint, I think, we are all dedicated to a common goal.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Roth.

Senator Breaux.

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

Senator BREAUX. Thank you very much, Mr. Chairman, and thanks for calling the hearing to welcome our new Secretary.

Now, I guess the Secretary realizes what witnesses used to have to sit through while we all made our speeches. [Laughter.]

I just want to say that when I was in Congress during the first term of President Reagan, it was really easy. And, it was a lot of fun because he asked us to cut taxes and spend more money. And that was really easy for Congress to do.

A majority of the Congress signed up to that plan. They said, "Let's cut taxes and spend more than we have." And we did it. And as a result, we have a $4 trillion long-term debt and a $300 billion plus deficit.

Those fun days are over. It is now time to pay the price of the mistakes that we made in the past. And that is why this, or any proposal, drafted by anyone that is serious is going to be disliked by a large number of people who prefer something easy.

Some people have said "I don't like this plan because it spends too much. It actually calls for spending more in some areas."

I think that is not the problem. It is not just how much we spend. It is how we spend those dollars.

One area that the United States has not invested enough in the infrastructure of this country. We spent too much in bad areas. And, we spent not enough in other areas.

So it is not just a question of whether this budget has more spending in it. It is where those funds are going to be spent.

And if you look at this budget that has been presented I would suggest that for the first time, it moves away from spending on consumption. It moves toward spending on investment and rebuilding the infrastructure of this country.

To illustrate, this proposal caters new spending in programs such as the Job Corps, youth apprenticeship, defense conversion, welfare reform, national service, for Head Start programs.

I suggest that what we have is a very good starting point. Yes, it does call for more spending in programs that are good for this country and desperately needed and in a race in which we fall far behind other Nations that are moving faster than we are in economic growth.

And, yes, it calls for some major cuts in some programs on which we should be spending less. And, I would suggest that when the

American public finds out what all those cuts are about, we are probably going to get more complaints from our constituents about the cuts than we will because of the tax increases.

Finally, I think it is very important to show that we are serious about making cuts in unproductive programs. I think we have to do it at the same time we are talking about raising taxes.

Middle-income Americans have been hit by seven separate Social Security increases. They do not want anymore tax increases unless we can show we are serious about spending less in unproductive areas.

So I think we have to time things carefully. Do it simultaneously with the stimulus package. And I think, we will make a real start in moving this country forward again. I commend the Secretary for putting this package together along with the President.

The CHAIRMAN. Thank you, Senator Breaux.

Senator Danforth.

Senator DANFORTH. I have no statement, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Danforth.

Senator Chafee.

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

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

I join in welcoming our friend and former colleague.

We are in a situation here, Mr. Chairman, where perhaps everything has been said, but everybody has not said it.

Secretary BENTSEN. Can I add the Texas rice to that one?

Senator CHAFEE. Mr. Secretary, I firmly believe that the most serious domestic problem facing the country are these deficits. And I commend the President for having the goal of doing something about them.

And I think that is wonderful, but I must say it seems bizarre to me, and you can correct me in your testimony if I am in error, but it does seem bizarre that the first thing we do right out of the box is to spend more money without paying for it. That is the stimulus package.

Now, maybe there have been changes. I read in the newspaper today that perhaps the stimulus package has been deferred until we do have a method for paying for it. And I think that is splendid. And I hope that is right.

I must say that reporting on behalf of my constituents, they are prepared to pay more taxes. And I am prepared to support that. I do not think the tax package is all bad.

But what they do want is commensurate reductions in spending and also to have more of it devoted to reducing the deficit. Clearly in this package, we are embarking on substantial new spending in some instances we are creating new programs and in others we simply expand existing programs, all of which may be good.

There are precious few programs in the Federal Government now that somebody does not like, but it is the old question, are we really going to tackle this deficit or aren't we?

And it seems to me—and again, I look forward to your testimony—that there is a lot of motion here, but when all is said and

done with the new spending and the taxes, that the deficit has been reduced precious little. And that is disappointing.

The CHAIRMAN. Thank you, Senator Chafee.

And then, Senator Daschle.

OPENING STATEMENT OF HON. THOMAS A. DASCHLE, A U.S. SENATOR FROM SOUTH DAKOTA

Senator DASCHLE. Thank you, Mr. Chairman.

I, too, want to welcome our close friend and colleague and former chairman, the Secretary, this morning.

I can recall as a very young member of the House of Representatives in 1981 being asked by so many at that time to give the new President a chance.

That was really the battle cry, "Let's give the new President a chance. He has been elected, not by an overwhelming majority, but he came to the Congress with a set of ideas that he felt deserved an opportunity to be supported."

So we gave him that chance. A vast majority of members of the Congress on both sides of the aisle gave the President in 1981 the chance that he asked for.

But we elect our Presidents one at a time. And I think now is the time for us to give this President a chance, the same way we did and in the same bipartisan spirit that we did in 1981.

It is a given that each of us has differences, that we could come up with our own set of ideas for a plan that we think works better. But I frankly do not believe any one of us could have come up with a plan that has any better prospects of passing both Houses of Congress with a bipartisan majority than what the President has proposed in the last week.

I hear a lot of concern about taxes and understandably so, but I really hope that we will focus our concern on the deficit, as Senator Chafee has just indicated. Those who oppose this particular plan have to explain what alternatives there are for reducing the deficit.

If there are no alternatives, then, I think we are faced with the same potential demise that we have faced for the last 12 years. The alternatives we have experienced over the last 12 years are not acceptable: debt, deficits, and slow or no economic growth.

And I think we have got to face the American people and tell them, as we must recognize ourselves, that that is just unacceptable.

More is at stake frankly than just this economic plan. I believe the institution itself is at stake. The degree to which we show that we can govern, that we can come to grips with these problems, is the degree to which our credibility will be enhanced.

Those who oppose this plan will be asked to justify more gridlock. They will be asked to justify greater deficits. They will be asked to justify little investment and unacceptable economic growth. Those are the results of inaction and further gridlock.

I hope we can show that we can act. I hope we can show that we can govern. I hope we improve the credibility of this institution. And I certainly hope that, with credibility, we can address the problem forthrightly. And we begin that today.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Daschle.

And now to wrap up, Senator Boren.

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

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

Mr. Secretary, it is a pleasure to welcome you back and also to welcome you with enthusiasm for the package that has been presented by the administration to Congress.

As all of you on both sides of the aisle know, I have always tried to be bipartisan in my approach to these matters.

During the terms of our two previous Presidents, while I have been serving here, I have tried to support them when I thought they were right, sometimes to the criticism of those on my side of the aisle who felt that I was being too bipartisan at times.

I think this is a package that deserves the support of the Congress, whether we are Democrats or Republicans. I have been waiting 15 years now for a President to come forward and tell the truth to the American people.

We all know, in spite of our lip service to the contrary, that you cannot increase your spending and lower your income and try to balance the budget.

And now, the President has had the courage to tell the American people the truth. The people themselves understand that we are threatening the future of the next generation if we do not do something dramatic to get these deficits under control.

By the end of the decade we will devote 25 percent of our whole budget just to pay interest on the national debt. This will destroy the future opportunity for the next generation of this country.

And it will destroy the world leadership of this country. We will never again play the role in the world that we have played for the last several decades.

I think that for the benefit of our own people and for the benefit of the free world, we cannot allow this to happen. We are going to destroy this country. That is the truth. And the President has had the courage to tell the truth.

If we do not have the courage to pass this package and to meet at a minimum his deficit reduction target, we should not be here. The people should quite frankly, remove us.

I do not think any of us who are not willing to meet the President's deficit reduction target is fit to continue to serve in this Congress. We would not have kept faith with the American people, not only Americans that are alive now, but those that will follow us.

So I for one intend to fully support what the President has asked us to do in terms of deficit reduction. I think all of us should take the pledge that if we want to change parts of this package, we ought to do it in such a way that we, ourselves, propose paying for

our amendments; this way we do not compromise our ability to reduce the deficit as the President has asked.

That is certainly the way I intend to proceed. And I find that my constituents, as long as we keep faith with them and actually reduce the deficit, are willing to make sacrifices.

I would make one point. I have been saying that we have to be very careful not to pass the spending parts first, the so-called stimulus package. And I have said that it is like saying to your 5-year-old, "Now, you can have your dessert first. And later, I am going to ask you to eat the spinach."

Unfortunately, our record in the Congress demonstrates that we do not always have the ability to exercise that kind of self-restraint, anymore than some 5-year-old.

So I am glad to hear that the budget resolution will be offered first before we vote on the stimulus package. It is a step in the right direction.

I would say, however, Mr. Chairman and Mr. Secretary, that the budget resolution is still not totally self-enforcing, as we know it.

And I would hope that even if we do that, the stimulus package would be pared down to only those items that have to be passed very quickly, like the summer youth employment and unemployment. We should keep it as small as possible and try to move all the rest of the stimulus package with the reconciliation bill.

In 1981, we were able to move the reconciliation bill within 4 months of the budget resolution. I hope the budget resolution will be modified to set up the timetable to do it even faster this year.

The urgency is even greater than it was in 1989 to get that deficit reduced. I would hope that we could do it in 2½ to 3 months to really get on with the business, pair down the stimulus package. And let's have the dessert and the spinach at the same time and keep faith with the American people.

The CHAIRMAN. On that emphatic note, Mr. Secretary, we welcome you once again, sir.

STATEMENT OF HON. LLOYD BENTSEN, SECRETARY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Secretary BENTSEN. Mr. Chairman, I am delighted to be back here with you. We have worked on so many economic problems together. And I approach you again in a bipartisan way. On the vast majority of measures, we have passed through this committee with bipartisan support.

I have heard some people say that this can be the vote of a lifetime. I think that is true. I think we are at a critical point in the life of this country.

And if we do not do it now, it is going to be a lot tougher to do it 4 years from now. The options will be much more constrained. And this is the time to try to get it done.

I was listening to the minority leader saying he was going to be meeting with Prime Minister Major later in the day. In having breakfast with the Prime Minister this morning, I was, with a great deal of pleasure, telling him that we had heeded the advice and the counsel of the G–7 countries in doing something about getting our deficits under control, and that this President had presented a very courageous and whole package to accomplish that ob-

jective. It was going to be with great pleasure that I go to the G–7 meeting on Saturday in London to be able to give to those countries our response of what we think has to be done in a cooperative effort amongst our Nations, the G–7 countries, in getting the world economy back on the move again, seeing what we could do to have sustained growth without inflation and open up these markets.

Let me say what we are doing this morning. We are coming to you with not a completed, detailed package. We are coming to you before we send you the budget to talk to you about some things where we want your input, where we want you to fill in and help us with the further detail.

If you have some cuts that you want, let's all put our fingerprints on them. And let's pay the political price, if that is what it means, but I do not think it means a political price.

I think the American people are ready for this. And they are ready to move. And I think the overwhelming support that we have seen in the public opinion polls tells us that.

Oh, I know that the lobbyists are gearing up to try to protect this part of it or that part of it, where they have a self-interest, but I think the American people see over that.

I know they are jamming up your switchboards. And they are going to cover you up with mail. As I have said to you before, you fellows have been around awhile. And you surely know the difference between grass roots and astro turf. [Laughter.]

So what we are seeing is an investment in the future along with a strong and enduring recovery. We are talking about reversing the dismal, underlying trends of slow productivity growth and economic stagnation.

To improve our standard of living, we need productivity growth. And to do that, we have to have investment.

Oh, I looked at that number up there, that it was $325 billion and what we were talking about in cutting back, but that is a net figure. And we have said so all along.

And the plan put out by the administration highlighted that, page 22 of that plan. We did not try to hide it. That is $325 billion total, apart from the gross.

We are talking about improving the skills of our people, making them more competitive in the international market.

The plan has three parts: a modest stimulus for the problems facing us now, and an investment package to expand America's capacity to produce, and a deficit reduction program containing specific spending cuts and tax increases to free up money for the investment we need.

Senator Boren, I used your example yesterday before the Budget Committee in the House, the spinach and the dessert. And I think it made an impact.

And once again, that is where you fellows in the Congress are having some influence in this package. Talking about seeing that those cuts are made before the stimulus is done, we are ready to do that.

But Americans need jobs now. They need to know that the jobs they have will not evaporate and that they are good jobs.

The stimulus package is both a response to the short-term economic stagnation that has seen economic growth falter and a down payment on longer-term investments to create more jobs.

It has two components: tax incentives for plant and equipment and then, spending on the public infrastructure.

Although I think we have seen some encouraging economic reports recently, we still have too many people out of work and too many factories have too little to do.

We are operating at just under 80 percent of our industrial. And even more important, we have over 9 million people unemployed. That recovery just has not produced the usual job growth.

On my chart, we give you an example of what is happening this time: two-tenths of 1-percent recovery in the way of job growth, previous recoveries, 6.5 percent.

The major reason for this kind of slow job growth is the anemic recovery that we are seeing. As my next chart shows, real GDP growth has averaged only about 2 percent in the seven quarters since the recession technically ended in the spring of 1991. And that compares to about 5 percent over the comparable periods in the past.

We need to ensure faster economic growth. And we need to create new jobs. The $30 billion stimulus package in the President's plan does both.

It does not so do it by cutting taxes or increasing spending to boost consumption, but by focusing on investment programs essential to long-term growth. And it will put money into the economy quickly.

Roughly, half of the money goes for tax incentives to stimulate the private investment. Specifically, the plan includes a temporary 7-percent incremental investment tax credit for large businesses, and a permanent investment tax credit, phasing down from 7 percent to 5 percent in 2 years on investments by small businesses. Small businesses are vital to our economy, since they are the major source now of new jobs.

The other half accelerates spending for programs to enhance long-term growth and to jump-start the economy. For example, it increases spending for highways and mass transit systems. It creates the equivalent of about 500,000 full-time jobs overall. Americans need those jobs now. And they deserve them.

We are going to be working with the leadership in the House and the Senate to do what has to be done to ensure passage of all elements of the economic program, whatever process is used.

In addition to the tax incentives and direct investment in our stimulus, at the Treasury Department, we are working with the Federal Reserve and FDIC to alleviate the credit crunch.

I came from business. I know how important access to credit can be. And we want to be sure that they have every opportunity to expand and to create new jobs.

The stimulus package in easing the credit crunch is what we need to do to tackle today's challenge. Yet, we all know that that is only half the battle.

The second component of our plan attacks stagnating productivity and wage growth. The growth and output per worker has prac-

tically ground to a halt over the last two decades. And real wages have barely budged at all.

Average Americans have seen little increase in their living standards, particularly middle-income Americans.

Just recovering from the recession is not good enough. We need to not only create more jobs, we also need better jobs with higher wages.

Under-investment and private business capital and public infrastructure and the skills of the American work force have contributed to the problem, as you can see on this next chart. Look at the difference at what we invest as compared to our major competitors.

Look at the United States, 15.5 percent, France 24 percent, Germany 22.5 percent, Italy 24 percent. And look at Japan, 32 percent. United Kingdom is closer to ours. So that is what we want to try to turn around.

It is not just simply a question of bricks and mortar. We need to make much greater investment in our most important resource of all. And that is the people, Americans.

More investment is critical to improving productivity, wages, and living standards. The program contains two major efforts to improve both public and private investment.

The investment package will start shifting the composition of the Federal budget from consumption to investment, as was pointed out by Senator Breaux in his comments.

It will expand America's capacity to produce and offer better opportunities to workers. It will bear fruit long after the current recovery has been firmly established.

The package includes both tax incentives and public investment expenditures. The tax side of the investment package includes two important provisions for small business, since small companies are such a major source of jobs.

First, small business will continue to enjoy the permanent investment tax credit that is introduced in the stimulus package.

Second, we propose that investors in corporations under $25 million of capital be able to exclude 50 percent of the gain on stock held more than 5 years. And that is quite comparable to what we did in this committee before. That exclusion is carefully targeted to benefit small growth companies and to avoid abuse.

Small and large capital-intensive corporations paying the minimum tax will continue to benefit from the simplified and enhanced depreciation provisions in the package.

Remember how many complaints we had about having to figure out three different depreciation schedules. Now, we are talking about getting it to one. And we are talking about shortening that depreciation period. And that is a major help to capital-intensive companies in this country.

In addition, the tax side of the package permanently and retroactively reinstates several provisions that expired last June.

For example, we make permanent the research and development tax credit to let business better plan research investments.

And how many times, Senator Danforth? You have been one of the leaders in that. And you know what we are talking about here in letting companies plan with some continuity insofar as research

and development. And we think that will help. That will help bring it up.

To stimulate investment in housing for moderate and low-income families, we permanently extend both the low-income housing credit and the mortgage revenue bond provisions.

Mr. Chairman, you have been long interested in that, as have many other members of this committee.

Since investment in people is as important as investment in machines, our plan makes permanent the targeted jobs credit to include workers in an apprenticeship program, frankly along the lines of what Senator Breaux proposed last year. The plan also would expand the exclusion for employer-provided educational assistance.

Now, this part of the program also authorizes the establishment of enterprise zones. And while the details of that are being refined, the purpose is to provide incentives to hire and train workers, to improve the physical capital of some of our Nation's most distressed urban and rural areas.

The incentives in the investment package for the private sector are reinforced by increased public investment in a range of initiatives relating to physical and human capital. Both are critical for productivity and growth. This reaffirms investment themes that President Clinton articulated during the campaign.

First, by 1997, the program commits nearly $19 billion per year to infrastructure improvements, including transportation, the environment, rural projects, community development, and technology.

Second, the President believes that in an age of mobile production and mobile capital, and we sure have it, that the one important resource that is here within our borders is our people.

And that is where we ought to be spending some money for lifelong learning, including fully funding Head Start. We are talking about nearly $16 billion there.

It starts the composition of spending toward programs to increase future living standards for us and for our children.

The last investment is making certain that we reward work. Anyone who works hard should not have to live in poverty. So to meet that goal, the program will sharply expand the earned income tax credit to bring working families above the poverty line.

You just should not have to work 40 hours a week and still find you have your family under the poverty level. And that is what we are working to correct.

The deficit reduction package is the third critical component of our plan to increase investment and enhance productivity. The deficit affects every American every day, not some abstract concept debated by communists. It has real impact on things, such as higher interest rates.

The large deficits that we face seriously impede investment. Every dollar the government borrows to spend on consumption is a dollar not available for private investment.

Large deficits can reduce our investment or make us borrow from abroad to finance our investment spending. In the 1980's, we did both.

Large annual deficits also produce a mountain of debt. And the interest on the debt accounts for an ever increasing share of the government's budget.

This year, we paid 14 percent of the budget on interest. The second fastest growing item next to health care. If we do nothing on it, as some have quoted earlier, by the end of this decade, it will be 20 percent.

Try serving as a Member of Congress. When you reach that point, maybe you have 5 cents out of a dollar to work with on things you think are necessary for the country.

The Congressional Budget Office estimates that this year's deficit will be $310 billion. Even once the economy recovers, the structural deficit is projected to continue rising sharply. Growing deficits and debt will rob us as public officials of the flexibilities that we need.

Spending on health care, mandatory programs, and interest will account for the rest.

We must cut the Federal deficit to lessen the government's drain on national savings, to free up funds for investment, to leave room in the budget for critical domestic programs that make our Nation less dependent on foreign capital.

President Clinton's plan takes a bold step in bringing that deficit under control. In 1997, when the provisions are fully phased in, this plan will reduce the deficit by $140 billion.

Now, let me clarify something about our debt reduction figure and the point I made a bit earlier. That $140 billion is a net figure. Our deficit reduction package alone actually lowers the deficit in 1997 by $195 billion.

Our investment program totals $55 billion in that year. And that is where you get your net of $140 billion.

The President has made some hard choices on spending. And he made sure that the deficit reduction plan is balanced. In 1997, when the plan is fully operational, roughly half the savings will come from spending cuts and half from revenues. In the years beyond, the proportion of spending cuts remains at least that high.

This administration's deficit reduction plan differs from previous plans in a number of respects. This package does not use the rhetoric of across the board cuts or dodging the reality of those who get hit. It offers 150 specific cuts.

Furthermore, the savings in this plan are all permanent, not temporary. This plan is not based on a rosy scenario, but rather uses the more conservative economic forecasts of the CBO.

And I look at what we did in 1990 and the package we put together. Basically, the Congress and the administrations live within those parameters, even though President Bush disavowed it later, but the big difference was in the economic assumptions and then, what happened to health care costs. Those two things put together is what torpedoed the targets.

So this time when you have more optimistic assumptions by OMB, by the blue-chip indicator, that is not what the administration shows. It shows the more conservative estimate of CBO.

Now, I understand what our farmers put up with to provide us with the best agricultural products in the world, but we are going to make some changes.

Farmers with incomes of more than $100,000 a year from things that do not feed or clothe people do not need agricultural price supports. That is fair.

Our plan also will make prudent cuts in the Medicare provider payments without—and let me repeat that—without reducing the care available to Medicare beneficiaries. Our plan does not raise premiums. And hopefully, it may reduce out-of-pocket costs for middle-income and low-income Medicare beneficiaries.

We propose no change in the cost of living increases in Social Security. But for upper income recipients, the plan increases the percentage of their Social Security benefits subject to tax from 50 percent to 85 percent. It brings that tax treatment more in line with that of private pensions.

Mr. Chairman, let me speak to you for a minute wearing my hat as Chairman of the Board of Trustees of the Social Security Trust Funds. I know you share my concern over the financial health of the Medicare fund, which according to the 1992 Trustees report will be exhausted by the year 2002.

Therefore, I am sure that you are pleased, as I am, that we are proposing that the savings from the increasing the portion of the Social Security benefit subject to tax go into the Medicare Trust Fund.

In other words, as you are collecting part of this income from those people who are the beneficiaries of the Social Security, we are putting it over here to protect the Medicare Trust Fund which they are deeply concerned about and want to be sure it is there, that they can count on it.

This money and the savings from reducing payments for providers will not solve the entire problem. To do that, we need comprehensive reform of our health care system. But it will extend the period of solvency.

The many Americans who depend on Medicare for their health care will be reassured by the improvement in that financial health trust fund.

Now, let me turn to the revenue side of the deficit reduction package. And here, the President's plan moves to a restore equity to our tax system.

For 12 years now, the affluent have really not been paying their fair share of the cost of government. Now, as this chart shows, between 1980 and 1993, the income of the top 1 percent rose 47.6 percent, while their effective tax rate declined by 24.6 percent. And we have to reverse that trend.

The revenue changes we propose restore greater progressivity to the individual tax system, making it more fair and equitable. Families with about $180,000 in adjusted gross income will have their rate increased from 31 percent to 36 percent.

A surtax of 10 percent is levied on those with taxable incomes of $250,000 or more and gross incomes substantially above that. Those changes will affect only the highest income of 1.2 percent of American taxpayers. And those rate changes will not touch the average American household at all.

Higher-income individuals are also required to increase their payments under the Medicare tax. And revenues from this proposal

will also go into the Medicare Trust Fund, thus extending the period of solvency.

Yes, and we are asking corporations to pay their fair share. Almost 40 years ago, over a quarter of the government's revenue came from corporate taxes. Now, it is about 9 percent.

We propose raising the top rate from 34 percent to 36 percent for corporations with incomes over $10 million. It is only going to affect 2,700 large corporations out of 2.2 million corporations.

That is a fair tax rate for the largest corporations, especially when you stop to consider what our competitor Nations are doing. Japan's rate is 40 percent. Germany's rate is 50 percent.

The plan also recognizes that there is some deductions, such as business meals, entertainment, and club dues that should be reduced or eliminated.

And we will make certain that foreign businesses pay the taxes they owe in the United States. And to do this, the package contains a series of international compliance reforms. The principal provision would require multinational enterprises to establish their transfer pricing methodology before they file their tax returns.

The administration will also institute a sweeping, new enforcement initiative targeted at transfer pricing abuses.

We expect marked improvement in compliance related to international transactions as a result of this investment of IRS resources. A related provisions restricts the ability of foreign-owned U.S. corporations to avoid tax on their earnings distributed as interest.

Other rules are proposed to prevent so-called back-to-back loans and other abusive arrangements.

Now, to ensure that we get the most revenue possible from our existing taxes, the package also includes a series of compliance measures.

The tax gap, the difference between what people owe in taxes and what is actually paid is a persistently large number. Much of this is attributed to unreported income, often by businesses.

This package includes several provisions raising over $2 billion in 1997 to help us get at that kind of a problem.

And finally, the plan includes a broad-based energy tax. It has three important goals: improving our environment by effectively taking on pollution and taxing it, reducing dependence on foreign oil.

And right now, we are importing almost $1 billion a week of foreign oil often from politically unstable areas. And, of course, we use it to help cut that deficit.

The President is very concerned about how it is going to affect American families. And by making other adjustments, we ensure that the energy tax would mean little or no loss in after-tax income for households with incomes of less than $30,000 a year.

It will have only a modest impact on families between $30,000 and $100,000. In fact, if you look at the table that we have provided, you will see that the net impact of the entire revenue package on a middle-income family earning $40,000 is under $17 a month. And that is in 1997 when the program is fully phased in.

The President believes that this is a fair contribution to ask of middle-income households toward reducing the deficit.

We have already seen that the bond market is encouraged by our plan. And this chart shows, interest rates have come down significantly. I must say, the chart is out date. They have come down even more. I think the rate yesterday was 6.82 percent. That must be the lowest in at least 10 years.

Let me show you what that does. If you are talking about $17 a month, the impact of the energy tax, and let's say you had a $100,000 mortgage and you put it into effect at 9 percent, and then you have refinanced it, where you have an adjustable rate, that would save for that family approximately $60 a month.

And that affects the loan on the car, consumer loans. That means that the saving on that home mortgage alone could be over three times as much as the impact that you would have on the energy tax.

So we have had an excellent response. I am also glad to see that the Chairman of the Federal Reserve thinks we are on the right track.

Our revenue increases and spending cuts will sharply reduce the budget deficit from the levels projected by CBO. I said earlier, in 1997, that deficit will be reduced by $140 billion.

However, even with a deficit reduction program, the deficit will begin to decline later in the decade. The main reason is the exploding cost of health care. That is why we need major reform of the health care system.

If we do nothing to control those costs in the next decade, the increase in spending for the Medicare and Medicaid programs alone will exceed the level of the current deficit.

So we are searching for ways to get that problem under control. By early May, we expect to have a plan to be enacted quickly. And bringing those costs under control is the key to permanently reducing the Federal deficit. And it is not going to be easy.

We will also offer legislation this spring to help shift Americans from welfare dependency to jobs.

And getting control of the health care costs and enacting our economic program are each significant steps toward reversing this growth of the deficit.

So finally, I will be working with those G–7 ministers this weekend. I think it is going to result in putting in a foundation for complementary action by these other countries to ensure an expanding world economy.

But the success of these efforts will largely depend on the credibility of our domestic, economic programs and our commitment to reduce that deficit. And a free and fair trading environment will help increase exports and our prosperity.

So this is it, folks. This is the time for meaningful change. For the first time in years, we have a plan that takes a credible approach to the deficit, to investment, to our long-term economic health.

Now, we have heard some criticism that it does not include enough cuts. Frankly, I would like to see more. So we will want the contributions and the ideas of what you think we can do to bring more about. And we are anxious to do it in a bipartisan way.

This is not a Democratic economy or a Republican economy. It is an American economy. And that is what is at stake.

Thank you, Mr. Chairman.

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

The CHAIRMAN. Sir, that was an extraordinary statement, and was everything we could have hoped for from you and everything that we have come to expect from you. It is bipartisan. It is open. It is candid. And I think, if I can presume to say, it is working.

You perhaps have not had the chance to read the Wall Street Journal this morning, but a headline says, "Bond Rally Roars Ahead on Clinton's Proposals."

Now, you do not see many headlines like that in the Wall Street Journal in New York. It begins, "The spectacular bond market rally accelerated yesterday with long-term Treasury bond yields plunging to another record low as investors rushed to embrace President Clinton's economic package."

As you just said, 6.8 percent probably is a record low.

Secretary BENTSEN. Oh, I am sure it is for many years.

The CHAIRMAN. Yes. The Journal says it that prices sank further into record low territory.

That is a vote of confidence from people who have to be pretty serious about what choices they make. And I think it is showing all across the country. And I think it is a great tribute to you, sir, as well as to the President.

On that positive note, Senator Packwood. [Laughter.]

Senator PACKWOOD. Thank you, Mr. Chairman.

Mr. Secretary, in the President's speech to the Nation, he said he was happy to use CBO figures. We will all be working from the same baseline.

Let's make sure we agree on what the baseline projection is. Basically, it is a projection of what we would spend if we do not change the laws.

Secretary BENTSEN. That is right.

Senator PACKWOOD. All right. CBO, for spending over the next 5 years, has one baseline. OMB or the administration's baseline, if you want to call it that, is $123 billion above CBO's baseline. Why is that?

Secretary BENTSEN. Well, obviously, there are more optimistic assumptions on the part of OMB. And the Blue-Chip projection was pretty close to OMB, as I recall.

But that is a problem we ran into in 1990, when—and I do not think the administration at that time was trying to mislead in any way. I think that was their honest projection as to what was going to happen, but it did not. We saw the economy go down.

Senator PACKWOOD. Yes. But my question is the President says we are going to use CBO figures.

Secretary BENTSEN. Yes.

Senator PACKWOOD. Why are you choosing to use for a baseline figure something different from CBO's?

Secretary BENTSEN. The baseline is the same by 1997. And that is our target year.

Senator PACKWOOD. Your figures are $123 million above CBO's for the 5 years.

Mr. COHEN. No. And, in addition, the baselines are the same by 1997.

Secretary BENTSEN. In 1997.

Senator PACKWOOD. Yes. But over the 5 years, you spend $123 million more on baseline.

Mr. COHEN. The difference over 5 years is much less than $123 billion and there is no difference in 1997, our target year.

Senator PACKWOOD. Well, that does not——

The CHAIRMAN. Can we get this sorted out?

Secretary BENTSEN. Sure.

Senator PACKWOOD. Sure.

Second, you estimate your deficit reduction from your baseline rather than from CBO's, don't you?

Mr. COHEN. I am sorry. What was the question?

Senator PACKWOOD. You estimate your deficit reduction from your baseline rather than CBO's?

Mr. COHEN. That is correct.

Senator PACKWOOD. Therefore, to the extent that you are above CBO when you estimate a deficit, you can estimate a bigger reduction than they would estimate because you are starting from a higher baseline?

Mr. COHEN. But in 1997 our target year, our baselines are the same.

Secretary BENTSEN. It comes out the same.

Senator PACKWOOD. In that year?

Mr. COHEN. That is correct.

Senator PACKWOOD. But over the 5 years, they are not the same?

Mr. COHEN. Not very much different.

Senator PACKWOOD. All right. Third question, on page 8, Mr. Chairman——

Secretary BENTSEN. I will tell you another we did, Senator, in trying to be conservative in this, if you look at the Bush defense budget and those cuts, those have to be enacted by the Congress. Some could have argued, "Well, then, we ought to get credit for it." We did not do that.

Senator PACKWOOD. On page 8 of your testimony, Mr. Secretary, you make reference to Japan's corporate tax rate and Germany's corporate tax rate. What is the relevance of that reference?

Secretary BENTSEN. I think the relevance is that it is substantially above what we are talking about.

Senator PACKWOOD. But we all know that the percentage of taxation is not nearly as critical as the base upon which it is levied.

Secretary BENTSEN. Well, let me also get to the point of what we are talking about insofar as corporate tax revenue is concerned. You are saying as a percentage of the GDP, that it is a higher percentage than it is in this country.

Let's look at the fact that——

Senator PACKWOOD. Say that again.

Secretary BENTSEN. As a percentage of the GDP, the amount of tax revenue percentage-wise or the percentage of—let's put it another way. Of the amount of total revenue that is received by the country from corporate, it is substantially higher in most other industrial countries from corporations than we have in this country.

Senator PACKWOOD. I beg to differ with you. And I am looking now at a chart called "Sources of Tax Revenues as a Percentage of Total Tax Revenue of 1990." And the source is OECD, Germany.

Secretary BENTSEN. Give me those numbers because I looked those up, too.

Senator PACKWOOD. And I would be happy to settle for Germany's distribution of collection of income. Germany, of the total revenues they collect, 27.4 percent comes from personal income. In the United States, it is 35.8 percent. So we collect more from personal income tax.

On corporate income, Germany collects of their total revenues, 4.7 percent from corporate. We collect 7.3 percent.

On consumption taxes, Germany collects 27.4 percent of their total revenue. We collect 16.5 percent.

Of what OECD calls social insurance, Germany collects 36.8 percent. We collect 29.5 percent.

Would you be willing to move us toward a tax system that basically mirrors Germany in the percentage of collections as a total of the gross domestic product?

Secretary BENTSEN. Well, let me get you different numbers.

Senator PACKWOOD. Okay.

Secretary BENTSEN. In the ones that I have looked at, the corporate income tax burden in most other competitive countries is higher than the United States.

In Japan, for example, the top rate is 40 percent. And the corporate income tax represents 6.7 percent of GDP, compared to 2.2 percent of the United States for Federal, State, and local revenues. Corporate income taxes represent 21.5 percent of revenues, compared to a little over 9 percent in the United States.

And then, in Germany, the top rate is 50 percent. Those are the numbers that I have.

The CHAIRMAN. May I say, Mr. Secretary, that the committee, Senator Packwood, and I have been talking about the committee having some hearings on these patterns and learn more about them.

And we look forward to working with your people in that regard.

Secretary BENTSEN. Good.

The CHAIRMAN. Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Secretary, I again want to compliment the new administration, as Senator Boren said, on being honest with the American people and taking the bull by the horn here in trying to get this deficit under control. We all have to do it.

I would just like to explore with you a little bit the proposed energy tax knowing that a lot of details have to be flushed out.

I generally agree that it is important for this country to begin to pursue a policy which encourages the American people and American industry to become a little more efficient in its use of energy.

I think that we can learn some lessons from Germany and Japan and other countries with much higher energy costs, but yet have very strong, vibrant economies.

My first question goes to your general thoughts on various alternatives of energy taxes, for example a gasoline tax, a oil-import fee, BTU, and so forth. Who did you consult with, what groups were consulted, what industries and so forth? Basically, why did you settle on the general BTU tax that you have in mind.

When you answer the question, I would like for you to address the degree to which you are going to be addressing some honest dislocations, that is some industries are going to be hurt much more than some others, and the degree to which we are going to try to deal with all of that.

One industry that comes to mind is the aluminum industry. The projection I saw is that it is going to cause about a 25 percent increase in production costs for the industry.

And that obviously is going to make it very, very difficult for them, an industry that cannot pass on its cost increases because you have to take the world market price, whatever the market price is.

A lot of major corporations can more easily pass on energy cost increases than some others. And I am just curious as to how we are going to deal with all of that.

Secretary BENTSEN. Well, we looked at aluminum production because, of course, it has high utilization of energy. And perhaps as much as 40 percent of aluminum's cost is attributable to electricity.

But I am advised that when the tax is fully phased in, that increased electricity costs are likely to increase the cost of aluminum by approximately 3 percent.

As we looked at the various ones, as we looked at a carbon tax, no question that it hit coal particularly hard. And some regions of the country would have been at a substantial disadvantage. So we backed away from that. We would not do it.

We looked at a gasoline tax. And the problem there for States like yours and mine, we depend so much on automobiles, and California, would take an additional hit.

We looked at an import tax on oil. And we should would have been hearing from New England and the resistance there.

So as we looked at pollution, and we looked at something that would have regional balance to the degree we could, we came down with the BTU tax.

Now, we did put an extra tax on oil because of our dependency on often politically unstable areas, the question of national security and the question of increasing debt to other countries and adding to our trade imbalance. And that is why we came up to this one.

Now, let's look at coal for a minute. The fully phased in energy tax as a percentage of producers' prices for coal at the mine mouth is 25.6 percent as a percentage of 1991 prices. And 24.7 percent is a percentage of projected 1994 prices.

And it is highest for coal because of environmental concerns on the high carbon content of coal and pollution. But we expect coal production to increase despite the tax, though at a slightly reduced rate.

Domestic coal production is projected to go up 6 percent during the period 1990 to 2000. Most of that increase is attributable to an increase in coal exports.

Senator BAUCUS. Mr. Secretary, excuse me. My time is about up here.

I guess my question also is the degree to which the administration is willing to look at, as I said, honest dislocations.

Secretary BENTSEN. Senator, no question. We will look at it.

Senator BAUCUS. Do you know the degree to which Germany, for example, has provisions which deal with dislocations caused by high energy prices that Germany imposes on its industry? I am trying to get at how they deal with dislocations.

Secretary BENTSEN. I know that some of our people who helped to draft this did. And we will be delighted to look into that.

Senator BAUCUS. Thank you.

Secretary BENTSEN. Thank you.

The CHAIRMAN. Thank you, Senator.

Senator Bradley.

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

Mr. Secretary, I just have three quick questions. They are in the form of clarification. In the so-called millionaires surtax that now goes into effect at $250,000 of income——

Secretary BENTSEN. That is taxable income.

Senator BRADLEY. Taxable income. My question is why have you excluded capital gains from the millionaires surtax?

The thought is, if you are on salary and you earn more than that, you get a 10 percent surtax. But if you sell an asset, you do not pay the 10 percent surtax on the gain from the asset. Was there a rationale?

Secretary BENTSEN. Yes. Part of that, at some breaking point, you get the locked-in situation on the sale of assets. And it is the feeling of many economists that that is about it, that you get less revenue and assets stay more locked in if you raise that capital gains tax up.

Another reason, we try to encourage to some degree people moving into equities to try to help start new ventures and to try to build new companies. Part of it was that, putting those two together.

Senator BRADLEY. I would then lead to the next question which is the differential.

Secretary BENTSEN. Okay.

Senator BRADLEY. If you take the rate plus the surtax plus the phasing out of Pease and PEP, you end up with about a 41 percent effective rate, with a capital gain rate of 28 percent.

Secretary BENTSEN. Right.

Senator BRADLEY. Now, why should that capital gain rate apply only to the top 2 percent of earners in the country?

Secretary BENTSEN. Well, are you arguing now that the capital gain rate is that much?

Senator BRADLEY. What I am saying is that those two positions are inconsistent. On the one hand, you are saying you do not want to tax capital gains. No matter if someone sells a piece of property and makes $5 million, that person is not going to have a surtax imposed on the sale of that property.

Secretary BENTSEN. That is right. And I gave you the reasons why.

Senator BRADLEY. And on the other hand, you then have a capital gain rate that applies to only to the top 2 percent because they are the only ones in the 41 percent bracket.

Somebody does not get a capital gain differential if they are in the 28-percent bracket. For them, their wage income and their capital income is taxed at the same rate, 28 percent.

Secretary BENTSEN. I am told that that is just not a correct assumption, that that 28 percent does not work that way. But I will be happy to get into it.

Senator BRADLEY. All right. So you are saying that the differential does not apply only to the top 2 percent?

Secretary BENTSEN. That is what I am advised. Yes.

Senator BRADLEY. All right. Because in reading the documents, that is clearly not what I read.

Secretary BENTSEN. Yes.

Senator BRADLEY. I read that the differential was only to the 28 percent. All right.

The last question, on this so-called qualified business stock. On qualified business stock, which is under about $25 million in aggregate capitalization, you get a 50-percent exclusion which means that you pay a 14-percent tax, if you sell that stock.

Secretary BENTSEN. You could be right.

Senator BRADLEY. You have, however, a 5-year wait.

Secretary BENTSEN. That is correct.

Senator BRADLEY. Now, have you done any budget estimates as to what will it cost at the end of 5 years? If you pass it now, and you say people have to hold it 5 years, then there is going to be no transactions over the next 5 years.

Secretary BENTSEN. Yes.

Senator BRADLEY. But in the sixth year, a lot of people are going to be selling their stock.

Secretary BENTSEN. We have done budget projections. I do not have them with me. And I would be happy to supply them for you. I surely will.

[The following information was subsequently received for the record:]

In order to qualify for the proposed 50% exclusion for capital gains realized on qualified small business stock, an investor would be required to hold the stock for at least 5 years. Therefore, our revenue estimates assume that the exclusion is not available for gains realized during the 5 year budget window. The $714 million revenue cost of the proposal during the window is attributable solely to deferral of tax by taxpayers who, but for the new exclusion, would have purchased taxable bonds or made short-term investments that would have generated taxable income during the budget window. By purchasing qualified stock, these taxpayers would not pay tax on any unrealized gains that accrue while they hold it for at least 5 years. That, of course, is the behavior we are trying to encourage.

The revenue estimators at Treasury and at the Joint Committee on Taxation do not project the dollar effects of proposals beyond the 5-year window. This is because the CBO and OMB baseline economic assumptions cover only 5 years, and because the reliability of predictions erodes dramatically as you try to stretch further into the future.

Nevertheless, we have considered the long-term revenue effects of the proposal. We added a number of limitations to the capital gains proposals that were included in last year's tax bills—including a smaller capitalization limit, a maximum exclusion of 50% instead of 100%, and a cap on the amount of gain that an individual can exclude with respect to each venture—that should limit the long-term cost of the proposal.

Although we have not tried to quantify what happens after the 5-year holding period is satisfied, our analysts believe that investors will: (1) start realizing deferred income that they would have realized during the budget window but for the 5-year holding period requirement; (2) start realizing gains that they would not have realized for many years, or even held until death, but for the 50% exclusion; and (3) continue to defer income on qualified investments made in 1994 and later years.

Senator BRADLEY. All right.

Secretary BENTSEN. But that is the way it works. That is correct.
Senator BRADLEY. All right.
The CHAIRMAN. Thank you, Senator.

So that everyone will understand, particularly perhaps our guests, we offer in terms of recognition of Senators according to the Bentsen rule which is that, when persons who are present at the time the hearing begins, we move by seniority after that by sequence of arrival. It confuses everybody, except for our secretary who keeps a list of that.

Senator Roth.

Senator ROTH. Thank you, Mr. Chairman.

Mr. Secretary, last week, my constituents and I heard the President say that his plan would not raise taxes on those earning less than $30,000.

Now, Dave Broder—I have a newspaper article, too—spells out that that $30,000 is artificially inflated because it includes noncash income to a family, such as computing rent and so forth.

But that is not the point I really want to raise at the moment. I received a call from a constituent back home in Wilmington, Delaware, a Mr. James Barry. And he indicated that he was a retiree, and that he and his wife lived exclusively on their pension and Social Security checks which were less than $30,000.

Now, he does not—I emphasize does not qualify for the earned income tax credit. So he receives no rebate on this proposed new energy tax.

Consequently, even if you accept that inflated $30,000 figure, the fact is that many people on Social Security, with a pension, will be paying the energy tax and will receive no rebate. So it is not accurate to say that the President's proposal would not raise taxes on those earning less than $30,000.

What do I write to this Mr.——

Secretary BENTSEN. Senator Roth, you write him and tell him that Mr. Broder was wrong, that the family economic income is a formula that has been used for at least 15 years.

It was used in the distribution tables in Treasury 1 and 2 in the Reagan administration. It has been used consistently since that time for distributional purposes by the Treasury.

Now, you got a situation, of course, where he would be eligible for LIHA that is available for retirees. And it is——

Senator ROTH. The fact is, Mr. Secretary, is that a retiree who has no earned income, but has a pension and Social Security will be paying an energy tax. And there is no offsetting tax.

Secretary BENTSEN. Oh, yes, there is. He has LIHA. And that is substantial. That is an assistance to him.

Senator ROTH. That, Mr. Secretary, is a spending program and only for those in a very low income. I think the fact——

Secretary BENTSEN. Well, we bolstered that substantially.

Senator ROTH. But nevertheless, it is still a spending program. What I am saying is the claim has been made that no one under $30,000 would pay additional taxes when, in fact——

Secretary BENTSEN. What we are talking about is making them whole. So it is a spending program that helps offset that. That is what those things have been put in for.

Senator ROTH. A claim has been made that there will be no tax increase.

Secretary BENTSEN. The claim is that that disbursement is made whole and it has been offset.

Senator ROTH. Why didn't that offset those with earned income then? I mean, why was it necessary to increase the earned income credit?

I think that if you look at taxes only, the President's statement that those earning less than $30,000 will not be taxed, then the fact is that they will be taxed under the energy tax. And there is no offsetting tax.

Secretary BENTSEN. Senator, it is not limited just to taxes. It is extended to those things that we do in spending programs to offset it so that they are made whole overall.

Senator ROTH. Mr. Secretary, we can argue this on, but I would like to go back to the point that our ranking member made about the baseline. As the President indicated, he was going to use the Congressional Budget Office as his baseline.

Senator Packwood mentioned that there is a Clinton baseline, although none of us have actually seen what that baseline is. And I would respectfully request that that be put in the record.

[The information requested follows:]

[From "A Vision of Change for America," p. 22]

TABLE 3–1. HIGHLIGHTS OF THE PLAN

(In billions of dollars)

	1993	1994	1995	1996	1997	1998	1994–1997 Total	1994–1998 Total
Baseline Deficit	319	301	296	297	346	390	1,241	1,630
Spending Changes:								
Defense Discretionary		-7	-12	-20	-37	-38	-76	-112
Nondefense discretionary	1	-4	-10	-15	-20	-23	-50	-73
Entitlements	-*	-6	-12	-24	-34	-39	-76	-115
Social Security		-3	-6	-6	-7	-8	-21	-29
Subtotal	*	-20	-40	-65	-98	-106	-223	-329
Debt Service	*	-*	-3	-7	-14	-22	-24	-46
Total spending cuts (-)	1	-20	-43	-73	-112	-128	-247	-375
Revenue increases (-)	-3	-46	-51	-66	-83	-82	-246	-328
Gross deficit reduction	-2	-66	-93	-139	-195	-210	-493	-704
Stimulus and Investment:								
Stimulus outlays	8	6	2	1	*	*	9	9
Investment outlays		9	20	32	39	45	100	144
Tax incentives	6	13	17	15	15	17	60	77
Total stimulus and investment	15	27	39	47	55	62	169	231
Total Deficit Reduction	13	-39	-54	-92	-140	-148	-325	-473
Resulting Deficit	332	262	242	205	206	241	916	1,157
Deficit as a percent of GDP	5.4%	4.0%	3.5%	2.9%	2.7%	3.1%	3.3%	3.2%

* $500 million or less.

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Senator ROTH. But the point I want to make is that what I am hearing from the people back home is that they want spending cuts before we proceed with any tax cut.

And if you look at the Congressional baseline and then the proposed spending by the Clinton proposal, you see every year of his first term, there is an increase in discretionary spending, going up $9, $9, $16, and $4 billion.

So I think it raises a serious question as to where are the tough decisions are being made when, in fact, instead of cutting spending during his first term, spending is being increased. I think that was the significance of the point my colleague made.

Secretary BENTSEN. Well, let me say first, that baseline is in the book that was published on February 17. Let me also say that as I look at that chart, I do not think that it gives us credit for the entitlement savings.

And when we talk about entitlement savings, let's remember that when President Reagan was talking about subjecting the beneficiaries' funds that were coming from Social Security, subjecting 50 percent of them to a tax, they listed that as an entitlement savings, not as a revenue, not as a tax.

And that is what we have followed. And I do not think your chart shows that.

The CHAIRMAN. I think, Senator, one last comment perhaps.

Senator ROTH. Well, I think the important point is that this is discretionary spending which includes defense, international, and domestic. The point I am making here is that there is no cut in any year of the first term of the President.

The CHAIRMAN. Senator, we will get back to this.

May I just say for the record, LIHA stands for low-income housing assistance.

Secretary BENTSEN. Oh, thank you, Mr. Chairman.

The CHAIRMAN. And it also includes cooling. And I believe the administration has proposed to increase the amount from $1 billion to $2 billion.

Secretary BENTSEN. That is correct. I remember debating that one on the floor of the Senate with some of the folks from the north about the problems of heat.

The CHAIRMAN. We do.

Secretary BENTSEN. And that we have more people die from heat than we do from cold.

The CHAIRMAN. There you are, sir.

Senator Breaux.

Senator BREAUX. Not in Louisiana. [Laughter.]

Thank you, Mr. Chairman. And thank you, Mr. Secretary.

The Energy Committee right now is having a hearing on taxes, and the impacts on the energy industry. I think some will be recommending at that hearing energy consumption tax on that instead of imposing the BTU formula that the administration should recommend an across-the-board consumption tax or a value-added tax on all goods that are consumed in this country.

My question is, did the administration consider this proposal? Is it a possibility in the future? If not, can you tell us why it is not a feasible idea to consider?

Secretary BENTSEN. Well, what you are talking about, if you talk about a value-added tax, something like that, you are talking about a very, very major tax change. And here, we are talking about, in effect, only raising $22 billion in revenue. And that would be an enormous change to bring that about.

The other thing that we have done is to try to attack pollution and lead toward a cleaner environment. And the value-added tax does not direct itself to negative environmental and those other things that are normally attached with consumption and fossil fuels.

Senator BREAUX. Of course, if you wanted to only raise $22 billion and you did the VAT tax, of course, you would just make it much lower to get the same——

Secretary BENTSEN. Yes. But a major change in accounting and what you call on people to have to change their reporting, it is—we have found where we have seen it in other countries that it is extremely expensive to collect.

That is not to negate it, to say that it should not have consideration, but I can recall talking to the British Prime Minister—not the British Prime Minister—to the Canadian Prime Minister and the Ambassador about the complexities and the problems they have had in collecting that tax. So it is not an easy decision in that regard.

Senator BREAUX. Would you call it a bad idea or an idea whose time has not yet arrived? [Laughter.]

Secretary BENTSEN. You do not give me much of a choice. Let me say, Senator, that obviously, it is one of those ideas that has been debated for years, but I do not think it is applicable in this situation.

Senator BREAUX. The President's proposal contains a 14 percent capital gains tax for those investments held 5 years in companies with paid in capital of $25 million or less. Some would argue that we should adopt a reduction for all capital gains.

If it is good for a certain type of investment, why shouldn't it be good for a broader range of investments?

Some would argue that this proposal would really create a distortion in the investment market, by only directing it towards smaller companies.

Secretary BENTSEN. Well, we have, in effect, held the capital gains rate without increasing it to people with higher incomes, but we have directed this one toward small business, trying to encourage small business and new ventures to be started.

We put a cap on that, as I recall. And also, they could not get over 10 to 1 or $1 million, I guess, which was the greater I believe. But it is to try to get new ventures, create ventures that give that kind of an incentive to them.

Senator BREAUX. May I ask a question? And we will discuss it, I am sure, as legislation is developed. My question relates to the imposition of the BTU tax for natural gas at the well head and for oil at that point that it would delivered to the refinery.

There is a lot of argument that the tax could be collected at a better stage, particularly on natural gas. Are you familiar with this issue?

Secretary BENTSEN. Let me say on—and we are debating these right now, some of these points, as I stated at the very beginning of this testimony. But we are looking at putting the tax on the basis of the output from the refinery, not the input to the refinery.

Senator BREAUX. What about natural gas? Any thought about whether the well head is an appropriate place or should it be imposed further down stream?

Secretary BENTSEN. We have not a final determination on that one.

Senator BREAUX. One final question, the proposal to eliminate lobbying deductions by special interest. My concern is that we treat all lobbying the same. If we are going to have special interests, law firms or corporations or individuals that would not be able to deduct their lobbying expenses, how are we going to treat those operations that are set up as tax-exempt operations that do extensive lobbying?

Secretary BENTSEN. Charity is an example.

Senator BREAUX. Sir?

Secretary BENTSEN. Charity.

Senator BREAUX. Not charity. I am talking about groups like the Sierra Club, the National Rifle Association which are not charitable organizations, but are tax-exempt organizations.

I want to make sure that if we remove the tax deduction for lobbying by businesses or corporations that we also remove the tax-exempt lobbying by organizations that are structured under a system that makes them tax exempt.

In other words, one group would be lobbying with tax-exempt dollars. And the other group would be lobbying using after tax dollars. I submit that everybody will reorganize as tax exempts, if we allow that to happen. Do you have any thoughts on that at this stage?

Secretary BENTSEN. We have been debating that ourselves in trying to decide where to come down. We want the input. That is one of the reasons we are talking to you and the other members early on.

Senator BREAUX. Okay.

The CHAIRMAN. I believe it is the case, Mr. Secretary, that the tax-exempt organizations already are restricted in what they are able to do in lobbying. And I see some nods back here.

Senator BREAUX. Mr. Chairman, my understanding, just so we have it on the record, I think and I am not sure, that lobbying organizations, like the National Rifle Association, are tax-exempt organization.

The Sierra Club, I believe is a tax-exempt organization. And no one could say that they do not do extensive lobbying.

The CHAIRMAN. Certainly not.

Secretary BENTSEN. That is right.

The CHAIRMAN. Senator Danforth.

Senator DANFORTH. Mr. Chairman, thank you very much.

Mr. Secretary, it is good to see you back. Mr. Secretary, does the administration anticipate sending to Congress other proposals for tax increases this year?

Secretary BENTSEN. Oh, I do not think we can make that judgment at this point. You see, what we have coming is health care

reform. We do not know how fast it will be phased in, how inclusive it will be. And I would not try to make that kind of an estimate at this stage.

Senator DANFORTH. All right. The Washington Post a couple days ago had an article which said that according to an internal memorandum within the administration, it looks as though the savings from a health care program would not take place until 1997 at the earliest and that the cost of bringing everybody into the health care program would be up to $175 billion over the next 4 years.

The New York Times, in an article last week, indicated anywhere between $30 and $90 billion of additional taxes per year would be required for a health care program.

Do you believe that in connection with the administration's pending health care program, we are going to see a proposal for a substantial tax increase?

Secretary BENTSEN. I have stated, Senator, I said with the surest speculation, there is no program put together yet. And a lot of work is being done on it. But to try to tell you whether it saves money or it cost money, I would not try to speculate at this point.

Senator DANFORTH. Is the administration looking at some two dozen proposals for additional taxes to pay for a health care program?

Secretary BENTSEN. Obviously, they have to look at the options from that standpoint at the same time they are looking at what they want to do in trying to have cost containment. All those options have to be explored.

Senator DANFORTH. Well, is it the view of the administration and has it been stated in memoranda that change in health care cannot generate savings until 1997?

Secretary BENTSEN. That, I do not know.

Senator DANFORTH. Isn't it a matter of certainty that a health care program is going to be sent to Congress this year and that health care program must be funded with additional taxes?

Secretary BENTSEN. I keep repeating to you, I do not know. We certainly expect to have the plan sent to you and have it in May, but to try to tell you, to give you any idea as to how far we extend health care and the availability in that plan and what its cost might be, would be sheer speculation. I am not going to do it.

Senator DANFORTH. Should we look at mandates in the same way we look at taxes, just as a matter of policy? Do they have the same economic effects on businesses?

Secretary BENTSEN. That is an interesting question. I would suppose to some degree, that is right, but also the question is, how much of a burden are they bearing now? Or are you just replacing that in another form? All those have to be decided.

What we do know is that some people will have substantial savings, we would anticipate, under health care reform.

Senator DANFORTH. Has the administration examined its economic proposal, the one you are testifying on today, in the light of possible proposals that will be made with respect to other taxes or other mandates?

What I am asking you is to see all the cards that are going to be dealt to us, or at least an idea of what those cards are. And if I cannot see the cards——

Secretary BENTSEN. Yes.

Senator DANFORTH. Then, what I would like to know is, has the administration in putting together this proposal, considered it in the context of its health care proposal?

Secretary BENTSEN. The things that are being done thus far in this proposal would be compatible with what we would anticipate would happen in the health care proposal.

Let me say that we are also looking at outlay cuts as a way of financing care and subsidies of small business. Those are also under consideration.

The CHAIRMAN. Thank you, Senator Danforth.

Senator Chafee.

Senator CHAFEE. Mr. Secretary, I previously in our telephone conversations expressed to you my anguish over the failure of the stimulus package to include the abolition of the so-called luxury tax, which you have spoken to and indicated you thought has been a disaster.

And I have trouble understanding why it was not included in this package since it is clear that that is something that truly would help jobs in our country.

And you indicated that you would be receptive to our installing that, placing that in the package, if I am quoting you correctly.

Secretary BENTSEN. Senator, your views on this have been long known and long held. And I am sure that members of this committee will look forward to being the authors of such.

Senator CHAFEE. Well, obviously, in your position in the administration, as we all know, what the administration thinks is always very, very important.

Secretary BENTSEN. Let me state, Senator, that some very tough choices have been made in these things. And some things that I supported as a Senator were not going to be the case. And I know that. I look at my friend, Senator Roth. We worked hard on the IRA's. They are not in this package.

But what we are trying to do is increase savings in this country. And one of they ways is by individual savings. And the other is by cuts in that deficit. And in this instance, I opted to support the effort to cut that deficit so that we could have more savings available for private capital and private enterprise.

Senator CHAFEE. Now, returning to the point that Senator Danforth was discussing, namely health care.

It seems to me that what you have done, if I understand it correctly, is to absorb the potential monies from Medicare savings in the budget in the proposal that you submitted for deficit reduction while leaving nothing available to pay for the health care reform when that comes along.

For example——

Secretary BENTSEN. No. I would not say that at all. We are talking about, much of what we have done are extensions in savings, seeing that the law does not expire.

Let me give you an example of some of the things that were debated during the Presidential campaign. A means testing for Medicare, that was proposed by President Clinton, by President Bush, and by Ross Perot.

Senator CHAFEE. That is the Part B premium?

Secretary BENTSEN. Yes. And that option is still there for consideration.

Senator CHAFEE. Well, that is right. However, you have included in your program an increase in the Medicare payroll tax.

Secretary BENTSEN. What we have done is we have had an extension of it. As you remember, in 1990, what happened there, it had a fixed dollar put on it. And that worked out to be 27.4 percent. And what we are talking about is just a continuation of that.

What is it now?

Oh, you are talking about HI wage cap?

Senator CHAFEE. Yes.

Secretary BENTSEN. Oh, I beg your pardon. Well, on that one, we raised——

Senator CHAFEE. Whatever that is, 2.7 percent.

Secretary BENTSEN. Yes. Take that cap off. It is $135,000. We took the cap off.

Senator CHAFEE. It goes up. If somebody is earning $1 million, they would pay. In effect, it is an income tax.

Secretary BENTSEN. That is correct.

Senator CHAFEE. Let me ask you, do you include in this package a provision that nondeductibility of executive compensation in excess of $1 million?

Secretary BENTSEN. Yes. That is in there, but also a correlation on performance to see that it is not applied in——

Senator CHAFEE. Now, who specifically would the cap apply to?

Secretary BENTSEN. Corporations.

Senator CHAFEE. Well, how about a .222 hitter in baseball that is making $2 million. Is he—is that all right?

Secretary BENTSEN. It looks like there is performance in that one. [Laughter.]

Senator CHAFEE. I would say inadequate performance. [Laughter.]

I am not sure. I got 2 seconds here. How does this work? Suppose somebody is the head of a corporation and employs 200,000 people and is successfully doing it. The head of General Electric, are they not entitled to pay him over $1 million or it is not deductible?

Secretary BENTSEN. Well, I will tell you. We are still in the process of developing the specific guidelines for the proposal. We would be delighted to have your input on it.

But what we are trying to do, our goal is to provide a strong tax incentive for corporations to link executive pay more closely with long-term performance in the business. That is what we are striving for. And if you can help us on it, we would be delighted.

Senator CHAFEE. Well, it is an issue that I would be happy to discuss with you further. Thank you.

The CHAIRMAN. Thank you, Senator Chafee.

Senator Grassley.

Senator GRASSLEY. Mr. Secretary—it was reported in the Washington Post this morning about the President's speech to the U.S. Chamber of Commerce. Clinton vowed in a speech to the group yesterday that, quote, "There are more cuts coming."

Are you in a position to give us any specifics on what those cuts might be or what sort of additional money you might be aiming at?

Or if you cannot give any specifics, when the specifics—the date the specifics might come?

Secretary BENTSEN. No. I cannot give you that, Senator. We made some very tough decisions here. We have gone farther than any administration ever has in outlining those.

We have told each of you we would be delighted to consider yours. If you want to add to them or substitute for them, we would be pleased to. We have come to you early on in the process before the final budget is submitted to you.

Senator GRASSLEY. My comment is not critical. It is only in regard to——

Secretary BENTSEN. No.

Senator GRASSLEY. You did say 150 specific programs. I am assuming what the President is talking about here is something beyond that 150.

Secretary BENTSEN. Yes. And I would assume that, too, but I do not think those have been determined. They would have been in the package.

Senator GRASSLEY. All right. Would they be—do you anticipate that they would be part of the discussion that we will have before we make a decision this year?

Secretary BENTSEN. Well, that is what we are talking about. We are just delighted to have any kind of recommendation you have in that regard.

Senator GRASSLEY. All right. But the President here is probably talking about some additional proposals that he is going to make.

Secretary BENTSEN. Well, if we can find them, we will. And we have surely been searching. We got you 150 of them. That is a pretty good start.

Senator GRASSLEY. All right. Another point would be a commentary, not necessarily a question. And that again, is based upon something I just read in the morning paper. And this is not legislative.

This is the President's own executive order, saying that he is going to have 100,000 positions eliminated in 4 years. And according to some discussion yesterday before a House committee, that evidently is in regard to the table of organization.

The departments never really filled their table of organization. I hope that what the President is talking about of reducing 100,000 jobs is 100,000 people that are today actually on the payroll, not some phantom job out there that exist on a table of organization that might not be filled. I hope that he is going to reduce it 100,000 below whenever he made that statement.

Now, my next point is this and it is based upon the proposition that the President has always said that he wants his deficit reduction efforts to be bipartisan.

And in the last few days, including some phone calls that my—four or five people on my staff have received, the Democratic National Committee is doing telephone solicitation, asking people for $50 to help President Clinton sell his economic plan.

It seems a little unusual, if not a little unseemly to have a political party using this economic plan as a fundraising tool. Is the administration involved in this money-raising operation?

Secretary BENTSEN. Senator, I am not informed on that.

Senator GRASSLEY. You are not informed on that. Well, I hope they are not. I hope that if they collect the $50 under this guise that it is going to go for reducing the deficit.

On another question, 2 days ago, CNBC quoted an unidentified Treasury official in saying that the investment tax credit provisions were not applied to farm equipment.

Secretary BENTSEN. Well, that is just wrong.

Senator GRASSLEY. That is wrong. Thank you. For my part, I am glad to know that because that is very important.

Secretary BENTSEN. And for my part, too. I want to be able to go back to Texas. [Laughter.]

Senator GRASSLEY. On Monday, Laura Tyson argued that everyone will benefit eventually if Clinton's program is passed because interest rates will be reduced. It was almost as if she was guaranteeing or promising that this would happen.

Do you think that lower interest rates are a given? And I would also like to have you tie into that, as you reduce interest rates, are you not reducing income for a lot of people that had investments, CD's, etcetera, that depend so much upon these interest rates.

Secretary BENTSEN. That is true, but I must say as far as guarantees, as to being able to reduce interest rates, I do not think that is in either in my job description or Laura Tyson's. But we think we can do things that will encourage the reduction in interest rates.

And that is quite true that for those people who depend on interest rates that there will be a reduction in income. Hopefully, some of them will go into investments where they will have a commensurate return there, maybe even better with the cost of borrowing money for corporations going down.

Senator GRASSLEY. In your plan, does Part B Medicare premiums go up? And if so, when?

Secretary BENTSEN. Part B Medicare premiums, what we have done is an extension. And that is the point I was making earlier. Where in the 1990 budget, it was for a fixed dollar. And that added up to about 27 percent. And we have proposed an extension of that.

Senator GRASSLEY. And only in that way would it affect Medicare premiums?

Secretary BENTSEN. At this point. I also made the point that means testing was something that was debated by the three candidates for the presidency. And that still remains a possible option.

Senator GRASSLEY. Thank you.

The CHAIRMAN. Thank you, Senator Grassley.

On that last point, we have the latest returns from the Washington Post that the interest yield on the 30-year Treasury bond fell to 6.82 percent, the lowest ever since the government began selling 30-year bonds in 1977.

Senator Daschle.

Senator DASCHLE. Thank you, Mr. Chairman.

Mr. Secretary, let me applaud you for the recognition by this administration of the importance of renewal fuels, as you have looked at the BTU tax. We feel very strongly that we have to find ways in which to encourage renewable fuel consumption. And certainly this plan attempts to do that. I hope that we can clarify the extent

to which renewable fuels can be encouraged as you move ahead with the plan.

Let me ask you to clarify if you can another issue, that is, the impact that the plan has on small businesses versus wealthy individuals.

I do not know if this issue has been covered in the past, but a number of my small businessmen have come forth to suggest that this plan treats small business virtually identical to wealthy individuals.

I would be interested in having your reaction to that concern.

Secretary BENTSEN. Well, this plan is definitely pro-small business. We heard some arguments last year. And I pointed out to many Senators who were inaccurately using numbers. I am even more familiar with these numbers now for this last year. We have them for the last year from Treasury. So let's present the data.

First of all, it is unreasonable to assume that every person with more than $1 of business income on their return is a small business person. Second, only a small percentage of small business owners are affected.

To determine if the taxpayer is a bona fide small business person, it is reasonable to look only at those taxpayers who had active business income that exceeded their wage income.

And of the nearly 7 million taxpayers with business income in excess of their wages, only 300,000 or 4.2 percent would face higher marginal rates.

Senator DASCHLE. Would you repeat that, 3.2 percent?

Secretary BENTSEN. Of the nearly 7 million taxpayers with business income in excess of their wages, only 300,000 or 4.2 percent would face a higher marginal rate.

Senator DASCHLE. 4.2 percent.

Secretary BENTSEN. Some of these taxpayers own very large businesses, have very high incomes, and thus would pay a greater share.

You cannot assume that every individual that has an S corporation, a partnership, or a farm income or a loss is a small business person.

So tax return data do not identify the size of the business from which a person earns partnership or S corporation income, but it is reasonable to assume that many of these taxpayers own very large businesses.

Third, others may own a small portion of a business while they receive most of their income from other sources. Moreover, many of them are doctors, lawyers and investment bankers and not the local hardware owner.

Fourth, the tax increases in the administration's plan are more than offset by the fact that this plan reduces the deficit which will result in lower interest rates, as was just cited by the chairman of the committee, and because of increased consumer confidence.

So this plan has a flat ITC target to small business. It includes a 50 percent capital gains exclusion for investments in small business. The plan includes a retroactive extension of the 25 percent deduction for health insurance premiums for the self-employed.

The ability of State and local governments to issue tax-exempt bonds for small businesses would be extended permanently. And

then, we are doing some things to really try to get rid of the credit crunch.

Take a look at what is happening to small business. And the regulation that has been put in. And the cost of making a loan to small businesses. And the question of character involved, as we have thought of it in the past in small towns, medium towns, towns like I came from.

We are working now, Treasury is, with the Federal Reserve and with the FDIC to see what we can do on just the regulation side to try to ease that without in any way impairing the security or the solvency or the soundness of those banks. And we are working to bring those out now.

Senator DASCHLE. Well, Mr. Secretary, I applaud you for that comprehensive answer.

I think that we have got to do a better job in the next couple of weeks of laying out the extraordinary differences between the treatment of wealthy individuals and small businessmen.

I think that your point, especially with regard to such tax tools as the investment tax credit, capital gains relief, and the the 25 percent deduction for health costs, is extremely important.

I would certainly urge this administration to bring those facts out as aggressively as they can as we continue to educate the American people about the importance of the entire package.

I understand I am out of time. Thank you.

The CHAIRMAN. Thank you, Senator Daschle.

And Senator Boren.

Senator BOREN. Thank you, Mr. Chairman.

Mr. Secretary, I want to associate myself with the remarks that Chairman Moynihan made immediately following your opening statement. Although no package is perfect, I truly believe that this economic package makes the most sense and is certainly the best that has been presented to this committee in my 15 years as a member.

And I want to not only commend the President, but to commend you for your part and for your input in the preparation of this package.

I believe that the American people will respond. I have been hearing from my constituents that they are willing to make the sacrifice as necessary. And as long as we stay on track with it, I think they really will be willing to support it.

It is one of those moments when we have to be willing to take the political risks. The President is taking a political risk by appealing to our best instincts as a people, by not underestimating the patriotism of our citizens. And we have to be willing in this body to take some risks as well to support it.

I would continue to urge that we keep the stimulus package down to the bare necessity of things that have to move first. And I would urge that the President and the leadership of the Congress set the dates for the enactment of the reconciliation bill. Those dates will be spelled out in the budget resolution.

I hope they will be greatly accelerated because I believe that with each passing week unfortunately, the special interests have a chance to get their hands on the package.

And as those who are employed to pick it apart try to do so, the longer we wait, the harder it will be to take the kind of action that is necessary. So I again repeat my urging that we move with dispatch.

I want to just touch on one point. And again, not to be negative, as I already indicated. I am prepared to support the President's package. I hope we can refine it in some aspects.

Senator Breaux has already mentioned the technical problem of collection of the BTU energy tax. And I want to just follow up on that. I understood that the administration has used the term "collection of the tax on natural gas," for example, "at the pipeline" or early in the process.

And I am concerned about that phrase, "at the pipeline.". That can mean either at the pipeline as it is put into the pipeline by the producer or it can mean at the other end of the pipeline as it goes out to the first consumer.

And I would strongly urge that, as you refine this program, collection would be at the point in which it goes out to the first purchaser, not where the producer puts it in.

I would raise these points. Of course, you are every bit as aware of them as I am, but many of the operators now are very lean in terms of the number of employees they have.

The average natural gas producer or operator has 10 or 15 people working for him or for her. And a collection point at this level would require producers of nearly 300,000 wells to identify more than 2.5 million working interests and royalty interest property owners for the purpose of tax collection.

This just becomes an overwhelming burden, especially for the smaller independents. And I have a great worry, whether it is oil or natural gas that we are talking about. The low-volume stripper wells that are usually produced by the smallest independents represent 77 percent of our wells but only 13 percent of our production; however, they are very important and would be the first ones that would suffer if we had a collection point at that place.

Also, of course, there is this exemption for feedstock use. If you collected it at the front end with the producer at the point the producer puts it into the pipeline, it would be almost impossible for a producer to know the end use or to be able to administer that exemption.

I understand that the Joint Tax Committee has looked at this and has recommended that the point of collection for natural gas should be at the point of removal from the pipeline to the purchaser or the direct user.

And I just wonder if you are at least open minded at this point on that issue.

Secretary BENTSEN. No question about that, Senator. And this is just the kind of input we want. That is why we are here at this stage.

Senator BOREN. Well, thank you very much. I will not prolong the point. Again, I want to commend you and commend the administration on the overall proposal. I certainly pledge to you as one Senator that I am going to be supportive of it and try to help move it along as soon as possible.

Secretary BENTSEN. Thank you.

The CHAIRMAN. Thank you, Senator Boren.

Now, Senator Conrad. Sir, you have been patiently waiting down there.

Senator CONRAD. Thank you, Mr. Chairman.

I, too, want to say to the Secretary how much I appreciate the magnitude of the proposal that has been put before us because I think the problems facing the country require an ambitious assault. This program represents that.

I think all of us have some things that we would like to see altered in the package, while preserving the overall levels of deficit reduction, perhaps expanding on them if we could while improving on the package on the margins.

But I want to say that I think in terms of the overall concept, this package moves in exactly the right way in terms of deficit reduction and in terms of changing the composition of Federal spending towards investment and away from consumption.

I understand from press reports at least that you have been one of those in the inner councils who has been a deficit hawk, somebody urging the administration to put forward a package that had serious deficit reduction in it.

Knowing you, I believe that that is the case. I want to publicly thank you for taking that position because I think it is terribly important for the country.

Secretary BENTSEN. Thank you.

Senator CONRAD. In trying to analyze the fairness of the package, which is obviously important to everyone, I've also looked at the impact on my State. Concerns have been raised because my State is a very agricultural State, and agriculture takes the biggest percentage reduction.

We are an energy State. In fact, my constituents are the fifth highest users of energy per capita in the country. So we seem to be disproportionately affected there.

In fairness, we are also disproportionately helped in some areas. The investment tax credit that is targeted to small business disproportionately helps a State like mine. And we appreciate that very much.

We are also not as adversely affected by the income tax part of this program as other States. Obviously, we have lower income people in my State. Seventy percent of the people in my State have incomes below $30,000. We do not carry as much of the burden on the income tax side as other States will do.

So we are trying to make a determination, where do we fit in? And I am wondering in that regard, Mr. Secretary, if there has been any State-by-State comprehensive analysis at this point of the burden and the benefits of this plan or whether that is being worked on.

Secretary BENTSEN. Well, I do not think we have it State-by-State, but we have it in regions where we thought some economic impact might result and tried to moderate that.

We did some things on the rural side in trying to ensure that rural hospitals, that they get the credit for a heavy dependency on Medicare, to try to see that some benefits were taken care of on rural referral centers under Medicare. Small rural hospital demonstrations, we put those in.

So some of those things we have stressed because living in a rural area in a very small town, so many people are moving away from them, yet so critical to them is having the availability of a hospital.

So we have leaned over to try to see that that is retained. And knowing full well in rural areas, the people are older than the average than they are in the urban areas. And therefore, it becomes Medicare dependent, the hospital does. And we are trying to assist on that one.

Senator CONRAD. Well, we appreciate those elements of the plan. They are very important.

I would like to bring up a very specific problem we have, if I might. We have the largest and only commercial scale gasification facility in the country in my State, a $2 billion plant.

You may recall the government took it over when the original owners walked away from it. It was then sold back into the private sector. A large regional cooperative in my State purchased it.

Now we face a situation, and I am sure it is unintended, that the plant would be forced to shut down under this plan. The reasons for it are very simple. First, in their contracts, they have no pass through provisions for a tax of this type.

Second, they would be taxed on the coal going into the plant and also on the gas going out of the plant. The combination of those two taxes is greater than the total profits of the plant.

In fact, they would be in a category of running a loss of $8 million a year. Obviously, you do not keep a plant open that is losing money. This would have an enormous economic impact in my State.

It is one of the largest employers in my State. The ripple effect would be enormous on the energy in my State. Is there something that can be done to address special problems like that one?

Secretary BENTSEN. Let us take a look at it, Senator. I am not aware of that specific situation, but let us see if there is something that can be done.

Senator CONRAD. All right.

Secretary BENTSEN. We would be pleased to have your input.

Senator CONRAD. We appreciate that.

The CHAIRMAN. If I could just say, that sounds like a specific question that you came here to hear about.

Secretary BENTSEN. That is right.

The CHAIRMAN. We very much appreciate just taking notes one by one.

Senator Wallop has arrived. And we are happy to hear from you, sir.

Senator WALLOP. Thank you, Mr. Chairman.

I am here below the salt.

Secretary BENTSEN. Senator, you have never been below the salt.

Senator WALLOP. Well, I mean, if you were still the chairman, you would barely see me. [Laughter.]

Secretary BENTSEN. That was one of the reasons that I suggested that we change these bloody lights around because I really could not see someone who was down there.

Senator WALLOP. Mr. Chairman, I would ask unanimous consent that my statement be included in the record.

The CHAIRMAN. Of course.

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

Senator WALLOP. I have all kinds of concerns, most of which have probably already been asked about the President's package, but let me focus on the energy tax, Mr. Secretary.

One of the first issues that is relatively obvious from an examination of the BTU tax is that everything Congress did last year by way of drafting an energy strategy is seriously negated by the imposition of this tax.

It puts western coal at a price disadvantage to eastern coal and puts eastern coal, a dirtier coal, into stronger play.

It creates a situation in which independent power producers ("IPP") who purchase gas through fixed price gas contracts will probably not be able to compete with coal. So what our national energy strategy tried to do with gas in putting it into plant generation will be negated.

We had testimony to this effect earlier today in the Energy Committee. No one knows who has to pay the BTU tax on a fixed price long-term contract. If the contract cannot be negotiated, the IPP is out of business. They could also switch to coal because one of the things that has been taking place in America is fuel switching.

One of the things we tried to do in the energy bill was to take advantage of it. Has that been brought up in the conversations?

Secretary BENTSEN. Senator, what I said when I first came here, we were here early on, trying to get the input, just as you are giving me now, before we make final decisions, before we submit the budget to the Congress. And we have had a lot of input here today concerning those kinds of issues.

I had them from Senator Breaux. I had them from Senator Daschle and various ones on particular issues. And I am delighted to have yours because that is what we tried to do when we looked at the situation. We looked at the carbon tax and said that is such a load on coal in some regions. And we negated that.

We looked at an import fee. And we knew what kind of reaction we would get out of New England on that one. And then, we looked at the gasoline tax. And I know what kind of reaction I would get out of Texas and California where they are so dependent on automobiles.

And finally, we looked at the BTU as something that would attack pollution, that would bring about a reduction of imports of foreign oil—we estimate some 350,000 barrels—and would raise substantial funds to take care of the deficit. That is how we arrived at it.

Now, there is a question as to whether you put that tax on at the end of the pipeline, or at the beginning of the pipeline of natural gas. The question is whether you put it on at the input of the refinery or the output, we decided on the output, but those things are being formulated at the——

Senator WALLOP. Well, one of the problems, of course, is that the exemption of feedstocks puts us in the position where fraud is going to become king.

Secretary BENTSEN. Where what?

Senator WALLOP. Where fraud is going to become king.

How does a person who has a gas well where the tax is assessed know whether his gas will go into feedstock or a house?

Secretary BENTSEN. So that once again is a determination I suppose as to where we put it on, but we want your input.

Senator WALLOP. The pipeline would be the chief beneficiary of that, but the problem is that almost anything can be called a feedstock. The testimony we had in the Energy Committee was that the feedstock percentage of energy would probably rise about 15 percent. So that——

Secretary BENTSEN. Well, any one of these taxes you put on, Senator, you look at a value-added tax. And I was listening to the Ambassador from Canada talking about what an incredible problem they were having collecting the value-added tax and the cost that was entailed in it. I have not found an easy one.

Senator WALLOP. You are familiar with business more than most who have held your position. How is the average gas well producer going to access daily the BTU content of his well?

Secretary BENTSEN. I do not have that detail of specificity, but those are the types of things we are working on.

Senator WALLOP. Another problem is that a lot of the gas in Wyoming is dirty gas: it has to go through a processing plant. The tax penalty for that type of gas as it comes from the well versus whether it goes through the processing plant is significant.

Secretary BENTSEN. That is right. Those are things we have to weigh in trying to bring it about, to bring about equity in it and to try to clean up the bookkeeping end.

Senator WALLOP. When do we get to weigh the proposal—before we pass it or after?

Secretary BENTSEN. You were not listening. That is what I am here doing.

Senator WALLOP. Well, I know, but when will we see the administration's proposed changes which answer some of these questions?

Secretary BENTSEN. Well, we have given you some of the broad changes now. We are trying to fill in the detail. And you are contributing to that. And I appreciate that.

Senator WALLOP. Let me ask you this. I believe it was you and I who held the only hearing that has been held on an import tax, and mostly we heard from New England.

Secretary BENTSEN. Well, you learn from experience.

Senator WALLOP. But there is at least one strong point of view that this BTU tax, in effect, increases rather than decreases our dependence on foreign oil. Let me give you two examples how one can——

The CHAIRMAN. Can you make that one example, Senator? [Laughter.]

Senator WALLOP. Oh, I am sorry. I will.

Lifting costs in the Middle East are such that they can lower their price and it would remain competitive. However, lifting costs of heavy oil, particularly in California, with this increased tax on use will make the product uncommercial. So our dependence on imported oil will grow and not decline.

Sorry, Mr. Chairman.

The CHAIRMAN. No, sir. These are the questions that the Secretary has invited.

Secretary BENTSEN. Sure.
The CHAIRMAN. We want to be considerate of your time, sir. And we will have just a few more questions.
Secretary BENTSEN. If you could, I would appreciate it.
The CHAIRMAN. Senator Packwood.
Senator PACKWOOD. Very quickly, Mr. Chairman. Thank you.
Mr. Secretary, you have a top right rate of 39.6 percent on upper incomes. And you take off the Medicare caps. So, if the person is employed, that adds another 1.45 percent to it on his or her income, 2.9 percent if they are self employed.
How much will PEP and Pease add on top on that?
Secretary BENTSEN. I do not know.
Senator PACKWOOD. About 2 or 3 percent?
[Pause.]
Secretary BENTSEN. They tell Pease is about 1 percent. PEP is about a half.
Senator PACKWOOD. All right. So let's say 1½ for PEP and Pease. So you have 39.6 percent. You add Medicare. It puts you at about 41 percent. You add PEP and Pease, you are up to about 42.5 percent on adjusted gross income.
On page 8 of your statement, you say, "The revenue changes we propose restore greater progressivity to the individual tax system, making it far more fair and equitable."
In your judgment, let's say someone makes $500,000 of adjusted gross income, what is a fair and equitable amount that that person should pay to all of the governments of the United States, Federal, State, and local as a fair and equitable share?
Secretary BENTSEN. Well, let me say, Senator, we reached a point where somebody making about $35,000 and somebody making $1 million had about a 3 percent differential in their tax. And that is where we were at one point.
And that is outrageous frankly. I do not think that is progressivity. It is a subjective thing obviously in trying to decide what is fair.
I look at rates around the countries around the world. And I can remember what our rate was. I can remember when it was 50. I can remember when it was 70. And I think that what we have arrived here is fair and equitable.
Senator PACKWOOD. Let's say, would 50 or 60 percent be fair and equitable of your total income to give to all governments?
Secretary BENTSEN. I think you are beginning to push the envelope when you get up into that area.
Senator PACKWOOD. Because I think probably, if you are living in Manhattan——
Secretary BENTSEN. I understand what you have in New York.
Senator PACKWOOD. But as I recall, a 7 percent effective State income tax, a 4 percent effective Manhattan tax and a sales on top of that, you are well over 50 percent.
Secretary BENTSEN. Sure. But I can remember when it was so much more than it is now, than what we are proposing.
Senator PACKWOOD. I want to ask you another question. And again, I am citing OECD statistics. And these are just percentages of taxing and spending in different countries because you mentioned Germany twice.

In 1990, Germany taxed 43 percent totally, all the governments, of the gross domestic product. They spent 46 percent. They had a deficit. In fact, all of the countries save four of the major industrial countries have deficits.

We taxed 32 percent and spent 36 percent. Do you suggest we should move more toward Germany's level, that we should be taxing and spending significantly higher?

Secretary BENTSEN. Well, I have told you what we have and what I have seen in some of these other countries. So I think we are in——

Senator PACKWOOD. Mr. Secretary, this is not so much a question of rates. It is just how much do we want to take in terms of total revenues out of the gross domestic product?

Ms. Tyson, in her confirmation hearings indicated that we ought to tax ourselves more like our competitors. Do you agree with that in terms of the total take out of the gross domestic product?

Secretary BENTSEN. No. I was citing what we were up against with other countries and what they were doing for comparative purposes. I think what we do is follow our own judgment in trying to arrive at what we think is necessary. Investing in the future of our country and trying to increase productivity means that we have arrived at a fair balance.

Senator PACKWOOD. And therefore, we shouldn't try to emulate necessarily the total tax take of other countries and shouldn't necessarily use them as an example.

Secretary BENTSEN. Well, I would say that if we look at other countries, we find that we are at the low end of all the industrial countries.

Senator PACKWOOD. Oh, I agree.

Secretary BENTSEN. Insofar as the U.S. tax burden.

Senator PACKWOOD. I agree with you. In terms of spending, only Switzerland and Japan are lower than we are. All the rest tax more and spend more.

Secretary BENTSEN. Yes.

Senator PACKWOOD. But are you suggesting that we should look like them?

Secretary BENTSEN. I am suggesting as related to those things we are trying to accomplish for our country and to improve the standard of living of our people that we have an appropriate level.

Senator PACKWOOD. Thank you, Mr. Chairman.

The CHAIRMAN. Well, Mr. Secretary, one final question. Now, you say that I mentioned earlier that we are going to hold hearings on this subject. So there will be an answer.

Senator Roth, a brief last question, if you wouldn't mind, sir.

Senator ROTH. Mr. Secretary, I will try to be brief. I want to go back briefly to the chart. As I said, this chart is based on the——

Secretary BENTSEN. That is becoming quite familiar. Yes. [Laughter.]

Senator ROTH. Is based on the CBO baseline. And that is very important because that is what the President said he was going to base his program on.

Secretary BENTSEN. I wish, Senator, you would correct your chart and put in the entitlement savings. They are not just in there. It distorts the chart.

Senator ROTH. Well, the point we are trying to make here with this chart, Mr. Secretary, is that in the first 4 years, there is no cut in discretionary spending.

The reason that is important, the people back home, at least the message I am getting, is that they want spending cuts before they see any tax increases.

But let's go just a moment to your——

The CHAIRMAN. Just a moment. [Laughter.]

Senator ROTH. To the question of entitlements. Again, in the first 4 years during this President's term, entitlements will be cut something like $28 billion. So on the spending side, during the first term, total spending changes have been increased $10 billion.

Revenue, however, is raised $137.5 million, much——

Secretary BENTSEN. Senator, we have a strong difference in agreement as to what is a revenue. And we have used what has been used by CBO, what has been used by OMB, what has used by the Reagan administration. And they are different.

Senator ROTH. Mr. Secretary, if you go to one of my senior citizens and try to tell them, for example, increasing the tax from 50 percent to 85 percent is not a tax increase, good luck. I just do not think it can be done.

Secretary BENTSEN. Well, the Reagan administration did a pretty good job at doing that and then showed it as a savings in benefits. And that is what we have followed.

Senator ROTH. I thought you were trying to change—the Reagan program. But in any event the point I wanted to make——

The CHAIRMAN. They are.

Senator ROTH. The point I am trying to make is that this administration has talked about dollar-for-dollar or even $2 for $1 spending cuts to tax increases. Why propose a $162 billion spending increase during this period of time? Why not, as Senator Dole suggested, why not increase the spending side cuts so that we have some real deficit——

Secretary BENTSEN. Because we are talking about some investments in the future of our country that we think are important in improving education and making us more internationally competitive. And that is because this budget's realigns spending toward investment in the discretionary accounts.

Senator ROTH. I am afraid—Mr. Chairman, and I will conclude, that this sounds in general like "tax and spend." Could we submit further questions?

The CHAIRMAN. Of course.

[Senator Roth's questions appear in the appendix.]

The CHAIRMAN. May I make the point that all 18 Senators have been present.

If you would be so good, we are going to submit questions to you in writing.

Secretary BENTSEN. I would be delighted.

The CHAIRMAN. It has been a very productive and for us an historic occasion that you should come before us. We wish you the greatest success on your trip to London with the G–7. I understand that it will be your first appearance on the international stage since you were over there as a bomber pilot. [Laughter.]

Secretary BENTSEN. I hope I do not bomb out.

The CHAIRMAN. The committee will stand in recess.

I hope some Senators can stay because we must address the emergency unemployment bill.

We will say goodbye to Senator Bentsen.

[The prepared statements of Senators Rockefeller and Hatch appear in the appendix.]

[Whereupon, at 12:32 p.m., the hearing was concluded.]

PRESIDENT'S ECONOMIC PLAN

WEDNESDAY, MARCH 24, 1993

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

The hearing was convened, pursuant to notice, at 10:06 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Daniel Patrick Moynihan (chairman of the committee) presiding.

Also present: Senators Baucus, Bradley, Riegle, Daschle, Breaux, Conrad, Packwood, Roth, Danforth, Chafee, Durenberger, Grassley, Hatch, and Wallop.

[The press release announcing the hearing follows:]

[Press Release No. H-7, March 22, 1993]

FINANCE COMMITTEE TO HEAR FROM FEDERAL RESERVE CHAIRMAN ON ADMINISTRATION'S ECONOMIC PROPOSALS

Sen. Daniel Patrick Moynihan (D.-N.Y.), Chairman of the Senate Committee on Finance, announced today that the Committee will hear from Federal Reserve Chairman Alan Greenspan on the economic proposals of the Clinton administration.

The hearing will begin at *10:00 a.m. on Wednesday, March 24* in room SD-215, Dirksen Senate Office Building.

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

The CHAIRMAN. A very good morning to our guests and our distinguished witness, Dr. Alan Greenspan, who is the Chairman of the Board of Governors of the Federal Reserve System.

This will be the first of a limited but crucially important number of hearings which the committee will hold on the general subject of the state of our economy, the state of our Federal finances, and the administration's proposal to address them in various specifics.

We are honored that our first witness, who will be Dr. Greenspan, has legendary achievement in public service, a person notably above party lines at this point certainly in his career, who has shown from appointment by earlier administrations a clear interest in working with the present administration, but much more importantly a clear concern that things need to be done and soon.

He has a statement which I know we will all read with great interest.

And so I will say no more than good morning, sir.

Senator Packwood.

Senator PACKWOOD. Good morning, Mr. Chairman.

Did you finally get the charts that I sent down to the office?

Dr. GREENSPAN. I did, indeed, sir.

Senator PACKWOOD. Perfect. I will have a few questions. And I have nothing more to say now.

The CHAIRMAN. Thank you.

If it is all right with the committee, we will hear from Dr. Greenspan, who is available to answer questions in response to his statement.

Good morning, sir.

STATEMENT OF HON. ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, WASHINGTON, DC

Dr. GREENSPAN. Thank you very much, Mr. Chairman and members of the committee which I am delighted to appear before for the first time this session. And I trust that you will invite me up on numerous other occasions on issues which confront us.

As I have indicated in previous testimony before the Congress in recent days and recent weeks, our burgeoning structural budget deficit, unless addressed, will increasingly threaten stability of our economic system.

Time is no longer on our side. At 5 percent of gross domestic product, the current deficit is very large by historical standards.

After declining through 1996, the current services deficit starts on an inexorable upward path again.

On a cyclically adjusted or so-called structural basis, the deficit has hovered around 3 percent of potential gross domestic product for the last 10 years, a phenomenon without precedent in our peacetime history.

I am encouraged that the President and the Congress are making serious efforts to restore a measure of balance to our fiscal affairs.

It is beguiling to contemplate the downtrend in inflation in recent years in the context of very large budget deficits and to conclude that the concerns about their adverse effects on the economy have been misplaced.

Regrettably, this notion is dubious. The deficit is a corrosive force that already has begun to eat away at the foundations of our economic strength.

Financing of private capital investment has been crowded out. And, not surprisingly, the United States has experienced a lower level of net investment relative to GDP than any other of the G–7 countries in the last decade.

To some degree, the impact of the Federal budget deficits over the past decade has been muted as we imported resources to help finance them.

This can be seen in our large trade and current account deficits. However, we should not, indeed, we probably cannot, rely on foreign sources of funds indefinitely.

If we do nothing, the markets will ultimately force an adjustment. By acting now to redress our internal imbalance, we can lower the risk of unpleasant stresses down the road.

Mr. Chairman, I shall eschew, as I have in previous testimonies, comments on the specific elements of the deficit-reduction proposals currently under review by the Congress.

I should like, nonetheless, to take the time you have made available to outline my views on the principles that should underlie current deliberations.

First, according to both the Office of Management and Budget and the Congressional Budget Office, deficits are likely to be held in check by relatively good economic performance over the next few years.

But from 1997 on, budget outlays under existing law are projected to rise appreciably faster than the tax base.

If such trends are not altered, stabilizing the deficit-to-GDP ratio solely from the receipts side, not to mention reducing it, will necessarily require ever increasing tax rates.

Senator PACKWOOD. Can I ask a definition question right here?

The CHAIRMAN. Yes.

Senator PACKWOOD. What do you mean by rates? You have underlined. it

Dr. GREENSPAN. What I mean by rates is the distinction between the tax base which are taxable incomes and the rate applied to that which is what gives you total revenues.

What I am saying algebraically is that so long as expenditures are rising faster than the tax base, obviously, to close the deficit, it can only be done by raising rates, effective rates.

Senator PACKWOOD. Yes. Senator Bradley asked the same question, unless you broaden the base. By rate you mean the percentage?

Dr. GREENSPAN Yes. In other words, I am including in the concept of rates, the base, anything which relates to taxable incomes. I do not mean those which necessarily are being taxed, but those which are capable of being taxed.

But you are quite correct, gentlemen. If I were to reread this, I would revise it slightly to capture the difference.

In any event, granted this relationship were we to progressively increase—I will put it exactly—receipts as a percentage of incomes, this would of necessity undercut incentives for risk taking and inevitably damp the long-term growth and the tax revenue potential of our economy.

The gap between spending and revenues will not close under such conditions. Thus, there is no alternative to achieving much slower growth of outlays if deficit control is our objective.

This implies not only the need to make cuts now, but to control the growth of future spending so that it does not exceed, and preferably is less than, the projected growth in the tax base to be read as incomes capable of being taxes.

The thought expressed by some that we can inflate our way out of the budget deficit is fanciful.

Aside from its serious debilitating effects on our economic system, higher inflation, given the explicit and implicit indexing of receipts and expenditures, would not reduce the deficit.

As I indicated in testimony to the Joint Economic Committee in January, there is a possibility that productivity has moved into a significantly faster long-term growth channel, which would boost real growth and tax revenues over time.

But even if that turns out to be the case, short of an increase beyond anything that we can reasonably anticipate at this time,

productivity, in itself, would not be enough to resolve the basic long-term imbalance in our budgetary accounts.

Thus, while economic growth is necessary to contain budget deficits, it regrettably is not sufficient.

In deciding how to pare a structural budget deficit, it is important to be clear on the different roles of boosting taxes, on the one hand, and cutting spending programs on the other.

All feasible taxes, by their very nature, restrain business activity. Hence, excluding so-called sin taxes and possibly environmental taxes, increases in taxes can only be justified to finance expenditures that are deemed essential.

The level and composition of outlays to be financed by revenues is, in our society, a political matter, as is also the degree of progressivity and incidence of taxation.

But over the long run, it is important to recognize that trying to wholly, or substantially, address a structural budget deficit by increasing revenues is fraught with exceptional difficulties, and is more likely to fail than succeed.

All else equal, reducing the deficit would enlarge the pool of savings available for private capital investment. But investment will not automatically occur unless there are adequate incentives for risk taking.

A greater willingness of a society to consume less of its current income should lower real interest rates and spur such investment.

But if risk taking is discouraged through excessive taxation of capital or repressive regulation, high levels of investment will not emerge. And the level of savings will fail as real incomes stagnate.

The process by which deficits divert resources from private investment is part of the broader process of redirecting the allocation of real resources that inevitably accompanies the activities of the Federal Government.

The Federal Government can preempt resources from the private sector or direct their usage by a number of different means, the most important of which are: (1) spending, financed by taxation; (2) spending, financed by borrowing, that deficit spending; (3) regulation mandating private activities such as investment in pollution control or safety equipment, which are likely to be financed through the issuance of debt; and (4) government guarantees of private borrowing.

What deficit spending and regulatory measures have in common is that the preemption of resources, directly or indirectly, is not sensitive to the rate of interest.

The Federal Government, for example, will finance its budget deficit in full, irrespective of the interest rate it must pay to raise the funds.

Borrowing with government-guaranteed debt may be interest sensitive, but the guarantees have the effect of preempting resources from those without access to riskless credit.

Government spending fully financed by taxation does, of course, preempt real resources from the private sector, but the process works through channels other than through real interest rates.

Purely private activities, on the other hand, are, to a greater or lesser extent, responsive to real interest rates. The demand for

housing, for example, falls off dramatically as mortgage interest rates rise.

Inventory demand is clearly a function of short-term interest rates, and the level of interest rates, as it is reflected in the cost of capital, is a key element in the decision on whether to expand or modernize productive capacity.

Hence, to the that the demand for savings exceeds its supply, interest rates will rise until sufficient excess demand is finally crowded out.

The crowded-out demand cannot, of course, be that of the Federal Government, directly or indirectly because Federal Government demand does not respond to rising interest rates.

Rather, real interest rates will rise to the point that private borrowing is reduced sufficiently to allow the entire requirements of the Federal Government, including its on and off-budget deficits and all its collateral guarantees and mandated services, to be met.

In these circumstances, there is no alternative to higher real interest rates diverting real resources from the private to the public sector.

In the short run, nominal short-term interest rates may temporarily be held down if the Federal Reserve accommodates the excess demand for funds through a more expansionary monetary policy.

But this will only produce greater inflation and, ultimately, have little, if any, effect on the allocation of real resources between the private and public sectors.

In such an environment, inflationary forces too often lead to increased risk premiums, higher real interest rates, and a higher cost of capital.

This, in turn, engenders a foreshortening of the time horizon of investment decisions and a decreasing willingness to commit to the long term a commitment that is so crucial to a modern technologically advanced economy.

Structural budget deficits and excessive collateral credit preemptions are symptoms of a society overconsuming and undersaving and underinvesting.

While there is no substitute for political will in reining in outsized structural budget deficits, there are changes, Mr. Chairman, I believe, that could make the budget process more effective.

In particular, it is worth reconsidering sunset legislation which would impose explicit termination dates on spending programs.

Expiring programs that still have merit should have no difficulty being re-authorized, but programs whose justification has become less compelling would not receive the necessary votes.

Indeed, it is hard to imagine that sunset legislation would not lead to at least some improvement over the current situation, quite possibly fostering non-trivial budget savings.

It would also be useful to take a look at the current-services methodology for evaluating budget changes.

A baseline estimate obviously is a necessary ingredient in the budget process that helps inform policymakers about the impact of policy proposals.

However, the current services concept assumes that no further Congressional, judicial, or bureaucratic actions will be taken to alter existing programs.

This is quite unrealistic, but it would be of no particular significance were it not for the fact that the bias of such actions is patently toward more spending rather than less.

Hence, merely owing to ongoing Congressional deliberations, administrative rulings, and decisions, an add-on to the current services outlay estimates is required to get a better view of what might be termed the "expected" deficit of the future.

It is not possible to know in advance which spending programs will be expanded, except that some will. In recent years, Congressional current-services outlay estimates have consistently been adjusted upward in response to such technical re-estimations of program costs.

Indeed, technical re-estimates explain a significant part of the failure of the deficit to fall as contemplated at the time of enactment of the Omnibus Budget Reconciliation Act of 1990.

Finally, while I do not favor a balanced budget amendment on the grounds that it might be impossible to enforce, I would support a constitutional amendment, or even a legislative provision that stipulates that all revenue and expenditure initiatives require super majorities, for example, 60 percent, to pass both houses of the Congress.

Combined with sunset legislation, such a procedure could probably go far to neutralize the obvious propensity of our political system toward structural deficits.

Let me conclude by reiterating my central message. The deficit is a malignant force in our economy. How the deficit is reduced is very important, that it be done is crucial.

Allowing it to fester would court a dangerous erosion of our economic strength and a potentially significant deterioration in our real standard of living.

Fortunately, we have it in our power to reverse this process. This committee has an important role in this process. And speaking as a citizen, I wish you all well in your difficult endeavors.

Thank you, Mr. Chairman.

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

The CHAIRMAN. Speaking as the chairman, your wishes are appreciated.

I will ask just one question by way of clarification and then somewhat of a larger one. Early on in your statement, sir, a very powerful statement, you say, "Increases in taxes can only be justified to finance expenditures that are deemed essential."

Now, we have before us a set of proposals from the administration. And we will get from this committee instructions to raise $294 billion in taxes during the next 5-year period.

We just had our first vote of some consequence on this matter on the floor. And by a 52–47 vote, we agreed that we will increase taxes on Social Security benefits for persons in higher, upper income brackets.

I would not take you to mean that we cannot, or should not, increase taxes to reduce the deficit in this present content.

Dr. GREENSPAN. I was referring, Mr. Chairman, to the more abstract concept that since all taxes have a negative effect on economic activity that, therefore, they should not be used for other than financing expenditures which are essential.

What I am basically getting at is that taxes are not a good in themselves. They are bad, if I may put it that way.

And one can justify their existence, in my judgment, only to the extent that they are employed for financing expenditures.

The reason I raise this question is that it is important to understand that in a economy, especially an economy such as ours, that taxes tend to depress the level of activity. They tend to depress the level of risk taking. They tend to depress the level of economic growth. And they should only be used when there are values to be achieved, which are greater than the clear cost that taxation creates.

The CHAIRMAN. But you have described an emergency situation with respect to the deficit.

Dr. GREENSPAN. I am not, in the context of the principles that I was discussing in my prepared remarks, addressing the specific situation.

The CHAIRMAN. Then, just one larger question. You observed that on the question of a constitutional amendment or other legislation that would require the majority, I can just say for what it is worth that I would have thought a constitutional amendment was a disaster 15 years ago, as a good Keynesian.

I, indeed, asked Charlie Schultz if he would run the 1977 recession on the OMB computer. And he did. He said the computer blew up. [Laughter.]

Which may be the clue to the difficulties we have had ever since, if the computer is not working. I never thought about that.

But you said that you are going to favor it. You are disposed, given the obvious propensity of our political system toward structural deficits.

That is a big question because early on, you said that we have been running at 3 percent of potential GDP for a decade by way of a deficit. You said that is unprecedented in our peacetime history.

Dr. GREENSPAN. Yes.

The CHAIRMAN. And it is. Well, if it is unprecedented, then, has our political system changed so much that it now has a propensity toward structural deficits?

Dr. GREENSPAN. I think it changed, as best one can judge, earlier in the post-World War II period.

The CHAIRMAN. All right.

Dr. GREENSPAN. I remember a press conference which President Eisenhower had in which he was close to being apoplectic because we had a $4 billion deficit.

And at the time, there was a general consensus within our society that revenues and expenditures should be closely tied and that running deficits was most inappropriate.

And I think the history of this country exhibits a very strong commitment towards maintaining balanced budgets in a general way.

Somewhere as we move through the post-World War II period, it is fairly clear that there has been a significant shift in a bias towards increasing commitments from government, which I must say if one looks at some of the data that Senator Packwood has presented, is basically an industrial country phenomenon where the proportion of government spending to gross domestic product has risen up until the mid-1980's pretty much across the spectrum of the industrial world.

I think that is a political value system issue. And I do think that we in the United States have a chronic problem with this, and the way I like to put it is that behind each of the thousands of items in our Federal budget is a political constituency.

And we find how significant that is when we endeavor to pare back even what most people would think are not very significant items.

The CHAIRMAN. So your thought is that this propensity is a postwar phenomenon?

Dr. GREENSPAN. Yes.

The CHAIRMAN. Because I just like to recall in the early days of the Kennedy administration, the economy was thought to be afflicted by a dread disease called fiscal drag.

And what fiscal drag meant was that as the business cycle improved and rose and revenues started coming in, Congress would not spend additional money.

And, therefore, there was a depressant. And we never quite reached full employment. And out of that, I know that Charles Schultz, as Director of OMB under a Republican administration and continued in a Democratic administration, continued sending to the Congress a full employment budget which said that if we had full employment, there would be sufficient revenues to make this a balanced budget. It's not balanced now because we want to have the stimulus that would, in fact, create that increased revenue.

So the economics profession got into the business of institutionalizing the deficit.

Dr. GREENSPAN. Oh, I agree with that, Mr. Chairman. In fact, I remember that period quite well. And I must say, there were a number of observers of that period who suggested that the implementation officially of the so-called high employment or full employment budget was an issue of necessity as distinct from an issue of thoughtful economic insight.

It became a way to explain why deficits were emerging and why they were allegedly of no significant concern.

I am fearful that in looking back at that period in retrospect that it was not a very useful process. And, indeed, my suspicion is that it has assisted us to move in the direction that we have.

The CHAIRMAN. The shift?

Dr. GREENSPAN. The shift. Yes.

The CHAIRMAN. Well, thank you very much, sir.

Senator Packwood, you have questions. You have charts.

Senator PACKWOOD. I have questions. And I have charts. And I will do a couple of general questions first, Mr. Chairman.

On page 3, and it is the part that Senator Moynihan asked about, it says, "An increase in taxes can normally be justified for financial expenditures that are deemed essential."

It reminds me a bit of those snow alerts we have where we say nonessential employees do not need to come to work. And I question, in that case, why do they ever need to come to work if they are not essential.

Can we presume ipso facto that if Congress passes a bill that increases expenditures and the President signs it, it is ipso facto essential?

Dr. GREENSPAN. As I said to the chairman in responding to his question, in discussing the concept of taxation and the very broad notion in the sense, not of this specific discussion——

Senator PACKWOOD. I understand.

Dr. GREENSPAN. Let me be very specific here. The sole point I'm trying to make on that issue is that because all—and I underline the word "all" taxes have a repressive effect on economic activity, that means that they are costly to the economy to impose and that therefore the rationale for the employment of taxes other than for meeting expenditures is an undesirable use, except as I indicated for the special cases where there are presumed to be social policies on the question of the progressivity or incidence of taxation or environmental taxes or the like, but those are relatively minor issues.

Senator PACKWOOD. I understand.

Dr. GREENSPAN. The point I'm trying to make is that taxes are costly to our system. They are not a free good.

Senator PACKWOOD. You are not suggesting that we divide the budget into two categories, essential services, nonessential services and we will tax to favor the essential ones and——

Dr. GREENSPAN. No.

Senator PACKWOOD. All right.

Dr. GREENSPAN. I will grant you that there is a certain grammatical logic in what you say, Senator, but that is not what I had in mind.

Senator PACKWOOD. Now, let me go to your constitutional amendment. And I am going to presume that you are opposed to it because it might be impossible to enforce.

And I am going to presume that we still are and will continue to be a government of laws. This will not be President Jackson saying to Chief Justice Marshall—since he has made his decision, let him enforce it.

It will instead be President Eisenhower saying in Little Rock, the court has decreed this to be illegal discrimination and we will use the Federal marshals to enforce the court order.

The CHAIRMAN. Why are you always picking on Democrats? [Laughter.]

Senator PACKWOOD. If it was possible to enforce a constitutional amendment to balance the budget, would you support it?

Dr. GREENSPAN. The question basically of the nature of the enforcement is really what the issue is. I mean, would the Congress be put in jail if it committed a felony or what?

Senator PACKWOOD. Well, I can give you two ways that are for better or for worse, assuming that the judicial system works. Two ways I think would be enforceable.

One is, assuming you give proper status to people to sue, you say to the courts, you will have the power to make the budget if the Congress does not, sort of like busing. If we don't do it, the court can do it.

My hunch is the court would say, well, we don't like this power. We wish we didn't have to do it. But if a constitutional amendment says we have the power to do it, okay.

Judge Green, in addition to running a communication system, will run the budget. That, I think, would be enforceable.

Dr. GREENSPAN. Senator, let me tell you why I have chosen this other vehicle, which I talk about, requiring super majorities.

The trouble with a constitutional amendment to balance the budget in a technical sense is it invariably focuses on receipts and expenditures which is very far down the road of authorization, appropriation, and various forms of pre-commitments which could be structured in the way that we finance our system.

And if you endeavor, for example, to confront a situation in which you have, say, entitlement programs which essentially create a deficit, you are putting the courts in that case in a position to abrogate previous laws.

Senator PACKWOOD. That is correct.

Dr. GREENSPAN. And it is a very difficult proposition. If you are asking me in the abstract would I like to see a restraint which restrains the budget deficit, the answer is, yes, I would.

And indeed, the reason I have testified before the judiciary committees of the Congress on this constitutional amendment issue over the years is that I believe that if we were to have the requirement of super majorities on all spending and revenue bills in their earliest stages so that authorizations as well as appropriations and outlays were subject to that, you alter the process at the beginning rather than create extraordinary distortions in the process by trying to reverse the process once it is very significantly under way.

But I do think and I always argue that the underlying notions of the need to have some constraint of this process, if necessary by constitutional means, is something which I have subscribed to because I do think there is a bias in our political system which requires neutralization.

Senator PACKWOOD. Okay. Let's go on now to the charts that I sent you. And you pretty much said in your statement that the history of the western—at least of the industrialized countries since World War II as taxes are up and spending is up, is a percentage of the gross domestic product—that is pretty much inexorable—and that the United States actually is at the lower end of the industrialized countries. Most of them tax more than we do and spend more than we do. Are we okay on those facts?

Dr. GREENSPAN. Those are facts.

Senator PACKWOOD. Yes. And indeed when Mr. Ball who used to be the actuary for Social Security and Dr. Aaron from the Brookings Institution were here, they both opined that we should be taxing more.

Dr. Aaron said we are the lowest of the industrialized countries. And we ought to tax more. Mr. Tyson, the new chairman of the Council of Economic Advisors in our hearing said we should look more like Europe in our taxes. We need to tax more.

Now, for the moment, I'm not asking your opinion on their opinions. They think we don't tax enough, and that we should tax more.

Do you think if we choose in terms of what are defined as essential services to spend 45 percent of the gross national product, we should tax 45 percent of the gross national product?

Dr. GREENSPAN. Well, if you are going to do that, and I emphasize the if, the answer is yes.

Senator PACKWOOD. Now, do you think it would be a good trend, assuming we could balance the income and the outgo to look more like our industrialized competitors and to tax and spend consistently more in ever increasing amounts of more of the total national income?

Dr. GREENSPAN. Senator, the answer may well be coming from the other side because as your table shows and, indeed, all data do show that the upward surge in the proportion of government spending to GDP in the major industrialized countries has been edging downward in recent years and, indeed, the general consensus amongst our trading partners is to move closer in our direction than the other way around.

Senator PACKWOOD. Well, in some of the countries when they finally get to this 55 or 60 percent, they finally say, we can't keep doing this. This is going too far. And they attempt to move downward. It is a struggle as Sweden is seeing.

Dr. GREENSPAN. It is a struggle basically for the reasons that we are having struggles right at this moment.

Senator PACKWOOD. Do you think, all things being considered, the country would be better off spending and taxing 30 percent of the gross national product than taxing 40 percent, spending and taxing 40 percent of the gross national product?

Dr. GREENSPAN. You're asking my personal view?

Senator PACKWOOD. Yes.

Dr. GREENSPAN. The answer is yes.

Senator PACKWOOD. Okay. And in your personal judgment—I am not asking you to comment on whether or not it is going to happen, but if the Clinton budget were to push this upward towards the 40 percent, would that be a bad trend?

Dr. GREENSPAN. As I said at the beginning and I would like to reiterate it, I have hopefully, successfully eschewed commenting on the specifics of any of the proposals for Congress.

I have not been wholly successful in the sense that people have read things into my remarks which I have not intended, but I hope I have not essentially committed, gone beyond the line where I am getting involved in this political discussion because I do not think——

Senator PACKWOOD. Excuse me. This will be the last question. Let me rephrase my question. If collectively, Congress, the President, and everybody else were to nudge us up toward 40 percent taxing and spending, would that be a good thing or a bad thing? Forget the President's specific budget.

Dr. GREENSPAN. That is a political judgment which the Congress and the President have to make. This is what a Democratic society is all about.

Senator PACKWOOD. But you personally think it would be——

Dr. GREENSPAN. I personally would prefer less, but I am one citizen. I have one vote.

Senator PACKWOOD. Thank you, Mr. Chairman.

The CHAIRMAN. You have two votes I think. You are also Chairman of the Federal Reserve Board.

Dr. GREENSPAN. The Federal Reserve Board does not vote on such issues. [Laughter.]

The CHAIRMAN. Senator Chafee.

Senator CHAFEE. I will wait.

The CHAIRMAN. Senator Durenberger.

Senator DURENBERGER. Mr. Chairman, thank you for being a wise man, but you are also a prudent man. And I think we appreciate that.

One of the problems that I have observed about being a Republican over the last 12 years is that we have really two different goals reflected, I think, probably on reflection by the House Republicans who abhor nothing more than taxes and some at least of the Senate Republicans who abhor nothing more than a deficit.

And that was played out in 1990. And it seems to get played out from time to time. And I think it is going to get played out a fair amount during the course of this year, even though we are still in the minority in the Congress.

But given that observation, I would like to move to a related one which is the observations that the President made to us when he came to see the Republican Senators. And I am sure he probably made the same observations to the Democratic Senators.

Looking back on that 12-year period, you said this, "You cut tax rates. You cut discretionary spending. You cut inflation. You cut interest rates. Then, in a combination, you increase defense spending. You increase job opportunities in this country. You increase both public and private debt. And you increase the value of the dollar to acquire foreign cooperation in financing all of that debt."

That was his general observation about what went on in that period of time. Then, he said that his goal—and I think this was his economic premise under his fiscal policy because he was appearing to defend his budget.

He said that his economic premise was to reduce public and private debt, try to sustain all the good things that have happened within the last 12 years, and that it is to try to reduce public and private debt by lowering interest rates by keeping long-term low interest rates low, keeping inflation low with the expectation that they were going to, in the private sector, refinance our debt and in the public sector, reduce our increasing deficit.

My first question is, how likely is the refinancing of private debt in this country over the next year or so, given what we have seen of the parameters of the President's fiscal policy, as articulated in his budget proposal which to most of us looks like about $3.82 of a marginal tax rate increase for every dollar in spending reduction?

Dr. GREENSPAN. Well, some of the refinancing of private debt, as you know, has been going on now for a couple of years at a fairly extraordinary pace.

There is a very substantial amount of public offering and private offerings of securities both equity and debt in the private markets, a substantial portion of which has been to refinance existing debt

to lower the interest burden and to substantially improve the balance sheets that the private sector went into the 1990's with.

So long as interest rates, long-term interest rates specifically, obviously, stay somewhere near these levels, one can expect that this refinancing will continue because it obviously has got a long way to go in that we know what the average interest payment is on private long-term business debt.

And clearly; it is coming down now and improving the overall liability side of the private business sector. And that still has a significant way to go. And presumably if rates stay down here or go lower, that will very significantly continue.

The same thing is very evident in the mortgage market in one to four family homes. And a substantial part of refinancing has already occurred, but here, too, there is still a fairly large block of mortgages whose interest rates are well above current market rates.

So I am not sure that the answer to the question gets to anything more significant than where one's forecasts of long-term rates will be over the next year or two.

Senator DURENBERGER. But the concern that a lot of us feel and you reflected in your statement about, you say, "From 1997 on, budget outlays under existing law are projected to rise appreciably faster than the tax base." And you go into all of that logic.

Up until the last couple of months, there has been a lot of economic activity, in refinancing, without a particular sense of direction. Now, we have some sense of direction from the new President.

And that sense of direction long-term does not appear to take on the issue of long-term spending. There seems to be a relatively small impact on long-term deficit.

Much of the spending reduction is in the so-called out years. Much of the political activity in the last week or so has been to create exemptions in this new tax, the BTU tax, a very close vote on the floor of the U.S. Senate relative to taxing Social Security.

Is there any sign of political will that you have noticed that would give encouragement to people that the direction that this administration has sent is towards substantial spending reduction?

Dr. GREENSPAN. Well, Senator, the President has acknowledged that the major problem in the rise in the deficit as we move towards the end of the decade is in the health care cost area. In that respect, he is correct. That is where the major areas of expenditure expansion are.

My view of the process that is going on is that it is in its early stages with respect to this budgetary process.

And frankly, the reason why I commended the President for putting this issue on the table is precisely in engendering this form of discussion and coming to grips with the problem which we can no longer hide from.

We are going through, as best I can see, democratic deliberations and politics in the best sense of the word. And that is what our society is all about.

And it is arguments such as this which are going to go on and go on for a long period of time, which I hope will bring this out at the end of the day where we would have resolved what is a very fundamental problem for this country.

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The CHAIRMAN. Very nicely stated.

Thank you, Senator Durenberger.

Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Dr. Greenspan, your central message is summed up in your concluding remarks. "The deficit is a malignant force in our economy. How it is reduced is very important. That it be done is crucial."

And I must say, I could not agree more with you. I think it is these deficits that are contributing to the difficulties in our economy today.

But there is a theory out there that is constantly espoused or reported that we have to be very careful how we go about reducing the deficit, and that any attempt to drastically reduce the deficit would create its own economic difficulties. Do you subscribe to that theory?

Dr. GREENSPAN. If you are asking me as a theoretical economist, the answer is yes. If you are asking me as an observer of the political scene, I do not find anything there which gives me any concern. [Laughter.]

Senator CHAFEE. Well, I suppose you think there is a little chance that we will do anything drastic.

Dr. GREENSPAN. Let me put it this way. It just does not strike me as credible that with the biases we have in our political system that the concern that we should be exhibiting at this stage is that we will overdue it. It is conceivable that some extraordinary set of changes in value preferences of our society will occur and something very dramatic will start. I find that extraordinarily unlikely as a forecast.

If it should begin to emerge, it is one of the easiest things to prevent from going too far.

But my real concern in all seriousness is if we have that as a central concern in the back of our minds, it is far more likely that we will do too little than too much.

Senator CHAFEE. I could not agree with you more. It seems to me that the "too much, too soon" concern is a marvelous excuse for putting off serious efforts to reduce the deficit.

Do you believe that if we get this deficit down in dramatic fashion that it will result in confidence and thus economic improvement in our society?

In other words, I believe there is a tremendous plus that comes from getting these deficits down in major fashion. Am I incorrect in that?

Dr. GREENSPAN. No. On the contrary, Senator, that is the main purpose of this whole issue. It is true that I have largely emphasized in my prepared remarks the dangers of the large deficit. And there is obviously the implication that if we move it down that we will remove the dangers.

But you are raising an important point that there is beyond that the positive side because to the extent that deficits can be removed as a force in our fiscal affairs over the long-term, there seems to be very little doubt that long-term interest rates will fall, as, indeed, they have fallen quite significantly in anticipation that a goodly part of this process will take place.

But there is obviously still a significant inflation premium embodied in long-term interest rates.

And removing that from our society is really very important because what the data do indicate increasingly is that the weight of increase in productivity is related to the level of inflation and that part of the reason, I suspect, that productivity has been doing as well as it has in the recent period is largely that we have brought the rate of inflation down quite significantly during the 1980's and into the early 1990's.

And past history clearly indicates that there is a quite significant relationship between the level of inflation and the rate of productivity which is obviously the basis for the growth in our standards of living.

To the extent that the deficit is brought down, or if I may even dare to say that we move towards a surplus, that will remove a very important element of inflationary pressures in our economy and foster a higher rate of increase in productivity and in standards of living than we have experienced in the last couple of decades.

Senator CHAFEE. My time is nearly up, but I want to ask you a quick question. It seems to me that this is not just a long-range thing. I mean, what every one of the Senators in this group believe in, I think, or are concerned about is the high unemployment in our Nation.

It is not inflation rates currently. It is not interest rates. It is unemployment. And I believe and I am asking whether you concur in this that if we made a dramatic effort to reduce our deficits that would result in confidence in the American people and businesses, that we are really getting somewhere, and that the unemployment would be reduced or employment increased.

Is that a fanciful thought? And I do not mean in the long run because long-term interest rates will come down.

Dr. GREENSPAN. Well, no. But to the extent that long-term interest rates are coming down in the short run, that has clearly had a positive effect on the level of economic activity.

Now, while it is certainly the case that a surprisingly disproportionate part of the increase in gross domestic product is the result or reflected in increased productivity and a relatively small amount in increased employment.

If we continue a growth rate of GDP anywhere near where we currently are, it is unquestioned, in my judgment, that since we cannot expect to continue running at a 3-percent productivity rate, we would be seeing a significant improvement in the job picture.

And I certainly concur with those who are concerned that a 7-percent unemployment rate is too high because it is too high.

Senator CHAFEE. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Chafee.

Senator Hatch.

Senator HATCH. Thank you, Mr. Chairman.

Welcome, Dr. Greenspan.

I am interested in your view of the impact of the President's plan on the Nation's savings rate and on capital formation.

Let me use an example to ask my question. Consider a typical family living in Orem, UT, earning about $40,000 a year. Let's say that the father commutes to Salt Lake City about 40 miles away, each day a distance that puts a lot of miles on his car.

The proposed BTU tax would significantly affect the family's household expenses through the increased cost in gasoline and the increased cost in the prices of many of the services that they buy.

Now, these higher costs, of course, all things being equal, will lower the family's discretionary income.

In your view, will the higher costs caused by the tax increases of the President's plan lead this particular family to lower its savings rate or to decrease its consumption of other goods and services?

Dr. GREENSPAN. Well, as I indicated in my prepared remarks, taxes have a depressive effect on economic activity one way or the other. And clearly, to the extent that you impose either income taxes, excise taxes, any form of taxes, it will suppress the levels of activity.

The question that we are confronted with is the broader question—which is creating greater problems to the underlying strength of our economy, the deficit or the issue of taxation?

And it is precisely this type of debate which is currently beginning in the Congress and pretty much throughout the country in which I hope we will find a proper balance which will enable us to clearly bring the deficit under control and in the process, not induce unintended side effects.

That is not an easy task. And there is no solution to the deficit problem which is easy. If this were an easy problem, it would have been completed a long time ago.

Senator HATCH. But if the savings rate is reduced—and you indicate maybe both of them would be affected—if the savings rate is reduced, that would have an impact on the efforts to increase capital?

Dr. GREENSPAN. However, to the extent that is offset by a fall in long-term interest rates, which has occurred as a consequence of the contemplated decline in deficit. Very substantial negative effects from that side are clearly being——

Senator HATCH. Sure. But on the other hand, if the consumption is lowered, of course, that could lead to reduced economic activity and possibly job losses.

I mean, either way, it seems to me, that you have made the point that increased taxes have a price?

Dr. GREENSPAN. No. Increased taxes have a price. However, I believe, you should also look at the total picture. What I do not wish to say at this point, because I do not think it is true, is that in the most immediate period that the decline in long-term interest rates is having a negligible effect on the country. I think it is having a significant effect of a positive nature.

Senator HATCH. With regard to the balanced budget amendment and the reason you do not support it, primarily is it that you do not think it is enforceable?

Dr. GREENSPAN. That is correct.

Senator HATCH. If you had an amendment that required a 60-percent vote to increase taxes or to increase the deficit——

Dr. GREENSPAN. No. Increase spending.

Senator HATCH. You would suggest a constitutional amendment or even a legislative provision that stipulates that all revenue and expenditure initiatives require super majorities, for example, 60 percent.

If you have that, how are you going to enforce that?

Dr. GREENSPAN. Well, I think it is much easier to enforce that because you are enforcing it right at the point in which the actual actions are taken.

In other words, if, for example, there were a constitutional amendment, then, in effect, a spending bill would not pass unless it had the 60 percent or more.

Senator HATCH. But let me tell you about the practicalities of that. A lot of members of Congress would like to have a 60-percent super majority to increase the deficit and a 60-percent super majority to increase taxes or revenues. And they know they cannot get that.

So the constitutional amendment as written provides for 60 percent to increase the deficit, and a constitutional majority, at least 51 Senators in the Senate and at least 218 members of the House to increase revenues or taxes.

What I am saying is that first of all, you can never get to your position because you could not get enough votes to pass a constitutional amendment that would require a super majority with regard to tax increases.

We do not have many tax bills around here that passed by 51 votes. They are generally very close battles. Nor are we going to have it. There is always going to be a very tough battle on tax increases.

So I think what I am pointing out is that in both instances, it is going to take political will and it is going to take political power of the people to enforce whatever constitutional amendment you have.

Just like Senator Packwood indicated in the Jackson illustration, you are going to have to have the will of the people to enforce the constitution. And politically, that is the only way it is ever going to happen.

Even if you wrote enforcement language in, I do no think it will——

Dr. GREENSPAN. No. I would not disagree with that, Senator. My main technical concern really rests on the issue of a balanced budget amendment reflecting the point of outlays as distinct from authorizations. It is the timing question that I have——

Senator HATCH. Well, I agree with that.

Senator PACKWOOD. Senator Wallop.

The chairman asked me to inform you that for the hearing, the order is Wallop, Conrad, Danforth, Grassley, Bradley, Daschle, and Breaux.

Senator WALLOP. Thank you, Mr. Chairman.

Chairman Greenspan, let me compliment you on the paper that you presented us this morning. I think it is a very lucid warning of the structural problems that face us.

One of the things that strikes me in reading it is your comments on the increasing willingness to commit long term.

Would you care to render any judgment to the committee as to what sorts of reasons may exist in the marketplace that, when the economy is growing as well as it has, the players seem unwilling to commit to new employment, and why overtime is at its highest rate ever?

Dr. GREENSPAN. Well, if one surveys employers, what the evidence tells you basically is, one, that the average work week, especially in manufacturing is up very significantly at very high levels and in certain places is straining the productive employment force.

We also have a very substantial increase in temporary employees, that is——

Senator WALLOP. Could this be because of anything that we are doing to the work place as far as working requirements?

Dr. GREENSPAN. Well, the employers have argued over the years that the cost of bringing on permanent employment is getting increasingly more onerous and what that then tends to do is to create incentives to avoid bringing on permanent employment.

And a goodly part of that obviously is in the health care costs area, but it is in workman's compensation. It is in a number of other mandated issues. What happens when you do that is create a disincentive for full-time permanent employment which is a major problem.

Senator WALLOP. I agree that it is a major problem. You have correctly stated in my way of thinking that all taxes have a depressing effect on economic activity.

Can any taxes have a depressing effect on government activity?

In other words, if we were to shift to a consumption tax so that people were readily aware of how much they were paying to function and for their government to function, would that have a depressing effect on government activity?

Dr. GREENSPAN. I really do not know the answer to that. It is clear that as all surveys indicate and, indeed, as periodic election analyses indicate there is a very strong reaction against increasing taxation by the American public.

I do not think that there is any deficit in concern, if I may say, about taxes in this country.

Senator WALLOP. Lastly, you have said that you would eschew comments on specifics. And I respect that. I will not ask you, therefore, to respond to what I am about to say.

But I would just say that your comment on the specifics of the program in front of us, is a significant warning, if not a condemnation, of it. And you correctly noted that structural deficits begin to rise again in 1997.

Those of us who look at this program see record new taxes with only a $7 billion net savings after 5 years. We see record new spending.

If it all works, what we have is the genuine case of smoke and clearing that was stated in the newspaper, and that some of us believe to be the handmaiden of the new administration.

The Washington Post has asked all these people how they are going to achieve these mystical administrative savings. And they cannot identify them.

We have a new minimum wage coming on, which refers back to my first question, which will make it increasingly difficult for people to enter the work place.

We have new labor requirements in place and more coming. And then, as if that were not enough, we have new taxes that will be necessary to pay for health care reform.

And it just strikes me that if the deficit begins to rise again in 1997, as you say and as their program says, we have a serious problem we will have raised taxes significantly and will have, by the time this is all done, tried to deal with the rest of the warnings contained in your paper.

I hope the committee has heard your comments. I very much appreciate your testifying before us today.

Dr. GREENSPAN. Thank you.

Senator WALLOP. Thank you.

Senator PACKWOOD. Mr. Chairman, let me just ask you a couple more questions until the chairman comes back.

What you said earlier is very important. These charts that you have have been given to other witnesses coming on in the next few days.

And the chairman and I have defined these hearings to find out whether or not it is desirable that we increase our spending and taxes as a percentage of the gross national product, as other countries have done throughout the world.

Some of the witnesses will testify, yes, we should, that that would be a good thing if we taxed more at the rate of France or Italy or Canada than we do now and spend more.

They would put that spending into the essential category. And we should tax and spend. I assume they say taxes rather than deficits.

But I want to come back again to your answer. Do you think it would be personally unwise for us to be moving toward that 40-percent level of taxing and spending?

Dr. GREENSPAN. Senator, I am saying that over the years, I have exhibited before this committee and other committees of the Congress a desire for lower levels of spending, lower levels of taxation, lower levels of debt. That is my own personal inclination.

If you are asking me as an economist, is there significant evidence that within narrow ranges that economic growth is significantly altered by small changes in the extent of government as a percent of the GDP, the answer is it is very difficult to find. Obviously, when you get into some of the higher levels, it is very clear.

Senator PACKWOOD. So it is obvious then?

Dr. GREENSPAN. But it is not all that easy to find in the data.

Senator PACKWOOD. No. It is not all that easy to find if you go from spending 31 percent of the GNP to 31.5 and then to 32. It is not so hard to find if you go from 30 to 60.

Dr. GREENSPAN. I would certainly agree with that.

Senator PACKWOOD. And I am not asking you to make the argument. I will make the argument that President Clinton's budget is going to push us in terms of spending and taxes towards the higher percentage of the GNP in both areas.

I am not asking you to even comment on that. I will make that case as we go along. But I will try to make the case.

And if the chairman were here, I think, I would ask unanimous consent to have these charts that I sent to you put in immediately before and immediately after your testimony so that when people read it, they will know what we are referring to in the charts.

[The charts appear in the appendix.]

Senator PACKWOOD. Thank you, Mr. Chairman, I appreciate that. [Laughter.]

I will tell you a quick aside. And then, I will go and vote. I told the chairman's Chief of Staff. One time, he and I were testifying before the Judiciary Committee, I think, on tuition tax credits. And they did not like it.

And there was a vote. And he and I went to vote. And we came back. And this is the Judiciary Committee. We came back. And the committee did not come back and did not come back and did not come back.

And finally, I had to assume the chair and call the committee to order. And I testified. And when the Judiciary Committee came back, they were somewhat irate. I cannot understand why.

But at the moment, I think, I will now go and vote. And the chairman is back.

The CHAIRMAN. Thank you, sir.

Senator Bradley.

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

There are some advantages to votes. You jump out of order and have a chance.

Dr. Greenspan, in your comments, you made a point about the world that you would create. There would be less taxes as opposed to more. You stated that the taxes are a problem for the economy and for growth and investment.

What is worse, the deficit or taxes?

Dr. GREENSPAN. As I put it in my comment that how one gets this deficit down is very important. That is the tax part. In other words, I do not like taxation. I think it is an inhibition to the system. But I like deficits less because I think they are a far more corrosive force.

And my view obviously and as I have indicated before other committees is that in principle, obviously, I would be forced to argue that I would prefer all of the deficit to be brought down on the expenditure side.

But we do have political processes in this country. And this is what in a sense democracy is all about. There are value preferences, and politics in the best sense of the word creates budgets and creates the allocation of resources as government affects them.

And if you are asking for my priorities, I would merely say that unless we resolve the deficit problem, we are in very serious long-term trouble.

Senator BRADLEY. So you would draw a distinction between taxes for spending and taxes dedicated to deficit reduction?

Dr. GREENSPAN. I certainly would, yes.

The CHAIRMAN. Could I just interrupt to say that was the thrust of my first question to you, that your statement of increases in taxes could only be justified to finance expenditures that are deemed essential. Reducing the deficit is a legitimate concern.

Dr. GREENSPAN. Oh, indeed. Yes.

The CHAIRMAN. Yes.

Dr. GREENSPAN. In this particular context, as I said to you——

The CHAIRMAN. That is what we are going to be trying to do here.

Dr. GREENSPAN. Yes.

Senator BRADLEY. On the spending side of the budget, would you draw a distinction between spending that could be termed investment versus spending that could be termed consumption?

Dr. GREENSPAN. I would be not inclined to do that as much as most people do, Senator. I do not deny that there are certain elements that governments do which improve the productivity of the society and theoretically, in that respect, are appropriately categorized as investment.

But the financial markets do not make that distinction. What they are interested in is what is government borrowing, what is expenditure, and what are receipts and what that expenditure is on does not affect the fact that the Federal debt to the public increases. And that is where the interest rate effects are.

We do not have self-amortizing types of investments in government, except in very limited circumstances. And it is only there where the analogy to the private sector is really appropriate.

I am concerned that the notion of how one looks at the budget leads one to conclude that if they are true investments, we should have a capital account and an operating account.

I would argue very strenuously against that on the grounds that the financial markets do not make that distinction.

And to the extent that we at the central bank are concerned about the financial system, it is aggregate deficit irrespective of how it is determined which is relevant.

Senator BRADLEY. Are you troubled by the claims that future pensions have on our gross national product and their present unfunded state?

And what would be your rough sense of their potential impact on economic growth?

Dr. GREENSPAN. Well, I do think—if you are asking me about the Pension Benefit Guaranty Corporation.

Senator BRADLEY. Not only that, but that is the narrower issue. The broader question.

Dr. GREENSPAN. Yes. As you know, as a consequence of the degree of funding in some areas, there has been a shift towards defined contribution programs as distinct from the defined benefit ones. And that obviously technically resolves that particular question.

Senator BRADLEY. But my point is that at some point in the future, there will be a real drag on the economy in order to fund all the pensions that more or less have been promised.

Dr. GREENSPAN. No.

Senator BRADLEY. Whether that is Social Security on the one hand or whether that is private pension on the other hand.

Dr. GREENSPAN. Oh, I am sorry. I thought you were referring solely to the private sector question.

Essentially retirees are paid in real terms out of the then current product. The issues of pensions and the issue of how one funds them is really a means by which we use our financial system to in-

vest in, to move consumption into savings and investment, into productive assets which produce the real goods and services which the pension beneficiary would require in the out years.

So I would say that what is crucial to this question is an evaluation as to whether, in fact, the rate of growth and productivity in the society overall is going to be adequate to fund a significant increase in the number of retirees relative to working people as we move into the 21st century.

Senator BRADLEY. Mr. Chairman, can I just ask a question? It will be a yes or no answer.

The CHAIRMAN. Yes. I interrupted you.

Senator BRADLEY. Do you support the line item veto applied to spending and to tax expenditures?

Dr. GREENSPAN. I would be inclined to——

The CHAIRMAN. Maybe the chairman could say just yes or no or a sentence or so. A paragraph, I welcome.

Dr. GREENSPAN. I will merely say, in the past, I have been inclined in that direction, but I have never considered it a major issue one way or the other.

Senator BRADLEY. As the chairman has——

Dr. GREENSPAN. I think that serves both of our purposes, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Bradley.

Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman.

Welcome, Dr. Greenspan.

The President has put before us a package of deficit reductions over 5 years of approximately $500 billion. At least that is the size of the package modified by the relevant budget committees on the House and the Senate sides. We are still adding $1 trillion to the national debt over that 5-year period.

While it is true that we are reducing the percentage of GDP going to spending and increasing it for revenue, in other words, we are closing that gap, it is still the case that a gap will remain.

Some are saying, in fact, many are saying we should not do more deficit reduction. They assert to do more would weaken the economy.

The question that I have for you is, is that your view? Do you believe that $500 billion worth of deficit reduction over 5 years is about as much as we should do?

What would happen if we did twice as much? What would happen if we did $1 trillion of deficit reduction over 5 years? Would there be enough of an interest rate response to offset the fiscal drag that would occur?

Dr. GREENSPAN. The key to that, Senator, probably is directed more, not at the next 5 years, but at the 5 and 10 years thereafter because what has been holding long-term interest rates—10 year, 15 year, 30 year issues—up, in my judgment, is the concern in the financial markets that no matter what we do in the short term, the deficit will start to move up after 1996 and that it has a self-cumulative aspect after that point.

And as a consequence, the inflationary implications that are out 30 years from now are driving that long-term interest rate level.

So it is not so much what we cut in addition in the period immediately ahead, it is what we cut in a manner which reduces the current services expenditure growth adjusted for that add-on I put in my official earlier remarks.

It is what that rate of increase is because unless it is brought down to a rate which converges with the growth in incomes, we will not eliminate this deficit.

But if we can find a means by putting in law today or next year or in 3 years at the latest, a means by which we take current services outlays on a much lower path, that would do more than anything I know of to bring the inflation premium embodied in these long-term interest rates down very significantly.

Senator CONRAD. Well, let me ask you this. I am not sure I got an answer to the question of could we do more in terms of 5 years—we are on a 5-year plan basis.

We understand that on an even longer term basis, you have those Social Security surpluses turning from surpluses to deficits when we get to about 2017.

So you have a window of opportunity here to do something about this structural deficit. And the question that I have is, could we do more? Should we do more in the 5-year plan of deficit reduction? Would it have an adverse economic impact as some assert?

Dr. GREENSPAN. As I indicated earlier, Senator, my own inclinations are to try to do more. I am not certain that one would find that easily done in the Congress.

But clearly saying that we bring the level of the deficit down to $200 billion 4 or 5 years out, that is not a significant degree of, I would say, pressure on the economy.

I think we can do considerably more without inducing a major problem in the economy provided that concurrent with doing that, we are resolving this longer term problem because under those conditions, long-term interest rates would fall much further than from where they are today and in that respect, cushion to a very large extent the fiscal drag which would occur as a consequence.

Senator CONRAD. Let me just as you very quickly because people are saying, we've gotten about as much interest rate benefit as we can get from deficit reduction, that is if we did more deficit reduction, we would not get much more interest rate reduction. What is your view of that?

Dr. GREENSPAN. I would say it depends in large part where it is. I would argue strenuously that merely reducing the next 5 years without addressing the period thereafter is not going to have the type of permanent effects that we need.

Senator CONRAD. I thank the chairman.

The CHAIRMAN. Thank you, Senator Conrad.

If I could just say this question of the rates at which expenditures grow is one you raise sort of a technical issue about in terms of the current service approach.

I think the committee will want to explore that and see whether there is an alternative that we can envision. And we thank you for it.

Senator Grassley, you are very patient. Sir.

Senator GRASSLEY. Thank you, Mr. Chairman.

I appreciate very much your statement. I want to ask a question on how we ought to read this bond market.

Administration officials and even members of this committee have said over and over that the bond market's declining interest rates mean that the market has confidence in the President's economic program.

And then, on the other hand, I have heard bond experts say that they are actually in a no lose situation, that they are betting that either the plan succeeds and the deficit will be cut or the plan fails and we fall back into a recession.

So isn't it true that——[Laughter.]

Well, that is what they are saying.

The CHAIRMAN. That is crazy. It is a great way to make a living. [Laughter.]

Senator GRASSLEY. So isn't it true that the bond market is not a very clear or decisive indicator of confidence in the President's plan?

Dr. GREENSPAN. I am not sure that one can argue that it is a reflection of the President's plan or anything specific, but I do think that what clearly comes forward in the data—when one disaggregates the structure of long-term interest rates—is what the markets are presuming is that there will be significant deficit reduction, whereas previously, they did not believe that. The evidence basically occurs when one unbundles the long-term interest rate.

In other words, we have the capability of taking a 30-year bond, which is the key bond in the long end of the market, and disaggregating it into the parts which are short term, intermediate term, and long term.

Very specifically, what we can do is algebraically make it the equivalent of 1 year maturities 5 years out, 10 years out, 15 years out, and 30 years out.

The reason why that is important is that it enables you to know where the decline in long-term interest rates are coming from.

Up until very late last year, virtually all of the declines in long-term rates were occurring because short-term and intermediate-term implied forward rates were coming down. And they are part of the total determination of long-term interest rates.

Since late last year, we have finally seen declines in the more distant implied forward rates—specifically, for example, the implied forward rate on a 1-year Treasury 10 years out.

This is indicative of the fact that the market is presumably beginning to anticipate that inflation will be lower over the longer run, not just in the next few years.

So it strikes me that irrespective of how one reads this particular market, the stronger evidence does indicate that for whatever reasons, the markets expect that the budget deficit over the long run will be constrained.

If there was a strong argument that the economy was going to come down, then, I have difficulty in knowing why the level of long-term interest rates was not much lower a year and a half ago when the short-term economic outlook was far worse.

So I am inclined to read into the market, a view that, for whatever reasons, at the end of this process, that deficits will be under greater control than they have been.

Senator GRASSLEY. Well, you just said unless the plan reduces the deficit beyond 5 years, that interest rates will not be reduced.

The President's plan does not go beyond those 5 years.

Dr. GREENSPAN. Well, Senator, that is correct. What I was referring to is that in explaining the most recent decline in long-term rates as distinct from bringing them down to where the long-term inflation expectations would have been essentially purged from the bond market, that is clearly not the case.

We are still, even at today's rates, showing a fairly significant inflation expectation embodied in those rates.

Senator GRASSLEY. So it sounds to me like you are saying that the plan will not bring down long-term interest rates.

Dr. GREENSPAN. Well, I am saying that unless the issue of the post-1996 problems are successfully addressed, that it will be very difficult to purge the inflation expectations that still exist in the system.

Senator GRASSLEY. And they are not addressed in this plan.

Dr. GREENSPAN. They are not.

Senator GRASSLEY. One of the main purposes of the President's stimulus package is to create jobs. Now, as I see it the problem is these jobs are going to be government-created jobs.

And the GAO has pretty clearly concluded that a stimulus package, that similar packages in the past have not worked.

Would you agree that these kinds of short-term temporary government jobs have little impact on our long-term economy?

Dr. GREENSPAN. Senator, I have said at the beginning, I am going to eschew commenting on any particular aspects of any of the programs which are before the Congress on the grounds that we at the Federal Reserve as central bankers have said that our concern is the deficit and the financial system.

And we do not believe that we should be commenting, and hopefully have not, on a lot of the specifics that are coming befoie the Congress.

Senator GRASSLEY. Now, Mr. Chairman. I am done, but I do want his comment on the title of the hearing. The title of the hearing is to hear Chairman Greenspan on the Administration's Economic Proposal.

The CHAIRMAN. Senator.

Senator GRASSLEY. And so if we cannot have Chairman Greenspan make some very specific comments, we—if it is okay for him to be touted in the press as sending some sort of a message because he sits beside Hillary Clinton.

And that is supposed to be an endorsement of the plan. It seems to me that we ought to be able to get some definite comments.

The CHAIRMAN. Senator, I have to insist. The title was chosen by the chairman, obviously inadvisably. If I cannot hear Chairman Greenspan on specifics, I would very much, as a second choice, hear him on generalities. [Laughter.]

And thank you.

Senator GRASSLEY. I sure did like his opening statements. I want to make that clear.

The CHAIRMAN. There you are. Now, you see, you are already cheerful. [Laughter.]

Senator Daschle.

Senator DASCHLE. Thank you, Mr. Chairman.

Dr. Greenspan, I think you have been very clear with your position on the effect of the Federal budget deficit on the economy.

I am unclear as to how you view other deficits and their effect on the economy. I am told that total debt is calculated with reference to GDP and is about 55 percent business debt.

In the aggregate, it may be as much as 60 percent. Consumer debt according to recent figures is 66, 67 percent.

To what degree do those debts have the same negative effects on the economy that the Federal budget deficit has?

Dr. GREENSPAN. Senator, I was commenting largely on the deficit as distinct from the level of debt for a very good reason.

The deficit has a very immediate effect on the supply and demand for funds in the system and has some extraordinary impacts on the private sector.

The level of the debt has other types of effects which are longer term. Obviously, it does affect interest payments as part of the budget. So it is not an irrelevant consideration.

But the size of debt per se is a lesser concern of mine at the moment than the fact that the deficit, the rate of increase in the debt is, I think, creating potentially unmanageable rises as we move into the 21st century.

But it is also the case, as you point out, that the levels of private debt are high. And they still are high having built up rather significantly during the 1980's.

Fortunately, there has been some marked reduction in debt service burden, both in the household and in the business sector in the sense that because interest rates have come down, the percent of household cash flow which is devoted to both mortgage and consumer purchases is down, as, indeed, in the corporate sector it is down, even though the levels of debt are still high and have come down only modestly.

Senator DASCHLE. Well, I guess my question is, to what degree can one look comparatively at deficits or debt in the public sector as well as the private sector and come to some conclusion about their ramifications within the economy?

I understand your point about the differences in the immediate term with regard to deficits as opposed to aggregate debt.

But let's put that question aside and just look at the relative consequences of deficit practices in the public sector versus the private sector. Do they have the same connotations within the economy?

Dr. GREENSPAN. No. They actually do two different types of things.

In the private sector, when we create debt, it is usually to create producing assets which enhance productivity so that in a sense, debts usually are matched with growth in the level of assets and to a large extent, producing assets which is essentially the mechanism by which productivity growth and standards of living grow.

That is obviously not the case in the Federal sector, even though there is a dispute with respect to the question of how much of the

Federal outlays have the investment characteristics which improve productivity the way the private sector debt does.

In an earlier discussion I mentioned to Senator Bradley that I was a little bit concerned that we would push the issue of investments in the public sector to a point where we would then look at them in a similar manner as in the private sector and have a separate capital account and an operating account in the Federal budget, which would not be appropriate because the markets view the total borrowing requirements of the Federal Government as the crucial issue.

And in that regard, we have very little in the way of income producing assets which are created as a consequence of Federal debt financing.

So in that respect, I would say that there are really quite substantial differences in that regard between private debts, on the one hand, to a large extent asset producing, productivity producing assets, and government debt.

Senator DASCHLE. I am curious about that. And I guess I am just about out of time. It would seem to me that investments in the public sector for housing and other infrastructure purposes have a very tangible effect on productivity in much the same way that business investments do.

Dr. GREENSPAN. That is true of a lot of public investments. There is no doubt, for example, that highways have a significant impact. And as you say, homes are indistinguishable from——

Senator DASCHLE. Let me just——

Dr. GREENSPAN. The crucial question, however, gets to whether they are cash-income producing as distinct from indirectly improving the productivity of the society.

Senator DASCHLE. Thank you, Dr. Greenspan.

The CHAIRMAN. I would hazard the thought that if we ever did go to a capital budget arrangement in which we distinguish between consumption items and investment items, probably about 95 percent of our budget curiously would turn out to be investment.

As a matter of fact, all of the spending proposals the President has so far made have been called investment, but that is another matter.

And Senator Riegle is next.

Senator RIEGLE. Thank you, Mr. Chairman.

Chairman Greenspan, we had an opportunity to discuss the aspects of this subject before the Senate Banking Committee, as you will recall. And I went back to see what you had said to us at that time with respect to the plan.

And on that particular date, which was February 18th, responding to the President's Economic Proposal, you called it serious and plausible and that it——

Dr. GREENSPAN. I think plausible was the economic assumptions, you may recall.

Senator RIEGLE. Right.

Dr. GREENSPAN. Which they are.

Senator RIEGLE. Yes. And I thought that was very important and that it provided a detailed program-by-program set of recommendations as distinct from general goals.

Dr. GREENSPAN. That is correct.

Senator RIEGLE. I agree with you. Those were important elements of the plan.

We talked that day also about the tendency for a credible and serious plan on deficit reduction to have an impact on interest rates and inflation. I will not go through all of that because that is a matter of record.

I will tell you what I found very interesting about your statement today, and that is that nowhere in the formal presentation we find the words "jobs" or "employment" or "unemployment".

I am worried and concerned that there is kind of a blind spot still.

I do not just say this to you, but I am talking about as we assess the economy and our economic future, to not zero in enough on the fact that we are in a jobless recovery.

I use this chart as an illustration that takes into account the track we have been on since this recession started and compare it with the average of the other recessions we have had since the end of World War II.

Whereas we have seen in past recessions on this blue line, as we lose jobs and bound into a recession, we get out in about 12, 14, 18 months. We bottom out. And then we climb back out.

We regain the jobs we lost, get back above this zero line. We add jobs as we get further out in time.

This recession is very different. We have talked about it before. And that is instead of seeing this classic U-shape where you get the jobs back as go out in time, we have stayed down. And we have pretty much continued to bounce near the bottom.

We have more of an L-shaped curve now. There has been a little tick up in the last month, but it is very interesting. Over half of the jobs in February were part-time jobs.

In the State of Michigan, 89 percent were part-time jobs. And that can parallel the fact that maybe we are starting to get a more sustained recovery, but we will have to see more data to know that.

It is interesting. The Bureau of Labor Statistics counts somebody as employed if they work as little as 1 hour a week. And so we do not know what the profile is of all those part-time workers, but it is obviously something less than 40 hours a week.

Given this and the fact that. I think, there is a tendency not to focus enough on the jobs dimension, the question of how we cope with this problem of a sort of jobless recovery, what more can we do?

In your judgment, what can we do to try to stimulate a more aggressive growth of private sector jobs than what we have done thus far and which has obviously given us a pretty anemic-looking response in contrast to what we have seen in other occasions?

Dr. GREENSPAN. Senator, I commented in part on an earlier question related to something similar to this. Let me expand on it.

As we have discussed in previous hearings, this is an extraordinary business cycle. It is without precedent in the post-World War II period. And, indeed, one aspect of it is precisely what you are showing here.

We have seen virtually all of the recovery which has not been a relatively small one in the last three quarters, associated with increased productivity as distinct from job growth.

And what that basically says is that for those who are employed, the real wage will eventually begin to rise because at the moment, it is showing up in increased profit margins.

But as profit margins begin to stabilize, that increased productivity ultimately moves into increased real wages, increased standards of living for those who are employed.

Senator RIEGLE. I hope that is right. The last 20 years has not been terribly promising in what has happened in terms of just average real incomes for families.

Dr. GREENSPAN. That is exactly right. And the major reason for that is that we have had an extraordinarily weak increase in productivity over the last 20 years.

And I trust that the most recent changes that we are observing are a reflection that something more permanent in the way of growth is occurring.

But as I said before the Joint Economic Committee back in January, it is too early for us in looking at this process to be certain that what we have is a cyclical phenomenon which is an abnormality that will go back to the 1-percent growth in productivity annual rate that we have had or whether we are going to move somewhat higher.

I suspect that we may be looking at something indicating that the long-term growth rate may be actually showing some improvement here.

If that is the case and growth occurs, then, the question is what do we do about getting more jobs?

First of all, let me say, the statistics on part-time are somewhat questionable, that is, it is not possible to have this level of average hours worked per week, especially in manufacturing, and have a large component of part-time work.

I think we have a partial statistical problem here, but that is a minor question. The major issue is when do we get job growth accelerating?

And that occurs only when the level of growth in the economy is significantly in excess of the rate of growth in productivity.

My own guess at this stage is we are probably moving into somewhat of a stronger job rate increase at this stage, but it is still not going to bring the unemployment rate, which at 7 percent I consider too high, down sufficiently quickly that I would feel comfortable with.

Senator RIEGLE. Well, I will just finish by saying my time is up.

I think this is one of the things that argues for why we have to have some way to try to get some additional lift into the economy. It is not self correcting in terms of job or job recovery.

I think it makes an argument that one can debate the kind of stimulus you want, tax incentives you want.

But we have to find a way to move into that blind spot and foster more job creation in the country. I think it is absolutely critical.

The CHAIRMAN. Thank you, Senator Riegle.

It is very clear in your testimony. You speak of a possibility that productivity has moved into a significantly faster long-term growth channel.

Would it be possible for you to send us a memorandum on this distinction between growth associated with increased productivity

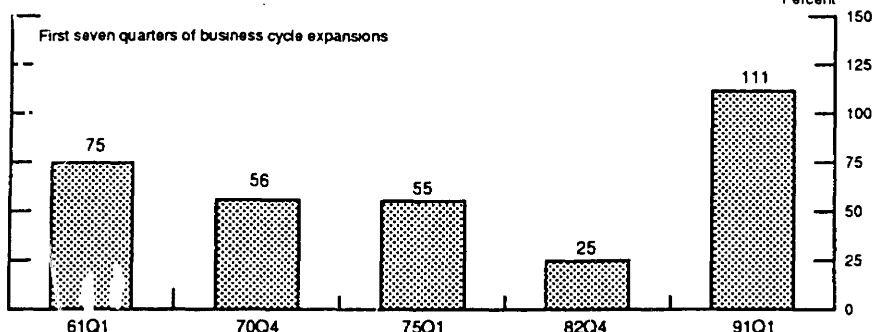
and growth associated with increased employment in the present recovery?

Dr. GREENSPAN. Certainly.

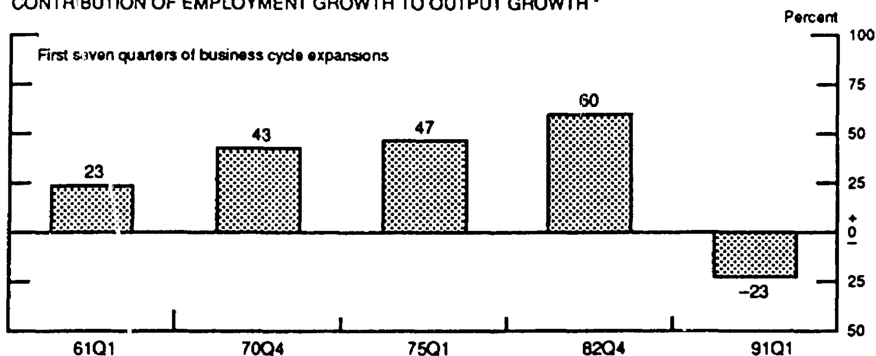
The CHAIRMAN. That is a new idea, at least for this member of the committee. And it would help us a great deal.

[The information requested follows:]

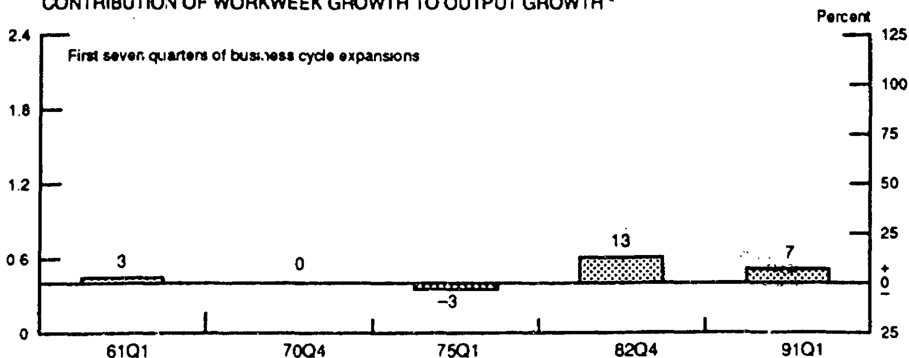
NONFARM BUSINESS SECTOR



* Percent change in productivity divided by percent change in output.



* Percent change in employment divided by percent change in output.



* Percent change in workweek divided by percent change in output.

NOTE Components may not add to 100 owing to rounding and the non-allocation of cross-product effects.

Dr. GREENSPAN. I might just say parenthetically, Mr. Chairman, that the reasons I suspect that the productivity issue may be something which is not an accident and may be real is that I believe what we are observing is that after a number of years of very significant increase in computer-related technology what we are finally seeing is our ability to use that in a much more productive manner as the software applications of the last 3 or 4 years have begun to free up a huge amount of the unused capability of the hardware which we have.

And we are producing goods in a different way from the way we used to. And this is a remarkable set of changes which are partly related to this restructuring question.

The CHAIRMAN. We had excess capacity in our mainframes.

Dr. GREENSPAN. Yes. Well——

The CHAIRMAN. Software is beginning to be made useful.

Dr. GREENSPAN. The way I would put it, Mr. Chairman, is I recall 10 years ago, we used to have this huge amount of mainframe technology. And everyone used to say we used 10 percent of it.

The CHAIRMAN. Yes.

Dr. GREENSPAN. I think what has occurred with the extraordinary improvements in technology, both with the hardware and bringing it down to the minis and the PC's, but more importantly, the extraordinary improvement in software applications and the ability to restructure production that we have created the possibilities here of a new channel of improved productivity which may be more than a cyclical aberration.

The CHAIRMAN. Fascinating.

Senator Roth.

Senator ROTH. Thank you, Mr. Chairman.

It is always a pleasure to welcome you, Dr. Greenspan. I apologize for being late, but I had a mark-up in another committee.

I had the pleasure of sitting in the Banking Committee when you appeared before it recently. And I listened to your testimony very carefully, but I was bothered the next day when I read the principal headlines in the New York Times and the Washington Post, as well as the Wilmington News Journal, my local paper, all of which said you endorsed the Clinton plan.

Now, I thought I had listened very carefully to you. You did say that it was a "serious plan," but it was my understanding you were endorsing no plan.

Dr. GREENSPAN. That is correct, Senator.

Senator ROTH. But I have never seen that corrected in the papers.

Dr. GREENSPAN. Well, I have tried on numerous occasion to differentiate the fact that what I was stating there, and I would state again, that I commend the President for putting this issue on the table because it is a very crucial and important issue and that his program is a serious program, that its economic assumptions are plausible. And it is a detailed program. It is something which has created, in my judgment, the discussions which the Congress is now involved with and which the markets have responded to, in my judgment, in a quite positive way on the grounds that they believe that what is entrained at this stage is a major commitment to reduce the budget deficit in this country.

And having started that process, I do think that the President should be commended. That is not the same thing——

Senator ROTH. I think we can all agree that——

Dr. GREENSPAN. Let me just go further. Unless the English language has changed, that is not the same thing as saying I endorse any program because I have endorsed none. I have not endorsed any of the programs here in the Congress nor the President's program nor have my colleagues.

Senator ROTH. I think that is an important difference that needed to be differentiated. I recognize that you said it was a "serious plan."

I think we all agree on this whole problem of the deficit. Maybe Perot is the one that deserves the most credit because he certainly has made that the key issue.

But it bothered me, and it still bothers me that the general impression is still out there that you are endorsing one particular plan. And I appreciate you clarifying that you are endorsing no plan.

Dr. GREENSPAN. As I said at that committee hearing that you attended, Senator, that we as central bankers have a very distinct interest in the issue of bringing the Federal budget deficit down because we believe that it is a corrosive force in our financial system.

But how that is done is a political question in the most appropriate sense and the best sense of the word.

And as I have said in response to earlier questions today, the process is a major element in our democratic society—in other words, this process of determining what the Federal budget priorities are is a major element in the democratic process in this country.

Senator ROTH. True, how a decision is made is political, but essentially, it is an economic question.

Dr. GREENSPAN. That is correct.

Senator ROTH. And both in the meeting with the Banking Committee and in your testimony here, I believe, at least in the Banking Committee, you testified that you had a preference for cutting the deficit by reducing spending.

And here, in your preparatory statement, you give the other side of the coin, "It is important to recognize that trying to wholly or substantially address a structural budget deficit by increasing revenues is fraught with exceptional difficulties and is more likely to fail than succeed."

Now, back in the early 1980's, we talked about cutting spending $3 for every dollar of tax revenue. In the 1990 agreement, I think, it was supposed to be a $2 cut in spending for every dollar in revenue.

Now, in this proposal, we find the very opposite. Even if you accept the Democratic numbers, we are talking about an increase in tax revenue $5 for every dollar increased in taxes. Frankly, I think it is much higher than that.

But my question is, does it make sense to rely primarily from a 4 to 1, 5 to 1, whatever ratio, of tax increases to spending? Is that going to really reduce the deficit, long term?

Dr. GREENSPAN. Senator, the reason I drew the conclusion that I did in my prepared statement rests on the notion that one can

readily find in both CBO and OMB documents that the rate of growth of current services outlays as we move through the end of this decade and into the 21st century is in excess of the levels of growth of income.

And the arithmetic of that basically says that you cannot resolve a long-term budget deficit substantially or wholly from the tax side. It is an arithmetical question.

So I am arguing basically that, one, as a necessary condition to confronting this long-term deficit that it is necessary that one must address the growth of spending.

Senator ROTH. Could I ask just one follow-up question? If you are increasing taxes $4 or $5 for every dollar cut in domestic spending, is that really going to make the kind of structural change that you need to really do something meaningful about the budget?

Dr. GREENSPAN. Well, I have chosen not to get involved in any of the details of any of the programs before the Congress.

Senator ROTH. Okay.

Dr. GREENSPAN. And I would appreciate it if I can——

The CHAIRMAN. Now, I believe that is the 18th time you have said that this morning.

Dr. GREENSPAN. I regret that I do that, but I do think that if we at the Central Bank got ourselves involved in this issue it would be most unfortunate.

Senator ROTH. Mr. Chairman, that is the reason I thought it was important that there be a clarification of your original statement at the Banking Committee with respect to——

The CHAIRMAN. I think you mean the newspaper accounts of your view?

Dr. GREENSPAN. That is not what I said.

The CHAIRMAN. Yes.

Dr. GREENSPAN. What I said then I will repeat today. The President should be commended for putting this issue on the table with a serious budget proposal. That is not the same thing as saying I endorse it.

The CHAIRMAN. It is not.

Thank you, Senator Roth.

Senator Baucus is the Chairman of the Committee on Environment and Public Works and has been holding a hearing all morning on some of those regulations that you have touched on. He has just been able to slip away for a moment.

Senator Baucus.

Senator BAUCUS. Thank you, Mr. Chairman.

Mr. Chairman, I hope this is not the 19th time you will be unable to answer. My question is this. Some of us are very intrigued with a broad-based consumption tax as a replacement for income taxes in this country.

Your views. Is that an approach you think we should pursue? Is that economically sound or not, and why?

Dr. GREENSPAN. Well, I have commented on that in the past, Senator. I obviously can comment on it now, or somebody will read back my testimony of an earlier period and ask me whether I agree with it.

Clearly, the deficit in savings in this country has been one of our critical concerns and critical problems because while savings in and

of itself does not create the investment that we need for improved productivity and growing standards of living, the incentive not to save does retard such types of investments.

And to the extent that we can move the bias of our tax system away from taxing savings to taxing consumption, we would probably find in the longer term that the efficiency of our system would be improved and the standards of living over the long term would be enhanced.

Senator BAUCUS. Thank you very much.

The CHAIRMAN. We thank you, sir.

There is just a terminological matter there. Our tax code refers to income from savings as being unearned which is not, for what it is worth, the case.

Senator Packwood.

Senator PACKWOOD. Mr. Chairman, when I went off to vote and I came back, you were just talking about you did not have great faith, even if we made some 5-year savings that if we did nothing to start changing, I think you said, the structural deficit or things beyond 5 years. Am I quoting it roughly right?

Dr. GREENSPAN. That is correct, Senator.

Senator PACKWOOD. Could you elaborate a little more on that?

Dr. GREENSPAN. A major problem that we have got so far as the deficit is concerned is that if one tracks the current services expenditure numbers, they are at a level of a rate of increase in excess of the rate of growth of the economy, which will create a continuous and enormous rise in the deficit as we move beyond the latter part of this decade.

Senator PACKWOOD. Translated, does that mean if spending is growing at X plus 10, and growth is only X plus 5, we cannot finance 10 out of 5?

Dr. GREENSPAN. Exactly. And it is an arithmetical problem. I am not raising a political issue. I am not raising a choice question. I am raising a problem of arithmetic.

Senator PACKWOOD. All right. Let me ask you a further question. This argument that certain spending does not cause a problem because we finance it out of trust funds, specifically Medicare Part A which is reasonably close to a income-outgo equality and Social Security. Is that a valid or invalid argument? That is certainly structural spending.

Dr. GREENSPAN. The nature of the types of trust funds that we have set up, as the chairman of this committee has often indicated, is not the same as trust funds as we envision them in the private sector where the investments of the fund are in income-producing assets and associated with real assets which create the productivity in the economy in which the real goods to the ultimate beneficiaries are paid so far as retirement funds are concerned.

So merely saying that we have taxed to finance a specific category of expenditure is not an irrelevant consideration.

Obviously, if we were required to add a tax to fund every expenditure, by definition, the budget would be balanced.

So I am not stipulating that I am opposed to this type of procedure. On the contrary, it is a crucial element in fiscal responsibility and fiscal sensibleness.

But it is important not to presume that, therefore, the funding is completely, actuarily sound, if I may put it that way, in the private sector sense and that, therefore, certain elements of the budget do not effect the structural deficit.

It is a complex issue which really gets down to the notion of what is the appropriate means of funding long-term obligations in the budget?

Senator PACKWOOD. It also might get down to your definition of essential and nonessential.

If we have a trust fund that finances something, Medicare, Social Security, and if that spending is growing at X plus 10 while the economy is growing at X plus 5, and we commit taxes to that end, it is taxes that we do not have to commit to some other end unless we want to increase other taxes in addition?

Dr. GREENSPAN. That is correct, Senator.

Senator PACKWOOD. Mr. Chairman, I would like to now say. When you were not here, I asked for unanimous consent to have these charts put in, both at the start and at the end of his testimony. And you graciously agreed in absentia to put them in.

The CHAIRMAN. I thought we had all memorized them. [Laughter.]

Senator PACKWOOD. I would like now to ask for unanimous consent just before I ask this question, to put in page 6 of the chart. And let me read what it is.

Page 6 of this chart states just four programs, Social Security, Medicare, Medicaid, and other retirement, other retirement being principally military and civilian Federal retirement. And interest, I guess you can count interest as a program. And we have to pay it.

Today those four plus interest are 54 percent of our total spending. The Congressional Budget Office predicted last month that in 10 years on baseline those four will be 69 percent of our budget.

They actually predict that in terms of constant dollars, we will have infinitely less to spend on everything else whether it is essential or nonessential if something does not address those four plus the interest.

The CHAIRMAN. The chair interrupts to state that you cannot have infinitely less. [Laughter.]

Senator PACKWOOD. You are right.

The CHAIRMAN. Much less.

Senator PACKWOOD. Is that the type of thing, Mr. Chairman, you are talking about when you are saying 5 years out?

There is just some spending that is growing so extraordinarily that if we do not get some of it under control, what we do in the first 5 years will not make a great deal of difference?

Dr. GREENSPAN. It will make some difference, but not a great deal of difference.

Senator PACKWOOD. Yes.

Dr. GREENSPAN. Yes.

Senator PACKWOOD. Thank you, Mr. Chairman.

The CHAIRMAN. May I just say that the chairman has stated that over and again. There was a theme.

And our last questions from Senator Chafee.

Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

As I analyze your appearance here today, Mr. Chairman, it is that you are sending out a clarion call to our Nation that these deficits have an incredibly deleterious effect on our Nation.

You used terms like corrosive, malignant, eating away at the foundations of our economic strength.

And you are not one to get up on soap boxes and shout to the world, but as I see what you are doing in your low-key way, if I would, you are saying these things are terrible, what is happening to our country. Now, am I overstating it?

Dr. GREENSPAN. I fear not, Senator.

Senator CHAFEE. I fear not either. And I just hope that the papers that so boldly interpreted what you said last time incorrectly will correctly interpret what you are saying this time, that these things are doing incredible damage to our Nation in the future.

Our grandchildren are going to being paying off in the form of $4 trillion of debt which currently runs over $200 billion a year in interest with no principle.

And, indeed, even with the efforts that President Clinton is taking, he shows in his own figures that the debt will increase by $1 trillion in the next 4 years.

Dr. GREENSPAN. What I must say in support of the President on this question, is that he does recognize that issue and is aware of the fact and has commented on the fact that in the latter years of this decade, beyond the scope of his existing program, that the deficit will rise unless expenditures are contained.

And he correctly evaluates the health care problem as being crucial to this. In that sense, it is not as though we are not looking at sets of data which every one agrees will create problems unless we go beyond where we are in the existing discussions which are quite important and are necessary. But they are only the prelude, as I see it, to a series of programs which ultimately restores balance over the longer run as well as over the very short-term period.

Senator CHAFEE. Well, Mr. Chairman, I do not differ with you very often, but I think you are overly optimistic to think that getting a grip on the health care is going to have great effects on our deficits.

I mean, I do not think anybody thinks that. And I have spent quite a bit of time on this health care business, that covering 37 million more Americans and changing our system to cover everybody is going to result in the short term certainly in reduced costs.

Dr. GREENSPAN. Well——

Senator CHAFEE. It is going to take additional taxes. I do not want to debate that here.

All I am saying is that what bothers me is we have this tremendous tax package that is being suggested here with increased spending accompanying it, but no one apparently is considering the cost of this health program that is going to come along, that certainly in the near term is going to increase expenditures.

We obviously hope in the long term it will, both private and public expenditures.

But my real question to you is, going back to your quote on the top of page 4, which Senator Roth referred to, in which you warned against addressing these budget deficits by increasing revenue.

I appreciate that. And I take it that you were not dismissing increased taxes, but you were saying that you would rather cut spending along with it.

Dr. GREENSPAN. I was saying that if over the long run, the rate of growth in expenditures is not brought down, then, we will not resolve this budget question. I am basically——

The CHAIRMAN. You are saying that is the arithmetic?

Dr. GREENSPAN. That is the arithmetic of the problem.

Senator CHAFEE. In other words, we can go ahead and plunge ahead with new taxes, but they just will not meet the rise in spending that are built in?

Dr. GREENSPAN. That is correct. See, the problem is the following dilemma, that you can close the deficit with expenditures rising faster than income by raising tax rates or increasing the tax base or doing something.

But you can only do that for a short while because it is clear that after awhile you begin to become counterproductive and create a decline in economic activity and a fall in revenues. And that, of course, worsens the deficit.

So what I am saying, no matter what is done, unless the expenditure issue is addressed, you cannot solve the deficit in the long term.

Senator CHAFEE. And that would apply—your tax illustration would apply even with the so-called sin tax?

Dr. GREENSPAN. Yes.

Senator CHAFEE. I think in your testimony you said that might be an approach. But just as the tax experience has shown, it has resulted in declining consumption which may be good, but it also results in declining revenue.

Let me just ask you one quick question. What we are doing in the United States I think is terrible. What is the experience in other countries?

Dr. GREENSPAN. Well, Senator, as you know, with the exception of a few countries, most of the European countries, for example, have levels of taxation and levels of expenditures higher than we do here, but they are pulling back in many instances, I am sure you are aware, of country after country trying to squeeze down their levels of outlays and in many instances, budget deficits.

But they are having problems. They are having the same types of problems that we are. I think it is a chronic problem which exists in democratic societies.

Senator CHAFEE. Well, thank you, Mr. Chairman.

And I hope the deficit will be dealt with.

The CHAIRMAN. And this member of this committee very much agrees.

I think we all agree that we have had a bravo performance.

Senator CHAFEE. Thank you.

The CHAIRMAN. It has been extraordinarily informative. And we have learned new things. We have had old verities reaffirmed.

We are very much in your debt, Mr. Chairman. We thank you very much. We would not have been able to get going, as I hope we will, without this. And for that, we are deeply grateful.

Dr. GREENSPAN. Well, thank you very much, Mr. Chairman.

[The prepared statements of Senators Baucus and Hatch appear in the appendix.]

[Whereupon, at 12:21 p.m., the hearing was concluded.]

PRESIDENT'S ECONOMIC PLAN

THURSDAY, MARCH 25, 1993

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

The hearing was convened, pursuant to notice, at 12:30 p.m., in room SD–215, Dirksen Senate Office Building, Hon. Daniel Patrick Moynihan (chairman of the committee) presiding.

Also present: Senators Baucus, Packwood, and Grassley.

[The press release announcing the hearing follows:]

[Press Release No. H–9, March 23, 1993]

ECONOMISTS TO TESTIFY ON THE PRESIDENT'S ECONOMIC PLAN AND THE NEED TO ADDRESS THE BUDGET DEFICIT

Sen. Daniel Patrick Moynihan (D.–N.Y.), Chairman of the Senate Committee on Finance, announced that the Committee will hold a hearing on the economic impact of the Clinton administration's deficit reduction and long-term economic growth plan.

The hearing will begin at *9:30 a.m. on Thursday, March 25* in room SD–215, Dirksen Senate Office Building.

The hearing will focus on the short- and long-term effect of the administration's economic plan on the U.S. economy. The Committee is also interested in the witnesses' views on the need to address the budget deficit.

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

The CHAIRMAN. A very good afternoon to our somewhat truncated hearing.

We are most apologetic to our distinguished witnesses who have come from around the country for this occasion and put off and rescheduled themselves.

It is simply that the Senate was in one of its moments of distemper. We had to have 30 votes from 6:00 o'clock last evening.

But we are chastened by that experience into a sense that we really ought to be better at governing than we have been of late.

And for the purpose of being instructed in that matter, we have a great distinction—I do not know if we have before—of having two former Chairmen of the Council on Economic Advisors with us.

I know that Dr. Stein and Dr. Boskin are hugely welcomed by me. And I suspect that they will be welcomed by the former, once, and future chairman, if you answer his questions correctly. [Laughter.]

Do not expect any mercy.

Senator PACKWOOD. If they do not answer them correctly, I am not likely to be chairman.

The CHAIRMAN. No. You are not likely to like their answers.

Senator PACKWOOD. Have them fire away.

The CHAIRMAN. Good morning, gentlemen.

And I should say, Bob Shapiro would have been with you, but he is absolutely required to be in Chicago.

In that case, just the way the things appear, Dr. Boskin. Good morning, sir. Proceed exactly as you like. Your statement will be placed into the record.

STATEMENT OF MICHAEL J. BOSKIN, PH.D., VISITING SCHOLAR, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Dr. BOSKIN. I want to cover a few points, but first, let me say that this is my first opportunity to testify, both again as a private citizen and under your chairmanship, Senator Moynihan. So congratulations to you.

We have worked on a large number of issues over the years from transportation to Soviet GDP to Social Security. And I am sure the committee will thrive under your leadership.

And Senator Packwood, I wanted to say, over the long number of years I have had the privilege of working with you, I cannot think of anybody in the Senate to whom the citizens of this country owe a greater debt of gratitude for what improvements we have been able to make in a too complex and burdensome tax structure.

The CHAIRMAN. I would like to back that up.

Dr. BOSKIN. I am sure the citizens of Oregon and of the country who complain about the tax system would have even more to complain about were it not for the immense energy and drive and insight that you have brought to this committee in your days in the Senate. So I want to thank you as a citizen for that.

What I would like to do is just read separate sets of things. They are interrelated however. One is I want to say a few words about the current economic situation and the budget, the President's proposals, and the general relationship amongst spending, taxes, deficits, and economic growth because I think there are some overly simplistic statements that get made about these things in numerous dimensions.

So first, I would like to say that like almost all Americans, I was enormously pleased to see the President raise all the right questions in his address to the country.

I think that those questions should and hopefully will, including this hearing and the questions you have raised in your invitation, get a full and complete airing, not only in the course of the debate on the President's proposals this year, implementing whatever, the resolution, as this committee moves to come up with the revenues it is required to and whatever changes in entitlement programs it will be doing and likewise, the other committees, but over the coming several years as well.

Those questions, such as, how important is it to reduce the budget deficit? How fast and how should it be done?

Should the government be trying to pump up the recovery, the recovery going at a decent, not robust rate, with a traditional short-run stimulus program?

Is a major expansion of government planning or even controls on private economic activity from health care to fiber optics desirable, let alone affordable?

How large a defense draw down can we afford militarily? And how much makes sense economically and at what speed?

Should we raise tax rates to try to make the tax system fairer? Is substantially more government spending on new programs likely to help the disadvantaged? Will it be target effective?

Those are questions we should be continually debating. And I will admit to my chagrin, as a Nation, we have not debated them, whether in a gross general sense for too long in my opinion.

So I give the President great credit for raising those questions. And I hope the Nation will be debating them throughout the year.

While I had hoped that I would agree with the general thrust of the President's proposal and could support it even if I disagreed with some of its components, my own analysis of its likely economic impacts precludes me from supporting the overall program.

Although I must in all candor say, there are many specific elements of it that I do support, I find it difficult and undesirable to be inconsistent.

And there are many items, including some on the revenue side, which have been proposed in previous administrations, which I support, the user fees, auctioning spectrum are simple examples.

So while I do believe that the net impact of this program is likely to slow the economy and that it is likely to raise less revenue than hoped for various reasons, including that there will be more tax sheltering and tax avoidance if tax rates go up, and in my opinion, there will be far more new spending if history is an ample guide.

When new programs come in, they wind up growing more than is projected. I do not believe that there is any iron law that every dollar that is raised will be automatically spent

But I am concerned that in the attempt to address what the President considers, and I would agree with some of these, ostensibly noble goals, that we not set in train a series or a cycle of some new spending which we think will solve a problem that only makes a dent or does not solve it, is not very cost effective. It grows in the out years more than we had anticipated.

Then, we raise taxes. And they do not raise as much revenue either through the cost of the impact on the economy or because of the rates, cause people shelter, undoing some of the 1986 reform benefits.

The deficit does not come down as much as we had hoped. Again, I do not have a mechanical dollar, every dollar that is taxed will not reduce the deficit automatically but be spent, but that we are setting ourselves up, in my opinion, for the possibility.

I hope I am wrong. If, indeed, this passes in this form, I hope I am wrong. But I worry that we set ourselves up for a ratcheting up of these things, chasing a progressively elusive target, not because of any iron law or any mechanical iron law, but because the spending programs have a way of costing more than you thought they would when you enacted them. And once enacted, they are very, very difficult to curtail and to undo.

That is my general reaction. I would be happy to respond to some specifics of the President's program, some parts of which, as I said,

are good and some parts of which, I think, are quite inconsistent with his basic overall goals.

The second thing I would like to say is that the basic reason to want to reduce the budget deficit obviously is to help the economy.

The basic logic of that is having more available private savings, the government borrowing less means we will be able to finance more, which over the longer term over decades should help raise future living standards, if indeed, that process is put into place.

Therefore, it is essential as a principle. It is a simple matter of elementary logic that if the reason you are trying to reduce the budget deficit is to have more private savings to finance more private investment, you should not try to reduce the budget deficit in ways that harm private savings or private investment.

It is just undoing with the right hand what the left hand is trying to do. I will give you one simple example. The rise in corporate tax rates, in my opinion, is illogical given what is being attempted.

It will leave less after-tax corporate profits, for investment. If the idea is to reduce the deficit to have more capital available for the businesses to invest and we tax them in order to do that, it seems to me to be illogical.

It is my opinion that the only way to be convinced or be convincing that we will have very serious substantial, permanent, lower structural deficits over the long term—and I do agree with these projections that show we run the risk of the deficit rising in the latter part of this decade to even larger levels.

The only way to be sure to do that, in my opinion, is both to control the growth of existing spending programs, be very, very tough on the establishment of new programs and on their growth, and to develop programs that help to increase economy, increase economic growth and improve the economy.

In my view, that involves tax reforms that move in somewhat of a different direction than has been proposed by the President, a bolder move to tax consumed income, which would eliminate the double taxation of savings, and generate more private savings.

It would eliminate the double taxation of corporate source income for corporate investment and eliminate the tax on reinvested capital gains.

I realize that that is not on the table now, but it is something that I hope this committee will think about over the longer term as it tries to grapple with the problems that the country will be facing for the significant future.

Again, while I believe we should be trying to do this primarily, if not exclusively, on the spending side, I do want to make it clear that there are differences amongst types of taxes and what they are likely to do.

I have indicated that we ought to be dealing with consumption, not savings and investment. I also believe that there is ample theoretical and ample historical evidence, including that following the 1986 tax reform, that establishes the following simple principal point.

The higher tax rates go, the progressively worse is the economic harm done by those rates, that is moving from 31 to 32 will raise some revenue, not as much as most of the bureaucrats project.

But the higher up you go, progressively less will be revised because there will be more and more of an incentive to shelter.

I believe it was a great achievement in the 1980's to get tax rates down.

Deficits, as you know from my numerous testimonies before this committee and private conversations, public statements, I think, are a serious problem. But getting tax rates down is a major, major improvement.

Now that we have broadened the base, I think moving to raise tax rates in any significant amount, in my opinion, will cause some substantial misallocation of resources, can do serious potential harm to the economy.

It is likely to raise far less revenue than projected. And even the most careful study I have seen to date, by Martin Feldstein and Dan Feinberg of the National Bureau of Economic Research suggests that it will raise only about 30 percent of projected revenue.

The President's proposal will raise—for raising income tax rates, will raise only about 30 percent of the revenue that Treasury and the Joint Tax Committee project.

I would also add something that is of the particular expertise of this committee, that we ought to be aware that a sizable fraction of the income in these brackets is Subchapter S corporate income.

And it is important to understand that. I mean, I am rich by these definitions. And if it will help the country, I will pay more. If we can control spending and reduce the deficit, I will help the country. That is fine if we can do those two things.

But the fact of the matter is, to the extent that we are, by raising the income tax rates, not realizing that we are also raising corporate rates on those Subchapter S corporations, at least some of which are available to reinvest in small business as opposed to a doctor doing—sheltering income or something of a sort.

I think it is important to understand. So my general advice is again, deficits are very important. The President has raised the right questions

I am delighted by the inquiry I got and the questions I was asked to address are on those same questions.

I am very concerned that the movement that is being made in this program could wind up to be the first step on the path to a series of more spending and more taxes, perhaps some but not as much deficit reduction as people would like, and we wind up gradually progressing toward a European-sized share of government in the economy.

I think that would be a bad mistake, if it, indeed, was allowed to happen. And I am sure that this committee will not allow it to happen.

Thank you very much.

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

The CHAIRMAN. We thank you. Dr. Boskin.

Since you mentioned Martin Feldstein, we invited him to testify. He has sent us a long letter which is quite explicit on your point that it is not at all clear that the estimated revenues could be had from increasing taxes—that a higher marginal tax rate could, in fact, eventuate that they would not show up because of behaviors.

Dr. BOSKIN. Well, I think we are at an age where taxpayers, the median taxpayer, not just the rich taxpayer, has become a lot more sophisticated.

There is a lot more mass marketing of increased home mortgages, deduct the interest, and avoid the taxes. If not that, something else. People can get low dividend stocks instead of high dividend stocks. They can move from wages to fringe benefits, things of that sort.

The CHAIRMAN. Senator Baucus, would you like to make a statement?

Senator BAUCUS. No statement. Thanks.

The CHAIRMAN. I will put that letter of Mr. Feldstein's into the record at this point.

[The letter appears in the appendix.]

The CHAIRMAN. Have there been any chairmen who served two Presidents? I think there has been one other. Dr. Heller, would he have been?

Dr. STEIN. That is right. Of course, my service with the second President was very brief.

The CHAIRMAN. Not less distinguished.

Dr. STEIN. Anyway, Michael Boskin refers to having previous conversations with you. I go back to Harold Kaudson and people like that.

STATEMENT OF HERBERT STEIN, PH.D., SENIOR FELLOW, AMERICAN ENTERPRISE INSTITUTE, WASHINGTON, DC

Dr. STEIN. Anyway, I have submitted a statement which is only five pages long.

The CHAIRMAN. It will be put into the record, of course.

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

Dr. STEIN. And I will give you a summary of what I like and do not like, which is all we ever do anyway. I think we should reduce the budget deficit.

The primary reason for my feeling that is that you all say you are going to do it. I am a great watcher of C-Span. I never see any Congressman or Senator get up there and say that he is not in favor of reducing the budget deficit. They all say they are. And I believe honesty is the best policy and may be contagious.

So I think it would be a good thing for the country if you would do what you said you were going to do. And if you are not going to do it, say you are not going to do it. I think it would help to defeat some of the aimlessness and helplessness that abounds in this country.

I believe that the Clinton package will reduce the deficit if you adhere to it. And it will not reduce the deficit if you do not adhere to it. And that is about all there is to say about that.

The CHAIRMAN. Now, on that point, we have just had Martin Feldstein write to say that, no, it will not.

Dr. STEIN. Well, he says it will not reduce it as much as you think.

The CHAIRMAN. Yes.

Dr. STEIN. And also, I mean, he is not the last econometrician, as you know. And you can find another one who will say something different.

The CHAIRMAN. Oh, that other economist. [Laughter.]

Dr. STEIN. So I can remember all those econometricians who said how much we are going to raise the revenue when we cut the taxes in 1981. That did not quite work out.

Anyway, I am not particularly impressed with this law, which Michael Boskin said is not an iron law, but which he thinks is a law of some kind, a fuzzy law, about how increasing the revenues will increase the expenditures.

I do not think you are here—if I may say so, you are not here to predict what you are going to do. You are here to decide what you are going to do.

And if you spend the revenue, that will be because you decided to do it. And it will not be because the devil made you do it. And you have to decide.

It is like saying that an alcoholic should not stop drinking because all previous experience is that when he stopped, he started again. And at some time, he has to stop. And if he is sufficiently determined, he will stop. And I think——

Senator PACKWOOD. Would it be fair to say though, doctor, that we might possibly predict what we might do in the future by what we have consistently done in the past?

Dr. STEIN. No. I do not think so because you are here to change it. I think you are open to change. I hope so. If I did not, it would be a hopeless situation.

Anyway, I think that the Clinton package or the budget resolution that you just adopted will not reduce the deficit after 5 years. So more is needed, either now or later, if you want permanent deficit reduction.

I suppose this is water over the dam, but I think the stimulus package is bad policy. I do not know whether the stimulus will help or hurt us right now, but I think a policy in which you say that whenever unemployment is 7 percent and declining, we are going to declare an economic emergency and say, now, we have to depart from our long-run plan of budget policy. It is not going to be a long-run plan of budget policy because you will have a lot of such emergencies.

So I think this is not the kind of occasion in which you should adopt an emergency program.

I do not think that the deficit reduction proposed now or even more will tend to depress the economy on the demand side by reducing the demand for output.

But if it does, I think that it is the function and the responsibility and the capacity of the Federal Reserve to help keep that from happening. So I would not worry about that.

Now, unlike many other people, I am not concerned about the distribution of the package between revenue increases and expenditure cuts in general because I do not think anything in general can be said about the merits of raising taxes as compared with cutting expenditures.

They are both ways of taking money away from people. And what matters is who you take it away from and under what conditions.

There are some expenditure cuts that would be worse than some revenue increases and vice versa. But I think you have to look at the particular programs.

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I think I could write a better package than Mr. Clinton did. And I am sure that Michael Boskin could and so could many other people, but the question is, would you enact them if we did write them? And I think the answer is probably no.

But I will give you some suggestions. I agree very much with Michael that we should stick more to the principle of the 1986 tax reform, try to remove unfair and uneconomic discriminations, and try to raise the revenue with the lowest marginal rates.

Within the program that has been presented, I think the corporate rate increase is a mistake. I think that one of the great defects of the present U.S. tax system is and has been for 40 or 50 years the double taxation of corporate income. And I do not see any reason to make that worse.

I would like to eliminate the 10-percent surcharge on people who are quarter-millionaires. I think that is just a kind of flourish of hostility towards people who are making a moderate amount of money, what is now a moderate amount of money in this country.

I think, probably the man who runs the gas station down on the corner near the Watergate probably makes that and the 200 hitters in baseball make that. [Laughter.]

Dr. BOSKIN. A shortstop that hits 200 makes that.

Dr STEIN. That is what I meant. I do not mean to count up to 200 I mean, hitters who bat 200.

I remember many years ago during the war when a committee with which I worked—was thinking about the post-war tax system.

A very wise man who was a member of the committee said, "Well, at some point, there ought to be a high rate on incomes that people would regard as kind of outrageous."

And they sat around the table then in 1942 or 1943 and tried to decide what that was. And they said it was $1 million. Well, that would now be $5 million in today's dollars, or so.

And I would not object if you feel that there is a certain kind of contribution to social solidarity in demonstrating that very, very rich people make large contributions.

But I think to start it at $250,000 is really not sensible. It is not going to yield very much revenue, especially if you have the kind of thing that Michael talks about, an attempt to divert revenue incomes from taxable sources.

I do not think you should impose an energy tax on the business uses of energy. I think for one thing, it is very dangerous for some kinds of businesses that are high energy users and their foreign competition.

For example, there is the case of aluminum, where you can go across the border into Canada and get aluminum for energy production at a very low price.

And also businesses that use large amounts of capital tend to use large amounts of energy so that a high energy tax is kind of a discriminatory tax against the high-capital using businesses.

I am not in favor of all of the preferences for small business that are in the President's plan. I think they reflect the kind of romantic notion about the exceptional contribution that small business makes to employment and innovation in this country. And I do not think that is justified.

Since I have suggested several tax increases that I would not like I will suggest some revenue sources I would prefer. I would prefer to begin the income tax rate increase at a somewhat lower level of income than the President proposes.

I would favor a higher energy tax increase. And I——

The CHAIRMAN. A higher energy tax on a more narrow basis?

Dr. STEIN. On consumer use, not on business use.

I would like to phase out the earned income credit faster. We have looming over us the prospect of how are we going to finance the health care thing. But at some point, I think, we ought to make health benefits provided by employers taxable as income to the recipient.

On the expenditure side, I would not favor any of the increases called investments in the President's program, except those that I would label as being for the very poor because I think that the real problem in this country is the problem of the very poor and the associated pathologies that go with that.

As I look over the President's list of expenditure initiatives called investments, I would think about one-quarter of them fit in the category of having something to do with improving the condition of the very poor people.

I think there are a lot more cuts that can be made at some point also. Maybe this can come up in the health care thing. The enormous subsidies involved in providing medical care for people like me who are over a certain age and who are not poor, is a totally unjustified cost of government. It runs to tens of billions of dollars that do not need to be in the Federal budget.

So those are my views. Thank you.

The CHAIRMAN. Well, Senator Baucus, do you have any questions?

I know you have to go to another hearing.

Senator BAUCUS. I am fine. Thanks. Except I was a little bit surprised, Dr. Stein. I do not know if you said it orally. I read it in your written statement that we should not worry about spending on investment, but rather, I think I heard you say or maybe I saw in your statement that expenditures should be more on poverty—on low-income programs.

It has always been my thought that if we are going to spend dollars, we should tend to spend for the longer term, that is on investment, infrastructure, etcetera, and particularly if we are going to reduce the budget deficit that we should spend our dollars thinking about the longer term.

Dr. STEIN. Well, there are a lot of questions involved in that. And I will tell you what my view is. I think this country is very rich. And I think it is getting richer, although at a very slow rate.

I do not think the great problem of this country is not that it is not rich enough or that it is not on average getting richer fast enough.

So I think the great problem of this country is the 10 or 12 or 13 percent of the population that is disadvantaged, that is living in the state of persistent unemployment, low education, crime, drugs, all that, that whole ball of wax.

I think that is our big problem. So I would like to focus our attention on doing something about that.

Now, as far as the investment in the budget is concerned, I always use the investment in the budget in quotation marks. The Clinton people say we need to do two things: we need to increase investment and we need to reduce the budget deficit.

Well, I regard reducing the budget deficit as a way of increasing investment that is, as the way of increasing private investment.

And I do not share their preference for the so-called targeted or government managed investment. I do not have any confidence that that will be more productive than the investment that we will get out of the ordinary market process.

I am just amazed that the President says that we have a government that does not work. And then, he wants to give them all of these complicated and sophisticated assignments, like building a high-speed train. Anyway, I am not in a particular hurry to get anywhere. [Laughter.]

So anyway, about the whole question of promoting growth through the budget what we are saying is that, I am going to collect $10,000 in taxes from you so that the government can invest it so that your children and grandchildren will have higher income.

Well, if I cared about that, I could take the $10,000 and invest it. And my children and grandchildren will have higher incomes.

That whole argument about the budget as a means of promoting growth in the future seems to assume that we are all very childlike and incapable of managing our affairs and that you need to take our money and invest it for us.

That is why when I come down to it, I am very ambivalent about the importance of reducing the budget deficit as an economic proposition. And if you had not all said that you were going to do it, I would not be so insistent on it.

If you all came along and passed a resolution saying the budget deficit ought to be 4 percent of the GDP forever, I think that would be a discussable proposition.

What offends me because you all say it ought to be zero. And then you go on making it 4 percent.

Senator PACKWOOD. Thank you very much.

The CHAIRMAN. I detected in both of your testimonies a certain willingness to live with the deficit larger than we have historically experienced.

But we had your friend and sometime colleague, Alan Greenspan, here 2 days ago saying it is not going to stay at 4 percent. It is going to start going up. It will start compounding in some general sense 5 years out. On that, both of you agree?

Dr. BOSKIN. Yes.

Dr. STEIN. I think we are all concerned. I think we should be concerned about the prospect that the deficit is going to turn up and become much bigger.

And there is some point, some size of budget deficit, at which the deficit becomes explosive. If the deficit is very large relative to the growth of GDP, then the debt will rise faster than the GDP. Then interest will rise faster in GDP and the debt and deficit will get bigger and bigger.

But equilibrium does not require zero budget deficit.

Dr. BOSKIN. That is correct.

Dr. STEIN. You can go on forever with a budget deficit that is 2 percent, 3 percent, 4 percent of GNP if the GNP is—I am an old fellow. I still say GNP when I should say GDP.

But anyway, if the GNP is rising in nominal terms at 6 percent, you can stabilize with a budget deficit at 4 percent.

So if you say the thing is not explosive and you can live with it, then, you have a simple question of how much do we want to depress consumption and other goodies now for the sake of the future. That is a question of social judgment.

And what I was saying at the end is you are kind of interposing your social judgment as against the sum of the individual judgments of the American people because if they all cared a great deal about the fact that their children's and grandchildren's income is not going to be doubled—is not going to double until 100 years, they could do something about it.

Dr. BOSKIN. Now, I would add to that the fact that Americans, I think, are quite concerned about the apparent passage of larger liabilities to the future.

What I tried to say in the earlier part of my testimony, as part of the general initiative I tried to launch when I was in the government improving the quality of the statistics is that the way we measure the budget deficit is a very imprecise and imperfect measure of that and very incomplete.

And also obviously, it depends on what else is going on in the economy. If we are developing a lot of private assets, if we are strengthening our school system, and so on, one would be less concerned about the deficit.

I also think that it is important not to delude ourselves that we could reduce the budget deficit very, very quickly as some have proposed, 2 or 3 years or something of that sort, and not do a lot of harm to the economy in the short run. I think that is a fallacious proposition.

So I believe quite strongly we need to control the budget. We need to get it on a downward course. We need to get it down and down further.

We need to do much more on the spending side, in my opinion, because I think that is likely to be a lot more permanent. While it is difficult to do, it is likely to be more permanent trying to do it on the tax side.

The CHAIRMAN. That, of course, is Senator Packwood's question.

Senator PACKWOOD. My ultimate question.

And I am little confused by Dr. Stein's answer. Is it your personal view that you do not mind living with a certain deficit as long as it does not get too big? Or is it your personal view that we ought to be trying to narrow it down?

Dr. STEIN. Well, leaving aside the question of honesty and doing what you said you would do——

Senator PACKWOOD. Not what we would do, what you would do.

The CHAIRMAN. But he has made the point that if we keep saying we should do it, then, maybe we should. [Laughter.]

Senator PACKWOOD. I understand.

Dr. STEIN. But if you started this from scratch, I would not regard reducing the budget deficit as the primary objective. This will be a question of priorities.

If you ask me, would I rather reduce the budget deficit by $10 billion or eliminate the—or spend the $10 billion on Head Start, I would say I would rather spend the $10 billion on Head Start.

If you ask me, would you rather reduce the budget deficit by $10 billion or spend the $10 billion on a super collider, I would say reduce the budget deficit.

Senator PACKWOOD. Well, let me ask on your statement on page 3 where you say, "The great argument over the portion of the deficit reducing package that consists of tax increases rather than expenditure cuts is meaningless and demagogy.

There is no general economic or political distinction between rising taxes and cutting expenditures and no general reason to prefer one over the over. Both are taking money from people."

Does it make any difference then, whether we tax and spend 30 percent of the GDP or we tax and spend 50 percent of the GDP?

Dr. STEIN. Well, you would have to tell me what you are taxing and spending it for.

Senator PACKWOOD. Well, let's take what Dr. Boskin said. He says this moving more toward, if we keep going the way we're going, to a European-style taxing and spending. And we would undoubtedly spend it if we do like they do on more social welfare legislation.

Dr. STEIN. Well, I would not be in favor, if you stipulate that that is what we are going to spend it for. Beyond some point, I would think that would not be a good idea.

Senator PACKWOOD. Well, Head Start is one of those programs.

Dr. STEIN. I believe that if we could spend more money in way which would increase the productivity and earnings of the poor people, I would be for it.

Senator PACKWOOD. Could we spend 45 to 50 percent o' the GDP all on programs that you would define as that?

Or at some stage you would think: I am not sure of all of those programs no matter how——

Dr. STEIN. At some stage, I would think—but we have spent 45 percent of the GDP on purposes that I thought were very important. We did it during World War II, but that is not our situation.

Senator PACKWOOD. No.

Dr. STEIN. If you could tell me what——

Senator PACKWOOD. No. In 1944 and 1945, we were spending 40 percent of the GDP and 90 percent of the budget on the military.

Dr. STEIN. Right.

Senator PACKWOOD. And we thought it was necessary. And we borrowed half of it. The military budget today would be $2.3 trillion if we were spending on the same basis that we were spending in 1944 and 1945.

But what I fear in those charts that I sent you—that are not my figures, they are just either Library of Congress or the Congressional Budget Office or what not—show two trends.

It is not a Newtonian law, I grant you that. But the trend seems to be, if we have the money, we will spend it. We very seldom refund it to the taxpayer. If we have money or if we raise taxes, we have spent it in the past.

Dr. STEIN. But we did not spend it plus 4 percent of the GDP in the past. There did not seem to be any iron law which required us to run a deficit equal to 4 percent of the GDP.

Senator PACKWOOD. Oh, no. I agree.

Dr. STEIN. So that is what our problem is. And all you could observe in the past is that by and large, except in times of war or in times of depression, we spent no more than we collected.

And that all changed in 1981. Then, for the first time—unless you consider that to be a war time. Then, for the first time in a period of fairly high employment, we spent a lot more than we collected.

Senator PACKWOOD. Let me——

Dr. STEIN. I think that something there changed. And that was not an iron-law politic, but it was politics.

Senator PACKWOOD. Let me say something—because I have sent these figures to the chairman before—about 1981. From the summer of 1980 until about the summer of 1981, both the Congressional Budget Office and OMB were predicting significant surpluses by 1984, 1985, or 1986, I mean, in the magnitude of $150 to $225 billion.

And these were, as I say, the CBO under Alice Rivlin and OMB under President Carter and then under President Reagan. And when the President presented his tax cuts in 1981, Treasury in their projections reduced the revenue projections almost dollar for dollar with the tax cuts. They did a static projection.

And when they did it, here was their argument, "If we don't cut the taxes and we have those kinds of surpluses, we will spend it."

So I do not think based upon what we thought our revenues were going to be, it is fair to say that was the philosophy, at least of this committee, when we did it.

And then, there are three things to remember about what we did. Or one thing about we did and two things about what we did not know.

When President Reagan submitted his budget, he did not have any indexing. We are the ones that indexed it.

Dr. STEIN. Yes.

Senator PACKWOOD. And we could, as I recall, assume just about a 1.4 to 1.5 percent increase in revenues for each 1 percent increase in inflation. That is the first thing. We did that, not him.

Two, we were projecting 9, 10, 15 percent inflation for the next 2 or 3 or 4 years. And none of us were predicting a recession.

When you add all of those together—and it is no wonder our revenues fell. But I am not sure it is to say that was the conscious decision in 1981.

Dr. STEIN. Well, that is a very much disputed period of history. And I do not remember it all. What I do remember is that when these projects that you referred to, the first projections that you referred to, and I think particularly of then-candidate Reagan's economic speech in September of 1980. And he had these projections of how big the revenue was going to be and therefore all the room there was for cutting taxes.

The fatal flaw in that was that these projections assumed a very high, long continued inflation rate. Whereas it was also part of his program that we were not going to have that inflation rate.

Then, when they came into office and you had some people sitting down with the figures, they realized that that all was not going to work. And we had a whole new look at the budget. I do not think anyone then anymore after the Reagan team came in was still predicting 14, 15 percent inflation rates.

And there is a disagreement now among people who were around about whether Mr. Reagan actually thought cutting the taxes would raise the revenue. They thought they were going to get a lot more revenue than they did.

Dr. BOSKIN. My argument is a little bit more complex and has several different components to it. One is, if it is there, they will spend it view. And I said I do not think that is an iron law, but it is a lot more than a rendering.

There are enormous pressures to spend. I think this comes in very good political science reasons for this that the way people receive concentrated benefits whether those are producers subsidized in a particular agricultural product or whatever it happens to be.

Well, it is hard to get that undone. And it is easier for them to get their will done in the country than the diffuse interests of the general taxpayer. And I think that general principle has lots of other corollaries, but I think that there are lots of pressures to spend.

There is also a tendency on the part of the Congress, concerned about problems, to think that spending on them will solve the problems. Sometimes it does. Sometimes it does not. Sometimes it does more harm than good.

But the history that I was particular interested in, is the history of new programs. And part of it was over the years in Republican and Democratic administrations and on Capital Hill involved as budget gimmicks. You only do 5 years. You start something in the middle of the fiscal year. And it does not look bad at the start or whatever.

But there is a very distinct—a political scientist, I think, would call this a law. It would not elevate itself to a law by the more rigorous quantitative standards of economists, but programs to grow.

The constituencies grow. They become more powerful. Things that may not be called entitlements even in the jargon of Washington, the recipients think of as entitlements. And it is very hard not to vote them year after year and so on.

So I am very concerned when I look at the structure that is being proposed, the new spending programs and very little cuts in anything other than defense.

And that, I think, is going to lead the pressure so both, from the revenue side getting less, from the spending side being a lot more than you are likely to see in these figures.

I think there is a legitimate concern, if history is any guide, that you ought to be very concerned that this committee will in short order be back worried about more entitlement savings, more tax increases, etcetera. And you will be chasing kind of a moving target, not for necessarily any ill will, but this process just continues on and on.

The CHAIRMAN. I cannot forget the fact that you have told us that you have to be out of here by a quarter after one.

Dr. BOSKIN. Yes.

The CHAIRMAN. And we have five minutes. Could I just say—it is little abstract—I am surprised that Dr. Stein would not want to fund the super collider.

Now, surely, there is a role for it. I mean, what is an organized society for? What will a super collider do?

It will add to the culture. We will know more about physics than we have known. And nobody is going to pay for that. And so it is not going to happen unless everybody wants it.

Dr. STEIN. But we do not need it this year. I mean, we do not need to know that right now. There are a lot of things. We do not know as much as we already know. Most of us do not. [Laughter.]

I do not have an objection to government financing some scientific research, but this is a period in which there are budget constraints. We must make some choices.

The CHAIRMAN. And remember that old question, cui bono. Thirty years in the evaluation search has produced a fair degree of skepticism about what works, but we do know who gets.

And it is rarely what they are. It is something that you are supposed to work for. And if you would always ask yourself, what is the median income of the person who received this government money which is designed to help persons lower than themselves, you will find a pattern of this.

I would ask just a general question. Maybe it is a little too abstract. We had hoped to have Bill Baumol here. He could not come.

Has there been a migration of activities into the public sector, where you have a cost disease problem, and a comparative cost rise because of the accessibility to productivity gains in chamber music in kindergarten as against telecommunications? Isn't there a little bit of that?

Dr. BOSKIN. I believe that that can be demonstrated empirically, but I will remember on what the overwhelming bulk of the Federal Government spends its receipts, whether taxes or borrowed on, are transfer payments back to people.

The CHAIRMAN. Right.

Dr. BOSKIN. But in State and local governments, I think, this is a particular problem.

The CHAIRMAN. Yes. I do, too.

Dr. BOSKIN. And we really do not have in the Federal Government—we did not have it when I was in the Federal Government, trying to improve the cost benefit analysis somewhat.

We do not have the rigorous review procedures, whether that is zero-based budgeting, whether that is changing the baseline from we will assume that over 5 years, this will be privatized or it will be phased out and replaced with vouchers and the bureaucrats will be eliminated.

And it will not be done as part of a large public bureaucracy as a way of dealing with the cost as baseline.

And you have to justify why you are going to deliver better services doing it through government bureaucracy than doing it by giving people the resources to buy from the private sector.

We do not have anything like that. And we do not have the discipline of the market. Now, a lot of projects fail ex post in the private sector, but ex ante, there is a discipline of the market.

Dr. Stein mentioned that earlier when he was talking about being underwhelmed with the preference for public investment versus private investment.

There were many of the things that I did at CEA where the nature of taking something I was almost certain had benefits that maybe were a third of the cost and trying to reduce it in half.

And that was what I was trying to help our citizens that way by cutting back projects that were, indeed, investments in the mechanical sense that they were going to be long lived and last a long time, but not only did not have a positive rate of return, but almost certainly would not recover the original capital expenditure.

The CHAIRMAN. A fair point. It is just that still there are some things that adorn the republic. I frankly think the moon landing was one and the super collider is another.

Now, we did not learn anything in the moon landing, but it was great TV. And the super collider will just add to the culture of the species.

Dr. BOSKIN. Well, I will not get specific about the super collider. I would make—since I am going to have to leave in a moment, if I can take advantage of my long-standing relations with this committee and each of you and just, as it looks inevitable that the budget resolution is passed and the committees are going to be instructed and so on, I would like to second some of the things that Dr. Stein said and others, in turn, to try to be constructive.

I have indicated that I could not support the President's program because I thought it would not help the economy, indeed, the reverse. It would more likely damage the economy than help it.

But I do believe as you turn to the tax side and so on, moving from the general principles, I would strongly endorse removing the business uses from the energy tax, if an energy tax is going to remain. I think that makes a lot of sense.

The CHAIRMAN. Would you give a very rough estimate of what proportion of energy use is by business?

Dr. BOSKIN. It is well under half, but it is sizable.

The CHAIRMAN. Under half?

Dr. BOSKIN. I think it is under half, but it is sizable.

The CHAIRMAN. The rest is on wheels and home heating?

Dr. BOSKIN. That is right. I understand the politics of trying to have everybody but the voters think that they are paying for all of this. But the fact is the voters are going to pay for it, whether that is passed on in the prices of the goods, whether that is in the health care system.

If you tax the providers, they are going to pay for it in either less care or the costs are going to get passed forward or you are going to have price controls. And they are going to wind up having less care and so on.

So even though I understand the argument, I have heard it from members of this committee, I think not either of you, that, well, we do not want—keep in mind, people, when they show up at the pump or whatever, we want it removed.

The fact is taxes are paid by people eventually. They are paid by our citizens. And we ought to—if we are raising revenue, you ought to try to do that in a way that harms the economy the least.

That means to try, to the extent you can, scale back the rate increases, make it on consumption, not on business use. Do not harm our international competitiveness. Do not raise the corporate rate if you can avoid that, things of that sort.

The CHAIRMAN. Senator Grassley is here. And I know you have to leave.

Dr. BOSKIN. Yes.

The CHAIRMAN. Senator Grassley, Dr. Boskin has to leave.

Senator GRASSLEY. Yes. I think Dr. Boskin should be allowed to go. He should not be penalized just because I am late. I can maybe ask a couple of questions. Is Dr. Stein going to stay around?

The CHAIRMAN. Fine.

Would you be able to do it?

Before Dr. Boskin departs, I think it ought to be noted that there is a tremendous struggle just now as to whether Stanford University should be provided Federal funds for the development of what is called a B-factory, which is designed to study the sub-particles of quarks.

Dr. BOSKIN. Yes.

The CHAIRMAN. And knowing any more about quarks could do nothing more than add to the joys of Murray Gellmann and the legacy of American civilization and the honor of Stanford.

But in any event, I share your notion that there is some value in the advancement of knowledge that may—and that at some point you have to have a notion that you are willing to have a small portion of society's portfolio devoted to that.

And it is definitely a portfolio. Some small fraction of it will reap commercial benefits. Some will enrich society. Much of it will go unnoticed in musty libraries.

I share that view without getting specific about any specific project.

The CHAIRMAN. Thank you very much, doctor.

Dr. BOSKIN. It is always a pleasure to be here.

The CHAIRMAN. Senator Grassley, Dr. Stein is all yours.

Senator GRASSLEY. Well, he does not have to worry. [Laughter.]

And I am sorry I missed, Dr. Boskin, what you had to say, and also Dr. Stein, but I had another meeting I had to be at with the Attorney General.

You may have expressed, Dr. Stein, some agreement with a question that I am going to ask you about, but I would ask for further observation. And this is in reference to a 1986 General Accounting Office report that dealt with an analysis of the 1983 stimulus package.

It found that a job creation program is effective if, in the first instance, legislation is enacted as soon as possible after a recession is identified.

Secondly, funds are spent quickly. And people are hired when the economy needs new jobs. And three, funds are spent before the economy recovers.

Assuming you agree with that criteria, because that is what the GAO report said, it would appear that the President's stimulus package would be ineffective, while at the same time, it would increase the deficit. I would like to have—of course, that is my conclusion.

But I would like to have your comment on whether or not you would see the President's stimulus package violating what the principles the General Accounting Office felt were so necessary for a stimulus to work, at least as it related to the 1983 one.

Dr. STEIN. Well, I agree with those criteria. And I already indicated I do not think the stimulus package is good policy at this time.

I think that you have to have some general rules or principles about how you will behave. And I think the rule or principle ought to be that the departure of the economy from its desired path ought to be fairly extreme if it is going to justify departure from a serious, well-established path for the budget and for the deficit.

And I do not think that the present situation is in that extreme category. It may turn out that the stimulus package adopted now will be just right. I cannot predict that.

I mean, it may turn out that if you bet on all the horses whose name starts with S, that will turn out to be just right. [Laughter.]

But that would not be a general good rule of behavior. And so I do think this—and I have been through a great many of these things in 1958 and in 1971 and in 1975.

And I think the record is very poor of our ability to adapt a fiscal policy to meet the needs of recessions. And I think in many of those cases, the situation was much clearer than it is today.

Senator GRASSLEY. So in addition, then, the criteria laid out by the General Accounting Office are as reasonable a benchmark now as they were in 1983?

Dr. STEIN. Yes. I would have a somewhat different benchmark. I would say that you have to be in a quite serious recession.

If you say that you want to act early, it is a good thing to say, but you do not know. You do not know in time. You do not act in time. So you are going to miss the boat somewhat.

But I think you would have to be far away from where you would like to be. So you have to be in a situation so far from high employment and potential output that if you do overshoot the mark, it will not be by much.

And I do not think that is the case today. If there was a case, it would have been best if it could have been done in the beginning of 1991.

But even at the beginning of 1992, there was more reason to do it. And I testified then that, if things did not seem to be getting better, we should take some fiscal steps. But certainly not now. Well, I should not say certainly, but I do not think so.

Senator GRASSLEY. On the question of taxes and what impact they will have negative or positive on the President's program, the administration keeps making the point that whatever negative aspects there are about increased taxes is going to be outweighed by decreased interest rates.

Now, yesterday, Chairman Greenspan contended that interest rates will not come down unless the deficit is reduced beyond the 5-year budget. And that is what we are working on today is a 5-year budget.

Greenspan agreed that the President's plan would not reduce the deficit beyond the 5-year plan and would not purge the inflation expectations that exists in the system.

The plan, therefore, would not affect long-term interest rates, as the administration argues that it would.

I would like to have your assessment, not only of what Greenspan said and I hope I gave justice to his position and statement yesterday, but also how you feel the whole argument about interest rates, they are coming down offsetting whatever negative impact there is of increased taxes.

Dr. STEIN. Well, I think the decline of interest rates will offset the negative effect of increased taxes on the demand side of the economy. And if they do not, I think, then, it is up to Mr. Greenspan to see that they do.

Senator GRASSLEY. Now, you are talking about for this 5-year period of time? And I wanted to focus on beyond the 5-year period.

Dr. STEIN. Well, I think it is important. it would be a great advantage if you could do something which would indicate that you are not going to allow the deficit to raise again after 1996 or 1997, as it will, even with the present budget resolution.

So I think that is important. And I said earlier in my testimony that even now or later, you are going to have to deal with that prospective increase in the deficit. And it would be better if you could deal with it now. But you were up all night last night.

Now, as far as the inflation expectation is concerned, I really think that is Mr. Greenspan's problem and not your problem.

I think that we can have stable price levels or a low rate of inflation with big budget deficits, or with a rise in budget deficits if they are not rising at an unexpected and unforeseen way, if the monetary policy is managed appropriately. And that is what his responsibility at the Federal Reserve is.

I note that the Chairmen of the Federal Reserve always love to come up here and talk very explicitly about fiscal policy and very cagily about monetary policy. [Laughter.]

The CHAIRMAN. On that note, Dr. Stein, it is a rare privilege for us to have someone who started working on the political economy in the recession of 1938 and gone through one disaster after another. And he is still here and so are we.

Dr. STEIN. Thank you very much. It has been a pleasure.

The CHAIRMAN. It is a big honor to have you, sir.

He has watched some chairmen of the Federal Reserve Board in his time.

Now, our closing panel we are very happy to have here. We see Dr. White. We see Dr. Levy. We see Dr. Olson.

So gentlemen, will you come forward? Again, we are very much aware that we have put you out of your arrangements. Both Dr. White and Dr. Levy have had problems of some length for this purpose. And you are all the more welcome, sirs.

I see David Levy in the room. And I would like to welcome you. He is a member of the faculty at the Jerome Levy Institute. And S Jay Levy is the lead-off witness.

STATEMENT OF S JAY LEVY, CHAIRMAN, THE JEROME LEVY INSTITUTE, BARD COLLEGE, ANNANDALE-ON-HUDSON, NY

Mr. LEVY. Thank you, Chairman Moynihan and Senator Packwood and Senator Grassley for this opportunity.

Let me begin by saying, the Clinton program is a commendable, genuine effort to improve the economy and dramatically reduce the deficit starting next fiscal year. Yet it runs a great risk.

To reduce the budget deficit by $70 billion in 1994, whether by cutting expenditures, raising taxes, or a combination of the two, risks shoving the economy into a recession, thereby defeating any possibility of near-term deficit reduction. Such an outcome, I think, would be rather demoralizing for the country.

The United States is suffering from excess capacity. Office building vacancies stay around 20 percent. General Motors and IBM continue to close plants. Still solvent airlines are really in dire straits. Similar stress plagues other industries from computers to hotels.

Excessive capacity, a stubborn problem in every industrialized country, depresses private investment in plant and equipment.

In the United States it is manifested in the smallest investment in new structures and equipment as a percentage of the gross domestic product since World War II.

I ask you to look at Exhibit A, and particularly B, which is net private investment, investment after depreciation. Exhibit B shows that we almost have no investment.

The CHAIRMAN. It is almost at 1 percent.

Mr. LEVY. Now, our economy did improve in 1992, the result of an increase in the deficit. President Bush in his State of the Union Address last January announced a fiscal boost for the economy. He described cuts in withholding tax rates, but not tax liabilities, and stated that Federal spending would be accelerated.

These steps contributed to a $44 billion annual rate increase in the Federal deficit from the last quarter of 1991 to the third quarter of 1992.

Toward the end of 1992 and in early 1993, consumers gave the economy a further boost. Their spending increased faster than their incomes. The personal saving rate, just over 5 percent in the first half, fell to 4.5 percent in the final quarter of last year.

The 1992 fiscal boost to the economy is being reversed in 1993. Because of the reduced withholding, consumers are now receiving substantially smaller income tax refunds and face higher tax payments on April 15th than would ordinarily be the case. Thus, government during the next few months will be taking back much of the stimulus that it gave during 9 months of last year.

Consumers also have acquired other obligations. Leading credit card companies reported that charges in December and January ran about 20 percent larger than a year earlier.

The CHAIRMAN. By charges?

Mr. LEVY. Right.

President Clinton's proposed stimulus for 1993 is needed to counter these negative developments. However, it will not outweigh them and the effects of excessive capacity and low investment.

The economy will be growing slowly, even weakly, as 1994 begins. Under these circumstances, any combination of spending cuts and tax increases that aims to reduce the deficit by $70 billion next year has at least a 60-percent chance of causing a recession.

And, of course, that would reduce the revenues and increase outlays for unemployment insurance and other programs.

Most economists recognize that both private investment and government deficit spending are economic stimuli. But little attention is paid to their effect on corporate profits.

Profits increased $27 billion, annual rate, from the last quarter of 1991 to the third quarter of 1992. Without the $44 billion increase in the Federal deficit, profits would have declined. At their present level, profits are still too low to induce business to adequately revive investment in new structures and equipment.

The stimulus provided by a Federal deficit is a crutch supporting an economy wounded by excessive capacity in real estate, industry, and commerce by related financial problems, and, therefore, by weak new investment. A robust rate of private investment in needed, new fixed assets is the necessary stimulus or source of profits for sustained, healthy prosperity in a capitalist economy.

The Clinton program is a bold effort to take control of the deficit. But it should provide for a contingent short-term fiscal stimulus, such as a temporary tax cut, if its ambitious efforts do start to set the economy back. We should also bear in mind that history and the nature of the present problem argue that a major business boom will develop in a few years and provide a great opportunity to reduce not only the deficit, but also the debt.

Thank you.

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

The CHAIRMAN. Thank you.

If you do not mind, if my colleague does not mind, I wonder if we shouldn't now go to John White who I think will have a different view. And both of you live very much in the present day life.

And then, perhaps let Mancur Olson give us the historical perspective on how two equally intelligent persons have such diametrical thoughts.

Dr. White, we welcome you, sir.

STATEMENT OF JOHN P. WHITE, PH.D., DIRECTOR, CENTER FOR BUSINESS AND GOVERNMENT, JOHN F. KENNEDY SCHOOL OF GOVERNMENT, CAMBRIDGE, MA

Dr. WHITE. Thank you, Mr. Chairman and Senator Packwood.

I think that our country is in danger of long-term economic decline due to low productivity and slow economic growth.

And while I think the recovery is more robust than has just been indicated, I think we should not shield ourselves by that recovery from the fact that we have these very fundamental, longer-term problems that we need to deal with.

It is important, therefore, that we reverse the trends of low productivity, low economic growth, low savings and low investment.

We need to increase investment, both public investment and private investment, but mostly private investment.

We would like to obviously find a way to do that by increasing private savings. We have not been able to do that, as you know.

As a result, it seems to me that we are going to have to find most of our savings increase from deficit reduction in the short run. It strikes me as perfectly appropriate.

Consequently, it seems to me that we do need, in fact, a real deficit reduction program enacted now.

President Clinton should be applauded for proposing such a program. He has shown courage. He has shown a great ability to communicate. And, of course, his program has the added virtues of being specific, since it is a budget.

I think his leadership is obviously very important in this process and his is a step in the right direction, a good first step, but I would submit that we need to go further.

As has been indicated by prior witnesses, the deficit will again rise in 1998 and, I think, therefore, dampen much of the growth that we are trying to generate here.

In my judgment, the deficit should be cut to zero at full employment within the next 8 years. A zero deficit would mean deeper spending cuts and cost controls on entitlements, including, I think, means testing of entitlements.

Because until spending is controlled, the deficit will not be under control and the economic benefits from deficit reduction will not be realized.

Regarding Senator Packwood's question that was provided in advance, I like Dr. Boskin do not think that there is an iron rule. However, it seems to me on the part of the American people either you have not done your job until we have spending under control.

In addition to that because, I think, this is a long-term process, I submit that we ought to have a mid-course review in about 1997 and that such a review ought to be written into law so that we can look at the progress we have made, not only in terms of deficit reduction, but in terms of these more fundamental issues around the economy, namely savings, investment, productivity, and long-term growth.

Let me end by saying that the most pernicious aspect of large deficits is the unfair burdens we are placing on future generations.

We have a responsibility to be good ancestors. And it seems to me that in the current past, we have not done so by running up these huge deficits.

And therefore, it seems to me that it is in the interest of both fairness and good economic policy, now and in the long-term term to get the deficit down.

I would urge you not to lose the opportunity provided by the President to act responsibly and begin now to get this deficit under control.

Thank you.

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

The CHAIRMAN. Thank you, sir.

And Mancur Olson help us, clear our minds. We have just heard equal and opposite instructions from equally talented public servants, public-minded, public-spirited persons.

STATEMENT OF MANCUR L. OLSON, PH.D., DISTINGUISHED PROFESSOR OF ECONOMICS, UNIVERSITY OF MARYLAND, COLLEGE PARK, MD

Dr. OLSON. I would say that one reason I am concerned about the deficit and do not share Herb Stein's indulgence about it is that there is a persistent tendency in our society to come up with arguments for postponing or weakening or stopping the efforts to deal with the deficits. The kind of 4 percent deficit that Herb Stein said

he could live with if we have 6 percent growth in nominal income is something I think we could not live with partly for the reason——

Senator PACKWOOD. Could not live with?

Dr. OLSON. We could not live with it, among other reasons because of the fact there would always spring up theories and arguments of a beguiling kind which say that we need this year a 5-percent, 6-percent, or 7-percent deficit. And before long, the rate of interest on the debt exceeds the rate of growth of the economy. And the next stage we are a Bolivia.

So I believe all these beguiling arguments, springing up like dandelions on a spring lawn, are one of the reasons why the deficit is such a desperately serious problem.

Now, I would like, Senator Packwood, to relate this to the questions that you posed earlier. There are a whole series of ideas that suggest there is an easy way to deal with the deficit. And somewhat unfairly, I am going to put some of your questions in that content.

Obviously, it is a popular thing to suggest that taxes should not be increased. It is an easy thing to suggest that taxes should be lowered.

So the suggestion that taxes should not be increased or that they should be lowered, because any tax proceeds will be spent, is a suggestion that has, among other effects, the effect of making it harder to deal with the deficit.

It reduces the probability that the hard choice of cutting spending or the hard choice of raising taxes will actually be made.

Look at why government spending occurs in the first place.

Well, it either occurs for good reasons or for bad reasons. If they are good reasons, these good reasons are still there, whether we cut the taxes or raise them. The good reasons for spending are still there after tax rates have been cut.

But the forces behind the bad reasons for spending will be there also. Whatever lobby begot the bad spending is going to remain even when you do not raise taxes.

And if that lobby is not sufficiently tender about the needs of the Nation to keep itself from demanding spending that would lead to increased taxes, it will not stop because the spending it demands adds to the deficit.

So it is for sure not "tax and spend." It is instead "spend and tax." Let us go back to whomever was the first taxer, let's say to Sargon who founded the dynasty of Akkad in ancient Sumeria. I am sure that it is not that he came on some tax revenues and said, hey, let's spend them. [Laughter.]

No. He wanted some fighting men or a palace or something like that. And that desire to spend led to taxes. And so I believe it will always be.

So I think you cannot solve the problem of the deficit by not raising taxes or by cutting taxes. You have to reduce spending and increase taxes in order to deal with the deficit.

Now, the question of a balanced budget amendment.

I think that there is a persistent tendency in our society when we see an evil to pass a law against it.

But if there is an evil of deficits and excessive government spending, the kind of law you pass to deal with that is a constitutional law. You will make the evil unconstitutional. But, of course, that does not do away with the source of the evil.

Prohibition did not do away with alcoholism. Price and wage control does not do away with the spending or the money printing that causes inflation. So you do not solve a problem by passing a constitutional amendment against it.

The same shortcomings in our political process which lead to the deficits in the first place would lead to interpretation's of the Constitution that allow deficits to continue.

So I think we cannot solve these deficit problems in the easy way of a balanced budget amendment, either.

Now, if it is all right to take a moment more, can I relate this to Jay Levy's point?

The CHAIRMAN. Please do.

Dr. OLSON. I am, like Jay Levy, a great admirer of the brilliance of John Maynard Keynes and am to some degree myself a Keynesian economist.

But I believe that, if we are to be really honest, we must trace some part of the present deficit to a Keynesian kind of thinking that again and again works against efforts to deal with the budget deficit.

Fundamentally, the Keynesian argument is that if you have deficit spending at a time when there is not full employment, that additional spending will increase the amount of output and employment.

But what could make that argument true? Only certain markets in which prices or wages were fixed too high.

If in every market prices were at competitive levels and purely flexible, and there was more spending, we would have the same real national output and employment at a higher price level.

So the only way a Keynesian policy works is when prices or wages in highly organized sectors, collusive and cartelistic sectors——

The CHAIRMAN. When you have sticky prices?

Dr. OLSON. Sticky prices above market clearing levels. They have to be above market clearing levels.

The CHAIRMAN. That is Keynes' training?

Dr. OLSON. That is right.

Now, the sticky prices and wages above market clearing levels are relative prices that are too high vis-a-vis the prices that are not set by collusive or cartelistic forces.

So then, a Keynesian expansionary policy, by inflating the economy somewhat, will temporarily raise the prices and wages that are not sticky, making the sticky prices relatively lower.

The fact that these prices are sticky means they do not change, which means that a Keynesian expansionary policy will have the effect temporarily of changing relative prices: it raises competitive and flexible prices, thereby making cartelistic and sticky prices relatively lower.

But, of course, the interests that set the sticky prices sooner or later will get around to adapting to the expansionary policy.

So you get, in the long run, stagflation. In other words, high unemployment and inflation at the same time, as we know from experience.

So then, Keynesian policy, when it works, works precisely because it pulls the wool for awhile over the eyes of the organized interests, but you cannot fool them very long. So it, therefore, cannot work in the long run.

But so long as lots of people think it will work, there are demands for stimulus and demands that work against dealing with the deficit. And that is another reason why I think the deficit is one hell of a serious problem. The liberal Keynesian approach, like the conservative tax-cutting and balanced-budget amendment approaches, often keeps people from making the difficult choices needed to reduce the deficit.

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

Mr. LEVY. I would like to defend myself. [Laughter.]

I do not identify myself as a Keynesian.

The CHAIRMAN. I was going to say.

Mr. LEVY. As a matter of fact, I think there is a lot of merit in Keynes, but that he was rather primitive. I will not explain that in detail.

But I would also like to point out, following up on what Mancur said, if we look at last year, we did have a fiscal stimulus, we did have rising prices. We had less than inflation than the year before. We had smaller wage increases. I do not think that his prescription applies.

And while we are talking about Keynes, I would also like to make a comment on what Dr. White said about saving and investment.

Now, Keynes, I think, by writing the equation, saving equals investment with saving first, set us all off on the wrong track. I mean, investment equals saving. And investment can cause saving. We do not have to have saving to cause investment.

If I may, I will give you an example, first, where saving does cause investment.

The CHAIRMAN. Okay.

Mr. LEVY. The spring shopping season is approaching. If consumers decide to be very frugal and spend a great deal less money than business retailers expect them to spend, they will be stuck with a lot of inventory that they did not want to carry.

They will have an investment in inventory caused by saving. I do not think that is what we want.

The CHAIRMAN. Oh. [Laughter.]

Mr. LEVY. Now, let's take another example. Let's take an example of a firm which goes to its bank and convinces the bank that the bank should give it a loan for buying a new computer network.

The moment the firm with the loan sends off its check of $150,000 to the computer manufacturer, it has created saving, business saving, if you will, in the hands of this computer manufacturer. So the investment can create saving.

And finally, I would like to make another point. We do not lack for capital. If you talk to money managers, their big problem is: where do we invest the money?

If you look at the list of stocks on the over the counter market, you will find many companies which are without profits, do not pay dividends, but which have some sort of high-tech or advanced products and stocks that sell at prices that are surreal.

And you will even find among this group, companies that are really research and development operations. And money is certainly attracted to them.

Now, I do not deny that there are firms that should be able to borrow money from their banks, which cannot get the loans today, but I do not think that is the——

The CHAIRMAN. Do you think that is excess capacity?

Mr. LEVY. Well, obviously, nobody is going to build a new office building these days. And very few people are going to build a hotel. And certainly, General Motors is not building new plants, it is closing them, nor are any of its competitors.

The CHAIRMAN. A lot of those office buildings, I think you will agree, are the result of the tax code. I mean, we are trying to follow our 1986 rules of getting a tax code that has as little effect as possible on economic decisions.

Mr. LEVY. I do not think that was a major thing. It did not contribute to over capacity in the computer industry or the automobile industry.

The CHAIRMAN. No.

Mr. LEVY. So I mean, this was a whole sort of syndrome, I think, based on the idea that inflation was here to stay. No matter what asset you had, it would be worth more in the future. And thinking did not go too much beyond.

The CHAIRMAN. Dr. White.

Dr. WHITE. Well, let me make a couple of comments, if I may. First of all, we have certainly had periods in which we have had higher investment than savings. We did this through parts of the 1980's.

And, of course, what we did was borrow abroad. And in order to do that, we raised interest rates, reduced exports, and had some other untoward and unfortunate results.

It seems to me that that is a fundamental problem. We cannot live in a society that will generate the kind of growth we need with a 2-percent savings rate. It is not going to work. The resources are not there. Getting our investments overseas causes a number of other problems.

So I would submit that, in fact, we need more resources available, less consumption, and more savings.

The second point I would make and it gets back to what Mancur said, and that is the following. What we need to focus on is a very, very fundamental pernicious problem, a huge deficit, not a large deficit, a huge deficit, a deficit at 5 percent of GDP, a deficit that is having very negative effects on our economy.

We will see a lot more growth, a lot more opportunities for capital, a lot more progress in this country if, in fact, we can get down that weight of the deficit.

So it seems to me this is a period in history in which you as our representatives and we as a society have an opportunity to address that problem. And we ought to address it.

The CHAIRMAN. Dr. Olson, help.

Dr. OLSON. Me?

The CHAIRMAN. Yes.

Dr. OLSON. Well, could I just say in responding to what Jay Levy was saying that in some ways our views are similar.

In the cases that he mentioned, if there is less spending by consumers, inventories will accumulate in the retail sector. And then, there will be fewer orders to the factory and less employment and so on.

This happens only when there is a fixed price. And it is that price or wage which makes the argument correct.

And one way of testing that is to look at history. In the 19th century, the price level here and also in Great Britain, fell by about half.

From the end of the Napoleonic wars to 1896, there were not steady increases, but great reductions of prices and wages, great deflation.

Indeed, you may remember that is what William Jennings Bryan's "you will not crucify mankind on a cross of gold" speech was about. A lot of people had borrowed and had to pay back more valuable dollars than those that they had borrowed. That is what they were complaining about.

But the United States' economy and the British economy grew very rapidly because then these economies did not have prices and wages in many sectors fixed too high.

Now, that is not the only example. Let's look at Korea, Taiwan, and Hong Kong after World War II. They have had monetary policies that have been quite unstable, often periods of great disinflation, sometimes even deflation.

But in these circumstances, according to traditional theory, they should have had huge amounts of unemployment. In fact, they grow about 10 percent a year.

In other words, the only circumstance in which too little spending, too little stimulus, as it were, causes problems, is the circumstance in which something else is also wrong.

Now, in our economy, lots of other things are wrong. And these other things that are wrong will also need direct treatment. That is not always going to be politically easy. But in my opinion, there is no solution without the harder course.

The CHAIRMAN. My understanding is, Dr. Olson, the direct treatment that you prescribe is losing World War II.

Dr. OLSON. No. I certainly would not prescribe that. It is——

The CHAIRMAN. You do not prescribe it, but in accounting for the German and the Japanese miracles, you say all those cartel systems and those collusions, the organized efforts to control prices, they got wiped away.

Dr. OLSON. Yes.

The CHAIRMAN. Whereas in Britain and the United States, they didn't?

Dr. OLSON. That is right. I feel as though I were in one of those Japanese jujitsu matches where your opponent uses your strength against you. And you are just throwing me over your shoulder, drawing on some of my own work.

But still I think in a larger perspective that these arguments are consistent in that, in fact, the implication of my book on The Rise

and Decline of Nations is not that one ought to lose a war, but rather that one ought to wise up. [Laughter.]

No historical process, including the historical process I described in The Rise and Decline of Nations, is inevitable if it is understood.

And if we understand the need for an efficient competitive economy, if we resist the siren calls of protectionism, if we have sensible deregulation, if we apply the antitrust laws forcibly, if we stand up to special interests' pleading because the public comes to understand the need to do that, then we can have our own economic miracle without anything so painful as a war.

The CHAIRMAN. It is not just the war. It is the losing of the war.

Mr. LEVY. I would like to argue a little bit with Dr. Olson about history. Going back to the 19th century, we had a depression in the 1970's, a lengthy depression, and another one in the 1990's.

So it was not always quite as rosy as——

Dr. OLSON. A million immigrants came here and found jobs in some of these years.

Mr. LEVY. But I think, by the way, that all of us, except Herb Stein, who is not here to defend himself, are not tolerant of the deficit, that we all think that the deficit should be eliminated.

And the issue is over a period of time, what is the relevant strategy?

I would like to say something about a matter on which Herb Stein made a remark, which may not be of great importance, but with which I agree. I think it is not unimportant.

Senator Packwood has pointed out in the information he sent to us, the growing cost of Medicare and Medicaid. Medicare doubles about every 7 years.

And I refer back to Herb Stein's remark that this is a kind of subsidy that people—many of us in our circumstances do not really need or should not have from this government.

I realize that there is a very large and growing constituency of people like Herb Stein and I who have been around for awhile. And I was glad that he made that remark.

I am glad to have this opportunity to second it. In short, I think it is a disgrace.

The CHAIRMAN. Don't worry. We will get to you.

Mr. LEVY. Okay.

The CHAIRMAN. If only on doctrinal grounds. I do not think there is any money in it.

Senator Packwood.

Senator PACKWOOD. I appreciate the references to the material I sent. And there are two issues in that material. One is the deficit. You all seem to agree we should get it down.

And Dr. White has indicated especially, and you have Mr. Levy that if we do not, we are going to get eaten alive by Medicare and Medicaid and retirement programs if we do not do something.

It really will not matter what else we do with the rest of the programs if we do not at some stage get those down.

And those charts I sent you, just those four programs, Medicare, Medicaid, Social Security, and other retirement and interests are 54 percent of what we spend now. And they will be 69 percent in 10 years on just the baseline.

And that is before the baby boom starts to retire. I do not know what a 20-year projection would look like on a baseline, but I assume 65 or 70 percent of all the money we spend would be for those four programs.

But I am curious, because in those charts, whether or not the spending came first and we wanted to build a palace or the taxes were around and we spent it for a palace. They both went up.

I do not think we want to look like Denmark in 20 years. Although when I bounced this theory off of Pat, he said, "No, no. We won't look like Denmark." He said Brazil. You said Bolivia. [Laughter.]

And the two of you were probably more correct.

But does it matter, assuming we get rid of this deficit if we tax and spend 50 percent of the gross national product?

Will that be a deterrent on the kind of growth, Dr. Olson, you are talking about? Does it make any difference whether we tax then 50 percent or 40 percent or 30 percent of the gross national product?

Dr. OLSON. It makes a difference. And it is significant that countries like Sweden—about which I have lately written a book called How Bright Are the Northern Lights?—have been.

Trying to cut back their level of taxation and expenditure. They are recognizing they pushed it too far.

So, of course, it is true that taxes distort incentives. They distort them some even when there is uniformity in the tax code, and much more if there are lots of loopholes.

So I am not for a society which spends 60 percent of the GDP through government. And you do not need to have that to deal in a generous way with the poor.

One of the mistakes that the European countries make, and we also make on a somewhat smaller scale, is the mistake of having programs which tax everyone to aid everyone to help the poor.

In other words, we have all sorts of programs where everybody, even the rich, get the benefit and everyone pays. And that means, we have more deadweight loss from taxation. More bureaucracy is needed to pass the money through.

It is as though we were in a society where we were going to give free transportation to the poor and we would subsidize the truckers for doing it.

So the poor get to where they need to go, but not in some economical vehicle, but in some big truck. And that is an analogy to the waste from universalistic programs.

Senator PACKWOOD. But then, how do we—what is the touchstone? Because those charts indicate that we just go up and up. And we are obviously paying for things we do not need so we can take care of people we need to take care of.

How on earth do we devise a system that says, we do not need these programs for 80 percent of the people?

Is that just political will? Why is it inexorable that it happens in all of these industrialized countries? We are not unique. It happens in all of them.

Dr. WHITE. Well, it seems to me, Senator Packwood, there is political will in that, in fact, you are now at a juncture in terms of

this debate. We would have an opportunity to do something about it. We all do.

And I agree with your comments. I think the point is when you have that opportunity, you ought to seize it. And that opportunity does address the issue of what we are going to do about spending principally entitlement programs.

And that means, in my judgment, means testing. Now, we may want to call it something else and so on and so forth.

I do not know how the politics will work, but sooner or later we have to be a society that does not give more entitlements to rich than we do to poor people which is where we are today.

Senator PACKWOOD. But, doctor, what I see in the President's program is that we will tax the rich more. If his entire program passes as it is, it may or may not narrow the deficit.

I do not think it is going to, but it might. But it, indeed, is going to increase taxes and spending because we are not doing much to reduce spending other than in defense.

We are not doing much in the President's program to pare very much spending. We are increasing spending significantly and increasing the taxes even more significantly and thereby narrowing the deficit, if it all works. But it is the European tendency that we are going up in both areas.

Dr. WHITE. Well, sir, it seems to me that the President's program does, in fact, reduce the deficit from about 5 percent to about 2.5 percent of GDP. And I think that ought to be supported, as I said earlier and in my written statement.

And it seems to me that is not enough. We ought to do more.

Senator PACKWOOD. It narrows the deficit if it works, but it also increases spending and taxes as a percent of GDP.

Dr. WHITE. Well, my point would be that we ought to get spending down, that is that you ought to do more in terms of reducing spending and not do more on the side of taxes.

The CHAIRMAN. Senator Packwood asked everybody, the most brilliant economists in the country about whether taxes produce spending and why there are different levels of taxation in different societies. You never asked me. [Laughter.]

I think in the main, the level of taxation reflects the level of public trust in the society. And a homogeneous society, such as Sweden, has enough trust relationship so they can say, yes, we can do this collectively and provide collective goods.

Whereas societies that have very low levels of trust are not taxing.

Dr. Olson, do you want to comment?

Dr. OLSON. I think there is an awful lot of truth in that.

The CHAIRMAN. That is why we are relatively a low-tax country. We have relatively low levels of mutual trust.

Dr. OLSON. I am sure that is right. I have no doubt it is right. It is important to add to it a further point.

And that is the point that if we look at those countries which have relatively little corruption in government, countries like those in North Europe, Britain, ourselves, and so on, we find the habits of trust and law-abidingness and paying taxes and so on emerged in an era when tax rates were lower than those that have lately persisted.

The CHAIRMAN. Right. They preceded the tax increases.

Dr. OLSON. So it is only countries that have had representative, popular democratic governments and have not demanded too terribly much of them—it is only these countries that have been able to have something like an honest government.

The CHAIRMAN. It reflects a certain happiness. In India, they tell jokes about Sikhs which are called Sardargi jokes, one of which is that of the Sardargi. It is the middle of July. And the heat is intolerable.

And the Sardargi is sitting out in the middle of the public square and the sun is beating down on him. And a friendly villager comes up and says, "You could come over and sit under the shade of the people tree." And the Sardargi says, "I could, but what will you pay me?" [Laughter.]

Now, they have low levels of public trust.

Well, this has been fascinating. I think we do have a vote of about four to one against poor Herb who is not here to defend himself.

Although we did hear from you, Jay Levy, that if we raise these tax rates at the proposed level, there is a 60-percent chance of recession.

Dr. White and Dr. Olson.

Dr. WHITE. I do not agree.

The CHAIRMAN. Dr. Olson.

Dr. OLSON. I would not agree with that. It seems to me that getting down the deficit means the government is borrowing less. With the government borrowing less, interest rates will tend to be lower.

With interest rates lower, it seems to me there will be more investment. So I think we could get along without the stimulus. It is the deficit reduction that we need.

The CHAIRMAN. Dr. White.

Dr. WHITE. I could not agree more.

The CHAIRMAN. The last word.

Mr. LEVY. I believe first of all that the administration is hoping—maybe that is not the right word—or expecting that low interest rates are going to offset the problem that I have been describing.

I think—my experience and some of the studies, particularly some current studies by Professor Steven Fazzari at Washington University of St. Louis, point out that the cost of capital is ordinarily not as big a factor in determining investment as is generally believed.

I think the bigger factors are cash flow or profitability and sales growth. And that you do not have during a period of——

The CHAIRMAN. We have respectable anecdotal evidence. I should speak to Dr. White that when you ask a group of businessmen what makes them decide to build a plant—maybe it is only people like this get into business—and they will say it has to do with the tax rate or something. The only thing Ira asks is, "Can I sell the damned stuff?"

Maybe it is only people who can sell the damned stuff who get into building plants.

Dr. WHITE. Mr. Chairman, may I make one comment to your point about trust which I agree with? And it goes back to this issue

of cutting programs. The American people, it seems to me were ready for this reduction. Hence, we did not have outrage when the President proposed what he——

Senator PACKWOOD. Reduction in programs?

Dr. WHITE. Reduction in programs. And when the President proposed even raising taxes, there was not the outrage that some people anticipated.

The second point I would make is that they think they are ready to sacrifice if, in fact, others will sacrifice, as was said earlier by Mike Boskin.

The third point is, but they will not do that if they think, in fact, that special interests are going to profit from all of this.

And the way to demonstrate that that is not the case is to control spending. The American people are convinced because it is true that there are lots of goodies in these budgets for various special interests, and that, in fact, the way you demonstrate that, in fact, you mean it and that you can bring the people along, that they are willing to make the sacrifice that is necessary is, in fact, by cutting out a lot of those special programs.

The CHAIRMAN. And that would be under Olson's doctrine of the economic equivalent of losing the war.

Dr. OLSON. Yes.

The CHAIRMAN. And that is what we need.

I would like to note that while this conversation has been going on, the sun has come out. [Laughter.]

We thank you very much. It has just been hugely generous of you. And we are obviously going to call on you in the future.

But this record and this volume will be published quickly.

You have been an immense help to us. We are much in your debt.

And we thank our reporter.

[The prepared statements of Charles A. Bowsher and Robert J. Shapiro appear in the appendix.]

[Whereupon, at 2:18 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED

PREPARED STATEMENT OF SENATOR MAX BAUCUS

Thank you, Mr. Chairman. I want to welcome the Chairman of the Federal Reserve here today, and say how much we appreciate him coming here to help us evaluate the President's program. I think it is clear to everyone that if the economic package we enact does not earn the confidence of the financial markets and contribute to a sound monetary policy, our scope for improving the economy is very limited.

I also want to congratulate you, Mr. Greenspan, for the job you have done over the past few years. Inflation was 3% in 1992, and future prospects look good. This, in combination with the President's package, has driven long-term rates to exceptionally low levels. That can only be good for the economy.

The most recent GDP growth numbers have also been very encouraging. As you are well aware, however, we came out of this past recession more slowly than usual, and even the healthy growth we see now is not accompanied by the kind of job growth I would like to see.

I think that these trends are hints of continuing long-term problems in the U.S. economy. Low savings rates and low national investment rates bleed through into inadequate infrastructure and sluggish productivity growth, into stagnating wages .

Clearly, sound monetary policy underpins all our of forts to build a strong economy. We must also get our fiscal policy in order. But I cannot help but think that we need to do more, if we are to revitalize America.

PREPARED STATEMENT OF SECRETARY LLOYD BENTSEN

Chairman Moynihan, members of the committee: It's a special pleasure for me to appear before the Senate Finance Committee today to discuss the administration's economic plan. We've worked together over the years on many of the nation's challenges, and I look forward to continuing this process, in the same collegial and bipartisan spirit, as we work to revitalize the American economy.

The President has put forth a balanced, bold, and fair plan that invests in America's future. The goal is not only to ensure a strong and enduring recovery, but also to reverse the dismal underlying trends of slow productivity growth and stagnant incomes.

The key to improving our living standard in the long run is productivity growth. And the key to improving that is investment. Thus, our plan is designed to increase private investment in plant and equipment, public investment in our infrastructure, and both public and private investment in the skills and knowledge of our work force.

The plan has three parts. We are proposing a modest stimulus for the immediate problems facing us; an investment package to expand America's capacity to produce; and a concrete deficit reduction program containing specific spending cuts and tax increases to free up money for the investment we need.

I. SPEEDING RECOVERY FROM THE RECESSION

Americans need jobs now. And they need to know that the jobs they have will not evaporate, as we have been seeing all too often recently. The **stimulus package** is both a response to the short-term economic stagnation that has seen employment growth falter, and a down payment on longer term investments that will create

more jobs. It has two components: tax incentives for plant and equipment, and spending on public infrastructure.

Although we have seen encouraging economic statistics recently, too many people are out of work. And too many factories have too little work to do.

We are operating at only 79 and 1/2 percent of our industrial capacity. Even more important, 9 million workers are unemployed. This recovery simply has not produced the usual increase in jobs. As my first chart shows, employment has risen only 0.2 percent since the recovery began. Compare that to a typical post-war recovery where employment would have risen by 6.5 percent.

A major reason for the slow job growth is the anemic nature of this recovery. As my next chart indicates, real GDP growth has averaged only about 2 percent in the seven quarters since the recession technically ended in the spring of 1991; this compares to about 5 percent over comparable periods in past recoveries.

We need to ensure faster economic growth and we need to create dew jobs. The $30 billion stimulus package in the President's plan does both. This stimulus, however, does not simply follow the conventional route of cutting taxes or increasing spending to boost consumption. Instead, it focuses on investment programs essential to long-term growth. And, it will get money into the economy quickly.

Roughly half the money goes for tax incentives to stimulate private sector investment. Specifically, the plan includes a temporary 7 percent incremental investment tax credit for large businesses, and a permanent investment tax credit—phasing down from 7 percent to 5 percent in two years—on investments by small businesses. Small businesses are vital to our economy, since they are the major source of new jobs.

The other half of the stimulus accelerates spending for programs that serve the twin objectives of enhancing long-term growth and jump-starting the economy. For example, it increases spending for highways and mass transit systems. It creates the equivalent of about 500,000 full-time jobs overall. Americans need jobs now, and they deserve them.

My friend, Senator Boren, has likened passing only the stimulus, without assurances the cuts will also pass, to serving a youngster desert before asking if he'd like spinach. I think that's a sound analogy. I will work with the leadership in the House and Senate to do what has to be done to ensure passage of all elements of our economic program, whatever process is used.

In addition to the tax incentives and direct investment in our stimulus, at the Treasury Department we are working with the Federal Reserve and the FDIC to alleviate the "credit crunch." was in business. I know how important access to credit can be. Small businesses are the ones who are going to be creating many of the new jobs in this economy, and we want to be sure they get they help they need.

The stimulus package, and our efforts in conjunction with the Federal Reserve and the FDIC to ease the credit crunch, are what we need to do to tackle today's challenge. Yet we all know that that's only half the battle.

II. THE LONGER RUN

The second component of our plan attacks the nation's stagnating productivity and wage growth. The growth in output per worker has practically ground to a halt over the last two decades, and real wages have barely budged at all. As a result, average Americans have seen little increase in their living standards. This means that simply recovering from the recession is not good enough. We not only need to create more jobs, we also need better jobs with higher wages.

Under-investment—in private business capital, in public infrastructure, and in the skills of the American work force—has contributed to the problem.

As you can see on this next chart, America devotes a much smaller share of its Gross Domestic Product to private investment than other developed countries. Public infrastructure spending has declined from 4.5 percent of GDP in the 1960s, to 3.3 percent in the 1970s, down to only 2.6 percent of GDP in the 1980s. The next chart shows this decline.

It is not simply a question of bricks and mortar. We need to make much greater investment in our most important resource of all, Americans. Recent trends have not been encouraging. For example, our students repeatedly score below their counterparts in other developed countries on math and science tests.

More investment is critical to improving productivity, wages, and living standards. The program contains two major efforts to improve both public and private investment.

The **investment package** will start shifting the composition of the federal budget from consumption to investment. It will expand America's capacity to produce, and offer better opportunities to workers. It will bear fruit long after the current

recovery has been firmly established. The package includes both tax incentives and public investment expenditures.

The tax side of the investment package includes two important provisions for small business, since small companies are the major source of new jobs.

First, small business will continue to enjoy the permanent investment tax credit that is introduced in the stimulus package. Second, we propose that investors in small corporations, that is, companies with under $25 million of capital, be able to exclude 50 percent of the gain on stock held more than 5 years. This exclusion is carefully targeted to benefit small growth companies and to avoid abuse.

Small and large capital intensive corporations paying the minimum tax will continue to benefit from the simplified and enhanced depreciation provisions in the package. This greatly enhances investment incentives for these taxpayers by using—for new investments—the shorter regular tax depreciable lives for both minimum tax as well as regular tax purposes.

In addition, the tax side of the package permanently reinstates retroactively several provisions that expired last June. For example, we make permanent the research and development tax credit to let business better plan research investments. To stimulate investment in housing for moderate and low-income families, we permanently extend both the low-income housing credit and the mortgage revenue bond provisions.

Since investment in people is as important as investment in machines, our plan makes permanent the targeted jobs credit to include workers in an apprenticeship program, along the lines of what Senator Breaux has proposed. The plan also would expand the exclusion for employer-provided educational assistance.

This part of the program also authorizes the establishment of enterprise zones. While the details are still being refined, the purpose is to provide incentives to hire and train workers, and to improve the physical capital of some of our nation's most distressed urban and rural areas.

These tax incentives in the investment package for the private sector are reinforced by increased public investment in a wide range of initiatives relating to physical and human capital. Both are critical for productivity and growth. This reaffirms investment themes President Clinton articulated during the campaign.

First, by 1997 the program commits nearly $19 billion per year to infrastructure improvements. That includes transportation, the environment, rural projects, community development, and technology.

Second, President Clinton believes that in an age of mobile production and mobile capital, our most important resource is our work force. Hence, by 1997, the package provides nearly $16 billion annually for lifelong learning, including fully funding Head Start.

Now, some will argue that these expenditures are not all investments, and that one government program is much like another. This argument simply does not hold water. There is a big difference between the Head Start program, which we are fully funding, and a subsidy for honey, which we are eliminating. The investment package begins to shift the composition of spending towards those programs that will increase future living standards for us and our children.

The last investment item is making certain we reward work: anyone who works hard should not have to live in poverty. To meet this goal, the program will sharply expand the Earned Income Tax Credit to bring working families above the poverty line.

The **deficit reduction** package is the third critical component of our effort to increase investment and enhance productivity. The deficit affects every American, every day. It is not some abstract concept debated by economists. It means higher interest payments on mortgages and credit cards. It lowers our standard of living. It touches us all.

The large deficits we face seriously impede investment because every dollar the government borrows to spend on consumption is a dollar not available for private investment. Large deficits, therefore, can reduce our investment and force us to borrow from abroad to finance our investment spending. In the 1980s, we did both.

Large annual deficits also produce a mountain of debt, and the interest on that debt accounts for an ever increasing share of the government budget. This year, we pay 14 percent of the federal budget for interest. If we do nothing, in a decade it will be 20 percent.

The Congressional Budget Office estimates this year's deficit at $310 billion dollars. Even once the economy recovers, the structural deficit is projected to continue rising sharply. Rapidly rising deficits and a growing stock of outstanding debt rob us, as public officials, of any flexibility in controlling government expenditures. With deficit increases out of control, the day may come when you are arguing over only

5 cents on every dollar of outlays. Spending on health care, mandatory programs and interest will account for the rest.

We must reduce the federal deficit to lessen the government's drain on national saving, to free up funds for investment, to leave room in the budget for critical domestic programs, and to make our nation less dependent on foreign capital. President Clinton's deficit reduction plan takes a bold step in bringing the deficit under control. In 1997, when the provisions are fully phased in, this plan will reduce the deficit by $140 billion.

Let me clarify something about our debt reduction figure. The $140 billion figure is a net figure. Our deficit reduction package alone actually lowers the deficit in 1997 by $195 billion, our investment program totals $55 billion in that year, producing net deficit reduction of $140 billion.

President Clinton made hard choices on spending, and he made sure that the deficit reduction plan is balanced. In 1997, when the plan is fully operational, roughly half the savings will come from spending cuts and half from revenues. In the years beyond, the proportion of spending cuts remains at least that high.

This administration's deficit reduction plan differs from previous plans in a number of respects—and here I really can speak from experience. I know what it's like to receive a proposal from the Executive Branch that promises vague cuts and then asks Congress to make all the tough choices.

This package doesn't use the rhetoric of across-the-board cuts, while dodging the reality of-who gets hit; it offers 150 specific cuts. Furthermore, the savings in this plan are all permanent, not temporary. Finally, this plan is not based on a "rosy scenario," but rather works off the more conservative economic forecasts of the CBO.

Let me just give you a few of the details on the plan. We have taken the first steps to changing our economic course within the federal government itself. It is only fair that if we ask America to contribute, we make our contribution first. Through 1997, we're cutting the cost of running our departments and agencies by 14 percent. I'm taking my share of these cuts at Treasury.

Major cuts will be made in domestic non-defense categories, reducing spending by $20 billion in 1997. And, we will see $37 billion savings with prudent reductions in defense expenditures.

The fair and equitable changes we propose in entitlement programs will save $42 billion a year by 1997. Let me give you a few examples of the entitlement cuts we have made.

I understand the troubles that our farmers put up with to provide us with the best agricultural products in the world. But we need to make some changes. There are some people who farm, who also earn more than $100,000 a year from activities that have nothing to do with feeding or clothing Americans. That $100,000 is a good income, anywhere in America. We will end agricultural price supports to these individuals. It's only fair that subsidies end for those who do not need them.

Our plan also will make prudent cuts in the Medicare provider payments without, and let me repeat that, without reducing the care available to Medicare beneficiaries. Our plan does not raise premiums. And hopefully, it may reduce out-of-pocket costs for middle and lower-income Medicare beneficiaries.

We *propose no* change in Social Security benefits or the cost-of-living increases. But for upper-income recipients, the plan increases the percentage of their Social Security benefits subject to tax, from 50 percent to 85 percent. This brings their tax treatment more in line with the tax treatment of private pensions.

Mr. Chairman, let me speak to you for a minute wearing my hat as Chairman of the Board of Trustees of the Social Security Trust' Funds. I know that you share my concern over the financial health of the Medicare fund, which according to the 1992 Trustees report will be exhausted by 2002.

Therefore, I am sure that you are as pleased as I am that we are proposing that the savings from increasing the portion of Social Security benefits subject to tax go into the Medicare trust fund.

This money, and the savings from reducing payments for providers, will not solve the entire problem—to do that we need comprehensive reform of our health care system—but they will extend the period of solvency. The many Americans who depend on Medicare for their health care, will be reassured by our effort to improve the financial health of the trust fund.

Now, let me turn to the revenue side of the deficit reduction package. Here, the President's plan moves to restore equity to our tax system. For 12 years now, the affluent have not been paying their fair share of the cost of government. As the chart shows, between 1980 and 1993 the incomes of the top 1 percent rose 47.6 percent, while their effective tax rate declined by 24.6 percent. We must reverse that trend.

The revenue changes we propose restore greater progressivity to the individual tax system, making it far more fair and equitable. Families with about $180,000 in adjusted gross income will have their rate increased from 31 percent to 36 percent. A surtax of 10 percent is levied on those with taxable incomes of $250,000 or more. These changes will affect only the wealthiest 1.2 percent of American taxpayers. These rate changes won't touch the average American household at all.

Higher-income individuals are also required to increase their payments under the Medicare tax. The proposal eliminates the current cap of $135,000 on earnings subject to the Hospital Insurance portion of the payroll tax. Revenues from this proposal go into the Medicare trust fund, further extending the period of solvency.

And we're asking corporations to pay their fair share. Almost 40 years ago, over a quarter of the government's revenue came from corporate taxes. Now, it's just 9 percent. We propose raising the top rate from 34 percent to 36 percent for corporations with incomes over $10 million. It's only going to affect 2,700 large corporations out of 2.2 million.

This is a fair tax rate for the largest corporations, especially considering what some of our competitor nations charge. Take a look at Japan's rate—40 percent. Take a look at what it is in Germany—50 percent.

The plan also recognizes that there are some deductions, such as business meals, entertainment and club dues, that should be reduced or eliminated. And we will make certain that foreign businesses pay the taxes they owe in the United States.

To do this, the package contains a series of international compliance reforms. The principal provision would require multinational enterprises to establish their transfer pricing methodology before they file their tax returns. The administration will also institute a sweeping new enforcement initiative targeted at transfer pricing abuses. We expect marked improvement in compliance related to international transactions to result from this investment of IRS resources.

A related provision restricts the ability of foreign-owned U.S. corporations to avoid tax on their earnings distributed as interest. Other rules will be proposed to prevent so-called "back-to-back loans" and other abusive arrangements.

To ensure that we get the most revenue possible from our existing taxes, the package also includes a series of compliance measures. The tax gap—the difference between what people owe in taxes and what is actually paid—is a persistently large number. Much of this is attributed to unreported income, often by business. This package includes several provisions—raising over $2 billion in 1997—to help us get at this problem.

Finally, the plan includes a broad-based energy tax. This proposal has three important goals: improving our environment by effectively taxing pollution, reducing dependence on foreign oil, and cutting the deficit.

Now, you're going to hear a lot about how this tax will affect American families. The President has been very concerned about this issue. By making other adjustments, we were able to ensure that the energy tax will mean little or no loss in after-tax income for households with incomes of less than $30,000 a year. And it will have only a modest impact on families making between $30,000 and $100,000.

In fact, if you look at the table we provided, you see that the net impact of the entire revenue package on a middle-income family earning $40,000 is under $17 a month—and that's in 1997 when the program is fully phased in. The President believes that this is a fair contribution to ask of middle-income households towards reducing the deficit.

We have already seen that the bond market is encouraged by our plan, and—as the chart shows—interest rates have come down as a result. And I'm delighted that Alan Greenspan thinks we're on the right track.

Those lower interest rates mean our plan is already more than paying off for homeowners. We estimate that the interest cost for a new, refinanced or floating rate $100,000 mortgage is about $60 a month lower now than just a few months ago.

III. STILL TO COME

The revenue increases and spending cuts in the package will sharply reduce the budget deficit from the levels projected by CBO. As I said earlier, in 1997 the deficit will be $140 billion.

However, even with the deficit reduction program, the deficit will begin to rise again later in the decade. The main reason is the exploding cost of health care, as the next chart shows. This projected increase underscores the vital importance of health care reform to resolving the budget dilemma.

Medicare and Medicaid costs are the fastest growing element in the federal budget. And the cost and availability of health care are among the most important con-

cerns of all Americans. If we do nothing to control these costs, in the next decade the increase in spending for the Medicare and Medicaid programs alone will exceed the level of the current deficit.

We're searching for ways to bring this problem under control. By early May we expect to have a plan that must be enacted quickly. Bringing these costs under control is the key to permanently reducing the federal deficit.

We also will offer legislation this spring to help shift Americans from welfare dependency to jobs. Getting control of health care costs, and enacting our economic program, are each significant steps toward reversing deficit growth.

Finally, I am also going to work with the G7 ministers who I'll be visiting with this week in London. The president's program will lay the foundation for complementary actions by other countries to ensure an expanding world economy. But the success of these efforts will largely depend on the credibility of our domestic economic program and our commitment to reduce the deficit. And, a free and fair trading environment will help increase exports and our prosperity.

This is the time for meaningful change. For the first time in years, we have a plan that takes a credible approach to the deficit, to investment, to our long-term economic health.

We hear criticisms that our plan does not include enough cuts. We made decisions about what to cut, at least 150 of them. We put our fingerprints all over this plan. If those who are critical of what we've done want to recommend further reductions—real, specific ones—let's have them name exactly what they are. Don't hide behind the vague approaches that leave the tough decisions to others. Step up and join us in putting fingerprints on our plan to restore our economy.

We are anxious to do this in a bipartisan way, because this is not a Democratic economy or a Republican economy. It's an American economy. And it's America's future that is at stake.

Thank you very much.

Attachments.

Administration's Revenue Package, Taking Account of Phase in of Energy Tax and Gasoline Tax Extension (1) (1994 Income Levels)

Family Economic Income Class (2) ($000)	Number of Families (Millions)	Average Tax Per Family Per Month				
		1994	1995	1996	1997	Average 1994–1997
0 – 10	14.9	–4	–3	–1	–1	–2
10 – 20	18.4	–4	–3	–1	0	–2
20 – 30	16.0	–7	–4	0	2	–2
30 – 50	22.4	1	7	14	17	10
50 – 75	17.4	14	22	32	36	26
75 – 100	9.9	20	31	44	49	36
100 – 200	8.8	41	54	69	76	60
200 & over	2.4	1,139	1,162	1,188	1,198	1,172
Total (3)	110.7	30	36	43	46	38

Department of the Treasury
Office of Tax Analysis

February 19, 1993

(1) This table distributes the estimated change in average monthly tax liabilities per family due to the Administration's revenue proposals, including taxation of Social Security Benefits. Included by 1997 is a total of $10.2 billion of expansions in the EITC and increases in transfers for Food Stamps and the Low-Income Home Energy Assistance Program (the EITC expansions are effective beginning in 1994, while other increases are phased in with the energy tax). The energy tax is imposed at one-third rates 7/94, at two-thirds rates 7/95, and at full rates beginning 7/96. The gasoline tax extension is effective 10/95.

(2) Family Economic Income (FEI) is a broad-based income concept. FEI is constructed by adding to AGI unreported and underreported income; IRA and Keogh deductions; nontaxable transfer payments such as Social Security and AFDC; employer-provided fringe benefits; inside build-up on pensions, IRAs, Keoghs, and life insurance; tax-exempt interest; and imputed rent on owner-occupied housing. Capital gains are computed on an accrual basis, adjusted for inflation to the extent reliable data allow. Inflationary losses of lenders are subtracted and gains of borrowers are added. There is also an adjustment for accelerated depreciation of noncorporate businesses. FEI is shown on a family rather than a tax-return basis. The economic incomes of all members of a family unit are added to arrive at the family's economic income used in the distributions.

(3) Families with negative incomes are included in the total line but not shown separately.

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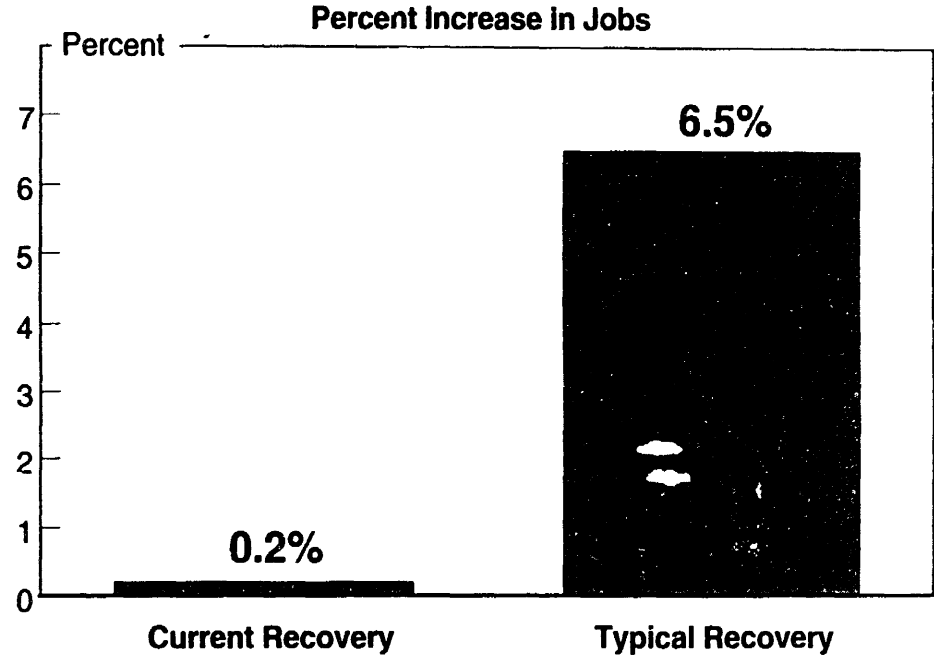
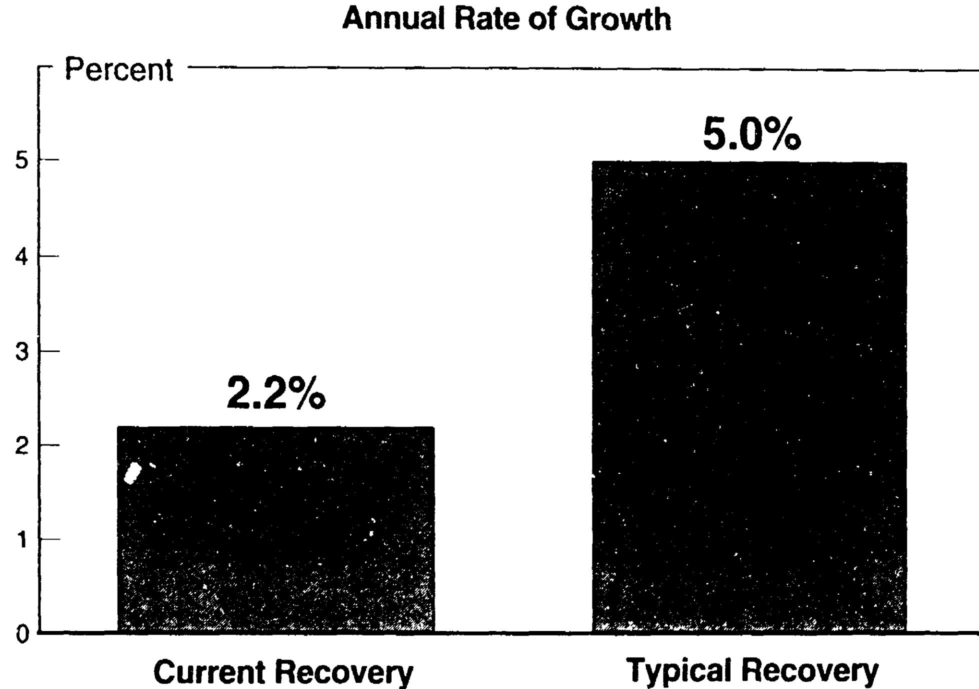
This Recovery Has Produced Virtually No Job Growth Compared with Typical Recovery



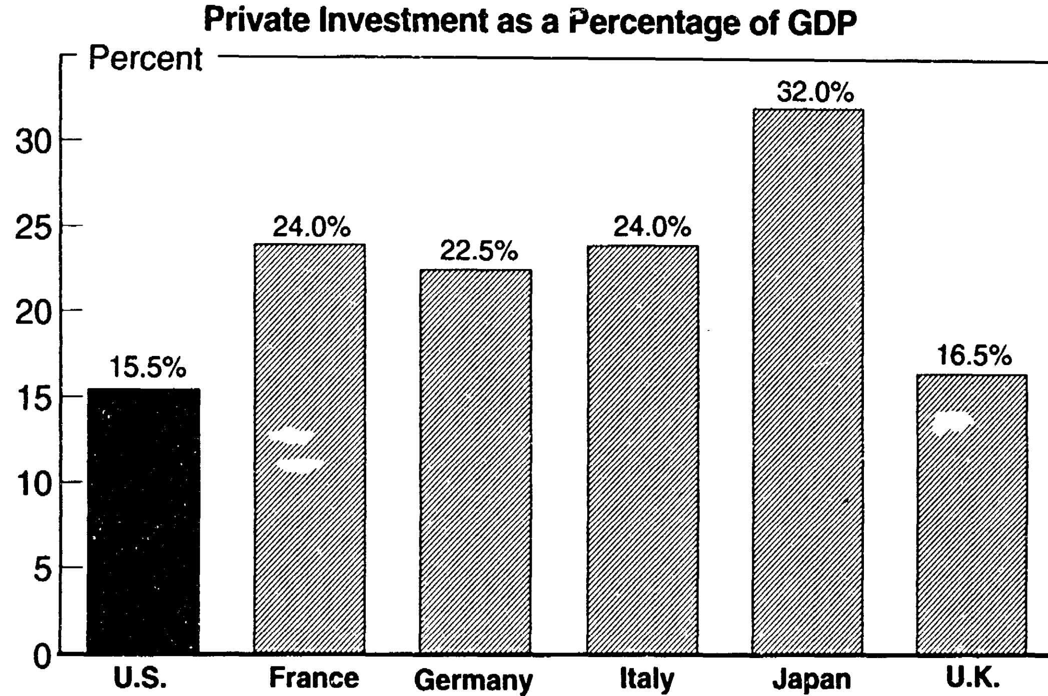
Source: Department of Labor

Real GDP Growth in this Recovery Has Lagged Far Behind Typical Recovery



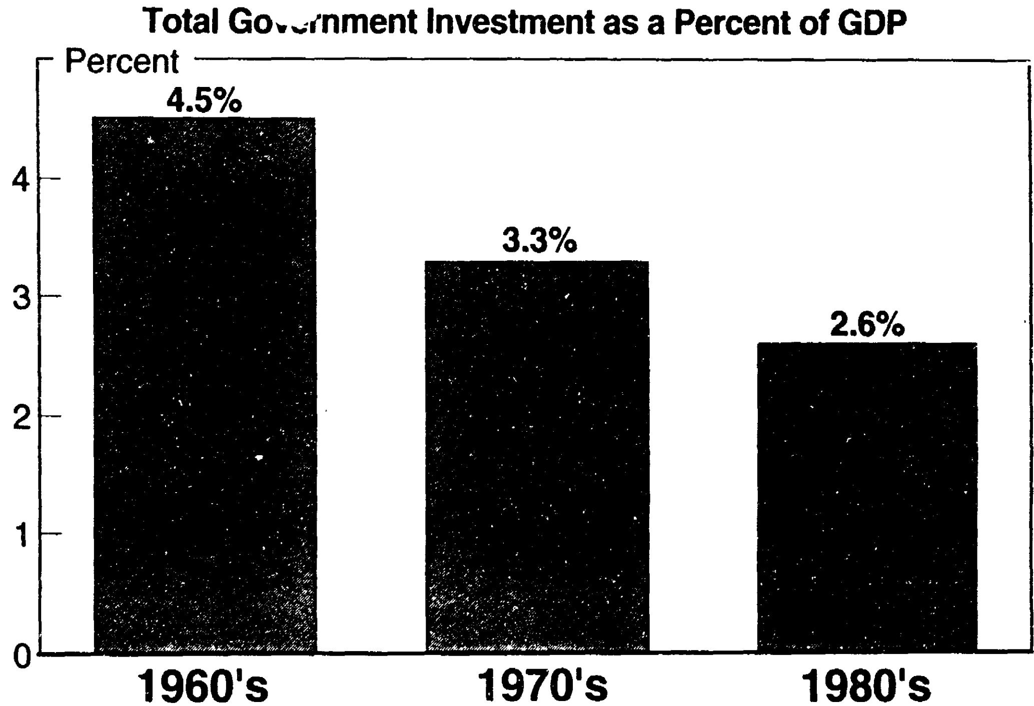
Source: Department of Commerce

U. S. Invests Less Than Its Competitors



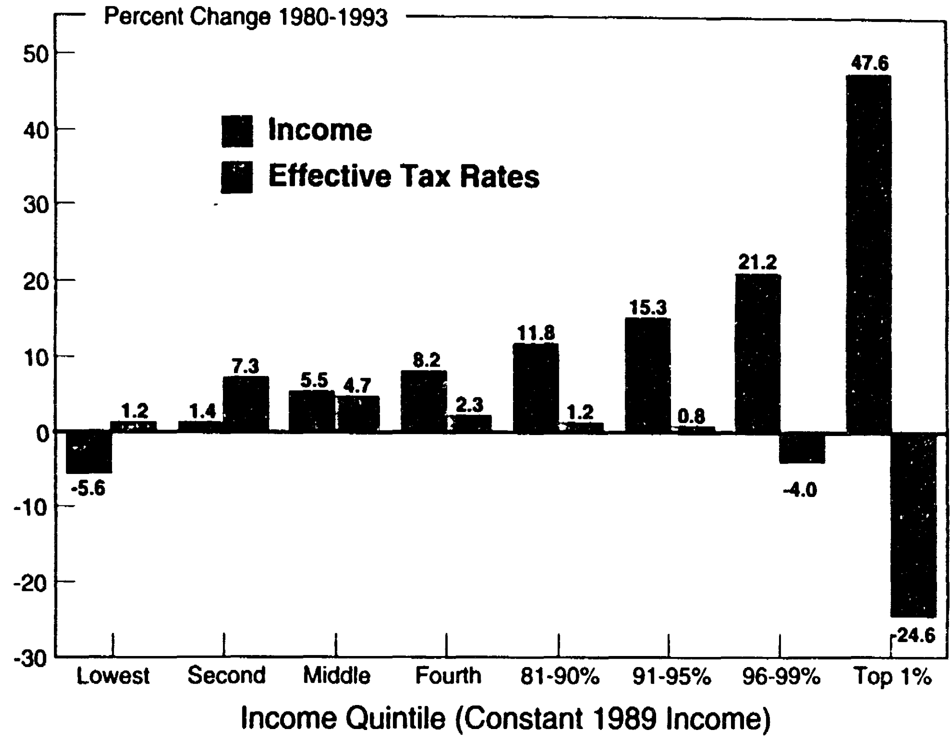
Source: OMB

Public Investment Has Declined



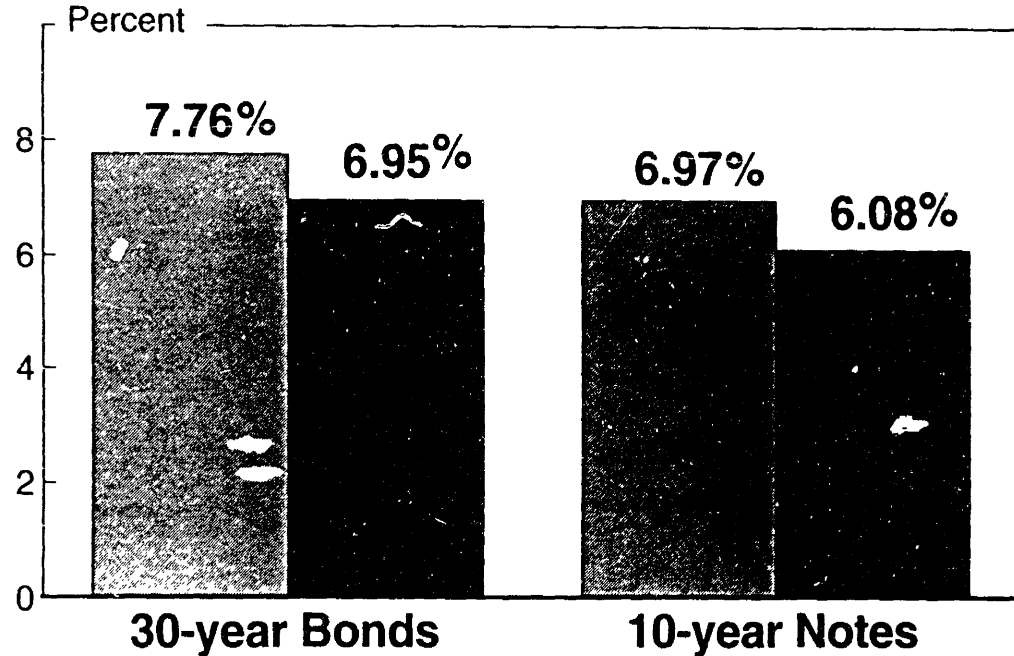
Source: OMB

Affluent Have Not Been Paying Their Fair Share



Source: 1992 Green Book.

Interest Rates Have Come Down

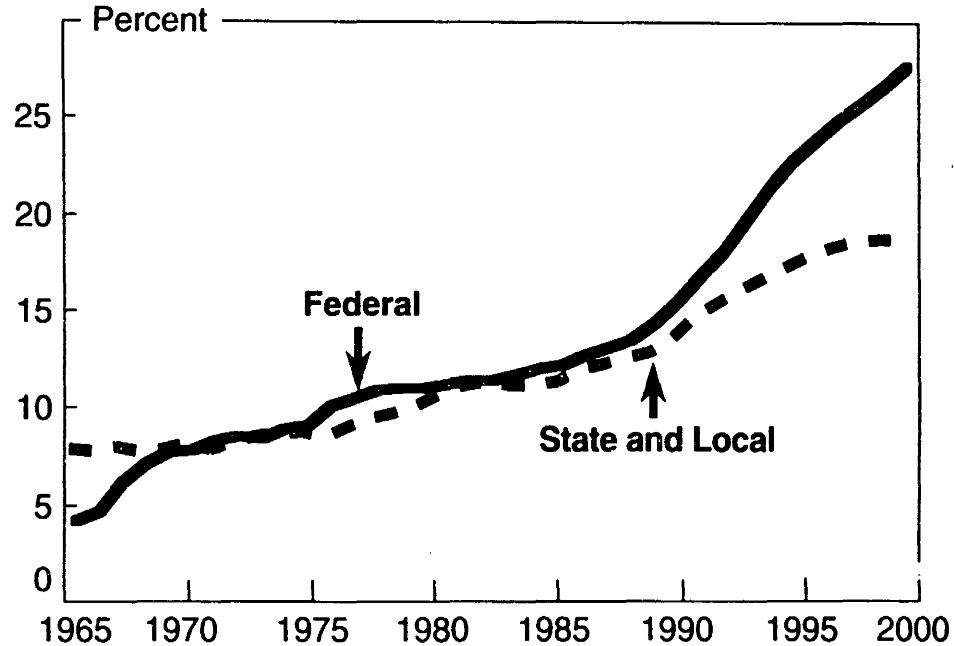


Source: Department of the Treasury

November 6, 1992
February 22, 1993

Health Care Expenditures Are Exploding

(As a Percentage of Government Expenditures)



THE SECRETARY OF THE TREASURY
WASHINGTON

May 18, 1993

The Honorable Robert J. Dole
Republican Leader
United States Senate
Washington, D.C. 20510

Dear Bob:

I very much appreciated the opportunity to describe the Administration's tax proposals in my testimony before the Senate Finance Committee. You had sent me a note listing quite a few questions you wished to have answered for the record. As agreed, I enclose a response to ten of your questions.

Sincerely,

Lloyd Bentsen

Enclosures

Tax Increase Question 2

Question:

With higher tax rates, will we be encouraging tax shelters designed to convert ordinary income into capital gains?

Answer:

Although it is not likely that the higher tax rates will generate tax shelter activity of the type prevalent prior to the Tax Reform Act of 1986, the relatively few taxpayers affected by the higher tax rates will seek to reduce their tax liabilities by various methods. Such methods include replacing a portion of their investments that generate ordinary income (such as taxable bonds and high-dividend stocks) with investments that generate tax-exempt or capital gains (such as tax-exempt bonds and high-gain, low-dividend stocks). Such taxpayer behavior is accounted for in Treasury's estimate of the revenues attributable to the increase in the top individual income tax rates.

Distribution Table Question 2

Question:

How does $30,000 in "Economic Income" translate to adjusted gross income? How does it translate to taxable income?

Answer:

Family Economic Income (FEI) is a broad measure of income used by Treasury economists to assess the distributional impact of tax proposals. FEI was first used by the Reagan Administration in November 1984 in distribution tables for Treasury I. It has been used in identical form since that time. Prior to 1984, Treasury had used a concept nearly identical to FEI as far back as the Ford Administration.

For a typical family with $30,000 of FEI, 90 percent would be in the form of cash income (wages, interest received, social security benefits, etc.) and over 95 percent would be in the form of cash income and fringe benefits (employer-provided health insurance and pension contributions). Less than 5 percent of their FEI would be in noncash forms, such as interest earned on an IRA. FEI is not used in determining when a family pays income taxes, or how much income tax a family pays, so there is no need to translate FEI into AGI or into taxable income.

Small Business Question 4

Question:

Will the Administration consider surtax exemptions for business income "allocated" to taxpayers from pass-through entities (partnerships and subchapter S corporations)?

Answer:

The Administration's proposal to increase the top marginal tax rates does not distinguish between different sources of income. Thus, if taxable income exceeds $140,000 for a married couple or exceeds $115,000 for an unmarried individual, the higher tax rates would apply to the totality of the taxpayer's wages, rental income, dividends, interest, partnership income, subchapter S income, and other income in excess of $140,000 (or $115,000).

Energy Tax/Agriculture Question 2

Question:

Would the Administration consider a rebate for agriculture or other export industries negatively affected by the BTU tax?

Answer:

The Administration's proposed energy tax is designed to raise substantial revenues for deficit reduction while advancing environmental, energy conservation and security objectives. Providing a rebate for certain industries would require a higher rate of tax on other energy consumers and would remove the incentive the tax would otherwise provide these industries to reduce environmental damages and to conserve energy. For these reasons, the Administration's proposal does not contemplate such a system of rebates. The Ways & Means Committee has adopted revisions to the Administration's proposals which would provide relief to agriculture and certain industries. In addition, the Ways & Means Committee adopted a border adjustment on imports of energy intensive products.

Energy Tax Question 3E

Question:

Please provide us with information of where the tax will be collected for each fuel source, and how any exemptions will work.

Answer:

Under the Administration's proposal, the collection point for the tax would be the refinery tailgate for oil, the local distribution company or industrial user for natural gas, the utility or industrial user for coal, the utility for hydro- and nuclear-generated electricity, and the importation point for imported electricity and imported taxable products. The Ways & Means Committee reported a bill that changed these collection points.

Energy Tax Question 4

Question:

Has the Administration analyzed how this tax would affect the competitiveness of energy-intensive U.S. industries like steel, aluminum and automobile manufacturing? If so, please provide this analysis. If not, when do you expect to complete such an analysis?

Answer:

Our analysis is that the energy tax will not harm the overall competitiveness of U.S. industry. The average cost increase for all manufacturers will be less than 0.1 percent when the tax is fully phased in. The deficit reduction made possible by the revenues generated by the energy tax should reduce interest rates, which will reduce the cost of capital to U.S. businesses. It should also be noted that U.S. energy prices, even after imposition of the energy tax, would be the lowest or second lowest (depending on the type of energy) in the G-7 countries.

Energy Tax Question 11

Question:

Please provide us with a state-by-state analysis of the costs of this tax. In other words, please provide the amounts that you estimate the energy producers, transporters, refiners, or consumers in each state would pay each year.

Answer:

We have not produced such a state-by-state analysis. We have produced an analysis, shown in the following table, of the regional impacts of the Administration's proposed energy tax on consumers when the rates are fully phased in (July 1, 1996). This analysis assumes that all of the energy tax will be passed forward to consumers. In the table, the first column shows by census region the dollar amount of tax that would be paid on a per capita basis. The second column of the table expresses the tax as a percent of disposable personal income in each region. The third and fourth columns show the same information as the first two columns, but expressed as a percent of the national average.

The Administration's proposed energy tax is better balanced regionally than alternative energy taxes such as an increase in the gasoline tax or an oil import fee. Note

that while the tax burden on a given region may be higher than the national average on a per capita basis, it is often lower than the national average as a percent of disposable personal income, and vice-versa.

Impact on Consumers of Energy Tax by Region

Census Region	Tax Increase		Percent of National Average	
	Amount Per Capita	As A Percent of Income	Amount Per Capita	As A Percent of Income
New England	$ 124	0.57%	112%	95%
Middle Atlantic	115	0.54	104	91
South Atlantic	113	0.62	102	104
East North Central	110	0.60	100	101
East South Central	102	0.67	92	113
West North Central	110	0.63	100	106
West South Central	106	0.66	96	111
Mountain	104	0.63	95	106
Pacific	108	0.54	98	91

Energy Tax Question 12

Question:

When will heating oil be taxed and at what rate?

Answer:

As amended by the Ways & Means Committee, the proposed basic rate of tax on home heating oil is $0.268 per million BTUs. The tax at one-third of this rate would be imposed beginning July 1, 1994; two-thirds beginning July 1, 1995; and the full rate beginning July 1, 1996.

Investment Tax Credit Question 2

Question:

Will leased property restrictions discriminate against a business that can't get credit to buy equipment and is instead forced to lease it?

Answer:

To reduce the revenue cost, the investment tax credit for large businesses is incremental; it applies to investment in excess of a given percentage of the firm's historical

level of investment. Restrictions are required to avoid the revenue loss that would occur if a firm could circumvent the incremental rules through leasing rather than purchasing equipment. The Ways & Means Committee reported a bill that did not contain the investment tax credit proposal.

International Question 2

Question:

What portions of this revenue is attributable to our U.S. businesses operating overseas? And what portion is attributable to foreign operations in the U.S.?

Answer:

The international tax provisions in the Administration's proposals represent a mix of reforms and measures to enhance compliance and enforcement. As such, these provisions affect all businesses, both U.S. and foreign-controlled, in a balanced way. Foreign-controlled businesses operating in the United States will be subject to measures that close down loopholes and combat abusive practices by these businesses. These measures include the transfer pricing compliance initiative and the enhanced "earnings stripping" rules. We expect these provisions to substantially improve compliance by these taxpayers and to help ensure that they pay their fair share of taxes, thereby raising a significant amount of revenue.

U.S. businesses operating overseas will, of course, also be affected by the transfer pricing compliance initiative, which we anticipate will foster significantly improved compliance on their part. The remaining international provisions are generally designed to encourage U.S. businesses to carry out their business activities in the United States rather than abroad. These provisions include changes to the foreign tax credit for multinational oil companies, placing royalty payments in the passive basket for the foreign tax credit, allocating research and experimentation expenses based on the location in which the activity is carried out, and the repeal of deferral for excessive accumulated foreign earnings. The Ways & Means Committee reported a bill that deleted the royalties proposal and modified the proposed allocation of research and experimentation expenses.

RESPONSES OF SECRETARY BENTSEN TO QUESTIONS SUBMITTED BY SENATOR ROTH

Question 1

Question:

How will social security beneficiaries and retirees with incomes of less than $30,000 be impacted by the Administration's proposals? Such individuals will have to pay increased energy taxes although they will not qualify for increased benefits from the earned income tax credit (EITC).

Answer:

Families with incomes of less than $30,000 a year and no earned income will benefit from several provisions in the Administration's program. The provisions (other than the EITC) which will assist lower income people are summarized below.

The Administration's proposals increase funding for LIHEAP by $1 billion per year. (This amount is phased in with the energy tax.) LIHEAP provides assistance to low-income households in the form of assistance with heating or cooling bills, weatherization, and relief for

energy related emergencies. Eligibility is limited to households with incomes that are less than 150 percent of the Federal poverty level or 60 percent of State median income. (In 1993, 150 percent of the Federal poverty level is $14,145 for a family of two and $21,525 for a family of four.) LIHEAP is administered through block grants to the States. States are permitted to set their own eligibility requirements (within the Federal eligibility limits described above), except that they are not permitted to set a ceiling lower than 110 percent of the Federal poverty level.

The President proposes to increase funding for the Food Stamp program. (This increased funding will be phased in with the energy tax.) In general, Food Stamps enable a household to buy an adequate low-cost diet while spending no more than 30 percent of its cash income on food purchases. Eligibility is limited to households with incomes of less than 130 percent of the Federal poverty level. President Clinton's proposals will permit increased assistance per eligible household.

The Administration's spending proposals include over $100 million per year in weatherization assistance, primarily for low-income households. This funding will provide for the weatherization of over 500,000 houses over the budget period, thus reducing energy costs for many to less than current levels.

The Administration's proposal would extend the low-income housing credit and the authority to issue mortgage revenue bonds. These programs increase the availability and affordability of housing for low-income and middle-income households.

The Administration's overall budget proposals will help reduce the deficit, which should result in lower interest rates. Households that do not benefit directly from the Administration's spending and tax relief proposals may benefit indirectly through reduced mortgage payments and other reductions in interest costs. In addition, removing the $135,000 per year cap on earnings subject to the 1.45 percent Medicare hospital insurance tax will enhance the solvency of the hospital insurance trust fund and fund future benefits to current and future retirees at no additional cost to all but the wealthiest wage earners.

Question 2

Question:

What sort of savings incentives does the Administration support?

Answer:

The Administration does not currently propose to expand IRA savings incentives or other similar savings incentives through the income tax system. We are addressing the need for increased national savings by proposing ways to decrease the Federal budget deficit. Deficit reduction will make more of Americans' savings available for increased private investment.

Question 3

Question:

Why does the Administration propose to deny deductions for compensation in excess of $1 million paid only to business executives? Would it favor extending the proposal to other highly-paid individuals?

Answer

Concerns have arisen that some corporate executives have received exorbitant compensation packages even while their companies have performed poorly. Our proposal addresses these concerns by introducing a strong incentive for corporations to explicitly link executive pay to productivity.

The deduction limit is to apply exclusively to corporate executives for two reasons. First, it is this class of employees who control the business and have the most direct impact on how it performs. Second, in many cases corporate executives can, in effect, set their own salaries without adequate disclosure or approval by the shareholders. The result can be a generous pay package for an executive even in a year when the firm's employees and shareholders are suffering the consequences of substandard sales and profits.

For these reasons, we would not support an amendment extending the proposal to cover highly-paid individuals other than corporate executives.

Question 4

Question:

How many business men and women will be affected by the increase in top individual income tax rates? Will the proposed rate increase result in the loss of jobs? What sort of "marriage penalty" results from the proposed rate changes?

Answer:

Of the 1.2 million taxpayers affected by the new 36 and 39.6 percent rates in 1993, 0.8 million report at least $1 of income or loss through some form of business (i.e., sole proprietorship, farm proprietorship, partnership or subchapter S corporation). However, not all taxpayers reporting business income or losses are what many think of as a small business man or women. For example, some taxpayers only report passive income, while others only report losses. When these taxpayers are excluded from the estimates, 0.5 million taxpayers with business income would be affected.

This estimate includes many taxpayers with only small amounts of business income. If only taxpayers whose small business income exceeded their wage income were included in the estimates, only 300,000 taxpayers with business income would pay higher taxes.

Nevertheless, even using the more liberal definition of who might be characterized as a business man or woman, about 300,000 of the 14.5 million sole proprietorships, 600,000 of the 4.8 million partners, 300,000 of the 1.9 million filers reporting S corporation income, and less than 50,000 farmers will pay higher taxes.

The Administration's budget proposal has been designed to increase the number of jobs and employment opportunities for Americans. In looking at the macroeconomic effects, it would be misleading to concentrate solely on the proposal to increase the top tax rates while ignoring the rest of the budget proposal. The Administration believes that in total, its proposal will increase jobs and speed economic growth.

The combined federal income tax of two single persons often differs from the tax they would pay if they marry and a file joint federal income tax return. If marriage increases the tax, the couple is said to incur a "marriage penalty." If marriage lowers the tax, the couple is said to receive a "marriage bonus." When one spouse has most of the income, marriage bonuses are common. When spouses have approximately equal incomes, marriage penalties tend to predominate. Marriage penalties occur because tax brackets for joint filers are not twice as large as for single filers. Similarly, standard deductions are not twice as large as for singles.

In order to show the levels of, and changes in, marriage penalties and bonuses which might result from the Administration's proposals, the Office of Tax Analysis has calculated the tax liability for representative examples of couples at different income levels and with different divisions of income. The examples assume that two single persons marry; neither has any dependents. It is further assumed that itemized deductions are equivalent to 18 percent of income, and that taxpayers claim the larger of their itemized deductions or the standard deduction.

Table 1 shows the <u>changes</u> in marriage penalties for different earnings splits at selected income levels. It might be noted that:

- The changes in individual income tax rates will raise marriage penalties (or reduce marriage bonuses) significantly for many high income, two-earner taxpayers. However, some high income couples, especially where the second earner earns less than 15 percent of combined earnings, will continue to receive marriage bonuses even after the proposed changes. The increases in marriage penalties stem from the proposed 36 percent and 39.6 percent tax brackets.

- Marriage penalties and bonuses will not change for most taxpayers in the middle income range. Where one spouse earns considerably more than the other spouse, marriage bonuses will continue to be common.

- There will be reductions in marriage penalties for:

  -- two-earner couples where the lesser-earning spouse earns under 10 percent to 15 percent of combined earnings and who have combined earnings in the $150,000 to $250,000 range, and

  -- for couples with incomes over approximately $150,000 where one spouse earns all of the income.

Table 1

Increases(+) or Decreases(−) in Marriage Penalties from Clinton Tax Proposals, at 1993 Levels

Adjusted Gross Income	Division of Earnings Between Spouses										
	100% and 0%	95% and 5%	90% and 10%	85% and 15%	80% and 20%	75% and 25%	70% and 30%	65% and 35%	60% and 40%	55% and 45%	50% and 50%
150 000	−462	−50	0	0	0	0	0	0	0	0	0
175,000	−1,250	−879	−507	−135	237	274	275	275	275	275	275
200,000	−1,250	−825	−400	25	450	875	1,300	1,337	1,337	1,337	1,337
250,000	−1,250	−719	−187	344	875	1,407	1,938	2,469	3,000	3,462	3,462
300,000	−1,250	−550	87	725	1,362	2,000	2,637	3,275	3,913	4,550	4,726
400,000	−1,250	213	1,674	3,135	4,597	6,059	6,973	7,786	7,786	7,786	7,786
500,000	−1,250	578	2,405	4,233	6,060	7,888	9,253	10,018	10,783	10,846	10,846
600,000	−1,250	944	3,136	5,330	7,522	9,253	10,171	11,089	12,007	12,925	13,780
700,000	−1,250	1,309	3,867	6,426	8,947	10,018	11,089	12,160	13,231	13,780	13,780
800,000	−1,250	1,674	4,598	7,522	9,559	10,783	12,007	13,231	13,780	13,780	13,780
900,000	−1,250	2,040	5,329	8,619	10,171	11,548	12,925	13,780	13,780	13,780	13,780
1,000,000	−1,250	2,405	6,060	9,253	10,783	12,313	13,780	13,780	13,780	13,780	13,780
1,500,000	−1,250	4,233	9,253	11,548	13,780	13,780	13,780	13,780	13,780	13,780	13,780
2,000,000	−1,250	5,060	10,783	13,780	13,780	13,780	13,780	13,780	13,780	13,780	13,780
2,500,000	−1,250	7,888	12,313	13,780	13,780	13,780	13,780	13,780	13,780	13,780	13,780
3,000,000	−1,250	9,253	13,780	13,780	13,780	13,780	13,780	13,780	13,780	13,780	13,780
4,000,000	−1,250	10,783	13,780	13,780	13,780	13,780	13,780	13,780	13,780	13,780	13,780
5,000,000	−1,250	12,313	13,780	13,780	13,780	13,780	13,780	13,780	13,780	13,780	13,780

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Question 5

Question:

Under the Administration's proposed rate increase, how many taxpayers might be subject to marginal federal and state tax rates in excess of 50 percent?

Answer:

The effective marginal tax rate which a taxpayer faces depends not only on statutory rates for federal income taxes, social security taxes, and state and local income taxes, but also on various interactions with other provisions within each tax system and between tax systems.

Within the federal income tax system, the effective marginal federal income tax rates faced by higher income taxpayers typically depend on three provisions: (1), the statutory rate brackets; (2), the limitation on itemized deductions ("Pease"); and (3), the Personal Exemption Phaseout ("PEP"). The Administration's proposals call for highest statutory income tax rate to be 39.6 percent. That rate will apply to taxable income in excess of $250,000. Under the Administration's proposals, however, only 1.2 percent of returns will face either of the new statutory rates of 36 percent and 39.6 percent. Thus, 98.8 percent of all tax returns will not be affected by higher marginal income tax rates. By itself, the new top rate would produce a marginal rate of 39.6 percent for affected taxpayers.

The limitation on itemized deductions generally reduces allowable itemized deductions in 1993 by 3 percent of the amount by which AGI exceeds $108,450. (The base amount is indexed annually to reflect inflation.) As a result, Pease effectively raises marginal rates to 103 percent of the statutory rates. Pease would increase marginal tax rates by 1.19 percentage points in the 39.6-percent bracket, producing an effective marginal rate of 40.79 percent.

The deduction for personal exemptions ($2,350 per exemption for 1993) begins to be phased out for taxpayers with AGI above $162,700 (joint), $108,450 (single), or $135,600 (head of household). (These thresholds are for 1993 and indexed annually to reflect the effects of inflation.) Since PEP reduces all personal exemptions simultaneously, in the phaseout range effective marginal income tax rates depend on family size. In addition, since the PEP phaseout occurs over a $125,000 AGI range which remains constant from year to year, whereas the size of each personal exemption is indexed annually to reflect inflation, the marginal rate effects of PEP may increase annually. In 1993, the phaseout of each personal exemption would increase the 39.6 percent statutory rate by approximately 0.74 percentage point. Similarly, the phaseout of each personal exemption would increase the 36 percent statutory rate by about 0.68 percentage point, and would increase the 31 percent statutory rate by about 0.58 percentage point.

For single and head of household taxpayers, personal exemption phaseouts do not occur while taxpayers are in the 39.6 percent tax bracket. For married taxpayers filing jointly, however, there is a small income range over which some taxpayers could be affected by both the 39.6 percent statutory marginal rate and PEP. In most cases, however, PEP will affect taxpayers in the 31 percent and 36 percent tax brackets.

Effective marginal federal income tax rates including the impact of Pease alone and of Pease and PEP together are shown for four person families in Table 1. Table 2 contains similar data for single filers. Note, however, that it is very unlikely for a taxpayer in the 39.6 tax bracket to be affected by PEP.

Removing the HI wage base cap will affect all workers with earnings exceeding $135,000. It will not have any impact on workers earning less than $135,000, or on those without any earned income.

Marginal tax rates on the employee earning over $135,000 will increase by 1.45 percentage points from its current level of zero. (Under the assumption that the corresponding increase on the employer is borne by the employee, the resulting increase on the worker is 2.9

percentage points. The 2.9 percent level should be reduced, however, to reflect the income tax deductibility of the employer share of HI taxes.) Since marginal tax rates due to the HI tax for employees and to federal income taxes are additive, the maximum combined marginal federal income tax plus HI tax rate for a worker in the 39.6 percent income tax bracket who is affected by both Pease and PEP will be 45.22 percent (income tax of 43.77 percent plus HI of 1.45 percent). In the more typical case of a 39.6 percent bracket taxpayer who is only affected by Pease, the combined effective marginal rate will be 42.24 percent. (In other situations, the combined HI and federal income tax rates can be obtained by adding the HI rate to the rates shown in Tables 1 and 2.)

Although the HI tax rate for self-employed workers is 2.9 percent, that rate only applies to 92.35 percent of self-employment income, and one-half of the self-employment tax is deductible for income tax purposes. As a result, the combined marginal federal income and HI tax rates for self-employed workers are not significantly higher than for employees. For example, the 39.6 percent tax bracket employee who is affected by both Pease and PEP has, as described above, an effective marginal income tax rate of 43.77 percent and an HI rate of 1.45 percent, for a total rate of 45.22 percent. If that same worker were self-employed, the HI rate would be 2.68 percent but income tax deductible of half of the HI tax would reduce the marginal federal income tax rate to 43.22 percent. The combined rate would be 45.90 percent for the self-employed worker as compared with 45.22 percent for the employee.

State and local income taxes can further increase the effective marginal tax rates cited above. As for federal income taxes, the effective marginal rates depend not only on statutory marginal rates but also on various provisions, phaseouts, and interactions within each state's or locality's own tax system. However, the resulting state and local marginal tax rates cannot simply be added to federal income tax rates to obtain a combined rate. Because state and local income taxes are generally permitted as itemized deductions for federal income tax purposes, the combined rate is less than the sum of the state rates and federal rates discussed above. Moreover, the higher the marginal federal rate, the greater will be the reduction from deductibility for state and local income taxes.

If a taxpayer were in the 39.6 percent tax bracket and were affected by both Pease and PEP, his or her effective federal marginal income tax rate would be 43.77 percent and his or her HI rate would be 1.45 percent. In order for state and local income taxes to push this taxpayer's combined marginal tax rate to the 50 percent level, the effective marginal state and local tax rates would have to exceed 8.5 percent, as shown in Example 1.

In the less unusual situation of a taxpayer in the 39.6 percent tax bracket and affected only by Pease, his or her effective federal marginal income tax rate would be 40.79 percent and his or her HI rate would be 1.45 percent. In order for state and local income taxes to push this taxpayer's combined marginal tax rate to the 50 percent level, the effective marginal state and local tax rates would have to exceed 13.1 percent, as shown in Example 2. Thus, a taxpayer living in New York City and facing the maximum combined state and local income tax brackets of 12.335 percent would not reach a combined federal, state, and city marginal income tax and HI rate of 50 percent.

Table 1

Effective Marginal Federal Income Tax Rates in 1993 Under Clinton Proposals For 4–Person Families */

Statutory Income Tax Rate	Effective Marginal Rates	
	Including "Pease"	Including "Pease" & "PEP"
28%	28.84%	30.95%
31%	31.93%	34.26%
36%	37.08%	39.79%
39.6%	40.79%	43.77%

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*/ Since the Personal Exemption Phaseout reduces all personal exemptions simultaneously, the effective marginal income tax rate increases with family size.

Table 2

Effective Marginal Federal Income Tax Rates in 1993 Under Clinton Proposals For Single Taxpayers Without Dependents */

Statutory Income Tax Rate	Effective Marginal Rates	
	Including "Pease"	Including "Pease" & "PEP"
28%	28.84%	29.37%
31%	31.93%	32.51%
36%	37.08%	37.76%
39.6%	40.79%	41.53%

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*/ Since the Personal Exemption Phaseout reduces all personal exemptions simultaneously, the effective marginal income tax rate increases with family size.

Example 1
Marginal State Income Tax Rate Required to Reach 50% Combined Rate
For a Taxpayer with an Effective Marginal Federal Income Tax Rate of 43.77%

	Effective Marginal Rates
Federal income tax rate in the absence of state and local income taxes	43.77 %
State and local income tax rate	8.50 %
Approximate reduction in marginal federal tax rate due to deductibility of state and local income taxes	-3.72 %
Hospital Insurance (HI)	1.45 %
COMBINED EFFECTIVE MARGINAL RATE	50.00 %

Example 2
Marginal State Income Tax Rate Required to Reach 50% Combined Rate For a Taxpayer with an Effective Marginal Federal Income Tax Rate of 40.79%

	Effective Marginal Rates
Federal income tax rate in the absence of state and local income taxes	40.79 %
State and local income tax rate	13.10 %
Approximate reduction in marginal federal tax rate due to deductibility of state and local income taxes	-5.34 %
Hospital Insurance (HI)	1.45 %
COMBINED EFFECTIVE MARGINAL RATE	50.00 %

Question 6

Question:

Would the temporary incremental investment tax credit encourage short-term planning? Does it encourage an acceleration of investment, rather than a higher level of investment?

Answer:

The Administration's proposal encourages capital formation in at least three ways. First, we offer a permanent investment tax credit (ITC) to smaller American businesses. Second, we offer a temporary ITC to large businesses. Third, our overall economic package would substantially reduce the federal deficit, and so would reduce market interest rates. The fall in interest r tes, in turn, would help encourage additional investment both in the short-term and the long-t rr .

The proposed temporary ITC would not encourage businesses to focus excessively on the short-run, at the expense of long-term objectives. It would, however, encourage businesses to make additional investments during the qualifying period, which would help to speed the recovery from the current recession. We believe the economic stimulus of an ITC would be especially appropriate since it would encourage capital spending, which has been lower in the U.S. than many would desire. Furthermore, since capital investments are long-lived, the temporary ITC would help raise the U.S. capital stock for many years to come, even though the investment incentive is only temporary.

A temporary ITC does present opportunities for shifting purchases between periods. That is why we include in our proposal elaborate recapture rules. Under these rules, companies must pay the ITCs back to the government if their future investment falls below historic levels. Thus, companies that simply accelerate next year's investment into the current year to generate ITCs next year will have to recapture their current ITCs.

PREPARED STATEMENT OF DR. MICHAEL J. BOSKIN

Chairman Moynihan, Ranking Member Packwood and other distinguished members of the Committee, I am pleased to testify before this Committee or :e gain. As requested, I will briefly discuss taxes, spending and deficits, the interaction amou. g uem and with the economy. My remarks primarily will deal with general principles and historical interpretations, but I will present a few observations on the President's budget program.

1. Amercians have become increasingly concerned that the federal govenment is passing on to future generations large and growing liabilities that will reduce their standard of living below what it might otherwise have been. Of the many government activities that may affect future living standards, almost all of the attention has focused on the federal debt and the large and persistant federal governament deficits. Much of this concern is correctly placed: the debt and deficit can affect intergenerational equity and, under certain conditions, can adversely affect the economy's productive capacity.

2. However, the federal debt and budget deficit represent only two of many factors that will affect future living standards. They are an incomplete measure of the legacy being passed to the future because they do not incluse private assets, government assets, the increase or decrease in the future benefits citizens will receive from our economic and social institutions, such as a sound monetary system, open international markets, and the nation's educational system. If the nation were rapidly building assets, improving its elementary and secondary education system and strengthening its market institutions, the budget deficits would be less of a concern.

3. Even in accounting for the federal government's liabilities, the debt and deficit are narrow and imprecise measures. The traditionally measured deficit reflects current cash outlays and receipts, ignoring the future costs of current commitments; it fails to account for the effects of inflation in reducing the burden of the debt; and does not distinguish capital from current outlays and depreciation and obsolescence of govenment capital in a meaningful way, to name but a few obvious accounting problems.

4. While most of the attention has focused on the potentially negative consequences of deficits on the economy, deficits reflect as well as affect the state o :he economy. There has been a sizable cyclical component to the deficit for several years and /ill be for at least another two or three years. Once back to full employment, a higher rate of productivity growth will lead to even faster revenue growth which, if additional revenue is not spent, can reduce the deficit substantially.

5. At a given point in time, even if all the adjustments mentioned above were made, the deficit would simply be the level of spending less revenues. This simple accounting identity has caused too much discussion of the deficit, taxes, and spending to degenerate into an overly simplified arithmetic. If spending exceeds revenues by $300 billion this year, it is tempting, but quite possibly wrong, to conclude that cutting spending or raising taxes by $300 billion will balance the budget. This is so for many reasons, the two most important which are that this thought process ignores the effects of fiscal policy on the economy and the political dynamics of fiscal policy. For example, a large tax increase will slow economic growth which in turn will offset some or all of the attempt to raise more revenue, the amount depending in part on the tax structure and types of tax changes proposed. To the extent additional revenues are raised, they may not be devoted to deficit reduction, but rather to spending increases. While I do not believe there is a mechanical "iron law" that every dollar of additional revenue will automatically be spent, I do believe that political theory and ample historical evidence exists to warrant a healthy degree of skepticism that planned tax increases will permanently reduce the deficit anywhere close to dollar for dollar.

6. The tax structure heavily affects the economy and revenues. High marginal tax rates lead taxpayers to defer and) ıelter income and therefore raise little if any exta revenue. In fact, the most careful analys.s to date of the likely impact of President Clinton's proposed tax rate increases concludes they will raise only 30 percent of what the Administration projects because of taxpayer behavioral responses to reduce tax burdens. And as this committee knows from the hearings and debates surrounding the 1986 tax reforms, the economic loss from tax rate increases becomes progressively worse as the rates rise.

7. The putative reason to reduce the budget deficit is to decrease the drain on private saving available for productive private investment so that increased investment can raise future living standards. This implies that tax increases which reduce private saving or investment are counterproductive to the purpose of reducing the deficit, even if the obstacles mentioned above are overcome and the deficit is reduced. This implies that changes in the tax structure moving toward taxing consumed income, thereby eliminating the double taxation of savings, can help achieve the same goal as deficit reduction. Such a tax reform is increasingly viewed as more ammenable to simplicity and fairness as well. It would be simpler to integrate the corporate and personal taxes, eliminating the double taxation of corporate source income and part of the bias toward debt finance, in this context. And capital gains which were reinvested would not be taxed at all, similar to the current tax treatment of housing, whereas if no other adjustments were made, realized capital gains which were consumed would be taxed at ordinary rates. From the standpoint of tax structure, the President's proposed increase in the corporate income tax rate is but one example of undoing with the right hand what the left hand is allegedly trying to accomplish. I might add that a sizable fraction of the income slated for higher marginal tax rates under the President's plan is subchapter S small business corporate income. I believe this is not fully appreciated. The proposal will not just tax "the rich," but will substantially reduce the after-tax corporate profits available for job-creating reinvestment in small businesses which produce the bulk of the new jobs in our economy.

8. With respect to the specific questions raised in Senator Packwood's letter, I believe the charts he presents are quite in :uctive: 1) Higher taxes have accompanied higher spending and persistent or even growing deficits. While it is noted above the causality among these features is complex, I do believe it is fair to conclude that absent strong controls on spending, and measures to enhance the economy's growth, tax increases are unlikely to reduce the budget deficit substantially and permanently. Controlling the growth of existing spending programs and avoiding new programs with their proclivity for future growth are far more likely to reduce the structural deficit permanently. 2) While the numbers are difficult to compare across countries, the share of government spending gross domestic product in the United States is far more conducive to a healthy economy than the much larger shares in Europe. In fact, it is certainly better to have the current U.S. share of government spending in the economy even with current structural budget deficits than it would be to have a European sized 50-60 percent government spending share with a balanced budget. 3) While the economically optimal share of government spending in the economy may vary over time, for example due to swings in demography, or temporary emergencies such as wars, a growing body of statistical evidence is accumulating in academic economics journals in recent years which suggests that a larger government share in the economy is associated with slower economic growth in a broad cross-section of developed and developing countries. While the government does have some important functions to perform, government spending crowds out private activity which in general must be the basic engine of growth in a healthy economy. 4) An absolutely necessary component of any successful deficit reduction strategy must involve slowing the increase of spending in government retirement programs and in government financed health care. While one can quibble over the details in the Congressional Budget Office and Library of Congress charts, the basic conclusion drawn from them is certainly correct.

9. Finally, the best fiscal approach to dealing with the problems potentially caused by the large and persistent budget deficits projected to grow still larger late in this decade and into the next is to slow the growth of government spending and reform the tax structure to stimulate economic growth. In this regard, President Clinton's budget proposals are particularly disappointing. Insufficient attention is paid to slowing the growth of non-defense spending over the longer term. The many new programs are likely to grow far beyond the projected amounts and will be difficult to curtail. The defense reductions, above and beyond the already approved future drawdown to the smallest defense share in GDP since the 1930's, will be difficult to make in a dangerous and volatile world. And the tax changes are more likely to retard growth than to enhance it, even if they somehow manage to raise revenue.

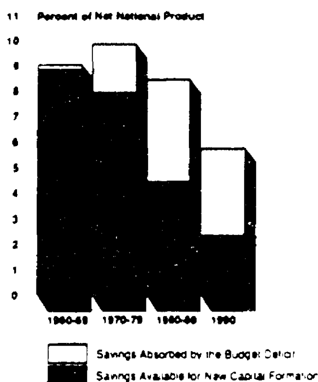
PREPARED STATEMENT OF HON. CHARLES A. BOWSHER

Mr. Chairman and Members of the Committee: I appreciate the opportunity to appear today to discuss the importance of deficit reduction to our nation's long-term economic health.

The federal deficit is not the only problem we face as a nation, but if we cannot turn the deficit path around—if we cannot put ourselves on a credible path toward balance (or surplus)—then our ability to solve our other pressing problems will be severely limited.

Deficits by themselves do not create crises, but they do erode the savings needed for private investment and future economic growth. As figure 1 shows, the rising deficit in the 1980s and early 1990s coincided with a sharp drop in the net national savings available for investment. The share of national savings absorbed by the deficit grew from 2 percent in the 1960s to 58 percent in 1990. Only an influx of foreign capital sustained investment. Unfortunately this reliance on foreign investment has its price, because future profits and interest payments will flow abroad. There is much we do not yet know about increasing investment and productivity, but we do know that increasing national savings by reducing the deficit will promote greater investment and long-term economic growth.

Figure 1: Effect of the Federal Budget Deficit on Net National Savings (1960-1990)



Source: Economic Report of the President, February 1992

Last June we issued a report[1] in which we sought to describe in concrete terms why we must act. In that report, we adapted a model developed by economists at the Federal Reserve Bank of New York to explore the long-term effects of different fiscal policies. In particular, the model captures the links between the deficit, interest costs, and the national savings rate. This year's deficit not only reduces this year's national savings, it also increases interest costs and deficits in future years, further depressing savings and economic growth.

INACTION IS NOT A SUSTAINABLE POLICY

If we were to continue our recent spending and tax policies, our projections show deficits exploding to 20 percent of gross national product (GNP) by 2020. Figure 2 shows the deficit under this "no action" scenario. We do not believe this scenario can occur because we would face financial crisis before we reached that point, but the trends that produce the result are instructive. The steep increase in the projected deficit after 2010 reflects the symbiotic relationship of the growing debt and the increased interest costs associated with financing it, as well as rising retirement and health care costs. In our model this is happening in the environment of an economy whose growth is slowed by the debilitating effect of the deficits on national savings and investment. Indeed, in the final years of the projection period, the model shows the economy actually contracting.

[1] *Budget Policy: Prompt Action Necessary to Avert Long-Term Damage to the Economy* (GAO/OCG–92–2, June 5, 1992).

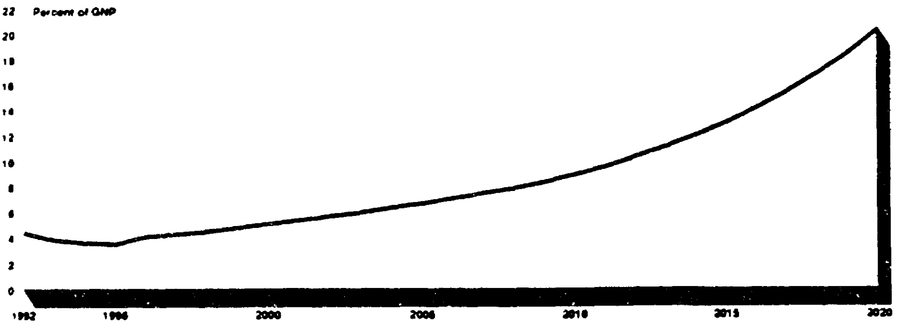


Figure 2. No Action Scenario Budget Deficits (1992-2020)

Although these projections show what looks like an economic extreme, they are the logical extension of recent tax and spending policies. We do not believe this "no action" path is sustainable. If we do not act on our own initiative, a financial crisis would force us to act. Therefore, it is important to recognize that the question facing policymakers is not whether to reduce the deficit, but rather when and how to reduce it and whether we will design the program or have it forced upon us.

Figure 3 shows the forces driving the long-term explosion of federal spending if recent policies continue: health spending, interest payments, and retirement costs. Beginning around the year 2010, the nation will undergo a major demographic shift. The baby boom generation will enter retirement at a time of increased life expectancy. Not only will the number of elderly increase, but the number of the very old—who have disproportionately large needs for health and other services—will also increase. Moreover, in the year 2020, the ratio of workers to retirees will decline from today's 3.4-to-1 to 2.4-to-1.

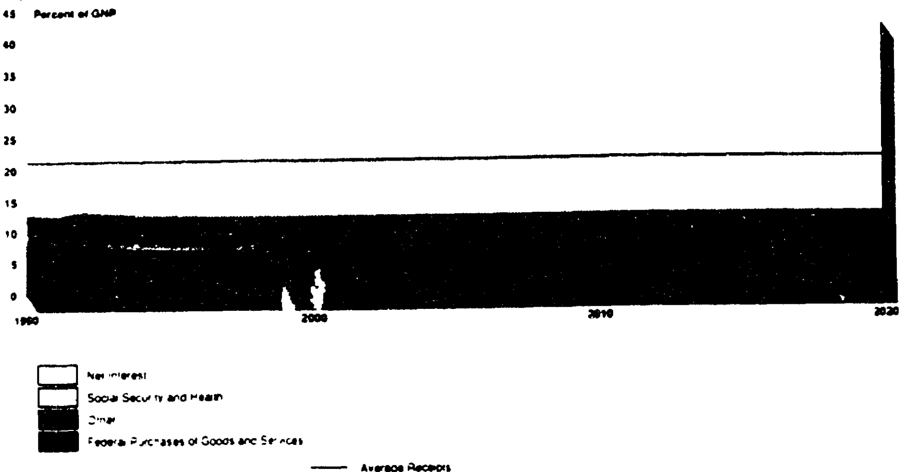


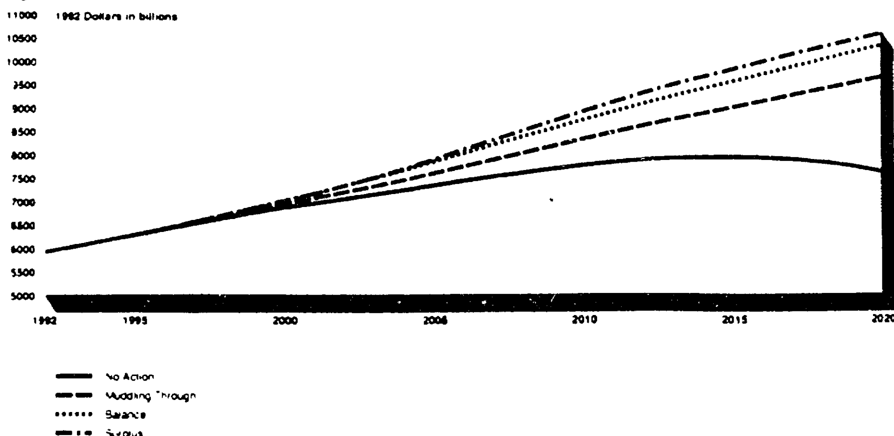
Figure 3. Federal Expenditures in the No Action Scenario

These demographic trends have profound implications for the budget. The size of the annual Social Security surpluses will begin declining around 2010, with outlays projected to exceed revenues by 2017 unless adjustment are made. The aging of the population will fuel the already-rapid growth in health care costs. Data fro: the Department of Health and Human Services indicate that Medicare and Medicaid out-

lays alone will grow from 2.8 percent of GNP in 1990 to about 7 percent in 2020. The burgeoning interest costs that inevitably accompany persistently high deficits will grow to consume over 30 percent of federal spending.

"MUDDLING THROUGH" STILL DOESN'T SOLVE THE PROBLEM

Recognizing that "no action" is unsustainable, we also looked at alternative deficit paths: (1) a "muddling through" scenario in which the deficit is held to 3 percent of GNP, (2) a balance scenario in which budget balance is achieved in 2001 and maintained, (3) a surplus scenario in which a 2 percent surplus is reached in 2005, maintained until 2010, and then phased down to balance by 2020. Our analysis showed that the timing of deficit reduction has a great impact on the magnitude of the sacrifice required as well as the economic benefits ultimately realized. Figure 4 shows the alternative GNP paths under our four scenarios.



Choosing either the balance or the surplus policy path would represent a kind of preemptive strike against the otherwise inexorable spiral driven by health, interest payments, and retirement costs. While either of these choices would require sizable sacrifice and very difficult decisions in the near term, either would yield great long-range benefits to the health of the economy. Real GNP would grow significantly while both foreign debt and public debt would shrink. Major gains in economic output would be achieved while a greater share of domestic investment would be financed by domestic sources.

In contrast, while the "muddling through" option of bringing the deficit down to 3 percent of GNP and holding it there requires less sacrifice in the short term, it grows progressively more difficult—and it offers much less in terms of economic health. The "muddling through" option can be tempting; it could look like a kind of stable equilibrium after the substantial initial dose of deficit reduction required to get to 3 percent. Unfortunately, this is not the case. Maintaining a 3 percent deficit offers no escape either from progressively harder decisions or from an unacceptable economic future. It only postpones the date of a full confrontation with the underlying problem.

Moreover, failure to deal decisively with the deficit early on leads to a dramatic growth in interest costs—already the fastest growing component of federal spending. Compound interest is a wonderful thing when you are earning interest on savings. But, as you have so often pointed out, Mr. Chairman, compound interest is killing us in the budget. Over the last decade, we have seen how compound interest adds to the damage of a growing deficit as interest to finance the debt in turn adds to the amount of debt that must be financed. Under the "muddling through" option this phenomenon continues as interest costs reach nearly $400 billion in 1992 dollars by 2020. Figure 5 shows net interest costs under the four scenarios.

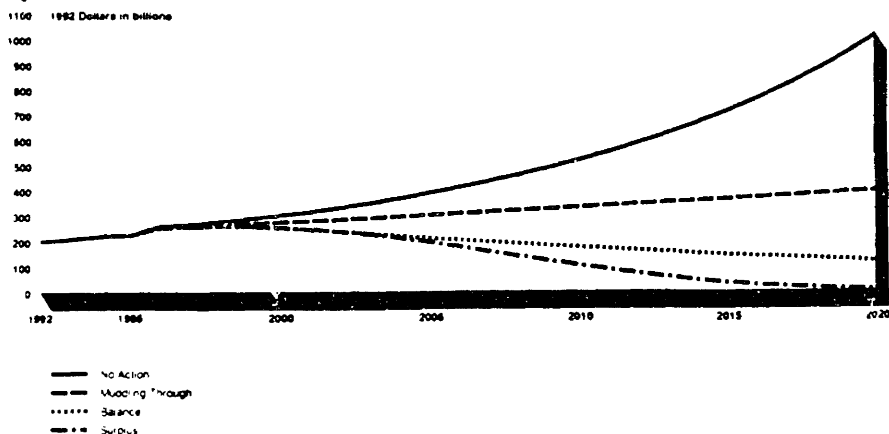


Figure 5 Net Interest Costs (1992-2020)

WHAT IS THE OUTLOOK TODAY?

The projections I discussed above were released last June, based in part on Congressional Budget Office (CBO) near-term deficit projections as of January 1992. Depressing as these figures are, they now look to have been overly optimistic. Due in large part to the weakness of the economic recovery, the near-term deficit outlook is substantially worse than was predicted at the start of last year.

To provide some sense of how much worse, we reran the deficit scenarios with lower, now more realistic, inflation rates and compared the results to those of last spring. Current CBO baseline estimates are about $40 billion higher than those we projected last spring. That is, we are starting even further down than we thought last year. (For more detail on what we did and the results, see attachment to this statement.)

Bad as these deficit numbers and the ones we usually cite are, in some ways they understate the problem. The 1992 unified deficit of $290 billion was the result of a federal fund deficit of $386 billion offset by trust fund surpluses of $96 billion. Of that $96 billion, $51 billion was the social security trust fund surplus.

The role of interest payments in our budgetary woes is also highlighted by looking at the federal funds budget. The $199 billion in net interest we paid in 1992 does not count the $78 billion in interest paid to the trust funds—almost $24 billion of which was paid to the social security trust fund.

Although the unified deficit is an accurate indicator of the impact of the federal budget on today's economy, it does not tell the whole story about the future. When we say the social security trust fund can cover promised benefits, we are assuming it continues to receive not only payroll tax payments but also interest on its balances. If we are concerned about providing for the baby boom's retirement without unduly burdening the next generation of workers, then we must be concerned about the trust funds. The trust fund surpluses will not help us deal with the future if they serve merely as an excuse to avoid making other deficit reductions. We should be seeking to reduce or eliminate the federal funds deficit.

In addition, most of the risks seem to be on the side of a worse-than-expected result rather than a better-than-expected outcome. By convention, budget projections ignore many future claims and the costs of unmet needs unless they are the subject of policy proposals in the budget. Examples of such claims and needs—some of which this administration did partially address—are: Pension Benefit Guaranty Corporation liability for underfunded pension plans; the cost of cleaning up and modernizing the Department of Energy's nuclear weapons production complex; the cost of hazardous waste pollution cleanup at military facilities; cost overruns in weapons systems, and modernization programs at the Internal Revenue Service, the Federal Aviation and Social Security Administrations, and the National Weather Service.

I list these not to create despair but to underline the need to act rapidly and decisively. There is much less risk of doing too much than of doing too little.

WHAT DOES THIS SAY ABOUT POLICY PROPOSALS?

The President's budget proposals and the House and Senate budget resolutions recognize the importance of bringing down the deficit. In addition, these proposals acknowledge that serious deficit reduction cannot be accomplished if any major spending category or revenue increases are left "off the table." Those involved deserve a great deal of credit for recognizing these facts.

The package of proposals now before the Congress represents an important first step although it will not, by itself, put us on a path to balance or surplus. Therefore, it is natural to question the wisdom of going ahead with the stimulus program. This is really-a question of risks. The program is small enough that it does not appear to raise the risk of reigniting inflation. And it does provide a modest amount of insurance in case the recovery proves to have weak legs. After all, economists have thought they smelled recovery before and been wrong.

There are always judgment calls in the design, size, and pace of economic programs. How fast should we bring down the deficit? How much deficit reduction should occur in the early years and how much later? Our judgment is the problem is less the current pace of deficit reduction and more its overall size.

Moreover, a huge piece of the deficit puzzle remains uncertain at this point. Controlling the rise of health care costs must be the second step in changing the direction of our deficit path. If health care reform is able to constrain the growth of health care costs—and the government's share of those costs—it could materially improve the outlook for the deficit. On the other hand, if expanded health insurance coverage were to be financed by the government without some way of offsetting the cost, the outlook for the deficit might worsen significantly.

Beyond health care there are further opportunities for serious re-examination of our goals and the effectiveness of programs designed to meet them. We will not be able to put ourselves on a path to balance or surplus simply by taking ever-larger cuts distributed across all programs. For example, how we restructure our defense effort will have budgetary implications far beyond any system-by-system reductions. I am hopeful that Vice President Gore's National Performance Review will help this process of reexamining basic assumptions and structures.

Finally, policymakers need to be prepared for contingencies. I spoke earlier about future liabilities and unmet needs. One of the lessons of the past is that budget outcomes are rarely better than expected. Moreover, putting off solutions usually just make: them more expensive. Aiming toward balance or surplus will give the budget a little more room to meet these claims and needs.

CONCLUSION

Mr. Chairman, I hope these projections have helped to make the case for prompt and significant action to bring down the federal deficit. Deficit reduction is never painless. There is a supporter for every program and an opponent for every tax. Putting the budget on a path toward balance or surplus will require difficult decisions and some pain. But—and perhaps this is the most important part of my message—delay will eliminate neither the need to mike hard decisions nor the pain they will inflict. Delay only guarantees that the decisions will be even harder and the pain even greater when policy correction is finally made. We do not have a choice *whether* to act; sooner or later action will be forced upon us. The question before us is when to act and how.

ATTACHMENT—DESCRIPTION OF MODEL UPDATE

To provide a perspective on recent economic experience and on the administration's economic plan, we adjusted the four deficit scenarios in our report in one respect. We replaced the constant 4 percent per year inflation rate in the projections with lower, more realistic rates of increase of the implicit price deflator for Gross Domestic Product. For 1991 and 1992 we used the historical values, for 1993–1998 we used the forecast and projected values released by the CBO 2 months ago. This procedure gives us projected current dollar values for the four deficit paths out to 1998, figures that are comparable to the CBO's baseline figures and to the administration's estimates based on "CBO economics." Since the model we used for the projections is based on calendar year data from the national income and product accounts (NIPA), we used that basis consistently in the comparison.

This exercise gives rise to the following observations. First, for calendar 1992 the NIPA budget deficit turned out to be $295.2 billion, as compared with a figure of $258.8 billion in our projections made in June 1992. For 1993, the recent CBO fig-

ures suggest a calendar year baseline deficit of about $273.5 billion; we had projected $233.9 billion. Because the administration's economic proposals are oriented toward fiscal stimulus in the near term; their net effect on the NIPA deficit this year is to increase it by about $9 billion.

Our four scenarios begin to diverge in 1994. In that year, the CBO baseline now indicates a calendar year NIPA deficit of about $256.5. The administration's economic proposals would reduce that to $223.5. Thereafter, the administration plan gradually reduces the deficit toward the value projected in our "muddling through" scenario. In calendar 1998, the administration plan would imply a deficit of about $235.8 billion. Our 1998 "muddling through" value is $230.4.

PREPARED STATEMENT OF SENATOR BOB DOLE

Mr. Secretary, it's good to see you again this morning. As a former chairman of this committee who has wrestled with some major deficit reduction proposals, you know the difficulties that await us as we try to reach agreement on a serious proposal to attack the deficit.

TOO HEAVY ON THE TAX SIDE

I have to tell you that a lot of Senators on both sides of the aisle are going to have a difficult time voting for any plan containing a record $360 billion in tax increases.

Take a look at this pie chart. This chart shows how the Clinton plan would reduce the deficit between 1993 and 1998. as you can see, most of the deficit reduction—63 percent—comes from a net tax increase totalling $293 billion. You have another 5 percent from user fees, and only 18 percent from spending cuts—and almost all of the real cuts come out of defense. In fact, as I understand it, if you take away the defense cuts, President Clinton's plan would actually increase domestic spending above inflation over the 5-year period.

ECONOMIC STIMULUS

I have to question why the President insists on including an economic "stimulus" package in a plan that is supposed to reduce the deficit. Frankly, most economists agree that a $31 billion stimulus package is too small to have any measurable, positive effect on a six trillion dollar economy.

This traditional, tax-and-spend package may create some short-term government make work jobs this summer, but it will not create good high-wage jobs that will last. In fact, a $360 billion tax hike could easily stall the recovery that is under way.

Don't get me wrong. Republicans support a number of the provisions in the stimulus package—more spending on WIC, more highway spending, a permanent R&D tax credit, capital gains, and enterprise zones. In fact, we have a few of our own that we may want to and—like repeal of the luxury tax. As I look around the room, that is one change that would actually create jobs in Louisiana, Maine, Rhode Island, Kansas . . . .

But, if the trade-off for $15 billion in tax incentives is going to be a $360 billion tax increase, I believe the price is simply too high.

REPUBLICAN RECOMMENDATIONS

Although we were not consulted while the plan was being developed, we are serious about reducing the deficit, and we want to be helpful.

The first step you should consider is eliminating the $178 billion in spending increases contained in the Clinton plan. The American people don't want to pay higher taxes to finance more Government spending. Taking this one step would produce the same deficit reduction as the President's proposal *with half the taxes.*

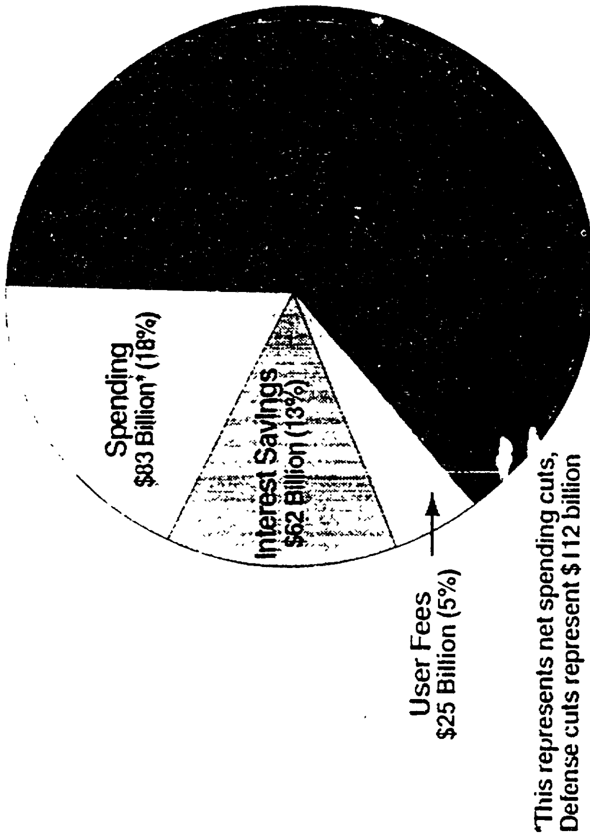
You could even go a step further and do away with the $67 billion in tax cuts for "stimulus." Reduce the tax hikes and user fee increases in the Clinton plan by the same amount—$245 billion—and you end up with a plan that produces the *same amount of deficit reduction as the Clinton plan with roughly one third of the taxes.*

I'm not proposing this as an alternative. There are some progrars—like WIC—where we may want to increase spending, provided that it is offset with other spending cuts. But, this is clearly the direction we should be taking. With roughly one dollar in tax increases for every $2 in spending cuts, this proposal appears to be consistent with the definition of deficit reduction that *you and OMB Director Panetta endorsed during your confirmation hearings last month.* And, there is no doubt that this proposal is far better than the plan the President has proposed.

CONCLUSION

This is serious business. The campaign is over. The American people have a right to know what is really in the President's plan, but we still don't have all the details.

Later, I plan to ask you a series of fairly detailed questions about the president's plan. By working cooperatively with you, I hope to learn more about how some of the specific provisions in the Clinton plan can create jobs, stimulate investment, or spur economic growth.



PREPARED STATEMENT OF ALAN GREENSPAN

As I have indicated to other committees of the Congress in recent days our burgeoning structural budget deficit, unless addressed, will increasingly threaten the stability of our economic system. Time is no longer on our side. At 5 percent of GDP, the current deficit is very large by historical standards. After declining through 1996, the current services deficit starts on an inexorable upward path again. On a cyclically adjusted or structural basis, the deficit has hovered around 3 percent of potential GDP for the last ten years, a phenomenon without precedent in our peacetime history.

I am encouraged that the President and the Congress are making serious efforts to restore a measure of balance to our fiscal affairs.

It is beguiling to contemplate the downtrend in inflation in recent years in the context of very large budget deficits and to conclude that the concerns about their adverse effects on the economy have been misplaced. Regrettably, this notion is dubious. The deficit is a corrosive force that already has begun to eat away at the foundations of our economic strength. Financing of private capital investment has been crowded out and, not surprising, the United States has experienced a lower level of net investment relative to GDP than any other of the G–7 countries in the last decade.

To some degree, the impact of the federal budget deficits over the past decade has been muted as we imported resources to help finance them. This can be seen in our large trade and current account deficits. However, we should not—indeed, we probably cannot—rely on foreign sources of funds indefinitely. If we do nothing, the markets will ultimately force an adjustment; by acting now to redress our internal imbalance, we can lower the risk of unpleasant stresses down the road.

I shall eschew, as I have in previous testimonies, comments on the specific elements of the deficit-reduction proposals currently under review by the Congress. I should like, nonetheless, to take the time you have made available, Mr. Chairman, to outline my views on the principles that should underlie current deliberations.

First, according to both the Office of Management and Budget and the Congressional Budget Office, deficits are likely to be held in check by relatively good economic performance over the next few years. But from 1997 on, budget outlays under existing law are projected to rise appreciably faster than the tax base. If such trends are not altered, stabilizing the deficit-to-GDP ratio solely from the receipts side, not to mention reducing it, will necessarily require ever increasing tax *rates*. This would surely undercut incentives for risk taking and inevitably damp the long-term growth and tax revenue potential of our economy. The gap between spending and revenues will not close under such conditions. Thus, there is no alternative to achieving much slower growth of outlays if deficit control is our objective. This implies not only the need to make cuts now, but to control the growth of future spending, so that it does not exceed, and preferably is less than, the projected growth in the tax base.

The thought expressed by some that we can inflate our way out of the budget deficit is fanciful. Aside from its serious debilitating effects on our economic system, higher inflation, given the explicit and implicit indexing of receipts and expenditures, would not reduce the deficit. As I indicated in testimony to the Joint Economic Committee in January, there is a possibility that productivity has moved into a significantly faster long-term growth channel, which would boost real growth and tax revenues over time. But even if that turns out to be the case, short of an increase beyond anything that we can reasonably anticipate at this time, productivity, in itself, would not be enough to resolve the basic long-term imbalance in our budgetary accounts. Thus, while economic growth is necessary to contain budget deficits, it regrettably is not sufficient.

In deciding how to pare a structural budget deficit, it is important to be clear on the different roles of boosting taxes, on the one hand, and cutting spending programs on the other. All feasible taxes, by their very nature, restrain business activity. Hence, excluding so-called sin taxes and possibly environmental taxes, increases in taxes can only be justified to finance expenditures that are deemed essential. The level and composition of outlays to be financed by revenues is, in our society, a political matter, as is also the degree of progressivity and incidence of taxation. But over the long run, it is important to recognize that trying to wholly, or substantially, address a structural budget deficit by increasing revenues is fraught with exceptional difficulties, and is more likely to fail than succeed.

All else equal, reducing the deficit would enlarge the pool of savings available for private capital investment. But investment will not automatically occur unless there are adequate incentives for risk taking.

A greater willingness of a society to consume less of its current income should lower real interest rates and spur such investment. But if risk taking is discouraged

through excessive taxation of capital or repressive regulation, high levels of investment will not emerge and the level of saving will fall as real incomes stagnate.

The process by which government deficits divert resources from private investment is part of the broader process of redirecting the allocation of real resources that inevitably accompanies the activities of the federal government. The federal government can preempt resources from the private sector or direct their usage by a number of different means, the most important of which are: (1) spending, financed by taxation; (2) spending, financed by borrowing i.e., deficit spending; (3) regulation mandating private activities such as investment in pollution control or safety equipment, which are likely to be financed through the issuance of debt; and (4) government guarantees of private borrowing.

What deficit spending and regulatory measures have in common is that the preemption of resources, directly or indirectly, is not sensitive to the rate of interest. The federal government, for example, will finance its budget deficit in full, irrespective of the interest rate it must pay to raise the funds. Borrowing with government-guaranteed debt may be interest sensitive, but the guarantees have the effect of preempting resources from those without access to riskless credit. Government spending fully financed by taxation does, of course, preempt real resources from the private sector, but the process works through channels other than through real interest rates.

Purely private activities, on the other hand, are, to a greater or lesser extent, responsive to real interest rates. The demand for housing, for example, falls off dramatically as mortgage interest rates rise. Inventory demand is clearly a function of short-term interest rates, and the level of interest rates, as it is reflected in the cost of capital, is a key element in the decision on whether to expand or modernize productive capacity. Hence, to the extent that the demand for saving exceeds its supply, interest rates will rise until sufficient excess demand is finally crowded out.

The crowded-out demand cannot, of course, be that of the federal government, directly or indirectly, because federal government demand does not respond to rising interest rates. Rather, real interest rates will rise to the point that private borrowing is reduced sufficiently to allow the entire requirements of the federal government, including its on- and off-budget deficits and all its collateral guarantees and mandated activities, to be met.

In these circumstances, there is no alternative to higher real interest rates diverting real resources from the private to the public sector. In the short run, nominal short-term interest rates may temporarily be held down if the Federal Reserve accommodates the excess demand for funds through a more expansionary monetary policy. But this will only produce greater inflation and, ultimately, have little, if any, effect on the allocation of real resources between the private and public sectors.

In such an environment, inflationary forces too often lead to increased risk premiums, higher real interest rates, and a higher cost of capital. This, in turn, engenders a foreshortening of the time horizon of investment decisions and a decreasing willingness to commit to the long term, a commitment that is so crucial to a modern technologically advanced economy. Structural budget deficits and excessive collateral credit preemptions are symptoms of a society overconsuming and undersaving and underinvesting.

While there is no substitute for political will in reining in outsized structural budget deficits, there are changes,- I believe, that could make the budget process more effective. In particular, it is worth reconsidering sunset legislation, which would impose explicit termination dates on spending programs. Expiring programs that still have merit should have no difficulty being reauthorized, but programs whose justification has become less compelling would not receive the necessary votes. Indeed, it is hard to imagine that sunset legislation would not lead to at least some improvement over the current situation, quite possibly fostering non-trivial budget savings.

It also would be useful to take a look at the current-services methodology for evaluating budget changes. A baseline estimate obviously is a necessary ingredient in the budget process that helps inform policymakers about the impact of policy proposals. However, the current services concept assumes that no further congressional, judicial, or bureaucratic actions will be taken to alter existing programs. This is quite unrealistic, but it would be of no particular significance were it not for the fact that the bias of such actions is patently toward more spending rather than less. Hence, merely owing to ongoing congressional deliberations, administrative rulings, and decisions, an add-on to the current services outlay estimates is required to get a better view of what might be termed the "expected" deficit of the future. It is not possible to know in advance which spending programs will be expanded, except that some will. In recent years, congressional current-services outlay estimates have consistently been adjusted upward in response to such technical reestimations of pro-

gram costs. Indeed, technical reestimates explain a significant part of the failure of the deficit to fall as contemplated at the time of enactment of the Omnibus Budget Reconciliation Act of 1990.

Finally, while I do not favor a balanced budget amendment on the grounds that it might be impossible to enforce, I would support a constitutional amendment, or even a legislative provision, that stipulates that all revenue and expenditure initiatives require supermajorities (for example, 60 percent) to pass both houses of the Congress. Combined with sunset legislation, such a procedure could probably go far to neutralize the obvious propensity of our political system toward structural deficits.

Let me conclude by reiterating my central message. The deficit is a malignant force in our economy. How the deficit is reduced is very important; that it be done is crucial. Allowing it to fester would court a dangerous erosion of our economic strength and a potentially significant deterioration in our real standard of living. Fortunately, we have it in our power to reverse this process. This Committee has an important role in this process. Speaking as a citizen, I wish you well.

INDEX OF THE SIX ATTACHED CHARTS

No. 1. The history of taxing and spending in the U.S. from 1950 to 1992, rounded to the nearest full percent.

No. 2. The history of taxing and spending in the major industrialized nations from 1965 to 1990, rounded to the nearest full percent.

No. 3. The history of military spending from 1937 to 1997, in constant 1993 dollars.

No. 4. The history of spending, from 1950 to 1997, according to the Library of Congress, in four categories, in constant 1993 dollars:

(a.) National defense

(b.) Human Resources (soft goods: education, Medicare, Medicaid, Social Security, etc.)

(c.) Net interest (Interest on the government debt held privately. This does not include internal debt such as interest on the bonds held by the Social Security Administration.)

(d.) Other (hard goods: port, dams, airports, concrete. NOTE: There is an anomaly in this chart. The Library of Congress included the Savings and Loan bailout figures in the 1990–1993 spending column.)

No 5. The growth of the following four programs and their percentage of the Federal budget:

(a.) Social Security

(b.) Medicare

(c.) Medicaid

(d.) Other retirement (Primarily federal employees—civilian and military.)

No. 6. The baseline projections of the Congressional Budget Office (CBO) for Social Security, Medicare, Medicaid, other retirement programs, and net interest over the next 10 years.

FEDERAL, STATE/LOCAL, AND TOTAL GOVERNMENT TAXES AND SPENDING AS A PERCENTAGE OF GROSS DOMESTIC PRODUCT: 1950–1992

[In percent]

Year	Federal		State/local [1]		Total	
	Tax	Spend	Tax	Spend	Tax	Spend
1950	15	16	7	7	21	23
1955	17	18	7	7	24	25
1960	18	18	8	8	26	26
1965	17	18	9	9	26	26
1970	20	20	10	10	30	30
1975	19	22	11	10	29	32
1980	20	23	10	9	30	31
1985	19	24	11	9	29	33
1990	19	22	11	10	30	33
1991	19	24	11	11	30	34
1992	19	24	11	11	30	34

[1] This column does not include the receipt or spending of grants-in-aid from the federal government, which are counted as federal expenditures.

Source: ***Budget Baselines, Historical Data, and Alternatives for the Future,*** Office of Management and Budget, January 1993.

Note: All figures rounded. Totals may not add due to rounding. [Prepared February 23, 1993]

TOTAL GOVERNMENT TAXES AND SPENDING FOR SELECTED ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT (OECD) COUNTRIES AS A PERCENTAGE OF GROSS DOMESTIC PRODUCT, 1965–90

[In percent]

	1965		1970		1980		1985		1990	
	Tax	Spend	Tax	Spend	Tax	Spend	Tax	Spend	Tax	Spend
Switzerland	23	20	27	21	33	29	34	31	34	31
Japan	20	20	21	19	28	33	31	32	35	32
U.S.	27	28	29	32	31	34	31	37	[1] 32	[1] 36
U.K.	33	36	40	39	40	45	42	46	40	42
Germany	36	37	38	39	45	48	46	48	43	46
Canada	28	29	34	35	36	41	39	47	42	47
France	38	38	39	39	46	46	48	52	47	50
Italy	30	34	30	34	33	42	38	51	42	53
Norway	37	34	44	41	54	51	55	46	56	55
Netherlands	37	39	42	44	53	58	54	60	50	56
Denmark	31	30	42	40	52	57	57	59	56	58
Sweden	40	36	47	43	57	62	60	65	64	61

[1] 1989 data.

The percentages in this chart are compiled by the Organization for Economic Cooperation and Development, an association of the major industrialized countries of the world. The OECD uses a different method of calculating government expenditures and revenues than the standard budget accounting method the U.S. government uses. Therefore, while the figures in this table give an accurate comparison of the spending and revenue trends of our major competitors, these figures should not be compared directly to other data.

Note: All figures rounded.

Source: Prepared by Greg Esenwein of the Library of Congress from Organization for Economic Cooperation and Development data, updated January 1993.

NATIONAL DEFENSE SPENDING IN CONSTANT FY93 DOLLARS, AS A PERCENTAGE OF TOTAL FEDERAL SPENDING, AND AS A PERCENTAGE OF GROSS DOMESTIC PRODUCT: 1937–1997

[In billions of dollars and percent]

Year	Defense outlays	Percent of budget	Percent of GDP	Year	Defense outlays	Percent of budget	Percent of GDP
1937	$13	12	1	1967	$333	46	9
1938	14	15	1	1968	364	46	10
1939	15	12	1	1969	354	45	9
1940	21	18	2	1970	327	42	8
1941	77	47	6	1971	298	38	8
1942	280	73	18	1972	276	34	7
1943	670	85	38	1973	251	31	6
1944	819	87	39	1974	240	30	6
1945	888	90	39	1975	235	26	6
1946	456	77	20	1976	227	24	5
1947	125	37	6	1977	229	24	5
1948	86	31	4	1978	230	23	5
1949	118	34	5	1979	237	23	5
1950	120	32	5	1980	244	23	5
1951	185	52	8	1981	256	23	5
1952	333	68	14	1982	275	25	6
1953	370	69	15	1983	298	26	6
1954	352	70	13	1984	310	27	6
1955	300	62	11	1985	330	27	6
1956	283	60	10	1986	349	28	7
1957	287	59	10	1987	350	28	6
1958	282	57	10	1988	349	27	6
1959	282	53	10	1989	350	27	6
1960	276	52	10	1990	335	24	6
1961	276	51	10	1991	315	22	5
1962	292	49	9	1992	309	22	5
1963	297	48	9	1993 [1]	289	20	4.7

NATIONAL DEFENSE SPENDING IN CONSTANT FY93 DOLLARS, AS A PERCENTAGE OF TOTAL FEDERAL SPENDING, AND AS A PERCENTAGE OF GROSS DOMESTIC PRODUCT: 1937–1997—Continued

[In billions of dollars and percent]

Year	Defense outlays	Percent of budget	Percent of GDP	Year	Defense outlays	Percent of budget	Percent of GDP
1964	293	46	9	1994 [1]	271	19	4.3
1965	266	43	8	1995 [1]	263	18	4.1
1966	287	43	8	1996 [1]	256	18	3.9
				1997 [1]	250	17	3.8

[1] Estimated.

Comparison: 1993 defense spending if we spent the same percent of GDP on defense that we spent in 1944: $2.4 trillion

Note: All figures rounded.

Source: Prepared by Keith Berner of the Library of Congress, January 1993.

BUDGET OUTLAYS BY LARGE CLUSTER IN CONSTANT 1993 DOLLARS AND AS A PERCENTAGE OF TOTAL OUTLAYS, FY 1940–1997

[In billions of dollars]

Year	Defense		Human Resources		Net interest		All other		Total outlays
1940	$22	9%	$41	36%	$10	9%	$41	36%	$114
1941	76	48	37	23	10	7	36	22	159
1942	263	69	25	7	11	3	80	21	379
1943	627	80	12	2	15	2	133	17	787
1944	780	82	5	1	22	2	141	15	947
1945	876	88	4	1	30	3	89	9	998
1946	493	80	29	5	35	6	58	9	613
1947	128	42	54	18	30	10	95	31	307
1948	80	35	49	21	28	12	73	32	230
1949	107	37	53	18	28	10	99	35	287
1950	116	37	73	23	30	10	96	31	315
1951	209	58	48	13	28	8	77	21	361
1952	365	72	45	9	28	5	69	14	506
1953	387	72	43	8	29	6	76	14	535
1954	356	73	50	10	27	6	52	11	486
1955	300	66	59	13	27	6	69	15	455
1956	281	63	63	14	27	6	73	16	445
1957	288	62	69	15	28	6	79	17	464
1958	281	60	86	18	28	6	75	16	469
1959	274	55	96	19	28	6	100	20	498
1960	267	55	99	20	33	7	90	18	489
1961	274	54	114	22	32	6	92	18	512
1962	282	51	119	22	32	6	117	21	550
1963	243	47	123	24	35	7	117	21	519
1964	276	48	129	23	37	7	130	23	572
1965	252	45	131	24	38	7	138	25	559
1966	282	46	153	25	40	7	143	23	619
1967	336	48	178	25	43	6	147	21	704
1968	367	48	200	26	44	6	149	20	761
1969	348	47	220	30	48	7	124	17	739
1970	324	44	241	32	52	7	127	17	744
1971	292	39	282	38	51	7	125	17	750
1972	270	35	322	42	51	7	127	17	770
1973	242	31	336	44	54	7	139	18	771
1974	227	29	349	45	62	8	141	18	779
1975	226	26	425	49	61	7	161	19	873
1976	218	24	472	52	65	7	158	17	913
1977	217	23	478	52	67	7	165	18	927
1978	217	22	488	50	74	8	190	20	970
1979	221	23	497	51	82	8	181	18	982
1980	229	22	529	51	93	9	196	19	1,047
1981	243	22	550	51	110	10	185	17	1,088

BUDGET OUTLAYS BY LARGE CLUSTER IN CONSTANT 1993 DOLLARS AND AS A PERCENTAGE OF TOTAL OUTLAYS, FY 1940–1997—Continued

[In billions of dollars]

Year	Defense		Human Resources		Net interest		All other		Total outlays
1982	263	24	561	50	127	11	166	15	1,117
1983	283	25	578	50	129	11	165	14	1,154
1984	296	25	566	48	153	13	154	13	1,169
1985	320	26	599	48	171	14	164	13	1,255
1986	339	27	591	46	175	14	170	13	1,275
1987	346	28	592	47	173	14	147	12	1,258
1988	347	27	605	47	183	14	152	12	1,287
1989	350	26	619	47	195	15	160	12	1,324
1990	333	24	648	47	204	15	206	15	1,390
1991	293	21	690	49	207	15	218	16	1,407
1992	317	21	762	50	205	14	239	16	1,523
1993	291	19	779	51	214	14	231	15	1,515
1994	274	19	812	57	224	16	120	8	1,430
1995	265	18	837	58	227	16	113	8	1,442
1996	260	18	859	59	230	16	115	8	1,463
1997	254	17	899	61	232	16	100	7	1,485

Source: Philip Winters of the Library of Congress, January 1993.
Note: All figures rounded.

SELECTED HUMAN RESOURCES OUTLAYS IN CONSTANT 1993 DOLLARS, 1950–1997

[In billions of dollars and percent]

Year	Social Security	Medicare	Medicaid	Other retirement [1]	SS, Medicare, Medicaid, other retirement	Percent of budget	Total budget
1950	$5	....	....	....	$5	2%	314
1951	9	....	....	....	9	2	358
1952	11	....	....	....	11	2	505
1953	14	....	....	....	14	3	534
1954	17	....	....	....	17	4	485
1955	23	....	....	....	23	5	453
1956	28	....	....	....	28	6	444
1957	33	....	....	....	33	7	462
1958	39	....	....	....	39	8	467
1959	46	....	....	....	46	9	499
1960	54	....	....	....	54	11	489
1961	57	....	$1	....	57	11	513
1962	65	....	1	$12	77	14	550
1963	70	....	1	13	83	15	550
1964	72	....	1	14	87	15	575
1965	75	....	1	15	91	16	562
1966	86	$1	3	17	107	17	624
1967	88	11	5	18	122	17	711
1968	94	18	7	21	139	18	755
1969	103	21	9	22	155	20	747
1970	109	22	10	24	165	22	750
1971	124	23	12	28	186	25	754
1972	132	25	15	31	204	26	776
1973	155	26	15	36	232	30	778
1974	164	28	17	40	249	32	785
1975	172	34	18	48	273	31	876
1976	185	40	21	47	292	32	915
1977	196	45	23	49	313	34	930
1978	202	49	23	50	324	33	971
1979	207	53	25	54	338	35	981
1980	213	58	25	57	354	34	1,044
1981	230	65	28	61	383	35	1,087
1982	241	72	27	62	402	36	1,118
1983	252	78	28	62	420	36	1,156

SELECTED HUMAN RESOURCES OUTLAYS IN CONSTANT 1993 DOLLARS, 1950–1997—Continued

[In billions of dollars and percent]

Year	Social Security	Medicare	Medicaid	Other retirement [1]	SS, Medicare, Medicaid, other retirement	Percent of budget	Total budget
1984	252	81	28	62	424	36	1,171
1985	257	90	31	60	438	35	1,256
1986	262	92	33	62	447	35	1,276
1987	267	96	35	63	457	36	1,260
1988	267	96	37	64	464	36	1,289
1989	271	99	40	64	474	36	1,326
1990	276	109	46	64	495	36	1,392
1991	285	111	56	65	517	37	1,409
1992	296	122	75	65	558	37	1,524
1993	302	129	84	66	582	38	1,515
1994	308	138	95	67	608	43	1,429
1995	313	149	107	68	636	44	1,440
1996	318	163	119	69	669	46	1,460
1997	324	177	132	69	703	47	1,481

[1] Other retirement data is not available prior to 1962.

Notes: All figures rounded. Total may not add due to discrepancy in deflators. Undistributed offsetting receipts are not included. 1993–1997 figures are estimated.

Source: Based on data from Philip Winters, Library of Congress, January 1993.

PROJECTED CONGRESSIONAL BUDGET OFFICE REVENUES, OUTLAYS, AND DEFICITS: 1993–2003

[In billions of dollars]

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Revenues	1,143	1,215	1,291	1,356	1,414	1,482	1,540	1,600	1,664	1,733	1,804
Selected spending:											
Social Security	302	319	335	351	368	385	403	420	439	459	480
Medicare	146	167	188	211	234	259	286	316	350	389	432
Medicaid	80	92	105	118	131	146	162	179	198	219	240
Other retirement	61	64	67	71	75	79	82	85	89	93	97
Net interest	198	211	231	250	270	292	314	339	368	400	437
Total selected spending	788	852	926	1,001	1,078	1,160	1,251	1,341	1,444	1,559	1,686
Total spending	1,453	1,507	1,575	1,643	1,733	1,839	1,943	2,055	2,178	2,312	2,458
Selected spending as a percent of total spending	54%	57%	59%	61%	62%	63%	64%	65%	66%	67%	69%
Deficit	310	291	284	287	319	357	404	455	513	579	653

Source: ***The Economic and Budget Outlook,*** Congressional Budget Office, January 1993

PREPARED STATEMENT OF SENATOR ORRIN G. HATCH

[February 24, 1993]

Mr. Chairman, I am pleased to see the Committee meeting today to consider testimony relating to the Clinton Administration's economic proposal, and it is always a pleasure to see Secretary Bentsen again. I recognize what a tremendous personal effort the Secretary has put into this plan over the past months.

Over the past week, Mr. Chairman, we have heard a great deal of commentary, from both sides, on the perceived merits and the problems of the administration's plan. While there are many aspects of the Clinton plan that we will discuss today, I would like to focus my opening comments on what I see as being two of the biggest concerns for taxpayers in my home state of Utah.

The first concern is whether this deficit reduction plan will be the one that finally works. Unfortunately, this is not the first time we have tried to solve the deficit problem. Like the President, I don't want to assign blame because that will get us nowhere. In my view, though, any successful plan will have to do two things. First, it must remove the impediments to the economy" long term growth, which will increase revenues without the need for new taxes; and, second, it must limit spending growth.

Sadly, Mr. Chairman, the Clinton proposal seems to miss on both counts.

The true measure of the worth of a deficit reduction plan is not in the upfront projections, but in the actual results Unfortunately, it appears that the Clinton Administration has not learned the lessons of 1982, 1984, 1987, and 1990. If nothing else, the results of the deficit cutting plans enacted in those years show that the way *not* to cut the deficit is by increasing taxes. The tax increases in those four plans resulted in higher—not lower—deficits. The ill-conceived 1990 budget agreement should serve as an excellent reminder to all of us of the folly of increasing taxes as a way to deficit reduction. Instead of raising revenues by the projected $175 billion over 5 years, the new taxes, along with the effect of the recession that the agreement helped put us in, has left us $570 billion below the 1990 mid-session baseline. This will result in a revenue loss of $3.25 for every dollar the new taxes were supposed to generate.

My colleagues may remember that the 1990 agreement was supposed to be the budget deal to end all budget deals.

I am also particularly concerned about the effects of the higher taxes—especially the energy tax—on my home state of Utah. Make no mistake. The innocuous sounding numbers we heard from the President as a result of this tax are far from the final economic result on families. Like many other western and rural states, Utah will suffer a double or even a triple hit from the proposed BTU tax. First, Utahns will pay higher prices for energy directly, like other Americans. Second, since Utah is an energy producing state, the effect of the higher taxes will be multiplied throughout the economy and result in lost jobs and lower economic growth. In fact, the economy of two of Utah's counties depends almost exclusively on the viability of the coal industry. When a Utah coal miner loses his or her job because of this tax, do I tell them that it's their patriotic duty to contribute their livelihood to the deficit? Finally, let us not forget that a sizable portion of this energy tax will cause gasoline prices to go up, thus unfairly impacting those in rural states like Utah, who are called upon to shoulder a heavier load than the more urban states.

There is much more I could say, Mr. Chairman. And, needless to say, Utahns feel strongly about this. I urge my colleagues on the committee to consider all of these adverse ramifications.

PREPARED STATEMENT OF SENATOR ORRIN G. HATCH

[March 24, 1993]

Mr. Chairman, I am pleased to join you and our colleagues this morning in a hearing on the President's deficit plan. I want to express my warm welcome to Chairman Greenspan.

The Senate has a tremendous responsibility this year to carefully examine the deficit reduction plan the President placed before us last month. Nowhere is that responsibility placed more heavily than on this committee. Over 90 percent of the deficit reduction instructions to committees included in the currently pending budget resolution is for this committee.

Part of our responsibility in examining the President's deficit plan is to attempt to measure the effectiveness of the plan in reducing the deficit and to determine the impact of the plan's provisions on the economy as a whole as well as on various sec-

tors and regions Accordingly, we should ensure that the plan we vote out of this committee maximizes deficit reduction while minimizing impediments to economic growth and the burden on individuals and industries.

I have to say, Mr. Chairman, that in terms of both effectiveness and regional, sector, and income class fairness, I have serious doubts about the President's plan. The way I see it, my home state of Utah is in for real economic trouble from this proposal, if enacted as the President has indicated. I could go on at length about some of my specific concerns, and I am sure it will be a relief to my colleagues that I will not do that today.

Much has been said about the mix of tax increases and spending cuts in the President's plan. Proponents of the plan believe that we can best slay the deficit dragon with a combination of greatly increased taxes, on both the so-called wealthy and the middle class, and very limited spending cuts. Like many others on my side of the aisle, I have serious doubts that this approach will effectively cut the deficit much less spur economic growth and global competitiveness.

While no one in the Senate would argue with the need for serious deficit reduction this year, we have a duty to ensure that, before we take the steps that the President is urging, this plan will really work. In the short-run, this plan will have a profound impact on our still fragile recovery. In the long-run, we need to know the impact the plan will have on research, investment, growth, and job creation.

We promised the country a $500 billion deficit cut just three years ago. Some of our constituents may have forgiven us for not delivering. But, before we repeat the mistakes of 1990, let us carefully examine this proposal. To that end, I look forward to Chairman Greenspan's remarks and his answers to the questions of the committee.

PREPARED STATEMENT OF S JAY LEVY

The Clinton program is a commendable, genuine effort to improve the economy and dramatically reduce the deficit starting next fiscal year. Yet it runs a great risk. To reduce the budget deficit by $70 billion in 1994, whether by cutting expenditures, raising taxes, or a combination of the two, risks shoving the economy into a recession, thereby defeating any possibility of near-term deficit reduction.

The United States is suffering from excessive capacity. Office building vacancies continue to hover around 20%, General Motors and IBM continue to close plants; still solvent airlines are in dire straits. Similar stress plagues other industries from computers to hotels.

Excessive capacity, a stubborn problem in every industrialized country, depresses private investment in plant and equipment. In the United States it is manifested in the smallest investment in new structures and equipment as a percentage of the gross domestic product since World War II (exhibits A and B).

Our economy did improve in 1992, the result of an increase in the deficit. President Bush in his State of the Union Address in January 1992 announced a fiscal boost for the economy. He described cuts in withholding tax rates, but not tax liabilities, and stated that federal spending would be accelerated. These steps contributed to a $44 billion annual rate increase in the federal deficit (national income and product accounting) from the fourth quarter of 1991 to the third quarter of 1992.

Toward the end of 1992 and in early 1993 consumers gave the economy a further boost; their spending increased faster than their incomes. The personal saving rate, just over 5.0% in the first half, fell to 4.5% in the final quarter of last year.

The 1992 fiscal boost to the economy is being reversed in 1993. Because of the reduced withholding, consumers are now receiving substantially smaller income tax refunds and face higher tax payments on April 15 than would ordinarily be the case. Thus government during the next few months will be taking back much of the stimulus that it gave during nine months of last year.

Consumers also have other obligations. Leading credit card companies reported that charges in December and January ran about 20% larger than a year earlier.

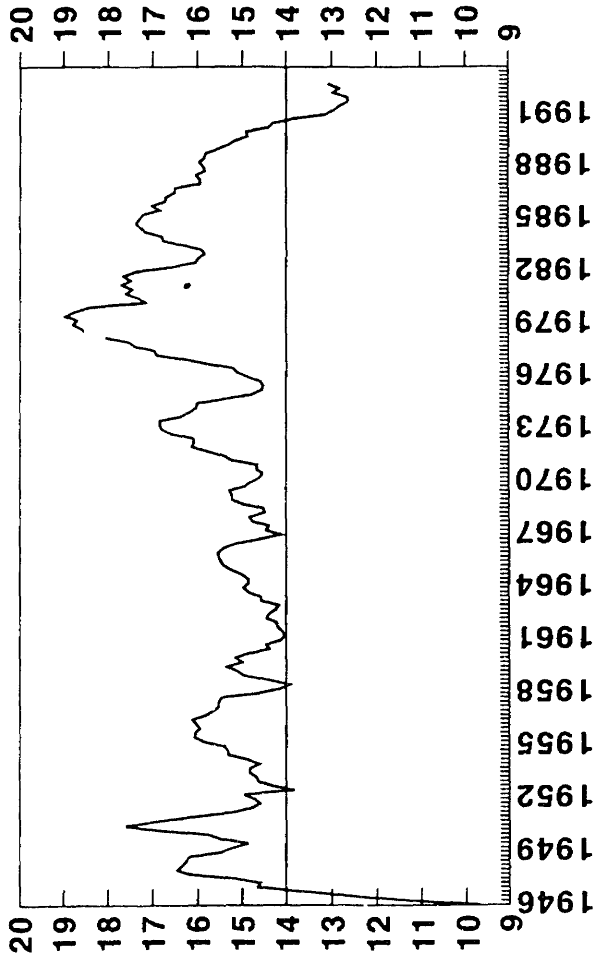
President Clinton's proposed stimulus for 1993 is needed to counter these negative developments. However it will not outweigh them and the effects of excessive capacity and low investment. The economy will be growing slowly, even weakly, as 1994 begins. Under these circumstances, any combination of spending cuts and tax increases that aims to reduce the deficit by $70 billion next year has at least a 60% chance of causing a recession.

Most economists recognize that both private investment and government deficit spending are economic stimuli. But little attention is paid to their effect on cor-

porate profits.[1] Profits increased $27 billion from the last quarter of 1991 to the third quarter of 1992. Without the $44 billion increase in the federal deficit, they would have declined. At their present level, profits are still too low to induce business to adequately revive investment in new structures and equipment.

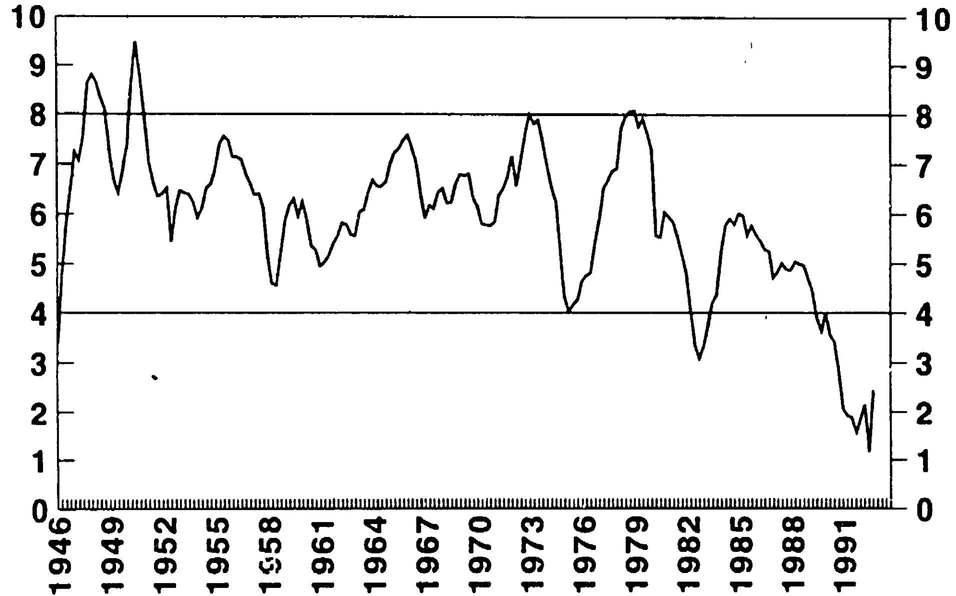
The stimulus provided by a federal deficit is a crutch supporting an economy wounded by excessive capacity in real estate, industry, and commerce, by related financial problems, and, therefore, by weak new investment. A robust rate of private investment in needed, new fixed assets is the necessary stimulus or source of profits for sustained, healthy prosperity in a capitalist economy.

The Clinton program is a bold effort to take control of the deficit. But it should provide for a contingent short-term fiscal stimulus—such as a temporary tax cut—if its ambitious efforts do start to set the economy back. We should also bear in mind that history and the nature of the present problem argue that a major business boom will develop in a few years and provide a great opportunity to reduce the deficit and even the debt.



[1] The "sources of profits" are described in S Jay Levy and David A. Levy, *Profits and the Future of American Society*, New York, Harper and Row, 1983.

EXHIBIT B.
NET PRIVATE FIXED INVESTMENT
AS A PERCENTAGE OF GDP



Source: National Income and Product Accounts

[Submitted by Senator Daniel Patrick Moynihan]

NATIONAL BUREAU OF ECONOMIC RESEARCH, INC.

MARTIN FELDSTEIN
President and
Chief Executive Officer

March 22, 1993

The Honorable Daniel Patrick Moynihan
United States Senate
464 Russell
Washington, DC 20510

Dear Pat:

I'm sorry that I could not appear before your committee on March 25th and that we didn't get to meet when I was in Washington last week.

I have been studying the President's plan to raise tax rates on high income individuals. My analysis shows that even a quite modest response of taxable income eliminates most of the revenue that the Treasury and the Joint Tax Committee predict. The attached Table 1 shows that the proposed tax rate changes would raise the tax payment (including the personal income tax and the 2.9 percent HI tax) by $3,305 for a couple with $180,000 of taxable income. But if they reduce their taxable income by just 5 percent, their tax payment would actually be $196 less than under current law. And if they reduce their taxable income by 10 percent, the Treasury would lose $3,697!

As you know, it isn't hard for a high income couple to reduce their taxable income by 5 percent or 10 percent through a combination of working a bit less, converting taxable compensation into untaxed fringe benefits, shifting portfolio investments into untaxed or low-taxed forms, etc.

I've done some work at the NBER with a tax simulation model like the one used by the Treasury and the Joint Committee. When I assume no behavioral response to the proposed increase in tax rates, I estimate that the higher income tax rate and the increased HI tax base would raise $26.1 billion a year (at the 1993 level of income). This figure is very similar to the Administration's estimate.

But if the higher tax rates -- the 25 percent jump in the marginal rate up to $250,000 and the 37 percent jump in the marginal rate above $250,000 -- cause these taxpayers to cut their taxable incomes by just 10 percent, the increased revenue would fall to only $6.6 billion. (These figures are shown in the attached Table 2.)

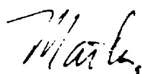
In other words, because of the way that the President's tax increase was designed, a modest 10 percent reduction in taxable income destroys about three-quarters of the revenue that would be collected if taxpayers did not reduce their taxable incomes.

I know that the Treasury and the Joint Committee staffs say that they take some behavioral response into account. They refuse to say how much behavioral response they take into account. They apparently won't even tell the CBO! But the basic fact is that the NBER no-behavioral-response estimate is very similar to the Administration's estimate so any behavioral response that they assume must be very small.

I believe that the sharp rise in marginal tax rates would cause a significant waste of resources and would reduce real incomes in the economy. These harmful effects of higher marginal tax rates cannot be justified by any corresponding gain in deficit reduction.

I have some ideas about how to revise the President's proposals in ways that would raise at least as much revenue with much less distortion and waste. I'd be happy to talk with you about them.

Sincerely,



Martin Feldstein

Table 1

Effects of Reductions in Taxable Income on Tax Liabilites of a Married Couple with $180,000 of Taxable Income

The following analysis shows how President Clinton's proposed increase in personal tax rates and of the HI tax base would affect the taxes paid by a married couple with $180,000 of taxable income under three alternative assumptions about their response.

Revenue Effect with No Behavioral Response	REVENUE CHANGE
Individual Income Tax: Income tax rates rise from 31 % to 36 % on the $40,000 of taxable income between $140,000 and $180,000	+ 2,000
HI Tax: The 2.9 percent HI tax rate is applied to income between $135,000 and $180,000.	+ 1,305
Net Revenue Effect	+ 3,305
Revenue Effect with 5 Percent Induced Decline in Taxable Income to $171,000	
Individual Income Tax:	
Income tax rates rise from 31 % to 36 % on the $31,000 of taxable income between $140,000 and $171,000	+ 1,550
No income tax collected at 31 % on the $9,000 of previously taxed income between $171,000 and $180,000	- 2,790
HI Tax: The 2.9 percent HI tax rate os applied to income btrween $135,000 and $171,000	+ 1,044
Net Revenue Effect	- 196
Revenue Effect with 10 Percent Induced Decline in Taxable Income to $162,000	
Individual Income Tax:	
Income tax rates rise from 31 % to 36 % on the $22,000 of taxable income between $140,000 and $162,000	+ 1,100
No income tax collected at 31 % on the $18,000 of previously taxed income between $162,000 and $180,000	- 5,580
HI Tax: The 2.9 percent HI tax rate is applied to income berween $135,000 and $162,000	+ 783
Net Revenue Effect	- 3,697

Testimony of Martin Feldstein, Ways and Means Committee, March 16, 1993.

Table 2

Aggregate Revenue Effects of the Clinton Plan: Implications of Alternative Behavioral Responses

	Projected change in	
	Personal Income Tax Revenue ($ billions)	Total Tax Revenue ($ billions)
No Behavioral Response	21.8	26.1
5 percent reduction in taxable incomes	12.2	16.1
10 percent reduction in taxable incomes	3.0	6.6
15 percent reduction in taxable incomes	-5.7	-2.5
9 percent reduction in taxable incomes below $250,000 and 13 percent reduction in taxable incomes above $250,000.	0.1	3.6

Source: NBER TAXSIM calculations reported in Martin Feldstein and Daniel Feenberg, "Higher Tax Rates with Little Revenue Gain: An Empirical Analysis of the Clinton Tax Plan," (To be published in Tax Notes, March 22, 1993.)

These projections are estimates of changes in tax liabilities at 1993 income levels. The "total tax revenue" projections include the 2.9 percent HI tax on incomes above $135,000. The analysis deals only with the proposed increase in individual income tax rates and in the HI tax base and does not reflect the proposed changes in the taxation of Social Security benefits, in the alternative minimum tax and in other tax rules.

Statement of

Martin Feldstein
Professor of Economics, Harvard University

before the

Committee on Ways and Means, U.S. House of Representative
March 16, 1993

Thank you, Mr. Chairman. I am pleased to testify before this committee again today.

I have appeared before you on several occasions over the past decade to advocate tough deficit reduction policies. Unfortunately, the problem is still with us.

I was very pleased therefore by the emphasis that President Clinton put on deficit reduction in his address to the Congress and the nation last month. He spelled out the importance of reducing the government deficit and the resulting borrowing, so that funds can remain in private hands to finance additional business investment that can raise productivity and the future standard of living of the American people.

I was however very disappointed by his specific proposals. After analyzing his plan, I have reached two principal conclusions:

First, the President's deficit reduction plan is totally inadequate. Contrary to its claim, it would actually leave the full-employment deficit substantially higher in 1997 that it is today.

Second, the President's proposal to raise marginal tax rates on high income individuals would produce little or no additional revenue but would weaken the economy and waste scarce investment dollars.

Let me now explain both of these conclusions.

The President's Deficit Reduction Plan

- A realistic analysis of the President's proposals indicates that the actual deficit reduction in 1997 would be less than $50 billion, not the $140 billion that his plan claims. Even that $50 billion estimate depends on several favorable assumptions, including the assumption that the new spending that the President calls "investments and incentives" would be limited to the $55 billion in 1997 that is indicated in the economic plan.

- The resulting deficit would be at least 3.9 percent of GDP, even assuming that the economy is back at full employment in 1997. By comparison, the Congressional Budget Office has estimated that last year's 1992 full employment deficit was only 3.3 percent of GDP. In other words, the deficit problem would grow substantially worse over the next four years.

- A deficit of that magnitude would absorb nearly two-thirds of the private saving in our economy. As a result, the rate of investment would not keep pace with the growth of the labor force, dragging down productivity.

- The national debt is currently more than 50 percent of GDP and that share would still be rising in 1997 under the Clinton plan.

My conclusion that the projected 1997 deficit reduction is realistically at least $90 billion <u>less</u> than the President claims is based on four considerations:

(1) As I will explain in a moment, the **higher marginal tax rates and the elimination of the income ceiling for the Medicare (HI) tax** are likely to produce $24 billion less in tax revenue in 1997 than the economic plan projects.

(2) The President's proposed **defense outlays** for 1997 are 25 percent lower than the outlays needed to maintain today's level of real defense spending. That's a cut of $79 billion in 1997 from the "constant real defense spending" baseline (more than double the $37 billion cut that the President's plan refers to by using a defense baseline that is actually $42 billion less in 1997 than today's real spending level).

I believe that the Congress will not be willing to make such a drastic cut in defense spending at a time of increasing military uncertainty and conflict around the world and a new global proliferation of arms and ballistic missiles. If Congress votes a 15 percent real cut in defense spending over the next four years instead of the 25 percent cut projected by the President, defense outlays will be $30 billion more in 1997 than the Administration plan projects.

(3) Of the $60 billion of projected **nondefense "spending cuts"** for 1997, nearly $30 billion are for the kind of wishful-thinking management improvements that purport to save money without program reductions or increased user charges. While such projections make budget bottom lines look good, they somehow never happen in practice.

(4) These three adjustments to the President's budget projections add $84 billion to the projected 1997 deficit and smaller amounts to the deficits in the intervening years. The result is a larger national debt in 1997 than the administration forecasts and therefore $9 billion more of **debt service costs** in 1997.

The result is $93 billion less in deficit reduction in 1997 than the Clinton plan projects. Note that this assumes that all of the revenue projections other than the taxes on high income individuals are accurate and that new spending programs (including the health program that is not even part of the economic plan) do not increase outlays more than the $55 billion projected for 1997.

The Proposed Increases in Personal Tax Rates

- The President's proposal to raise marginal tax rates on high income individuals would produce little or no additional revenue but would weaken the economy and waste scarce investment dollars.

- Consider the effect of the President's proposed tax rate increase on a married couple with $180,000 of taxable income. If they respond to the proposed 25 percent jump in marginal tax rates (from 31 percent today to 38.9 percent including the HI tax under the Clinton plan) by cutting their taxable income by only 5 percent, the Treasury would actually collect less revenue from them under the Clinton plan that it does today.

As members of this Committee know all too well, a high income couple could easily achieve a five percent or ten percent reduction in taxable income by a combination of working a bit less, transforming taxable compensation into untaxed fringe benefits, shifting investments from taxable bonds and high dividend stocks into untaxed municipal bonds or low dividend stocks, increasing their home mortgage interest deduction and investing the borrowed funds in low tax investments, etc..

The attached Table 1 shows how a relatively small behavioral response to the jump in marginal tax rates would actually reduce the couple's tax liability under the Clinton plan relative to their liability under existing tax rates. Instead of the $3,305 of additional tax revenue that would be collected if there were no behavioral response, a five percent reduction in taxable income would reduce the couple's tax payment below what they would pay under current tax rates by $196 while a ten percent reduction in taxable income would reduce the couple's tax payment by $3,697.

- Since half of the taxpayers with incomes over $140,000 have incomes below the $180,000 level used in this example, this example shows that even a 5 percent reduction in taxable income would mean that the majority of taxpayers who would face higher tax rates under the Clinton plan would actually pay less tax than they do under the current tax law.

- These examples indicate the importance of taking the behavioral response of taxpayers into account in evaluating the revenue effects of the President's proposed tax increases. I have now done this in collaboration with Dr. Daniel Feenberg, a colleague at the National Bureau of Economic Research (NBER). Our study is based on a computerized sample of almost 100,000 anonymous individual tax returns.

The computer simulation model that we use (the NBER's TAXSIM model) provides estimates similar to those produced by the staffs of the Treasury and the Joint Tax Committee and can also be modified to show the effects of alternative assumptions about how taxpayers respond to changes in tax rates and tax rules.

- The NBER study is described in a report that is attached to this testimony and that will be published in the March 22nd issue of Tax Notes ("Higher Tax Rates with Little Revenue Gain: An Empirical Analysis of the Clinton Tax Plan").

Our simulation analysis indicates that the higher tax rates and the expanded Medicare tax base in the President's plan would raise taxes by a total of $26 billion a year (at 1993 levels) if taxpayers do not respond to the sharp rise in marginal tax rates. This figure is consistent with the revenue estimate made by the Clinton Administration.

But the assumption that taxpayers do not change their behavior when confronted with marginal tax rates that are 25 percent higher than they are today (or 37 percent for those with incomes over $250,000) is clearly wrong. If these substantial increases in marginal tax rates cause taxpayers to reduce their taxable incomes by just 10 percent, the additional revenue collected by the Treasury would be less than $7 billion a year.

These figures are shown in Table 2 which distinguishes between the effect on total revenue (column 2) and the effect on revenue excluding the HI tax. (column 1).

These calculations make no allowance for the adverse effect on tax revenue of the slower pace of economic recovery that is likely to result from the Clinton plan.

These adjusted revenue estimates have important implications for the Administration's deficit projections.

- The Administration projects a net deficit reduction of $39 billion in 1994, of which more than $30 billion is projected to come from the higher tax rates on high income individuals. Correcting only the Administration's estimate of the likely increase in the tax revenue reduces the 1994 deficit reduction from $39 billion to only $17 billion.

- Applying this analysis to 1997 implies that the Administration's projection of $33 billion of additional revenue from higher tax rates on high income taxpayers should be reduced to $9 billion. The $24 billion difference between $33 billion and $9 billion is the amount that I referred to earlier in this testimony in my analysis of the President's deficit projections for 1997.

- The NBER report also reviews evidence on how taxpayers responded to the tax rate reduction in the early 1980s. If taxpayers are even half as sensitive to the proposed Clinton tax rate hikes as they were when rates were cut in the early 1980s, the additional revenue raised by the Clinton plan would be even less than the projections based on a ten percent reduction in taxable income.

The final row of Table 2 shows the effect on tax revenue if taxpayers are just half as sensitive to the increased tax rates as they were when rates were cut in the early 1980s. Those with incomes between $140,000 and $250,000 would reduce their taxable incomes by 9 percent but those with incomes over $250,000 (whose marginal tax rates would rise by 37 percent) would reduce their taxable incomes by 13 percent. The result would be a net revenue gain to the Treasury of only $3.6 billion a year, essentially all of which would come from the higher HI tax collections and none from higher individual income tax collections.

Because the sharp rise in marginal tax rates would distort taxpayers' decisions about work and saving and personal investments, it would cause a significant waste of resources and would reduce real incomes in the economy.

In my judgement, the NBER study shows that these harmful effects of higher marginal tax rates cannot be justified by any corresponding gain in deficit reduction.

The President's budget and tax plan were prepared in haste and without the help of the necessary staff that had not yet been appointed. I hope that the Congress will reject the President's proposal and that you will use the expertise of this Committee to cut future deficits by reducing spending on programs that are within the Committee's jurisdiction and by raising revenue in ways that are far less damaging than the President's proposal.

PREPARED STATEMENT OF MANCUR OLSON [1]

If our country is to get out of the deficit predicament, it first has to realize how it got into it. We fell into the fiscal hole we are in mainly because dramatically different theories, offered by people of opposing ideologies and political allegiances, embodied the <u>same</u> beguiling error. This error has rarely been recognized because it is in each case intertwined with good -- even great -- ideas. Sometimes when awed by great ideas, we have overlooked mistakes that would otherwise have been obvious.

The story starts with the great depression that hit the United States in 1929. Behind the high Fordney-Macomber and Smoot-Hawley tariffs, many American manufacturing industries had, through various collusions and trade associations, fixed high monopoly prices. In the sclerotic British economy that John Maynard Keynes observed most closely, wages in most industries were at set at cartel levels by rigid unions. When bank failures, monetary mismanagement, and other mistakes led to a sudden reduction in the quantity of money and the level of spending, those prices and wages that had been set by collective action of firms or workers could not be reduced quickly. Prices and wages that were already at monopoly levels in normal times became very much too high. With prices and wages in cartelized and collusive sectors far above market clearing levels, there was naturally widespread unemployment and excess capacity.

As incomes fell so did tax receipts, and initial efforts to raise taxes to balance the budget reduced spending and made things worse. Keynes brilliantly explained the flaw in this effort and rightly suggested fiscal and monetary expansion that would bring spending up to a level that would, in effect, not only re-establish the relative prices and wages that prevailed before the depression, but even inflate enough to bring the prices in the competitive, unorganized sectors to a level that largely eliminated the monopoly element in the relative prices of the organized sector. By quickly increasing spending, society

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[1] Mancur Olson is a professor of economics and Chair of the Center on Institutional Reform and the Informal Sector (IRIS) at the University of Maryland. IRIS is supported by the U.S. Agency for International Development. Olson's views are his own alone and he does not speak for U.S. AID or for the University of Maryland.

could undercut the organized interests that had fixed many prices and wages too high to clear markets without the political costs of confronting these interests directly. Keynes incautiously called his persuasive analysis of this special situation a "general theory."

In time, the over-simplification and dogmatization of Keynes's insights led to the prescription that any economy that was not at its maximum level of productivity should be treated with expansionary fiscal and monetary policies. Even the moderate underutilization of capacity and unemployment that resulted from everyday price and wage fixing should be treated by a hyper-Keynesian expansionary policy. There was almost always less than really full employment, so it was almost always possible, by this hyper-Keynesian theory, to get something for nothing. It was routinely possib e cut taxes and increase government spending without cost -- even with the benefit of higher levels of unemployment.

Naturally, in an environment guided by hyper-Keynesian policy, organized groups setting prices and wages and governmental price or wage fixing processes began to take it for granted that any higher prices and wages would be offset by a government inflationary policy. So, by indexation or other means, the organized interests that set prices and wages too high to clear markets in the first place, set still higher prices and wages. The expansionary policies were offset and the result was "stagflation": high inflation and high unemployment. The policy that promised the society something for nothing proved to be as costly as most "something for nothing" deals in private life.

There was inevitably an intellectual reaction to the failure of hyper-Keynesian fine tuning. It consisted mostly of renewed emphasis on another great idea: the familiar idea that firms and individuals are responsive to incentives and that free markets are the main source of economic efficiency and dynamism. Everyday experience underlined the importance of the point that the individuals respond to the incentives arising out of the marketplace, the tax code, and the government's subsidies and transfers. Of course, this idea was also susceptible to oversimplification and dogmatization.

The valid idea that taxes impair incentives came in some quarters to be the idea that lower tax rates would <u>increase</u> tax collections: to the beguiling notion that you can get something for nothing. But cutting tax rate not only means people get more reward for work -- it also means they can afford more leisure! Of course, no tax is paid on leisure, so government tax collections fell as tax rates fell. So through a kind of transvestite Keynesianism the nation was, on an incomparably greater scale than ever before, led into the continuing structural deficits that are now such a danger to our republic.

Under opposing theories, and under different ideological auspices, the American people have been gulled into accepting the illusion that the country can routinely get something for nothing.

This is an illusion that the nation can not survive very much longer. The deficit should be reduced and reduced now. The Congress should cooperate fully with President Clinton and give him all the deficit reduction he requests, if not more.

David S. Broder

Beware the 'Trust' Deficit

President Clinton's economic pl-- ad-dressed, he says, not to one deficit but to three: the budget deficit, the investment deficit and the social deficit.

Americans, he says, must shut down the drain of red-ink budgets that have virtually quadrupled the national debt in the past dozen years. At the same time, we must increase the investments that promise productivity growth and future prosperity. And there are, he says, unmet needs for AIDS research, public housing rehabilitation, preschool education and a score of other things that cannot wait.

Clinton is right to say all three deficits must be faced. But he is wrong—dangerously wrong—to do so in a way that worsens a fourth deficit: people's trust in their leaders.

The new president is being rightly praised for putting all these issues on the table in a comprehensive and coherent fashion. But if his diagnosis of the nation's needs is accurate, his prescription falls far short of a remedy. His plan just doesn't achieve its advertised goals. And it will avail Clinton little to push his economic program to passage if voters decide afterward that they have been misled about what it will do.

Doubts about his reliability plagued Clinton all through the campaign year and caused him to wind up with the lowest share of the popular vote of any winner since Richard Nixon, in a similar three-way race, 24 years earlier.

Now people are discovering that Clinton really played fast and loose with the facts in last year's campaign. When reporters challenged the assumptions and the internal mathematics of Clinton's campaign-season economic plan, "Putting People First," the Democratic nominee brushed off the questions. When Republicans said he was being deceptive, he issued indignant denials that ring hollow today.

"As administration officials have conceded, the higher tax bites actually begin at a figure closer to $20,000 than to $30,000."

Last Oct. 1, for example, when the Bush campaign ran ads based on the calculation that Clinton could finance his campaign promises only by raising taxes on every family earning more than $36,600 a year, this is what the Democratic nominee said:

"It is blatantly false. . . . It is a disgrace to the American people that the president of the United States would make a claim that is so baseless, that is so without foundation, so shameless in its attempt to get votes under false pretenses."

Last week Clinton, unembarrassed, put forward a revised program requiring tax increases the administration says will affect most families making over $30,000, one-sixth below the threshold George Bush had forecast. Clinton claims he has been forced to these steps by the unexpected $346 billion size of the deficit he inherited. But last July, he told Business Week the deficits would approach $400 billion.

The more serious problem is that the new economic plan, "A Vision of Change for America," looks almost as jerry-built as the campaign document it replaced. The administration's $30,000 threshold, for example, is not what most people understand as income, or even the Form 1040's familiar adjusted gross income line. It is a figure concocted to include all kinds of "non-cash income," including fringe benefits and even the imputed rental value of the family home. As administration officials have conceded, the higher tax bites actually begin at a figure closer to $20,000 than to $30,000.

These artifices were carefully concealed in Clinton's State of the Union address, helping him to gain a favorable first public reaction. Assiduous salesmanship on his part has so far sustained that image of evenhandedness.

But the more that is learned about the plan, the less solid it looks. As much as $54 billion of claimed spending reductions are actually increases in taxes or fees. More important, major cost-cutting moves are of dubious value.

The plan calls for more than $38 billion in Medicare savings over the next four years, not through any reforms but simply by cutting government payments to hospitals and doctors. In the past, when Republican administrations have proposed such "savings," Democrats have objected, properly, that hospitals and doctors will be forced to shift those costs to private patients and to raise their rates to make up for the loss. The argument is still valid. In effect, Clinton is proposing an additional "tax" on anyone unlucky enough to enter a hospital as a non-Medicare patient in the next four years.

Leon Panetta, the conscientious former House Budget Committee chairman recruited by Clinton as director of the Office of Management and Budget, knows these games for what they are. That may explain why he looks so uncomfortable defending such artifices, as he was forced to do repeatedly after Clinton's speech. But the accounts of the plan's formulation suggest that Panetta lost some crucial inside battles when Clinton sided with political aides who wanted to sugarcoat the message, as Clinton did during the campaign.

That is bad politics as well as bad economics. Clinton is likely to get a budget-economic package passed this year. Passing one that just pretends to fix the deficit is no fix at all. It simply moves the day of reckoning closer to the next presidential election. George Bush is the living evidence of the danger of following that course.

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[Submitted by Senator William V. Roth, Jr.]

PREPARED STATEMENT OF SENATOR JOHN D. ROCKEFELLER IV

For twenty-five years, I have worked to build the economy of my state, West Virginia. Recently, the battle got even harder when budget cuts hit us unfairly, and national policy almost left us in the dust. I commend the new Clinton Administration for a program that finally changes our course and, if we help, can start us on the road to recovery and growth. I don't think we have a minute to waste.

We need a genuine debate about what revenues are needed and what cuts are needed to meet goals like rebuilding our roads and reviving our schools at the same time we cut the deficit. The overarching goal is more investment -- private and public, and that must be done by spending more on federal programs that make us more competitive and by reducing the deficit to make room for the private sector to prosper.

There is no doubt that the American people expect us, and should expect us, to cut waste and abuse in government -- as a prerequisite for asking for a dime more of their taxes. Twelve years of Pentagon scandals, HUD scandals, and S & L scandals is twelve years too many.

And in this debate, I believe people will see that the President's program of deficit reduction is going to pay off in their lives, on Main Street, and not just Wall Street -- by bringing down interest rates on home mortgages and cars and college loans and by spurring business investment that will create new jobs and higher wages. People will have a chance to see that most of the critics who talk about not enough of this and too much of that are just talking, with no specific alternatives to back up the talk.

The debate is healthy because people will see that this program makes up for years of neglect of those things we need to restore our country's strength. People will have a chance to see the critics who are talking about waste but really are just trying to slash programs to invest in our children, to clean up the environment, or to develop technology so we can regain our edge in global competition.

When the debate is over, details may be changed, but the President's basic program will be enacted because the public will be persuaded that this program will restore our country and preserve its legacy for our children. I commend the Administration and Secretary Bentsen for his leading role within the Administration, and I look forward to working to see this program enacted into law.

PREPARED STATEMENT OF ROBERT J. SHAPIRO

In my judgment, approval of President Clinton's proposed budget program would substantially improve the prospects for the U.S. economy.

The program's strengths are three-fold. First, the program will alter the basic pattern of federal spending from the 1970s and 1980s by slowing the rate of growth of consumption-related spending while increasing public investment in common economic resources. Second, the program establishes structural fiscal discipline, primarily by increasing revenues and secondarily by reducing consumption-related public spending at a faster rate than it would increase public investment. Third, many of the President's initiatives incorporate new program designs which would have the effect of strengthening market dynamics.

However, in order to achieve the President's goals -- raise the trend growth rates of overall economic activity, net investment, productivity and incomes -- these three basic elements should be enhanced. Consumption-related federal spending can be curtailed more sharply; in certain cases, public investment can rise more dramatically; deficit-reduction can be greater, primarily through stronger restraints on spending; and efforts to strengthen markets can be expanded.

The President's program sets U.S. economic policy, for the first time in nearly a generation, on a course supported by economic data and reasoning. Individually and together, the program's three basic elements should promote private investment and competitive pressures for innovation and efficiency, on which improved U.S. performance in the global economy depends.

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The program's first strength is fundamental: the President's proposals have changed the basic terms of national debate from *whether* the federal budget deficit will be cut to *how*. There are disputes about the accounting, and skepticism about White House projections for reducing annual federal borrowing from $302 billion this year to $229 billion in 1998 is reasonable, based on past experience. The response of the U.S. bond markets, however, should reassure us that the program *would* substantially reduce the long-term structural budget deficit. To be sure, this result is achieved more through net tax increases than through net spending reductions, a choice to which capital markets are largely indifferent.

It is further reassuring that Congress, with the President's support, has signalled its intent to improve the original proposal. The House Budget Resolution would cut the deficit to $199 billion in 1998, and the Senate version would reduce the 1998 deficit to $214 billion.

In the aggregate, the House and Senate resolutions are quite similar. The House version contains $697 billion in spending cuts and tax increases over five years; 26 percent of these gains are given back for new investment spending and 10 percent for new tax incentives. The Senate version contains $638 billion in spending cuts and tax increases over five years; 19 percent of these gains are given back for new investment spending and 10 percent for new tax incentives.

Disaggregation reveals modest differences. The House resolution contains $1.50 in net revenue increases for every $1 in net spending cuts, while the Senate calls for $2 in net revenue increases for each $1 in spending cuts. Over the next five years, the House program would cut current programs by $411 billion (including interest savings), shift $182 billion of these savings to public investment, and so produce $229 billion in net spending savings. Over the same period, tax changes would raise $337 in new revenues and forfeit $70 billion in new tax incentives, leaving $267 in net revenue gains. The Senate plan relies less on spending cuts and more on new revenues. Over the next five years, the Senate plan would cut current spending by $333 billion and shift $124 billion to public investment, for net spending reductions of $209 billion. The proposal also would raise $360 billion in new revenue while offering $64 billion in new tax incentives, for a net revenue gain of $296 billion.

The imbalances in both versions between spending and revenue changes (if that's what they are) decline over time. By 1998, the House plan would produce $91 billion in net spending cuts as compared to $72 billion in net revenue increases. In the same year, the Senate version would produce net spending cuts of $73 billion and net revenue increases of $74 billion. Moreover, under both versions, federal spending

would grow substantially more slowly than the economy. Under current law, federal outlays are forecast to grow by 26 percent over the next five years, only marginally less than the 28.5 percent rate at which economy is expected to grow. By contrast, outlays would expand by only 19 percent over the next five years under the House resolution and by 20 percent under the Senate version.

There has been extensive comment about the program's early measure of deficit-increasing stimulus. In the second half of 1993, the program *would* raise the deficit by $7 billion -- barely one-tenth of one percent of the year's expected Gross National Product. In fact, the short-term increase in the deficit is likely to be less than forecast as falling long-term interest rates reduce federal interest payments and pare a few billion dollars off this year's deficit. By October, when the 1994 fiscal year begins, the President's program proposes a substantial measure of fiscal drag as the deficit baseline begins its four-year slide.

The program's short-term stimulus is of the sort that aims to spur not overall demand but only particular activities. In this respect, the first priority is business investment that can raise worker productivity. Half of the new stimulus for 1993 would come from a new tax credit for companies that buy new equipment. Small firms would claim a credit equal to seven percent of what they spend this year and next on new equipment; larger businesses operating on long-term investment schedules would get a seven-percent tax credit for the amount by which they increase their equipment spending this year and next over what they were spending in previous years.

Most of the rest of the 1993 program proposes increased spending, but much of it would be temporary. More than $5 billion is proposed for a variety of programs to help poor people, especially young ones: summer-school Head Start for poor tots and an expansion of regular summer school for older poor children; food and immunization for poor youth; public-sector summer jobs for poor adolescents (and for strapped elderly people); and special education for young Native Americans. When summer passes, most of this new spending ends. This part of the program also includes extended unemployment benefits, and if the President's plan helps to spur overall growth, extra jobless benefits also will be unnecessary by mid-1994.

The program also includes new spending for a series of traditional purposes -- veterans hospitals, Community Development Block Grants, the Economic Development Authority, Historic Preservation Museum projects, local homeless programs, and a few more. It all comes to little more than $3.5 billion over two years. Some of these funds will find good use and some will prove less valuable, but once again all of it is on a one-time basis.

The 1993 stimulus package also includes the first stage of the President's long-term investment program for upgrading basic U.S. economic performance. Most of it in 1993 goes to infrastructure: repair highways; update airport-safety systems and the weather service; support mass transit and Amtrak; improve rural-water systems, failing watersheds and sewage treatment; and jump-start development of a broad-band transmission network linking public facilities. The President's proposals for 1993 also would begin a long-term expansion of support for industry-led projects in generic research and development, new manufacturing processes, and energy efficiency and conservation.

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The long-term public investment program contains the first basic principle of the President's economic strategy: increase the share of national resources dedicated to strengthening the structural factors in economic performance. The President's case is that these measures will promote better-functioning markets and higher productivity by firms and workers.

The five-year investment program is comprised of more than 100 line items, but the thrust and most of the spending are directed to some 25 initiatives. With a few notable exceptions, these large initiatives are directed not to particular sectors or income transfers, but to aspects of economic life common to all market activity -- principally infrastructure, education and training of the workforce, and technological advance. To a substantial degree, the President also has proposed to program these new commitments in non-traditional ways, often with free-market elements.

It may also surprise many people to learn that the President's new spending ambitions are quite modest. The gross spending increases and tax benefits in both the President's investment program and the House resolution -- even before taking account of his proposed spending cuts and revenue increases -- total $253 billion over five years, or two-thirds of one percent of an expected G.D.P. of more than $33 trillion for the same period. The proportion under the Senate resolution, with $188 billion in gross spending increases and tax benefits, is even smaller. In all three cases, these proportions clearly cast government as a catalyst, not a substitute, for private economic activity.

New infrastructure investments totals less than $36 billion over five years, not $20 billion a year. New education and training commitments, at $56 billion over five years, are less than many had assumed during the 1992 campaign. Direct spending increases for research and development come to about $2.5 billion a year. The largest new claims on the budget come not from new spending at all, but from new tax benefits, mainly for business investment and wage subsidies for lower-income working people.

The first part of the investment program would increase funding for transportation, environmental and energy systems, a classical strategy for economic development by better connecting businesses and better binding together markets. It was Adam Smith who counselled that governments should build roads (and educate children) because markets alone fail to channel enough private resources to the common resources of any economy.

The Clinton infrastructure program begins with modest expectations for the present and optimism about the potential of future technologies. The President wants to raise funding for highway repairs and improvements up to the level agreed to by President Bush and the Congress in 1991. He would increase grants to expand the capacity of urban mass transit (mainly through bus purchases) and air-traffic control, without providing more federal subsidies to operate local systems. There's also a little more money for state programs to combat drunk driving, and a new substantial commitment to support high-speed rail development. There is perhaps one questionable proposal in the $11.5 billion, five-year transportation proposal: $154 million for airport-runway expansions which could better be funded by the airlines and travelers using them.

The President also proposes $12.0 billion in additional spending over five years for environmental infrastructure. Much of this increase incorporates a market-sensitive strategy. For example, nearly $7 billion goes to extend the current wastewater treatment program and to create a new drinking-water program (mainly to replace municipal water-distribution pipes made of lead). In both cases, the programs do not provide a new stream of unfettered funding, but rather rely on state-based revolving funds. Under this approach, states will have to provide 20 percent matching payments, and all of the proceeds would be *lent* to communities; in turn, their repayments are to be used to capitalize new loans. Of the rest of the new environmental spending, a substantial share goes to research and development. To be sure, there also is additional spending less directly-related to economic productivity: over the next five years, $325 million is earmarked for planting trees, and $2 billion to "improve" national lands. All told, these proposals claim less than 20 percent of the President's environmental initiative.

The President also proposes $4.6 billion over five years in additional spending for energy programs. Nearly two-thirds is earmarked for research and development -- conservation and renewable-fuels, advanced neutron and fusion-energy research, and the like -- and some of that includes cost-sharing by the private sector. Another quarter of the new energy money is earmarked for upgrading the energy efficiency of federal buildings across the country, which could prove to be a sound investment. Even the one traditional element not related to economic performance -- $375 million more over five years for state programs to help low-income people weatherize their homes -- will require state-matching payments.

The program also includes $5.3 billion in additional funds for community development over the next five years. Once again, the President, in the main, has adopted approaches that rely on or strengthen market signals and dynamics. More than $4 billion of the total is in enterprise-zone tax benefits; and while we should be cautious about the efficacy of this approach, it is time to test it as an alternative. As innovative and perhaps more promising is the President's plan to fund a network of non-profit Community Development Banks at a five-year cost of $470 million, in order to offset a current market failure which stifles pri ate lending to businesses and people in blighted areas.

His budget also calls for $23.7 billion in additional resources over five years to promote technology and business development. Less than four percent of these new funds would be earmarked to subsidize a troubled sector (NASA research for civil aviation and short-haul aircraft). Instead, one-third of these resources are reserved to cover the cost of extending the current tax credit for businesses that increase their own spending on R&D; most of the rest is designated to support university-based research, private R&D in dual-use defense technologies, a network of centers to help U.S. manufacturers learn about and apply new production technologies, and an ambitious initiative to modernize and automate the government's own operations.

Private investment receives additional tax-code support in the new budget. The small-business tax credit for investing in new equipment is retained after the 1993-94 stimulus program ends. Investors would gain a capital-gains tax incentive for investments that capitalize new businesses, addressing entrepreneurs' chronic shortage of funds. The largest item by far in this area -- nearly $27 billion over five years -- is President Clinton's proposed expansion of the Earned Income Tax Credit (EITC), in order t s renghten current incentives for poor people to work.

The largest broad area of new spending is education and training, based on the President's view that the skill level of a nation's workers is an important factor in global competitiveness and the one which government can most affect. Education and training would receive some $55 billion over the next five years in new funding and tax benefits. More than $20 billion is earmarked for a series of innovative education reforms -- including public-school reform, a national-service program that would exchange college-tuition support for a student's commitment to perform community service, and new apprenticeship programs to provide non-college-bound high-schoolers with skill training. Details have not yet been released, and it is vital that the finals designs of these initiatives justify the major investments proposed by the President.

This part of the program also includes equally substantial funding to retrain workers who lose their jobs due to import competition, defense cut-backs or general lack of skills. It is vital that the Administration evaluate carefully past approaches for government training and retraining efforts, which often have yielded fewer benefits than hoped or predicted. The President's pledge to raise the growth rate of productivity also will require steps to ensure opportunities for all workers to upgrade their skills on an on-going basis. The mandate proposed by President Clinton in 1992 would be a sound step in this direction.

Finally, the program includes substantial increased funding in other areas which are not strictly considered to be economic investments, such as housing and health care. Here, too, the President's initiatives avoid many of the problems of traditional direct spending. For example, of $9.6 billion additional funding slated for housing needs over five years, less than $800 million is earmarked for the programs that build and operate public housing. However, some of the approaches advanced here are problematic, as means of promoting productivity and growth. Nearly 60 percent of the new commitment for housing goes to tax incentives for investors in low-income housing, for operators of multi-family rental units, and for states that float mortgage-revenue bonds. There is substantial evidence, however, that the low-income-housing tax credit is not very efficient and often provides investor windfalls, and in some states mortgage-revenue-bond programs provide subsidized loans for affluent people. Most of the rest of the new housing funding is earmarked for innovative purposes, such as housing vouchers, low-income tenant-ownership programs, and anti-crime efforts in public housing.

The last area in the President's proposed budget is the provision of $36.4 billion over five years for new health-related spending. Roughly one-third is earmarked for more food stamps, one-third for public-heath programs such as childhood immunization and AIDS research and education, and the remainder for a variety of long-standing programs for rural health, veterans hospitals, and drug-abuse treatment. These expenditures should not be expected to generate direct net economic benefits, but rather should be evaluated as social policy.

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On the deficit-reduction side of the budget program, the President's proposals sustains a preference for reforms which can strengthen the operations of markets.

The President's savings are, in the main, driven by three basic principles. First, in the aftermath of the Soviet Union's dissolution, future Pentagon budgets can safely reflect a sharp decrease in the nature of the threat to U.S. security.

Second, domestic government programs and operations should operate on sensible economic or business principles. This effort begins with the President's requirement that government manage itself on smaller administrative budgets, with 100,000 fewer permanent positions, and more modest automatic salary increases. Next, many industries using the services of taxpayer-supported federal agencies are asked to begin paying for them. For example, the investment community would fund the operations of the Securities Exchange Commission and the Commodity Futures Trading Commission; pharmaceutical firms would pick up more of the costs of the Federal Drug Administration; state-insured banks would pay for FDIC auditing services; and utilities would pay the Energy Department's costs for enriching their uranium. The President also includes proposals to require more self-sufficiency from the Patent and Trademark Office, part of the Customs Service, some Veterans Administration life-insurance and lending programs, Federal Crop Insurance, federal grain inspections, and the Bureau of Alcohol, Tobacco and Firearms.

The President's program broadens this critique of taxpayer subsidies to cover other areas of the budget: for example, raise the price of timber sales from national forests so they cover the government's costs; limit subsidies for wool and mohair producers to $50,000 per person; hike FAA registration fees for general-aviation aircraft; reduce postal subsidies for non-profit organizations; raise the fuel fee that helps finance federal-inland-waterway operations; increase recreation fees at National Parks and National Forests; add a royalty payment for mining on federal lands; target crop subsidies to families with non-farming income of less than $100,000; limit deficiency payments to farmers; limit additional payments for "overhead" costs to universities receiving research grants; auction off the public electromagnetic spectrum to television, radio and other users instead of giving it away; charge polluters, where feasible, for the costs of clearing-up their hazardous wastes; and more.

The President's proposal to reduce many long-standing subsidies is vitally important to the success of his economic strategy. Such reforms not only reduce the deficit; they also can strengthen the economy. The current structure of industry-specific tax and spending subsidies places sectors denied such special largesse at a competitive disadvantage in the market for attracting capital and labor, distorting the market economy's most basic activities. Moreover, over time, these subsidies can harm the industries they intend to help, by insulating them from the competition which ultimately drives innovation and productivity gains in a global economy.

Congress can strengthen the program by reducing subsidies further. For example, instead of reforming the premiums for Federal Crop Insurance for a five-year savings of $730 million, the program could be replaced by direct assistance when bad weather drives crop yields far below average, at savings of $2.4 billion. Instead of raising the fuel fee for companies using federal inland waterways, for a five-year savings of $1.3 billion, Congress should consider assessing a user fee that would raise $2.2 billion. Instead of raising FAA registration fees for a five-year savings of $211 million, Congress should examine the impact of an airline user fee for air-traffic control services, which could raise $6.8 billion. And if the President's proposed reforms of farm-deficiency payments were introduced this year instead of in 1995, the proposed $1.7 billion, five-year savings would rise to $3.9 billion.

I also endorse the President's call for substantial cuts in many programs of economically-dubious value, and his request for a limited form of line-item veto to enforce such judgments. The President's program would eliminate grants for building wastewater treatment plants in favor of the revolving fund, saving more than $6 billion over five years. Special payments to school districts where federal facilities reduce the local tax base would end, if parents working at the facilities live in other school districts. Grants for special projects funded by congressional edicts amendments rather than through competitive bidding or peer review are would be back. Funding for two major NASA projects, the superconducting collider and the space station, are to be scaled back or stretched out. These two projects operate in much like special subsidies, and if Congress were to eliminate them the savings would be reach $13 billion instead of $3 billion.

The third major aspect of the President's spending-reduction strategy is health-care reform for Medicare and Medicaid, the fastest-growing items in the budget. These reforms are both serious and structural: the savings in 1994-to-1998 would total $60 billion. There is necessarily a tentative quality to the proposals, because broad cost-containment reforms for the health sector presumably will overtake many of the provisions -- and produce both greater savings for Medicare and Medicaid and substantial additional costs to cover the 37 million people currently uninsured.

The outlines of the President's approach to health-care reform may be evident in his Medicare and Medicaid proposals. Nearly all of the proposed savings come from health-care providers of every kind, through changes that would cut payments to hospitals, skilled nursing facilities and home-health agencies; to doctors, insurers and drug companies, to medical schools, medical labs and medical suppliers. These reforms may presage some form of price controls on all providers. The President also calls for modestly-higher Part B Medicare premiums, a small step towards more burden sharing by patients. Last, the program would bar payments to doctors who, for example, refer patients to their own therapy centers, which may portend more regulation of business practices in medicine.

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Compared to the complex structure of proposed spending cuts and new investments, the revenues provisions in the President's program are straightforward. With one notable exception, the provisions are driven by the principle that a person's tax burden should rise with income.

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First, the personal income-tax rate for high-income people would rise: income above $180,000 for a couple ($140,000 for singles) would be taxed at 36 percent instead of 31 percent; income above about $250,000 would be taxed at 39.6 percent. The Treasury estimates that these changes should raise $125 billion over five years. Another $29 billion is expected from applying the Medicare tax (1.45 percent for both employers and employees) to all salaries instead of only to salary income of up to $135,000. Nearly as much again is forecast by raising the corporate tax rate from 34 percent to 36 percent, but only for 2,700 of the nation's 2.2 million corporations, with taxable income of $10 million or more.

A series of smaller reforms, many aimed at tax subsidies benefiting highly-paid executive or particular industries, are also part of the package. The current tax incentives for U.S. firms operating in Puerto Rico would end. Deductions for business meals and entertainment, lobbying expenses, country-club dues, and executive salaries in excess of $1 million would all be cut back or repealed. Securities dealers would have to declare the market value of securities they own.

Nothing is absolute in the law or economics of tax provisions, and prudential arguments can be made for and against all of these proposals. Nevertheless, there are two fundamental questions for any new tax proposal. First, who bears the additional burden? The answer in this case is principally the top 1.2 percent of the population and the top one-tenth of one percent of corporations. Second, would the reforms harm the economy? Lower taxes are always better for the economy than higher taxes, but lower deficits are equally better for the economy than higher deficits. As to the President's specific proposals, recent experience and data show that lower tax rates on wealthy people in the early and mid-1980s had no discernable net effect on American rates of investment, productivity, incomes or growth. Therefore, it seems probable that higher personal rates in the service of reducing the deficit should also have no untoward macroeconomic impact.

The program also would require that retired couples with incomes of $32,000 (and retired singles with incomes above $25,000) pay income tax on 85 percent of their social security benefits, instead of only 50 percent under the law today. This would clearly affect people of middle-class income. Regarding wealth, however, these same people are more upper-income: retired persons with incomes of $30,000 a year often $200,000 or more in income-producing assets to generate part of this income.

The President also proposes a broad-based energy tax that could raise about $20 billion a year, while encouraging environmental quality and energy conservation and independence. This provision seems to contravene the progressive principle long stated by the President, that so long as middle-class incomes are stalled or falling, their taxes should not rise. It clearly would produce an additional tax burden of $10 to $20 monthly for most people. However, if the entire program succeeds in restoring economic growth to drive up incomes, this burden would be quickly offset; if it doesn't, middle-class tax relief should be considered again. The President also proposes to offset the effect immediately for lower-income people by providing additional food stamps, and for moderate-income people by raising the income ceiling for EITC benefits to $30,000.

While the EITC is a sound program, I would urge some caution. Under the higher income-ceiling, the EITC would provide some wage subsidy for 30-to-35 percent of all workers, a potential economic distortion of some consequence. Instead, I would suggest that the current ceiling of $23,000 be retained, and the additional resources be used to provide limited tax relief for moderate-income people with young children, or more deficit reduction.

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PREPARED STATEMENT OF HERBERT STEIN [1]

The time is short and the subject is long. I will only set down briefly my opinions and preferences.

1. Significantly reducing the budget deficit is highly important. This is simply a matter of trustworthiness and courage in government. If all politicians aver than the budget deficit is the worst thing in the world and swear that they will reduce it and have the means to do it they should do it. Failure to meet such an elementary test contributes to the feeling of aimlessness and helplessness that infects our public life.

2. The Clinton package, now embodied in the budget resolution, will reduce the budget deficit if it is adhered to. It will not reduce the budget deficit if you do not adhere to it.

3. Senator Packwood has asked me, in a letter, whether the record does not show that raising taxes is ineffective as a way of reducing the budget deficit because expenditures will rise as much as revenue. I do not think so. The record shows that during the past twelve years we ran large budget deficits in times of peace and fairly high prosperity, something we did not do before. It shows that during this period we spent more than we taxed or taxed less than we spent, the two statements being equivalent. There is no law of nature, economics or politics requiring expenditures to exceed the revenues by 4 percent of GDP or by zero. Whether they do or not is up to you. You should not be predicting your own actions; you should be deciding your own actions.

4. The path of gradual deficit-reduction embodied in the budget resolution or even a more rapid path will not *tend* to slow down the return to high employment or prevent its maintenance once achieved. If there turns out to be any such tendency it is the responsibility of monetary policy, and within its competence, to prevent the undesired result from occurring.

5. The Clinton package is not the best of all conceivable budget packages. I could write a better package, and so could any man on this panel. But the question is whether you would enact them if we did write them. Probably not, alas. But I will tell you some ideas for a better package all the same.

6. The stimulus package is a mistake, in defense of which its supporters only say that it is very small, which is true. If economic conditions like the present ones are to be regarded as extreme emergencies justifying departure from the agreed-upon path of the budget we will never achieve the goal, because such conditions will occur again and again.

7. One great virtue of the Clinton package is that it breaks with the taboo against a President, or Presidential candidate, recommending a tax increase on a large proportion of the American people. This taboo has been a major obstacle to responsible budget policy in the past.

8. The great argument over the proportion of the deficit-reducing package that consists of tax increases rather than expenditure cuts is meaningless and demagogic. There is no general economic or political distinction between raising taxes and cutting expenditures and no general reason to prefer one over the other. Both are ways of taking money away from people, which is what has to be done to reduce the deficit, and the real issues are from whom and on what conditions.

9. The package should have provided for getting the deficit down to zero in six or eight years. The advent of a new Administration was the time to do that. That chance has obviously been lost. You should be on notice that another big deficit-reduction package is going to be needed in a few years, because even with the new package the deficit is going to turn up again sharply after a few years.

10. It would have been better to eliminate most of the new so-called "investment" programs contained in the budget. They would do less to raise productivity in America than application of the same amount of money to deficit reduction. They are part of a general policy of this Administration that favors government-targeted investment. That policy is a mistake. It is strange that a President who says that government doesn't work should want to give it new difficult responsibilities for which it shows no aptitude.

11. The only national objective of sufficiently high priority to justify increasing expenditures at this time is the correction of the conditions of poverty and social pathology in which a small but not insignificant proportion of our population lives.

12. The proposed increase in the rate of corporate income tax from 34 to 36 percent is a mistake. The double taxation of corporate income—once at the corporate

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and once at the individual level—is unfair and economically distorting and should not be made worse by an increase of the corporate rate.

13. Increasing the rates of individual income tax is a fair and, in general, efficient way to raise additional revenue. It would be better to start the rate increase at a somewhat lower level of income than is proposed in the Clinton package. On the other hand the proposed 10 percent tax surcharge on incomes in excess of $250,000 reflects and encourages an unnecessarily hostile attitude to people who earn moderately high incomes in the United States. The surcharge should be abandoned.

14. The energy tax is a reasonably harmless way of raising small amounts of revenue from each of a great many individuals. Applying the tax to energy used by business is a bad idea because it discriminates against certain types of business, especially if they face competition from other countries that do not impose a similar tax on business use of energy.

15. The various preferences for small business contained on both the revenue and expenditure side of the Clinton budget reflect a romantic and unrealistic view of the special role of small business as a source of jobs and innovation. They should be eliminated.

16. Senator Packwood has asked me in his letter what I think is a reasonable percentage of the GDP for government to be spending in the U.S. I don't think that question can be answered in the aggregate—that is, without looking at individual programs and judging whether they are worth while or not. I believe that if that were done we would find many programs that are not worth while and also some that should be increased. I believe that the net of this would be a reduction of spending relative to GDP, but I could not arrive at this conclusion simply by looking at the total number.

17. Senator Packwood has also asked me whether it is possible to reduce the deficit without making major changes in Social Security and other retirement programs, and/or health Care. I believe that it will not be possible to reduce the deficit substantially, especially when we get into the next century, without such changes. I believe that it will soon be necessary to give attention to at least two changes. One would be to reduce the enormous subsidy given to old people who are not poor through the Medicare system. The other would be to make health care benefits provided by employers taxable income to the recipients.

I will try to elaborate on any of these points in the question period. I also submit two recent articles of mine that are relevant to today's subject and that I would like to have included in the record.

Attachments.

THE WALL STREET JOURNAL WEDNESDAY, FEBRUARY 24, 1993

Budget Le(d)gerdemain

By Herbert Stein

In the time of Emperor Vespasian, the government provided urinals in the streets of Rome and charged a fee for their use. The emperor, seeking to reduce his budget deficit, decided to raise the fee. His son, a finicky fellow, asked the emperor whether the additional receipts should be considered a tax increase or a reduction of government expenditure for the provision of the facilities. To this the emperor made his famous reply (in Latin, the only language he spoke): "Non Olet!" The literal translation is, "It doesn't smell." But the meaning is, "It's all money, and it doesn't matter which side of the ledger you put it on."

I am reminded of this story by the current furor over the division of President Clinton's deficit-reduction package between tax increases and expenditure cuts. The Clinton people seem intent on showing that the expenditure cuts are equal to the tax increases, or nearly so. The opposition seems intent on showing that the tax increases are, say, five times as large as the expenditure cuts. This is all very peculiar, because we don't know whether some major items should be called tax increases or expenditure cuts and we don't know what practical difference these ratios make.

The leading case is the inclusion of a larger share of Social Security benefits in the taxable income of the beneficiary. Some people want to call this an expenditure cut; others want to call it a tax increase. There is no answer to the labeling question because the terms "tax increase" and "expenditure cut" are arbitrary, and no significant conclusion follows from what name we apply. The new treatment of Social Security benefits will not be good if we call it an expenditure cut or bad if we call it a tax increase. When I pay the additional amount next year it will not matter to me whether I have less money because my tax has been raised or because my benefit has been cut. It's all money that I won't have.

Doctors' Fees

But Social Security is only the most obvious case. The administration proposes to limit doctors' fees in order, as it says, to "cut expenditures." But couldn't that alternatively be called a tax increase on doctors? Is the freeze on federal salaries an expenditure cut or a tax on federal employees? Or look at the other side of the coin. The administration proposes to give a tax credit for certain kinds of investment. Is that a tax reduction or an additional expenditure to subsidize a chosen kind of investment? Suppose, as many have suggested, that a cap should be placed on the amount of employer-provided health insurance that is excludable from taxable income. Would that be a tax increase or the reduction of government expenditure that now promotes expensive health insurance?

The basic fact is that the government is involved in paying money out to people and taking money from people. The budget-reducing effort is an effort to reduce the net of this—the excess of payments out over payments in—by reducing the payments out and/or increasing the payments in. No realistic statement about the consequences or relative merits of reducing payments out or increasing payments in can be made without specifying the conditions of the payments. That is, unless we know to whom the payments are to be made or from whom the payments are to be received, and on what conditions, we know nothing significant about the transactions, whether we call them tax increases or expenditure cuts.

It will be said that tax increases depress the economy. It is now conventional wisdom in some circles that the 1990 tax increases caused the recession of 1990, as if we didn't have enough other explanations. This argument runs in part on the demand side. If you tax money away from people, they will spend less and that will depress the economy. But if the government spends less, that also depresses total demand. In either case the negative effect on demand may be offset by the positive effect of a smaller budget deficit on the availability and cost of capital. We used to have a theorem in economics that an equal cut of spending and revenues resulted in a net decline of demand. We may not be so sure of that anymore, but we are a long way from knowing the reverse.

> **Board of Contributors**
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> *The size of government and its danger are much better measured by the character of what it does, and especially by the selectivity of what it does, than by the aggregate numbers in the budget.*

A more important argument is made on the supply side. It is said that tax increases have bad incentive effects. Probably all taxes have incentive effects, but not all incentive effects are bad. Suppose, to take my favorite example, we were to cap the amount of health insurance that is deductible from taxable income. That would be a tax increase, and it would have the desirable effect of reducing the incentive to take so much of income in the form of generous health-insurance policies. Although the application of the energy tax to energy used in business is, in my opinion, a mistake, one can easily argue that the energy tax as applied to consumers would have good incentive effects. The proposed investment tax credit is, I suppose, a tax cut, but it is not at all clear that its incentive effects are good.

Expenditure cuts also have incentive effects, some good and some bad. Will the proposed controls on doctors' fees, part of the expenditure-cutting program, have good or bad incentive effects? I don't know. One can easily imagine doctors having an incentive to prescribe more procedures, if the price per procedure is curtailed, and that would probably be a bad incentive effect. On the other hand, economists have been arguing for decades, correctly, I believe, that cutting government expenditures for farm price supports would have beneficial incentive effects. And I suppose, or hope, that increasing expenditures to improve Head Start would improve incentives.

Surely we should look at the incentive effects of what the government does. But it is unrealistic to start with the presumption that tax increases have worse incentive effects than expenditure cuts without reference to the particular taxes and expenditures.

The most general argument is that we should oppose tax increases and favor expenditure cuts because big government is a bad thing. I don't suppose many people really believe that with respect to all functions of government, but I do not want to enter that argument here. It is relevant, however, to ask whether total expenditure is the proper measure of what we fear about big government, especially if we don't know what an expenditure is. Will the government be bigger and more dangerous if we call the taxation of Social Security benefits a tax increase rather than an expenditure cut? Surely not. Is the government bigger and more dangerous when it is spending $200 billion a year for interest on the debt than 25 years ago when it was spending $30 billion? Not on that account.

I would offer the proposition that the size of government and its danger are much better measured by the character of what it does, and especially by the selectivity of what it does, than by the aggregate numbers in the budget.

The government can collect hundreds of billions through a broad-based, general income tax with little distortion of the economy or power over individuals. But it can be much more dangerous if it collects less money in a system with preferences for the oil industry and the real estate industry, and the forestry industry and small business, etc. It can more safely spend hundreds of billions of dollars in Social Security benefits than it can spend $20 billion in highway funds that it will award at its discretion to particular areas and contractors. Those concerned about the size of government should try to apply more sophisticated analysis than repetition of the budget totals.

Where I Stand

I would like if possible to avoid being labeled a supporter of all tax increases and enemy of all expenditure cuts. I do not like some of Mr. Clinton's tax increases. I oppose raising the corporate profits tax and the application of the energy tax to business use. I regard the surcharge on quarter-millionaires as offensive, demagogic bravura. But I would favor an energy tax applied to consumers at a higher rate and capping the deductibility of health insurance benefits. On the expenditure side, I would be for a substantial cut in the Medicare subsidy. I am skeptical of the bride's bouquet of "investment" giveaways that the president tossed to the cheering Congress on Feb. 17.

But my main point is not about such things. I am trying to urge consideration of the realities of the budget proposal rather than partisan harangues exclusively consisting of shibboleths.

A former chairman of the president's Council of Economic Advisers, Mr. Stein is an American Enterprise Institute fellow.

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THE WASHINGTON ECONOMIST

BUDGET IMPERATIVES

By Herbert Stein

The need to stop the disintegration of budget policy and the opportunity to do so are both greater than at any time in many years. If this opportunity is not taken now, it will not soon come again. We will drift farther and farther from a desirable path, and the effort to get onto the path will be more difficult and potentially disruptive.

The weakening of budget discipline has, as nearly all Americans acknowledge, been going on for some time (see box page eight), and it has resisted numerous efforts at correction. We have abandoned the rule of the balanced budget, which I used to call "the old-time religion," but we have put nothing in its place. In remarks I made in 1967, I noted what I thought the long-term consequences of this development would be.

"One w uld expect that if fiscal decisions are free of overall restraints within some range, t e d. isions will gradually move to the edge of the range where expenditures are high, taxes are low, and the deficit is big. Decisions will be dominated by the political attractiveness of taxing less and spending more until the deficit reaches the size that the public considers shocking or until the economy reaches the rate of inflation that the country finds intolerable. These are both moving limits, mainly matters of habituation, so one could visualize continuously growing deficits and inflation as the result of the proce Or monetary restraint might not perm endless inflation, so this curb on rising deficits would not exist, but the consequences of the deficits would still be fe in the absorption of private saving to fi nance public spending and the consequent restraint of private investment

This forecast has surely come true The deficits have risen to levels that would once have been shocking. But th public's perception of what is a shockingly large deficit has risen too, so we a always shocked somewhat but never enough to prevent a further rise of the deficit, which accustoms us to a further rise, and so on. Monetary restraint has been sufficient to prevent the rate of inflation from accelerating, although not stabilize the price level. We now think that an inflation rate of 3 percent per year, doubling the price level in 24 yea, is price stability. Perhaps more important, the deficit has become a significant drain on private saving and thereby on private investment, contributing to the dreary prospect for income growth that now confronts the nation.

The Reagan Bush experience contributed much to this disintegration of fiscal policy. It was in this period, of course, that we became habituated larger and larger deficits. The Reagan period was a laboratory demonstration of the ability of the country to live with large deficits and still avoid the evils usually forecast—accelerating inflation and/or persistent stagnation.

In 1990, the economy did run into trouble and many people associated it with the deficit But we didn't know whether the problem w

MIKE LUCKOVICH FOR THE ATLANTA CONSTITUTION

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that the deficit was too large or that it was too small.

Before the Reagan presidency, it seemed that the president was the guardian of the fisc, as against the free-spending, tax-cutting Congress. Ronald Reagan decided in 1980 to give up that hair shirt approach to the presidency. He would make a big tax cut the centerpiece of his policy. That this shift in the role of the president occurred with Ronald Reagan was especially significant because it made overt what had previously been less obvious—that the attachment of conservatives to balancing the budget was only skin-deep.

The Reagan Bush team could not make a forceful case against budget deficits because they were so allergic to taxes. If deficits per se were really terrible, an increase in taxes to reduce the deficit might be an option, but they could not admit this. So the Reagan-Bush formulation of the fiscal objective was "deficit reduction through restraint of expenditures." This was not economically logical or politically saleable. There is no general difference in economic effect between a tax increase and an expenditure reduction. Particular tax increases have effects that will be different from particular expenditure reductions (perhaps better or perhaps worse from some standpoint) but nothing valid can be said about that without specification of the taxes and the expenditures. Politically, the proposition was not saleable because it looked like insistence on reducing the deficit by cutting the benefits of the poor and the middle class while protecting the rich from sharing the pain as they would if taxes were raised.

The Present Situation

Congress shares the blame for the degradation of budget policy after 1980. But irresponsible fiscal behavior has been a characteristic of Congress for a long time. What happened after 1980 was that the president started behaving like the Congress. That, however, is water over the dam. Where are we now?

> **The deficits have risen to levels that would once have been shocking. But the public's perception of what is a shockingly large deficit has risen too, so we are always shocked somewhat but never enough to prevent a further rise of the deficit....**

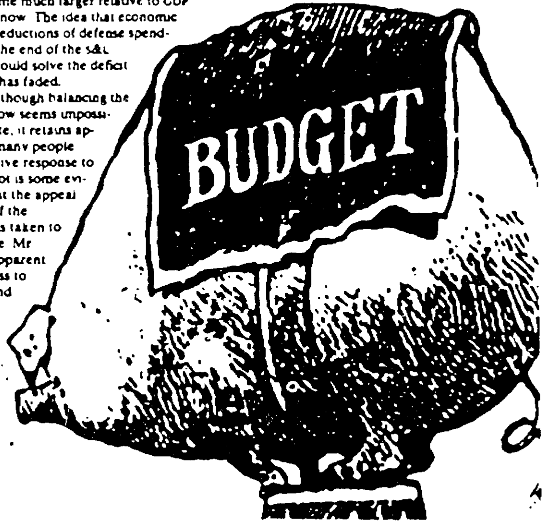
1. The budget deficit for this year, fiscal 1993, will be the largest ever.

2. Although there is the prospect that even with present policies the deficit will decline for a year or two, the best estimates are that the deficit will rise again thereafter and without strong measures will become much larger relative to GDP than it is now. The idea that economic growth, reductions of defense spending, and the end of the S&L bailout would solve the deficit problem has faded.

3. Although balancing the budget now seems impossibly remote, it retains appeal for many people. The positive response to Ross Perot is some evidence that the appeal remains if the promise is taken to be sincere. Mr Perot's apparent willingness to specify and support painful measures to reduce the budget deficit attracted many people to him, whereas Mr Bush's attempt to exploit the sentiment for balancing the budget by calling for a constitutional amendment was unpersuasive. Mr Bush had not supported visible or strong measures to eliminate the deficit, so his support for the amendment was seen to be hypocritical.

4. We seem to be groping our way to a better understanding of the economic significance of large continued budget deficits. There is no longer much talk about the inflationary consequences of such deficits or about the obstacle they pose to the achievement of high employment. The deficits are seen as a critical element in the choice between present consumption and future income—sometimes called the intergenerational equity problem. This is not a new view of the significance of deficits; indeed, it is very old. But it is more recognized among those who make national decisions and influence opinion than it has been for a long time.

We are, however, still a long way from knowing just how to translate that



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view into policy. We don't know what measure of the deficit is most relevant from this standpoint, how to calculate the quantitative trade-off between present deficits and future national income, and how to get such calculations taken into consideration.

5. The new president is less inhibited about raising taxes because of prior commitments or ideology and, therefore, has more flexibility to develop a package of measures to reduce the deficit.

6. For the first time in 12 years, we have a president and a Congress of the same party, and it may be the first time in 24 years that we have a Congress inclined to follow the president's lead.

The Clinton Budget Plan

The economic program submitted by President Clinton on February 17 is probably the most far-reaching effort ever made by a president to control the budget deficit. Still, in the light of the challenge and the opportunity facing him and the country, it is disappointing:

■ The proposed deficit reduction is much too small. Even on its own terms it would leave a large deficit in 1997 and, more important, the deficit would be rising thereafter. The deficit-reduction goal for 1997 is arbitrary. It provides no basis on which to stand and resist the inevitable temptations to whittle the reduction down still further. The program would have been more defensible if it had taken as its goal reduction of the deficit to zero, even if that had to be accomplished over six or eight years.

■ The program does not take advantage of some of the most reasonable options for reducing the deficit substantially. These include reducing the federal subsidy for Medicare, limiting or eliminating the exclusion of fringe benefits from taxable income, and cutting expenditures more sharply for the space station, for the supercollider, and for farm price supports. The energy tax, the broad-based levy that almost all would

The Puritan Ethic and the Economic Calculus

Someone, it may have been Abraham Lincoln, said that if we knew better where we have been and where we are, we would know better how to proceed. I think of that in connection with the decisions that now have to be made about the federal budget.

Rummaging through my old files recently, I came across a speech that I gave in May 1967 in which I tried to appraise budget policy. I believe that these remarks are suggestive of where we have been and where we are. In my 1967 speech, I outlined three stages in the history of budget policy, as follows:

• **The liberation of budget policy in 1933.** Herbert Hoover's budget policy in the depression had been inhibited by the gold standard and by the lack of cooperation from the Federal Reserve. Roosevelt changed that. He took the country off gold and took control of the monetary system so that he did not have to fear that even large budget deficits would have unwanted monetary consequences. This change was permissive. It freed the budget from previous constraints, but it did not say what budget policy should be.

• **The espousal, beginning in 1938, of a policy of trying to manage the budget to compensate for fluctuations of the economy.** The new government policy was to take positive fiscal action to achieve full employment, with the scale of the action being flexible and depending on the expected state of the economy. This step was a response to the wildfire spread of Keynesianism and was precipitated by the 1937 recession.

• **The domestication of fiscal policy in the years 1947 to 1949.** This was an attempt to establish some rules of budget policy as safeguards against the dangers inherent in unconstrained functional finance. One of these was that trying to adapt fiscal policy to new forecasts of changes in the economy—what was later called "fine tuning"—would turn out to be destabilizing rather than stabilizing, because of the unreliability of economic forecasts. Another was that the new policy, as implemented in the political process, would undermine the discipline of requiring expenditures to be matched by taxes. As a result, expenditures and deficits would rise excessively, with damaging effects upon growth in the long run.

The rule that emerged was that taxes should be high enough so that they would balance the budget or yield a moderate surplus when the economy was operating at high employment. This would leave room for deficits when the economy was in recession but would restrain the long-run rise of spending and deficits. A basic part of the argument for this policy was that the notion of balancing the budget still had emotional appeal in the country and that a rule invoking that notion, even in the watered-down form of balancing at high employment, might resist political pressures. The fiscal policies of the Eisenhower and Kennedy administrations conformed to this kind of rule.

When I made my speech in 1967 (three years after the Kennedy-Johnson tax cut), it seemed to me that we were passing out of the era of even this watered-down budget rule. The economists of that time believed that the rule unduly limited their ability to manage the economy. Walter Heller, President Kennedy's economic adviser, dismissed the balanced-budget rule as a "Puritan ethic." As soon as the rule began to bind, the Johnson administration abandoned it. But the Congress and other active forces in the country were not prepared to have their fiscal decisions dictated by econometric calculations from the Council of Economic Advisers.

So we were left, as I said in 1967, with "the specter of disintegration of fiscal policy. ... It is not simply that we have abandoned what little was left of budget-balancing. But that we have abandoned it without having accepted anything in its place."

pay, could have been imposed at a higher rate without a severe burden on anyone

■ The proposed increase in the rate of corporate profits tax, from 34 percent to 36 percent, only increases the inequity that results from the double-taxation of corporate profits and would be an obstacle to the growth of investment—one of the main goals of the program

■ The application of the proposed energy tax to the use of energy by businesses will also deter investment, because production that uses much capital tends also to use much energy. Taxing energy used by business will drive energy-intensive production—such as aluminum smelting—out of the country

■ The investment credit would be highly discriminatory among different kinds of capital—depending on their durability and among different businesses—depending on their history. The result is as likely to be a loss of efficiency as a gain.

■ The program is dotted with little giveaways, like tax breaks and soft loans for small business, and supports for particular ventures, like a high-speed train, that undermine the notion of a stern and comprehensive effort to deal with a national problem. In sum, these giveaways will cost tens of billions of dollars. Most of them could be properly described as "investments," which is how the president describes them. But many of these are unlikely to be as productive as the private investments that would result if the same amount of money were devoted to deficit reduction. In general, the strategy of the administration shows a preference for government investment or government-directed investment over market-determined private investment that is unjustified by our experience.

■ The selling of the program to the American public is heavily based on the notion that the more progressive the tax system is, the fairer it is. That is not only a simple minded view of fairness, it is also a dead end for budget policy. It means that when the economic limits of taxing the rich are reached there is no possibility of getting more revenue from the middle class, because that would reduce progressivity. In fact, this probably limits Mr Clinton's present program. He cannot put more burdens on the middle class without putting much more burden on the rich, and he recognizes that he must be close to the point at which more taxation of the rich is counterproductive

But—and this is a big but—the Clinton plan is the only deficit-reduction plan that has a chance of being adopted. Some people, including leading Republicans, will say that they have an alternative plan. That plan is to cut expenditures much more sharply than Mr Clinton proposes to do. But this plan is always described in general terms. It never specifies the particular large expenditures that are to be cut. The fact is that the proponents of such plans have no more stomach than Mr. Clinton does for attacking the large middle-class benefits that are the essence of the budget problem

> **The selling of the program to the American public is heavily based on the notion that the more progressive the tax system is, the fairer it is. That is not only a simple-minded view of fairness, it is also a dead end for budget policy.**

This judgment may be too pessimistic. Some leadership may arise on the Republican side of the Congress that would push for significant specific expenditure cuts. And if that happens, the president, given political cover by Republican support, may accept and possibly even welcome the cuts. In that case we could get a better program than the one the president has proposed

But at present there is no sign of such a development. There is now little chance of getting a bigger deficit reduction package than Mr Clinton's or even one just as large but with a better composition. But there is every chance to defeat Mr Clinton's package. Precisely those elements of the program that contribute most to reduction of the deficit will be most vulnerable because they are most painful to most people. Advocates for the elderly will be resisting the increased taxation of social security benefits. All kinds of users and suppliers will be resisting the energy tax. Unless some forces in the country and in the Congress are sufficiently concerned about the deficit to support these proposals of the president—however much they may dislike other parts of the package—the whole deficit-reducing effort could collapse

If this effort fails we will probably not see another one for some time. The lesson will be that the system rejects even a cautious attempt by a president to exercise fiscal responsibility and make a few tough decisions. And the public will have learned again that no one really cares and that all the talk about the national interest in reducing the deficit is only a cover for the struggle of everyone to get his

But if the present effort succeeds there will have been a demonstration of the willingness of the Congress and the public to accept some sacrifice. Some of the untouchables on both the expenditure and the revenue side of the budget will be seen not to have been so untouchable. Discussion of future steps to reduce the deficit can resume in a less demagogic and emotionally charged atmosphere. In that case we may yet say that 1993 was a turning point away from the disintegration of budget policy that has been going on for the past 25 years

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PREPARED STATEMENT OF SENATOR MALCOLM WALLOP

Thank you Mr. Chairman for holding this very important hearing, and thank you Mr. Bentsen for appearing before us to discuss the president's package. It is nice to be back on the committee.

Mr. Chairman, this hearing begins the review of two of the most important campaign promises of the Clinton administration—to reduce the federal deficit in half over four years and to provide middle-class families $60 billion in tax relief. The program we are considering today is vastly different from that promised in "putting people first." Instead of reducing federal spending, we are off on a new direction increasing domestic spending by $13 billion over the next four years. Instead of middle class tax relief, we are increasing taxes on everyone whose gross annual wealth exceeds $30,000.

I have some serious reservations about the president's plan. It lacks permanent, real cuts in federal spending that are absolutely necessary if we are to reduce the federal deficit. I will repeat the obvious—although Clinton promised during the democratic convention that he was a "new kind of democrat," the plan that he has presented to the American people clearly reflects the "tax and spend" policies of old democrats. It does not require perfect vision to realize that this plan does not reduce the deficit—that the new taxes will be devoted to new federal spending on an "investment" program.

Two short weeks ago, Mr. Clinton, himself, stated at the Detroit town meeting that deficit reduction means "we have more of your tax money to spend on the education of your children or on developing new jobs, or on health care." Since when is spending synonymous with deficit reduction? This is certainly a new definition—along the same lines as "spending" meaning "investment" and more "taxes" meaning "contributions." I simply do not understand how the lack of serious spending reductions coupled with dramatic tax increases will create jobs and stimulate the economy.

While I am extremely disturbed by the President's package, I would like to focus specifically on two tax proposals that will hit Wyoming constituents especially hard—the increase in individual income tax rates and the BTU energy tax. Both of these taxes are likely to have a negative impact on Wyoming's economy at a time when we can ill-afford it.

First, a 5-percent increase in individual income tax rates, from 31 percent to 36 percent for many individual taxpayers, along with increased energy costs from the BTU tax, will no doubt hurt small businesses. As you know, eight out of ten small businesses pay taxes as individuals, so an increase in individual rates will effectively raise taxes on millions of small businesses and family farms. These two groups are the backbone of Wyoming's economy. President Clinton has spoken about the important role small businesses play in creating new jobs and stimulating economic growth, and has proposed a permanent investment tax credit and a targeted capital gains tax cut. Yet, the very benefits achieved by these tax incentives are negated by the increased rates. How can small businesses be expected to invest in the economy when the revenues earned will be subject to more tax? this is not a tax on the rich, it is a tax on economic growth and middle America. At the very least we should be decreasing the payroll taxes which impact the costs to small business not adding to their burden.

Second, I have just come from an Energy Committee hearing on energy taxes where we were able to take a closer look under the hood of the administration's shiny new car. My colleagues on this committee may recall that my opposition to energy taxes goes way back and nothing has happened lately to change my mind. It simply doesn't make any economic sense.

Like the increased tax burden on small business, the BTU—that's defined as "Bill's taxing unit"—tax will have a devastating impact on Wyoming and all of rural America. On a per capita basis, Wyoming will be the hardest hit by the BTU tax than any other state. And don't think that consumers won't feel the impact of this tax. Because distances from town to town, job to home, neighbor to neighbor are tremendous in my high plans state, the energy tax will be a special burden on the mobility of the people of Wyoming. It appears to me that the net result of the new taxes and new spending will be to further burden low and middle income Americans—those people who were told the President was putting first. Last Congress the Energy Committee fashioned a comprehensive national energy strategy. This policy relies on the marketplace to establish energy prices and energy uses related to environmental requirements. The administration's BTU proposal would only serve to distort this strategy before it has had an opportunity to be of any benefit.

Mr. Chairman, we must enact real spending cuts before we consider any tax increases. I look forward to pursuing these and other questions with the Secretary today. I agree with many of my democrat colleagues that this program must undergo a transformation before it can become law.

PREPARED STATEMENT OF JOHN P. WHITE

Good moming, Mr. Chairman, Members of the Committee.

It is a privilege to be here, and I want to thank you for the opportunity to testify.

As a society we face great opportunities. The Cold War is ›ver; we live in a truly global economy; continuing improvements in technology offer ˛ ·e t benefits to mankind; and we in the U.S. are positioned as the wealthiest economy as well as the most powerful country in the world.

Paradoxically, we face a set of fundamental problems that must be dealt with now because we are threatened with long term economic decline. With that decline, we would lose our leadership. But more importantly, I am concerned that if we do not solve our problems we will be the first generation in the history of the Republic to leave this country worse off economically than when it became our responsibility.

Today, my emphasis is not on the U.S. as a world leader, but on you and me as good ancestors. At the rate we are going, our children and grandchildren will be left to live below their own capabilities in order to pay for our excesses. The American people recognize this inequity and are prepared to do their part to redress it. Having participated in the presidential election campaign, first with Ross Perot and then in support of the President, I am convinced that while the campaign rhetoric emphasized the immediate economic situation and the need for campaign and government reform, much of what was really being voted on was the need to change the economic fundamentals that we are here to talk about today.

I will not spend any time on the important institutional problems facing us such as education, health care, trade agreements and government inefficiencies, but rather, want to focus on the underlying economics . The most important of these is productivity. We experienced productivity growth between 1947 and 1973 of about 1.9 percent a year; from 1973 to 1992 it was only about 0.7 percent per year. Real wages, which are directly related to productivity, are actually lower today than they were in 1970. It is no wonder that people think they pay too much in taxes. And our saving rates are down around a pitiful 2 percent net with the deficit eating vo-thirds of all private savings. Our investments have shown secular decline. Frc.n 1980 to 1989, the average annual growth rates were 4.5 percent of GDP for the United States, 8 percent for Germany and 16 percent for Japan. And our long term economic growth (1965-1989) is no better: 2.8 percent for the U.S. and 5.5 percent for Japan.

What have we done in the face of all these problems? It is truly astounding but our reaction has been to go on a massive spending binge. When we entered the 1980s we had $1 trillion dollars in outstanding debt and now we have $4 trillion in debt. In fewer than fifteen years, we have moved from being the largest creditor country in the world to being the largest debtor country in the world.

Why have we as a free society behaved in a way unprecedented in our history? What did we think we were doing? Is it purely selfishness and greed? Have we no concern for our children, for preserving our legacy, for passing on the American dream?

What is to be done? I suggest that we do what we as a society have done before when faced with such challenges, as in the depression and as in the post WW II period. We need to significantly reform and restructure many of our dominant institutions. Those that have served us in the post WW II period will not carry us through the new challenges of a global economy. As deToqueville said, "I am tempted to believe that what we call necessary institutions are no more than institutions to which we have become accustomed. In matters of social constitution, the field of possibilities is much more extensive than men livir ı i their various societies are ready to imagine."

This means making agonizing choices and, yes, certainly some sacrifices. And it means making them now for future generations. But I would argue that in some cases those choices are largely known. Let me turn to today's concerns: economic growth, productivity, and deficit reduction.

I support the call of the Competitiveness Policy Council that we seek a fundamental turnaround in our long term economic situation by the beginning of the next century. Achievement of such a goal means raising national productivity growth to an annual average of 2 percent and achieving annual economic growth of at least 3 to 3.5 percent. An effective strategy to achieve these goals has many elements, and we can not address all of them here. But we do know that an underlying problem in the decline in productivity is inadequate investment. If we are to increase the well being of our citizens we must increase productivity which means increasing private and public investment. By raising investment by 4 to 6 percent of gross domestic product (about $300 billion in private investment) we can move towards these goals.

Of course, in order to provide more investment, we must provide more savings. That is, less consumption. The decline in private savings has been a puzzle to us and we have been unable to fashion policies to correct it. But we do know what to do about the massive public spending binge that I spoke of earlier. We know that if we really cut the deficit we will free up significant amounts of resources for the private sector which will then be available for investment. For example, the deficit is running at some 5 percent of GDP and yet, if we could have that $300 billion in actual investments, we would be a significant way along in improving our productivity.

Can we develop an effective deficit reduction plan? Yes.

President Clinton has presented a deficit reduction plan. He should be applauded for his political courage, for his skills in communicating these issues to the American people, for the specificity of his plan which draws the fire from so many special interests and, most importantly, for his fundamental leadership in presenting a complete plan and articulating the need in a way that has not been done in recent memory.

The President's plan is an outstanding first step in our long term deficit reduction efforts. He has provided us with a great opportunity. We seem within reach of enacting a real deficit reduction program that will make a fundamental difference in the economic health of this country.

If fully implemented, the President's plan will cut the deficit from 5 percent of GDP to 2.5 percent of GDP over the next four years. It will increase national savings by almost 3 percent by 1997. Consequently, it is a good start towards our productivity and growth goals.

However, the Administration's plan does not go far enough. We should drive the deficit to at least zero, if not a surplus, (at full employment) within the next eight years. This means more spending cuts and/or tax increases, but principally spending cuts.

Further cuts are required because we need more resources available for investment than are provided by the Administration's plan. In addition, under the Administration's plan the total national debt continues to grow as a percentage of national income. This will only be corrected if we get the deficit down around $150 billion per year.

There is also the issue of mix. I prefer to see more spending cuts than tax increases. Until we get control over spending in a real sense, we will not have satisfied the requirement for long term deficit reduction. Without major spending cuts the political process has not come to grips with the issue of curtailing the special interests. The current budget is filled with special interest programs in terms of both expenditures and tax relief that ought to be corrected. In addition, the problem will not be solved until entitlement growth is under control. Sooner or later, we must face reality. Entitlements must be controlled. Controlling entitlements requires means testing programs. The President is to be applauded for his proposed taxes on Social Security beneficiaries as a bold, first step in this direction.

The President's program emphasizes what he can do during this term, which is sensible. However, the deficit begins to grow again in 1998, so there is no question but that we will need to do more unless we are very fortunate in other regards. Consequently, if it does not appear politically feasible to get further reductions now, I would suggest that the Administration and the Congress conduct an intensive mid-course review some time toward the end of the initial four year period. This review would be intended to not only look at the deficit but, more importantly, at the key variables such as productivity, economic growth, changes in the level of national investment and savings, and our overall competitiveness in the world. Such a review should be written into law.

The most pernicious aspect of our current situation is the burdens that we are placing on future generations. To a significant extent, this debate is about inter-generational equity. What responsibility do we have to leave the country in better shape than we found it? What right do we have to burden future generations with our spending excesses?

In closing, Mr. Chairman, let me say how important it is that we seize the opportunity that has been created, largely by President Clinton. This is a time for deficit reduction. It is a fundamental requirement. We should avoid arguments that say we ought to embark on a longer term reform activity that would persuade us to defer hard choices. Now is the time to get the deficit under control. We have a responsibility to seize the opportunity and thus, to be good ancestors.

COMMUNICATIONS

STATEMENT OF CITIZENS FOR AN ALTERNATIVE TAX SYSTEM

Thank you for the opportunity to present this public statement of Citizens for an Alternative Tax System regarding the President's economic plan.

Most Americans support the President's vision of reducing the federal deficit and putting this country back on the right economic track. Most Americans agree that, if our country is going to continue into the next century as a global economic force with an increasing standard of living for our citizens, we must make some fundamental changes.

It is easy to agree that we must reduce the deficit. At the same time we need to reverse the dwindling productivity spiral, increase the number of higher paying jobs and create a decent standard of living for all Americans, now and for the future. However, America is confronted with the continued problems of low savings and investment, a declining standard of living and a global marketplace where U.S. competitiveness is a vital issue.

Citizens for an Alternative Tax System is a nationwide grass roots public interest group working to educate the American people about the inherent flaws of our income tax system, and a solution, a national retail sales tax to replace the income tax. Since its inception in 1990, our organization has made over 3000 radio and TV appearances across the country. We now have over 400 chapters nationwide. Our supporters have widely divergent political beliefs, but all agree that replacing the federal income tax with a national retail sales tax is vital.

It is our position that a sane tax policy will resolve the following problems:

(1) Inadequate national savings and investment;
(2) Reduced productivity growth;
(3) Subsidized imports and penalized exports;
(4) A declining real standard of living;
(5) A decreasing work ethic;
(6) A flourishing underground economy;
(7) A misallocation of over six billion hours per year of productive time to non-productive paperwork now required by the present income tax system;
(8) An annual cost to the economy of in excess of $600 billion.

While more and more people agree that a consumption tax is needed, there is a growing debate between supporters of a value-added tax (VAT) and a national sales tax (NST).

A primary difference between the two taxes is the manner of collection. The VAT is collected at each stage of production and, in the European models, has a system of invoices and credits in which the tax is rebated and applied. However it is applied, most economists agree that in the final analysis the true cost of the VAT is borne by the final consumer because it is hidden in the cost of the goods or services consumed. In contrast, the NST is only collected at the retail level at the time of final sale.

There are some other significant differences between a VAT and the NST. The NST is very visible and consumers know exactly how much tax they are paying. The VAT is hidden. Only the final tax on the retail sale is visible and the rest of the taxes previously paid by businesses are hidden in the price of the goods. While the NST is very simple to administer and Americans are familiar with state sales taxes, the VAT is very complex and unfamiliar to most American companies and consumers.

Throughout history, nations have declined (including and especially our own) when their tax policy began to undermine production and productivity. It is a given that taxes adversely affect the activity being taxed. Stated another way, when we tax something we get less of it. Therefore, a tax on production equates to less pro-

duction, and a tax on savings and investment equates to less savings and investment. Conversely, when production, savings and investment are taxed less you get more of these activities.

Few "experts" in Washington, D.C. or anywhere else dispute the fact that the federal income tax penalizes production and savings, subsidizes foreign imports, distorts economic decisions and is also extremely difficult to administer. Recent studies indicate that the income tax system is burdening our economy with an estimated $600 billion to $1 trillion in costs, in addition to the taxes collected.

What NST rate would be needed? In an economic study commissioned by Citizens For An Alternative Tax System and presented in testimony to the House of Representatives Ways And Means Committee in July, 1991, Dr. John Qualls, President of Micro Economics, Ltd. and adjunct professor of Economics and International Affairs at Washington University in St. Louis, used the COREMOD policy simulation model to compare the economic effects of the *replacement* of the federal income tax with the NST. (COREMOD is often used by the Office of Management and Budget, the Congressional Budget Office and the Treasury Department for economic analysis and forecasting.) In 1990, the revenue generated by the income tax was $587 billion. Dr. Qualls determined that there was approximately $3.605 trillion of consumer spending in 1990 and that a NST rate of 16.3% of this figure was required to raise $587 billion.

In the conclusion of his report, Dr. Qualls stated, "Based on the results of this initial work, the replacement of the current U.S. individual and corporate income taxes by a national sales tax would result in faster economic growth, higher levels of employment, more business investment, higher productivity growth, and an increase in the private savings rate . . . " "In short, implementation of a national sales tax would go a long way toward rectifying the U.S.'s decline in international competitiveness."

Why would the NST be better for the American people than the federal income tax? An examination of some of our major economic problems and a comparison of the income tax and NST follows.

Hidden in the selling price of American-made products or services is a 10% to 25% increase in cost simply due to income tax-mandated increases from producers and service providers at every step of the production or service chain. The combined cost of paying and complying with the federal income tax is in fact another cost of doing business. This cost is estimated at between $1.2 trillion and $1.8 trillion annually or between 18% and 25% of the total gross national product in 1989, which has to be passed on to consumers or investors in order for any business to survive. For purposes of illustration, let's assume that the federal income tax-mandated price increases are an average of 20% of the price of American-made products. A shirt selling for $20 therefore contains only $16 of actual profits, materials, labor and other overhead costs and $4 in federal income tax-mandated price increases.

However, in addition to these price increases the true cost of the federal income tax is hidden from most Americans. Most Americans don't realize how much they have to earn in order to make ordinary purchases. To purchase a $20 shirt, an average taxpayer has to earn approximately $26, pay $6 in federal income tax and then use the remaining $20 to purchase the shirt. Under the NST, the shirt should have cost $16 plus $2.50 tax. However, under the present system it actually requires $26 of our earnings. An automobile selling for $20,000 will require earnings of $26,000 to pay for the automobile. Whether it be a home or a toothbrush, the real price Americans pay for these items is between 125% to 135% of the marked price because of the federal income tax.

Increasingly in a global economy the economic health of our country relies on exports. Currently, our exports total 13.1% and our imports total 15.1% of GNP. The U.S. Department of Commerce estimates that each billion dollars of exports creates 25,000 new jobs in the U.S. and that a 5% drop in U.S. exports could cut our already anemic real GNP growth by one-fifth. In addition, approximately 15% of U.S. imports come from foreign affiliates of U.S. companies. More trade barriers to imports only result in additional barriers to U.S. exports.

An April, 1992 study by the U.S. Department of Commerce showed that for every ten U.S. jobs directly supported by U.S. merchandise exports, 19 additional U.S. jobs were indirectly supported. Increased competitive ability, assuming quality controls are maintained, will result in increased sales of our products both here and abroad. Increased sales will in turn lead to an increase in the number of high paying goods-producing and service jobs here in the U.S.

How does our income tax system affect our ability as a nation to compete with other nations of the world? Unlike the U.S., in order to fund their governments our major trading partners rely heavily on consumption taxes. Consumption taxes are applied to all products, whether domestic or imported, sold in their countries. In Eu-

rope, the consumption tax rates vary from country to country and range from 14% to 30%.

Using an average European consumption tax of 20%, American exports and foreign domestic products each have their selling prices increased by an additional 20% when they are sold in a European Common Market country. Because of the structure of the income tax and because of the General Agreement of Tariffs and Trade ("GATT"), our exports contain our income tax-mandated increase in prices when they enter the foreign country. In addition to that the foreign country adds their 20% consumption tax, making U.S. products 20% more costly than comparable foreign goods.

However, the tax results are vastly different when foreign exports arrive in this country. As they are permitted under GATT, our trading partners increase the competitive position of their exports by rebating their 20% consumption tax on all their exports. This allows the selling price of the foreign export to be lower than in their own country.

When the foreign export, with its price reduced by the rebate of its country's consumption tax, arrives in the U.S., the income tax system does not require that it bear its share of the costs of the U.S. government. Former Congressman Dick Schulze stated that in 1989 the U.S. Treasury received federal income taxes amounting to less than one-tenth of one percent of the value of the imports.

Let's compare the treatment of an American-produced product and an identical foreign-produced product each having a selling price of $1. Both products contain an increase in price equal to $.20 because of the taxes in their respective countries. The tax treatment is very different when the foreign product is exported. The $.20 cost of government included in the foreign product will be rebated at its border, giving it a net cost of $.80 that is not increased by U.S. taxes when it enters the U.S. But the American product will receive no rebate of the $.20 cost of government when it is exported and will experience an additional $.20 increase in price when it becomes subject to the foreign country's 20 percent consumption tax.

If the federal income tax is replaced with the NST, our companies will no longer be forced to locate factories in other countries in order to compete in a global economy. This means that more higher-paying jobs can be given to Americans that would have otherwise gone to foreign citizens in their countries. With the NST, we will no longer be exporting jobs to foreign countries but rather exporting products and services.

There is a real concern that our children will not enjoy as good a lifestyle as we have enjoyed. It is a fundamental truth that the improvement of the earnings of our citizens depends upon increasing the productivity of the United States. Dr. Qualls calculated that if the productivity rate of the American economy continued during the 1970's and 1980's at the same rate as in the 1960's, we would be in a much different America today. At current levels of federal spending there would not be a deficit. The average family would have $10,000 more of disposable income each year.

However, in order to increase our productivity we must have the capital for investment in more productive tools. The amount of capital for investment and the cost of that capital is directly proportional to the amount of savings in a country. Americans save about 5.6% of their disposable income, the Japanese save 15.3% and the Germans 12.2%. U.S. savings represent only 15.1% of gross domestic product while savings in Japan account for 33% of its gross domestic product.

Net national savings—savings in the nonfederal economy as well as personal savings minus the budget deficit—provides the amount of money available for investment that will increase productivity. In the 1970's the net national savings averaged 7.2% of GNP. By 1988 this rate was down to 2.8%. An increased availability of capital directly reduces the percentage charged for the use of that capital. A 1990 study for Congress by the Office of Technology Assessment estimates that each year from 1977 to 1988 the cost of capital in America averaged 3.4 percentage points higher than the cost of capital in Japan for investments in machinery and equipment with a physical life of 20 years, 4.9 percentage points higher for a factory with a physical life of 40 years and 8 percentage points higher for a research and development project with a 10 year payoff. It is not merely a coincidence that the countries with higher savings rates have higher rates of sustained productivity growth.

One of the major factors in determining a country's savings rate is whether the tax system encourages or penalizes savings. In a recent study prepared for the National Center For Policy Analysis, Gary and Aldona Robbins indicate that the income tax, by taxing investment income, increases the cost of capital by approximately 20 percent. This is important because, according to the Robbins', ". . . every $1 reduction in annual capital taxes will lead to about $25 in increased national output every year. Reductions in taxes on capital primarily benefit wage earners. In

general, every $1 reduction in annual capital taxes will lead to a $12 increase in aftertax wage income."

Under the federal income tax, a person who receives either earned or investment income is taxed. If the person saves a portion of their earnings, the return on the savings is again taxed. Under the federal income tax, the more we produce and the more money we earn, the more taxes we pay and the less we can keep of what we earn.

Under the NST, we can keep all we produce and earn. There is no withholding of federal income tax or quarterly tax estimates to pay. Instead of being forced to devote an increasing amount of productive time to complying with the ridiculously complex rules of the federal income tax, we could choose to work more or to devote more time to our family or leisure activities. By rewarding production on an individual basis we will get more production.

The most compelling argument for the NST arises when the real casualties of the present economic debacle are examined. It is a common misconception that all of our income taxes are shown on our income tax returns. This is not true. We also pay a hidden income tax, from 10%–25% of the price of products or services, every time we make a purchase.

The federal income tax especially hurts people in low income brackets not only because it deprives them of the opportunity to raise their incomes but also because of both the hidden and direct income taxes they pay. In 1960, Frederick Hayek stated, "It would probably be true, on the other hand, to say that the illusion that by means of progressive taxation the burden can be shifted substantially onto the shoulders of the wealthy has been the chief reason why taxation has increased as fast as it has done and that, under the influence of this illusion, the masses have come to accept a much heavier load than they would have done otherwise."

Does a consumption tax have to be regressive? Some maintain that the NST must exempt items like food and shelter. However, these exemptions would force the NST rate to be over 20%. Further, if we do want to target benefits for the lower income groups it is important to remember that a family of four with an income of $20,000 spends proportionately less on food and shelter than a family of four with an income of $50,000 on food and shelter. Congressman Sam Gibbons (D-FL) suggests that we ensure that the impact of a consumption tax is equitable by giving monthly cash rebates.

If each member of a family received a rebate of $50 per month, a family of four would receive $2400 per year in cash rebates which would equal the amount of tax on the first $14,400 of the family's expenditures for the year. This rebate can be adjusted to provide assistance for certain members of our society and can be done less expensively and more equitably than by exempting categories of expenditures.

The public approval of President Clinton's remarks about sales taxes at his recent town meetings indicate that the public is ready for a fundamental change. Studies by the Advisory Commission on Intergovernmental Relations for the last 20 years have shown that our citizens believe a state sales tax is fairer than the federal income tax. In Missouri, citizens have the right to vote on any tax increases. In every election there is usually an attempt to raise the state income tax but it is always voted down. The only tax increases approved by voters are normally sales tax increases for specific uses. Missouri voters intuitively sense that a state income tax increase will harm them. They also believe that the wealthy will escape the income tax but not the sales tax.

Finally, American companies and citizens will have an incredible compliance burden removed from their shoulders. Americans spend an estimated six billions hours a year simply filling out tax forms. This time is not spent producing goods and services. In 1990 it was estimated by former Congressman Schulze that the cost of preparing to pay the approximate $90 billion in corporate taxes was at least $80 billion, and was probably over $100 billion. Such a tax system is grossly inefficient. In addition to the tax paid by our companies and citizens, the federal income tax system drains from our economy from $618 billion to $1 trillion annually. This means that the administration of the income tax system is costing each of us from $2288 to $3700 every year. By diverting these funds from a non-productive area to a productive area, the productivity and income of American companies and citizens will immediately increase.

To quote an editorial that appeared in the NEW YORK TIMES August 21, 1992, "Tax changes can be effective but in ways Mr. Bush has never dared to propose. What about scrapping the personal and corporate income tax codes, which often discourage savings and investment, in favor of a consumption tax that would encourage them ? Such a tax should be structured to protect low-income families. That would be worth fighting for: pro-growth and fair."

As an historical footnote, in 1815 England had an enormous debt. It had spent 20 years fighting the Napoleonic Wars. Parliament ignored the dire warnings of the economic experts and eliminated the income tax which had been initiated to raise revenue for the wars. What followed was a 60-year bull market that has been called the Industrial Revolution.

CONCLUSION

(1) The NST will help recover both the domestic and international competitiveness we have lost. It will generate the growth in our economy necessary to ensure that we and our children will have the opportunity to enjoy the American dream.

(2) We will know exactly how much in federal taxes we are paying. The taxes will not be partially hidden in the price of goods but fully visible. Congress can obtain more money by helping the economy expand because the same percentage of a larger pie will produce more revenues.

(3) Congress and the President can propose additions to the NST for limited purposes—such as eliminating the federal deficit.

(4) The NST will encourage production and allow the attention now spent on nonproductive activities that exist solely for compliance with the federal income tax to be instead devoted to productive activities.

(5) The NST is not inflationary. In the study by Dr. Qualls, the inflation rate goes down.

(6) The NST will encourage savings, lower the cost of capital and increase the quality of life for all of us.

(7) The NST will give us the choice of how much tax we pay. If we choose to save or invest more of our income and help reduce the cost of capital then we will not pay taxes on those savings or investments.

STATEMENT OF THE COMPUTER LEASING AND REMARKETING ASSOCIATION

The Computer Leasing and Remarketing Association ("CDLA") submits these comments for the record of the Committee's February 24, 1993, hearing on President Clinton's economic plan. The CDLA is the nation's largest association of computer leasing companies and its members account for most computer equipment leased and used in the United States.

I. SUMMARY OF POSITION

The CDLA believes that the Administration's proposed alternative minimum tax ("AMT") depreciation revisions, while a step in the right direction, critically fail to deal with the current tax disincentive for any business to invest in computers. Moreover, postponing the proposal's effective date until 1994 would actually decrease investment in the short-term and is directly at odds with the Administration's stimulus proposals.

II. THE NEED FOR MORE APPROPRIATE AMT DEPRECIATION ALLOWANCES

Virtually all agree that computers and other high technology equipment are critical to America's economic future. The Clinton Administration's technology policy statement concludes that "[t]echnology is the engine of economic growth" and the key to creating a vital, high-wage economy.[1]

Despite this recognition, the tax depreciation rules governing computers are long outdated and actually discourage investment in computers. Under current depreciation rules, businesses recover their investment in computers over a five year period using the double declining balance method for regular tax purposes. The recovery rate slows to the 150-percent declining balance rate for normal AMT purposes and the straight line method for purposes of the adjusted current earnings ("ACE") AMT adjustment.

The recovery period for computers has remained largely unchanged since they were first recognized as a separate class of depreciable assets in 1973[2] and, not sur-

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[1] *See Technology for America's Economic Growth, A New Direction to Build Economic Strength,* p. 7 (2/22/93). The Office of Technology Assessment has similarly concluded that "technology is the key to competitive success." *See Making Things Better: competing in Manufacturing,* p. 1 (OTA–ITE–444, February 1990).

[2] *See* Rev. Proc. 73–2, 1973–1 C.B. 747 (adopting six-year asset guideline period for "information systems"). Prior to 1973, computers were not explicitly described in the depreciation tables, but would have fallen under the general category of "office furniture, fixtures, machines, and equipment," all of which were depreciable over ten years. *See id.* at 747. In 1981, computers

prisingly, fails to reflect the "computer revolution." The appended 1990 study by the Gartner Group concludes that computers were then losing their economic value over no more than 3.4 years or, using a five-year life, at a declining balance rate of 210 percent.[3] Moreover, because of industry trends—the quickening pace of innovation and the increasing preference for smaller computers, which tend to lose value fastest—the 1990 Gartner Group report almost certainly overstates the economic life of most computers placed in service today.

Because taxpayers must depreciate computers far slower than they actually lose their economic value, the Code not only provides no economic stimulus or preference for computer investment, but also effectively taxes capital invested in, rather than income generated by, computers. This discourages U.S. businesses from making the necessary investments in computer technology and decreases demand for U.S. made computer products, both of which are central to our economic future.

The Administration's proposal to replace the current MT depreciation allowance with the 120-percent declining balance method is obviously a step in the right direction.[4] It is also obviously far too small a step in that direction for computers. The proposal does little to bring the tax depreciation of computers in line with economic reality and thus leaves intact the substantial tax disincentive to make such investments.

If we are to make the necessary investments in computer technology to compete and succeed in the global marketplace, our tax laws cannot continue to discourage such investments. Accordingly, the CDLA urges the adoption of IT depreciation for computers at a 200 percent declining balance rate over five years (identical to the current normal tax treatment). This would be substantially more consistent with economic reality and our national policy objectives and would still be more conservative than the Gartner Group's findings.[5]

III. EFFECTIVE DATE

For reasons unexplained, the President's proposed change would only apply to assets placed in service on or after January 1, 1994. This postponement would discourage capital investments until the provision became effective. It was to avoid this result that both the President and Congressional leaders have proposed to make stimulus/investment measures generally effective as of December 3, 1992. Thus, the current date for the AMT proposals is both counterproductive and directly at odds with other aspects of the economic plan. Although the AMT depreciation proposal as applied to computers is not a stimulus measure, it would nevertheless postpone investments unless made effective on the same date as that proposed for the stimulus/investment proposals or some other reasonably current date.

STATEMENT OF THE DREYFUS CORP.

We are aware that President Clinton is concerned about modernizing our infrastructure both in terms of much needed improvements and as a way of providing a quick stimulus to the economy. As indicated in his recent economic address, we agree that he should be focusing on programs that achieve the following objectives: provide for a short-term economic stimulus for job creation; build an environment for long-term investment and growth; and reduce the overall budget deficit. In all cases, any program should be targeted to achieve the maximum positive impact on the United States economy for a minimum revenue cost.

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became five-year property under the then newly enacted accelerated cost recovery system and their recovery period has not changed since.

[3] Our major economic competitors already permit depreciation of computers in line with the conclusions of the Gartner Group report. As of 1991, Japan, Germany, England, and Canada provided for the recovery of 53.62, 51.00, 43.75, and 40.50 percent of computer costs, respectively, in the first two years of ownership, compared to only 30 percent under the current ACE/AMT adjustment and 33.12 percent under the Administration's proposal. *See* Ways and Means committee of the House of Representatives Hearings on U.S. International competitiveness, July 17, 1991 (statement of Stephen M. Chaleff on behalf of the CDLA) (comparison of depreciation allowances prepared by Arthur Anderson & company).

[4] The other aspect of the proposal, under which assets would be depreciated over the same recovery period for MT and regular tax purposes, would substantially benefit other types of assets, which now use a longer recovery period for MT purposes. Computers, however, would gain nothing from this change because they already are depreciated over five years for both the regular tax and the MT. It is ironic that the type of assets that are generally viewed as most important to our economic future would receive the least benefit from the proposal.

[5] The proposal is also consistent with the Administration's desire to make the research and experimentation credit permanent and, thus, to encourage the pace of technological progress (and obsolescence) for computers and other equipment.

In response to your recent request for comments regarding the Administration's economic program, we are writing you to suggest a mechanism to enable the immediate funding of new infrastructure projects. The proposal allows state and local governments to efficiently raise capital for such projects. Most importantly, this significant improvement in the way funds are raised for infrastructure projects can be implemented at little cost to the Federal government.

The specific proposal would permit state and local governments to issue bonds free from all state and local as well as Federal taxes. This exemption would apply regardless of where and how the holder of such bonds may be subject to tax. Under current law, such bonds are generally exempt from Federal income tax as well as the income tax imposed by the issuing state. However, most states do not exempt the income on bonds issued by other states from their income tax. As a result, there can be a significant disincentive for out-of-state investors to hold the bonds of many state and local governments.

We envision that this program would work as follows:

(1) A "Federal Infrastructure Financing Authority" ("FIFA") would be created to issue "All-State Tax-Exempt Bonds" (the "Bonds"). State and local governments would be required to pay FIFA for its services as well as repay all principal borrowed and all interest costs associated with the Bonds. All payments would be scheduled to precede FIFA payments to investors by at least 30 days. Bond issuers would maintain sinking funds to insure repayment to FIFA.

(2) Bond proceeds obtained under this arrangement could be used to finance transportation facilities (roads, mass transit, airports, etc.), educational facilities, government-owned facilities, water and sewer projects and government-owned utilities.

(3) Since the Bonds would be exempt from Federal, state and local taxes, we believe that borrowing costs for issuers could be at least 30 basis points lower than without this exemption. To make this program self sustaining, FIFA would impose a 10 basis point charge against Bond interest payments for the cost of administering the program. However, FIFA would not provide any Federal guarantee for any Bond issue.

We believe that implementing the FIFA program could result in substantial savings for state and local governments. At the same time, the program could be carried out at no cost to the Federal government.

Attached is a term sheet that provide further insight behind FIFA and the Bonds. We hope you will be willing to give careful and serious consideration to this "win-win" proposal.

Thank you for taking time to review this suggestion. In addition, as you have requested, six additional copies of this letter and term sheet have been appended to this letter. We look forward to discussing this matter further and considering any additional refinements you might feel appropriate.

Attachments.

All State Tax Exempt Bonds—General Term Sheet

THE ISSUER

A "Federal Infrastructure Financing Authority" ("FIFA") would be created to issue All-State Tax-Exempt Bonds (the "Bonds"). State and local governments would be obligated to reimburse and compensate the FIFA for funds made available to such government entities.

PURPOSE OF BOND ISSUANCE

Bonds issued by the FIFA could reduce the cost of funds for state and local infrastructure borrowing. The FIFA would be a facility for the issuance of Bonds. Bond proceeds would be used to rebuild the American infrastructure. Projects eligible for Bond financing would include transportation facilities (e.g., roads, mass transit, and airports), government-owned facilities, education facilities, water and sewer projects, and government-owned utilities.

TAX STATUS

All bondholders would be free from all forms on federal, state and local taxes on the Bonds as well as the income and gains therefrom, notwithstanding the state or local government backing of the Bonds. Such exemption would be provided as part of the enabling legislation creating the FIFA.

THE ROLE OF THE STATES

Bond proceeds would be available to state and local governments (and related municipal jurisdictions). State and local governments issuing Bonds would be required to maintain sinking funds to insure repayment of Bond proceeds at maturity.

ANTICIPATED MATURITY

Since the proceeds would be used for infrastructure repair or enhancement, the Bonds would be issued for terms no less than 5 years and no greater than 40 years.

ANTICIPATED YIELD

Because the Bonds would, in effect, be general obligations of the state or local governments, coupled with the breadth of exemption from tax, Bond yields are expected to be at least 30 basis points less than comparable in-state tax-exempt general obligation bonds.

IMPACT ON THE FEDERAL DEFICIT

The Bonds would not require any outlay of federal funds. Therefore, the federal deficit would not be directly affected by Bond issuances.

IMPACT ON THE DEFERRAL DEFICIT

The FIFA would direct proceeds from Bond issuances to the state or local governments. The state or local government would be required to remit interest and/or principal payments to the FIFA within 30 days prior to the scheduled interest and/or principal payment date for bondholders under the Bonds. The FIFA would not be a guarantor of the Bonds. In addition, the FIFA would not be required to make any payments to Bondholders prior to the receipt of funds from the state or local governments that have drawn down funds and are obligated to the FIFA.

Costs incurred for the issuance of Bonds and FIFA overhead would be financed by a charge computed at a rate of 10 basis points of the interest payments on interest bearing Bonds.

VOLUME CAPS

States would be subject to an annual Bond issue volume cap computed as the greater of: (1) $50 for every individual who is a resident of the state (as determined by the most recent estimate of the state's population released by the Bureau of Census before the beginning of the year to which the limitation applies, or (2) $150 million. States may elect to carry forward any unused portion of the annual Bond issue volume cap for up to three years.

Statement of the Equipment Leasing Association of America

Mr. Chairman, Ladies and Gentlemen. This written statement is provided by the Equipment Leasing Association of America. The statement addresses one part of President Clinton's proposal to stimulate the American economy, the reinstatement of an Investment Tax Credit.

The equipment leasing industry supports the reenactment of an Investment Tax Credit and believes that a tax credit which has the effect of lowering the cost of capital will act as a stimulus for all types of American companies to acquire new, more, productive equipment.

For over forty years, American business has increased the use of leasing--recognizing that the value of equipment comes from its use not its ownership. More companies, particularly small companies, acquire new productive equipment through leases than through secured loans. Of the $375 billion spent by business on productive assets in 1992, $120 billion, or 32%, was acquired through leasing according to the U.S. Department of Commerce. The Commerce Department forecasts that American business will rely on leasing for $126 billion in 1993.

Leasing expands the capital available to business--it fights the credit crunch. The unique structure of a lease contrasted with a loan--longer term, fixed payment, and a residual value at lease end--allows the expansion of capital beyond the limits of traditional loans or traditional lenders. Leases expand the amount of capital because they are based not only on a credit decision, but on the value of the equipment itself. Leases provide new money that would not have been available to American business, especially small or new business, through loans. Eighty percent of U.S. companies lease all or some of their equipment. Companies that lease tend to be smaller, growth oriented, focused on productivity, and more technology oriented. These are companies long on ideas, short on capital, and in need of flexibility as they grow and change. Companies that lease tend to create more jobs and be the most entrepreneurial and competitive. These companies need the benefits of leasing.

Proposal: Leasing and the Proposed ITC

The ITC works--it has a record of stimulating investment whether equipment is owned by the company using the equipment or owned by a lessor. Prior to repeal of the Investment Tax Credit in 1986, all qualified property as eligible for the Investment Tax Credit, whether owned by an end user or owned by a lessor.

Under President Clinton's proposed ITC, certain qualifications for accruing the ITC are established. These qualifications relate to the size of a company and/or any net increase in equipment investment. This adds a new dimension that did not exist under the pre-1986 Tax Act. Consequently, the role of leasing as a provider of capital must be treated differently in the new ITC than it was under the previous ITC.

In the report of the Treasury Department describing the Investment Tax Credit proposal and other parts of President Clinton's economic package, the statement is made that "leased property would be subject to limitations to prevent shifting of the credit to firms able to claim the credit." The association takes this to mean that provisions for leased equipment in the new ITC should not permit leasing to be used to circumvent the targeted or incremental nature of the proposed ITC. The Equipment Leasing Association agrees with that principle and has studied the matter at some length. Based on that study, the

association recommends that the accrual (earning) of any credit b based solely on the historical fixed base of equipment (whether leased or owned) and the current level of equipment acquisition (whether leased or owned).

The intent of the President is to stimulate companies to acquire more, newer, highly productive assets. By targeting the accrual of the credit to either small companies (revenue under $5 million) or to net new investment (investment above the user's base line investment), the accrual of the new ITC is irrevocably tied to the company using the equipment. The beneficial role that leasing and the lessor can play in providing investment capital, however, can continue by providing that leased equipment, as well as owned equipment, is included in the investment base. No provision of the tax law should interfere with how a business chooses to acquire its equipment. Businesses lease for many reasons unique to their own company. Because the intent of the Investment Tax Credit is to incent companies to increase their investment, no additional provisions should be added that limit how a company acquires additional equipment.

A second provision should be included in the law that is consistent with prior law regarding ITC. In many cases, a company that uses leasing to acquire equipment is unable to use the tax credit it accrues. Pre-1986 law provided that a lessor/owner for tax purposes could either use tax credits it accrued on equipment it owned, or pass it to the lessee/user of the equipment. Under the new ITC in which all tax credits would be accrued by the company using the equipment, the law should provide that the user/lessee of equipment has the option to use the tax credit it has accrued or pass it to the lessor of the equipment. If the user of leased equipment elects to use the credit itself, it receives the economic stimulus to acquire equipment. If the lessee is unable to use the credit against its tax liability and therefore get the economic stimulus for equipment, it can elect to pass it back to the lessor/owner of the equipment for the lessor's use. In that case, the economic stimulus for the lessee is reflected in lower lease payments.

In either case, the company acquiring and using equipment will receive the economic incentive which President Clinton intends to incent new investment.

Inclusion of the provisions described above related to equipment leasing and the ITC would accomplish two important objectives. It would permit equipment leasing to continue to play its prominent role of providing capital equipment to American business and industry. And the provisions would prevent the shift of investment base or incremental investment between an operating company and a leasing company to avoid the stated intentions of the new Investment Tax Credit.

The association thanks the committee for its consideration.

STATEMENT OF THE NATIONAL AUTOMOBILE DEALERS ASSOCIATION

Mr. Chairman and Members of the Committee: The National Automobile Dealers Association (NADA) is a national trade association representing over 19,000 franchised new car and truck dealers holding more than 35,000 separate franchises. The primary business of NADA members is the retail sale of new and used motor vehicles, both foreign and domestically produced. Our dealers also are engaged in automobile service, repair, and parts sales.

On behalf of domestic and import car dealers alike, NADA supports repeal of the luxury tax on all products as part of the legislation to implement President Clinton's proposals for public investment and deficit reduction. We believe the luxury tax was

ill-conceived, discriminatory and counter-productive. It isn't "soaking the rich," it's adding an impediment to car sales which is the last thing we need in this economic climate.

When the luxury tax was enacted in 1990, those items considered "luxury goods" were cars, furs, airplanes, yachts and jewelry. With regard to cars, the law provides that purchasers of vehicles retailing for more than $30,000 must pay a 10 percent tax on the amount in excess of $30,000. When Congress imposed this tax, it was ostensibly to raise revenue and at the same time respond to the situation in the Persian Gulf. The bill was developed hurriedly behind closed doors with almost no involvement by the Congress as a whole, and members had very little knowledge of what the bill contained.

Since enactment of the law, Congress reconsidered the wisdom of the tax and proposed to partially repeal it. The two tax bills (H.R. 4210, H.R. 11) vetoed by President Bush in the 102nd Congress included repeal of the luxury tax on all products *except cars* and indexed the $30,000 threshold for autos to the rate of inflation. The decision by Congress not to repeal the tax on cars was justified on the basis that cars "raise a lot of money."

Consequently, the whole issue of luxury taxes is back on the table in 1993. NADA supports repeal of the luxury tax on all products. It is unjust for Congress to single out one industry to bear the burden of this tax. If Congress moves the same repeal package again, a very basic inequity exists. A $300,000 yacht, a $250,000 diamond necklace, and an $80,000 fur coat will then not be considered luxury items, but a $31,000 car will be. This is a totally foolish policy and should clearly be changed.

The tax was originally enacted to collect more revenue from the affluent. However, in the real world the tax has become a negotiating element in the retail sale of the automobile. A potential customer will generally bargain with the dealer to pay a portion or all of the tax. In order to make the sale, the dealer will many times have to submit to the customer's demands. While the tax was designed to be paid by the "rich," in practice much of the tax is being paid by the small business automobile dealer. This hurts. Between 1989 and 1992 net dealership profit has fluctuated between 1.0 and 1.4 percent of total sales. This period represents one of the lowest profit levels ever. The further reduction of these profit margins which occurs when dealers are forced to pay "luxury" tax is a significant problem to dealers which was never intended by the taxing committees.

Equity and rational policy considerations demand that the tax be repealed. However, we know that tax legislation is not always driven by equity and rational policy considerations. It is driven by revenue concerns. For that reason, we are aware that repeal would require revenue replacement. At the present time we are actively seeking an acceptable revenue offset. We believe that we will be successful. However, in the event there is a hitch in our efforts, the automobile dealer still needs relief. At the very least, the tax must be taken out of the showroom. If the tax on automobiles is continued, it must be collected at the manufacturer level so it ceases to become part of the bargaining process.

We appreciate the opportunity to have our written statement included in the Committee's hearing record and urge the members to address the problems being created by this ill-advised tax.

STATEMENT OF THE UNITED STATES TELEPHONE ASSOCIATION

The following testimony is submitted on behalf of the United States Telephone Association ("USTA") USTA is the primary trade association of local telephone companies, serving more than 99 percent of the access lines in the United States. USTA represents over 1100 members ranging in size from the regional Bell companies to the smallest of independents.

USTA supports the Clinton Administration's goals of deficit reduction and long-term economic growth. USTA supports the notion of spending cuts set forth in President Clinton's Economic Stimulus and Deficit Reduction Plan and hopes Congress will find significantly more. USTA also is pleased that the Administration recognizes the critical role that capital investment, especially investment in the nation's technological infrastructure, must play in rebuilding our economy.

While USTA recognizes that deficit reduction and a balanced budget cannot be achieved totally through spending cuts, any tax increases must be fashioned in such a way as to not hinder capital investment which is critical to achieving a sustained economic recovery. Our industry's 1992 Federal income tax payments are estimated to be greater than 2 times the level experienced in 1985, prior to the enactment of the Tax Reform Act of 1986. The proposed 2% corporate rate increase will further reduce the industry's internally generated funds available for telecommunications

infrastructure development. The temporary incremental investment tax credit in its present form will do little to promote the technological investment essential for our nation's present and future competitiveness in the global economy and in no way will offset the long-term negative impact of the corporate rate increase.

A properly crafted investment tax credit mechanism, however, might achieve the stimulus sought by the Administration, and USTA stands prepared to work with this Committee to reach that goal. We would add that other, more targeted long-term structures might be employed to focus on the technology infrastructure which the President's program is attempting to enhance. Again, we stand ready to assist this effort.

A strengthened economy is essenti·.ı for our industry's continued growth. The Administration's proposals clearly put the proper focus on improving our economy by dealing with the heavy burden of government debt and the consequent lack of investment in our future. What remains to be done is to implement proposals worthy of those ends. USTA would be pleased to join with the Committee as it approaches this task.

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