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LONG-TERM IMPACT OF THE FEDERAL DEFICIT ON THE U.S. ECONOMY

HEARING

BEFORE THE

SUBCOMMITTEE ON DEFICITS, DEBT MANAGEMENT AND INTERNATIONAL DEBT

OF THE

COMMITTEE ON FINANCE UNITED STATES SENATE

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SECOND SESSION

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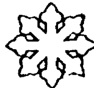

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LONG-TERM IMPACT OF THE FEDERAL DEFICIT ON THE U.S. ECONOMY

FRIDAY, JUNE 5, 1992

U.S. SENATE,
COMMITTEE ON FINANCE,
SUBCOMMITTEE ON DEFICITS, DEBT MANAGEMENT
AND INTERNATIONAL DEBT,
Washington, DC.

The hearing was convened, pursuant to notice, at 10:00 a.m., in room SD-215, Dirksen Senate Office Building, Hon. Bill Bradley (chairman of the subcommittee) presiding.

Also present: Senator Hatch.

[The press release announcing the hearing follows:]

[Press Release No. H-32, June 1, 1992]

SUBCOMMITTEE HEARING TO EXAMINE ECONOMIC IMPACT OF THE DEFICIT; BRADLEY SAYS GAO REPORT SHOWS LONG-TERM DAMAGE TO ECONOMY

WASHINGTON, DC—Senator Bill Bradley, Chairman of the Senate Finance Subcommittee on Deficits, Debt Management and International Debt, Monday announced a hearing to address the long-term economic implications of the Federal budget deficit.

The hearing will be at *10 a.m. Friday, June 5, 1992* in SD-215 of the Dirksen Senate Office Building.

Bradley said the hearing will focus on the General Accounting Office report *Budget Policy: Prompt Action Necessary to Avert Long-Term Damage to the Economy.*

In addition to testimony from Charles Bowsher, Comptroller General of the United States, the Subcommittee will hear from a panel of leading economists.

"The GAO report is unique in its description of the negative effects of continued deficits on our economic prospects over the long term. The report clearly portrays the need for comprehensive action on the deficit and tradeoffs that such action will entail," Bradley said.

"This hearing will help frame the debate about this critical issue, and it is my hope that it will also show the need for strong leadership by the President and by the Congress to achieve meaningful deficit reduction."

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

Senator BRADLEY. The subcommittee will come to order. Good morning. This hearing is another in a series of hearings of the Subcommittee on Deficits, Debt Management and International Debt which have focused on the long-term impact of the Federal deficit on the U.S. economy.

The primary focus this morning will be a discussion of a new report by the General Accounting Office. The report is aptly titled, "Budget Policy—Prompt Action is Required to Avoid Long-Term Damage."

I share the concern of the General Accounting Office about the urgency of the budget deficit.

During my tenure in the Senate, I have seen our National debt rise from $800 billion to nearly $4 trillion. I have seen us move from being the world's largest creditor to being the world's largest debtor.

I also have seen Japan with an economy half the size of ours invest more on an annual basis than we do. And as the record deficit this year shows, our past efforts to control the deficit have been largely unsuccessful.

Mr. Bowsher and I have been talking for about a year and a half now about ways to take a longer term view of budget policy, to get beyond the immediate to the longer-term questions.

Too often, we pass things around here without full understanding of their cost over the long term. For example, this March, we passed a back-loaded IRA, even though their eventual costs over the future 5-year periods could be 8 times the original 5-year cost.

As always, your thoughts on this matter are far sighted and informative. And part of your response has been the preparation of this report. I appreciate it very much.

I am sure that it will be a great help as other Senators debate the tough choices that all of us are going to have to make if we are serious about getting the deficit under control.

Frankly, the report does not paint a pretty picture. It tells us that if we do not put our fiscal house in order and soon, we will be dooming our children to a stagnating economy and lower standards of living.

Large Federal deficits absorb an alarming percentage of our National savings' pool. It is this pool that provides the capital for investments by the private sector. Such investment is critical to maintaining our productivity and growth rates.

This report is also about the future that could be. All too often around here, we focus on the short-term costs involved with deficit reduction. Who loses what benefit or who has to pay what tax?

If we are ever going to get serious about the deficit, I think our eyes have to be kept on the long-term payoff to greater fiscal responsibility.

In a very real sense, a debate has to be about the role of the Federal Government in the post cold-war world and about the kind of world we want to leave to our children.

I look forward to hearing the reaction of the panel of experts who have graciously agreed to testify today. And while the seriousness of this issue is generally agreed upon, there is a great diversity of opinion regarding how we should respond to it. The debate we hear today may soon be repeated on the Senate floor.

I would like to ask all the witnesses some of the same questions. How has and will the deficit impact our savings, investments, productivity, and growth rates? Why is it urgent to take steps now to reduce the deficit? What are the long-term consequences of failing to reduce the deficit?

What are the benefits if we do reduce the deficit and under what time table should we be doing it? What have been the primary causes for continued budget deficits in the United States? What

should be our first priority in seeking spending reductions? Will it be necessary to increase taxes?

What set of principles—and this is something I would very much like to focus on today to try to get some general guidance should we use to guide budget policy, principles that look to the future and principles that could be used in making both tax and spending decisions?

What budget reforms would help support decisions that would foster long-term economic growth?

Those are the questions that I think we will be pursuing today.

And I am very pleased to have as our first witness, Charles Bowsher, the Comptroller General. Thank you very much for coming, Mr. Bowsher. And the floor is yours.

Oh, I see Senator Hatch. Do you have anything you would like to say, Senator Hatch?

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

Senator HATCH. Well, if I could just say a few words. Welcome to the committee all of you, especially you, Mr. Bowsher. We appreciate having you here as well as all the rest of you.

Thank you, Mr. Chairman. I want to commend you for holding his hearing today on what really is a timely and important subject, especially after last evening.

The deficit has become one of the top priorities for American citizens. And we have seen several of our colleagues retire, citing their frustrations of Congress' inability to deal with this problem.

And a recent poll conducted in my home State of Utah, Utahans listed the deficit and budget problems as the number two national concern, only behind the current recession.

The problem of the deficit, as we all know, is not a new one. In the last 30 years, the Federal Government has had a surplus for only 1 of the last 30 years. Not only have we run deficits, but these deficits have grown substantially.

And during the same 30-year period, the Federal deficit has grown from $4.8 billion in 1963 to a nearly $400 billion shortfall in the current period.

The cumulative result of these deficits is an outstanding Federal debt of nearly $4 trillion. The interest on this debt has tripled in the last 30 years, growing from 6 percent of taxes to over 18 percent. This trend is not very encouraging.

These deficits are draining national savings and putting a strain on private-sector productive investment. We have seen spending in areas such as research and development, human capital, and plant and equipment decline as a result of the huge share of available capital that is siphoned into the public sector.

And for the most part, these siphoned funds are used to service the interest on the debt. Therefore, the public sector is not investing in these important areas. These are the very investments that promote economic growth.

I think we have to reverse this trend and free up this capital for investment and job creation. This is not really news to anyone. We all agree that the deficit must be reduced.

What we cannot seem to do in the Congress at least is to summon the will to make the hard decisions, to make the hard priority choices among competing programs in order to achieve this objection.

Congress has tried to restrain the growth of the deficit several times, most notably with the Gramm-Rudman-Hollings budget rules and the Budget Enforcement Act of 1990. And despite our attempts, the deficits have continued to grow. We appear to be unable to bind ourselves to meaningful restraints in reducing the deficit.

Now, the Senate will soon be considering the balanced budget tax limitation amendment. It is tax limitation because it would require a constitutional majority of the whole number of both Houses in order to increase taxes. It would require a three-fifths majority to increase the debt.

I have been a strong supporter of the balanced budget tax limitation for many years. I led the fight for it in 1982 and also in 1986. We won here in the Senate in 1982 with 79 votes. And in 1986, we lost by 1 vote with only 66 votes, 1 vote short of the two-thirds necessary for a constitutional amendment.

Now, I feel we need to make a broader statement of intent of the Federal Government to eliminate the deficit and balance the budget. I think the President is right. And I was pleased with his press conference last night where he is making this a focal point of his domestic agenda.

If we pass and ratify this amendment, we will be forcing Congress, where all money bills originate, to face the issue of the deficit head-on.

Yes, it will involve difficult and possibly politically painful decisions, but we have to reverse our tendency to take the short-term view of political convenience and turn that around and look at the long term.

Short-term bandages are obviously not enough to help the growth or to reduce the deficit. The fact that we have not yet seen many of the obvious adverse effects of the Federal deficit in the short run has allowed Congress to avoid the difficult task of exercising strong budget discipline.

We are now beginning to see that our high Federal deficits are squeezing out national savings and productive investment. We are seeing our dependence on foreign capital increase to uncomfortable levels that cannot be sustained for much longer.

The recent recession is a strong illustration of the deficit as restraining the ability of Congress to use fiscal policy to adjust to economic fluctuations.

And I see that Mr. Bowsher of the General Accounting Office is going to report on the study into these long-term effects of the Federal deficit on the U.S. economy. So I look forward to his testimony and, of course, the testimony of the other witnesses as well.

In closing, I just want to say that by continuing this trend of high deficits, we are pushing the cost of our consumption on to our children and grandchildren.

While we may escape the serious consequences of our actions, they, our children and grandchildren—and I have 6 children and 13 grandchildren—will be sentenced to a lower standard of living

and a nation with less ability to compete in the international economy.

We must do something to reduce the deficit and give the future generations of America the chance for economic growth and international competitiveness.

So I look forward to hearing the testimony today. And thank you, Mr. Chairman, for holding these hearings on this important issue.

Senator BRADLEY. Thank you, Senator Hatch.

Mr. Bowsher.

STATEMENT OF HON. CHARLES A. BOWSHER, COMPTROLLER GENERAL, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, DC, ACCOMPANIED BY PAUL POSNER, DIRECTOR, BUDGET ISSUES, ACCOUNTING AND FINANCIAL MANAGEMENT DIVISION; SIDNEY G. WINTER, CHIEF ECONOMIST, OFFICE OF THE CHIEF ECONOMIST; AND HARRY S. HAVENS, ASSISTANT COMPTROLLER GENERAL, OFFICE OF THE CHIEF ECONOMIST

Mr. BOWSHER. Thank you very much, Mr. Chairman and Senator Hatch. We are pleased to be here today. We would like, if we could, to put our statement in the record. And I will summarize it here in the next few minutes.

Senator BRADLEY. Your statement will be in the record in full.

[The prepared statement of Mr. Charles A. Bowsher appears in the appendix.]

Mr. BOWSHER. Our budget deficits at the Federal level were running at about a $150–$200 billion level pretty much from the mid-1980's right to the present time until this last fiscal year when it jumped up to $270 billion. Estimated for this fiscal year's deficit increase to $400 billion.

This increase comes about partly because we lose $100 billion due to the recession on the revenue side. We also have a new line item in the budget that we did not have prior to 1989. That was $75 billion for deposit insurance.

And we have another $25 billion for interest costs which is what we are adding practically every year now because of these large deficits.

We have a $1.5 trillion expenditure budget at the Federal government level. However, we are only taking in revenues of $1 trillion. So we have really a $.5 trillion gap.

We finance one-fifth of that, about $100 billion with the Social Security trust fund surplus. So that is how you get to a unified budget deficit of about $400 billion.

Now, what effect has this had on our net savings because that is how we actually have to finance the budget deficits?

We have seen here that in 1960 to 1969, we used only about 2 percent of net national savings for financing the Federal debt. In the 1980's, deficits absorbed 48 percent of that savings. And in 1990, it was running at 58 percent.

Also, in the 1980's, some of our deficits were financed by foreign investment. That means that foreigners were buying our treasury bills and helping to finance our deficits. Much of this financing from overseas has disappeared. And now more and more, the Americans are having to finance their own Federal budget deficit.

Financing the deficit means that investment in the private sector has to be reduced. And our first chart indicates exactly what has happened since the 1960's as far as the effect of the Federal budget deficit on our net national savings.

Now, another thing that is happening, too is that deficits are increasing as a percentage of our GNP. In the 1970's, deficits ran about 2 percent of the GNP. In the 1980's and for the 1990's, deficits are 4 percent.

And if you read our report, you will see that what is going to happen in the outyears, the late 1990's and 20 years of the next century, is that these deficits could have the potential to explode.

Our model indicates that we could drive deficits to as high as 20 percent of GNP by 2020. This is due to several factors including the retirement bill that is coming with the baby-boom generation when they become eligible, slower economic growth that we will get because of these large deficits and their financing, and the continuing growth in such areas as health care costs.

Deficits at this level are not feasible. Something will happen before this level is reached. Something either on our own initiative that will curtail these large deficit trends or, perhaps some external economic event, like some type of fiscal crises or some type of foreign withdrawal of financial support of the American deficits.

The next chart shows the main drivers that are pushing up this deficit as a percentage of GNP.

Specifically, Social Security and health and net interest place upward pressure on Federal expenditures.

So what are the options? One of the options unfortunately is no action, but that is not really an option. We only list that because that is always a possibility.

The first option really is muddling through, as we call it. In other words, this option holds the Federal deficit to 3 percent of GNP. We have been trying to achieve this level in the last few years, but it gets harder each year.

In other words, it is harder this year than it was 3 or 4 years ago. It gets much harder as we head towards the end of this century.

And then when we get into the next century, sometimes you need huge reductions in programs just to pay the interest costs and one or two big items like the health care costs.

If we look at the next chart you can see the various options. Now, the second option we pose in our report is the idea of trying to achieve a balanced budget by the year 2001. In other words, roughly over a 9-year period.

This option still assumes using the financing of the Social Security trust fund surpluses. The balance budget option provides better economic growth, but not as much if you implemented the next option which is a 2-percent surplus.

The surplus option would reduce our reliance on the Social Security trust fund surpluses to balance the operating government. We would actually then start to buy down the debt that we have run up in the 1980's and the 1990's.

Page 12 of our report shows the differences between the various options and what happens to real GNP, foreign debt, and the debt held by the public.

Now, as both of you have indicated, what is needed is some real decisionmaking on some of the major issues. If I could just address several of the major deficit drivers.

One is Defense. Defense is coming down as a percentage of GNP. It has been running at the 6 percent level. The plans right now are to bring it down to about 3.5 percent over a 5-year period. Some people feel that you could get it down to 3 percent with some additional cuts.

I think the important thing on defense is that we have a program that allows us to end up with a strong defense program, but not one as large as we have had in the past.

On health care, which will soon pass defense as one of the larger items in the budget, is currently running near 13 percent of our GNP. And it could increase much higher in the next century.

Our major competitors in the world, Canada, Germany, Japan, France, are the countries that run a health care program generally with universal access at somewhere between 7 to 9 percent of their GDP, while Japan is at 6 plus percent.

So we are really loading on our economy and our private sector a spread of about 6 percent here for health care costs. This additional burden I think is really hurting, not only the Federal budget, but also the State budgets and many of our corporations and certainly our smaller businesses.

We also have a major item in the Federal budget now, that we did not have prior to 1989, and that is the deposit insurance program.

We have to get outlays for that program out of the Federal budget and get back to a safe and sound banking system which does not need taxpayer assistance. A very important issue in the next 3 to 4 years is to keep the reforms working were passed last year and work through this work-out of the various real estate holdings.

The interest cost, of course, is one of the biggest items. It is the one that is growing at a faster rate simply because of large persistent deficits.

The only way we can get on top of that line item in the budget is preferably to eliminate the deficits or get them down to a more manageable proportion.

We are adding about $10 to $15 billion a year to that line item just to finance the increase in the debt each year.

Now, another major area which I think our report details quite well is the retirement costs. We go out further than we have in previous reports to show that if we do not get better economic growth here in the balance of this decade and the early part of the next century, and if we do not have any changes in the Social Security program, that this becomes a big driver.

As we state in the report, the Social Security trust fund surplus starts to move from a positive balance into a negative balance in the year 2017, and this is one of the reasons why the Federal budget deficit reaches a large level of GNP in our projections.

These are the big issues that are driving the Federal budget deficit. I think there are other areas, but they do not have the same impact. However, they could have a fairly significant impact for deficit reduction. One such area would be an organized or system-

atic way to try to downsize government in some of the other areas of our government.

Looking at some areas such as agricultural, the revenue losses that we have at the IRS, reviewing the big ticket items that we are financing, and again possibly looking at the role of the Federal Government and the role of State and local governments can possibly move us in the area of deficit reduction.

I think that after you have looked at everything and tried to get these programs in more affordable shape, if we cannot close the gap—then, of course, you would have to look at the revenue side of the budget.

So these are the major areas that we believe that the Congress and the administration have to look to have a major effect on this budget deficit that we are currently experiencing.

The other issue we would like to discuss today is the budget process. The process has grown over the years and now involves numerous levels which complicates policy formation and agreement.

I think some day that Congress ought to make an effort to try to simplify the budget process. An effort in the executive branch would be very helpful also. Furthermore, I also think looking at a breakout of the budget that gives you a little better understanding of the longer-range impact of some of these programs would be helpful, both on the investment as well as the operating side.

As an example, we are looking at programs, such as Medicare costs, that look like they are in good shape because we have a trust fund surplus, but the truth of the matter is in a few years that turns into a negative balance.

And we are kidding ourselves if we do not look out and start to deal with those kinds of unfunded liabilities or longer term program costs.

I often use the military pensions as a good illustration. Twenty years ago, we had a relatively small line item for military pensions, but we knew at that time over at the Pentagon that this was really going to take off.

We looked at $4 billion of cost in those days. And we knew that in 20 years, it would be $20 or $25 billion. And, of course, that is where we are at today.

By not having some kind of major program accruals into the budget process, the decisionmakers were not seeing this emerging problem. And today, we have more Air Force officers on the retired payroll than we have on the active duty payroll.

Unfortunately, we still use the same pension programs as we did 40 years ago. As we proceed into the future, it seems to me those are the types of major program decisions that have to be looked at to see if some kind of change can be made to not only handle the cost of the current fiscal year, but the fiscal years 10 and 20 years out.

Mr. Chairman and Senator Hatch, that concludes our presentation. We would be happy to answer any questions.

Senator BRADLEY. Thank you very much, Mr. Bowsher, for your testimony and for the report. What I would like to do is focus a little bit on the problem so that we get a little more clarification on

the difference between taking no action and actually taking action that produces a small surplus.

You have a section in the report that describes this in some detail. And I wonder if you could be more specific and elaborate on what you see as the difference, particularly on its impact on investment and savings and growth between the action and surplus.

Mr. BOWSHER. Yes. If you take no action and just go along as we have been here, you have absorbed an increasing amount of the savings to finance these deficits.

And as I say, the interest cost continues to escalate. An increasing amount of the taxes that you are taking in has to go for interest rather than for productive investment purposes. Deficits have negative effects on investment.

This then, in turn, cuts down the economic growth that you are going to probably experience in the private sector simply because you are not getting the investment in plant and equipment because the Federal Government has taken more and more of those savings to finance the deficits.

Senator BRADLEY. Yes.

Mr. BOWSHER. So there is a big impact. Once you get the numbers as high as we have them today at the Federal level, you are really impacting the private sector and economic growth. Our economic model in our report shows these effects.

Senator BRADLEY. And I wish you would try to explain what this number means. If there is no action taken, as I read the report, it states that the economy would be 40 percent smaller, 39.8 percent smaller than it would be if we eliminated the deficit and ran a small surplus.

So the question is what does that mean, the economy would be smaller? And why should people be concerned about the fact the economy might be smaller?

Mr. BOWSHER. Well, it gets right to your standard of living. In other words, when the economy is smaller then you are not generating as much goods and as much wealth. And you are also —in this situation, when we have demographics that are going to change, where more and more people are going to retire, that means that you probably have an economy that cannot sustain living standards as well as an economy that is 40 percent larger.

Senator BRADLEY. What might it mean for income?

Mr. BOWSHER. Well, I think the income is going to be considerably less here for the workers.

Senator BRADLEY. Is there a rough parallel for what a 40 percent smaller economy means, 40 percent less than income roughly?

Mr. BOWSHER. Roughly, that is about right.

Senator BRADLEY. So that if we take no action on the deficit versus some surplus if we eliminate the budget deficit and get some surplus, incomes of Americans will rise 40 percent more than if we do nothing?

Mr. BOWSHER. That is what this model that we have adapted would indicate.

Senator BRADLEY. And could you explain that a little bit? Why is that so?

Mr. BOWSHER. Why don't you go ahead?

Mr. WINTER. Okay. Let me take that, Mr. Chairman. What happens in the no-action scenario is that the rising Federal deficit eats away year after year at the national saving rate.

The assumption we made which is crucial here is that the non-Federal sources of savings remain constant at 16.5 percent of GNP for gross savings.

Then as the deficit rises and there is no response to the problem, the national saving rate falls year after year. The amount of capital added, production plant and equipment that is added, is smaller and smaller year after year.

If you pursue this to the bitter end, beyond probably the point of credibility, then we actually see in this scenario an actual downturn of output.

So the smaller economy that you are getting there is the consequence of many, many years of under investment.

Senator BRADLEY. And the national savings' rate falls because there is public non-savings. Right?

Mr. WINTER. That is correct.

Senator BRADLEY. The budget deficit goes up, the overall savings drops. And national savings consist of——

Mr. WINTER. Private plus public.

Senator BRADLEY. Private savings, all the savings of individuals who put money in their accounts.

Mr. WINTER. It also includes State and local government surplus.

Senator BRADLEY. And then State and local governments and then the Federal Government. So the bigger the deficit at the Federal level, the greater the likelihood that people will have lower standards of living because there will be less money available for either investment or less money available for State and local governments.

Mr. WINTER. That is correct.

Mr. HAVENS. I think, Mr. Chairman——

Senator BRADLEY. Could you put up the first chart that you had?

Mr. BOWSHER. Okay.

[Showing the chart.]

Mr. HAVENS. I think, Mr. Chairman, you can even see it now in the last year, as we are trying to come out of the recession and with the credit crunch that we had over the S&L and the banking problems.

The banks have been buying an awful lot of the treasuries, financing our deficits. But when they do that, that means those savings then are not being used for the small business and the medium-sized business to finance inventories and finance business operations.

Senator BRADLEY. Let's take a section of the budget. Take entitlements, if you are going to reduce the deficit and you were going to reduce entitlements, how would you compare what people would lose through reduced, direct payments from the government to them and the increased income they would have because the deficit is lower and growth is greater?

Mr. HAVENS. Let me have a shot at that. I do not think—it is not easy to make a direct, one-to-one relationship because those who might have reduced entitlement benefits may or may not be

the same people or the parents of the same people who will gain the benefit of higher rates of growth in the future.

There clearly is a connection. We have not been able—have not done enough work to attempt to define the distribution of the income losses and gains that might result from the sort of budget policy that we think is necessary.

But clearly there are people—some people will lose if entitlements are restrained. And some people will gain as a result of the increased economic growth from the lower deficit, for example.

If you restrain entitlements in the health care area, for example, depending on how you do that, you could end up restraining the income of the providers of services or you could end up with reduced services. And how you design that shift becomes a very important determinant of whose benefits and how they are reduced.

Senator BRADLEY. So if you reduce the incomes of providers, the consumers of health care would not have necessarily a decrease in the quality of availability or cost of health care?

Mr. HAVENS. I do not think you can automatically assume that that would be the case. It would depend on how the provider reimbursements were reduced and how the providers themselves responded to the reduction in reimbursements. It is not a simple question.

Mr. BOWSHER. If I could pick up on that, Mr. Chairman. If you could go through and have some comprehensive reform in the health care system of our country, and let us assume you could reduce the administrative costs significantly, which is much higher than in any other country, at that point, you really should be achieving a health care system that delivers as good health care to the population at less cost, less Federal deficit.

It is those kinds of reforms, if you could achieve, would get the higher income for the people, as good service and maybe some people would argue better service, more quality, and have lower deficits.

And I think health care is a good example of a major area that is driving the Federal deficit, but where there is great opportunity to make real changes and end up with lower costs, not only to the Federal Government, but to the State governments and also to the private sector.

Senator BRADLEY. I saw a recent article that conveyed a statistic that I would like for you to explain. It talked about government benefits to individuals. And it stated that the average government benefit—this is Federal cash and in-kind benefits—the average government spending benefit to individuals that make more than $100,000 a year is $5,690. And the average Federal spending benefit to people that make under $10,000 is $5,560 a year.

Could you explain that?

Mr. BOWSHER. I suspect that they are looking at the tax expenditures that maybe some of the people in the $100,000 income bracket receive, like the interest on their mortgage which is tax deductible and things like that would be quite a high portion of that $5,600.

And so you have programs where the people earning over $100,000—were in a Keough Plan, they would be getting tax deductions.

Senator BRADLEY. No. I think that if you include took tax expenditures that the average expenditure benefit to people making more than $100,000 is about $9,300.

Mr. BOWSHER. I see.

Senator BRADLEY. And the average expenditure benefit to people making under $10,000 is about $5,700.

Mr. BOWSHER. Yes.

Senator BRADLEY. So if you include tax expenditures, it is more extreme.

Mr. BOWSHER. More extreme.

I have to see the numbers before I could explain it. But certainly in the retired group now, when you get people making over $100,000 in the retired group and drawing Social Security and government pensions and other benefits that could well be part of the $5,600.

Senator BRADLEY. So my question here is really do you have a suggestion for principle that could guide us as we try to eliminate the Federal budget deficit?

One principle would be government resources should go to people who have greater needs on the basis of income. That would be one way to look at it. Is that not correct?

Mr. BOWSHER. Yes. I think that is one type of principle you might want to look at. Another type of principle I think would be to look at these major program areas where the high costs are in the budget and see if you can get more effective, efficient programs at lower cost than what we have in the past.

Health care again, as I hold out, is an area where our system has grown over many years, but we have to recognize today that it is costing us much more than it is costing some of the other countries, our major western competitors.

And so it would seem to me that this is an area that we ought to try to get just as cost-effective and efficient programs than as some of our competitors.

Mr. HAVENS. Could I add another point that might well become one of the principles that one considers? And that would be to focus on the choice between short-term consumption issues and long-term investment issues.

We talk about the role of savings and permitting private investment to encourage growth. There is a key role for public sector investments in long-term growth, too.

And as we suggest in the report, if you do not maintain the infrastructure, if you do not maintain the R&D base, if you do not maintain an educated work force, you can produce all the savings you like, it is not necessarily going to translate into a more rapidly growing economy because the economy can be constrained by other things besides simply the volume of private investment.

Senator BRADLEY. Senator Hatch.

Senator HATCH. Thank you, Mr. Chairman. I have been led to believe that the figures I have seen that the upper 1 percent of all wage earners in our society pay about 26 percent of all income taxes. The upper 50 percent pay about 95 percent of all income taxes.

If you take the upper 20 percent, the average family income tax payment is about $22,000 of the upper 20 percent. The bottom 20

percent, they take in transfer payments about $8,800. Are you familiar with those figures?

Senator BRADLEY. Oh, I probably read them at one time or another.

Senator HATCH. Sure. Well, I do not need to blind-side you with them, but I am really concerned that when we start talking about fairness in the code, we in the Congress continually give money to people rather than teaching them how to support themselves and to make their own living and to become self sufficient.

In other words, we give them fish; we do not teach them how to fish. And in the process you are transferring from the upper brackets in society in transfer payments to the lower brackets.

Now, I think that may be as it should be, but we ought to do it through more effective programs to help them to become self sufficient and self sustaining.

But as I view your testimony, you are saying in your statement that the share of national savings that was absorbed by the deficit was 2 percent in the 1960's. And it has risen to 58 percent today, meaning that is why we do not have enough long-term savings or investment to really sustain this economy. And that is why we are relying on foreign investment to try and sustain our economy. Right?

Mr. BOWSHER. That is one of the main points. That is correct.

Senator HATCH. And one of the difficulties with that and one of the detriments is that the profits from such investments—since 58 percent is coming from foreign investment, or at least a high percentage is—the profits go to foreign investors rather than to the people in our country?

Mr. BOWSHER. It is correct—both the profits and the interest. In other words, we are paying quite an interest bill now overseas for all the bonds that were bought in the 1980's to sustain these large deficits.

Senator HATCH. On another point you made, in the early 1970's, deficits averaged just 2 percent of GNP. Where today in the 1990's, deficits are 4 percent of GNP. And if they continue to go up, they may go as high as 20 percent of GNP by the year 2020.

Mr. BOWSHER. That is correct.

Senator HATCH. And if that happens, that would be absolutely disastrous and would convert us from the leading country in the world to one of the also rans.

Mr. BOWSHER. Yes. It is so disastrous, Senator, that I do not think it could even happen. I think something would break before we hit those numbers.

Senator HATCH. Then you also point out that the baby-boom generation is about to return, and that will occur about 2010. And whereas when Social Security started, there were 46 workers for every 1 on Social Security, 46 workers to sustain every person on Social Security.

As of right now as I recall, it is about 3.4. And by the year 2010, that is going drop to about 2.4 workers for every person on Social Security. Right?

Mr. BOWSHER. That is correct. That is the trend.

Senator HATCH. And that is going to be a tremendous burden on those who are coming in future generations.

Mr. BOWSHER. That is correct.

Senator HATCH. So it seems to me that this budget debate that we are in and that we have been in ever since I have been here is coming to crisis proportions at this particular time.

Many Americans believe that the Social Security trust fund surplus is a fund that is set aside for the future payment of Social Security benefits, but our colleague on this committee, Senator Moynihan, has pointed out that this surplus is actually funding our deficit today.

Mr. BOWSHER. That is correct. In other words, every year when we have a surplus in that trust fund, we just literally take that money and we pay current bills.

Senator HATCH. We just fund the deficit and we give an IOU back to the surplus fund.

Mr. BOWSHER. That is correct.

Senator HATCH. Or should I say the surplus account?

Mr. BOWSHER. The surplus account is probably a better description.

Senator HATCH. So Senator Moynihan is right. So isn't it true that to have a true surplus in the Social Security trust fund, you have to balance the non-Social Security part of the budget?

Mr. BOWSHER. That is correct. Right now we are really running a budget this year of $1.5 trillion of expenditures on only $1 trillion of revenue.

And we are really financing $100 billion of that $500 billion problem with the surpluses from the trust funds.

Senator HATCH. Well, just to follow this through a little bit more so we all understand it. Two years ago, there was a great deal of debate in Congress about using the Social Security Trust Fund surplus to mask the true operating deficit.

Now, how did your study treat this surplus? Did you include it in your deficit figures?

Mr. BOWSHER. Well, we had those options: one where you get to a balanced budget and one on a 2-percent surplus. And it is the 2-percent surplus where you are not using the Social Security trust fund surpluses.

Senator HATCH. Basically, you did use it in your deficit figures?

Mr. BOWSHER. That is right.

Senator HATCH. Okay.

Mr. BOWSHER. Yes.

Senator HATCH. Well, then why do we do that? Wasn't the purpose of moving Social Security off the budget to prevent this masking of the deficit through the Social Security surplus funds?

Mr. BOWSHER. Yes. The problem is that we went to a unified budget concept back in the late 1960's. This concept has the advantage of showing to the economists how much impact all of the Federal budget is having on the economy.

So I have always said it is good to have the unified total, but we should also have a breakout that shows us really what it is.

Senator HATCH. What the real deficit is.

Mr. BOWSHER. What the real deficit is.

Senator HATCH. And we do not do that.

Mr. BOWSHER. And we do not do that. And I have been arguing for that for a number of years.

Senator HATCH. I understand. I agree with you. Does this mean that when you treat Social Security as an off-budget item that the operating deficit of our country is even higher than what you have shown here today?

Mr. BOWSHER. That is correct.

Senator HATCH. There is no question about it.

Mr. BOWSHER. No question.

Senator HATCH. And the American people do not understand that. As a matter of fact, I will tell you that most members of Congress probably do not understand that either.

So the real deficit is even higher than what we have been told, by how much?

Mr. BOWSHER. Well, in the current year, it is up by $100 billion.

Senator HATCH. So our $400 billion deficit is really $500 billion.

Mr. BOWSHER. It is approximately $500 billion. That is correct.

Senator HATCH. And that is what the American people really do need to know.

Mr. BOWSHER. And that is what they have got to know. In other words, they have got to know that the spread the Congress and the administration have to deal with here in the next few years is a spread of $500 billion in the current year, and not $400 billion.

Senator HATCH. And that will get bigger.

Mr. BOWSHER. And it will get bigger. That is exactly right.

Senator HATCH. As the chairman pointed out to me, that will get bigger. What effects of taking Social Security off the budget have on the study? For instance, would the budget problems be solved sooner or later than your predictions?

Mr. BOWSHER. Well, if you could take the actions that would give you either the program cost or the revenues, you get a much better result by trying to achieve a balanced budget not using the Social Security trust fund.

In other words, you really start to pay down even the debt as our 2-percent surplus option shows.

Senator HATCH. Okay. Now, you mentioned in your testimony the need to——

Mr. BOWSHER. If I could just add one more thing, Senator.

Senator HATCH. Sure.

Mr. BOWSHER. And that is what we are really trying to show here today is that if you can turn this around and get to that kind of budgeting in the Federal Government, then you start to bring down the interest cost to a very low figure and you start to get a much bigger economic growth in your private sector.

And so then you start to be able to afford that large retired population. But if you don't, it just kills you in the outyears. It just kills you.

Senator HATCH. I agree with you.

Mr. BOWSHER. Yes.

Senator HATCH. You mentioned in your testimony the need to control domestic discretionary spending. Do you feel that putting a cap on this domestic discretionary spending would be an effective way to control spending?

Mr. BOWSHER. Well, it looks like that part of the agreement in the 1990 budget has been working fairly well. What hasn't worked,

of course, is that everything outside of the agreement has been able to increase the entitlements, the——

Senator HATCH. That is the entitlements. But with interest, it really would be approximately two-thirds of the budget.

Mr. BOWSHER. Yes.

Senator HATCH. Is that a fair comment?

Mr. BOWSHER. It is about right. Yes.

Senator HATCH. And they are going up regardless.

Mr. BOWSHER. Yes.

Senator HATCH. You also stated the mandatory spending has to be looked at. Do you feel that caps——

Mr. BOWSHER. One thing I would like to make a point——

Senator HATCH. Just answer this question though. Do you feel that caps on spending could effectively be put on mandatory spending programs?

Mr. BOWSHER. I think there is a much different ball game there. In other words, I think when you move over to the mandatory entitlement programs, what you really have to do is get into the programs and redesign them.

And again, I will use health care as an example. It seems to me that you cannot just put caps on and then sequester the amount because that means you are going to pay hospitals and the doctors less and there is no basic change in the program.

It seems to me that what is needed badly here is to figure some comprehensive reform in our health care program so that the cost is really starting to flatten out and get more in line with some of our major competitors.

And so you just cannot do it by these kinds of caps and sequestering as you can under the discretionary side.

Senator HATCH. That is all well and good. And I think that is a very good suggestion to Congress. Do you really believe that Congress has the will to really resolve these problems in that way?

Mr. BOWSHER. I think the administration and the Congress has to do it that way in the next few years because you will not get the savings otherwise.

Senator HATCH. Well, the President last night called for a balanced budget tax limitation amendment because he has come to the conclusion that there is not the discipline in either the Congress or the administration to get together and to do exactly that.

And I think the past 38 years where we have not balanced the budget certainly would indicate that that is probably so. I would have to say that a balanced budget tax limitation amendment, it would be better if we did not go to that in the sense that it certainly is going to require more fiscal responsibility.

If we could do that voluntarily, we would be a lot better off. And I think that is the argument of some who are against it.

But do you really believe that any administration or the Congress of the United States, at least under current circumstances, is going to have the discipline or that they are going to make the priority choices among competing programs that have to be made in order to balance the budget? Do you believe we are going to have that discipline or we could do that? Do you think we have the will?

Mr. BOWSHER. It has not happened in the last few years. So I cannot say with great confidence.

Senator HATCH. It has been almost 50 years.

Mr. BOWSHER. But what I would like to say to you, Senator, and add is that that is really what has to be done because if you do not do it, what is going to happen is what I saw out in Chicago.

In other words, I went to one of the great medical centers in Chicago, the University of Chicago at the Wiler Children's Clinic. That is where—if you remember, they had a major breakthrough on liver transplants a couple of years ago.

Senator HATCH. Right.

Mr. BOWSHER. They have one of the best neonatal care units I have ever seen. So they are getting a lot of patients, but the State of Illinois cannot pay them for 5 months on their Medicaid claims.

If we cut down the Federal payment in the State of Illinois, then all of a sudden, the end user here who is providing the service is cut. That is why I worry about caps and sequesters and avoiding the basic program change.

I think we are making real progress in defense now. We had a big advantage because of the change in the world conditions. And so we are coming down—a lot of people do not realize—from 18 Army divisions to 12. We are coming down on the number of carriers for the Navy.

That is how you really reduce the defense costs over a number of years. One of the things we got to do over there is figure out how to do modern inventory control. We could get billions out of that thing.

I think it is those kinds of program changes that the administration and the Congress have to start working on in the next 5 years to really get real deductions in the budget.

Senator HATCH. Well, Mr. Bowsher, I agree with you. I have taken enough time here.

Mr. BOWSHER. Yes.

Senator HATCH. But let me just make these concluding comments. I agree with you. We need to get down to work and do that. But I disagree that the Congress has the will to do it.

First of all, I know. I am affiliated every day on the Labor Committee with Senators who have $3 trillion in additional spending programs they would like to pass, not billion, trillion. And they can go on and on and on.

I know there are leading budgeteers who are coming here today to say they are against a balanced budget amendment or at least have been against the balanced budget amendment.

I think almost everybody wishes we did not have to go to that kind of discipline. The fact of the matter is the Congress gets a lot more credit for spending than it does for conserving.

We get praised when we go home for spending programs; we are bringing home the bacon. We have seen outlandish illustrations of how members of Congress have fought for their own pork-barreled approaches. All of us have had to do it from time to time.

And one thing that allows us to do it is there are no restraints, no effective restraints, or there have been no effective restraints up to now.

We have seen the Budget Empowerment Act. I was on the Budget Committee for a number of years. I have to tell you that there are some who think that the Budget Committees are the two most

stupid committees that have ever been developed because they cannot get anything done. And it is apparent that they are not getting anything done. And things are growing worse.

We have seen the Gramm-Rudman-Hollings Act which worked to a more or less degree, but many feel less degree rather than a more. We are now seeing the so-called Budget Agreement of 1990. Since 1946, according to the economists that I have read, for every dollar that we have increased taxes, we wonderful members of Congress have spent $1.59.

Since 1990, for every dollar we increased in taxes under the guise that we were going to have a balanced budget in 1993 if we entered into that agreement, we are now spending somewhere between $1.71 and $1.91 of every dollar we have increased in taxes.

So it is apparent there is not the will here. It is apparent there is not the discipline. It is apparent that what you are saying is true and we have got to get the will

We have got to get the discipline. We have got to cut out the waste, the fraud, and the abuse that Mr. Bowsher is talking about. But it is a lot more than that. We have to get these programs so they work.

We have got to stop all the extraordinary bureaucratic installments and paperwork. We have got to reduce programs. But while we are reducing the Defense costs of the budget, the interest is going higher than the Defense costs.

And the problem is since two-thirds are entitlements—like Medicaid last year going up 39 percent because it is an entitlement program. And nobody has the will to really fight. And that means 50 percent of which is paid for by the states because the states are saddled with what we wonderful members of Congress do in our mandated programs.

What is happening is there is no restraint or control in effect today. And yet we have leaders in the United States Senate saying on the floor every day that they do not want a balanced budget amendment because it would tie the hands of Congress.

I think it is time we tied the hands of Congress. And I think the only way you are going to get to where you want to be is through some form of balanced budget tax limitation amendment. That is the only way we are going to get there.

And I wish we did not have to go that route, too, but I do not see any other way after the last 60 years where we have just spent this country into bankruptcy.

And you have indicated that if we do not stop it now with 58 percent of our savings being absorbed, we are never going to stop it. And we are going to wind up a nation that has really sold out our children and our grandchildren so that we can continue to be profligate today.

Now, I appreciate your testimony because I think you have made a lot of important points here that members of Congress ought to listen to. And I just hope that somehow or other we can resolve these problems and get a vast majority of people together to do so.

But I have not seen it. And I do not see it today. And I do not see it happening without some sort of mechanism within the Constitution to force us to do that which the founding fathers assumed we would do, except in times of acute distress, and then assumed

we would get back to a balanced budget after those times of the acute distress.

And until we are forced to make priority choices among competing programs—they are all good. As a senior member on the Labor Committee, they have 2,000 to 3,000 Federal programs that we oversee on that committee alone.

Every one of them has merit. Every one of them has a constituency. Every one has reason for existence, but some of them are much more important than others. And we are going to have to start making those priority choices.

So I appreciate the chairman holding these hearings. I have to go frankly to a balanced budget tax limitation meeting right now. I would like to hear the rest of the testimony.

But I hope that everybody in this country will start thinking about this. Maybe that is the only way we are going to get where you would like to see us get.

And I think we ought to be more honest in budgeting so that we include the surplus that we are spending. We are going to have to come up in the future with no revenues to come up with. Thank you, Mr. Chairman.

Senator BRADLEY. Thank you, Senator Hatch. I am sorry that you will not be here for the next panel, but I know that their testimony is available.

Let me thank you very much, Mr. Bowsher for the report and also for your testimony here today.

Mr. BOWSHER. Thank you very much, Mr. Chairman.

Senator BRADLEY. Thank you. We appreciate having you here.

Senator HATCH. I am going to stay for some of the next testimony.

Senator BRADLEY. Our next panel consists of: Robert Reischauer, Director of the Congressional Budget Office; Henry Aaron, director of economic studies, the Brookings Institution; Rudolph Penner, director of economic studies, Policy Economics Group; and Eugene Steuerle, the senior fellow of the Urban Institute.

John Makin who is the director of fiscal policy studies at the American Enterprise Institute was supposed to be here today, but he is ill. His testimony has been submitted to the record. And I think he added to our hearing today, but unfortunately he is not able to be with us today.

[The prepared statement of Dr. John H. Makin appears in the appendix.]

Senator BRADLEY. Let me welcome all four of you to the subcommittee. And I think we ought to begin. I would suggest that you make your opening comments. We will try to do it 5 minutes each and then go to questioning.

Let's begin with Dr. Reischauer. Let me thank you very much for being here Dr. Reischauer and also from the standpoint of time, agreeing to testify on the panel. I really appreciate your willingness to do that.

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

Dr. REISCHAUER. Thank you, Mr. Chairman and Senator Hatch. I appreciate the opportunity to appear before you. With your per-

mission, I will submit my prepared statement for the record and will spend the next 5 minutes discussing three points that relate to the issues before this hearing.

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

The first point is that the Congressional Budget Office agrees with GAO's analysis that the Nation's economic future is being seriously weakened by the persistence of large Federal deficits.

Such deficits, as was said already, dampen the pace of productivity gains, slow the rate of economic growth, and restrain the improvement of living standards.

My second point is that this problem cannot be solved painlessly. Some have claimed otherwise, arguing that with a little imagination we can restructure spending and tax policy in ways that would stimulate economic growth significantly and that this faster growth would take a substantial bite out of the deficit.

What are the possibilities on this front? First, I would not deny that carefully selected public-sector investment in such things as infrastructure and education can promote growth as effectively as private investment, but the scope of such investment may be rather limited now that the large and most productive infrastructure projects, such as the Interstate Highway System, have been completed.

Furthermore, our political system has not shown much enthusiasm for proposals that would shift resources from public-sector consumption to public-sector investment. In fact, Federal public investment has declined as a portion of the budget and as a fraction of GDP as the deficits have climbed.

It is also true that growth can be affected to some degree by the structure of our tax system for a given level of the deficit. A tax system that increased efficiency and strengthened incentives to save and invest could boost growth.

Economic efficiency could be enhanced if tax preferences that subsidize narrow economic sectors were minimized and the tax base was broadened. This would permit lower rates, which in turn would reduce the role that taxes played in private decisions.

The incentives to save and invest could be strengthened if tax burdens were shifted toward consumption and if the tax treatment of income from corporate and noncorporate investments were made more even.

But such moves are complex, controversial, and fraught with difficulties. Moreover, the bulk of the empirical evidence suggests that the impacts of such tax reforms on economic growth are uncertain and probably quite small.

The bottom line, then, is that although it may be worthwhile to reorient Federal spending toward investment activities and reduce the distortions and inefficiencies in our tax system, the most effective way to strengthen long-term economic growth is to increase national saving by reducing Federal borrowing—in other words, by cutting spending and increasing revenues.

My third and final point is that procedural innovations are no substitute for action. The latest procedural silver bullet, of course, is the balanced budget amendment, but enshrining a balanced budget requirement in the Constitution is not going to solve the

deficit problem or make the necessary budgetary decisions any easier.

A balanced budget amendment would be largely a statement of principle. To have any effect, it would have to be accompanied by enforcement legislation that would spell out how the deficit was to be brought down if our political institutions could not agree on the specific spending cuts and tax increases that would be required.

If a balanced budget amendment is sent to the states for ratification this year, the Congress should begin immediately to take the steps necessary to comply with the new regime. If it does not, we risk a period of economic or political chaos once the amendment is ratified. If Congress does approve one of the versions of the amendment that are under consideration, it is likely that the budget would have to be balanced by 1997.

That would be a difficult, but not an impossible, task. It would involve about 40 percent more in spending cuts and tax increases than was agreed to in the 1990 budget summit.

Initially, deficit reduction of this magnitude would reduce the rate of economic growth somewhat, but the short-run hardship that would result could be lessened if the reductions were carried out in a credible and consistent way.

Such an approach would encourage a drop in long-term interest rates, permit an easing of monetary policy, and foster a smoother adjustment by those private interests that would be affected by the changes in government spending and taxing policies.

Let me conclude by reiterating what Chuck Bowsher said, which was that the longer we wait to make the long overdue adjustments to a more responsible fiscal policy, the harder the task will be and the more damage will need to be repaired. Thank you.

Senator BRADLEY. Thank you very much, Dr. Reischauer.

Dr. Aaron.

STATEMENT OF HENRY J. AARON, PH.D., DIRECTOR OF ECONOMIC STUDIES, THE BROOKINGS INSTITUTION, WASHINGTON, DC

Dr. AARON. Thank you very much. I would also appreciate it if my statement could be put into the record.

[The prepared statement of Dr. Henry J. Aaron appears in the appendix.]

Dr. AARON. I want to express at the beginning my view that the GAO report is extremely valuable in calling attention to the damage that deficits do over the long run, and, in particular, that they erode U.S. national savings. The damage is never large in any given year. It accumulates gradually.

The report also emphasizes that the Trust Fund programs, Social Security and Medicare, are not now and have not in the past been part of the deficit problem, but that rising health care costs mean that they will become part of the deficit problem in the future.

In addition, by reminding readers that the budgetary chicanery prompted by the Gramm-Rudman deficit reduction rules, the GAO report explicitly warns us that a balanced budget amendment would be a veritable siren song summoning presidents and legislators to engage in outrageous shenanigans to avoid its strictures.

Fifth and last, the GAO report reminds us that other countries have faced problems similar to those that we now face and they have solved them. We can do the same.

I have three categories of critical comments. One of which is rather technical in character and I will not go into it unless you wish to later on.

The second concerns the way in which the deficit is portrayed by the GAO report. By looking 30 years ahead, well beyond the period which the very policies that GAO is extrapolating could conceivably be sustained, and then looking at the consequences of events that it has acknowledged could not actually happen, the report makes a big job, eliminating the deficit, seem to be a herculean one, one almost beyond the capacity of Congress and the President to do.

I believe that this is a disservice because the deficit can be eliminated. We could get to a balanced budget in government accounts through actions by Congress and the President, roughly half again as large as those undertaken in the 1990 Deficit Reduction Agreement.

I report calculations in my testimony of the amount of deficit reduction that would be required if we undertook to eliminate the deficit over a period of 4 years doing so in equal increments through either tax increases or spending cuts. It averages about $40 billion per year over 4 years and accumulates from year to year.

So the message of this part of my testimony is that rather than looking at the deficit—which indeed is damaging and does threaten long-run harm to the economy—as something that is somehow a mountain too high to climb, we should look at the magnitude of the actual problem, what is necessary to solve it in order to get back to a balanced budget. It is doable with discipline by Congress and the President.

My last category of comments refers to some of the accounting changes that GAO recommends, really a kind of a capital budget. I would urge that those recommendations not be followed. I do so for two broad sets of reasons.

The GAO report states: "The creation of explicit categories for governmental capital and developmental investment expenditures should be not viewed as a license to run deficits to finance these categories."

There is about as much chance of this high-minded advice being heeded as there would be if they had written, "Teenagers should not allow frequent contact with members of the opposite sex to provoke lustful thoughts and lusty acts."

Congress and the President should at all times formulate fiscal policy with an awareness that the balance between total spending and total revenues is what is going to effect the economy.

The emphasis on developmental or investment projects in the GAO report and its effort to reform accounts to achieve that desirable end, is laudable. But is there any governmental program you can think of, particularly if it is disproportionately in your State or district, which you could not argue is developmental capital or Federal capital.

Education is an investment in human capital. Health care is an investment in tomorrow's workers. National parks are an invest-

ment in our natural heritage. Maritime subsidies are investments in our transportation infrastructure, and so on. I do not need to go on.

The GAO reports that it is continuing to evaluate the definitions of what programs to include in the various categories of its restructured budget and to make further changes in the future. I dare say. If their framework were adopted, so would you.

My advice would be not to dither with the form of the budget, but to start acting on the content.

Senator BRADLEY. Thank you very much, Dr. Aaron.

Dr. Penner.

STATEMENT OF RUDOLPH G. PENNER, PH.D., DIRECTOR OF ECONOMIC STUDIES, POLICY ECONOMICS GROUP, KPMG PEAT MARWICK, WASHINGTON, DC

Dr. PENNER. Thank you, Mr. Chairman.

Large deficits in time of peace and prosperity are a relatively new phenomenon in American history. Although there has been an upward trend in the deficit for most of the World War II period, they were not really large until the 1980's.

The record breaking deficit in 1992 is, in large part, as Mr. Bowsher said, the result of temporary factors, the recession and deposit insurance. But once these problems are behind us, a longer-run problem will prevent the deficit from improving to satisfactory levels. And that is the soaring cost of health care.

As Henry noted, in standard economic theory, the harm done by deficits occurs gradually, but it accumulates to very large amounts. It can be mitigated by foreign-capital inflows, but it cannot be eliminated altogether.

The $2 trillion in debt that accumulated over the past decade may now be having a noticeable effect. If anything, in my view, the GAO model, which I think was very well done, understates the effects of deficits on economic growth because it assumes that investment and technical change are independent, whereas I prefer to assume that they are closely related.

There is less important assumption that they make that might go the other way. They assume that for each $1 that you reduce the deficit, foreign-capital inflows are only reduced about $0.333.

That could be an understatement which exaggerates the effects of deficit reduction on economic growth, but I believe the other assumption that that technological changes are independent is more important and leaves the model understating the harm done by deficits.

The GAO understates another danger. Given the very high deficits that they project into the 21st century, they think that some corrective action is inevitable. I wish I was as sure of that as they are, given our lack of progress on the problem so far.

If huge deficits do, in fact, occur, we face the ultimate risk posed by deficits. That is that they will cause hyper-inflation when the public debt becomes so high that further borrowing is deemed undesirable and spending is financed with money created rather than through borrowing.

We are far from that point today, but current policy implies that the debt will continue to outgrow our income for the foreseeable fu-

ture. If that occurs, while we are experiencing an economic recovery, a considerable peace dividend, and an unusually slow growth in the retired population because of low birth rates during the Great Depression, one must wonder what will occur when the baby-boomers start retiring in the early 21st century, given that already almost one-half of non-interest domestic spending goes to the elderly.

By far though, the greatest damage being done by deficits today involves their effects on economic growth. Some also complain that they have deprived us of our power to stimulate the economy during times of recession. That is not, however, an effect of deficits that I deplore.

We have been so unskilled in the past in our efforts to fine-tune the economy that I suspect that we have done more harm than good.

Ultimately, significant cuts in program spending and increases in tax revenues will be required to make progress on the deficit. Economists have suggested many options, but the political barriers to their adoption have been insurmountable.

This is true even though it is my strong impression that a large majority of today's Congress believes that large deficits are undesirable. That leads me to believe that there are institutional barriers to reform.

I think that we have to give our leaders more power to impose painful solutions on their followers. The organizational reforms of the Congress in the 1970's diffused power too much in my view. And earlier budget reforms left the President with too little influence over the budget.

But correcting these problems will not be enough to guarantee a solution to our budget woes. For reasons articulated by Henry Aaron, I do not believe that amending the Constitution to require a balanced budget has the remotest chance of working.

I also agree with his remarks regarding a capital budget. I think, however, that one has to distinguish between making a capital budget a formal part of the budget process in the sense that you would actually vote on the target for capital spending and using a capital budget solely for information purposes.

A formal capital budget not only has all of the disadvantages enumerated by Henry, but I think it complicates a budget process that today is far, far too complicated in any case. We have to work on simplifying it.

None of that though denies the fact that it is useful for the Congress to have more information about capital spending. And I think the OMB has done a very good job providing such information in recent budgets.

You can, in fact, easily construct a capital budget today if you want one.

But my main point is that new procedural tools are not enough. It is going still going to take strong leadership to solve the budget problem. Those tools must always be wielded with courage and skill. Thank you, Mr. Chairman.

[The prepared statement of Dr. Rudolph G. Penner appears in the appendix.]

Senator BRADLEY. Thank you very much, Dr. Penner.

Dr. Steuerle.

STATEMENT OF C. EUGENE STEUERLE, PH.D., SENIOR FELLOW, THE URBAN INSTITUTE, WASHINGTON, DC

Dr. STEUERLE. Thank you, Mr. Chairman. As you may recall, it was exactly 10 years ago this committee was sitting here debating the first of many deficit reduction bills that were to be enacted in the succeeding decade.

Even at that time, as the debate over the deficit began to heat up, one conclusion become more and more apparent to me: that there was going to be no real solution to the fiscal problems facing this Nation as long as the budget process concentrated mainly on next year's budget or even on the next 5 years' budgets only.

I thought then and I continue to think today that if we had worried about the long run first, the short run would eventually take care of itself.

Thus, in early 1982, if we had aimed at a reasonable budget balance, today we might not be sitting here conducting these hearings.

Regaining control over the situation will not be easy. My testimony emphasizes three points. First, what are the principal dangers in the current budgetary situation? It is that shifts in policy become dictated almost entirely by the decisions of previous policymakers or by crises.

In effect, we have given up control over our own ability to respond to today's needs, while denying to posterity also the flexibility to respond to the needs of their time.

Second, the primary reason for the paralysis in policy today is not the deficit per se. The deficit is merely a symptom of the inability of policymakers to respond and to adapt to the requirements of a new fiscal era that essentially succeeded an easy financing era following World War II.

And third, the budget problem will never be solved unless we restore fiscal slack to the budget.

Let me refer to the first of those points. That there are significant shifts in budgets and in priorities can be seen by simply looking at the numbers in the budget.

One can look at the dollars spent on repelling the invasion of Kuwait, one can look at the amount that we have spent on trying to resolve the problems of the savings and loans, and one can look at the several hundred billion dollars of increases in real expenditures that have taken place in health care, at least over a number of years.

Contrast, if you will, the size of these dramatic changes with the size of proposed funding for education and help to our central cities.

The President's budget suggests reductions in education spending relative to GNP, while with respect to problems in central cities, the goal is at best defined by a few billion dollars.

Thus, while there are significant shifts in policy, these shifts are either decided by crises, such as the collapse of financial institutions or by the ways in which previous policymakers have designed a policy as in the case of health care.

The paralysis stories of today, therefore, do not reflect a government that is totally stagnant. Instead, they reveal the frustration

of current policymakers and voters that in a sense we have lost control over our own destiny.

Second, for some the recent budgetary pressures are easy to explain. A conventional liberal wisdom holds that the deficit problems of the 1980's were due merely to the miscalculations of 1981.

A conventional conservative wisdom holds that congressional pressures for ever-expanding expenditure programs forced substantial tax increases on the nation.

Like so many pieces of conventional wisdom, each contains an element of truth, but is mainly misleading. By the late 1970's, the nation was moving clearly into a new era of fiscal decisionmaking.

The miscalculations of 1981, along with congressional pressures for spending only speeded up the process. Both budget and tax policymakers, however, have not adapted to ways to operate in this new era.

To summarize how we operated in the easy financing era after World War II, we had four essential means for paying for both domestic expenditures and tax cuts.

One, we enacted significant taxes on existing bond holders by accelerating the rate of inflation, and thus giving them negative, real interest rates on their bonds.

Second, we have undergone significant and substantial cuts in the Defense budget from about 14 percent of GNP following Korea to less than 4 percent by the late 1990's even under the President's budget. That drop of 10 percentage of GNP cannot be continued. We cannot drop from 4 percent of GNP to minus 6 percent of GNP in the future.

The third and fourth ways of providing balance in this easy financing era were through significant tax increases that were either automatic or little debated. The first of these was bracket creep in the individual income tax.

The bracket creep was increased as inflation accelerated. The other major tax increase came through increases in the Social Security tax rate.

For four decades, we had increases in Social Security that were almost exactly 3 percentage points of taxable payroll. That increase in Social Security taxes has also slowed or come to an end, probably about 1990.

These four sources of funds for expanding domestic programs, as well as paying for legislative tax cuts, were little debated in part because they seldom required legislation to identify losers.

The elimination of all these sources of funds over the last 15 years has profoundly affected the political process under which tax and expenditure policy is proceeded.

The bottom line is this. Changes in priorities had always required tradeoffs. The past sources of funds to pay for the new priorities were increasingly unavailable.

A third point is that along the way to moving to this new fiscal era, we enacted programs in ways that essentially eliminated fiscal slack. As Comptroller Bowsher stated, expansion by formula was often the key.

Formulas were set so that benefits would rise over time even in the absence of inflation. Many talk about entitlements, about social contracts and sticky expenditures. I would point in particular to

the open-ended nature of certain commitments, such as with health and as with the savings and loans deposit guarantees.

Senator BRADLEY. If you could summarize, Dr. Steuerle?

Dr. STEUERLE. Yes. Finally, it seems to me that policymaking institutions with the executive branch and Congress have only begun to adjust to the changes being forced on them in the new era.

Institutions formerly evolved through expansion in the number of agencies and departments in the executive branch and the committees and subcommittees in Congress.

If we are to move to deal with the new era, we must actually gain control over this expansion of agencies and committees and subcommittees.

Tremendous gains could also be achieved simply by the adoption of budgetary rules that focus on long term deficits and require the restoration of some fiscal slack.

As an example of these potential gains, the trustees of the Social Security system for several years have reported that the trust funds are not financially sound for the long run and that the situation is getting worse from year to year.

Congress and the administration could solve a great deal of the deficit problem implied in the GAO report simply by adopting a rule that required that these funds be kept in actuarial balance for the long run. Thank you.

[The prepared statement of Dr. C. Eugene Steuerle appears in the appendix.]

Senator BRADLEY. Thank you very much. I am interested if any of you could offer what you think would be a principle that could guide action on reducing the deficit.

Among the principles that have been suggested are need, generational transfer, investment versus consumption, or others that you might have thought of. Dr. Penner.

Dr. PENNER. Well, it is somewhat difficult for economists to do that, Mr. Chairman, because what we are really talking about here is equity between the generations.

How concerned should we be for the standard of living for our children and grandchildren? That to a considerable degree is a value judgment.

There are rules that emanate from economic growth theory that suggest an optimum amount of saving under the presumption that we do not discount the standard of living of our children and grandchildren at all.

In other words, we regard a unit of consumption enjoyed by our children as equal to a unit of our own consumption. If you believe that value judgment, then that calls for something economists call golden-rule growth which says that we should be investing enough to drive down the rate of return on capital to equal the growth rate of the economy.

That is a standard that we are far, far from matching right now.

Senator BRADLEY. And that would imply much higher levels of investment.

Dr. PENNER. Very, very much higher levels.

Senator BRADLEY. Can you give us some sense of how much more investment?

The golden rule of growth, that is not a bad thing, which means that do unto the next generation what has been done to you. Is that correct?

Dr. PENNER. That is exactly why economists invented the phrase. Yes, based on that same golden rule.

Senator BRADLEY. So how much more investment would we need?

Dr. PENNER. I cannot answer that off the top of my head. I can give you another standard Mr. Chairman, for the record.

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

It can be shown mathematically that the rate of return on capital will be driven down to the rate of growth of the economy of the savings rate is raised to equal the share of capital income in the GNP in the long run. In 1990, the share of capital income in the GNP was between 27 and 30 percent, including depreciation. The gross saving rate was slightly less than 13 percent. In that year, it would have been necessary to more than double the saving rate in order to adhere to the "Golden Rule of Growth."

Senator BRADLEY. Oh, sure. No problem. I am just interested if any of you had a thought on this. I have other things I would like to move to that would be more specific. Yes, Dr. Aaron.

Dr. AARON. I think the criterion that I would draw particular attention to is the effect on savings. Investment has fallen somewhat in the United States. Savings have dropped like a rock.

We filled in the gap by borrowing significantly from abroad. We can keep on doing that for a long time, but only at the price of increased payments by future generations.

I agreed completely what with Rudy said, especially his remark that economists are not well equipped to answer the question you posed because what you have listed are a set of desirable objectives. And inevitably, you are going to be making tradeoffs among them.

Senator BRADLEY. Right.

Dr. AARON. That is what politics is about.

Senator BRADLEY. Okay. Well, if no one else has a comment on the guiding principle. If you do, make it.

Dr. STEUERLE. Well, Senator, I was going to add one point. Once again, if we could force the budget process to look a little beyond the 5-year budget window and at long-term deficits, I think we would make substantial gains in getting this budget situation under control.

And the best example for me is given by the way we used to enact Social Security bills. Formerly we lived by adopting an implicit rule that we would bring these various trust funds into actuarial balance. And in that way, we focused on the long run.

If you want to consider the major success stories for the 1980's, they were the 1983 Social Security amendments and the 1986 Tax Reform Act.

In both cases, we thought about the long run first. While the short run provided constraints that guided action, we thought first about where we were headed in the long run with respect to both of these bills.

Senator BRADLEY. I think that is an interesting concept, so long run versus short run.

Dr. REISCHAUER. Let me just add something, which is that economists tend to talk in terms of gross domestic product, gross national product, things we can measure using a monetary unit.

What is ultimately of concern here, of course, is per capita standards of living. That is a much broader concept, and it includes the social environment one lives in and the natural environment also.

If you could run a little experiment and ask future generations whether they would be concerned about large deficits during the 1980's and 1990's if those deficits were used to clean up the environment—the water and the air that future generations will breathe—even though that will not appear in the GDP, and even though they will have to live with dollar wages that are 5 percent lower in a real sense, would they take that trade-off? They would probably say yes.

And if you told them the large deficits of the 1980's and 1990's were devoted to addressing some of the very serious problems of our society—to eliminating poverty, to developing a better set of race relations so that when their generation had its day in the sun it would not have slums, it would not have tensions because of inequalities—would they take a slightly lower set of wages for that? "Sure," they would say.

But the unfortunate fact of the past decade and a half has been that we have been running these very large deficits to finance consumption, current consumption. And future generations may not be so willing to bear the burden of that.

Senator BRADLEY. And what would you point to as the most important Federal programs that hit consumption?

Dr. REISCHAUER. Well, at the risk of generating thousands of letters, Social Security.

Senator BRADLEY. And any others?

Dr. REISCHAUER. Health.

Senator BRADLEY. So the health expenditures and the retirement expenditures essentially.

Dr. REISCHAUER. They are big. Most other Federal expenditures, except for defense, come in smaller amounts.

Senator BRADLEY. Let me go to Dr. Penner. You laid out this possibility of hyper-inflation. Do you see that coming when the situation gets bad enough so that no foreign capitals are available for the United States to borrow? At what point do you see this is a real possibility?

Dr. PENNER. Well, first of all, let me emphasize that we are a long way from that danger right now.

The danger grows greater as the debt-GDP ratio rises and the interest burden grows.

As those trends continue everybody, especially foreigners, will become less and less eager to buy our bonds, especially if we still sell them in a non-indexed way.

The foreigners might provoke a crisis if they not only stop buying bonds, but start selling bonds that they have purchased in the past. That would create a serious foreign exchange crisis.

Looking at hyper-inflations around the world, it is very hard to say exactly why they occur. It is partly a political decision. At some point, policymakers say the interest bill is killing us. It is rising so much faster than our income that we cannot tolerate it anymore.

But if they do not have the political courage to raise taxes or to cut spending, they are left with only one alternative, and that is to start financing government with money creation.

Senator BRADLEY. At what point does this in your view become realistic—what is the sign? You say if this happens, we are heading toward——

Dr. PENNER. I do not think there is much danger at the moment.

Senator BRADLEY. What is the sign? I mean, is there some ratio or some event?

Dr. PENNER. The next point I was going to make is that sometimes hyperinflation can occur purely by accident. Italy's debt exceeds 100 percent of their GDP. They have still not gone to hyperinflation. So I think it has to be a debt more than 100 percent of GDP.

I have recently been working on fiscal problems in the Philippines where you have a very different situation.

There you already have an inflation rate of about 20 percent. You have a treasury bill rate of about 25 percent.

They cannot borrow long even with indexed debt because of the uncertainty about the inflation rate. They have to refinance almost their whole debt every year. Their debt is only about half of their GDP, but their interest bill is 40 percent of all spending.

A rumored coup, a volcano blows up, and nobody shows up to buy treasury bills some week. The central bank has no choice but to swallow them and to thereby create monetary reserves. A series of accidents of that type puts you into hyper-inflation. So there is no clear-cut numerical standard I can give you.

I would again emphasize we are far from it, but if we truly went to the kinds of deficits indicated by the GAO report in the period 2010 to 2020, I would suggest it would be a very real danger at that point.

Senator BRADLEY. Dr. Steuerle, you said in your testimony that we ought to have some controls on tax expenditures. Do you have any suggestions on how we could that? Or how we could actually control the growth of those tax expenditures?

Dr. STEUERLE. Senator Bradley, there would obviously have to be some agreement between the administration and the Congress to do this.

But my sense is that we should tackle those programs, both on the expenditure side and in the tax code that we are essentially open-ended. That is where the amount of expenditures or tax expenditures is really under the control of the private decisionmakers rather than the Congress.

Put constraints or change the very parameters of those programs in such a way that they are not so open-ended. The goal must be to solve this long-term problem. That would imply, of course, that some tax expenditures, such as for health care expenditures by employers, in some way or another would have to be capped.

Senator BRADLEY. And any other targets other than employer paid health care?

Dr. STEUERLE. I think we could go a lot further in capping mortgage interest deductions. Pensions are probably somewhat under control now by the ways that we cap them, but I think we could certainly give them a further look. Although my concern there is

more that we need to change the nature of our pension policy than necessarily to raise revenues——

Senator BRADLEY. And the rationale for that would be—why do want to do these things?

Dr. STEUERLE. Well, Senator, the rationale is that if we want to change health policy, pension policy, and housing policy over time, we should be able to have a policy that is adaptable to current needs.

You may remember in the recent debate on our urban problems, that concern was expressed about providing housing opportunities for the poor. If so, we might be able to trade off one type of housing expenditure for another. When we have an open-ended housing commitment, the policy is essentially under the control of private decisionmakers. We lose control within the Congress to change that policy.

Senator BRADLEY. So the fifth house of Ross Perot or any other of your ordinary billionaires has the same value to his mortgage interest deduction as some struggling family who has just made it into the top tax bracket.

Dr. STEUERLE. That is correct. It turns out that our policy of trying to favor home mortgages in the early post-war period probably did help expand home ownership.

What has happened now—I am sure you know by looking at your mail everyday when you come home and see your fifth request to open up a second equity loan on your house—is that we are essentially using these home mortgages to finance consumption.

One way we do this is somewhat of a technical matter: we allow the inflationary component of the interest rate to be deducted. In the end, we have a housing policy that is really not doing what essentially it was intended to do.

Senator BRADLEY. So your idea is to decide what you want government to do and then have spending, whether it is through the appropriation-entitlement side or whether it is through the tax incentive side, reflect that decision about what you want government to do.

Dr. STEUERLE. That is correct. And we make decisions that programs not be left open-ended, particularly open-ended after the fifth year of a budget window.

Senator BRADLEY. Dr. Reischauer, in your testimony, you seemed to be very critical of a value-added tax. Was I wrong to read that into your testimony?

Dr. REISCHAUER. Yes. You were wrong. [Laughter.]

I think that is an exaggeration. I said that it is not a panacea, that substitution of a value-added tax for, let's say, a surtax would not produce some of the exaggerated economic responses that some advocates of value-added taxes have suggested.

But a very broad-based value-added tax would shift the burden more onto consumption and could have some marginal growth-enhancing effect.

Senator BRADLEY. What would be its impact on savings?

Dr. REISCHAUER. Well, the assumption is that since you are taxing consumption more heavily and saving and investment less heavily, there might be some response to an increased——

Senator BRADLEY. Do you think that that response is exaggerated?

Dr. REISCHAUER. What I suggested is that it is relatively small. We have produced a report on the value-added tax, which I would be glad to share with this subcommittee.

Senator BRADLEY. Dr. Aaron, do you have any comment that you would like to make on any of the aforementioned questions?

Dr. AARON. On the last one, I think the important point to keep in my mind about a new tax like a value-added tax is that its primary effects are going to be in generating revenue, its direct and obvious effects.

One should not adopt it as a device for boosting the national savings' rate. One should not fear it because it has to be excessively regressive or it has to promote inflation. The VAT, large increases in personal income tax rates or boosts in payroll tax rates are devices by which revenues could be increased. They need to be evaluated on that basis.

Senator BRADLEY. Let me thank all four of you very much for your testimony. And let me thank you also for your willingness to be available to share your views with the committee in a non-formal setting as well.

I think that it is very important as we go ahead. My hope is that in the first 6 months of the Presidency of 1993, whoever is President, that we will come to focus on this issue in a much more direct way than we have in the past.

And the purpose of this subcommittee's hearing process is to try to prepare for that time by having a very clear view of what choices and what principles should guide us in that time of decision.

So I want to thank you very much. You have added a lot to our thought process. Thank you.

The subcommittee is adjourned.

[Whereupon, the hearing was concluded at 11:45 a.m.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED

PREPARED STATEMENT OF HENRY J. AARON *

Mr. Chairman: Thank you for the invitation to testify on issues raised by the report of the General Accounting Office on actions necessary to prevent continuing government deficits from damaging the U.S. economy. This report serves a valuable function by making five simple but vitally important points.

- First, the deficit matters because it reduces the U.S. national saving rate. Saving is important for growth. The variable that counts is saving.
- Second, the damage deficits do accumulates gradually. Small in any given year, this damage eventually erodes economic growth, cutting deeply into the improvement in living standards that might otherwise be achieved.
- Third, the GAO report makes clear that trust fund expenditures are not *now* and have not *in the past* been part of the deficit problem. The deficit problem we now face reflects large cuts in taxes flowing into the general fund that were enacted in the early 1980s and that were not matched by corresponding cuts in expenditures. The direct result was the emergence of a primary budget deficit that with fluctuations persists to this day. The resulting additions to debt and increased interest rates caused large increase in debt interest. Payroll taxes more than suffice to cover the costs of social security and medicare. But rising health care costs *will* become part of the deficit problem as rising costs for medicare part B and for medicaid will begin to push up the federal government deficit by the middle of this decade.
- Fourth, by reminding readers of the budgetary chicanery prompted by the Gramm-Rudman deficit reduction rules, the report implicitly warns us that a balanced budget amendment would be a veritable siren song summoning presidents and legislators to engage in outrageous shenanigans to avoid its strictures.
- Fifth, by pointing to the successes of other countries in reducing budget deficits, some of which rivalled our own, the GAO report reminds us that the task we face has precedents. So do the solutions.

On balance, therefore, I believe that the GAO report adds yet another voice to the call for immediate action to reduce the federal budget deficit. The deficit problems, which are hard enough now, will only get worse if we continue to procrastinate.

While I agree with the general thrust of the GAO report, I shall focus my testimony on what seem to me to be three problems with the report.

- The projections are puzzling and seem in some respects to be inconsistent or insufficiently explained.
- More importantly, the mechanical extrapolation of trends—which, as GAO acknowledges, cannot be sustained—exaggerates the admittedly serious budget problem we face. By doing so, the GAO report makes an unquestionably difficult problem seem overwhelming. It isn't. The president and Congress made the deficits. A modicum of courage that every U.S. citizen has a right to expect from its elected officials is all that is required to solve it. The steps necessary to close the deficit are easy to specify and could be understood and accepted by the American people if explained honestly and straightforwardly.

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* Director of Economic Studies Program. The views expressed in this statement do not necessarily reflect those of staff members, officers, or trustees of The Brookings Institution.

- The specific accounting reforms that GAO advocates seem to me to be counterproductive, rather than helpful.

PROJECTIONS

GAO's general approach to modelling the effects of deficits on the economy is similar in many respects to one that Barry Bosworth, Gary Burtless, and I used in projecting the economic consequences of rising social security costs and of alternative methods of financing them.[1] It uses some simple assumptions regarding growth of the labor supply and savings, feeds these inputs into a simple aggregate production function, which generates a rising stream of output per worker because of increasing total factor productivity.

One of the projections indicates falling per capita gross national product. This projection seems to arise because payments enormous borrowing abroad required to pay for even more enormous government deficits results in huge debt service payments to foreigners. Despite rising total domestic output, payment of this debt service leaves a shrinking residue for domestic consumption and investment. The GAO acknowledges that this outcome is quite unlikely to eventuate because steps would be taken to force reductions in government deficits well in advance of the accumulation of such enormous debts.

In some key respects, however, the technique employed by GAO seems to differ from the approach we used at Brookings. I say "seems," because the incomplete explanation of the model makes it hard to tell.

The problem is this. Private saving, less the government deficit (or plus the government surplus), must equal domestic investment plus foreign investment (or less foreign borrowing). The GAO report states that gross private saving is fixed at 16.5 percent of gross national product, the same assumption we used at Brookings. The government deficit absorbs part of this saving, leaving the rest for domestic or foreign investment. When the federal government deficit varies, as it does among the four scenarios GAO treats, the GAO report does not adequately explain how these variations are divided between foreign and domestic investment.

This issue is important. The report says that social security benefits and taxes are estimated for one scenario and the real dollar values are then used in all of the other scenarios. This approach is defensible if domestic investment is held constant across all of the scenarios, which would imply that capital/labor ratios and hence wage rates and the marginal product of capital are the same. But the report also says that interest rates vary among the four scenarios. If interest rates vary, then domestic investment would also tend to vary. So would earnings, payroll taxes, and social security benefits, rendering incorrect the assumption that these are the same in all the scenarios.

In short, the assumptions and conclusions stated in the report do not seem consistent. To put matters another way, it is not clear whether variations in the government deficit affect gross domestic product or leave gross domestic product unchanged while causing differences in the gaps between a constant path of gross *domestic* product and gross *national* product.

DEFICIT REDUCTION: BIG JOB OR HERCULEAN LABOR?

GAO abjures Congress to set budget policy with an eye on events thirty years into the future. A very long view makes sense for some operations of government, such as pensions and retiree health benefits, where long term commitments are involved. In these cases, it is only prudent to reconcile promised benefits with projected revenues under plausible assumptions, however thoroughly experience may have taught us that these assumptions are certain to be falsified in crucial ways be events. Most government programs do not entails such long term commitments, however. And looking as much as ten years ahead stretches the bounds of plausible extrapolation and fully satisfies the demands of prudence.

Even on a the shorter horizon of a decade, the GAO report suggests that achieving budget balance will require deficit reduction of as much as $300 billion by 2001. Looking even further into the fathomless murk of the future, GAO anticipates that under a course of action labeled "muddling through" (not a designation that indicates it is GAO's favorite) will require deficit reduction cumulating to more than $500 billion by 2020. The report does not make clear whether this deficit reduction includes the interest savings that will follow automatically from cuts in other expenditures or from tax increases.

[1] Henry J. Aaron, Barry Bosworth, and Gary Burtless, *Can America Afford to Grow Old,* Brookings 1989.

I suggest that by extrapolating behavior that GAO stresses is unsustainable far beyond any date that such unreasonable behavior could be sustained, GAO demonizes the deficit. One gets quite another feel for the manageability of the deficit problem if one focuses on the amount of deficit reduction necessary to balance the budget by the end of the decade.

The arithmetic is quite simple. Were Congress to enact and the president to sign a deficit reduction agreement in 1993 roughly half again as large as the deficit reduction agreement of 1990, the overall budget would be in balance by 2000. The deficit reduction agreement of 1990 cut the deficit by approximately 1.6 percent of gross domestic product over the five years in which it was in effect. Deficit reduction cumulating to 2.3 percent of gross domestic product would balance the budget by the year 2000. The exact schedule of reductions would be as follows:

Year	Deficit Reduction, each year (billions of current dollars)
1993	$37
1994	39
1995	41
1996	44

This estimate is overly optimistic in one sense and unduly pessimistic in another. It is overly optimistic because it assumes no appearance of the budgetary equivalent of Murphy's law that seem to inflict upon us each period some unanticipated event that is sufficient to invalidate careful and honest forecasts. On the other hand, it takes no credit for the reduction in interest rates and the associated savings on interest outlays that would surely follow if financial markets were persuaded that the budget would, at last, be balanced. These savings would probably be quite significant, possibly as much as 1 percentage point on the long term interest rate.

In characterizing the size of the steps necessary to balance the budget as one and one half times the size of the 1990 agreement, I do not mean to imply that these are baby steps. Those of you who lived through that negotiation realize that it was no picnic. You understand far better than any person whose job does not depend on voters' approval that measures half again as large would be hard to negotiate and enact. But the deal could be done between a willing president and Congress determined to put the deficit issue behind us.

ACCOUNTING CHANGES

The GAO report embraces a new method of reporting government expenditures and revenues. They propose to divide federal expenditures and revenues into three categories in addition to the Unified Budget. Within each of these three categories expenditures and revenues would be categorized into three categories: general, trust, and enterprise.

The GAO argues for the new framework largely on the ground that it would tend to favor growth promoting expenditures by the federal government. I share the view expressed in the report that the federal government should increase the share of public spending for purposes that can promote economic growth. However, I urge that the GAO framework not be adopted. I do so for two broad sets of reasons.

First, although GAO states that "The creation of explicit categories for governmental capital band developmental investment expenditures should not be viewed as a license to run deficits to finance these categories." I think that there is about as much chance of this high minded advice being heeded as there would be had they written "Teenagers should not allow frequent contact with members of the opposite sex to provoke lustful thoughts and acts." To be sure, it sometimes may make sense for long-lived, growth-promoting capital projects to be financed by borrowing (that is one of the overflowing list of reasons why the balanced budget requirement is so pernicious). But Congress and the president should at all times formulate fiscal policy with the awareness that the balance between total revenues and total spending will affect current demand for goods and services in much the same way however outlays and revenues are distributed between capital formation and current services. The GAO may tell harried members of Congress and badgered budget directors not to think that outlays on "federal capital" or "developmental capital" can be more easily financed by debt than can the "operating budget." They may believe that officials should look at the unified budget when making fiscal policy and at the three budget categories when determining the composition of spending. But the table they present in the report shouts louder than any words they can write, "call your pro-

gram 'developmental' or 'federal' capital if you can, since you have to balance the operating budget and don't need to worry much about the rest."

Having said that, I want to applaud the emphasis that the GAO report gives to government efforts to promote growth. As in efforts to cut the deficit, formal accounting reforms will not achieve the desired change in emphasis. This shift will come only from a recognition by executive agencies that current and proposed outlays should be scrutinized on the basis of whether they will contribute to higher economic growth as well as on such traditional criteria as fairness. This change will come as easily within the current accounting framework as within the one proposed by the GAO.

Second, the GAO framework could even become an obstacle to focussing real analytical attention on governmental activities that promote economic growth. Just as the emphasis on the Gramm-Rudman deficit reduction targets became a substitute for doing something real about the deficit, and just as the balanced budget requirement now under consideration could easily become a focus for budgetary gimmicks to avoid real deficit reduction, the adoption of the accounting framework proposed by GAO would surely become the occasion for debates about whether this expenditure or that deserved to be classified in the privileged budgetary sanctuary of "governmental capital" or "developmental capital," rather than in the budgetary dungeon as part of the "operating budget." Is there any governmental program that you can think of, particularly if it is disproportionately in your state or district, which you could not argue is developmental capital or federal capital. Education is an investment in human capital. Health care is an investment in tomorrow's workers. National parks are an investment in our natural heritage. Maritime subsidies are investments in our transportation infrastructure. Agricultural price supports are investments in the capacity of one of America's great industries. Need I go on? GAO reports that it is "continuing to evaluate the definitions of what programs to include in the various categories of our restructured budget and expect to make further changes in the future." I dare say they are. If their framework were adopted, so will you. My advice would be not to dither with the form of the budget and to start acting on the content.

I would urge GAO also to give up on the idea of adding tax expenditures to direct expenditures in any set of official accounts. The point is simple. Direct expenditures are an enumeration of dollars we actually spend. Tax expenditures are an enumeration of dollars we don't actually collect that we might have collected had we followed some other standard of taxation than the one we actually chose to follow. But the number of logically consistent and plausible tax regimes other than the one we actually adopted is infinite. That means that the possible enumerations of tax expenditures are also infinite, each equally defensible and each different. To try to add together dollars actually spent with dollars not actually collected is inevitably arbitrary and will debase the quality of statistics.

While no attempt should be made, in my view, to add direct expenditures and tax expenditures in official budgets, I want to emphasize that the concept of tax expenditures is extremely useful and should be retained in official statistics, and that estimates should be reported more or less as they are today. These estimates provide a useful input into program analyses. When considering, for example, whether to promote health insurance among small employers it is useful and important to know how much revenue would be generated if the exclusion of health insurance premiums from personal income taxation were terminated and the revenues were used for direct subsidies. It is useful when considering how to encourage retirement saving how much revenue is reduced by the exclusion from current income taxation of contribution to qualified pensions. These and the hundreds of other tax expenditures reported by OMB and CBO help analysts sift the budgetary implications of the range of options on how to achieve various public objectives. A scalpel is a useful surgical instrument, but one would not try to take a patient's temperature with it. In the same sense, tax expenditures are a useful instrument for program analysis, but one should not use them to measure the fiscal stance of the federal government.

Prepared Statement of Charles A. Bowsher

Mr. Chairman and Members of the committee: I appreciate the opportunity to appear today to discuss the importance of deficit reduction and better budgetary decisions to our long-term economic health. The report[1] we are issuing today presents

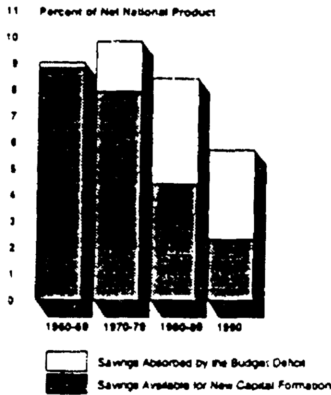
[1] *Budget Policy: Prompt Action Necessary to Avert Long-Term Damage to the Economy* (GAO/OCG-92-2, June 5, 1992).

an urgent double message: we must put our fiscal house in order, and we must shift our federal spending priorities away from consumption and toward investment.

Deficits, by themselves, do not create crises, but they do quietly 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. It is clear, however, that increasing national savings by reducing the deficit will promote greater investment and long-term economic growth.

Using deficits to finance a high level of spending on public investment programs could mitigate the dampening effects of deficits on economic growth. However, pressures created by deficits and the accompanying growth in spending on mandatory programs and interest on the debt have caused a reduction in the share of the budget spent on infrastructure, research and human capital programs vital to 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

INACTION IS NOT A SUSTAINABLE POLICY IN THE FACE OF WIDENING DEFICITS

In the short-term, the costs of reducing the deficit may seem greater than the benefits of doing so. In addition, the task must sometimes seem hopeless. Despite the various deficit reduction acts and budget summits of the past 7 years, the deficit has grown. In the 1970s, deficits averaged just over 2 percent of gross national product (GNP). Under Congressional Budget Office (CBO) projections, the average cash basis deficit for the decade of the 1990s will be 4 percent of GNP, the same as the 1980s. This assumes compliance with the Budget Enforcement Act (BEA) and that discretionary programs grow no more rapidly than inflation after BEA expires in 1995.

As frustrating as this seems, we cannot walk away from the problem. It will only get worse and much harder to deal with over the long run. In the unlikely event that we continue our current spending and tax policies, our projections show deficits exploding to 20 percent of GNP by 2020. This is not sustainable. If we do not act on our own initiative, external economic events will force us to act. For example, the withdrawal of foreign investment would bring escalating interest rates or accelerating inflation, or both, and ultimately force painful adjustments. Thus, the key question facing policymakers is not whether to reduce the deficit, only when and how.

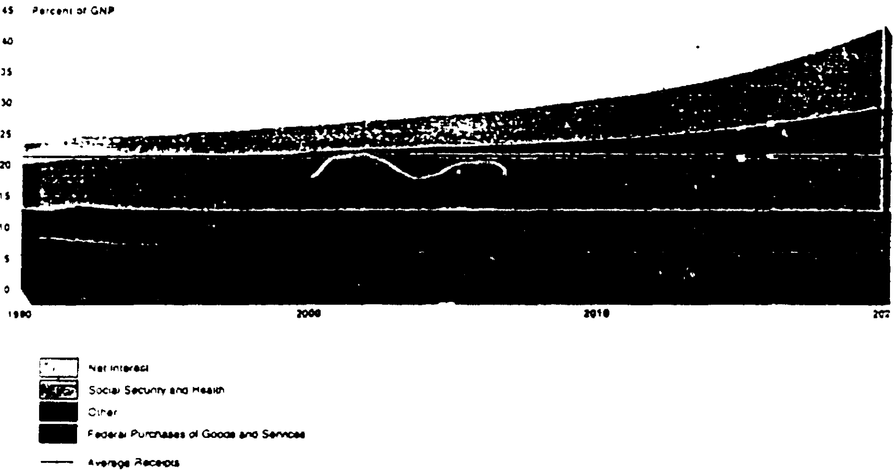
Although it is unlikely that this projection could come to pass, the individual assumptions underlying it are, in fact, conservative. To produce the numbers characterizing this scenario and others, we adapted an economic growth model developed by economists at the Federal Reserve Bank of New York. The expanded model allowed us to explore the long-term effects of different fiscal policies. In particular, the model captures the vicious circle linking the deficit, interest costs, and the na-

tional savings rate. This year1s deficit not only reduces this year's national saving rate, it also increases interest costs and deficits in future years, further depressing saving and economic growth. This model, and our assumptions, are described in the report we are issuing today.

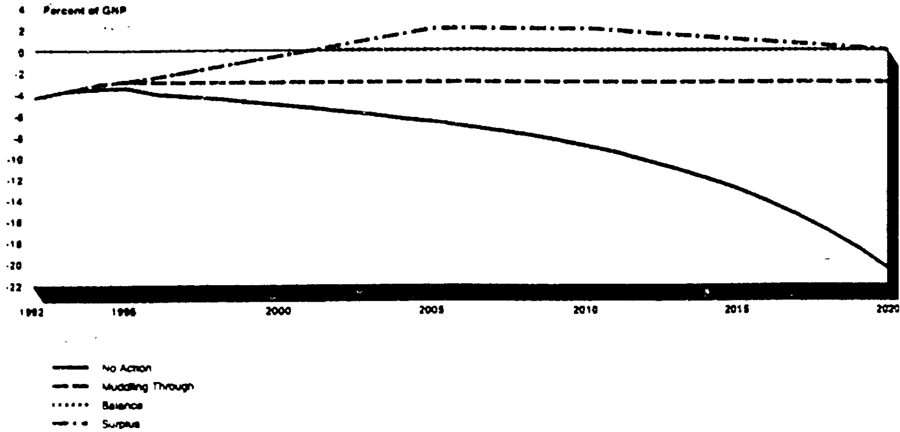
Figure 2 shows the forces driving the long-term explosion of federal spending if current policies continue: retirement costs, health spending, and interest payments. We called this course the "no action scenario." Beginning around the year 2010, the nation will undergo a major demographic shift. The 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 very old will increase. Moreover, the ratio of workers to retirees will decline from today's 3.4-to-1 to 2.4-to-1 in 2020.

These demographic trends have profound implications for the budget. The annual Social Security surpluses will begin declining around 2010, with outlays projected to exceed revenues by 2017 unless adjustments are made. to revenues or benefits in the meantime. The aging of the population will fuel the already rapid growth in.health care costs. Data from the Department of Health and Human Services indicate that Medicare and Medicaid outlays alone will grow from 2.8 percent of GNP in 1990 to about 7 perr ·nt by 2020. The burgeoning interest costs that inevitably accompany persistently ' ' ǵh deficits will grow to consume over 30 percent of federal spending.

Figure 2 Federal Expenditures in the No Action Scenario



Recognizing that the path of "no action" is unsustainable, we examined three alternative approaches to deal with the deficit, which are illustrated in figure 3. We called the first alternative "muddling through" since we assumed that somehow the deficit would be held to 3 percent of GNP. We compared this to (1) a path where budget balance is achieved in 2001 and maintained and (2) a surplus scenario where a 2 percent budget surplus is reached in 2005, maintained until 2010, and then phased down to balance by 2020.



THE ADVANTAGES OF PROMPT ACTION

A close examination of the results of the muddling through option shows the advantages of taking the early and major deficit reduction implied by either balance or surplus paths. Although muddling through requires less pain initially, maintaining a deficit of 3 percent of GNP grows progressively more difficult. We have to reduce the 2020 deficit alone by over half a trillion 1992 dollars to hold the deficit to 3 percent of GNP. This scenario would continue the government's preoccupation with deficits well into the next century, while perpetuating the current policy paralysis as well.

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. 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. Early and major deficit reduction, on the other hand, turns compound interest into a boon. Early cuts reduce debt service costs, thereby reducing the amount of deficit reduction that must come from real program reductions or revenue increases. The sooner we act, the more interest we save.

Demographics also argue for early action. Achieving a more robust economy by 2010 will help the relatively smaller working population shoulder the increased Social Security burden without reducing their future living standards. It will take time, however, for actions reducing the deficit to produce higher levels of investment and more rapid growth. If we wait until after the demographic shift begins and retirement costs start to escalate, the economic growth dividend may not come in time to help the next generation. We need to act early to ensure that the surpluses built up in the Social Security trust fund can actually be used to promote economic growth before they are dissipated by the program's future spending needs.

In addition, early action broadens the range of substantive policy options available. A short-term perspective leads to a search for "fast hits"—changes that yield quick savings. A long-term perspective allows for gradual changes and for the effects of early changes to multiply. It allows some changes to be phased in over time, permitting society to adjust and plan for the consequences. Often, a sensible path for policy changes shows small savings in early years but larger savings in later years.

The problem of health care cost containment provides a vivid example of this phenomenon. The preoccupation with each year's budget in isolation forces us into a hectic search for ways to save a few million dollars, often by fruitless attempts to shift costs to others. A longer time frame would encourage consideration of more fundamental issues regarding the way we deliver and finance health care, issues

having profound implications for the economy as a whole as well as the federal budget for decades to come.

Of course, moving from our current fiscal policy path to either the balance or surplus path will require sacrifice. The real question is, are the benefits achieved worth the pain? One way to answer that question is to assess the kind of legacy each alternative path leaves for the economy in the long-term and for succeeding generations.

Adopting either a balance or surplus path would provide the greatest benefit to the long-term health of the economy. As shown in table 1, real GNP would grow significantly while both foreign debt and public debt shrink toward zero. Major gains in economic output would be achieved under either scenario, while a greater share of domestic investment would be financed by domestic sources.

Table 1.—RESULTS OF ALTERNATIVE DEFICIT PATHS FOR 2020

[Per capita 1992 dollars]

Deficit paths	Real GNP	Foreign debt	Debt held by the public
No action	$23,875	$19,243	$45,816
Muddling through	30,374	8,460	18,702
Balance	32,555	3,748	4,665
Surplus	33,353	1,979	219

The gains associated with deficit reduction do not, of course, come for free. The hard choices needed to achieve a balance or surplus would temporarily reduce consumption as savings are increased. In the long term, however, the higher national saving rate brought about by deficit reduction would raise consumption significantly beyond levels that could otherwise have been achieved. Again, early deficit reduction would help ensure that the temporary reduction in consumption is spread over the larger current working population. The earlier we begin this effort, the greater assurances we have that economic benefits can be realized by the next generation of workers.

This shift in fiscal policy is long overdue, but simply making more resources available for private investment will not be enough. In a competitive world economy, we need to make this nation an attractive place to invest. Public policies encouraging the development of human capital, infrastructure, and research will help retain this country's status as a productive platform for economic growth and development. In this regard, it is particularly disturbing that federal programs oriented toward investment actually lost ground in the 1980s, surpassed as a share of GNP by federal interest payments and health care spending.

MAJOR BUDGET POLICY DECISIONS NEEDED

The task we face is large, but not impossible. Other nations, including Germany, Japan, Australia, and the United Kingdom, have moved from large deficits to near balance or surplus in the 1980s. However, we should not pretend that we can reach either of these paths without fundamental policy changes. I bow to no one in my commitment to and concern for efficient management, good financial controls, and accountability in government programs. We cannot afford to waste any of our scarce resources. And we cannot afford the erosion of public trust in government that inevitably follows the loss of accountability for public funds. But strengthened accountability and more efficient management and implementation of current programs, while vital objectives in their own right, cannot save enough money by themselves to solve our deficit problem.

Moreover, the amount of deficit reduction needed to achieve either balance or a surplus will be difficult, if not impossible, to achieve if any major areas of spending or potential revenues are set "off the table." The very magnitude of the changes needed should prompt a major debate over the role of the federal government and how to pay for it. Facing these issues openly will be painful, but the issues will not go away.

To achieve the necessary deficit reduction, decisionmakers must look at large and/or growing areas of the budget. I believe that every effort should be made first to reduce spending in these major categories. If a national debate on the federal role and spending priorities fails to identify sufficient savings to close the deficit, revenues could then be addressed as part of the deficit reduction strategy.

Mandatory spending is a logical category for examination because it has grown to be the largest sector of federal spending. Within that category, spending on health care—which is large and rising rapidly—is a particular candidate for review.

In this area, we must find ways to reduce underlying costs and the pressures increasing those costs. It is increasingly apparent that we cannot solve the problem by tinkering at the margin and shifting costs to others.

Sooner or later, the Social Security program must be adjusted, not only because it has such a large effect on the budget, but also because its projected annual outlays will exceed revenues by 2017. At that point, Social Security will be adding to the total deficit rather than offsetting it, as is the case today. Defense spending is another very large component of federal spending and, hence, must be included in all deliberations. It could become a candidate for additional reductions as the nation continues to define its changing role in the world.

Although domestic discretionary spending took large budgetary hits in the 1980s, it should not be exempt from scrutiny. A fundamental rethinking of the respective roles of federal, state, and local governments as well as the private sector might very well lead to reductions in this category of spending. However, since most federal investment activities are in domestic discretionary programs, some portion of the savings might be devoted to increased investment.

STRUCTURAL CHANGES IN THE BUDGET PROCESS

The available tax and spending choices that could move the budget toward balance or surplus are already well known and could be made under existing rules and practices. However, current practices place too little emphasis on the future effects of either aggregate fiscal policy or the composition of spending. A budget structure and a process that explicitly links current decisions to their impact on long-term economic growth would help focus the debate on these choices. The significant but short-term sacrifices of deficit reduction could be more easily compared to the long-term benefits accruing from such changes in budget policy.

There may be understandable skepticism about any proposal for a longer time frame. However, making and keeping commitments to long-term goals are not alien to American society. The interstate highway system, which took a generation to complete, and the Social Security system, with a 75-year planning horizon, are two prominent examples.

Any process that promotes a long-term focus would also direct attention to how the components of federal spending affect long-term productivity and growth. Although federal programs vary considerably in their impacts on the economy, the present budget process and structure do not encourage decisionmakers to take these differences into account in allocating resources.

Further, there is no framework to consider the investment implications of federal tax policy subsidies, such as depreciation rules or the research and experimentation tax credit, when making decisions on related spending programs. If planning for long-term economic growth is to become a central objective of the budget process, a new decision-making framework is needed—one in which the choice between consumption and investment spending is highlighted throughout the decision process rather than being displayed for information purposes after the fact.

If such a framework were in place, the Congress, each year, could determine explicitly the aggregate funding for total investment-related programs, as well as for the physical capital, human capital and research and development components of that total. To support such a decision process focusing on investment choices, improvements would be needed in the tools and information used to evaluate the relative impacts or rates of return of the various federal investment programs, to ensure that limited federal resources are used to promote the best choices among competing strategies and programs.

Having endorsed these changes in our budget process, let me hasten to add that there is no substitute for making the tough choices needed to set the nation on a productive path for future growth. We need to undertake the painful but necessary process of educating the American people on the choices and the consequences of failing to make them.

[Submitted by Senator Bill Bradley]

Issues Involved in Possible Revenue Options to Reduce the Federal Deficit

[Prepared by the Staff of the JOINT COMMITTEE ON TAXATION, June 4, 1992, JCX-20-92]

INTRODUCTION

The Senate Finance Subcommittee on Deficits, Debt Management, and International Debt has scheduled a public hearing on June 5, 1992, to address the long-term economic implications of the Federal budget deficit.

This document,[1] prepared by the staff of the Joint Committee on Taxation in connection with the June 5 Subcommittee hearing, discusses why policy makers might be concerned about the deficit and examines several selected revenue raising options to illustrate both the magnitude of revenues that could be generated by the alternatives and the potential economic impact of enacting these alternatives. The discussion of economic effects is brief; however, this discussion attempts to highlight key economic concerns that policymakers should address. Among the economic issues covered are: the potential for economic inefficiency that could be caused by enactment of the alternative; the distributional consequences of the alternative (i.e., who in society actually would bear the burden of the alternative); and the administrative or transitional costs that would accompany enactment of the alternative. Discussion of possible expenditure reducing or cost saving options is not within the scope of this document.

Inclusion of particular revenue raising options in this document should not be construed as[2] endorsement by the staff of the Joint Committee on Taxation. These alternatives were selected as representative of the categories of alternatives which might be considered as part of a serious effort to reduce the Federal deficit by raising additional Federal revenues. The primary goal of these illustrative revenue raising alternatives is to provide information for policymakers to help evaluate the alternatives.

The document is organized as follows. Part I presents some data on the size of the Federal deficit and briefly discusses why policymakers are concerned about the deficit. Part II presents several alternative rate increases in the context of the individual and corporate income taxes. Part III presents several income tax base broadeners for the individual and corporate income taxes. Finally, Part IV presents a number of excise and other consumption tax alternatives.

I. THE DEFICIT

During the past two decades large Federal budget deficits have become a central feature of public finance as practiced in the United States. Numerous commentators have warned of the dire long-term economic consequences of chronic Federal deficits.[3] Such widespread concern has drawn the attention of many policymakers. Virtually all agree that the problem of a large Federal deficit will not succumb to a simple solution. Rather, a concerted effort by citizens and their elected officials is needed in order to grapple with a deficit that exceeds $350 billion (over $1400 for every United States resident) in fiscal year 1992. The deficits have increased the national debt. The total interest bearing debt of the Federal government outstanding at the end of 1991 was approximately $3.8 trillion, or more than $15,000 per capita. A concerted effort to reduce the size of the deficit may require additional revenues and/or reductions in expenditures at the Federal level.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Issues Involved in Possible Revenue Options to Reduce the Federal Deficit* (JCX-20-92), June 4, 1992.

[2] Similarly, omission of a particular alternative should not be perceived as a statement of the preferences of the staff of the Joint Committee on Taxation. Time constraints in preparation of this document for the June 5 Subcommittee hearing precluded an in-depth analysis of various revenue options and limited as the number of alternatives discussed within each of the major categories.

[3] A sampling of these writings include: Richard Darman, "Director's Introduction," in President of the United States, Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1993,* January 1992; Congressional Budget Office, *Reducing the Deficit: Spending and Revenue Options,* February 1992; General Accounting Office, *Budget Policy: Prompt Action Necessary to Avert Long-term Damage to the Economy,* May 1992; and Joint Committee on Taxation, *Tax Policy and the Macroeconomy: Stabilization, Growth, and Income Distribution* (JCS-18-91), December 12, 1991.

Federal deficit

The Federal deficit for the 1991 fiscal year totaled $268.7 billion and is estimated to be in excess of $300 billion for the 1992 and 1993 fiscal years.[4] For 1991, this figure represented more than 4.5 percent of the nation's gross domestic product (GDP).[5] The projected deficits for 1992 and 1993 are estimated to represent more than six percent of GDP in 1992 and more than five percent of GDP in 1993.[6] While deficits of $200 billion or more represent large numbers, they are smaller in comparison to the size of the economy than some previous deficits incurred by the Federal Government. Figure 1 presents the Federal deficit as a percentage of real gross national product (GNP) from 1970 through 1991. Relative to the size of the economy, the deficit was larger from 1982 through 1987 than it is today. During the World War II, the Federal deficit exceeded 20 percent of GNP. However, between the end of the World War II and 1982, the Federal deficit only rarely exceeded 2.5 percent of GNP.

What does the deficit measure?

Overview.—The reported deficit measures the difference between current year Federal receipts and outlays. This measure has been subjected to criticisms on several grounds by accountants, economists, budget analysts, and policymakers. A common theme of the criticisms is that the measured deficit is an inadequate guide for policymakers to use in a number of situations and should not be relied upon to the exclusion of all other measures. Below is a nonexhaustive list of these criticisms.

Full-employment deficit.—Many observers argue that the actual size of the Federal deficit provides an inaccurate measure of government stimulus of aggregate demand. Even with no change in government policy the size of the deficit will change in a recession as the economic downturn reduces tax revenues and increases counter cyclical spending (e.g., unemployment benefits). These observers argue that for purposes of assessing macroeconomic policy, the deficit should be measured relative to full employment.[7] For example, a deficit of $100 billion when the economy is experiencing eight percent unemployment might be reduced to $25 billion if the economy were at full employment. The concept of the full-employment deficit is meant to measure the net fiscal stimulus the government is adding to the economy.

Accrual rather than cash accounting.—Some economists have commented that neither the actual nor the full-employment deficit is an accurate measure of Federal fiscal policy. They argue that such measures of the deficit include outlays, the liability for which may have occurred earlier and that the actual timing of the outlay has no real effect on the economy. An example in the current economic context would be the expansion in the actual Federal deficit incurred to cover insured deposits in the thrift and banking industries. Such liabilities were incurred when it became apparent the financial institutions were insolvent which occurred prior to the current outlays. Similarly, the cash budget does not include the outlays or receipts from future years for which the liability is incurred by a policy enacted today. For this reason, certain increases or decreases in the cash deficit may not accurately represent changes in government fiscal policy. On the other hand, it is often difficult to determine the proper amount of income to accrue under an accrual accounting system. For example, In the case of deposit insurance, it is not clear at what point liabilities should have been determined to have accrued.

Capital expenditure and trust fund budgeting.—Some analysts object to lumping together expenditures on capital goods with current expenditures on nondurable goods. They observe that capital expenditures, such as for the construction of a bridged provide services to the public for many years while non-capital spending may finance current consumption (e.g., transfer payments). They argue it is there-

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[4] President of the United States, Office of Management and Budget, *Budget of the United States Government, Fiscal Year 1993,* January 1992. See, also, Congressional Budget Office, *Analysis of the President's Budgetary Proposals for Fiscal Year 1993,* March 1992. The Congressional Budget Office (CBO) estimates the budget deficit to be $368 billion for fiscal year 1992 and $336 billion for fiscal year 1992.

[5] Gross Domestic Product (GDP) of a country is the value of all marketed goods and services produced in that country. Gross National Product (GNP) is GDP plus the net factor income received by residents of that country from abroad. Thus wages earned by a United States resident from temporary work abroad constitutes part of GNP but not GDP. Similarly, the returns from investment abroad constitute part of GNP but not GDP. Empirically, the difference between GDP and GNP is small for the United States.

[6] Congressional Budget Office, Analysis of the President's Budgetary Proposals for Fiscal Year 1993.

[7] By full employment, economists do not mean an unemployment rate of zero, but rather some larger number to reflect the normal quitting and search process of labor markets. There is debate about the "correct" measure of full employment for the United States economy.

fore appropriate to borrow to fund capital expenditures because borrowing and servicing the debt better matches the benefits and costs on an annual basis. To the extent that a deficit exists to finance capital expenditures, these analysts would argue the deficit should be no cause for concern. Similarly, these analysts argue that the budget should report separately capital expenditures and operating expenditures. This is the budget reporting practice of many States and local governments.

Similarly, others argue that where earmarked revenues have been provided to trust funds, separate accounting should be given to each trust fund. They argue that separate trust fund accounting would help policymakers better assess the costs and benefits associated with specific government programs.

Changers in values of government assets.—Another criticism of current deficit measures is that they do not account for the changing real value of government assets.[8] For example, the value of the national debt has been substantially reduced by inflation over the past two decades. Similarly, the real value of mineral rights on Federal lands has increased substantially. The reduction in the value of the debt and the increase in the value of mineral rights are like additional revenue to the government. In the case of debt, the government will now require fewer real resources to service the existing debt. In the case of mineral rights, the government in the future could auction such rights for greater revenues. To the extent that measures of current receipts and outlays omit changes in values of assets, the measured deficit need not tell policy makers anything about the current net income position of the government.

Policy concerns relating to large deficits

Constraints on current expenditures

Some policymakers are concerned about the size of the budget deficit because of the indirect effect it has on the level of current government expenditures for goods and services. By adding to the stock of the national debt, large budget deficits increase required outlays to meet interest expense on the national debt. If policy makers have agreed to limit the size of aggregate government expenditures, an increase in expenditures for interest reduces resources available for other purposes.

Potential "crowding out" of the private sector in the credit markets

Effect on investment and purchases of consumer durables.—Federal government spending that is financed with increased issuance of government bonds may increase the rate of interest in the Treasury bond markets. This rise in the Treasury bond rate in turn will raise rates for bonds issued by corporations and State and local governments as well as rates for consumer, mortgage, and business loans and may cause the rationing of credit. Such a tightening of credit markets can reduce business investment and personal consumption expenditures. This especially may be true for interest-sensitive sectors such as housing and consumer durables and for capital goods purchased by businesses that may have difficulty in obtaining credit. The Federal deficit is said to "crowd out" private investment and consumption.

Alternatively stated, by raising real borrowing costs, the cost of capital (the rate of return that investments must earn to be profitable) is increased. This makes many investment projects less attractive and aggregate investment falls as fewer investment projects are undertaken. Rates of investment are important because when an economy's rate of net investment (gross investment less depreciation) increases, the economy's stock of capital increases. A larger capital stock permits a fixed amount of labor to produce more goods and services. The larger a country's capital stock, the more productive its workers and generally, the higher its real wages and salaries. Thus, increases in investment tend to cause future increases in a nation's standard of living. Many policy makers are concerned that continued large deficits will continue the trend of low growth of wages and per capita GDP experienced by the United States for the past twenty years.[9]

Effect on trade.—Besides the contractionary effects of higher interest rates on consumer durables and investment goods, higher interest rates may also have a negative effect on net exports. Higher domestic interest rates attract foreign investment which drives up the value of the dollar. An appreciation of the dollar reduces the cost of imports to U.S. residents and raises the price of U.S. exports in foreign markets. As the price of imported goods falls relative to domestically produced goods, United States residents may substitute imported goods for domestically pro-

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[8] Robert Eisner and Paul J. Pieper, "How to Make Sense of the Deficit," *Public Interest*, vol. 78, Winter 1985, pp. 101–118.

[9] For more discussion of long-term economic performance, see, Joint Committee on Taxation, *Tax Policy and the Macroeconomy: Stabilization, Growth, and Income Distribution* (JCS–18–91), December 12, 1991.

duced goods to the detriment of trade sensitive industries. If these price changes result in a reduction in net exports (or an increase in net imports), there would be a contraction in the aggregate demand for U.S. goods and services.

Dearth of saving.—The effect on investment and on trade is exacerbated by the low rate of saving in the United States. Either domestic saving or borrowing from abroad funds private investment and government deficits.[10] The United States national saving rate is low when compared to that of other developed nations.[11] With saving rates lower and deficits larger than those that prevailed in the late 1960s, the share of national income devoted to investment must decline unless funds are borrowed from abroad.

Table 1 presents United States net saving by component as a percentage of gross national product. National saving is divided into private saving and public saving. Private saving comprises household or personal saving and business saving. Households save by not spending all of their disposable (i.e., after-tax) income. Businesses save by retaining some of their after-tax earnings. Public saving reflects the extent to which the Federal, State, and local governments run budget surpluses. As Table 1 demonstrates, net business saving,[12] net personal saving, and public saving were all lower during the 1980s than in any of the three previous decades. Though private saving remained positive, it fell during the 1980s. Moreover, public saving was consistently negative during the 1980s as the result of Federal deficits. The magnitude of public dissaving generally was larger relative to GNP in the 1980s than in earlier years. As the table indicates, net national saving is lower after 1981 than at any time in the post-World War II era. In 1983, 1985, 1986, and 1987 aggregate governmental dissaving consumed all, or more than all, of personal saving.

Table I.—COMPONENTS OF UNITED STATES NET NATIONAL SAVINGS AS A PERCENTAGE OF GNP, SELECTED YEARS, 1929–1990

Year	Net personal saving	Net business saving	Total net private saving	Public saving	Total net national saving
1929	2.5	2.3	4.8	1.0	5.8
1939	2.0	0.3	2.3	−2.4	−0.1
1949	2.8	4.0	6.9	−1.3	5.6
1954	4.4	2.6	7.0	−1.9	5.1
1959	4.4	3.2	7.6	−0.3	7.2
1964	4.8	3.9	8.8	−0.4	8.4
1969	4.4	2.6	7.0	1.0	8.0
1974	6.6	1.4	7.9	−0.3	7.6
1975	6.5	2.3	8.9	−4.1	4.8
1976	5.4	2.6	8.0	−2.2	5.8
1977	4.6	3.1	7.7	−1.0	6.7
1978	4.9	3.1	8.0	0.0	7.9
1979	4.7	2.5	7.2	0.5	7.6
1980	5.0	1.4	6.4	−1.3	5.1
1981	5.2	1.4	6.6	−1.0	5.7
1982	4.9	0.6	5.5	−3.5	2.0
1983	3.8	1.9	5.7	−3.8	2.0
1984	4.4	2.5	6.8	−2.8	4.1
1985	3.1	2.6	5.7	−3.3	2.4
1986	3.0	2.0	4.9	−3.4	1.5
1987	2.0	1.8	3.9	−2.4	1.5
1988	3.0	1.9	4.9	−2.0	2.9
1989	3.3	1.0	4.3	−1.7	2.6
1990	3.3	0.5	3.8	−2.3	1.5
Average 1950–59	4.7	2.8	7.5	−0.1	7.4
Average 1960–69	4.6	3.5	8.1	−0.3	7.9
Average 1970–79	5.6	2.4	8.0	−1.0	7.1
Average 1980–89	3.8	1.7	5.5	−2.5	3.0

Source: Department of Commerce, Bureau of Economic Analysis.

[10] For a more detailed discussion of saving, investment, and foreign borrowing, see Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States* (JCS–6–91), May 30, 1991.

[11] See Joint Committee on Taxation, *Factors Affecting the International Competitiveness of the United States*, for more data and discussion on this point.

[12] Table 1 presents net saving, which equals gross saving less capital consumption (depreciation).

Potential "accommodation" by the Federal Reserve

An additional concern caused by large Federal deficits is that Federal Reserve may "monetize" the debt. Expansionary monetary policy could keep interest rates low and credit abundant despite increased demand for money and loanable funds. This type of accommodating monetary policy may alleviate any tightening of credit, especially in the short run. However, many economists believe that, whatever improvements in credit conditions are provided by expansionary monetary policy, they are not sustained in the long run and are earned only at the cost of a higher rate of inflation.[13]

Intergenerational equity

Overview.—Policymakers have long argued whether deficit finance is fair to future generations. The simple analysis is that borrowing to fund current expenditures necessitates future taxes to service the debt obligation. The benefit of the expenditure may be received by current generations, while the debt is serviced by future generations. Historically, prior to the last twenty years, most debt incurred by the Federal government has been related to war finance. Arguably, the benefits of insuring freedom are valuable to all future generations. Many analysts have noted that the recent sizable additions to the national debt have not been war related, although they may, in part, be related to increased defense expenditures.

The discussion of alternative deficit measures suggested that the simple analysis of current expenditures leading to current benefits is not always accurate.[14] There is, however, a popular perception that the national debt is a burden on future generations and that large increases to that burden may represent a shifting of a portion of the burden from one generation to the next.

Generational accounts.—Recently, the notion of "generational accounting" has been developed to attempt to address the shortcomings of the deficit as a measure of intergenerational wealth transfers.[14] The goal of generational accounting is to calculate the present value over many years of the benefits and costs of government programs and assign the net value to various age cohorts of the current population as well as to cohorts yet unborn. For example, generational accounting would compute the present value of social security benefits that each individual might expect to receive during his or her lifetime and the present value of the same individual's payroll tax liability. In theory, generational accounts would reflect not only the burdens of taxes and the benefits from expenditure programs, but also the burdens and benefits of regulatory policies. Because the concept of generational accounting requires estimates of future economic activity such calculations are only suggestive. Accepting these caveats, one exercise in generational accounting has estimated that future generations will pay 79 percent more in taxes (net of transfers) than the generation of people who have just been born.[16]

Do deficits matter?

Even if there is no crowding out in the credit markets, some economists believe that increases in deficits do not matter to the aggregate economy. According to this school of thought, changes in fiscal policy provide no net stimulus because individuals receiving a tax cut or the income from increased government expenditures recognize that additional disposable income realized today will be offset by tax increases in the future that will be assessed to support the current increase in the deficit.[17] For example, it is widely believed that consumption is a function of con-

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[13] Milton Friedman, "The Role of Monetary Policy," *American Economic Review*, vol. 58 (March 1968), pp. 1–17.

[14] Discussion below introduces the economic concept of "Ricardian equivalence" which suggests that the debt service obligation may not create a burden for future generations.

[15] See Alan J. Auerbach, Jagadeesh Gokhale, and Laurence J. Kotlikoff, "Generational Accounts: A Meaningful Alternative to Deficit Accounting," in David Bradford, ed., *Tax Policy and the Economy*, vol. 5 (Cambridge: MIT Press for the National Bureau of Economic Research), 1991.

[16] This calculation combines the taxes and transfers of all levels of government, not solely the Federal Government. See, President of the United States, *Budget of the United States Government, Fiscal Year 1993.*

[17] This proposition is known as the "Ricardian equivalence" theorem. For more discussion, see Robert Barro, "Are Government Bonds Net Wealth?" *Journal of Political Economy*, vol. 82, November–December 1974. Ricardian equivalence does not necessarily hold in an economy where consumers and businesses are unable to obtain sufficient credit to meet their demands. In that case, when the government borrows to put cash in the hands of its citizens through lower taxes or increased spending it is, in effect, borrowing on their behalf. Accordingly, government borrowing may have some impact on output even though consumers perceive the future tax liability because in effect they get a loan for consumption through the government that they would not otherwise be able to obtain at the same cost.

sumers' wealth, which includes the current value of assets net of debt obligations plus the present value of future after-tax earnings. Because cuts in capital taxes increase the value of capital and cuts in wage taxes increase the present value of future earnings, tax cuts, especially permanent tax cuts, are believed to increase wealth and therefore increase consumption. However, many economists would argue that wealth is really not increased when increased future tax obligations (necessary to fund the current debt) are taken into account.

It may be improbable that all consumers fully take into account increased future tax obligations that result from an increase in the current government deficit. However, it does seem plausible that an increase in personal wealth resulting from a tax cut financed by an increase in public debt is less stimulative than a real increase in wealth resulting from higher pre-tax (and after-tax) income.

II. POSSIBLE INCOME TAX RATE INCREASES

A. Individual Income Tax Rate Increases

1. Create a 35-percent rate bracket for taxable incomes above $135,000 (unmarried individuals filing separate returns), $150,000 (unmarried individuals filing as heads of households), $200,000 (married individuals filing joint returns), and $100,000 (married individuals filing separate returns).
2. Impose a 10-percent surtax on individuals with taxable income over $1,000,000 ($500,000 for married taxpayers filing separate returns).

These proposals would be effective for taxable years beginning after December 31, 1992.

REVENUE EFFECTS

[Billions of dollars]

	1993	1994	1995	1996	1997	1993-97
1. 35-percent rate for higher-income taxpayers	3.9	7.1	7.5	7.4	7.4	33.3
2. Surtax on taxable income over $1,000,000	0.9	1.6	1.8	1.9	2.0	8.2

Proposals similar to these two alternatives were included in H.R. 4210, which was passed by the Congress on March 20, 1992, and vetoed by the President. Capital gains income would continue to be taxed at a maximum rate of 28 percent, as under present law. The thresholds for the 35-percent bracket would be indexed for inflation in the same manner as present law. The surtax would equal 10 percent of otherwise computed tax liability multiplied by the ratio of taxable income in excess of $1,000,000 to total taxable income. The effect of the surtax is that the more taxable income exceeds $1,000,000, the closer the surtax approaches a 10-percent increase in total tax liability. For alternative minimum tax purposes, the surtax would be implemented by increasing the tentative minimum tax by 2.4 percent of the amount by which alternative minimum taxable income exceeds $1,000, 000.

The burden of these rate increases would be concentrated among those taxpayers with the highest incomes. This could result in an increase in the progressivity of the individual income tax system. It can be argued that this tax increase provides a disincentive to labor supply. To the extent that the highest income people in society are the most productive, this tax rate increase may have some effect on overall output by discouraging labor supply from these members of society. To the extent that high incomes are primarily the result of random events and not due to extraordinarily high productivity, the effect on overall output will be smaller and perhaps negligible. Similarly, this tax rate increase will act to reduce the after-tax return to saving by affected individuals, perhaps discouraging these taxpayers from undertaking saving and encouraging consumption.

The proposed rate increase would widen the gap between the tax rate on ordinary income and the tax rate on capital gains income. This would provide additional incentive for individuals to attempt to convert ordinary income into tax-favored capital gains income.

B. Corporate Income Tax Rate Increases

Raise the top marginal income tax rate for corporations from 34 percent to 35 percent, effective for taxable years beginning after December 31, 1992.

REVENUE EFFECTS

[Billions of dollars]

	1993	1994	1995	1996	1997	1993–97
35-percent top rate on corporate taxable income	1.7	2.8	2.8	2.9	3.1	13.3

This tax rate increase would affect approximately 10 percent of corporate taxpayers; these corporations earn approximately 90 percent of corporate taxable income. An increase in the top corporate rate would increase the tax difference between firms that organize as corporations and those that choose other organizational forms (e.g., sole proprietorships, partnerships or subchapter S corporations). This could provide a tax disincentive to organize as a corporation, even when there are valid business reasons for favoring the corporate form of organization. Moreover, this increase could provide an incentive for existing investment to shift from corporate form to other organizational forms.

Increasing the top tax rate on corporations might increase the burden on investment activity done in the corporate form. If this resulted in a reduced after-tax return to these investments, fewer of these investments would be made. This effect might lower overall output by reducing investment.

To the extent the burden of a corporate income tax rate increase is borne by the owners of corporate shares, this proposal could result in a windfall loss to current shareholders. This would occur as the price of corporate shares decreases to equate the after-tax rate of return to these investments with the after-tax rate of return of investments of comparable risk. To the extent the burden of the corporate income tax is borne by all capital (rather than just corporate shares), there would be a similar windfall loss to all owners of existing (or "old") capital.

III. POSSIBLE INCOME TAX BASE BROADENING OPTIONS

A. Limit Individual Exclusion for Fringe Benefits

The proposal would limit the exclusion from gross income for employer-provided health insurance to $335 per month for family coverage and $135 per month for individual coverage (these amounts are expressed in 1993 dollars and would be indexed for inflation). In addition, the proposal would limit the benefits payable under a defined benefit pension plan to the Social Security wage base ($55,500 in 1992 dollars), with commensurate reductions in the limits on contributions for defined contribution pension plans. The proposal would be effective for years beginning after December 31, 1992.

REVENUE EFFECTS

[Billions of dollars]

	1993	1994	1995	1996	1997	1993–97
Limit on exclusion for employer-paid health insurance	11.6	19.4	24.1	29.5	35.5	120.1
Decrease limits on defined benefit pension plans to the Social Security wage base (with commensurate reduction for defined contribution plans)	1.3	3.7	4.1	4.5	4.5	18.1

Under present law, amounts contributed by employers for employee health and pension benefits generally are excluded from the employee's gross income. The proposal would limit the amount of health and pension benefits that may be excluded.

Because the tax rate on health benefits is less than that on cash wages, employees and employers have an incentive to fashion compensation packages to include more health benefits than they would if there were no difference in tax treatment. An employee would prefer to be compensated with health benefits as long as the value of a dollar of health benefits is worth at least (1—employee's marginal tax rate) dollars in cash wages to the employee. This incentive for overconsumption of health benefits

could be reduced if the value of an extra dollar of health benefits would be equal to that of a dollar of cash wages.

The tax treatment of pension benefits creates a similar bias in favor of compensation in the form of pension contributions. Subject to annual contribution limits, pensions are taxed under consumption tax principles: an exclusion is allowed for contributions, no tax is imposed on accruing earnings, and all proceeds are taxed when distributed. Such treatment allows tax-free accrual of returns and is more favorable than the tax treatment allowed under income tax principals. Limiting the exclusion would make saving for retirement more expensive; the net effect on the amount of saving is uncertain because of competing substitution and income effects. If saving for retirement is reduced by the proposal, then the Government may be induced to increase payments to future elderly generations, which would require additional outlays.

In general, lower-income individuals receive fewer health and pension benefits than do high-income individuals. Limitations on the benefits may thus increase progressivity.

B. Limit Home Mortgage Interest Deduction

The proposal would alternatively eliminate the deduction for mortgage interest (including home equity loans) or reduce the maximum amount of home mortgage indebtedness that qualifies for interest deduction to $300,000. Under the latter alternative, there would be no grandfathering of existing mortgages. The proposal would be effective for taxable years beginning after December 31, 1992.

REVENUE EFFECTS

[Billions of dollars]

	1993	1994	1995	1996	1997	1993-97
Eliminate mortgage interest deductions	31.0	52.8	54.7	56.6	58.6	253.6
$300,000 limit on home mortgage indebtedness that qualifies for interest deductions	1.0	2.6	3.2	3.7	4.2	14.7

Under present law, taxpayers who choose to itemize deductions may claim a deduction for interest paid on home mortgage and home equity indebtedness. The amount of home mortgage indebtedness that may qualify for interest deductions is limited to $1,000,000. The amount of home equity interest that may qualify for interest deductions is limited to the lesser of $100,000 or the amount of equity in the house.

To the extent that the deductibility of mortgage interest subsidizes owner-occupied housing, this proposal reduces the subsidy. This reduction in the subsidy could improve equity, since the value of the subsidy is larger for those taxpayers in higher marginal tax brackets. Yet the main subsidy to owner-occupied housing is not the deductibility of mortgage interest but the absence of taxation on the flow of housing services the house provides.[18] Under the proposal, this underlying benefit of untaxed flows of services will continue to be worth more for taxpayers in higher brackets.

Denial of the deduction for mortgage interest may put otherwise similar renters and mortgagee owners on an equal footing (the renter gets no deduction for rent

[18] To illustrate this point, consider a taxpayer with $80,000 in assets who wants to live in an $80,000 house. Assume that the rate of return on all capital (including housing) is 10 percent. The taxpayer has a choice of renting an $80,000 house (for which the annual rent would be $8,000 (10 percent of the house's value)), buying an $80,000 house for cash, or borrowing $80,000 (at 10 percent interest) in order to buy a house. In all three cases, the taxpayer receives an identical amount of housing services; only the tax treatment differs across the choices.

If the taxpayer rents, he can invest his $80,000 to yield taxable dividends of $8,000. What remains after tax can be used to pay some of the $8,000 rent. He has taxable income of $8,000 on the transaction.

If the taxpayer purchases the home for cash, he has no taxable income on the transaction.

Under present law, if the taxpayer borrows $80,000 to purchase the house, he can invest his own $80,000 to yield dividends of $8,000 sufficient to pay the interest on his mortgage. Because the mortgage interest is deductible, it offsets his dividend income, leaving him with no taxable income on the transaction. Thus, under present law, homeowners are benefited relative to renters regardless of whether they have a mortgage or not.

payments and the mortgagee gets no interest deduction). But taxpayers who are able to buy their homes outright are advantaged relative to mortgage owners because the return to their investment inowner-occupied housing is untaxed.[19]

C. Limit Benefits of Itemized Deductions to 15 Percent

The proposal would limit the benefit of itemized deductions by in effect converting them into tax credits equal to 15 percent of the amount of itemized deductions. For taxpayers in the 15-percent marginal tax bracket, the provision would result in no change from present law. For taxpayers in higher marginal tax brackets, the value of the itemized deductions would be reduced. The proposal would be effective for taxable years beginning after December 31, 1992.

REVENUE EFFECTS

[Billions of dollars]

	1993	1994	1995	1996	1997	1993-97
Limit tax benefit of itemized deductions to 15 percent	26.8	61.6	66.2	72.4	79.4	306.4

Taxpayers may claim either a standard deduction or itemized deductions from adjusted gross income. The value of itemized deductions to a taxpayer depends upon the taxpayer's marginal tax rate. By limiting the benefit of itemized deductions to 15 percent of the amount deducted, the proposal would make the value of itemized deductions the same for all taxpayers who choose to itemize.

The proposal may increase equity by allowing the same value of itemized deductions to all taxpayers. But to the extent that itemized deductions are allowed to reflect reduced ability to pay (for example, in the case of medical expenses), then the proposal would result in higher taxes for those taxpayers less able to pay. Also, the proposal would lead to income mismeasurement by reducing the value of deductions such as those for casualty losses and miscellaneous employee expenses.

D. Reduce Deductibility of Business Meals and Entertainment

The proposal would allow taxpayers to deduct only 50 percent of the cost of meals and entertainment expenses incurred in connection with business activity. The proposal would be effective for taxable years beginning after December 31, 1992.

REVENUE EFFECTS

[Billions of dollars]

	1993	1994	1995	1996	1997	1993-97
Reduce deduction for business meals and entertainment to 50 percent	1.6	3.4	3.4	3.5	3.6	15.5

Under present law, taxpayers may deduct 80 percent of the cost of meals and entertainment expenses incurred in connection with business activity.

Businesses are allowed to deduct from gross income the ordinary and necessary expenses of generating such income. To the extent that some part of the expenditure on business meals and entertainment represents consumption and not a cost of generating income, the deduction should be limited. There is not, however, a clear delineation of what fraction of such expenditures represent consumption.

E. Include Capital Gains in the Last Tax Return at Death

Under present law, at the death of an individual who holds appreciated capital assets the basis of such assets is stepped up to the fair market value at the time of the death. Thus heirs who later sell such assets are liable for tax only on capital gains since the death of the previous holder. Any capital gains on the asset prior to the death of the holder are untaxed. The proposal would include the capital gains prior to the death of the holder in the decedent's last tax return. The proposal would be effective for taxable years beginning after December 31, 1992.

[19] Return to the example from the previous footnote. Under the proposal to eliminate the deduction for mortgage interest, if the taxpayer borrows $80,000 to purchase the house, he can no longer offset the $8,000 of dividend income with mortgage interest. He is in the same situation as if he rented.

REVENUE EFFECTS

[Billions of dollars]

	1993	1994	1995	1996	1997	1993–97
Tax capital gains at death	(1)	3.2	3.9	4.6	5.3	17.0

[1] Less than $50 million.

Because holding appreciated capital assets until death results in an effective tax rate of zero on these capital gains, taxpayers have an incentive to hold on to such assets until death. This incentive is a major contributor to the so-called "lock-in effect" of capital gain taxation rules. Investors may forego higher before-tax returns that could be earned on another asset because selling the appreciated capital asset to purchase the new asset would result in a lower after-tax return. Eliminating the step-up in basis as death would reduce the lock-in effect. On the other hand, taxing the appreciation of an asset at death will reduce the after-tax return to these assets, compared to current law. This may act to discourage saving, where the intent is to pass assets on to one's heirs.

F. Increase the Portion of Social Security Benefits Subject to Income Tax

Under present law, a portion of Social Security and tier 1 railroad retirement benefits is included in taxable income for taxpayers whose combined income, defined as adjusted gross income (AGI) plus (1) interest on tax-exempt bonds and (2) 50 percent of Social Security and tier 1 railroad retirement benefits, exceeds a threshold amount. The threshold amount is $32,000 for married taxpayers filing joint returns and $25,000 for unmarried taxpayers. The amount of benefits included in taxable income is the lesser of (1) 50 percent of Social Security and tier 1 railroad retirement benefits, or (2) 50 percent of the excess of the taxpayer's combined income over the threshold amount. The proposal would increase the maximum portion of Social Security and tier 1 railroad retirement benefits included in gross income from 50 percent to 85 percent. The alternative would be effective for taxable years beginning after December 31, 1992.

REVENUE EFFECTS

[Billions of dollars]

	1993	1994	1995	1996	1997	1993–97
Increase maximum portion of Social Security benefits in taxable income from 50 percent to 85 percent	2.7	5.6	6.2	6.9	7.7	29.1

This proposal would increase the individual income tax liabilities of those Social Security and railroad retirement recipients with combined incomes above the applicable threshold. Thus, the proposal would primarily affect older taxpayers with incomes above the median for elderly households. A large percentage of any current Social Security recipient's benefits does not constitute a return of the original contribution made with after-tax dollars. Rather, the bulk of benefits received consists of the employer's contribution plus the implicit earnings on these contributions. The Social Security Administration has estimated that, for individuals retiring between 2025 and 2030, the lifetime aggregate employee contributions will, on average, equal approximately 7 percent of aggregate benefits. Similarly, CBO has estimated that the highest corresponding figure for single males earning the maximum Social Security taxable wage base is 15 percent. These estimates indicate that the 85-percent inclusion figure used in this proposal is a reasonable estimate of the portion of benefits received that represents amounts other than employee contributions made with previously taxed dollars.

G. Repeal Percentage Depletion for Extractive Industries

Under present law, a specified percentage of a property's gross income may be deducted in determining taxable income, regardless of the actual capitalized costs of the property. The proposal would eliminate the availability of percentage depletion deductions for all extractive industries, while retaining the availability of cost depletion. The proposal would be effective for taxable years beginning after December 31, 1992.

REVENUE EFFECTS

[Billions of dollars]

	1993	1994	1995	1996	1997	1993–97
Repeal percentage depletion	0.5	0.9	1.0	1.0	1.0	4.5

Percentage depletion deduction is claimed when the amount is larger than the deduction under cost depletion, which permits a ratable deduction of the capitalized costs of the property. In particular, percentage depletion deductions are available for properties where the adjusted basis (essentially the cost of the property less any depreciation or depletion claimed) is small or zero. Thus, percentage depletion deductions may result in a mismeasurement of net income from a property. In the long run, the burden of any tax increase resulting from this alternative would generally fall on the owner of the mineral rights to the property, since this would ordinarily be the least mobile factor of production. In the short run, the burden of the tax may fall on other parties (e.g., operators of the production facility, workers in the production facility, consumers of the product), since there may be fixed or contractual relationships that cannot be altered in the short run.

H. Repeal the Possessions Tax Credit

A United States corporation operating in Puerto Rico or any U.S. possession may claim the possessions tax credit instead of the foreign tax credit (the possessions tax credit is referred to as the Section 936 credit). The possessions tax credit effectively exempts income sourced by a U.S. corporation to Puerto Rico or another U.S. possession from U.S. corporate income tax. This alternative would repeal the possessions tax credit for taxable years beginning after December 31, 1992.

REVENUE EFFECTS

[Billions of dollars]

	1993	1994	1995	1996	1997	1993–97
Repeal possessions tax credit	1.7	3.1	3.3	3.4	3.6	15.0

A U.S. corporation may elect to claim the possessions tax credit if at least 80 percent of its gross income for the last three years is sourced to Puerto Rico or another U.S. possession and at least 75 percent of this income is from the active conduct of a trade or business. The possessions tax credit is intended to promote employment in Puerto Rico and other U.S. possessions, and studies indicate that a substantial fraction of all manufacturing employment in Puerto Rico takes place in corporations claiming the possession tax credit.[20] However, one effect of the possessions tax credit appears to be the encouragement of the reallocation of income generated by intangible assets (e.g., patents) to sources located in U.S. possessions. This artificial reallocation of income does not, by itself, promote employment in the possessions, and may be viewed as an inefficient use of society's resources. When viewed in the context of revenue foregone per job created, the possessions tax credit is sometimes considered an expensive economic development tool. For instance, a recent report by the General Accounting Office has estimated that the average amount of tax benefits received by firms in the drug industry (a major user of the possession tax credit) in 1989 was over $70,000 per job created.[21]

IV. POSSIBLE CONSUMPTION TAX INCREASES

A. Impose a Narrow-Based Federal Value-Added Tax

The proposal would impose a 5-percent value-added tax on consumption, with exemptions for food, housing, and medical care. The proposal would be effective as of January 1, 1994, due to the lead time needed to implement a Federal value-added tax.

[20] For example, see Internal Revenue Service, U.S. Possessions Corporation Returns—1987, *Statistics of Income Bulletin*, Summer 1991.

[21] General Accounting Office, *Pharmaceutical Industry: Tax Benefits of Operating in Puerto Rico*, GAO/GGD–92–72BR, May 1992.

REVENUE EFFECTS

[Billions of dollars]

	1993	1994	1995	1996	1997	1993-97
5-percent value-added tax on narrow consumption base	....	47.0	70.7	73.0	77.0	267.0

A Federal value-added tax has approximately the same economic effect as a national level retail sales tax. This means that a value-added tax would discourage consumption of the affected goods and services, and generally would encourage saving over current consumption. The burden of this tax is generally believed to fall on those individuals purchasing taxed goods and services. When compared to annual income, a value-added tax is regressive, since the relative burden is larger for those who consume all, or nearly all, of their annual income. When compared to a measure of lifetime income, a value-added tax is more nearly proportional, since nearly all taxpayers consume the vast bulk of their lifetime income.[22] Imposition of a value-added tax would be expected to cause a one-time increase in consumer prices, and hence, measured inflation. However, assuming the Federal Reserve reacted to accommodate this price increase, there would not be an acceleration in ongoing inflation. Most countries have chosen to implement a value-added tax instead of a national level sales tax (even though both have very similar economic effects) since there is less scope for tax evasion under the multi-stage collection procedures inherent in a value-added tax. However, the administrative costs of starting a new tax system would be substantial. Accordingly, conventional wisdom is that if a value-added tax is adopted, the rate should be sufficiently high (say, 5 percent) to offset the initially large start-up costs.

B. Impose a Broad-Based Energy Tax

The proposal would impose a 5-percent ad valorem excise tax—on a broad class of energy purchases. Conceptually, this tax would be a retail level tax on all consumption of energy (e.g., coal, petroleum, natural gas, electricity). The tax would apply to all energy purchases on or after October 1, 1992.

REVENUE EFFECTS

[Billions of dollars]

	1993	1994	1995	1996	1997	1993-97
5-percent ad valorem tax on all energy consumption ...	13.4	16.6	17.4	18.2	19.0	84.6

A broad-based energy tax could be justified as correcting the externality caused by the market price of energy being below its social cost (e.g., social costs due to pollution caused by energy consumption). The proposed excise tax would make energy purchases more costly in relative terms than other types of consumption. This would encourage conservation of all forms of energy, potentially limiting emissions of carbon dioxide, often cited as a "greenhouse gas." To the extent the tax is borne by firms that consume energy in the production process, U.S. manufacturers may be put at a competitive disadvantage relative to foreign firms that operate in jurisdictions without such energy taxes. Mitigating this potential effect, though, is the observation that almost all other countries tax energy consumption more heavily than does the United States.

Generally, it is believed that much of the burden of an excise tax on energy consumption would be passed forward in the form of higher prices to consumers of energy. To the extent that energy consumption increases less than proportionately with income, this excise tax would be regressive with respect to annual income. This larger relative consumption of energy among lower-income individuals could be the case if these individuals are unable to easily shift to more energy-efficient heaters, automobiles, and/or appliances.

This excise tax could be imposed as a retail level tax on all energy sales. Such a point of imposition would have the beneficial effect of not altering relative prices

[22] See, for example, Congressional Budget Office, *Effects of Adopting a Value-Added Tax*, February 1992.

for different energy sources, thereby minimizing market distortions. However, a retail level tax would entail many more taxpayers being brought into the excise tax system than if the tax were imposed at the producer level. In this case, administrative costs must be weighed against efficiency costs in choosing the point where the tax is levied.

C. Increase Motor Fuel Excise Taxes

The excise taxes on motor fuels (currently 14.1 cents per gallon for gasoline and 20.1 cents per gallon for diesel fuel) could be increased by 12 cents per gallon. The proposal would be effective on October 1, 1992.

REVENUE EFFECTS

[Billions of dollars]

	1993	1994	1995	1996	1997	1993–97
Increase motor fuels taxes by 12 cents per gallon	10.9	11.0	10.8	10.9	11.2	54.8

More than 25 percent of total energy consumption in the United States is attributed to transportation, the bulk of which is motor fuels consumption. Increasing the excise taxes on motor fuels would provide encouragement for conservation of these energy sources, reducing U.S. dependence on imported petroleum.

Generally, it is believed that much of the burden the motor fuels excise tax is passed forward in the form of higher prices to consumers. To the extent that motor fuels consumption increases less than proportionately with income, this excise tax will be regressive with respect to annual income. This larger relative consumption of motor fuels among lower-income individuals could be the case if these individuals drive less energy-efficient automobiles. To the extent that consumption of motor fuels is larger in some regions of the country than others, this proposal might be considered regionally non-neutral. For example, it is often asserted that residents of western States drive much greater distances than do residents of more densely populated eastern States.

An increase in the tax rates for motor fuels that is intended to promote conservation might have its effect blunted somewhat if the various exemptions for motor fuels taxation are maintained. For instance, State and local government use of motor fuels is tax-exempt, as is off-road use (e.g., farming). It might be appropriate to extend the increase in motor fuels taxes to these currently exempt uses.

D. Increase Excise Tax Rates on Alcoholic Beverages

The proposal would increase all alcoholic beverage excise taxes to the equivalent of $16.00 per proof gallon, effective on October 1, 1992.

REVENUE EFFECTS

[Billions of dollars]

	1993	1994	1995	1996	1997	1993–97
Increase excise tax rates on all alcoholic beverages to $16.00 per proof gallon equivalent	5.0	4.9	4.9	4.9	5.0	23.5

Current Federal excise taxes on beer and wine are significantly lower than the tax on distilled spirits on an equivalent alcohol content basis. The current tax on distilled spirits of $13.50 per proof gallon is a tax of about 21 cents per ounce of alcohol. This compares to a tax rate of about 10 cents per ounce of alcohol for beer (assuming an average alcoholic content of 4.5 percent for beer) and a tax rate of about 8 cents per ounce of alcohol for table wine (assuming an average alcoholic content of 11 percent for table wine). A tax of $16.00 per proof gallon on all alcoholic beverages would result in a tax of about 25 cents per ounce of alcohol.

Studies have indicated that the direct and indirect social costs ("external costs") from alcohol consumption are much higher than the revenues currently generated

from alcohol excise taxes.[23] Increasing the alcoholic beverage taxes could help discourage consumption of alcoholic beverages and reduce some of the external costs of alcohol consumption.[24]

Although excise taxes are generally viewed as regressive, the alcoholic beverage taxes are imposed on discretionary purchases as compared to necessities for lower-income persons. From a public policy perspective, it could be argued that alcoholic beverage taxes should be imposed at equivalent rates based on alcohol content, since the major types of alcoholic beverages often are substitutes for each other.

In addition, the excise tax on alcoholic beverages could be indexed for future inflation. This alternative proposal is not reflected in the above revenue estimates.

E. Increase Excise Tax on Cigarettes

The proposal would increase the scheduled excise tax rate for cigarettes on January 1, 1993, from 24 cents per pack (of 20 cigarettes) to 48 cents per pack. (The current law tax is scheduled to increase from 20 cents to 24 cents per pack on January 1, 1993.)

REVENUE EFFECTS

[Billions of dollars]

	1993	1994	1995	1996	1997	1993–97
Increase excise tax on cigarettes to 48 cents per pack	2.9	3.9	3.8	3.8	3.7	18.1

The current Federal cigarette excise tax rate is imposed at a flat rate per unit, rather than being adjusted to reflect inflation. Although the cigarette tax rate was increased from 16 cents to 20 cents per pack on January 1, 1991, and is scheduled to be increased further to 24 cents per pack on January 1, 1993, the effective rate (in real terms) is still much lower than it was in 1951 (the excise tax rate for 1951 translated to 1992 dollars would be approximately 42 cents per pack).

Studies have indicated that there are significant direct and indirect social costs ("external costs") associated with cigarette smoking as well as governmental health expenditures attributable to cigarette-related diseases.[25] Increasing cigarette excise taxes could discourage consumption and might prevent people from starting to smoke, which would reduce long-term health costs and premature deaths associated with smoking.

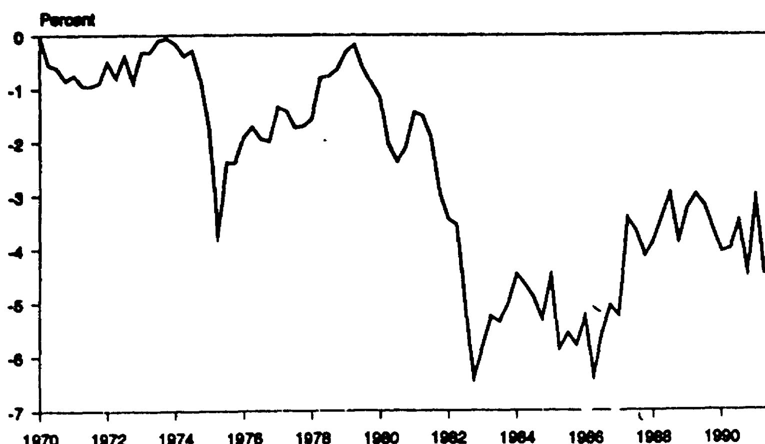
While excise taxes generally are viewed as regressive, cigarette excise taxes are imposed on discretionary purchases rather than necessities for lower-income persons. This may ameliorate the concern with the regressive nature of this proposal.

In addition, the excise tax on cigarettes could be indexed for future inflation. This alternative proposal is not reflected in the above revenue estimate.

[23] W. Manning, E. Keeler, J. Newhouse, E. Sloss, and J. Wasserman, "The Taxes of Sin: Do Smokers and Drinkers Pay Their Way?," *Journal of the American Medical Association*, Vol. 261, No. 11, March 17, 1989.

[24] Philip Cook and George Tauchen, "The Effect of Liquor Taxes on Heavy Drinking," *Bell Journal of Economics*, Vol. 13, No. 2, Autumn 1982.

[25] Manning, et al, "The Taxes of Sin: Do Smokers and Drinkers Pay Their Way?"



PREPARED STATEMENT OF JOHN H. MAKIN

Mr. Chairman and Members of the Committee, thank you for allowing me to testify on the important subject of the long-term economic implications of the federal budget deficit and to offer some comments on the General Accounting Office report entitled *Budget Policy: Prompt Action Necessary to Avert Long-Term Damage to the Economy.*

I am attaching to my testimony today a recent analysis I conducted of U.S. fiscal policy that contains more detailed material that underlies my brief statement before the committee today. Beyond that I am burdened with some strong pre-dispositions about the long-run role of debt and taxes in the American economy, just having completed a book on that subject with my colleague Norman Ornstein.

Here I would like to characterize briefly my views on the primary issues raised in your letter of invitation to testify. I view budget policy as something with modest potential to reduce economic fluctuations or to smooth out business cycles with relatively little impact on the long-run trajectory of growth. Tax policy provisions per se, especially tax policy that affects saving and investment such as the tax treatment of interest income and expense, double taxation of dividends, integration of corporate taxes with individual taxes, and inflation indexing of the tax code are measures with a more important impact on economic growth. The U.S. Treasury's recent study on integration of individual and corporate tax is a good example of analysis of tax policy relevant to economic growth.

In order to render a professional judgment on the model of the Federal Reserve Bank of New York relied upon by GAO to perform simulations on the economic effects of deficit reduction, I would need to examine the specification of that model. However, as the GAO study specifically and cautiously recognizes, simulation studies, especially long-run simulation studies are prisoners of some controversial assumptions about economic behavior. Therefore, I do not think it necessary to be too much constrained in expressing my own views by the favorable results indicated in the FRBHY model simulations concerning deficit reduction and growth.

Identification of the primary causes of continued federal budget deficits in the U.S. is considerably simpler than analysis of their economic impact. The growth of entitlements, specifically social security, medicare and medicaid are the primary causes of the growth of structural or underlying budget deficits. By definition, since no changes in the laws that govern these programs has occurred during the period since 1985 when the struggle with the budget deficit began, none of these programs has been altered as part of the efforts to reduce budget deficits. Since taken all together they constitute about half of total federal outlays it is little wonder that efforts at deficit reduction have not been successful.

Economists are not best equipped to discuss reforms in the budget process, but I do believe that the capital-based budgeting proposed by GAO is a sound idea. In terms of the long-run help of the economy there is a fundamental difference between federal government outlays on sound public infrastructure projects and federal government outlays that go largely to augment consumption.

In view of the extreme difficulty encountered by the Congress and the administration in reducing federal budget deficits, I am a supporter of a balanced budget amendment to the Constitution that would require that the president submit to the Congress a balanced budget and that Congress enact a balanced budget. I am well aware of the ability of executive and legislative bodies to get around the constraints of a balanced budget amendment, primarily by classifying as many outlays as possible as capital outlays, but still believe that a Constitutional amendment that requires a balanced budget would be useful. You can't beat a law without a law. The balanced budget amendment would provide a sound legal footing to initiate changes in legislation necessary to reduce the growth of outlays on entitlements. This step is a necessary condition to reduce the federal budget deficit.

Beyond budget reforms, the federal government of course needs to maintain important infrastructure such as highways and ports and to provide inducements for investment in human capital and research and development. However, the experience of the last three decades does not suggest that simply spending more money in areas like education provides a reliable improvement in the measured performance of American students. In my view the best thing that the federal government could do to improve education would be to enlarge the range of choices available to parents attempting to obtain for their children the best possible education. Broadly characterized, the American system of primary and secondary education in the public sector displays many of the symptoms of a protected monopoly that should be eliminated. It should be possible for American families to send their children to private schools without being fully taxed to maintain public schools that are unable to teach students basic reading and mathematics skills.

If the primary focus of the ongoing exercise of examining the effect of budget deficits on long-run economic performance is to find ways to improve economic performance, then increased taxes cannot play a positive role. A significant increase in the federal tax burden beyond the 20 to 21 percent of GDP that has characterized federal taxes over the past several decades would increase the dead weight loss that inevitably is associated with the collection of taxes. If the objective is to improve economic performance rather than increase taxes, the U.S. should complete the job of tax reform begun in 1986 and remove the biases against saving and investment that were left unaddressed in that tax reform.

Broadly, the case put by GAO and others against large federal budget deficits is that they absorb private saving and thereby reduce domestically financed investment that leads to enhanced capital formation and economic growth. Over the last decade both large federal budget deficits and reduced personal saving by American households have contributed to the reduction in the national saving rate so that during the 1980s when investment was strong it was necessary for the United States to import capital from abroad in order to finance an increase in investment. The result, of course, has been that a small portion of the U.S. capital stock is now owned by foreigners who will benefit from its productivity over the years.

I believe that it would be prudent for the U.S. government to take steps to reduce the budget deficit, primarily by reducing the growth of outlays on entitlements. These measures would include adjustments to the indexation formulas that are used to maintain the real purchasing power of entitlements. The consumer price index overstates inflation for well known technical reasons and therefore the oft-repeated suggestion to use two-thirds of the CPI inflation rate as the indexing formula for entitlements should be seriously considered. The growth of outlays on health care could be reduced to manageable proportions by giving tax payers above the poverty level an incentive to self-insure. This incentive could be provided by replacing the deductibility of health care costs with a tax credit that households could allocate on health care as they saw fit. What households would discover, as all specialists in health care costs know would be that modest self-insurance, say up to $1,000 of

medical expenses a year, would greatly reduce the cost of heath care insurance. It would also put health care consumers in the position of not being indifferent to the cost of routine health care.

With all of the intensely negative discussion of the economic harm from large federal budget deficits over the past decade it is important to maintain some perspective. I believe that federal budget deficits have gone on long enough at a level large enough to suggest that some structural changes should be undertaken to reduce the budget deficits so that the growth rate of federal debt is held to a level about equal to the rate of real economic growth. That could be accomplished with constraints on outlays on federal health care and retirement programs without tax increases.

I do not believe that either the balance sheet or the income statement of the federal government has reached crisis proportions. I base this belief on an analysis I did comparing federal income statements and balance sheets with those of U.S. corporations. (See detailed analysis in attached *Perspective on U.S. Fiscal Policy Before and After 1990.*) Broadly the federal government's fiscal condition has gone from one that is superior to most private corporations to one that is about equal to that of most private corporations over the last decade during which budget deficits have been unusually large. In view of the federal government's ability to tax to finance its borrowing, judged by the criterion employed to judge credit-worthiness of private companies the fiscal position of the federal government is essentially sound but the deterioration should be stopped.

A very broad look at U.S. wealth accumulation over the last six decades is also useful in assessing the need for increased national saving. The 1930s was the last decade when national net real wealth per capita actually fell at an average rate one percent per year. The average growth rate of national net wealth per capita rose steadily in the following three decades to 1.32 percent per year during the 1940's 2.1 percent per year during the 1950's and 2.68 percent per year during the 1960's. Thereafter the annual growth rate of net real wealth per capita began to decelerate to 2.09 percent per year during the 1970's and 1.33 percent per year during the 1980's.

It is important to remember that although the increase in national net real wealth per capita has slowed that, even during the much decried 1980s, Americans on average were getting wealthier from a very high base. It may be appropriate to liken America during the past decade to a wealthy family that decides to lower the rate at which it increases wealth in order to undertake a higher level of consumption out of current income. Obviously, reduced wealth accumulation means a lower increase in the sustainable level of future consumption especially that of one's children. Beyond that, the ability to deal with unforeseen difficulties while maintaining levels of wealth and consumption is reduced. If one wants to return the higher levels of wealth accretion and enhancement of future consumption levels then measures must be undertaken to increase saving and investment.

In my view the federal government's contribution to this process would be twofold: To reduce the growth of outlays on entitlement and to increase the probability of succeeding in that effort by adopting a balanced budget amendment to the constitution and second to complete the tax reform process begun in 1986 by removing from the current tax code disincentives to saving and investment.

Attachment.

3

Perspective on U.S. Fiscal Policy before and after 1990

John H. Makin

The worst thing about the 1990 budget agreement is *not* its failure to lower prospective deficits. In fact, the total 1991–1995 deficit went from $857 billion in July 1990 *without the highly touted budget agreement* to $1,065 billion in September 1991 *with* the agreement. The worst thing about this agreement *is* that to get it passed, its advocates had to engage in collective fantasizing about the links between budget deficits and the economy that in turn caused them to engineer modest tax increases and spending cuts four months into a recession and thereafter to fail even to propose tax cuts on income from capital or other modest stimulative measures as the recession threatened to resume in the fourth quarter of 1991.

The 1990 agreement is accurately described by G. William Hoagland, ranking minority staff member of the Senate Budget Committee:

> Along the way to an acting agreement, fundamental political, social and fiscal policy issues were confronted. The final political consensus needed to enact the legislation was not achieved because these difficult issues were resolved, but rather in large measure the result of exhaustion and convenience—to bring the debate to a close and adjourn the Congress for the year to campaign.[1]

By the absolute criterion of deficit reduction, the agreement was a spectacular failure. The baseline deficit for 1991–1995, defined to include the social security surplus and to exclude deposit insurance, was advertised before the deficit agreement in October 1990 at $938 billion, up $81 billion in just three months since July. See table 3–1 for a numerical description of the dizzying evolution of estimated budget deficits. The deficit reduction agreement promised $479 billion of deficit reduction, leaving a total

five-year deficit from 1991 through 1995 of $459 billion.

By September 1991 the Congressional Budget Office estimated that the projected 1991–1995 deficit had risen to $1,065 billion. The Office of Management and Budget projected a parallel figure of $903 billion. By either measure, the October 1990 budget agreement was a spectacular failure: virtually all of the advertised deficit reduction was eliminated, at least on the surface, in just one year. Yet, judged relative to the Gramm-Rudman-Hollings agreement of October 1995, the October 1990 agreement is typical. The Gramm-Rudman-Hollings agreement promised to eliminate the budget deficit by 1990. Actually, the subsequent five years from 1986 through 1990 saw budget deficits averaging 3.8 percent of GNP. In September 1992, budget deficits by the less optimistic CBO forecasts are expected to average 3.4 percent of GNP over the period that was to have seen the total elimination of the deficit. Therefore, on a relative, rather than an absolute, standard, the 1990 budget agreement performed slightly better when judged by the criterion of the ratio average prospective deficit to GNP during the five years following the agreement, than by actual outcome after the Gramm-Rudman-Hollings agreement of October 1985. The question remains of how the agreement will look between now and October of 1995.

Most important from the standpoint of judging the effects of the deficit is to consider its weight upon the economy. By this criterion, prospective deficits over the next five years, at currently estimated levels, will not produce an extraordinary drag on the economy. From 1962 to 1989 the deficit to GNP ratio averaged 2.5 percent. As already noted, during the 1986–1990 period, deficits averaged 3.8 percent of GNP. According to OMB and CBO forecasts during the summer of 1991, the deficit will average between 2.4 and 3.4 percent of GNP over the 1991–1995 period (see table 3–1). In short, prospective deficits have followed a predictable pattern since the 1970s, when the Congressional Budget Office and the Office of Management and Budget first studied them. Over a five-year horizon, the budget deficit, according to official forecasts, is always headed toward zero or even toward surplus territory. After the fact, the budget deficit averaged about 2½ percent of GNP for the 1962–1989 period, rising to 3.8 percent of GNP for the 1985–1990 period. Now in the 1990s in the space of just a year, the prospectively disappearing budget deficit has atrophied back to an average of about 3.0 percent of GNP, slightly above or slightly below, depending on whose forecast one believes. Deficits averaging 3 percent of GNP have not proved debilitating either for the U.S. economy or for other advanced industrial economies over the past ten years.

A favorable impact of the 1990 budget agreement can be gauged

TABLE 3–1

ESTIMATED BUDGET DEFICITS
1991–1995
(billions of current dollars)

	1991	*1992*	*1993*	*1994*	*1995*	*Total, 1991–95*
Baseline, July 1990	162	179	182	177	157	857
Baseline, October 1990	199	231	209	170	129	938
October 1990 deficit reduction	42	72	89	126	150	479
Postagreement baseline	157	159	120	44	–21	459
Baseline, August 1991	226	223	217	201	188	1,055
						Mean 1991–95
Share of GNP (Mean, 1962–89 = 2.5%)						
July 1990	2.8	2.9	2.7	2.5	2.1	2.6
August 1991	4.0	3.9	3.4	3.0	2.6	3.4
GNP						
July 1990	5,832	6,215	6,620	7,035	7,514	
Fiscal year, August 1991	5,591	5,939	6,315	6,699	7,106	

NOTE: Figures exclude the Resolution Trust Corporation but include the social security surplus.
SOURCES: For July 1990 baseline, Congressional Budget Office, *Economic and Budget Outlook*, table II–1, p. 32, Washington, D.C.:CBO, July 1990. For August 1991 baseline, G. William Hoagland, "The 1990 Budget Agreement One Year After–One Year Ahead" (Paper presented at the American Enterprise Institute–Japan Economic Foundation conference, November 9, 1991); excludes Desert Storm.

directly by calculating the estimated revenue loss from a slowdown in projected economic growth between July 1990 and August 1991 (table 3–2). Given the reduction in GNP forecasts (indicated in table 3–1), the estimated revenue loss would be approximately 10.0 percent of the drop in GNP since revenues average about 19 percent of GNP. The resulting figures are shown in table 3–2 and sum to $301 billion for the 1991–1995 period.

In comparing these figures with the actual rise in estimated deficits between July 1990 and July 1991, the estimated impact of the October

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1990 budget agreement on deficits can be measured. In total, estimated deficits rose $208 billion for the 1991–1995 period from July 1990 before the budget agreement to July 1991 after the budget agreement. Since without the budget agreement we estimate a total deficit increase (excluding deposit insurance, social security surplus, and Desert Storm) of $301 billion, the 1990 deficit agreement saved $93 billion over the five-year period after 1991. During 1991 and 1992, based on the estimates in table 3–2, the agreement actually permitted some modest rise in the deficit beyond what would have been predicted based on deterioration of economic conditions. Indeed, changes in CBO deficit estimates from December 1990 to August 1991 readily identified $16 billion in additional outlays on Medicare, Medicaid, employment benefits, food stamps, social security, and other income maintenance programs. Starting in 1993, the October 1990 deficit agreement produces lower deficits than would have been forecast given the deterioration in economic conditions over the last year and thereafter makes a modest contribution to deficit reduction, provided that its underlying economic assumptions are realized.

The recurring efforts to reduce deficits since the mid-1980s is reminiscent of the efforts of a middle-aged athlete to get back to his college weight. Normally, middle-age lifestyle and nature tend to add weight steadily. The athletic six-footer for whom a natural entropy produces a tendency toward weight in the 180–200 pound range may constantly set a goal to return to 150 pounds. Projections are set during which time it is predicted that weight to fall steadily toward the 150-pound goal. Gradually, as weight actually continues to hover around 190 pounds a sense of failure and loss of control over one's lifestyle emerges. The objective reality is that a tolerable situation, weighing about 190 pounds, continues and cannot be changed without extraordinary effort that would involve a fundamental change in lifestyle.

The U.S. budget deficits are not unlike a spread in the middle-aged girth. As a mature economy that is growing more slowly than it did in its early postwar, vibrant youth while simultaneously becoming more oriented toward comfort and security by mandating hefty entitlement programs for the middle class, the United States is structurally predisposed either to run budget deficits or to require higher taxes. Such higher taxes have been deemed politically impossible at the federal level as have cuts in middle-class entitlement programs, and so the burden of raising taxes and cutting government services has been left to states and localities. Meanwhile, budget deficits of 2–3 percent of GNP have become as inevitable as weight gain by normal middle-aged humans.

TABLE 3–2

Estimated Impact of October 1990 Agreement on 1991–1995 Deficits
(billions of current dollars)

	1991	*1992*	*1993*	*1994*	*1995*	*Total, 1991–95*
1. Estimated revenue loss from slower growth[a]	46	52	58	67	78	301
2. Rise in estimated deficits, July 1990 to July 1991[b]	64	54	35	24	31	208
Net, 2 – 1	18	2	–23	–43	–47	–93

a. Nineteen percent of drop in estimated GNP.
b. Excludes Resolution Trust Corporation, Desert Storm, and social security surplus.

A fundamental question is whether with the failure to break out of a cycle of 2–3 percent of GNP deficits, any room remains for discretionary policy in an economic slowdown, particularly one that does not seem susceptible to a dose of easier money. The judgment by many responsible observers of the American budgetary scene is that tax cuts would be worse for the economy than would measures like the October 1990 budget agreement that slightly reduce the budget deficit or at the least do not allow it to increase. Some careful judgment is required on this subject; the answer is not obvious. It is important, however, not to avoid confronting the question by suggesting that any discussion of tax cuts to stimulate the economy is out of bounds because the tax cuts would get out of control. Fiscal policy is not viable in an environment where the administration, the Congress, or both engage in irresponsible measures designed to increase demand when the real requirement is to encourage growth of investment financed by a higher level of saving.

Despite all the rhetoric, one conclusion cannot be avoided: to stimulate the economy, a budget package must involve a larger deficit. In 1992 that involves answering the question of whether allowing a transitional increase in the budget deficit of about 1 percent of GNP would be sufficient to stimulate the economy and to improve economic performance by an amount that would make the action self-financing over the subsequent five years. Such measures could be designed largely to include measures to reduce the tax burden from income on capital, widely recognized by

economists as being too high and arbitrary. Indexation of capital gains as well as depreciation measures and adjustment of interest income and expense for inflation would encourage investment by lowering the effect of the tax burden on income from capital and by relieving an undesirable situation where the after-tax real return on investment is highly dependent on the rate of inflation over the life of an investment project. The remainder of this essay attempts to undermine the notion that American budget deficits in the 1980s and prospectively in the 1990s are disastrously high either by historical standards, by the standards of sustainability, or in comparison with other mature industrial countries. Beyond that, some comparison of the balance sheet and income statement of the U.S. government with that of a typical U.S. corporation is also instructive.

Fiscal Policy and the 1990–1991 Recession

By the autumn of 1991, as the American economy lingered in a state of near recession, the forecast for the deficit in the 1992 fiscal year that had just begun stood at about $235 billion, excluding $115 billion of deposit insurance outlays. Headlines boomed the total of $350 billion. A year earlier, a bipartisan budget agreement had been concluded after the president had granted to an adamant Democratic Congress some modest yet ill-timed tax increases, including higher payroll and excise taxes, along with a symbolic swipe at "the rich" in the form of a small increase in tax rates for very high-income individuals.

Although it was not known at the time, the October 1990 budget summit concluded its deficit-cutting exercise four months after a recession had already begun. The agreement was concluded amid White House and congressional cries of self-congratulation about having demonstrated an ability to govern. From the standpoint of encouraging a stable economy, the only good thing about the budget summit was the predictable result that the deficit reduction achieved during its first two years of operation was modest. Had it been larger, as many of the principals in the budget negotiations had advocated, the recession would have been made even worse.

Data that appeared during February and March 1991 revealed that the economy had been experiencing a negative annual growth rate of 1.6 percent during the fourth quarter of 1990 as Congress and the White House labored to agree on a package of tax increases and spending cuts. Simultaneously, the uncertainty surrounding the buildup for military action in the Persian Gulf caused businesses and households to put spending

plans on hold. The annual growth rate of the economy sank even lower, to a negative 2.8 percent, during the first quarter of 1991 as the payroll and excise tax increases enacted in the previous fall's budget summit took effect.

The rapid conclusion of the gulf war caused many economy watchers and some businesses to conclude that a consumer spending spree driven by postwar euphoria would push the economy out of recession. The negative annual growth rate of the economy did moderate to 0.5 percent during the second quarter as consumers returned briefly to shopping malls to stock up on small-ticket purchases postponed during long hours of watching Desert Storm on television. Businesses, anticipating a stronger surge of consumer demand, began to increase production in anticipation of increased consumer purchases of big-ticket items like automobiles, refrigerators, and washing machines.

By spring, most analysts together with the White House declared that the trough or the bottom of the recession had been reached in April 1991. It began to look as though the improvement in mood accompanying the end of the gulf war together with a steady downward pressure on interest rates exercised by the Federal Reserve put the economy back on a path to steady growth.

After Labor Day, as the Congress returned to Washington from its summer break, an uneasy feeling about the economy began to creep over Washington. The hoped-for increase in consumer spending had flickered over the summer, and the hum of American factories turning out goods for supposedly euphoric consumers had been heard faintly, but by September the murmur of economic resurgence had died. During their tours back in the home districts, congressmen had discovered that the anecdotal evidence about the economy did not square with the official picture that an economic recovery had begun in the spring. The White House was also getting disquieting noises from big business while even upper-middle-income white-collar households began to chime in with tales of layoffs and bankruptcies.

The initial response at the White House was the usual jaw-boning pressure on the Fed to cut interest rates further. But in view of the fact that the Fed had already pushed its short-term federal funds interest rate down from nearly 10 percent in the spring of 1989 to 5¼ percent by August, the suspicion had begun to sink in that perhaps easy-money policy, or at least lower interest rates, would not be sufficient to get the economy moving again.

Into the atmosphere of uneasiness about the economy came, on

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October 20, suggestions from congressional leaders that some middle-class tax cuts may be necessary to get the economy moving again. Senator Lloyd Bentsen suggested a program of tax credits and individual retirement account incentives, while OMB Director Richard Darman hinted that the White House might consider some stimulative measures provided that the previous year's budget agreement was not violated. The House and Senate Majority leaders, Tom Foley and George Mitchell, endorsed the idea of a middle-class tax cut. Conservative Republicans Phil Gramm and Newt Gingrich together with Jack Kemp began to beat the drums for a capital gains tax cut as a means to jump-start the economy.

All of the tax-cut proposals blurred when they confronted the uneasy reality that the October 1990 budget agreement did not allow tax cuts without offsetting spending cuts. Senator Bentsen was not prepared to explain how revenue-neutral tax cuts, especially those designed to encourage increased saving, would jump-start the economy when the problem was inadequate growth of spending. The White House was not prepared to push hard for a capital gains tax cut, which would be portrayed by the Democrats as a present to the president's rich friends, when widespread layoffs continued and the president had just vetoed a Democratic-sponsored bill to extend the period over which the unemployed could receive unemployment benefits.

The Fiscal Legacy before the Reagan Era

This recap of budget and economic history from October 1990 to October 1991 illustrates Washington's remarkably muddled thinking about the relationship between budget deficits and the economy. The October 1990 budget agreement was portrayed as a tremendous benefit for the American economy, a kind of last chance to be rescued from the eternal damnation that befalls profligate nations. Yet, just a year later, facing a budget deficit even larger than the one faced in October 1990, Congress and the White House were toying with the idea of tax cuts as a measure to jump-start the economy. Although the tax-cut proponents hastened to add that their proposals would be revenue neutral, markets and most Americans were rightly skeptical of the idea that tax cuts matched by spending cuts could do anything to jump-start the economy. The influential business newspaper, *Barron's*, described as "fiscal follies" Washington's flirtation with tax cuts. With monetary policy apparently not working, the need for stimulative tax cuts meant lower taxes and larger deficits, and the bond market registered its concern with a weakness that pushed up long-term interest rates.

JOHN H. MAKIN

Official Washington has consistently demonstrated that it has little conviction about the relationship between budget deficits and the economy. It took less than a year for a 180-degree change from the "deeply held" conviction that budget deficits must be reduced for the good of the economy to the notion that tax cuts may be just what the economy needs. Clearly, views on the budget deficit are politically driven; in fact, politically driven views on the budget deficit accompanied by an overlay of a questionable economic rationale have, as we have seen, a long history in American politics. Coupled with this long history is the reality that economists have failed to provide consistent and coherent analysis of the economic effects of budget deficits. A review of the testimony from economists and businessmen to the National Economic Commission on the relationship between budget deficits and the economy reveals a range of opinions sufficiently wide to provide solace for any action that politicians may wish to take on the budget deficit.

Both major political parties are heirs to a long tradition of cynicism surrounding their views on budget deficits. During much of the nineteenth century, Republicans worshiped balanced budgets as a means to justify high tariffs that actually were aimed at protecting emerging American industries from foreign competition. Generous pork-barrel spending programs were devised by Republicans, especially after the Civil War, to buy off resistance to the high tariffs. Eventually, the revenue requirements of the government programs that grew up after 1870 outran the revenue-generating potential of tariffs, and despite their best efforts to prevent it, Republicans found themselves faced with an income tax, a revenue-generating machine with the power to expand greatly the scope of the federal government. Faced with the income tax, Republicans suddenly became worshipers of a balanced budget as a means to limit spending financed by the income tax.

Democrats adhered to the balanced budget orthodoxy through and including Presidents Franklin Roosevelt and Harry Truman. Roosevelt abandoned fiscal orthodoxy only in the face of an overwhelming political reality that some action was required in the face of a serious prolonged depression. The depression, and after it World War II, resulted in budget deficits and an accumulation of national debt that would never have been dreamed of in normal times and, had they been foreseen, would have been labeled as sources of economic disaster. Actually, the debt accumulated by 1945, though unequaled in the history of the nation, even when deflated by GNP, was easily rendered manageable by a combination of generally balanced budgets—at least until the mid-1960s—and solid economic growth.

The Truman and Eisenhower years saw a return to fiscal orthodoxy in the form of an effective bipartisan commitment to balanced budgets that together with a surge of economic growth that was not supposed to have accompanied large budget deficits, sharply reduced the burden of the deficit during the fifteen years from 1945 to the election of John F. Kennedy in 1960.

The Kennedy administration, with some trepidation and considerable resistance from Congress, began to contemplate the first experiments with fiscal policy as a means to increase economic growth. Kennedy's willingness to discuss and even to propose measures like an investment tax credit, initially decried and condemned by the business community, eventually produced the first enactment of such measures. By 1965 the Kennedy-Johnson fiscal program had convinced White House economists that tax policy could push the long-run average growth rate to more than 4.0 percent while mitigating if not eliminating business cycles. The surge in the economic growth rate between 1961 and 1967 to 4.9 percent, well above the average of about 3.0 percent, formed a broad base of optimism in Washington about the ability of the economy to support both the Great Society and the Vietnam War.

The Kennedy-Johnson experiment with fiscal policy was not so much concerned with comprehensive budget policy, although it adhered to the balanced-budget orthodoxy, as it was with the structure of tax policy. The belief was that if tax measures were enacted to give business the right incentive to invest, then a persistently higher level of investment would lead to creation of more jobs and faster economic growth.

John Kennedy and Lyndon Johnson differed on the implications of higher growth for social policy. In Kennedy's view, expanded social programs were conditional on the achievement of higher growth. In Johnson's view, once he became totally enamored of the Great Society, these programs were so important that Americans would come to love them and would be willing to pay persistently higher taxes—even at higher tax rates—to finance them.

Richard Nixon, while adhering to fiscal orthodoxy and a stated belief in balanced budgets, did little to resist the expansion of the social programs begun by Johnson. Far more significantly, however, he allowed huge increases in social security benefits as part of a contest with Wilbur Mills, the Democratic presidential hopeful who chaired the Ways and Means Committee overseeing social security benefits. The generous expansion of social security benefits coupled with their indexing to inflation in 1976 just before a burst of inflation and the demographic reality of an expanded

over–sixty-five population laid the groundwork for a massive expansion of social security benefits that by 1983 had bankrupt the system. The 1983 social security rescue package promulgated further increases in payroll taxes as a means to continue the rapid growth of spending on social security and other entitlements.

The proximate sources of large budget deficits during the 1980s and larger during the 1990s are bipartisan, political, and economic. Somewhat ironically, the Kennedy-Johnson experimentation with supply-side tax cuts for business generated a belief among economists in Washington that the U.S. economy could sustain economic growth of about 4.0 percent. That conviction together with the politics surrounding Great Society programs and the growth of entitlements during the Nixon administration resulted in legislated increases in government spending that continued irrespective of the actual performance of the economy. The growth of spending on social security was especially significant because it is included in the so-called entitlement section of the budget. Entitlements that together with mandatory payments of interest on the debt have come to make up nearly 70 percent of total government spending are not subject to reduction as part of deficit reduction negotiations. Laws would have to be changed to alter the path of spending on entitlements; throughout all of the budget negotiations since 1985, no successful effort was ever mounted to reduce the growth of spending on entitlements.

The Reagan Era

Other things being equal, had the economy continued to grow at an average rate of 4.0 percent after 1967, there would be no budget deficit today. Indeed, if economic growth had proceeded at 4.0 percent between 1967 and 1990, along with the average inflation rate of about 6.0 percent, the 19.4 percent share of GNP that represented federal revenues in 1990 would have produced total revenues of $1,406 billion. That would have produced a surplus of $153 billion, given FY 1990 outlays of $1,253 billion. One could argue that 4.0 percent growth, rather than the 2.67 actually achieved, would have meant slower inflation, possibly less outlays for deposit insurance, and less cuts of discretionary spending such as occurred during the 1980s. Still, much of the deficit problem of the 1990s is simply the result of government spending programs that have been legislated permanently against the background of a transient surge of economic growth during the 1960s.

The Reagan era with its supply-side tax cuts, defense spending

increases, and relentless growth of entitlement spending caused the political and economic debate about the budget deficit to heat up by 1985. Ronald Reagan threw a monkey wrench into the accepted fiscal orthodoxy with his willingness to cut taxes and especially to cut tax rates and to provide special investment incentives in the face of prospective large budget deficits. By abandoning the Republican orthodoxy on budget deficits and emphasizing instead a willingness to cut tax rates and taxes, Reagan overwhelmed the wrong-footed Democratic opposition at the beginning of his first term in 1981.

Democrats had never moved beyond hopes for faster growth as a means to finance the ambitious spending programs begun under the Great Society. Reagan caught them flat-footed in 1981 by proposing radical tax cuts that reduced tax rates and virtually eliminated tax collections from corporations.

At the time, Reagan's economic advisers deflected criticism about the prospective budget deficits by assuming a high rate of inflation in their forecast for the next few years. High inflation rates pushed taxpayers into higher and higher tax brackets and inflated tax revenues. In fact, from 1976 to 1981, the surge in inflation had pushed tax revenues from a low of about 17.5 percent of GNP in 1976 to more than 20 percent of GNP in 1981. Reagan's economic advisers found that with the right inflation assumptions and by a careful postponement until 1985 of the indexing of tax brackets that would largely eliminate bracket creep, they could predict a budget surplus in a few years.

The Reagan fiscal revolution spawned numerous myths while offering many useful lessons about the relationship between taxes, budget, and the economy. Simultaneously with its initiation of the Economic Recovery Tax Act of 1981, the Reagan administration and the Volcker Fed embarked on a program of inflation control that was successful enough to bring inflation well below the forecasts of its budgeteers and thereby result in a sharp increase in deficits that brought the deficit from 2.6 percent of GNP during a 1981 recession to a 5.4 percent of GNP during 1985, a year of rapid growth.

The sharp rise in the deficit and the national debt between 1981 and 1985, even when measured as a share of GNP, was alarming enough, especially in view of the perceived economic orthodoxy that rising deficits were bad for the economy, to prompt Congress to begin to cut spending. Reagan's successful advocacy of tax cuts as good for the economy broadly precluded discretionary tax increases as an avenue for the Congress to use to close the deficit gap. Payroll taxes to finance entitlement programs rose

steadily throughout the Reagan years, and the additional burden on most American households gave rise to numerous articles about the gap between the rhetoric of Reagan tax cuts and the reality. Reagan capped increases in the individual income tax and lowered tax collections from corporations by an amount that roughly offset the huge increases in payroll taxes. During the eight years of the Reagan administration, from 1981 through 1988, total revenues were actually $140 billion higher than they would have been if the ratio of tax revenues to GNP that prevailed between 1973 to 1980 had continued during the Reagan years. After 1982, when the Reagan tax measures had taken effect, individual income taxes held about steady relative to the pre-Reagan years while the corporate income taxes averaged about $40 billion less per year than they would have under the tax regime of the 1970s. Meanwhile, 1981–1988 payroll tax collections were above levels that would have flowed from 1973–1980 payroll tax rates.

Reagan's ability to hold the line on income taxes coupled with Congress's concern about budget deficits led to sharp reductions in nondefense discretionary spending, basically the social programs initiated under the Great Society. In 1981–1988, nondefense discretionary spending was cut to a total of $300 billion less than it would have been at spending rates during the eight years before the Reagan administration. Meanwhile, the same calculation for entitlements and other mandatory spending showed an increase for 1981–1988 of $360 billion along with an increase in national defense spending of $270 billion. Another category of mandatory spending, net interest on the debt, was $422 billion higher during 1981–1988 than it would have been if expenditures on that category had proceeded at rates equal to the rates during the eight years before the Reagan administration. Broadly, Reagan's tax cuts coupled with congressional concern about the budget deficit marked a new era in the Republican political approach to budget deficits.

The nineteenth-century rationale of high tariffs to reduce budget deficits followed by the budget orthodoxy of the twentieth-century, control of spending to control budget deficits, was replaced by Reagan's preemptive tax-cut strategy. If a popular president cut taxes and Congress continued to believe that deficits were bad, eventually spending had to come down. What came down was nondefense discretionary spending, the only category of spending over which Congress had control. The difficulty with the strategy of reducing budget deficits by cutting taxes was the 70 percent of spending entitlements and interest on the debt that were not controlled by Congress. The tax-cutting strategy coupled with the fear of deficits could ultimately succeed in reducing deficits only if the congressional fear of

deficits outweighed the congressional fear of the wrath of voters if popular middle-class entitlements programs such as social security benefits, Medicare, and Medicaid were cut. The test of wills came in 1985, when a courageous group of Republican senators fashioned a deficit reduction program that included some modest caps on the *growth* of social security benefits. During the critical eleventh hour of negotiations, Reagan sided with the then-Democratic House Majority Leader Tip O'Neill to abandon the package in favor of a more cosmetic approach that left entitlements untouched. Had Reagan supported his own party in Congress in 1985, the growth of entitlements would have been curbed, budget deficits would have been far below those actually realized, and the great Reagan fiscal experiment of cutting taxes to reduce the budget deficit would have succeeded.

The president's desertion of his own party in its support of control of the growth of entitlements is even more difficult to comprehend when one recalls that he had already been elected to a second and last term as president and need not have feared the wrath of the voters. Beyond that, to achieve an agreement on the budget package, the Republicans who then controlled the Senate took a terrific political risk. By abandoning the Republican senators who had supported a budget package that included caps on the growth of entitlement spending, the president doomed many of them to defeat in the 1986 congressional elections. As a result, the Republicans lost control of the Senate, which they had held since 1982.

The best explanation for the president's failure to follow through with measures that could actually have achieved his stated long-run goal of controlling federal spending was a distinct loss of focus in the Reagan administration during its second term. History has shown that foreign affairs may have been distracting the attention of the president and the White House staff during 1985. But had the president held a clear vision of a strategy of tax cuts as a means to control budget deficits, the opportunity presented to him during the summer of that year ought to have been seized, even in the midst of heavy demands on his time from foreign policy concerns.

Some Washington observers argue that the president's unwillingness to agree to a package with limits on the growth of entitlements went back to the very negative reaction encountered by the White House in 1981 when the president had proposed some limits on the growth of social security outlays. The president's popularity plummeted in the wake of such a suggestion, although later it recovered. The best explanation for the president's action in the summer of 1985 may be that he did not wish to expend political capital on the issue of the budget in view of the need to

conserve that capital for initiatives in other areas. Whatever the reason, the president's abandonment of his own party and the subsequent painful lesson to politicians that any efforts to limit even the *growth* of spending on popular entitlement programs like social security was political suicide made it almost true arithmetically that the budget deficit problem would not go away. Even the sharp reductions in the growth of defense spending that began to be enacted in 1985 were not enough.

The Post-Reagan Era

Between 1985 and 1990 the annual growth rate of spending on mandatory programs like entitlements and interest on the debt, at 7.2 percent a year, was nearly twice the 3.75 percent annual growth rate of spending on discretionary programs, including defense. More starkly, inflation-adjusted spending on discretionary programs, including defense, actually *fell* at an annual rate of 3.4 percent between 1985 and 1990 while spending on mandatory programs rose at an annual inflation-adjusted rate of about 1.8 percent or approximately equal to the modest growth rate of the real economy.

By the time the Bush administration confronted the FY 1991 budget in the midst of the October 1990 budget summit, the options for reducing the budget were limited indeed. The politically brilliant Reagan strategy, which had been abandoned by Reagan himself in 1985—cutting taxes to control spending—was no longer an option. The category of spending under the control of Congress had already been cut nearly as much as was politically possible. In that environment, and probably in view of President Bush's more orthodox views on deficits, Democratic rhetoric that spoke of a need to raise taxes to reduce the (harmful) budget deficit gained sway. The president was forced to concede some modest tax increases as part of a budget summit agreement to eliminate the budget deficit within five years.

Unfortunately, at least for the promises put forth by the budget summiteers, the October 1990 deficit reduction package offered little in the way of real deficit reduction until after the 1992 election and then relied largely on optimistic economic assumptions to eliminate the budget deficit by 1995. The perceived need to reduce the budget deficit without the politically viable means to do so caused Congress and the president to agree to a deficit-reduction package that included spending cuts and tax increases as the economy headed into a recession. The notion that a fiscal policy that implies less burdensome taxes is good for the economy had obviously died between 1985 and 1990. Meanwhile, in October 1990, Washington budgeteers were left with nothing but wishful thinking and a

remarkable lack of concern about anticyclical budget policy. The need to avoid tax increases or spending cuts as the economy was slowing down was a principle that had been accepted even by Republicans steeped in the balanced-budget orthodoxy since the Eisenhower tax cuts in the 1950s.

In the absence of any sound conviction about appropriate budget and tax policy, both the Republican president and his Democratic colleagues in Congress became the object of criticism by idealogues on the Right and the Left. Steven Moore of the conservative Cato Institute published in February 1991 a study entitled "The Profligate President: A Mid-Term Review of Bush's Fiscal Policy." Wrote Moore:

> Midway through his presidency, George Bush is mired in a fiscal policy crisis worse than anyone could have envisioned when he entered the oval office two years ago. This crisis is the resurgence of record fiscal deficits.... The crisis has been caused by an explosion of new domestic spending under Bush. Between the time that Reagan left the White House in 1989 and the next year (FY 1992), domestic spending will have climbed by $300 billion—from $670 billion to $970 billion. Since 1989 the federal government's domestic outlays adjusted for inflation have grown by an enormous 10 percent per year. Domestic spending is expanding at a faster clip under Bush than it did under other recent presidents typically labeled as big spenders, including Lyndon Johnson, Richard Nixon, and Jimmy Carter. Incredibly, Bush is on the way to being the biggest champion of domestic spending since Franklin Roosevelt.

The Cato analysis is representative of the extreme disaffection with Bush from the conservative side of the political spectrum attendant upon his agreement to small tax increases during the 1990 budget summit. Cato's attack on the spending side is hardly substantiated by the facts. FY 1991 saw a 17.4 percent increase in mandatory spending, including a tremendous increase in outlays for deposit insurance while discretionary spending, under the control of the president or Congress, rose by only 5.4 percent, virtually a zero increase in inflation adjusted terms.

Just eight months later, in October 1991, Democratic Senators Lloyd Bentsen and Bill Bradley were taken to task by Jeff Faux, president of the liberal Economic Policy Institute, for proposing middle-class tax relief and a reduction in the capital gains tax as a means to jump-start the economy. Faux's criticism was based on the recognition that if the tax cuts had to be matched by spending cuts, no net stimulus would be left to jump-start the economy. Faux went on to ask:

> What if Bentsen's or Bradley's tax cuts were not matched by spending cuts elsewhere in the budget? Wouldn't that stimulate the economy in the short run? The answer is yes, just as Ronald Reagan's tax cut driven deficits stimulated the economy in the early 1980s. The result then was the string of damaging fiscal deficits. Investment in the human, physical and technical capital needed to support America's competitiveness in the new global economy was squeezed out of the federal budget. Politically, Democrats were denied the resources to support broad-based domestic programs for their traditional constituencies.

Faux then recommended stimulating the economy by increasing the budget deficit with extended unemployment benefits and by the federal government providing emergency revenue sharing to distressed states and cities, amounting to some restoration of the cuts in domestic nondefense discretionary spending that had been effected over the previous decade. He did not specify his economic rationale for the claim that such measures, presumably financed by higher taxes, would boost the economy.

In the 1990s, as throughout the 200-year history of the nation, discussions of the stance of fiscal policy have been largely driven by the politics of the Right and the Left. With budget deficits nominally more than $300 billion, conservatives are reluctant to talk about tax cuts but feel free to complain about increases in spending even though they are not under the control of the president or Congress. Meanwhile, potential presidential challengers, like Bentsen from the Democratic side, talk about potential tax relief financed by cuts in defense spending or, if push comes to shove and the economy really weakens, by a countercyclical increase in the federal budget deficit. Talk of tax cuts by Democrats, especially the unforgivable mention of a capital gains tax cut by Bentsen, enrages left-wing commentators like Faux, who want to see the "peace dividend" devoted to restoring the cuts in domestic discretionary spending that resulted originally from the pressure of Reagan's tax cuts and the fears of Congress about the perils of deficit spending. Few care to note that the defense buildup was financed by a buildup of debt; debt-decriers logically should wish to use the peace dividend to pay down debt.

Comparing Federal and Corporate Fiscal Health

The American business community has often expressed deep concern about

the impact of chronic budget deficits on the economy. Addressing the National Economic Commission on November 16, 1988, James T. Lynn, cochairman of the Business Roundtable, an action-oriented business group, expressed typical concerns of the business community:

> Let me begin with some general observations. First, chronic budget deficits pose a grave danger to our economy, to our standard of living, to our leadership role in the world and to the perceived community of interests which units American society—old and young, rich and poor. And time is running against us. It follows that the set of issues this Commission is considering is of historic significance.

For the sake of a broad perspective, and in view of the grave concerns expressed by leaders of the American business community about federal deficits and debt, it is helpful to compare the debt of the U.S. government relative to its assets, together with its interest expense relative to its revenues, with similar ratios for typical large corporations in the United States.

Fortunately, the widespread criticism of the "debt boom of the 1980s" by business economists like Henry Kaufman has led to careful studies of U.S. corporate debt growth and interest burdens in the 1980s relative to previous periods. A study by Ben S. Bernanke and John Y. Campbell of Princeton University examined the ratios of corporate debt to corporate assets and corporate interest expense to income for a sample of 643 U.S. firms. They found that these ratios were remarkbly constant between 1969 and 1986. Bernanke and Campbell did express concern that a small subset of businesses had taken on debt burdens during the 1980s that could cause unusual problems in a recession. But generally, even after updating their study for the 1986–1988 period, Bernanke and Campbell concluded that although some firms in cyclical industries could encounter debt problems in a recession, "the profession's understanding of how capital structure affects the economy is so rudimentary, [that] any policy changes [by the government regarding corporate debt] should be slow and incremental." The two economists did acknowledge that "one attractive strategy would be to reduce artificial incentives for high leverage, including the tax advantage given to debt over equity and the implicit subsidization of high leverage through the deposit insurance system."[2]

Bernanke and Campbell examined the ratio of corporate debt to the market value of corporate assets from 1969 to 1988. They also examined the ratio of interest expense to income of corporations. From 1970 to 1975

corporate ratios of debt to assets averaged 0.3 in the Bernanke-Campbell sample. The ratio rose to 0.32 during the 1976–1981 period, to 0.31 during the 1982–1986 period, and ranged from 0.3 to 0.27 during the 1986–1988 period. Ratios of interest expense to cash flow were on average 0.13 from 1970–1975, 0.15 for 1976–1981, 0.18 for 1982–1986, and about 0.17 for 1987 and 1988.

The two economists also performed simulations to see how the ratios would behave in a recession. They found only a modest increase in ratios of debt to assets while ratios of interest expense to cash flow rose as high as 22 percent in a recession like the 1981–1982 recession, when short-term interest rates were very high.

This study provides valuable perspective concerning the balance sheet and income statements of American corporations. Ratios of debt to assets have stayed very close to 0.3 over the past twenty years while ratios of interest expense to cash flow have risen from about 0.13 to about 0.17.

Over the period from 1969 to 1991, federal ratios of debt to assets and interest expense to revenue have risen more rapidly than the modest increase in the corporate sector but still remained low relative to corporations. But the federal government does not face the same risks faced by corporations during recessions. Although federal revenues may fall in recession, so do interest rates. During recession, federal debt instruments become especially attractive relative to corporate instruments because the federal government has the power to tax and therefore can offer less risky assets to investors than can the corporate sector. Based on the fundamental reality that the revenues of the federal government and its assets are more secure than those of any individual corporation, even if federal ratios of debt asset and interest expense to revenue are similar to those of private corporations, the federal government still has a conservative fiscal stance.

The measurement of federal debt is simple. Detailed statistics kept on federal debt are in the hands of the public. The debt of a corporation is also easy to measure by a glance at the corporate balance sheet, although the market value of both corporate and federal debt may vary as market conditions change. If interest rates rise, the market value of debt carrying a given interest rate falls, while a drop in market interest rates raises the market value of debt carrying a given interest rate. Some adjustments may be necessary to respond to changes in the market value of debt although broadly debt-asset ratios do not display a high degree of sensitivity to alternative methods of valuing corporate debt and assets. Theoretically, a corporation's value should be equal to the present value of its net income stream discounted at some market interest rate. The discount rate may be

raised or lowered as the risk or uncertainty attached to the net income of the corporation rises or falls.

The major asset of the federal government is the acknowledged power to tax to finance its activities. Tax revenues have been remarkably stable at about 19 percent of GNP over the past several decades. The cost of collecting taxes is negligible, so the 19 percent represents the net income derived from the power to tax. The market value of the power to tax at a rate of 19 percent of GNP can be calculated as the present value of 19 percent of gross national product, discounted at an interest rate that reflects the average interest rate on federal debt. In 1991, for example, the gross national product was $5,670 billion. Nineteen percent of that, or $1,077 billion divided by 8.00 percent, a measure of the average interest rate on federal debt, places a value of $13.5 trillion on the federal government's ability to tax 19 percent of GNP in perpetuity. This is a conservative measure since the federal government does have the power to raise tax rates and occasionally has done so when emergency situations such as war or extraordinary social needs have dictated.

In 1991 the net interest payments by the government on its debt outstanding were $196 billion. This represented 18.5 percent of federal revenues during the fiscal year 1991.

Performing these same calculations for 1969 and 1980 reveals the increase in the debt asset ratio and the interest expense– revenue ratio for the federal government. In 1969 the estimated debt-asset ratio for the federal government was 12 percent, while in 1980 it was 11 percent. The ratio of federal interest expense to federal revenues in 1969 was 6.8 percent, rising to 10.1 percent in 1980. By 1991 the federal government's estimated debt-asset ratio had reached 20 percent while, as we have seen, interest expense was 18.5 percent of revenues. That ratio is expected to remain constant through 1996.

If the federal government were viewed as a corporation in 1991, its interest expense relative to revenues would be almost identical to the average level of interest expense relative to revenues for a typical corporation in the private sector. Such a ratio may become a problem for a corporation in the event of a recession or some change in business conditions that reduces the demand for the products of a given company, but such risks are not faced by the federal government, which can always rely on tax revenues. Beyond that, in a recession, companies may face more difficult financing problems in view of the risks implicit in the recession for the viability of the business. Recessions pose no particular risks for the federal government, however, and since federal liabilities become attrac-

tive in recessions as safe havens, the federal government has a built-in cushion for its interest costs during recession even though total revenues may fall as GNP falls and tax revenues fall with it.

The concern expressed in the business community about the fiscal health of the federal government may have more to do with the fact that debt-asset and interest-expense ratios for the federal government have risen more rapidly in the past twenty years than have similar ratios for corporations. The level of such ratios, however, makes the federal government indistinguishable from a corporation with a conservative balance sheet. At 20 percent, the federal government debt-asset ratio is only two-thirds the debt-asset ratio typical of American corporations. While the federal government's ratio of interest expense to tax revenue has risen to a level comparable to or slightly above that of typical American corporations, the far lower risk profile of the federal government more than compensates for a one percentage point differential between its ratio of interest expense to revenue and that of typical corporations.

Historically, the U.S. government's ratio of interest expense to its revenues has been below the current level, with some notable exceptions. At the founding of the Republic in 1789, historical statistics suggest, the ratio of interest expense to revenue for the fledgling U.S. government was 53 percent. At the end of the Civil War, the ratio was 25 percent, and at the end of World War I, it was 20.5 percent. By the end of World War II, the ratio had fallen to about 10 percent, partly because federal revenues had risen so rapidly and partly because patriotic Americans lent money to their government at interest rates well below market levels. At the bottom of the depression in 1933, the ratio of U.S. government interest expense to its revenues was 37 percent, due largely to a collapse in revenues attributed to a collapse of economic activity. Still, at that time, interest rates on federal debt fell to their lowest levels in history because the federal government was offering a riskless asset when the debt or equity of corporations was viewed as highly risky.

The perspective offered by a comparison of U.S. government fiscal health with that of a typical private corporation helps to suggest reasons for the absence of a fiscal calamity for the federal government even with a rapid increase in federal government debt relative to GNP. If the federal government's debt and interest expense were to rise out of control, eventually the federal government could pay its bills only by printing money, much as the Soviet Union did before its demise and as Germany was forced to do after World War I. The actual experience of the last decade, however, has been to the contrary. The Federal Reserve has pursued a

policy of consistently bringing down the rate of inflation and resisting the temptation to use inflation to reduce the burden of federal debt. That burden remains eminently manageable both in terms of flow—interest expense relative to tax revenues—and in terms of the more fundamental ratio of federal debt to assets.

The political stalemate in Washington that leaves nominal deficits at levels above $200 billion and sometimes higher is frustrating to Americans and constraining to the federal government regarding its ability to pursue countercyclical fiscal policy. While Congress and current and future presidents must continue to struggle with these problems, they are far from unmanageable or disastrous in character, as many observers of the American fiscal scene have suggested.

Concluding Observations

The 1980s will be seen as a time when both corporations and the federal government made more aggressive use of debt. The facts show that the federal government's change in its use of debt was more radical than that in the private sector, but that by the early 1990s the federal government had reached a fiscal state that was far from disastrous or on the brink of imminent collapse. Rather, its fiscal problems, while manageable, had clearly identified sources. Decisions made previous to the 1980s to offer middle-class Americans generous entitlements in the form of social security and health care, indexed to inflation, pushed up federal outlays beyond the level that Americans were prepared to finance by increasing current taxes. The accumulated debts will have to be serviced, and therefore eventually either federal spending programs will have to be reduced—as some such as nondefense discretionary programs were during the 1980s—or taxes will have to be raised.

Part of the debt accumulated during the 1980s—a maximum of about $250 billion—was due to the defense buildup. That may have been a good investment if it had anything to do with the end of the cold war, which in turn means, given reasonable stability in a post-superpower world, that American outlays on defense during the 1990s can be reduced significantly below levels typical of the 1980s. It is true also that America, as a mature, wealthy nation, during the 1980s elected to spend at a rate that required an increase in borrowing from newly emergent economic super powers, particularly Germany and Japan, to finance government spending and private consumption and investment. Viewed broadly, however, the debt buildup is manageable although by definition it implies, as would any

reduction of a national saving rate, that the growth of future consumption will be slower than it would have been without the debt buildup.

The recession of 1990 has shown that when the U.S. economy is growing at a zero rate, the net importation of foreign loans can fall to zero. Part of the reason for the prolongation of the 1991 recession is the rebuilding of balance sheets by American households and corporations as debt is paid down by both. Simultaneously, American corporations have reduced variable costs to a point where they can expect to be highly competitive in global markets.

The 1990s will not see a debt buildup in the private sector comparable to what occurred in the 1980s. Nor will it likely see a deficit as high as 6.00 percent of GNP, such as it was in 1983. The resumption of growth sometime during 1992 will move the U.S. fiscal posture back on to a fully sustainable path according to the criterion set forward by the Organization for Economic Cooperation and Development. If Americans tire enough of $200 billion-plus annual deficits, then they will have to choose between higher taxes—about 10 percent higher than currently paid—and a moderation in the growth of spending on entitlements. The choices will emerge slowly only as Americans signal their preferences in major elections in 1992 and beyond.

PREPARED STATEMENT OF RUDOLPH G. PENNER

SOME HISTORY

In fiscal 1992, the budget deficit will near $350 billion. It is worth asking how we got into this sorry state.

For most of American history, there was a strong presumption that the budget should be balanced except in times of war or recession. This discipline did not begin to falter until more than ten years after World War II.

On average, the budget was close to balance for the whole decade of the 1950s. But the 1960s witnessed only two years of surpluses and by the 1970s, deficits occurred every year, the average being greater than 2 percent of GDP. In 1981, a very large tax cut was combined with an acceleration in the rate of growth of defense spending, and as a result of the policy shift and the recession of 1982, the deficit soared. There were some minor cuts in domestic spending, but they were far from sufficient to control the- deficit. It reached 6.3 percent of GDP by fiscal 1983.

Almost immediately after the error of 1981, the administration and the Congress began to take corrective action. Some of the personal and corporate income tax cuts were taken back by TEFRA in 1982, gasoline and payroll taxes were increased in 1983, and business taxes were increased by DEFRA in 1984. In 1986, budget authority for defense began to be cut in real terms, and, throughout the decade, there was considerable stringency shown toward domestic spending. Domestic discretionary spending fell from 4.9 percent of the GDP in 1980 to 3.3 percent in 1989. There were also small tax increases in every year from 1985 to 1989.

By 1989, this fiscal discipline, combined with the effects of a very long economic recovery, lowered the deficit to 3.0 percent of the GDP. There was, at that time, same small hope that we would eventually put the deficit problem behind us.

But the economic recovery ended, health costs exploded, and the costs of resolving the thrift crisis placed an enormous burden on the budget. CBO's current policy pro-

jection of the deficit for fiscal 1992 is now $352 billion or 6.0 percent of the GDP. The three percentage point increase in the deficit relative to GDP between 1989 and 1992 can be broken down as follows: 2.0 percentage points are due to the recession; 0.7 percentage points are due to the increased cost of deposit insurance; and 0.3 percentage points are' due, in large part, to rapidly rising health costs, a considerable portion of which are being offset in the short run by the peace dividend.

THE FUTURE

At first sight, this breakdown seems reassuring, because the recession and the cost of deposit insurance are clearly temporary phenomena. It appears as though the deficit will be on a rapid downward track when these problems disappear over the next few years.

Unfortunately, the short-run problems that disappear are replaced by a severe long-run problem that threatens to worsen the budget outlook after the middle of the decade. That is the exploding cost of health care and its effects on the budget cost of Medicaid and Medicare. In some recent CBO 10-year budget projections, health costs are the single most important reason that, after reaching a low of 2.4 percent of the GDP in 1996, the deficit begins a steady upward march to 4.0 percent of the GDP by 2002. The Administration has not done 10-year projections, but their 5-year projections show that the deficit outlook fails to improve between 1996 and 1997.

Needless to say, long-run budget projections tend to be highly inaccurate, but almost always because they are too optimistic. It is particularly distressing to see projections of a worsening deficit after 1996, because the late 1990s should be the best of times for the Federal budget. The projections assume that the economy is nearing full employment at that time and that the nation will have enjoyed a substantial peace dividend. More important, demographic conditions are highly favorable to the Federal Budget. Current policy implies that by the mid-1990s, over one-half of noninterest domestic spending will be going to the elderly. The elderly population will be growing very slowly at that time because of low birth rates during the Great Depression.

If the deficit outlook is worsening during the best of times for the Federal budget, one must worry a great deal about what happens when the demographic situation begins to worsen rapidly with the retirement of the baby boom generation after 2010. That will occur in combination with very slow labor force growth rates because of low birth rates starting in recent decades. The burden imposed by increased social security pensions is not severe economically, but it will require substantially higher taxes or program cuts elsewhere and the political difficulty of enduring this burden may outweigh the economic burden. The increased burden of providing health care to the elderly, assuming no radical reform of the health care system, is, however, so severe economically and politically that it is difficult to imagine continuing far into the 21st century with anything like our current health system.

The GAO Report suggests deficits will grow to 20 percent of GDP by 2020 with no change in policy. It was noted above that no budget projection, even one for one year, is likely to be very accurate. However, there is nothing implausible about the GAO result. We know with virtual certainty that during the retirement of the baby boom, current policy implies deficits very much larger than the massive deficits experienced in the 1980s.

THE DEFICIT AND ECONOMIC GROWTH

The effect of the budget deficit on economic growth is not an easy topic. There are considerable differences in how various economists interpret the problem. I believe, however, that the GAO approach represents the majority view. I have put the basic theory in my own words in what follows.

If the American economy were totally insulated from the rest of the world and if the budget deficit decreases national saving roughly dollar for dollar, it would then reduce investment in the United States roughly dollar for dollar, because saving is necessary to provide the resources for investment. That means that it would reduce the stock of machines, housing and other structures available to American workers. With less capital to work with, worker productivity falls, real wages therefore fall, and the standard of living is lower in the future. Our desire to spend more than we pay for can only be satisfied at the expense of our children.

The story changes significantly when it is assumed, more realistically, that the United States is not insulated from the rest of the world, but is closely integrated into the world economy. If the United States saves less because of a budget deficit and interest rates begin to rise, foreigners will begin to invest more in the United States in order to take advantage of the higher interest rates. In other words, for-

eigners will replace some of the American savings destroyed by the budget deficit. Consequently, investment, worker productivity, and future standards of living will all be reduced less because of our ability to draw on foreign capital.

The United States will have to pay interest and dividends on the money invested by foreigners and this will be a drain on the living standards of our children, but the damage done to American productivity and growth is much less if foreign savings are available to make up for the deficit than if the deficit reduces investment in the United States dollar for dollar. We even obtain some tax revenues from the capital income going to foreigners.

The response of foreign investors will reduce the effects of the deficit on American interest rates. This is probably one reason that it is so difficult for economists to find an empirical relationship between deficits and interest rates. Any relationship that remains can easily be overwhelmed by other factors, such as changes in monetary policy.

The link between the deficit and economic growth can be broken in a number of ways. If an increase in the budget deficit stimulates real economic activity by stimulating aggregate demand, there will be increased private saving out of increased incomes and there will also be a greater incentive for private investment if demand is strong. Therefore, for the basic story to be true, monetary policy must counteract any effect of the deficit on short-run economic activity, or the economy must already be working at full capacity, or fiscal policy must have little effect on economic activity. The last assumption is accurate if the foreign investment sucked in by the increased deficit so increases the value of the dollar that the trade balance deteriorates significantly and offsets any effect of the budget deficit on economic activity.

It should also be noted that the deficit financing of public investment that pays a high rate of return should not be defined as a reduction in national saving. However, it may not be quite as easy to find public investment opportunities paying high rates of return as some of the recent discussion of an infrastructure problem would seem to imply.

Another argument breaking the link between deficits and growth comes from a few economists who argue that Americans are wise enough to know that an increase in the deficit now is likely to require a tax increase later to service the increased public debt. They will therefore increase their private saving to offset the increased public deficit, so that they or their descendants will have sufficient resources to pay for future tax increases. That would imply that the deficit has no effect on long-term economic growth or short-term economic activity. Most economists believe, however, that Americans are neither well informed enough nor altruistic enough toward future generations to offset much of the effect of the government deficit on saving.

Assuming that the standard story is more or less correct, the deficit's effect on living standards accrues very slowly, but it compounds into significant amounts over long time periods. For example, the deficit relevant to national saving is expected to be $266 billion in 1992. This deficit concept is smaller than the better known unified deficit, mainly because the outlays on deposit insurance that are included in the latter do not affect national saving when they occur. They are simply a transfer of assets that reflects the settlement of liabilities that accrued in the past. The liabilities reflect a terrible waste of national saving that occurred when lenders were financing inefficient projects. Other accounting adjustments are made to the unified deficit to arrive at its effect on national saving, but they need not be described here.

A reduction of $266 billion in national saving amounts to about 1½ percent of the nation's private wealth. If the physical capital stock is reduced by this amount, the type of growth model used by GAO implies that the loss in production would be about 0.5 percent of GDP, hardly a noticeable amount. If some of the loss of national saving is made up by capital inflows, the loss in U.S. production and income is even less. However, the impact compounds over time as lower income implies lower private saving in the future.

The GAO uses a model developed by Harris and Steindel of the Federal Reserve Bank of New York [1] in order to estimate the effect of reducing deficits on future economic growth. Harris and Steindel assume that about one-third of the fall in national saving is offset by increased foreign capital inflows and I believe that GAO makes the same assumption. In one of GAO's scenarios, a balanced budget is achieved in 2001 and maintained thereafter. Compared to following current policy which implies almost no increase in living standards, GNP per capita is raised by more than one-third. Not only is this difference extremely important to living standards, it may be sufficient to determine whether the United States is one of the world's leading economic and military powers with enormous influence over inter-

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[1] FRBNY Quarterly Review/Winter 1991, pp. 1–19.

national events and the formation of international economic policy, or whether it is simply an also-ran following the lead of Europe and Japan.

My own judgment is that deficit reduction would be offset somewhat more by a reduction in foreign capital inflows than is assumed by Harris and Steindel. If the offset is greater, this would lower the growth impact of deficit reduction. However, I also believe that this point is overwhelmed by another assumption that goes in the other direction. The GAO estimates assume that the pace of technological change is independent of the rate of investment. If a portion of new technology can only be exploited by investing or if there are other positive links between the two variables, the effects of changes in private saving and government deficits on the growth rate will be considerably greater. I believe it quite reasonable to assume that our store of technological knowledge can only be fully exploited if we sustain a relatively high level of investment and therefore, the GAO estimates understate the impact of deficit reduction on economic growth.

THE DEFICIT AND INFLATION

There is one danger that is mentioned only in passing by GAO that I believe deserves a great deal more attention. If we do very little to get the deficit under control by the time the baby boom retires, the deficit will be so large and the debt and interest bill will be rising so fast that I cannot believe that our government will be willing to finance the entire deficit by issuing debt. They will instead be tempted to finance government spending by creating new money. That, in turn, implies hyperinflation—an inflation rate that reaches triple or quadruple digit levels or even far beyond, as in the case of Weimar Germany.

While hyperinflation is not a concern at current debt levels, some believe that there is always a temptation for government to engineer a more moderate inflation to tax away the debt and lower its interest cost. In the United States, this approach would not work very well under current conditions. Any increase in inflation will quickly raise nominal interest rates. Given the current maturity structure of the public debt, about one-third must be refinanced every year. Therefore, the interest bill would rise very quickly. Combined with the indexing of much of the tax and spending sides of the budget, this means that a higher inflation rate cannot be used to reduce the deficit, although it does reduce the deficit-GDP ratio slightly because it increases the ratio's denominator. However, this small advantage is unlikely to provide sufficient justification for engineering a moderate inflation. The gains from inflation would be greater if the debt had a much longer average maturity, so that the interest bill was not raised as quickly by an increase in the inflation rate.

THE DEFICIT AND STABILIZATION POLICY

It is often said that today's large deficit prevents us from purposely increasing it in order to provide needed stimulus to the economy. I do not think that this is an important loss. The history of our attempts to stabilize the economy using fiscal policy is not reassuring. Indeed, the economy has probably been destabilized more often than it has been stabilized. The recessions of 1960 and 1970 were probably caused by abrupt shifts to a contractionary fiscal policy, and a small contractionary shock was applied with the budget agreement of 1990 after the current recession had already started. Similarly, shifts to stimulus have often been ill-timed. The worst instance occurred in 1977 when President Carter and the Congress implemented a stimulative package after two years of rapid recovery from the recession of 1974. An oil price shock occurred on top of the effects of the fiscal stimulus and of course, inflation soared.

Although the loss of flexibility to operate a countercyclical policy may not be important, the deficit and the huge interest bill that it has engendered clearly reduce the ability of the Congress to address the long-run needs of the nation, whether through spending programs or new tax incentives. It is no exaggeration to say that the deficit has paralyzed budget decision making.

SOLVING THE PROBLEM

Those economists, who think it important, typically have their own favorite list of options for reducing the deficit. It is clear that it cannot be done politically without distributing the pain widely throughout the population. To the extent that tax increases are required—and they will be—economists usually take exactly the same position as you did Mr. Chairman, during the tax reform effort of 1986. That is to say, they favor the elimination of tax preferences or base broadening over tax rate increases or new taxes. That is because base broadening devices tend to be more efficient in that they reduce the extent to which the tax system distorts the use of economic resources and they are more equitable in that they further the equal tax

treatment of those earning equal incomes. Of course, any tax preference that survived the onslaught of tax reform in 1986 has considerable political staying power. Most of those remaining involve owner occupied housing, tax free fringe benefits, and the tax preference given government benefits such as social security.

On the spending side cuts should be concentrated on consumption-type items, such as middle class entitlements rather than on investment-type items such as infrastructure spending. Of course, almost all middle class entitlements go the elderly and that makes them very difficult to cut.

Any solution to the deficit problem is politically difficult, because the pain is immediate while the rewards are far in the future. I worry that our current institutions are not up to the task of taking on this political challenge. It is often alleged that we lack leadership, but leaders need power to be able to function. I fear that the reforms of the early 1970s went too far in decentralizing power in the Congress and in depriving the president of power over the budget. I would restore some of the power earlier enjoyed by the Congressional leadership and committee chairmen. I would also give the president more power not to spend appropriated funds and the power to veto budget resolutions.

None of this would guarantee progress on the deficit, but it would reduce the extent to which the leadership has to bargain with 535 individual legislators—an almost impossible task practically.

On another process issue, you asked whether I favored GAO's "developmental investment budget." I believe that the Congress should be kept up to date on the path of public investment, and in fact, the president's budget provides a very large amount of information on this issue.

I would not like to see capital budgeting become a formal part of the budget process, however, in the sense that the Congress would actually vote on a target for public investment. The budget process is already far too complicated and time consuming. It needs simplification rather than more complexity. Moreover, economists are not very good at precisely differentiating capital from operating spending. Without a precise definition that might discipline the system, it is likely that more and more spending items would be defined as capital investment, because it would be argued' that it is permissible to borrow to finance these items. The prospects for deficit reduction would become even more remote, if that is possible.

It should be emphasized that no process reform will solve the problem if the will does not exist to make the very hard choices to cut spending and raise taxes that deficit reduction requires. That is certainly true of the proposed constitutional amendment to balance the budget, if it is passed devoid of any enforcement mechanism. Budget accounting rules are very loose and easily circumvented as we have seen at the state level where they have created off-budget agencies and used every accounting gimmick known to man. Government intervention can, of course, avoid the budget altogether. There is little accomplished through taxing and spending that cannot be accomplished through mandates and regulation, albeit much less efficiently. That is not to say that the balanced budget amendment would have no effect in reducing deficits. The prohibition amendment apparently reduced the per capita consumption of alcohol. But the cost was enormous and the constitution was demeaned. The same result will follow if the balanced budget amendment is ever enacted.

SUMMARY AND CONCLUSIONS

Large deficits in times of peace and prosperity are a relatively new phenomenon in American history. Although there has been an upward trend in deficits for most of the post World War II period, they were not really large until the 1980s. The record breaking deficit in 1992 is, in part, the result of temporary factors—the recession and deposit insurance. But once these problems are behind us, a longer-run problem will prevent the deficit from improving to satisfactory levels. That is the soaring cost of health care.

In standard economic theory, the harm done by deficits occurs gradually, but it accumulates to very large amounts. It can be mitigated by foreign capital inflows, but it cannot be eliminated altogether. The $2 trillion in debt accumulated over the past decade may now be having a noticeable effect.

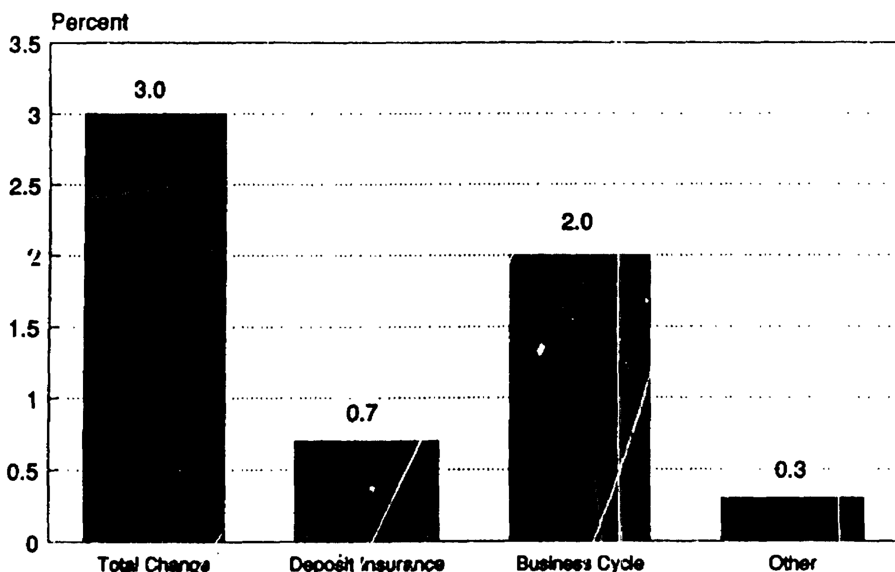
The ultimate risk posed by deficits is that they will cause hyperinflation when the public debt becomes so high that further borrowing is deemed undesirable, and spending is financed with money creation. We are far from that point today, but current policy implies that the debt will continue to outgrow our income for the foreseeable future. If that occurs while we are experiencing an economic recovery, a considerable peace dividend, and an unusually slow growth in the retired population because of low birth rates during the Great Depression, one must wonder what will

occur when the baby boom starts retiring in the early 21st century given that already almost one-half of noninterest domestic spending goes to the elderly.

By far the greatest damage being done by deficits today involves their effect on economic growth. Some also complain that they have deprived us of our power to stimulate the economy during times of recession. That is not, however, an effect of deficits that I deplore. We have been so unskilled in the past in our attempts to design stabilizing fiscal policies that I believe that we have done more harm than good.

Ultimately, significant cuts in program spending and increases in tax revenues will be required to make progress on the deficit. Economists have suggested many options, but the political barriers to their adoption have been insurmountable. This is true, even though it is my strong impression that a large majority of today's Congress believe that large deficits are undesirable. That leads me to believe that there are institutional barriers to reform. I think that we have to give our leaders more power to impose painful solutions on their followers. The organizational reforms of the Congress in the 1970s diffused power too much and the earlier budget reforms left the president with too little influence over the budget. But correcting these problems will not be enough to guarantee a solution to our budget woes. Certainly, amending the constitution to require a balanced budget will not work. It will still take strong leadership to accomplish to solve the budget problem. Improving the tools is not enough. They must be wielded with courage and skill.

Causes of the Change in the Deficit, 1989 to 1992, as a Percent of GDP



PREPARED STATEMENT OF ROBERT D. REISCHAUER

Mr. Chairman and Members of the Subcommittee, I appreciate the opportunity to appear here to discuss how budget deficits affect long-term economic growth.

The Congressional Budget Office agrees with the Government Accounting Office and most economists that large persistent federal deficits dampen the rate of productivity and economic growth. Ultimately, deficits of the sort this country has experienced for over a decade keep living standards from attaining the level they could reach if the deficits were smaller. The problem is all the more pressing because the deficits occur at a time when other factors—low private saving rates, the slow

growth in productivity, and demographic trends—will also tend to restrain the improvement of living standards.

Policymakers as well as economists widely recognize these arguments. But recognizing and understanding a problem is not the same as doing something about it: after more than two decades of discussion and procedural changes, we still do not have either agreement on the policy changes necessary to cut the deficit or the procedures that will effectively bring about a budget close to being balanced.

Many are now determined to try another procedural innovation: enshrining a balanced budget in the Constitution. I fear that the constitutional approach could divert attention from the fundamental job of deciding what spending is to be cut or what taxes are to be increased. Inevitably, these decisions must be made, with or without a constitutional amendment. Nevertheless, I am sympathetic with the underlying aim of the amendment—namely, to keep the need for deficit reduction at center stage.

LOWER GOVERNMENT BORROWING WOULD INCREASE GROWTH

Without a doubt, reducing government borrowing will reap very real long-run benefits. Lower deficits would encourage economic growth in the long term by raising net national saving and investment, and would reduce borrowing from foreigners. From an accounting point of view, any reduction in the deficit—provided it does not come out of government investment—is a reduction in government dissaving and, therefore, an increase in national saving.

Although some analysts are concerned that private saving will decline as government dissaving drops, the offset is not likely to be particularly large. Studies indicate that reducing the deficit by one dollar might reduce private saving by 20 cents to 40 cents, which implies that national saving will increase by 60 cents to 80 cents for every dollar of deficit reduction. [1] More net investment and lower borrowing from foreigners, both of which depend on increased national saving, will eventually permit a higher standard of living.

Deficit reduction will also promote long-term economic growth by providing a more stable environment for financial markets. Participants in the bond, stock, and foreign exchange markets carefully track the government's demands on credit markets; they react adversely to news that reflects a continuing lack of fiscal discipline.

As deficits fall and the pool of funds available for loans to the private sector grows, interest rates adjusted for inflation should drop. Lower interest rates will help to stimulate activity in interest-sensitive sectors, such as construction and business investment. They will also aid in making the dollar more competitive, thereby boosting exports and helping domestic producers to compete with imports.

Because government borrowing reduces investment and slows growth in the long run, it will impose a burden on future generations, and, in many people's minds, this is the single most important reason to reduce the federal deficit. The burden is in part reflected in the interest costs of servicing the federal debt. As you well know, these costs have already risen from 8 percent of tax revenues in the 1970s to 18.6 percent of revenues in 1991. The only way to reduce these costs is to reduce federal borrowing.

Is the Deficit All that Matters for Growth?

Although the federal deficit is only one of the channels by which federal fiscal policy can affect growth, an examination of the other major channels—federal government investment and tax policies—does not improve the outlook. The deficit tells us how much the federal government's borrowing takes out of the pool of private saving, and thus how much it cuts into private investment. In addition, we should look at the government's own investment—which can be as effective as private investment in generating growth—and at the effects of tax policy on the incentives for private saving and investment. [2]

Federal Investment Spending. Rising federal deficits would not adversely affect growth if they financed productive investments in such things as infrastructure and education. Education is an important factor in growth. Perhaps as much as one-quarter of the growth in output per worker from 1929 through 1982 was attributable to increased education—mostly government financed, though not by the fed-

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[1] See Lawrence H. Summers, "Issues in National Saving Policy," in Gerald F. Adams and Susan M. Wachter, eds., *Savings and Capital Formation* (Lexington, Mass.: Lexington Books, D.C. Heath & Co., 1986), pp. 65–88; and Michael J. Boskin, "Alternative Measures of Government Deficits and Debt and Their Impact on Economic Activity," in K.J. Arrow and M. J. Boskin, eds., *Economics of Public Debt* (New York: Macmillan, 1988), pp. 72–112.

[2] See Congressional Budget Office, The Federal Deficit: Does It Measure the Government's Effect on National Saving? (March 1990).

eral government. In the past, federal spending on infrastructure has been about as successful as private investment in promoting growth. Maintaining this record will be difficult because the most productive infrastructure projects—such as the interstate highway system—have already been completed. Nevertheless, spending on public investment could still be as productive as private investment if the projects are carefully chosen. The current and projected federal deficits do not reflect increased investment spending, however. As conventionally measured, federal investment as a share of gross domestic product (GDP) in constant dollars has fallen slightly over the last 20 years, and projections for the near future indicate little change in that share.

Changes in Taxation. Reducing the deficit by raising revenues is not the only way tax policy can improve future living standards. By influencing how much and where people work, save, and invest, taxes also help determine how efficiently society uses all its resources and how much of those resources are devoted to investment for the future. In particular, for a given level of the deficit, a tax system that increased incentives to save or invest might enhance future output and productivity by encouraging more capital formation. Usually, however, the effects of such a tax system on incentives are small or uncertain compared with the direct boost that lower deficits give to national saving.

Standard principles suggest two broad strategies for tax design for economic efficiency. First, minimize tax preferences that subsidize narrow sectors or activities. This step would increase efficiency by leveling the playing field—taxes would play a smaller role in private decisions—and it would permit lower rates by broadening the tax base. Second, make private parties pay more of the cost of the resources they use. This strategy obviously applies to narrowly provided government services such as those for air, water, or highway transportation. But it could also apply to broad national problems, such as environment and energy, because pollution and dependence on energy impose costs on our society that are not now reflected in market prices of the activities that generate those costs.

Economic efficiency might also justify shifting taxes toward consumption, but designing incentives to save or invest would require care. Greater incentives to save or invest could be provided within the current tax system or by introducing a consumption-based value-added tax (VAT) to replace the individual and corporate income taxes. A European-style VAT is a direct way to shift the tax burden from saving to consumption without introducing new dislocations in the income tax. But a VAT would impose additional costs of administration and compliance on taxpayers and the Internal Revenue Service, and it could introduce new efficiency costs if some goods and services are exempted. In addition, available evidence suggests that the response of saving to changes in tax rates is small and uncertain.

Tax policy might also increase efficiency by making the treatment of income from corporate and noncorporate investment more even, but again there might be problems. For example, lowering the corporate tax rate would apply to old capital, as well as new investment. Investment tax credits or accelerated depreciation schedules would apply only to new investment. But they are difficult to design if they are to apply uniformly to all types of investment. Nonuniform treatment can sometimes lead to substantial waste. During the early 1980s, for example, the combination of accelerated depreciation and favorable treatment of capital gains is believed to have contributed substantially to the excess of commercial construction.

It is certainly worthwhile to seek to improve the efficiency and reduce the distortions of the tax system. Nevertheless, as these examples have shown, tax reform is unlikely to offer as large an opportunity for enhancing long-term growth as would be gained by simply reducing federal borrowing, and in that way increasing national saving.

THE BUDGET OUTLOOK

Unless there is further legislation to reduce the deficit, however, the problem of excessive government borrowing is not going to resolve itself. For a few years, it will look as if things are getting better: the federal deficit could fall from around 6 percent of gross domestic product in the current fiscal year to around 2.5 percent in 1996 (see Table 1). But this apparent improvement is largely the result of the rebound from the current recession and the swing in the deposit insurance accounts Together, these two temporary factors account for about 43 percent of this year's deficit.

The more revealing calculation excludes these two factors and examines the longer-range outlook. From this perspective, the standardized-employment deficit rises from around 3 percent of GDP in the early 1990s to 4 percent in 2002 (see Table 1 and Figure 1). This increase will take place even with the substantial policy

changes that will be necessary to meet the discretionary spending targets of the Budget Enforcement Act. As the figure shows, the standardized-employment deficit as a percentage of potential GDP was historically high during the 1984–1991 period. That record, however, is likely to be challenged by the sustained high deficits that are projected through 2002.

Table 1. The Budget Outlook Through 2002 (By fiscal year)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
					In Billions of Dollars						
Revenues	1,088	1,173	1,262	1,340	1,413	1,490	1,578	1,665	1,755	1,851	1,953
Outlays	1,455	1,510	1,529	1,543	1,602	1,726	1,843	1,962	2,089	2,226	2,376
Deficit	368	336	267	203	189	236	265	296	333	375	423
Standardized-Employment Deficit[a]	208	198	186	179	202	245	262	289	322	360	406
Debt Held by the Public	3,049	3,385	3,656	3,865	4,061	4,304	4,576	4,879	5,220	5,602	6,032
					As a Percentage of Gross Domestic Product						
Revenues	18.6	18.8	19.1	19.1	19.1	19.0	19.0	19.1	19.1	19.1	19.1
Outlays											
Discretionary	9.4	8.7	[illegible]	7.7	7.5	7.3	7.2	7.1	7.0	6.8	6.7
Mandatory											
Social Security	4.9	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8
Medicare/Medicaid	3.4	3.6	3.7	4.0	4.2	4.4	4.7	4.9	5.2	5.5	5.9
Other	3.9	3.7	3.5	3.4	3.2	3.3	3.2	3.2	3.1	3.1	3.1
Subtotal	12.1	12.0	12.0	12.1	12.2	12.4	12.6	12.9	13.1	13.4	13.7
Deposit Insurance	1.1	1.1	0.5	-0.2	-0.6	-0.4	-0.2	-0.2	-0.1	-0.1	-0.1
Net interest	3.4	3.4	3.5	3.5	3.5	3.6	3.6	3.6	3.7	3.8	3.8
Offsetting receipts[b]	-1.2	-1.1	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0
Total	24.9	24.2	23.1	22.0	21.6	22.0	22.2	22.5	22.7	23.0	23.3
Deficit	6.3	5.4	4.0	2.9	2.5	3.0	3.2	3.4	3.6	3.9	4.1
Standardized-Employment Deficit[a,c]	3.4	3.1	2.8	2.5	2.7	3.1	3.1	3.3	3.5	3.7	4.0
Debt Held by the Public	52.2	54.3	55.2	55.2	54.8	54.8	55.2	55.9	56.7	57.8	59.1

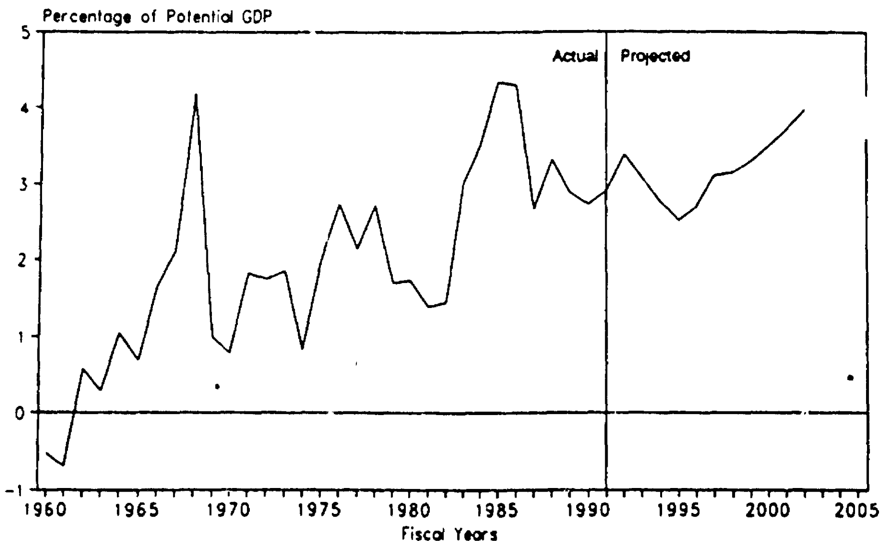
SOURCE: Congressional Budget Office (March 1992)

a. Excludes deposit insurance and Desert Storm contributions

b. Includes contributions from allied nations for Operation Desert Storm

c. Shown as a percentage of potential gross domestic product.

Figure 1.
The Standardized-Employment Budget Deficit



Source: Congressional Budget Office.

The persistence of large deficits would cause the debt held by the public to climb to more than 59 percent of GDP by 2002 under current policies, up from 52 percent today. Not since the mid-1950s (when the debt-to-GDP ratio was still heavily affected by the debt burden accumulated during World War II) has the debt-to-GDP ratio been so high.

The projected long-run increase in the deficit as a share of GDP stems from an acceleration in the projected growth in outlays that is not matched by a corresponding growth in revenues. Revenues remain at about 19 percent of GDP throughout the projection period, but outlays climb from 21.6 percent of GDP in 1996 to 23.3 percent in 2002. The growth in outlays is mostly in the government's big health care programs, whereas discretionary programs—defense, international, and domestic—gradually decline relative to GDP. Most other spending programs, including Social Security, roughly preserve their 1997 shares in the out-years. Social Security benefits stay at about 4.8 percent of GDP through the projection period, but they will begin to rise rapidly a few years after 2002 as the baby-boom generation reaches retirement age.

These projections would be even higher were it not for the severe restraint the Budget Enforcement Act imposes on discretionary spending through 1995. Yet, these limits will be hard to meet. After the required real reductions of 3 percent for 1993, the Congress will have to pare discretionary spending by an additional 4 percent in 1994 and a further 3 percent in 1995 to comply with the act. If these limits are not adhered to, deficits will be even greater than the baseline projection indicates, and the task of getting them under control will be correspondingly more onerous.

WILL THE BALANCED BUDGET AMENDMENT HELP?

Over the course of the past two decades, a number of procedural steps have been taken in an effort to rationalize budget policy and control the deficit. These measures include the Congressional Budget and Impoundment Control Act of 1974, the Balanced Budget Act (Gramm-Rudman-Hollings legislation) of 1985 and 1987, and the Budget Enforcement Act of 1990. Although they have heightened the attention paid to budget decisions and have helped restrain the deficit somewhat, they have not reduced the deficit to acceptable proportions.

The balanced budget amendments that are under consideration are another attempt to set up a procedure that will make the deficit even more central to Congressional budgetary decisions; indeed, such an amendment will make eliminating the deficit the single most important consideration of budgetary policy. Proponents hope that by enshrining a balanced budget in the Constitution, they will raise the stakes and force the hard decisions about spending cuts and tax increases that have not yet been made.

I am not sanguine that such a favorable result could be achieved for two reasons. First, the balanced budget amendment does not do anything to make the specific decisions to cut spending or raise taxes any easier. Second, any balanced budget rule could too easily be circumvented. Some methods that may be used to circumvent the rule, such as creating a capital budget, have some justification. Others would, however, be similar to the budget gimmickry and legerdemain that flourished in the Gramm-Rudman-Hollings era—for example, using optimistic economic assumptions, shifting expenditures off-budget, and changing the timing of receipts and outlays.

In a capital budget, the cost of outlays for capital items in the budget would be replaced by depreciation and thus would be spread out over a longer period of time to account for the long-lived nature of the assets acquired. Government capital spending may currently be disadvantaged, because its costs are front-loaded relative to the benefits that flow from such projects. A change in the budgetary treatment of capital spending would eliminate the up-front budget cost and thus might promote more capital investment. It is difficult, however, to put the concept of a capital budget into practice, primarily because so much depends on subjective assumptions concerning what capital is and how it is to be measured. Capital budgets at the state level have traditionally included only physical assets. Yet, investments in human capital (such as education) also have long-term economic benefits, and most economists would say they are investment just as legitimately as any physical building. Moreover, the creation of two categories of spending may increase playing games with budget definitions, particularly if policymakers seek to have their favorite programs classified as "investments," regardless of the actual contribution of the spending to economic growth.

Concurrent Actions Are Needed to Achieve Fiscal Discipline

A balanced budget amendment risks ignominious failure if it is not accompanied by a definite plan for reducing the deficit fast enough to reach a balanced budget in the time envisaged by the amendment. If a balanced budget amendment is approved and sent to the states for ratification, the Congress will be obligated to begin immediately to take the steps necessary to comply with a balanced budget regime.

To avoid the need to make sudden, draconian cuts in spending or massive, abrupt tax increases, efforts should be made to bring the deficit down substantially during the ratification period. Although this task is by no means easy—it is the problem that has bedeviled the budget process for the past decade—it is critical. If the amendment takes effect with the deficit still in the hundreds of billions of dollars, the Congress would be faced with the Hobson's choice of enforcing the new rule and inducing a recession or waiving the rule from the start, which would clearly be an inauspicious beginning for the new era.

It would be preferable for the President and the Congress to reach a consensus concerning the appropriate mix of policy changes necessary to achieve the goal of budgetary balance well before the effective date of the amendment. If such a consensus were not reached, however, transition legislation would need to specify methods to force a reduction in the deficit in a more automatic and mechanized way. Two different broad paths could be taken—granting power to the President to carry out budgetary changes without the specific action of the Congress, or resorting to formulas as was done in the Gramm-Rudman-Hollings act to effect automatic reductions if an agreement on alternatives was not reached.

Each of these paths would involve substantial constraints on the flexibility of policymaking and a substantial alteration in the distribution of power to make budget policy. Most analysts would not favor as a permanent diet the rigid specifications of the budget process that would be required for the transition period. The fail-safe procedures are too mechanical, and they would throw to the winds both countercyclical fiscal policy and the automatic economic stabilizers. But just such rigidity may be necessary to have a chance of making a successful transition to a new regimen of constitutionally mandated balanced budgets. Without a consensus on national goals—or drastic procedural measures that can enforce action in the absence of consensus—a balanced budget amendment is doomed to failure.

How Big Must the Policy Changes Be?

Let me now address what it will take to comply with the amendment if a balanced budget is required by 1997. Balancing the budget in five years is difficult but not impossible. For example, spending decreases and tax increases totaling $40 billion in 1993, $80 billion in 1994, and growing to $200 billion by 1997, together with the resulting saving in debt-service costs, would do the trick. Over five years, the required deficit-reduction measures would total about $600 billion, which is a bit more than 40 percent larger than the savings called for in the 1990 budget summit agreement.

This illustrative path is based on CBO's current economic and technical estimating assumptions and therefore ignores the effects on the economy of attempting to balance the budget. It should, however, be fairly close to the mark. To the extent that the deficit-reduction effort reduces overall demand and lowers income and employment, tax collections would be impaired, and the task of balancing the budget would be made harder than those numbers suggest. To the extent that interest rates are also reduced, however, the government's cost of borrowing would be lower, and the job would be made easier. Although these two effects will not precisely offset each other, the budgetary feedbacks are likely to be small.

DEFICIT REDUCTION NEED NOT CAUSE SEVERE HARDSHIP

Although deficit reduction will initially reduce the rate of economic growth, the short-run hardship can be lessened if the reduction is carried out in a credible and consistent way. A credible long-term plan would encourage a drop in long-term interest rates, permit an easing of monetary policy, and foster a smoother adjustment by the private sector to the changes in government spending and taxation policies.

Long-term interest rates are higher when financial markets anticipate large federal deficits in the future. The high rates depress investment. If the Congress and the Administration took steps that convinced financial markets that future deficits will be lower than currently anticipated, long-term rates would ease, thus stimulating investment. Unfortunately, the experience of the last decade has led participants in financial markets to be skeptical of promises to reduce government borrowing. Although it is not clear exactly what actions would be necessary for a deficit-reduction plan to become credible to the markets, the actual passage of bills that specified

particular tax increases or spending reductions would clearly be more credible than procedural reforms.

A credible plan for deficit reduction would also permit the Federal Reserve to provide more monetary stimulus, since fiscal policy would be less expansionary and the threat of inflation smaller. The Federal Reserve eased monetary policy in the wake of the passage of the Budget Enforcement Act of 1990, and similar deficit-reduction efforts are likely to encourage easier monetary policy in the future. Both long- and short-term rates would therefore be lower than they would have been without deficit reduction, and this change would offset part of the initial dampening effect of deficit reduction.

A deficit-reduction plan that resulted in a consistent fiscal policy would also help minimize the short-run adverse effects. Individuals, businesses, and communities could clearly respond more effectively to deficit reduction if the long-run pattern of federal spending and taxation policies were relatively predictable.

CONCLUSION

The budget outlook is grim, particularly given other developments in the last decade that indicate slower growth in living standards in the future. Investment and the long-run outlook for growth in labor productivity and living standards have been adversely affected by the persistently large standardized-employment deficits of the 1980s, and there is no relief in sight. Policy changes, particularly deficit reduction, can improve the long-run outlook for living standards, but these changes will be difficult to make and may entail a lower level of consumption and living standards in the short run.

The initial sacrifice could be reduced, however, if a credible and consistent long-run deficit-reduction policy is combined with an easier monetary policy. A balanced budget amendment, by itself, is unlikely to provide sufficient credibility to minimize the adverse short-run effects of deficit reduction. Markets will have to be convinced early in the process that the difficult decisions regarding specific taxes and spending policies are being made if we want to keep the short-run costs of deficit reduction low.

PREPARED STATEMENT OF C. EUGENE STEUERLE

Mr. Chairman and Members of the Subcommittee: Let me begin by congratulating both the Subcommittee for holding this hearing and the General Accounting Office for its fine efforts to examine the long-term implications of the federal budget deficit.

If there is any lesson at all that should be learned from the budget struggles of recent years, it is that the primary focus of budget policy should be on the long run. If programs are designed correctly for the long-run, then the short run is more likely to take care of itself. Budget bills that focus only on this year, or even the next few years, are woefully inadequate. Such deficit reductions as occurred in 1982, 1984, 1987, and 1990 did not fail because of the particular provisions of those bills: the bills did reduce the deficit, and sometimes by significant amounts. Instead, the bills failed because they did not deal with the long-run budget. Occasionally, they were even accompanied by claims that the deficit problem had been eliminated. Then, one or two years later, new projections would show that the budget remained out of control. Nothing conveys the lack of long-term control over the budget than GAO's projections that under current law expenditures would rise from 23.3 percent of GNP to 42.4 percent by 2020 while revenues rise from 20.3 to 21.8 percent.

Regaining control over this situation will not be easy. In this testimony, I would like to emphasize three points:

(1) One of the principal dangers in the current budgetary situation is that shifts in policy become dictated almost entirely by crises and by the decisions of previous policy makers. In effect, we have given up control over our own ability to respond to today's needs, while denying to posterity the flexibility to respond to the needs of their own time.

(2) The primary reason for the current paralysis in policy is not the deficit per se. The deficit is merely a symptom of the inability of policy makers to adapt to the requirements of the new fiscal era that has succeeded the Easy Financing Era that followed World War II.

(3) The budget problem will never be solved until we restore fiscal slack to the budget.

I. A LOSS OF CONTROL AND INABILITY TO RESPOND TO CURRENT NEEDS

It is a mistake to believe that the current sense of stagnation in government reflects a lack of shifts in policy over time. That there are significant shifts can be discovered simply by looking at recent occurrences. Recently the nation decided to repel the invasion of Kuwait at a total military cost estimated at over $60 billion and, initially, with a high probability that both the number and the U.S. share of the total cost would be much higher. Between 1989 and 1995, it has been estimated that the United States will invest over $250 billion to finance the bailout of the savings and loan industry and tens of billions more to maintain the financial integrity of banks. Recent and projected increases in government health expenditures add up to several percentage points of GNP, or hundreds of billions of dollars in excess of inflation.

Contrast the size of these changes with the size of proposed funding for education or help to our central cities. The President's budget suggests reductions in education spending relative to GNP, while with respect to problems in central cities the goal is to find at best a few billion.

Where there are significant shifts in policy, therefore, spending is decided either by crises, such as the collapse of financial institutions or by the ways in which previous policy makers have designed policy, as in the case of health care. The deficits that result from these runaway policies leave little to confront current needs.

The danger discussed in the GAO report, of course, is that we have so predetermined the direction of future policy—but without being willing to pay for it—that our long-term growth rate and rate of investment are reduced significantly.

The paralysis stories of today, therefore, do not reflect a government that is totally stagnant. Instead, they reveal the frustration of current policy-makers and voters that we are not in charge of our own destiny. If almost all shifts in spending are determined either by emergencies, or by past decisions, then how can we take some share of our income for today and spend it on what we believe to be the most important and pressing needs of our society?

II. THE NEW FISCAL ERA

For some, the recent budgetary pressures are simple to explain. A conventional liberal wisdom holds that the deficit problems of the 1980's were due merely to the miscalculations of 1981. A conventional conservative wisdom holds that Congressional pressures for ever-expanding expenditure programs forced substantial tax increases on the nation. Like so many pieces of conventional wisdom, each contains an element of the truth, but is mainly misleading. By the late 1970's the nation was moving clearly into a new era of decision-making. The miscalculations of 1981, along with continual Congressional pressures for spending, only speeded up the process. Both budget and tax policy makers, however, have been groping for procedures and ways to operate in this new era.

After World War II, the focus of government shifted toward domestic programs. New means of financing changing priorities were required, and the balances were provided in four principal ways.

First, especially in the early postwar era, there was a large, and unexpected, decrease in the value of outstanding government debt due to rises in the rate of inflation. Interest rates on government debt often were low or negative in real terms. Second, there was a significant decline in the size of the defense budget relative to GNP, with exceptions for the Korean and Vietnam Wars and for the slight build-up in the 1980's.

The third and fourth ways of providing balance were through significant tax increases. Bracket creep in the individual income tax raised individual tax rates, while continual and little-debated increases in Social Security tax rates were often enacted either to pay for expanded benefits, or, as in 1977 and 1983, because of a requirement to keep the Social Security trust funds solvent.

These four sources of "funds" for expanding domestic programs—as well as paying for legislated tax cuts—were little debated, in part because they seldom required legislation that identified losers

The Demise of the Easy Financing Period

As the nation approached the late 1970's and early 1980's, all of these sources of funds for expenditure or tax changes began to be reduced in importance or eliminated. One or another, of course, might be available for awhile—as in the case of social security tax increases in the 1980s and defense cuts from 1986 through the 1990's. Regardless of possible cyclical changes, however, the almost automatic nature of these sources of funds has been removed and, more importantly, together they became much smaller relative to the economy.

The elimination of all four of these sources profoundly affected the political process under which tax and expenditure policy proceeded. The bottom line was this: changes in priorities had always required trade-offs, but past sources of funds to pay for new priorities were increasingly unavailable. The nation was at the end of the Easy Financing Period of the postwar era. Now losers had to be identified more directly. Policy makers were forced to identify more directly who would pay for the changes sought—or to seek temporary reprieve in a larger deficit.

III. THE ELIMINATION OF FISCAL SLACK

Adding to pressures on the budget was the growth in ability of policy makers to spend future revenues well in advance. Partly due to the incentives of the Easy Financing Era, policy makers wrote laws in a way that removed future slack in the budget—slack which might allow debates over changes in priorities to be followed by action.

Expansion by formula was sometimes a key. Formulas were set so that benefits would rise over time even in absence of any legislation. A related phenomenon was the growth of "entitlement" programs that could be cut only through explicit legislation, as opposed to discretionary programs that require explicit annual appropriations to be funded. The entitlement supposedly derived from a "social contract" to pay future benefits on the basis of a formula fixed in the past. Allen Schick similarly points to "sticky expenditures"—entitlements, obligated bonds, long-term commitments—that respond only weakly to contraction policies. A number of programs were also designed with different types of "open" commitments: an absence of legislated limits on what would qualify for the particular government expenditure or subsidy. For instance, many governmental loan programs were designed with few or no limits on how much agencies could borrow, while Medicare and Medicaid continually accept a variety of new medical procedures that will be supported because of the open nature of what qualifies as medical care. Judging from the GAO report, these open commitments—particularly in the area of health—are primarily responsible for the size of future deficits under current law.

The elimination of fiscal slack was hardly confined to the direct expenditure side of the budget. Each of the methods of maintaining or increasing funding for direct expenditure programs had a parallel on the tax side. Many tax expenditures, for instance, might be labeled as tax entitlements rather than discretionary tax expenditures. Except for provisions that had to be extended every few years, the level of tax expenditure was almost never determined currently by policy makers. In a sense, the "appropriation" for 1985 or 1989 was set by legislation enacted as long ago as 1935 or 1954. Once an exclusion or deduction was granted for a given category of activity, its cost would often expand along with the level of that activity in the economy.

IV. REQUIRED ADJUSTMENTS IN BUDGET AND TAX POLICY MAKING

Policy-making institutions within the Executive Branch and Congress have only begun to adjust to the changes being forced upon them in the new era. In some cases, institutions have continued to act as if the country was still in the Easy Financing Era. Thus, authority continues to be diffused across more departments of the Executive Branch and among more committees, subcommittees, and members of Congress. These changes initially made the trade-offs required in the new era even more difficult to attain.

In the 1980's, the enactment of new, sometimes elaborate, and sometimes bizarre budget rules was one means that Congress chose to react to this new and inevitable balance sheet requirement placed on specific legislation. These rules should be viewed primarily as the means used to react to the constraints of the new era and, thus, not the basic source of pressure on policy makers.

Given the enormous size of the problems reported in the GAO report, it would be easy to be a pessimist and believe that the impasses of the recent past as to how to achieve shifts in priorities are somehow a permanent feature of government. (Perhaps the most important shift needed immediately is to increase net national saving by reducing the deficit.) While there is some logic to this scenario over the short-run, it is also destined to be wrong. Why? The demands of the population and its sense of priorities continue to change in a rapid manner. Part of this change is due to an expanding economy and a changing technology. We do not find it surprising, for instance, that private demands change annually by several percent of total income, or several hundred billion dollars, per year. It should not be surprising that the public's demand for government goods and services should occur at an equally rapid rate.

The simple fact is that trade-offs have always been required. In the new fiscal era, they must be made differently. "How will they be achieved?" The answer is that institutions and institutional processes will—indeed, must—change to accommodate new demands. How those institutions will change is at this point highly speculative. It will depend in no small part upon both Presidential and Congressional leadership.

My own prediction, as well as recommendation, is that ultimately the budget process in Congress will be strengthened significantly by vesting more authority in the leadership or in the budget or appropriations committees, while the Executive Branch will concentrate greater power in the Office of Management and Budget and the Treasury, that is, in those parts of the government with broad oversight over many or most tax and expenditure functions.

Tremendous gains could be achieved by adoption of budgetary rules that focused on long-term deficits and required the restoration of some fiscal slack. As an example, the trustees of the Social Security System for several years have reported that the trust funds are not financially sound for the long-run and that the situation is getting worse from year to year. Congress and the Administration could solve a great deal of the deficit problem implied in the GAO report simply by adopting a rule that required that these funds be kept in actuarial balance for the long run.

That we can succeed in the new era is foretold by some stories of success. Tax reform made trade-offs that by some estimates involved a reduction of close to $200 billion per year in tax expenditures. Social Security reform in 1983 made valuable trade-offs not just for the near term, but for the long run.

The ability to make these types of trade-offs, however, must now occur not only within particular parts of the budget, such as the tax system and the social security system, but among its many parts. Departmental, agency, committee, and subcommittee fiefdoms must be brought under control. A more adaptable process also requires that a broad range of programs be redesigned so that future growth is left to future decision-makers, rather than determined far in advance. Fiscal slack will need to be restored. This requires taking some of the built-in growth and open-ended features, out of many direct and tax expenditure programs.

These prescriptions—strengthening the ability of both Congress and the Administration to deliver budget and expenditure packages and the restoration of some fiscal slack—are the fundamental requirements of the new fiscal era. Until these reforms are achieved, however, there will remain a constant shortfall of revenues both to cover existing expenditures and to provide for new reforms. This shortfall, in turn, will be exacerbated by some of the harms discussed in the GAO report, including a low rate of investment and smaller growth in household net worth.

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