S. HRG. 104-162, VOL. I

CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 1996

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET UNITED STATES SENATE

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

January 25, 1995—CBO ECONOMIC AND BUDGET OUTLOOK 1996–2000

January 26, 1995—ECONOMIC OVERVIEW

February 7, 1995—THE PRESIDENT'S ECONOMIC PLAN

February 8, 1995—THE PRESIDENT'S FISCAL YEAR 1996 BUDGET

February 10, 1995—THE PRESIDENT'S DEFENSE BUDGET

February 15, 1995—THE PRESIDENT'S BUDGET: FOREIGN AFFAIRS

February 16, 1995—THE PRESIDENT'S BUDGET: AGRICULTURE

February 23, 1995—THE PRESIDENT'S HEALTH AND HUMAN SERVICES BUDGET

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CBO ECONOMIC AND BUDGET OUTLOOK 1996–2000

WEDNESDAY, JANUARY 25, 1995

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 9:38 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Nickles, Brown, Gorton, Snowe, Frist, Exon, Conrad and Murray.

Staff present: G. William Hoagland, staff director; and Cheri Reidy, senior analyst for budget review.

For the minority: William G. Dauster, democratic chief of staff and chief counsel; Jodi Grant, general counsel.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman DOMENICI. The committee will please come to order.

I thank the Senators who were able to make it here at the outset of this hearing, and we have some others who will be attending.

Let me welcome our distinguished witness—and we will only have one today—Dr. Robert Reischauer. We need to get started because we have a lot of ground to cover today. This is probably our last chance to question Dr. Reischauer in his capacity as director of the Congressional Budget Office. He always smiles when I say that, and I always tell him that I bear on feelings toward him other than absolute respect and gratitude for his public service and hard work.

On behalf of the committee, I want to once again express that gratitude for your outstanding work. You have a long record of service, and you have served Congress with fairness and I believe conviction, and we thank you for that.

The report that CBO is going to release early next week is entitled, "The Economic and Budget Outlook, 1996–2000." Yes, this is the first time the year "2000" appears on the cover of a CBO economic and budget outlook. This year, for the first time, our budget resolution will go out to the year 2000. Before that, we used to philosophize about governing in the 21st century, and everybody used to use that as a means of describing their concern about the future.

This year, we do not have to talk about it as if it is so much in the future; it is reality, and it is upon us.

Last year at this time, there was much rejoicing about the declining deficit estimates. CBO's January report showed the deficit falling to $166 billion in 1996. I played the part of the devil's advocate last year, when I warned not to pop the champagne corks yet. The estimated 1996 deficit represented the trough, and then the deficits climbed relentlessly after that rising to $365 billion by 2004.

Well, today the CBO director will tell us the deficit will not be as low as $166 billion in 1996. It will not be $175 billion or even $200 billion. CBO projects the 1996 deficit will be $207 billion, climbing to $421 billion by 2005.

Furthermore, the U.S. economy is now in the 45th month of expansion, just short of 4 years. We are all very pleased that that is the case, for all those in the United States who seek opportunity and advancement from this great economy.

The average peacetime recovery in the United States has lasted 43 months, or about 3½ years. CBO's annual report contains economic assumptions that show the current expansion continuing throughout the forecast period, and still the deficits jump sky-high. What will the deficits look like if we are unable to sustain the current expansion?

Governing in the 21st century means heading for a balanced budget, and it means starting down that path now. We will likely have a constitutional amendment that mandates that the budget be balanced early in the next decade, and thereafter we will no longer have deficits unless they are in emergencies.

I would like to hear your thoughts regarding undertaking major deficit reduction now, versus waiting a couple of years before we start. Obviously, a downward path toward a balanced budget represents a major long-term fiscal contraction. The last round of budget cuts did not do that, and I repeat, whatever they did, they did not get us on a trendline down.

The deficit reductions we undertake will have to balance the goal of a balanced budget with the goal of long-term economic health of our Nation. How can we do this and do it in the best way? What is the magnitude of the deficit reduction that the economy can endure annually?

Again, Dr. Reischauer, thank you for being here today. I wish you all the best in your future endeavors, whatever they may be, and hope that we can have you back again to give us some advice and your thoughts about the future.

Senator Exon, I yield now to you.

OPENING STATEMENT OF SENATOR EXON

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

I want to join you in welcoming our witness today, Dr. Robert Reischauer.

I would like to take a moment if I might to thank Dr. Reischauer for the enormous contribution that he has made during his tenure as CBO Director.

Dr. Reischauer, you are one of the finest public servants I have ever known. You have served in one of the most difficult and thankless jobs that I know of. You clearly have set a standard that those who follow you should seek to maintain.

Bob was often the messenger of some very bad news, but very important news, for Congress and the American people. Moreover, he had to fend off those who wanted to manipulate his message—of course, this Senator was not one of those who ever sought to manipulate that message. But I say in all sincerity that both Republicans and Democrats alike always try to massage the figures that we get to emphasize our points of view. But Dr. Reischauer always rose above the fray and always rose to the occasion.

Bob Reischauer combined acute intelligence, a ready wit, and an absolute devotion to principle that was truly outstanding. His legacy is one of integrity, courage and credibility, and above all else, honesty.

The CBO is all the stronger for his leadership and dedication. He leaves his office a better place than when he accepted it. For this, Dr. Reischauer, you have my deepest gratitude and I think the deep gratitude of all of us who sit on this panel, and all Americans.

Dr. Reischauer, as usual, the CBO presents us with a wealth of information—maybe sometimes too much information. As I interpret the report, we have a classic case of "good news and bad news." Although the deficit will decline from $203 billion in 1994 to $176 billion in 1995, we will see an upswing in the deficit between 1995 and 1999, as the Chairman has pointed out. Short-term deficits should increase by about $25 billion a year.

This is certainly no great surprise. These increases, as I understand, were expected as a result of the higher than indicated interest rates and somewhat lower revenues.

The good news is that deficits after 2000 will be slightly below CBO's August estimates. Annual growth in medicaid and medicare spending has declined.

However, this is good news with some very bad news, in my opinion, at its core. I do not take much comfort in a $421 billion deficit in the year 2005. No one here should. We should be ashamed that we are scaling the deficit mountain once again.

However, the most significant aspect of this very interesting report involves the balanced budget amendment. In a few short days, perhaps in a week, the Senate will take up a balanced budget amendment to the Constitution. In its report, the CBO prepared a sample deficit reduction path leading to a balanced budget in the year 2002. This path requires deficit cuts of $1.2 trillion over the 7-year period from 1996 to the year 2002.

I would only add the caveat at this point that in addition to the $1.2 trillion, if any of the significant tax cuts that seemingly are very popular within Congress today, if not with the American people, if anything like what is being talked about is enacted, I would think it would be safe to say that the $1.2 trillion that you outline as the mountain that we have to scale would be even somewhat higher, into the range of probably $1.5 trillion, according to my calculations.

CBO emphasizes in its report—and I would like to quote because I think it is important

> If the budget is to be balanced by 2002, it is vitally important that the Congress and the President begin immediately to put into effect policies that will achieve that goal.

I would like to add a loud "Amen" to those sentiments. This is exactly what I have been trying to get my colleagues to do since the session began 3 weeks ago. It is something that I will continue to press throughout this Congress.

We have to be honest with the American people. We have to show them that there is more to our will to balance the budget than mere words. Certainly, it is no panacea. We have to show them the specifics as to how we reach balance by 2002 if we are sincere. We have to show them a plan. The Republican majorities in both the Senate and the House, with the assistance and active support of the minority, need to step up to the plate on this very important issue.

I hope, too, Dr. Reischauer, that today you will give us your best predictions about our economy. The current expansion is now almost 4 years old, as the Chairman has outlined very correctly in his opening statement. Many economists, including those at CBO, are predicting that the economy will slow. If there is a risk that we could slip back into a recession, I would like your thoughts on how this could affect the budget deficit.

I would also like you to address deficit reduction this year and how that might affect the economy. How might the economy respond, for example, if we pass another budget reduction package? How would the economy react if we put the deficit on a path to balance in the year 2002? And how will interest rates, wages and jobs respond if we make further credible, serous cuts in the deficit?

So once again, in closing, and with my thanks to the Chairman, I welcome Dr. Reischauer. I look forward with great interest to your testimony, and I wish you all the very best in your future endeavors. You will be sorely missed here.

Mr. Chairman, thank you very much.

Chairman DOMENICI. Thank you very much, Senator Exon.

Senator Brown?

OPENING STATEMENT OF SENATOR BROWN

Senator BROWN. I do not want to add to Dr. Reischauer's "eulogy" this morning, but I would observe, Dr. Reischauer, that I have appreciated your frankness and, frankly, the integrity you have brought to an office that has not always been marked by that. You will be missed.

Chairman DOMENICI. Senator Conrad?

OPENING STATEMENT OF SENATOR CONRAD

Senator CONRAD. Well, I do want to add to it. I have found Dr. Reischauer to be honest, professional, nonpartisan, and absolutely consistent in his warnings to this panel and to the Congress at-large on the danger of deficits and the need to start early and to stick with it.

So I want to say to you, Dr. Reischauer, you will be missed. I can remember so well your coming to our deficit reduction caucus meetings, those early morning meetings, and going through a blizzard of statistics with a small band of dedicated deficit reducers. I think you gave real leadership to this country, and I think you can leave with great pride in the kind of conduct and the kind of service you have provided.

So I hope it does not go by unnoticed that this is perhaps your last time testifying before the Budget Committee, and I as one member just want to say to you that I think you have done a superb job.

With respect to what has happened with the deficit, I think it is important to review what has occurred, and I think some celebration is in order, and at the same time a sober reflection on what needs to be done to complete the job. But the fact is in 1992, we had a deficit of $290 billion—$290 billion—nearly 5 percent of gross domestic product. And because some of us had the courage to take action, to cut spending, and yes, to raise taxes on the wealthiest among us, we now face a deficit this year of $176 billion, about a 40 percent reduction. Measured against the size of our economy, it is about 2.5 percent of gross domestic product. So the deficit measured against the size of the economy has about been cut in half. That is significant progress, and it was a move in the right direction. It was something that had to be done.

There is still progress that needs to be made. But I think we should point out that while in dollar terms, the deficit will go up in succeeding years, measured against the size of the economy, the deficit is relatively stable.

That does not mean nothing is left to be done. Clearly, there is a further gap to close, and if we look beyond the immediate 5-year budget planning horizon, there is cause for concern.

So I think it is terribly important that we put this in perspective and that we measure the deficit against the size of the economy—that is really what matters, after all, in economic terms and matters in what happens in the lives of American people.

Interestingly enough, if one looks out into the future, and if we maintain a discretionary freeze, the deficit measured against the size of the economy would continue to go down to 2.1 percent by the year 2005.

Again, I do not think we should rest on our laurels. I think we want to close in on this and move toward a balanced budget. That will take tough decisions, and I think the American people deserve an outline of what will be required. We know now that about $1 trillion will be necessary to close the gap—I think the estimate is $1.035 trillion over the next 7 years.

If you read the Republican Contract with America, they say the first thing we ought to do is cut $364 billion of taxes, which would just make the hole deeper. My own view is that that would give us a $1.4 trillion hole to fill. Then they say raise defense $82 billion. Now we have created about a $1.5 trillion problem. That goes in the wrong direction.

We ought to be devising plans to reduce the debt and the growth of the debt, not plans to increase it. So I think there is a challenge that all of us confront, and the best thing to do is to be straightforward with the American people and start outlining precisely how we achieve the deficit and debt reduction that all of us I think favor.

I thank the Chairman, and I again want to thank you, Dr. Reischauer, for your service.

Chairman DOMENICI. Senator Frist?

OPENING STATEMENT OF SENATOR FRIST

Senator FRIST. Thank you, Mr. Chairman.

I also wish to thank Dr. Reischauer for appearing before us today to discuss the findings of the CBO on the economic and budget outlook for the remaining years in this century and beyond.

I too want to extend my appreciation for the work you have done. As you know, I am one of the newcomers to the United States Senate, and I just want to reflect that mandate with which I was elected, and I heard it loudly 3 months ago and have been back home each weekend, and that is to some way or another balance this budget.

The question that I entertain regularly as I have gone back home over the last several weeks is what progress is being made, and clearly people are looking very directly at what we do over the next year with regard to what happens over the balance of this century.

It is very clear to me, having been here even just a short time, that there are going to be some very tough decisions that have to be made. We are going to have to pass legislation that fundamentally alters the way government does business. We heard a little bit about responsibilities of government and philosophy of government yesterday, and that is going to have to be brought into the equation.

Current trends are clearly not sustainable, and the Members of our Congress are going to have to really learn to prioritize and not just give lip-service to it with rhetoric.

I understand that you will be outlining one path today for a balanced budget by the year 2002, and I look forward to hearing that and appreciate the work that you have done.

Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you.

Senator Gorton?

OPENING STATEMENT OF SENATOR GORTON

Senator GORTON. Mr. Chairman, along with the other members of the committee, I feel that Dr. Reischauer has held to his position during difficult times, with both honor, objectivity, and a high degree of competence. I look forward to this message on his part as one of America's great experts at reaching a goal to which all of us give lip service, but for which most of us have great excuses as to just how it is not the time, or not the way, or can't there be an easier path.

I do look forward to this message with great anticipation.

Chairman DOMENICI. Thank you, Senator Gorton.

Senator Murray—I am sorry; I guess in the real routine of things, I should have called on you before Senator Gorton, and I apologize.

Senator MURRAY. That is OK. Thank you, Mr. Chairman, and in my next life I will be taller so you can see me.

Chairman DOMENICI. In a few years, you will be over here.

Senator MURRAY. I thought I would be this time. [Laughter.]

OPENING STATEMENT OF SENATOR MURRAY

Senator MURRAY. Thank you, Mr. Chairman.

I just want to add my words of praise to you, Director Reischauer, for all the work you have done in serving this Congress and the people of this country. Your honesty in telling us where we need to go and how to get there is very much appreciated. I can only hope that your successor is as effective and balanced and fair as you have been with us.

Mr. Chairman, as you know, I have a number of concerns with some of the legislation that has been coming before this committee, including the balanced budget amendment, so I was particularly interested in the portion of the CBO report which describes one possible path toward that balanced budget by the year 2002. And I saw the massive saving necessary to achieve that—$1.2 trillion between now and 2002.

I was disappointed that Senator Hollings' amendment failed yesterday. It would have required us to specify how we were going to get to a balanced budget by 2002. I have seen the Treasury Department's analysis, which shows that the balanced budget amendment would reduce Federal grants to my home State of Washington by $1.3 billion—$730 million in medicaid, $117 million in our highway trust fund, $346 million in education, job training, environment—that would be gone. I think we have to be very cautious and careful as we set these priorities.

I think we all have to remember that deficit reduction in and of itself is not an economic policy, as you well know. We have to set fiscal priorities. That is the role of Congress, and we are definitely going to have to move toward reducing the deficit by setting priorities. I believe we have been doing that in the last several years. It is a tough road. We have had tough choices, and I want to continue to work in that direction.

But again, Dr. Reischauer, I do appreciate your work. We will miss you, and best of luck to you in the future.

Chairman DOMENICI. Thank you, Senator.

Please proceed, Dr. Reischauer.

STATEMENT OF ROBERT D. REISCHAUER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Dr. REISCHAUER. Mr. Chairman and members of the committee, I thank you for your kind words and the opportunity to appear before you this morning.

With your permission, I will submit my prepared statement for the record, and I will summarize for you CBO's economic forecast and our new set of budget projections. I will also say a few words about the challenge involved in balancing the budget by the year 2002, which might be required if the proposed amendment to the Constitution passes the Congress and is approved by three-quarters of the States.

With respect to the economy, CBO expects the strong growth that was experienced during 1994 to continue only slightly abated into the first part of this year. Because the economy is operating close to its potential, that growth will increase inflationary pressures and be likely to trigger additional efforts by the Federal Reserve to rein in the economy with higher short-term interest rates.

As a result of the expected monetary tightening and that which has already occurred, the economy should slow down at the end of 1995 and slow down further into 1996.

On a fourth-quarter-to-fourth-quarter basis, real economic growth was 3.7 percent in 1994. CBO expects that the economy will grow on this basis at 2.5 percent during the current year and 1.9 percent during 1996.

Over 3 million new jobs were created in 1994, during which the unemployment rate averaged 6.1 percent. The unemployment rate should average about 5.5 percent in 1995—that is about where it is now—and then inch up a bit to around 5.7 percent in 1996 as a result of the slowdown in the economy. Both of these figures are below CBO's 6 percent estimate of the rate of unemployment that is compatible with nonaccelerating inflation.

Although inflation has been quite subdued for the last few years—around 2.8 percent—CBO expects it to pick up modestly because unemployment is below this nonaccelerating rate and because actual output is exceeding potential output. The Consumer Price Index for urban consumers is forecast to increase by 3.2 percent in the current year and by 3.4 percent in 1996.

Over the course of 1994, the Federal Reserve tightened monetary policy, and the interest rate on 90-day Treasury bills rose from 3.2 percent in the first quarter to 5.2 percent in the fourth quarter. The rate on 10-year Treasury notes rose from 6.1 percent to 7.8 percent over this period.

CBO expects that the Fed will continue to tighten monetary policy in the first part of this year, and that the average rate on bills will rise to 6.2 percent for 1995 and the average rate on notes to about 7.7 percent.

Rates should fall a bit in 1996 as a result of the slowdown in the economy that we are predicting.

CBO's forecast implies that the Fed's effort to restrain the economy will slow it down without causing a recession. Other outcomes, of course, are possible. If the economy overshoots its potential by a wider margin than CBO now expects, the Fed could take more drastic actions, and that could pres age a recession next year or the year after.

Alternatively, it is possible that the rise in interest rates that has already occurred has been enough to slow the economy down, so if there was further tightening when we have already done a sufficient amount, that also could put the economy into a recession. Alternatively, there might not be any need for further Fed tightening. There is a lot of debate in the economics profession concerning these issues, and the CBO forecast is really a compromise between these various scenarios and is similar to that of the consensus of private economists.

With respect to the budget outlook, CBO expects the deficit for the current fiscal year to fall to $176 billion, or 2.5 percent of gross domestic product (GDP). In dollar terms, that will be the lowest level that we have experienced since 1989, and relative to GDP, it will be the lowest figures that we have experienced since 1979.

If further policies are not adopted to reduce the deficit, however, the 3-consecutive years of declining deficits that we have enjoyed will come to an end, and the deficit will begin to rise again in 1996.

The mounting deficits will be fueled primarily by the increases that we expect in medicare and medicaid, which we think will grow over the next 5 to 10 years at roughly 10 percent per year. Spending on all other components of the budget is projected to grow at only about half of that rate.

Chairman DOMENICI. Would you state that again, please?

Dr. REISCHAUER. I said that the rise in the deficit can primarily be traced to medicare and medicaid, which we expect to grow at around 10 percent over the course of the next 5 to 10 years; other spending in the aggregate should grow at roughly half that rate, roughly 5 percent.

Chairman DOMENICI. Could I ask for one clarification on your 10 percent rise in health care costs for the Federal Government's programs? Does that include the demographic add-ons, that is, the new entrants that must be——

Dr. REISCHAUER. Yes; That includes automatic cost-of-living increases, new folks coming into these programs, increases in benefits associated with the progress of medical technology, and higher earnings records for new social security recipients. All of that is factored in.

Chairman DOMENICI. Thank you.

Dr. REISCHAUER. By the year 2005, the deficit is projected to reach $421 billion, or 3.6 percent of GDP, if one assumes that discretionary spending is adjusted for inflation after the discretionary caps expire in fiscal year 1998.

If, on the other hand, discretionary spending is frozen at 1998 levels when those caps expire, the deficit would be only $241 billion, or 2.1 percent of GDP, in 2005, slightly lower than the level that we experience now.

However, the funds available for discretionary programs in 2005 would have only 73 percent of the purchasing power of the appropriations that you provided for discretionary programs in the current fiscal year. If defense were protected from the insidious effects of inflation over this 10-year period, the money available for all other discretionary programs in 2005 would have less than half of the purchasing power that the 1995 appropriations are providing to these programs this year.

This hints at some of the tough choices that will have to be made to balance the budget in 2002, which could be required if the effort to amend the Constitution is successful.

According to CBO's projections, some combination of spending cuts and tax increases totaling $322 billion in 2002 would be needed to eliminate the deficit in that year.

There are many possible paths to reach this objective, one of which we have presented on page 23 of my prepared statement[1] for illustrative purposes. This particular path first freezes discretionary spending through 2002 at the dollar levels of the 1998 caps. That action, together with the resulting debt-service effects, would produce $89 billion of the $322 billion in savings that are needed to balance the budget in 2002. The buying power of the discretionary appropriations that would be provided in 2002 under this

[1] See p. 20.

path would be about 20 percent less than the 1995 appropriations provide for these programs.

The illustrative path next assumes further savings from policy changes in a pattern similar to that of the mandatory program savings that were contained in the reconciliation bills of 1990 and 1993. If these savings were achieved entirely out of entitlement and other mandatory spending programs, excluding social security, they would represent about a 20 percent reduction from current-policy levels for those programs. In other words, you would have to lop roughly a fifth off food stamps, medicaid, medicare, student loan programs, farm price supports, et cetera.

Looking over the period from 1996 to 2002, the savings in the CBO illustrative path that result directly from policy changes total more than $1 trillion, and the associated debt-service savings amount to around $175 billion. But this picture probably overstates the severity of the required policy-related cuts. If the policy changes required to balance the budget are enacted into law soon, and financial markets are convinced that policymakers would stay the course, CBO would expect interest rates to fall below those included in the CBO forecast. That would increase the debt-service savings and reduce the amount of savings needed from policy changes. If interest rates were as much as 1 percentage point below the level assumed in the CBO forecast by the year 2000—and we think that is a plausible set of assumptions—the amount of savings needed over the 1996 to 2002 period from policy changes would be almost $140 billion less than the $1.035 trillion shown in that table.

I have testified many times before this committee on the long-run economic benefits of reducing the deficit. Productivity would increase; living standards would rise; we would be less dependent on foreigners for future investment funding; and our debt-to-GDP ratio would begin to decline.

But in economic terms, the road to a balanced budget would be one that we have never traveled before. It would involve sustained fiscal restraint that would average about four-tenths of a percent of GDP per year over this 6- or 7-year period. The contractionary effects of this would be offset to some degree by lower interest rates that would result from a reduction in Federal credit demands and possibly from an easing of monetary policy by the Federal Reserve; as well as by stronger exports that would be brought on by reduced exchange rates.

Nevertheless, it would be foolish not to assume that there will be a few bumps along this road if we begin traveling it.

Let me conclude by noting that the discretionary and mandatory cuts contained in the illustrative path to a balanced budget are large, but they are not unattainable. Their size could be reduced, of course, if tax increases were considered as part of the equation. If taxes are cut, on the other hand, deeper spending cuts will be required.

Irrespective of the outcome of that debate, the effort to balance the budget should trigger some much-needed rethinking about the activities that the Federal Government should continue to pursue, and those which, in times of fiscal stringency, are better left to other levels of government or to the private sector. And as the new

Senator from Tennessee pointed out, I think that is the crux of the issue that is before this Congress.

I will end at that point and will be glad to answer any questions that the committee might have.

Chairman DOMENICI. Thank you very much, Dr. Reischauer.

[The prepared statement of Dr. Reischauer follows:]

PREPARED STATEMENT OF ROBERT D. REISCHAUER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Chairman Domenici, Senator Exon, and members of the committee, I am pleased to be with you this morning to review the state of the economy and the budget. Next week, the Congressional Budget Office (CBO) will publish *The Economic and Budget Outlook: Fiscal Years* 1996–2000, which describes our current views in considerable detail. We have provided advance copies for the committee. My testimony summarizes that report.

No fundamental change in the economic or budget situation has occured since CBO published *The Economic and Budget Outlook: An Update* in August 1994. The economy may be a bit more robust in 1995 than had been anticipated at that time, but a likely slowdown in growth in 1996 leaves the long-term economic outlook little different from last summer's. CBO expects that the high levels of business investment and purchases of durable goods that spurred the economy to a 3.7 percent real rate of growth in 1994 will continue into the first part of 1995. Because the economy is already operating close to its potential (the level of gross domestic product, or GDP, consistent with the stable rate of inflation), that growth is expected to result in somewhat higher rates of inflation and interest. In turn, those higher interest rates are likely to slow growth by the end of 1995—cutting it to 2.5 percent in 1995 and 1.9 percent in 1996 and dampening inflationary pressures. In CBO's longer-term projections, average annual growth after 1996 is close to the 2.4 percent rate of growth estimated for potential GDP, over the 1997–2000 period covered by those projections, inflation averages 3.4 percent and interest rates drift down.

CBO projects that the deficit will decline from the $203 billion registered in 1994 to $176 billion in 1995, the lowest level since 1989 and the lowest as a percentage of GDP (2.5 percent) since 1979. After reaching a trough in 1995, the deficit will rise to $207 billion in 1996 (2.8 percent of GDP), grow again in 1997, and then level off in 1998. Those projections assume no change in current policies governing taxes and mandatory spending; they also assume compliance with the limits on discretionary appropriations that are in place through 1998. Under the assumption that spending for discretionary programs increases at the rate of inflation after 1998, deficits will grow to $284 billion (3.1 percent of GDP) in 2000, the last year of CBO's regular projections. Under an alternative baseline that assumes that discretionary spending remains frozen at the dollar level of the 1998 caps, deficits increase only to $243 billion in 2000.

CBO's extended projections for 2001 through 2005, which are less detailed than those through 2000, show deficits continuing to mount in dollar terms through 2005 if discretionary spending is adjusted for inflation after 1993 (see Figure 1 at the end of this statement). Deficits also grow as a percentage of GDP—to 3.6 percent in 2005. There is no reason to believe that this trend will be reversed in the years after that; indeed, the growth in the deficit is likely to accelerate in the second decade of the 21st century as large numbers of baby boomers become eligible for social security and medicare benefits. Extended baseline projections that assume that discretionary spending is frozen at the 1998 level show deficits that are nearly constant from 2000 throught 2005. As a percentage of GDP, the deficit in that baseline shrinks from 2.7 percent in 1998 to 2.1 percent 2005.

Higher-than-anticipated interest payments and lower revenues, which are only partically offset by lower spending for medical care programs, have pushed up CBO's deficit projection for fiscal years 1995 throught 1999 from last August's estimates by an average of almost $25 billion a year. After 2002, however, the deficits in the new extended projections are a little lower than the deficits projected in August.

The Congress in considering a constitutional amendment, which could go into effect as early as 2002, requiring a balanced budget. CBO currently projects a deficit of $322 billion for that year (assuming that discretionary spending is adjusted for inflation after 1998), which is only $3 billion more than the amount estimated last August. To illustrate the magnitude of the task facing those who would have to enact policies to comply with the balanced budget requirement, CBO has constructed an illustrative path leading to a balanced budget in 2002 that entails deficit reduction of $1.2 trillion over the 1996–2000 period. Major changes in current policies would be required to achieve deficit reduction on that scale.

CBO forecasts that the strong economic growth that the Nation experienced throughout 1994 will continue into the first part of 1995. Because the economy is operating close to its potential, that growth will increase inflationary pressures and is likely to trigger additional efforts by the Federal Reserve Board to rein in the economy with higher short-term interest rates. In the CBO forecast, the resulting moderate slowdown at the end of 1995 and during 1996 will gradually bring GDP back in line with potential output without seriously disrupting the economy. Even with somewhat higher short-term growth and the slowdown in 1996, the current economic projections for 1997 through 1999 are little difference from those CBO made last August.

THE FORECAST FOR 1995 AND 1996

The robust growth that the U.S. economy experienced in 1994 is likely to continue through the first part of 1995 but will fade by the end of the year. The 3.7 percent increase in real output (on a fourth-quarter-to-fourth-quarter basis) and the creation of over 3 million new jobs in 1994 were achieved without an increase in inflation, but that performance is not likely to be repeated in 1995 (see Table 1[1]). Because the economy is already operating close to its potential, it cannot persistently expand faster than the growth of potential output—estimated at 2.4 percent a year by CBO—without triggering modestly high inflation.

The Federal Reserve, which is determined to avoid any significant increase in inflation, raised the Federal funds rate by 250 basis points (2.5 percentage points) in 1994 and is likely to further boost short-term interest rates in 1995. CBO forcasts that 90-day Treasury bill rates will average 6.2 percent in 1995—up from 3.2 percent in the first quarter of 1994. Rates for 10-year Treasury notes are expected to increase more modestly. The high rates of business investment and personal consumption of durable goods that drove the economy forward in 1994 apparently have not yet declined and will keep growth strong in the first part of 1995. However, by 1996, the cumulative effect of past and future hikes in interest rates should begin to bring the economy back in line with potential output. As a result, CBO expects that growth of real GDP will slow to 1.9 percent in 1996.

Unemployment will remain low in 1995—it is forecast to average 5.5 percent compared with 6.1 percent 1994—but will climb to 5.7 percent in 1996. Even at 1996's slightly higher level, unemployment will be below CBO's estimate of 6.0 percent for the nonaccelerating inflation rate of unemployment (NAIRU). A sustained unemployment rate below the NAIRU indicates a future increase in wage inflation. With unemployment below the NAIRU and GDP exceeding potential output, inflation is expected to rise in 1995 and 1996. Because the economy has not become too overheated and is expected to cool down later this year, the forecast upswing in the consumer price index for all urban consumers (CPI–U) is modest—from 2.8 percent in 1994 to 3.2 percent in 1995 and 3.4 percent in 1996 (see Table 1[2]).

CBO's forecast assumes that the recent anticipated future increases in short-term interest rates engineered by the Federal Reserve will restrain the economy to an appropriate degree. If the continuing strong growth that CBO foresees in early 1995 does not take place—if the economy has already started to cool off—the expected additional monetary tightening will slow growth sooner and more sharply than anticipated. Alternatively, if the economy proves stronger and more resistant than expected to the anticipated increases in interest rates and it surges well above potential output, the Federal Reserve will probably respond with even higher interest rates to combat the risk of inflation. That stronger-than-expected growth and the Federal Reserve's response to it could usher in a cycle of boom and bust for the economy.

Some economists argue that potential output may be greater than CBO estimates, in which case the economy could grow at its current rate for some time without triggering higher inflation. The Federal Reserve, however, is unlikely to allow such growth unless the evidence for a shift in potential output is more compelling than it currently is.

PROJECTIONS FOR 1997 THROUGH 2000

CBO attempts to forecast the cyclical fluctuations in the economy only for the next 2 years. Beyond 1996, its projections are based on trends in fundamental fac-

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[1] See p. 18.
[2] See p. 18.

tors that determine the potential growth of the economy, including growth in the labor force, projectivity, and national saving.

CBO's projections follow a path that has the gap between GDP and potential GDP reaching it historical average level—with GDP 0.6 percent below potential—at the end of the projection period in 2000. Because CBO estimates that the level of GDP will exceed potential output in 1996, the average annual real growth projected for 1997 through 2000 is slightly below the estimated 2.4 percent rate of growth of potential output (see Table 2[3]). Unemployment is expected to increase slightly to 6.0 percent, the estimated level of the NAIRU. Projected consumer price increases are assumed to average 3.4 percent a year over the period, with projected interest rates declining from the levels associated with efforts to slow the economy in 1995 and 1996.

Although CBO now projects that the deficits for fiscal years 1995 through 1999 will be almost $25 billion a year higher, on average, than it anticipated last August, the fundamental budget outlook is not very different from the one CBO projected then. Moreover, there has been no substantial change in CBO's deficit projections since its report in September 1993, which for the first time reflected the more than $400 billion in deficit reduction enacted in the Omnibus Budget Reconciliaiton Act of 1993 (see Figure 2[4]). The deficit is still expected to fall in 1995 to its lowest level since 1989 and its lowest point as a percentage of GDP since 1979. As was also the case in August, the deficit is projected to begin rising again in 1996. CBO's extended budget projections show that trend continuing through 2005 if spending for discretionary programs increases at the rate of inflation after 1998. After 2002, currently projected deficits are slightly lower than the deficits forecast in August.

THE OUTLOOK FOR THE DEFICIT

Since 1992's record-high shortfall of $290 billion, the deficit has declined to $255 billion (4.0 percent of GDP) in 1993 and $203 billion (3.1 percent of GDP) in 1994. (Although a record in dollar terms, the 1992 deficit as a percentage of GDP was far short—at 4.9 percent—of even a postwar record.) CBO projects that the deficit will decline for a third straight year to $176 billion (2.5 percent of GDP) in 1995 (see Table 3[5]). That gratifying trend is expected to end the next year, however, with the deficit climbing under current laws to $207 billion (2.8 percent of GDP) in 1996 and $224 billion in 1997 (2.9 percent of GDP) before leveling off in 1998.

The standardized-employment deficit, which is an estimate of the deficit that would occur if the economy was operating at its potential, is of interest because it is a measure of the fiscal posture of the Federal budget without the cyclical effects of the economy. When the economy is operating below potential, the deficit swells as a result of reductions in revenues and increased spending for programs such as unemployment insurance. When the economy is operating above potential, revenues are increased and spending is lower. Because in CBO's forecast the economy will be operating close to potential throughout the 1995–2000 period, the projected standardized-employment deficits differ little from the projected total deficits. Despite that, a look at the standardized-employment deficit as a percentage of potential GDP is still illuminating. That measure varies only slightly from year to year during the 1994–1998 period, which makes it clear that the fiscal stance of the budget changes hardly at all during that time.

CBO's baseline projections for mandatory spending programs and taxes represent the outlays and revenues that will result if no changes are made in the laws governing those parts of the budget. The projections for discretionary spending (spending controlled by annual appropriations) assume compliance with the discretionary spending limits for 1996 through 1998 establilshed for general-purpose appropriations in the Balanced Budget and Emergency Deficit Control Act of 1985 and for specific anticrime appropriations in the Violent Crime Control and Law Enforcement Act of 1994. Because no level of discretionary spending is set by law for the years after 1998, CBO makes two different projections of the deficit for 1999 and later years. In one projection, discretionary spending grows at the rate of inflation; the purchasing power of the appropriations is thus held constant at the 1998 level. In the other, discretionary spending is frozen at the 1998 dollar level.

In the baseline projections with discretionary spending adjusted for inflations after 1998, the deficit resumes its upward path after the pause in 1998. By 2000, the last year of CBO's regular projectiions, the deficit of $284 billion is almost back to the record level of 1992 (although at 3.1 percent, it is well below the 1992 deficit

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[3] See p. 17.
[4] See p. 16.
[5] See p. 17.

as a percentage of GDP). CBO's extended projections show deficits that continue to climb after 2000, reaching $421 billion (3.6 percent of GDP) in 2005. The mounting deficits continue to be fueled primarily by increases in medicaid and medicare, even though projected costs for those programs are somewhat lower that CBO had estimated last August. All spending other than that for medicaid and medicare is projected to grow at an average rate of about 5 percent a year between 1998 and 2005, slightly slower than the rise in revenues. Projected spending for the two big Federal health programs, however, increases at an average rate of almost 10 percent a year after 1998.

In the baseline projections without inflation adjustments for discretionary spending after 1998, deficits level off at around $240 billion a year from 1999 through 2005. (The projected deficit of $242 billion for 2005 is equal to 2.1 percent of GDP.) Freezing discretionary appropriations at the 1998 dollar level through 2005 would result in funding for discretionary programs in 2005 that had about 27 percent less purchasing power than the 1995 appropriations. If total discretionary spending was frozen at the nominal 1998 level but defense spending was preserved at the 1995 funding level adjusted for inflation, the money available for all other discretionary programs in 2005 would have less than half the purchasing power of the 1995 appropriations for those programs.

All mandatory spending is the same in both baselines, except that interest payments reflect the lower deficits and debt in the version that does not adjust discretionary spending for inflation after 1998.

CHANGES IN THE PROJECTIONS

The deficits that CBO currently projects for 1995 through 1999 are almost $25 billion a year higher, on average, than those projected last August (see Table 4[6]). Yet despite those increases, there has been no fundamental change in the deficit outlook. In fact, by 2003, the deficits in CBO's current extended projections are slightly lower than the deficits CBO projected in August.

Legislation enacted since then has had very little effect on the deficit outlook. The two most significant laws were an act making major changes in the Federal crop insurance program in hopes of avoiding future ad hoc disaster assistance to farmers and an act implementing the Uruguay Round of the General Agreement on Tariffs and Trade (GATT). The crop insurance legislation increased estimates of the deficit by almost $1 billion a year. Because CBO's baseline projections were made on the basis of current law, they did not include any spending that might result from the enactment of future ad hoc disaster bills. Therefore, reducing the likelihood of such legislation did not produce savings that could offset the higher spending for crop insurance. The GATT implementing legislation added almost $3 billion to deficits over the 1995–1999 period because losses in revenues from lower tariffs were not completely offset by other revenue increases and spending cuts.

Changes in the economic forecast since August have had a greater effect on deficit projections than did legislation. Thoses changes have pushed down projected revenues by $9 billion in 1996 and $8 billion in 1997, largely because of lower wage and salary income than had been forecast in August. More significantly, the higher interest rates in the new forecast have driven up projected Federal interest payments by more than $15 billion a year, on average, in 1996 through 1999.

Taken altogether, technical reestimates—those changes that cannot be attributed to legislation or revisions in the economic forecast—have had little impact on projections of the deficit. But looking only at the total effect masks some significant changes. Projected medicaid spending is lower in every year—by as much as $13 billion in 1999—than was estimated in August, reflecting actual 1994 outlays that were lower than expected and evidence that the rapid growth in that program has slowed. Medicare expenditures are down only slightly over the 1995–1999 period, but CBO's extended forecasts have significantly lowered spending for medicare as well as medicaid in the years after 2000. The medicaid reductions in 1995 through 2000, however, are more than offset by technical reestimates that bring down projected revenues to reflect smaller-than-anticipated tax collections in 1994 and increased spending for a variety of programs other than medicare and medicaid.

A constitutional amendment requiring a balanced Federal budget will be considered during the early days of the 104th Congress. If the Congress adopts such an amendment this year and three-quarters of the State legislatures ratify it over the next few years, the requirement could apply to the budget for fiscal year 2002. If the budget is to be balanced by 2002, it is important that the Congress and the President begin immediately to put into effect policies that will achieve that goal.

[6] See p. 19.

According to CBO's latest projections of a baseline that adjusts discretionary spending for inflation after 1998, some combination of spending cuts and tax increases totaling $322 billion in 2002 would be needed to eliminate the deficit in that year. The amounts of deficit reduction called for in the years preceding 2002 depend on both the exact policies adopted and when the process begun.

For illustrative purposes, CBO has laid out one of many possible paths to a balanced budget in 2002 (see Table 5[7]). Starting from a baseline that assumes that discretionary spending is adjusted for inflations after 1998, that path first shows the savings that would be achieved by freezing discretionary spending through 2002 at the dollar level of the 1998 cap. Such a freeze, along with the resulting debt-service effect, would produce $89 billion of the required savings of $322 billion in 2002. Under the freeze policy, the buying power of total discretionary appropriations in 2002 would be approximately 20 percent less than in 1995.

CBO also built into its illustrative path a possible course of savings from further policy changes. The amounts of those savings are not based on the adoption of any particular set of policies; they do assume, however, that policy changes are phased in between 1996 and 1999 in a pattern that is similar to the changes in mandatory spending enacted in the last two major efforts at deficit reduction in 1990 and 1993. After 1999, the assumed savings increase at the baseline rate of growth for entitlement and other mandatory spending, excluding social security—implying that the cuts implemented in earlier years have a permanent effect but no additional policy changes have been made. If those savings were achieved entirely out of entitlement and other mandatory programs (excluding social security), they would represent about a 20 percent reduction from current-policy levels for those programs.

Over the entire 1996–2002 period, the savings in CBO's illustrative path that result directly from policy changes total more that $1 trillion (in relations to a baseline that adjusts discretionary spending for inflation after 1998). When the resulting savings in debt-service payments are included, the total exceeds $1.2 trillion. As noted, this path and the resulting $1.2 trillion in savings are illustrative only; the actual amount of cumulative deficit reduction over the 1996–2002 period will depend on the timing and exact nature of the policies enacted to achieve balance in 2002.

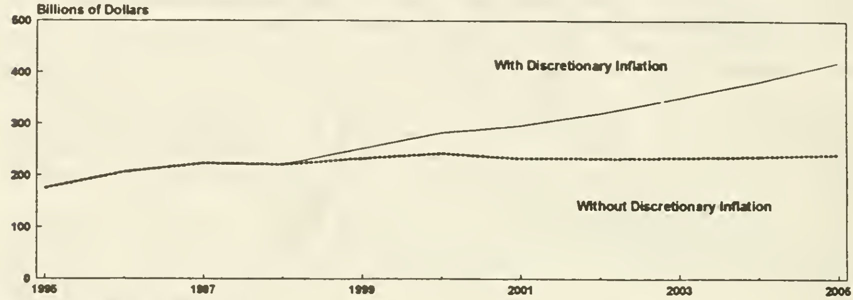
The required savings from policy changes would be smaller and the debt-service savings greater if, as CBO anticipates, ongoing deficit reduction efforts over this period in lower interest rates. CBO believes that by 2000, interest rates could be as much as 1 percentage point lower than it currently forecasts if spending cuts and tax increases that would lead to a balanced budget have been enacted and the financial markets are convinced that policymakers will maintain those policies. CBO estimates that such a drop in interest rates would lower projected Federal interest payments—and the amount of savings from policy changes needed to balance the budget—by almost $140 billion over the 1996–2002 period.

CONCLUSION

CBO's most recent economic and budget projections underscore the challenge facing policymakers who may have to enact the spending cuts or tax increases needed to balance the budget by 2002. Although the long-term budget outlook is no worse now than it was last August, the new projections emphasize that the deficit can be eliminated only through major changes in current policies.

[7] See p. 20.

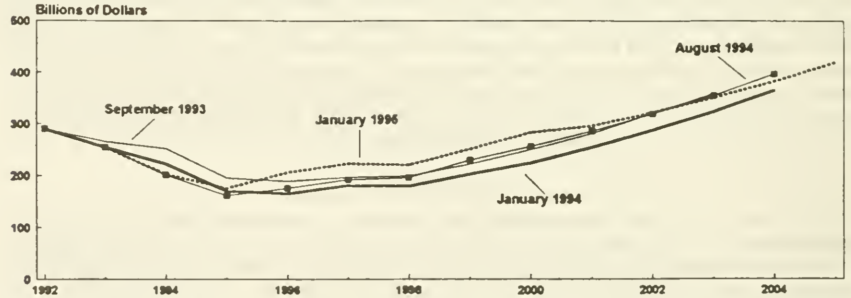
Figure 1.
Comparison of CBO Projections With and Without Discretionary Inflation After 1998 (By fiscal year)



SOURCE: Congressional Budget Office.

NOTE: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 caps.

Figure 2.
Comparison of CBO Deficit Projections (By fiscal year)



SOURCE: Congressional Budget Office.

NOTE: The projections assume that discretionary spending rises with inflation after the caps expire in 1998.

Table 2.
The Economic Forecast and Projections (By calendar year)

	Estimated 1994	Forecast 1995	Forecast 1996	Projected 1997	Projected 1998	Projected 1999	Projected 2000
Nominal GDP (Billions of dollars)	6,735	7,127	7,456	7,847	8,256	8,680	9,128
Real GDP (Billions of 1987 dollars)	5,338	5,505	5,602	5,736	5,870	6,004	6,141
Real GDP (Percentage change)	4.0	3.1	1.8	2.4	2.3	2.3	2.3
Implicit GDP Deflator (Percentage change)	2.1	2.6	2.8	2.8	2.8	2.8	2.8
CPI-U (Percentage change)[a]	2.6	3.1	3.4	3.4	3.4	3.4	3.4
Unemployment Rate (Percent)	6.1	5.5	5.7	5.8	5.9	6.0	6.0
Three-Month Treasury Bill Rate (Percent)	4.2	6.2	5.7	5.3	5.1	5.1	5.1
Ten-Year Treasury Note Rate (Percent)	7.1	7.7	7.0	6.7	6.7	6.7	6.7

SOURCE: Congressional Budget Office.

a. CPI-U is the consumer price index for all urban consumers

Table 3.
CBO Deficit Projections (By fiscal year)

	1994	1995	1996	1997	1998	1999	2000
In Billions of Dollars							
Baseline Total Deficit							
With discretionary inflation after 1998	203	176	207	224	222	253	284
Without discretionary inflation after 1998	203	176	207	224	222	234	243
Standardized-Employment Deficit[a]							
With discretionary inflation after 1998	187	200	216	223	221	247	273
Without discretionary inflation after 1998	187	200	216	223	221	228	233
As a Percentage of GDP							
Baseline Total Deficit							
With discretionary inflation after 1998	3.1	2.5	2.8	2.9	2.7	3.0	3.1
Without discretionary inflation after 1998	3.1	2.5	2.8	2.9	2.7	2.7	2.7
Standardized-Employment Deficit[b]							
With discretionary inflation after 1998	2.8	2.8	2.9	2.9	2.7	2.9	3.0
Without discretionary inflation after 1998	2.8	2.8	2.9	2.9	2.7	2.6	2.6

SOURCE: Congressional Budget Office

NOTE: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 caps.

a. Excludes the cyclical deficit and spending for deposit insurance

b. Shown as a percentage of potential gross domestic product

Table 1.
Comparison of Forecasts for 1995 and 1996

	Actual 1993	Estimated 1994	Forecast 1995	Forecast 1996
	Fourth Quarter to Fourth Quarter (Percentage change)			
Nominal GDP				
CBO	5.0	6.3	5.3	4.7
Blue Chip	5.0	6.5	5.7	5.4
Real GDP[a]				
CBO	3.1	3.7	2.5	1.9
Blue Chip	3.1	3.8	2.5	2.2
Implicit GDP Deflator				
CBO	1.8	2.5	2.8	2.8
Blue Chip	1.8	2.6	3.1	3.2
Consumer Price Index[b]				
CBO	2.7	2.8	3.2	3.4
Blue Chip	2.7	2.8	3.5	3.5
	Calendar Year Averages (Percent)			
Civilian Unemployment Rate				
CBO	6.8	6.1	5.5	5.7
Blue Chip	6.8	6.1	5.6	5.7
Three-Month Treasury Bill Rate				
CBO	3.0	4.2	6.2	5.7
Blue Chip	3.0	4.2	6.2	6.1
Ten-Year Treasury Note Rate				
CBO	5.9	7.1	7.7	7.0
Blue Chip[c]	5.9	7.1	7.9	7.6

SOURCES: Congressional Budget Office; Eggert Economic Enterprises, Inc., *Blue Chip Economic Indicators* (January 10, 1995); Department of Commerce, Bureau of Economic Analysis.

NOTE: The *Blue Chip* forecasts are based on a survey of 50 private forecasters.

a. Based on constant 1987 dollars.

b. The consumer price index for all urban consumers (CPI-U).

c. *Blue Chip* does not project a 10-year note rate. The values shown here for the 10-year note rate are based on the *Blue Chip* projections of the Aaa bond rate, adjusted by CBO to reflect the estimated spread between Aaa bonds and 10-year Treasury notes.

Table 4.
Changes in CBO Deficit Projections (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999
August 1994 Baseline Total Deficit with Discretionary Inflation After 1998	162	176	193	197	231
Changes					
Policy changes	2	2	2	3	3
Economic assumptions					
Revenues[a]	2	9	8	3	b
Net interest	8	16	17	15	15
Other outlays	b	b	1	2	2
Subtotal	10	25	27	20	17
Technical reestimates					
Revenues[a]	6	5	6	9	11
Deposit insurance[c]	1	3	b	b	1
Medicaid and Medicare	-7	-6	-8	-11	-15
Net interest[c]	b	-1	b	b	1
Other outlays	b	5	4	3	5
Subtotal	1	5	2	2	2
Total	13	31	31	26	22
January 1995 Baseline Total Deficit with Discretionary Inflation After 1998	176	207	224	222	253

SOURCE: Congressional Budget Office

NOTE: Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998.

a. Revenue reductions are shown with a positive sign because they increase the deficit.

b. Less than $500 million.

c. Excludes changes in interest paid by deposit insurance agencies to the Treasury. These interest payments are intrabudgetary and do not affect the deficit.

Table 5.
Illustrative Deficit Reduction Path (By fiscal year, in billions of dollars)

	1995	1996	1997	1998	1999	2000	2001	2002	1996-2002
CBO January Baseline Deficit with Discretionary Inflation After 1998	176	207	224	222	253	284	297	322	n.a.
Freeze Discretionary Outlays After 1998									
Discretionary reduction	0	0	0	0	-19	-38	-58	-78	-193
Debt service	0	0	0	0	-1	-2	-6	-10	-19
Total Deficit Reduction	0	0	0	0	-19	-40	-63	-89	-212
CBO January Baseline Deficit Without Discretionary Inflation After 1998	176	207	224	222	234	243	234	234	n.a.
Additional Deficit Reduction									
Policy changes[a]	0	-32	-65	-97	-145	-156	-168	-180	-843
Debt service	0	-1	-4	-10	-18	-28	-40	-54	-156
Total Deficit Reduction	0	-33	-69	-106	-163	-184	-208	-234	-998
Resulting Deficit	176	174	155	116	71	59	26	b	n.a.
Total Change from Baseline Deficit with Discretionary Inflation After 1998									
Policy changes	0	-32	-65	-97	-164	-194	-225	-259	-1,035
Debt service	0	-1	-4	-10	-19	-31	-46	-64	-175
Total Deficit Reduction	0	-33	-69	-106	-182	-225	-271	-322	1,210

SOURCE Congressional Budget Office.

NOTES Caps on discretionary spending are set by law through 1998. Measures of the deficit "with discretionary inflation" assume that discretionary spending grows at the rate of inflation after 1998. Measures of the deficit "without discretionary inflation" assume that discretionary spending remains frozen in dollar terms at the level of the 1998 caps.

n.a. = not applicable

a. These changes represent only one of a large number of possible paths that would lead to a balanced budget. The exact path depends on when deficit reduction begins and the specific policies adopted by the Congress and the President. The path illustrated in this table is not based on any specific policy assumptions but does assume that policies are fully phased in by 1999.

b. Surplus of less than $500 million.

Chairman DOMENICI. I was thinking, and sort of reminded by Senator Exon, that everybody has sung your praises so eloquently, and if I were in your seat I probably would have asked, "With all that good news, why am I going?" But you are a gentleman and did not ask that question, so I thought I would kind of put it on the record.

I do want to say that for Senator Sasser and me, as we screened the various nominees, it was a great pleasure to end up with you. I wanted to say that in my opening remarks, and I forgot.

I want to let a couple other Senators on my side go first, so I will start with Senator Frist, who was here first.

Senator FRIST. I will pass, Mr. Chairman.

Chairman DOMENICI. Does any Senator on our side desire to ask questions at this point?

Senator Gorton, please proceed, and then we will go to Senator Exon.

Senator GORTON. That last table of yours, Dr. Reischauer, is a most interesting one. It includes, of course, the numbers with the notation that there are a number of policy changes which could reach those numbers. Taking the case that you used there—that is to say, that there are no changes in the tax laws, and we do wish to balance the budget by 2002 by spending cuts alone; we accept the freeze that you have posited—what kind of policy changes in entitlements, especially in medicare and medicaid, are there that would contribute principally or primarily to reaching that figure?

Dr. REISCHAUER. Well, as you know, we put out a "cookbook" each year of options for you to consider, ways to cut the deficit, but we are not in the business of making recommendations. But to follow the path of Chairman Greenspan, one could change the indexing of the Social Security System; one could make major changes in the way medicaid reimbursements are provided; one could increase the premiums that are paid by better-off Americans for medicare (that proposal has been considered by Congress a number of times); one could establish coinsurance for certain aspects of medicare, like laboratory fees and home health care, that now do not have those copayment amounts.

So there are really a wide variety of incremental changes that could be added together, or fundamental rethinking of our entitlement system could be on the table, and the Congress could decide that certain of these programs are no longer a high priority.

Senator GORTON. Well, let us take the one that is in the news today, the latest idea, that the Consumer Price Index is literally higher under its present formula than it is in reality. Do you have any views, first as to whether or not that is true, and if it is true, the extent to which it is true? Do you agree with what I gather are the statements at the extreme end by Mr. Greenspan, or do you feel it is somewhat less than that, and at the level at which you think changes might be appropriate, what would those levels do with the figures you have in the statement?

Dr. REISCHAUER. We put out a report last fall on this very topic, and we concluded that although more research is certainly needed, the Consumer Price Index is probably overstating the increase in the cost of living by somewhere between two-tenths and eight-tenths of a percentage point each year. That is a pretty wide range.

It is also a range that is considerably lower than the one put forward by the Chairman of the Federal Reserve.

Taking as a midpoint half a percentage point, if we reduced the indexing of both benefit programs and tax system by half a percentage point from the CPI, total savings over the 1996–2000 period would be $64 billion.

Senator GORTON. And if we go to the year 2002, that would be closer to $100 billion.

Dr. REISCHAUER. Yes, it would.

Senator GORTON. And how much of that would be in lower benefits and how much in higher tax collection?

Dr. REISCHAUER. Of the $64 billion over that 5-year period, roughly a third, $22 billion, would be associated with higher revenues. We would obviously reduce the index used to adjust the bracket points in the tax system and the personal exemption and standard deduction. That would account for $22 billion, and of the rest, $36 billion would come from reduced spending on benefit programs, and another $6 billion, roughly, from the associated debt-service saving, if all of the savings went to lowering the deficit.

Of the $36 billion, the largest chunk, $26 billion of it, would come from social security. So it is primarily social security savings and increased taxes that would result from this policy change.

Senator GORTON. Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you very much, Senator Gorton.

Senator Exon?

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

Dr. Reischauer, let me follow up on the questions with regard to CPI that were raised by my colleague from Washington. I have long been interested in this particular proposition. Let me phrase my question in this manner. Do you have estimates, or have you done any work in your department, on how changes in the CPI would affect taxpayers and program beneficiaries at different income levels? If you understand, what I am getting at is that while I recognize that the CPI has been a blanket figure and I suppose somewhat weighted with regard to averages, perhaps, it is clear to me that a 27-year-old man and wife with three children are probably more adversely affected by many of the key elements that are used in arriving at the CPI.

For example, if you are 77 years old rather than 27 years old, you do not have children to worry about when you are 77 years old—at least, hopefully; in most cases, they are out on their own—you do not have to worry so much about the increased cost of education that is going to be bumping up against those 27-year-olds in the next 10 or 12 years. You do not have to worry so much about the cost of interest because usually, when you get to that age, your home is paid for. By and large, you do not have all of the credit cards outstanding that the average 27-year-old has today.

I guess what I am talking about—I am not suggesting that we have a whole series of Consumer Price Indexes, but does the present CPI tend to favor seniors as opposed to the primary working groups and young families today?

Dr. REISCHAUER. Well, it is a little complicated to understand the effects because there are so many different programs that would be affected by a policy change of this sort.

The change in income after taxes from reducing indexation in the tax system would be slightly higher for the bottom two quintiles, the lower income groups, than it would be for the middle class and the upper middle class, though roughly the same as for the very rich.

On the benefits side, the impacts are, as you suggested, much more significant among lower-income groups—aged people in particular, who are by and large concentrated in the bottom two or three quintiles of the income distribution. For people in the upper income brackets, although they might receive benefits, those benefits amount to a much smaller fraction of their total income, so reducing the rate of growth of the benefits has a much less significant impact on their total income.

Senator EXON. Do you have any kind of a table, or have you done any work on this that you could supply the committee for the record to show the distribution and how that came about and how you figured it?

Dr. REISCHAUER. Yes; we would be glad to. I have it here, but it is so detailed that I am sure you would not want me to go into the details.

Senator EXON. Simplify it so we can understand it and provide it for the record, please.

Dr. REISCHAUER. We will be happy to.

[The information requested by Senator Exon follows:]

The table shows the effect of reducing indexation of the Federal income tax by 0.5 percentage points, as well as reducing cost-of-living adjustments by 0.5 points for social security, supplemental security income, veterans' compensation and pensions, and Federal civilian and military retirement programs. This table represents the effect in the first year of cutting back on indexation. In the second year, the effect would be approximately twice that shown here, and the effect would grow with each additional year of alternative indexing.

TABLE. EFFECTS OF REDUCING INDEXING IN 1996 BY 0.5 PERCENTAGE POINTS (USING JANUARY 1995 ECONOMIC ASSUMPTIONS, 1996 INCOME LEVELS, AND 1996 LAW)

Families Ranked by Adjusted Family Income	All Federal Taxes: Average Tax Before Change	All Federal Taxes: Change in Dollars	All Federal Taxes: Percentage Change	Income After Taxes: Average Income Before Change	Income After Taxes: Change in Dollars	Income After Taxes: Percentage Change
Reduce 1996 Indexing of Federal Income Tax						
First Quintile	435	5	1.1	8,230	-5	-0.1
Second Quintile	3,211	11	0.3	18,367	-11	-0.1
Third Quintile	6,997	8	0.1	28,539	-8	0
Fourth Quintile	11,969	15	0.1	41,051	-15	0
Fifth Quintile	34,778	37	0.1	88,970	-37	0
All Families	11,490	15	0.1	36,675	-15	0
Reduce 1996 Indexing of Social Security, Supplemental Security Income, and Federal Pensions						
First Quintile				8,230	-14	-0.2
Second Quintile				18,367	-19	-0.1
Third Quintile				28,539	-19	-0.1
Fourth Quintile				41,051	-17	0
Fifth Quintile				88,970	-15	0
All Families				36,675	-16	0
Reduce 1996 Indexing of Federal Income Taxes and Social Security, Supplemental Security Income, and Federal Pensions						
First Quintile				8,230	-18	-0.2
Second Quintile				18,367	-30	-0.2
Third Quintile				28,539	-27	-0.1
Fourth Quintile				41,051	-31	-0.1
Fifth Quintile				88,970	-51	-0.1
All Families				36,675	-31	-0.1

SOURCE: Congressional Budget Office.

NOTES: Pretax family income is the sum of wages, salaries, self-employment income, rents, taxable and nontaxable interest, dividends, realized capital gains, and all cash transfer payments. Income also includes the employer share of Social Security and federal unemployment insurance payroll taxes, and the corporate income tax. For purposes of ranking by adjusted family income, income for each family is divided by the projected 1996 poverty threshold for a family of that size. Quintiles contain equal numbers of people. Families with zero or negative income are excluded from the lowest income category but included in the total.

Changes in individual income taxes, premiums, and entitlements are distributed directly to families paying those taxes and premiums or receiving those benefits. Changes in payroll taxes are distributed to families paying those taxes directly, or indirectly through their employers. Changes in federal excise taxes are distributed to families according to their consumption of the taxed good or service. Changes in corporate income taxes are distributed to families according to their income from capital.

Senator EXON. Let me shift to another matter that we are probably going to be taking up tomorrow with Mr. Greenspan who will be here, and that is the Mexican loan guarantee.

Do you agree with all of the estimates from most quarters that we have heard from that the proposed $40 billion borrowing guarantees by the United States government would have no adverse effect on the budget, certainly in the next year or two, only if there should be a default at some time in the future? Is that an accurate description of the plan as you understand it and the risks involved?

Dr. REISCHAUER. We have done an estimate for one version of this guarantee proposal that Chairman Leach presented to us, which was structured much like the plan that the Administration is putting together. We judged that that proposal would have no adverse consequences on the deficit, and in fact to the extent that there was an impact, it would most likely be to reduce the deficit. In other words, the fees that would be brought in would be larger than the expected value of the costs to the Federal Government, which is the way we now estimate the impacts of loan guarantees.

Senator EXON. Now, having said that, you are not suggesting, are you, Dr. Reischauer, that we launch on a series of loan guarantees to balance the budget over the long term? [Laughter.]

Dr. REISCHAUER. I do not think there are enough countries in the world to give loan guarantees to to bail you out of that one, Senator.

Senator EXON. Doctor, let me press you a little further on this. You are an economist, and we who are not tend to look at economists as the most well-informed people in the world on all subjects as long as their conclusions agree with ours, and the dumbest people in the world if they do not.

But let me ask you something. I have been, frankly, a little bit concerned about this bailout. Some people are comparing it to the S and L difficulties that we have had. Well, it is true that, from the standpoint of us maybe putting the full faith and credit of the United States behind these guarantees, it might not be totally unlike the S and L bailout. A key difference was that, rightly or wrongly, we were on the hook for bailing out the S and Ls; we are not yet on hook to bail out Mexico.

It seems to me, though, that there may be an option that has not been explored. My major concern with regard to the bailout is that there were a whole lot of people up on Wall Street who cast their net for a higher interest rate in Mexican waters when the American waters were not very productive, with 3 to 4 to 5 percent interest rates. I understand that some of these entrepreneurs cast their nets in Mexican waters to get up to maybe three times the annualized interest rate that they could have gotten in America.

Therefore, it concerns me a great deal that after that opportunism, or greed, or sound marketing investment strategy, depending on your point of view, that here we are coming along and saying, well, because you profiteers and you risk-takers invested your money in those clients of yours in Mexico, and the deal went bad, now we have an obligation to bail you out.

I wonder if there has been any consideration given to the fact that if Mexico is in the trouble that some people say it is today and is near bankruptcy, it would seem to me that those people who made those bad investments in Mexico maybe should have that $10, $20, $30, or $40 billion loan or whatever it is set off to one side, as you might do with regard to a company that finds itself in bankruptcy. The bank does not come in and say, "OK, we are going to pay off all your creditors and let you start anew." I would think that $40 billion, if we could fashion it in some manner, would be much stronger to help Mexico in the future by saying to those Wall Street money changers, "We are not going to bail you out. You work that out with the Mexican government, and we are not going to let any of this guarantee money go to guarantee risky investments that you made and expect the American taxpayer to bail you out."

It would make just as much sense, it seems to me, if we were to say to Orange County, "You made a terrible mistake down there, but we are going to take care of you."

Have the economists ever thought of anything like that, what I would call a little creative bookkeeping, not to bail out those who took the heavy risk, but maybe provide some security for Mexico in the future—which I agree does have some relationship to the economy of the United States.

Dr. REISCHAUER. I have not seen any discussion of that, but I am sure there has been some. There is a dilemma, of course, in a situation like this in which you have a borrower and a lender. You might have very little sympathy for the lender, but by punishing or holding the lender to the risk that that lender accepted as a consenting adult earlier, you are also going to visit repercussions on the borrower. And the borrower is who we are concerned about right now.

Unfortunately, I think there might be a problem in your proposal in that Mexico and the United States and the world economy are looking to these same individuals—mutual funds, pension funds, Wall Street financial interests——

Senator EXON. Money changers.

Dr. REISCHAUER. Well, I was trying not to use that word—I still have to find a job. [Laughter.]

They are looking to those people to provide additional resources to Mexico not only to help it over this short-term problem, but also to help it along in its economic development over the course of the next 5 or 10 years. I think there would be a legitimate concern that if these lenders were burned, they might not be forthcoming, or others might not be as willing to get into investments in Mexico.

Senator EXON. Well, Mr. Chairman, let me just say, to put my previous caveat into place here, that I do not agree with your conclusion. You state the standard conclusion that we hear from all the economist and from all the money changers. I guess what I am saying to you is can't we have a little bit of creative situation here. If I were a banker, and somebody came to me for a loan, I would simply say, well, I might help you out—just like we do in bankruptcies in the United States today—when somebody goes into bankruptcy, the banker is not going to say, "OK, we are going to pay off all of your creditors and let you start anew."

Dr. REISCHAUER. I wasn't saying——

Senator EXON. What they basically say is, "You work that problem out. Set those people aside. I will be glad to loan you some money for a new factory, or to hire new people to get you going in the future."

What you are saying is the traditional thing that we are faced with, and that is if you offend one of the money changers, you offend all of the money changers. I resent the fact, and I think it is pretty ill-advised for the United States of America to get itself into a position where we are bailing out those who cast their nets for high interest rates and then come back to Uncle Sam and say, "You have got to help us out; otherwise, we are in trouble."

I have no further questions, Mr. Chairman. Thank you.

Chairman DOMENICI. Thank you very much.

Dr. Reischauer, I would like to ask a few questions. First of all, I very much appreciate what I consider to be the very objective analysis of the fiscal policy of the country and the outyear deficits, and your analysis of what a constitutional amendment for a balanced budget, if enacted and implemented, could mean.

But I think there are two or three things about your statement that are rather startling and different, and I would like to dwell on them for just a minute. But first, let me ask, if I read your testimony and hear it correctly, in spite of the amount of reduction that we would have to take by the year 2002 or thereabouts under the current thinking, I read you to say that with some ups and downs and some things you would have to be careful of, that deficit reduction would not harm the economic prosperity of the United States, that it would not be bad fiscal policy. Did I read you correctly as saying that? You may have a preference, but your objective analysis—would you give us that, please?

Dr. REISCHAUER. Reducing the deficit, achieving a balanced budget, even achieving a surplus I think are worthy objectives and ones that the Congress has been pursuing for the last 4 years, at least, and should continue to pursue. There will be long run economic benefits from following this course. I have no disagreement with you on that.

Chairman DOMENICI. Now, the second thing that I find, and hopefully, we will hear this tomorrow from Dr. Greenspan, is that while people have been talking about dynamic versus static estimating, I find a rather startling dynamic exercise in this. CBO uses dynamic scorekeeping—in that you are telling us that we would save an additional $140 billion over that period because lower interest would result from deficit reduction.

Dr. REISCHAUER. Over the period.

Chairman DOMENICI. Is it 2002?

Dr. REISCHAUER. It is 2002.

Chairman DOMENICI. OK. From now until 2002, if the balanced budget were being implemented and moving in that direction, and we were getting there, we would save in debt service an additional $140 billion; is that correct?

Dr. REISCHAUER. That is. This is actually the same kind of exercise we engaged in at the request of the participants in the budget summit negotiations in 1990. We were asked then to build into our economic forecast the consequences of achieving a $500 billion deficit reduction package, which we did, and then you used those economic assumptions to price out the savings and the budgetary consequences of the package that was ultimately adopted. This is giving you a taste of the same kind of exercise that we engaged in at that point.

Chairman DOMENICI. OK. So that could be $140 billion. The CPI, as you indicate, there are numbers all over the ball park, but you would estimate, using your best numbers, is about another $40 billion; is that what you told Senator Gorton?

Dr. REISCHAUER. No; it was that if you took half a percentage point off the CPI, and you did it on the tax side as well as the benefits side, the savings would be about $64 billion through 2000—so presumably closer to $100 billion by 2002.

Chairman DOMENICI. OK. So a CPI adjustment, if rational and if based on facts and in the nature of what you have described, plus the interest savings that would come from dramatically reducing the deficit, we now have $240 billion, if I add the numbers up, through 2002; is that correct?

Dr. REISCHAUER. Yes, and that is coming off the $1.035 trillion aggregate savings on the policy side that one would have to do, as suggested in our illustrative path. So we are at roughly $800 billion.

Chairman DOMENICI. Right. So we have reduced the amount we would have to find in actual expenditures to roughly $800 billion under that scenario for the 2002 balanced budget.

Dr. REISCHAUER. Yes.

Chairman DOMENICI. We will hear, I am sure, on the balanced budget many talk about the present effects on certain members of the population of the United States and the State of New Mexico, and obviously, some will emphasize that we are going to hurt children by reducing the deficit. Now, obviously, we do not have to do that in balancing the budget. You have already stated to Senator Frist that it depends on what we decide to do with the programs.

I have come to the conclusion that the best thing we can do for the children of this country and the children yet to come is to balance the budget and to stay within a sound fiscal policy, because I believe we are spending their legacy the more we increase this deficit. And they do not have representation, they do not vote, and there is no more graphic example of taxation without representation than to continue to incur large debt and impose it on the next and the next generations.

Now, might I ask—I know it is a question of degrees, but would you not agree that to the extent that we defer and continue to multiply this deficit that we are really taking from the children and the next generation of children after that in the United States and their natural entitlement as Americans to a certain amount of opportunity and material wealth?

Dr. REISCHAUER. Oh, I would certainly agree with you that the benefits of reducing the deficit and balancing the budget will be largely bestowed upon the children and grandchildren and future generations. That does not necessarily mean that we should make them pay the price for the profligacy that we adults have engaged in. Rather, all of us have reaped the benefits of deficit spending over the last couple of decades, and in a just system, one would expect the adults, not the children, to try to right the system that they set off-kilter earlier.

Chairman DOMENICI. Let me proceed with just two other things. One, quickly, you have not heretofore had to estimate what the deficit would be in the year 2005, so in this context, it is the first time. And you are saying, using your kind of evaluations, that it will be up to $421 billion in the year 2005, and that will be up from what level this year?

Dr. REISCHAUER. For the current year, $176 billion.

Chairman DOMENICI. And the next year?

Dr. REISCHAUER. But a better way to look at it, of course, is as a percentage of GDP, because $1 in 2005 will be a very different animal from $1 today. What we will have then is a deficit that will be 3.6 percent of GDP as opposed to 2.5 percent, which is the current level.

Chairman DOMENICI. Yes, I understand, Dr. Reischauer, but it is my opinion that one of the reasons we need a constitutional amendment—which I did not think we needed 15 years ago—is that when we use comparisons, we will never lock the gate; and the $421 billion will not be $421 billion, it will be bigger than that, until we have some way of actually starting the clock. So I just want the numbers. The numbers are $421 billion in the year 2005, and what is it going to be in the year 1996?

Dr. REISCHAUER. In 1996, $207 billion.

Chairman DOMENICI. OK. So that however you regard it, it is up over $200 billion in 10 years.

Dr. REISCHAUER. Right.

Chairman DOMENICI. Does that not mean that we have not made structural changes in how we spend our money, so that we could get to a balanced budget? We have not done that yet in our budget exercises.

Dr. REISCHAUER. Well, I would emphasize the point that Senator Conrad made, which is that in fact you have done a tremendous amount. If one looked at the underlying structural problem that faced this country in the spring of 1990 and compared the current situation to that, one would have to conclude that the deficit reduction bills of 1990 and 1993 solved a little bit over half of the problem that existed in the spring of 1990. So you have made two giant steps forward. They still leave half of the problem there, and that is still a huge amount.

The changes that were made probably should not be defined as structural; I think you are right there. They were modifications around the edges of our existing policy structure, but we did not fundamentally rethink either the revenue side or the spending side, particularly the entitlement side. What we did was shave a little here, twist a little off there, snap a few twigs.

Chairman DOMENICI. Well, you have said it better than I, and I thank you.

My last one is that Senator Exon has made a point—and I will not quote your remarks—but something to the effect that if the budget is to be balanced by 2002, it is vitally important that Congress begin immediately—and the President, you said—that Congress and the President begin immediately to put into effect policies that achieve that goal.

Dr. Reischauer, you do not give us policy advice, so you did not intend that statement to mean that in your opinion, before we pass

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a constitutional amendment, we should put a total blueprint of how we get there out for the American public; that was not part of your job of being CBO Director. Is that correct? Am I correct or not?

Dr. REISCHAUER. Are you nervous about what I am going to say? [Laughter.]

Chairman DOMENICI. No; I just know you are a very honest person, and I know you have always done right.

Dr. REISCHAUER. No, no, I did not say that.

Chairman DOMENICI. Thank you very much.

Now, obviously, I would just ask you a follow-up question. What if we actually did $450 billion in net deficit reduction over the next 5 years—I am going to use that number of $450 billion—would that be moving in the right direction?

Dr. REISCHAUER. That would be a very significant step forward. You would be well on your way, particularly if those savings involved changes in the structure of entitlement programs or the tax system. If, however, you achieved $450 billion in savings largely through sales of assets or reductions in discretionary programs, some of which involved really a deferral of inevitable spending—such as large-scale elimination of military procurement, when we know that many of the weapon systems that we bought during the 1980's are going to have to be replaced early in the next century—then I in my role as an outside observer and other folks up on Wall Street would say that you had nibbled the bullet but you had not bit it.

Chairman DOMENICI. Thank you very much.

Senator Murray, you are next.

Senator MURRAY. Thank you, Mr. Chairman.

I want to go back to the line of questioning that Senator Exon started on the Mexican peso crisis. I heard your response that you did not see an adverse impact on the budget, but let me ask the question differently. I saw in your economic and budget outlook on page 11, you have an analysis of the Mexican crisis. I will read it to you. You write, "Although the crisis is likely to have significant effects on the Mexican economy, the overall effect on the U.S. economy will be small, particularly if stabilizing measures and reforms prove successful."

Are you saying that if we do not do the bailout, the effect on the U.S. economy will be insignificant?

Dr. REISCHAUER. One has to put all this in some perspective. Our exports to Mexico amount to about 1 percent of GDP. No matter what happens to the Mexican economy or to the bailout, Mexico is going to import a considerable amount from us. So it is inconceivable that that 1 percent would be eliminated. What we are talking about is some modest reduction in that amount. And if the financial situation in Mexico stabilizes, it is more likely that the value of the peso will rise——

Senator MURRAY. Is this with the bailout or without?

Dr. REISCHAUER. With the bailout, or with whatever mechanisms might be brought forward. But with the bailout, the value of the Mexican peso will rise, and exports from Mexico into the United States will not surge as much as they would otherwise. I would say it is a matter of degree, but I think the issue here is that under most plausible scenarios, this is not going to have a huge impact on the American economy.

Senator MURRAY. The crisis in Mexico.

Dr. REISCHAUER. The crisis in Mexico. It will have even less of an impact if we do—I do not want to use the word "bailout"—if we do provide——

Senator MURRAY. Loan guarantees.

Dr. REISCHAUER [continuing]. Guaranteed loans. The important thing to remember is that Mexico is not bankrupt. It has an economy that has gone through some very rapid reforms and changes. It has a budget that has been in pretty good shape over the last couple of years. It has adopted a lot of economic reforms, privatization and deregulation. It is going through some difficult reforms in its political system, evolving from a one-party state into a multiparty state, but it is a country that has oil, which is an international currency right now.

So we are not dealing here with a basket case; we are dealing with an economy that has stumbled.

Senator MURRAY. Who holds the short-term debt? Who are we bailing out?

Dr. REISCHAUER. A lot of the short-term debt is owned by investors in the United States, some by people in Japan, pension funds, insurance companies, those who, as Senator Exon said, were looking for higher returns in 1993 when interest rates in the United States were very low for short-term money, and they were attracted to the rates being paid by Mexico. Mexico used that money basically to support a current-account deficit that was unsustainable in the long run, and Mexican leaders were reluctant to take the steps they probably should have taken because it was in a Presidential election year. I think there is some sympathy in this room for that kind of response.

Senator MURRAY. I appreciate that, and my time is going to run out, so I want to switch quickly to another topic that is important: the unfunded mandates bill, which is on the floor of the Senate right now. We are considering it as reported out of the Governmental Affairs Committee.

My read of that bill is that it shifts a great burden to CBO to give us estimates on every amendment and bill that comes before us. If this bill is to pass as it is, how are you going to set priorities about which bills and which amendments you are going to estimate.

Dr. REISCHAUER. If the bill is passed, we would hope that CBO would be provided with additional resources to undertake this activity. I mean, this is an organization that is flat-out right now providing you with regular cost estimates, budget projections, and other analyses, most of which are required by law.

Senator MURRAY. So it would be very difficult for you.

Dr. REISCHAUER. This bill has within it authorizations for more resources for CBO.

Senator MURRAY. Yes, $4.5 million.

Dr. REISCHAUER. Yes. If those resources are not provided to CBO, and we are required to provide this new information, some of the existing information that you now receive and depend on and is necessary for the functioning of the budget process will not be done.

Senator MURRAY. In your estimation, could CBO become the new source of gridlock for Congress?

Dr. REISCHAUER. I do not think that will be the case.

Senator MURRAY. So you would be able to get back all of the estimates? What if there are 13 amendments on the floor?

Dr. REISCHAUER. We will do our best to do what is required by law. The law requires us to provide this service for bills reported from committees, and right now——

Senator MURRAY. Let me go back and ask how would you set priorities? If you were to get 13 amendments today, how would you decide which ones to go to work on? How would the CBO decide that?

Dr. REISCHAUER. I will give you the same answer that I gave during the health care debate, which is that I would hope that we would get guidance from the bipartisan leadership of the Congress. I say that having not received the guidance I asked for on the health reform legislation, but that will be the problem of my successor, not one that I will have to worry about.

Senator MURRAY. Thank you.

Chairman DOMENICI. Senator Snowe?

Senator SNOWE. Thank you, Mr. Chairman.

I also want to add my words of appreciation, Dr. Reischauer, for your longstanding service to Congress in your capacity as director of the Congressional Budget Office. I know you provided invaluable assistance to us, and you were always forthright in your testimony before the Budget Committee and the Congress, so I just want to wish you well, because I know it was often a difficult and thankless task. I certainly appreciate all that you have done for us during your term of office.

First of all, I want to be clear on one issue concerning the Mexican loan guarantee program. Will there be a cost impact on our budget?

Dr. REISCHAUER. The estimate that we have provided on the only bill that has been given to us for a cost estimate is that there will be no impact on the budget in a negative sense. There could be a positive impact in the sense that the fees that would be charged to Mexico would more than offset the expected costs.

Senator SNOWE. In your budget deficit projections for the future, by what amount will we be required to reduce the deficit in order to balance the budget by the year 2002?

Dr. REISCHAUER. If you just look at that year, that single year, the answer is $322 billion.

Senator SNOWE. Right, but between now and then, for each subsequent——

Dr. REISCHAUER. Well, you could do it in an infinite number of ways. You could procrastinate until 2002 and then cut it all, the economy would go in the tank, you would all be replaced, and we could start again. [Laughter.]

Senator SNOWE. That is heart-warming.

Dr. REISCHAUER. Well, that is one form of term limits. [Laughter.]

A more responsible and judicious way to do this would be to begin immediately with the 1996 budget resolution and reconciliation instructions in it. We have provided you with one of a large number of reasonable paths that would get you there.

Senator SNOWE. So $322 billion is what would be required of us in the year 2002 if we did nothing between now and then?

Dr. REISCHAUER. Right.

Senator SNOWE. OK.

Dr. REISCHAUER. But that is not really a possibility.

Senator SNOWE. Right, exactly. Is 7 years a sufficient period of time in which to reduce and balance the budget by that amount of money, assuming that that is the correct estimate, without any changes—and obviously, we know that will not happen.

Dr. REISCHAUER. It will be a tough row to hoe, but not an impossible one, and the objective a desirable. It will take some sacrifice, and as I suggested in my remarks, there will be some bumps along it. If the economy goes into recession, if there are some kinds of external shocks that we face, if there are some sort of major catastrophes in this country like there have been in Japan—these types of things one can never predict, and yet one knows that something will occur between now and 2002 that we have not foreseen.

Senator SNOWE. But do your assumptions include either a period of inflation or a recession between now and the year 2002?

Dr. REISCHAUER. No, not really, but we do not assume that the economy is going to operate along a path represented by its full potential. We believe that right now the economy is operating a bit above its full potential, and we have projected that between now and 2005, it will gradually fall to half a percentage point below its potential, which is consistent with some periods of relatively slow growth and some of average growth.

Senator SNOWE. My concern, in terms of these deficit projections into the future, is that you have obviously had to recalculate the amount of the deficit beyond 1996 by $25 billion per year. Now, in addition to that tax receipts were off in 1994 by $8 billion, based on your calculation. If the economy were growing vigorously, according to your statement in your testimony, then what accounted for that decline and why the reestimate of $25 billion per year? That is a major amount. I am concerned, as we are looking at balancing the budget, about what might also be required of us in the future for reestimating the amount of the deficit.

Dr. REISCHAUER. Well, not to be too humble, but in our business $25 billion is not very much by which to be off. Interest rates have gone up, and that is a significant part of the change. You have to remember when we are talking about being off by $8 billion on revenues, that we are talking about a base of $1.2 trillion or $1.3 trillion, and having an error of that amount is really rather small.

One does not want these errors always to be in the same direction, which is that spending is higher and taxes are lower. In the last couple of years, we have actually overestimated the deficit and brought our numbers down. This is the first time in a couple of years that we are bringing them up.

I should add that although you are correct that we have raised our deficit estimates over the next 5 years by an average of about $25 billion since we reported to you in August, if you look out to the year 2004, the deficit is actually a tad below what we thought it was going to be then. So other changes—namely, the slowdown that we anticipate in medicare and medicaid spending—have more than offset in the longer run the changes in interest rates and taxes that we see in the short run.

Senator SNOWE. I was just concerned given the fact that the task is much greater if the deficit estimates increase, and assuming that we pass a balanced budget amendment—which I hope that we do.

Dr. REISCHAUER. There is a lot of uncertainty in here, and if you pass the amendment, you might be coming back for painful mid-course corrections every couple of years.

Senator SNOWE. Which the States often have to do, especially in recent years, because of the economic downturn; they have to go back and adjust their budgets accordingly.

Dr. REISCHAUER. Right.

Senator SNOWE. Thank you very much, and I wish you well in the future.

Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you, Senator Snowe.

Senator Exon?

Senator EXON. Mr. Chairman, I have no further questions. I will probably have some for the record, but in the interest of time, I just want to close by once again expressing my fond respect for the tremendous job that the good doctor has done for us over the years. I just want to join in wishing him well, and echo what I think were your earlier remarks, that we do hope, Doctor, that you will come back at our beckon from time to time, because you might be as effective in front of this committee as an "outsider," free of all the constraints that you have in your position, and just being a free-wheeling economist, to come in here and give us your professional views on what we should and should not do.

I have one question that you might not want to answer. If you could take yourself out of your present position, which is not going to last for an indefinite length of time——

Dr. REISCHAUER. I hope so.

Senator EXON [continuing]. And place yourself in a position, in a shell, in a telephone booth, if you will, and answer this question: Do you as an economist feel that we should proceed to a balanced budget amendment, or do you think that is not in the long-term interest of the U.S. economy and trying to come to grips with the problem that I think concerns us all, that we continue to spend more than we take in?

Dr. REISCHAUER. I am fully in favor of the goal of a balanced budget. I hope that the Congress has the will to achieve that goal without resorting to drastic changes in procedures. And as CBO has testified and written a number of times, a balanced budget amendment is not a substitute for political will; a balanced budget amendment could be circumvented, just as the Gramm-Rudman law was circumvented. So this is really an issue that faces all of you, that you are going to have to belly up to the bar and make some tough decisions. The tough decision is not the balanced budget amendment itself; it is the steps that need to be taken to reduce spending or to raise taxes.

Senator EXON. Or both.

Dr. REISCHAUER. Or both.

Let me close by saying that I have very much enjoyed working with this committee over the past 6 years and with the staffs on both sides of the aisle. The bad news might be that Bob Reischauer is dead meat and he is going, but the good news is that the CBO director is really a very small part of the contribution that CBO makes to the budget process and to this committee. It is really the staff. I am the expression of a very dedicated, hard-working, nonpartisan group of people, and they will remain and will serve a new director and you as well as they have served me.

Senator EXON. Doctor, thank you very, very much.

Let me conclude on a little bit of a humorous note. I could not agree more with the last part of your statement. The answer to the first part of my question showed your great expertise as an economist, and I am sure that you graduated near the top of your class. And when you give me those kinds of answers, I simply say that I recognize the stress that you were under in this particular position——

Dr. REISCHAUER. I will call you from the phone booth.

Senator EXON [continuing]. And you have done a tremendous job, and I will miss you as not only a skilled administrator under a very important task, but also as a classic economist whom we have trouble getting yes and no answers out of.

Thank you very much.

Chairman DOMENICI. Wait a minute, I want to say something.

First, we have some young people here in the audience. Might I ask you—is serving the public in a career in public service worth it?

Dr. REISCHAUER. Oh, very much. I think it is the most rewarding thing you can do. It is also the most interesting. The hours are long and the pay is lousy, but everything else about the job is wonderful; and as you get older in life, you realize that those are the important things. The important thing is being able to go home at night satisfied that you have made some small contribution to making the country function a little better. So I would urge everyone to at least spend part of their lives in public service. And especially if you want to be highly critical of government or of what government is doing, I think the right thing to do is to go into the government, serve some time, and get some experience so you know what you are talking about.

The people of the United States have laid at the doorstep of the government all the problems that cannot be solved in the family, cannot be solved by the private sector, cannot be solved at the State and local level, the most intractable kinds of problems, and then they stand back and ask, "Why can't you do it better? Why can't you do it?"

These are tough problems, and you only realize how tough they are by being a part of government and trying to solve them.

Chairman DOMENICI. I keep forgetting things that I am supposed to do. I have this "American Economic Review" in front of me, Dr. Reischauer, and there is a minimum wage and employment case study out of New Jersey by Card and Krueger. Have you all analyzed that?

Dr. REISCHAUER. There are people at CBO who have read it and thought about it. Certainly there are some new analyses of the minimum wage and its effect on employment that do not find the large disemployment effects that earlier studies have found, and there is a controversy in the economics profession on how accurate these studies are, or whether this is a new reality that we are looking at.

I think the jury is still out.

Chairman DOMENICI. Might I close, then, by saying that in recognizing you, we recognize the excellence that has now become part of the Congressional Budget Office. It has been there for a long time, you have added to it, and it is probably one of the best institutions we have ever caused to come into existence to help the American people and their Congress. And I say that to all of the staff sitting behind Dr. Reischauer. Many of you work long hours. You are very good people. And clearly, as we screen successors to your director, one of the reasons it has taken a little while is because we are really looking for somebody very, very good, because you are very good; and we do not want you to think that this delay is so that somebody will be put in there who will not be part of causing your excellence and your contribution to remain front and center and as objective and positive as it has been. I can just give you that assurance that the successor will be that kind of person, be it a man or a woman, and it may take us a few more days, maybe even a few more weeks, but I hope not.

In the meantime, we thank all of you at CBO——

Senator EXON. Mr. Chairman, before you adjourn this meeting and before we make closing remarks, just let me add here an emphasis to what you have just said. We work very closely together on the matter of who is going to be the person who will take your place, Doctor, and I tend to subscribe to the fact that the Chairman is seeking someone with not only the credentials but the ability to perform as you have, and I thank him for the consideration that he has given the minority as part of this process.

Chairman DOMENICI. Thank you very much.

We stand adjourned.

[Whereupon, at 11:10 a.m., the committee was adjourned.]

ECONOMIC OVERVIEW

THURSDAY, JANUARY 26, 1995

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 9:37 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Gramm, Brown, Gorton, Gregg, Snowe, Abraham, Exon, Hollings, Johnston, Lautenberg, Conrad, Dodd, and Sarbanes.

Staff present: G. William Hoagland, saff director; and Peter Taylor, chief economist.

For the minority: William G. Dauster, democratic chief of staff and chief counsel; and Jim Klumpner, chief economist.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman DOMENICI. Members of the committee, Dr. Greenspan, first we want to welcome you today. I know you have been burdened with a lot of hearings, but we are charged with the heavy responsibility—and we always like to hear from you—as to the way the economy is progressing and other related matters.

Yesterday, Chairman Reischauer, the outgoing Director of the Congressional Budget Office testified before our committee, and he made an important statement that I am not sure was fully appreciated as he was giving it. First, he gave an illustrative path to a balanced budget in the year 2002 that he said would mean about a $1.2 trillion slower rate of growth in spending on programs and debt service and debt-service savings over the 7-year time to achieve it.

In this illustrative path of $1.2 trillion, 1.035 was from policy changes and 175 came from resulting debt-service savings. That means, he said, if we moved in that direction, the expected interest rates would be significantly lower than he had put in without the balanced budget movement. Most importantly, he said, and I quote,

> CBO believes that by 2000, interest rates

And I repeat this in detail as a quote

> Could be as much as 1 percentage point lower than it currently forecasts if spending cuts and tax increases that would lead to a balance budget have been enacted and the financial markets are convinced that the policy makers will maintain these policies. CBO estimates that such a drop in interest rate would lower projected Federal interest payments, and the amount of savings from policy changes needed to balance the budget by almost $140 billion over 1996 to the year 2000.

Mr. Chairman and members of the committee, I believe you all understand what this means. First, the amount of policy changes needed to reach balance is not $1.035 trillion but, rather, $895 billion over 7 years. Second, he indicated—and you will address this because we will ask you about it here today—that if we assumed that the CPI overstates inflation—and while he has different percentage changes recommended by his staff than you do in your previous testimony, he indicates that if we assume this and we use only five-tenths of a percentage point annually, and if this is corrected, the required amount of policy changes to reach balance is reduced further by another $100 billion over that period of time.

That means that the work required to reach balance in the year 2002 would be about $795 billion in actual policy changes and reductions.

Now, if we found the will in 1990 to have $500 billion in cuts and reductions in the deficit—that is over 5 years—and whether I agree with the policies or not, if Congress was persuaded to adopt a $430 billion 5-year deficit reduction package in 1993, then surely it is not out of the realm of possibility to believe that we can find $795 billion over 7 years.

I am not suggesting that this will be easy, but I am suggesting that it can be done. More importantly, as I have repeatedly said these last few weeks, it is not whether it can be done; it must be done, as I view it, if we are concerned about our children's future.

As we begin this hearing today, I hope either in your remarks or in answers to questions that you will comment on the CBO statement, Dr. Greenspan, and my conclusion that a balanced budget can and must be done.

I have additional remarks on a more broad subject that I will not deliver. I will ask that they be made part of the record at this time.

[The additional remarks of Chairman Domenici follows:]

Additional remarks of Chairman Domenici

Over the past few years America has been riding a cycle—not a bicycle but a business cycle. Three and a half years of uninterrupted economic growth has brought the unemployment rate down to 5.4 percent. Incomes have risen $1,000 per person since the middle of 1991, when a Republican still sat in the White House.

Fortunately for the current Administration, to this point we have been on the up side of this business cycle. In particular the recovery has been the primary source of deficit reduction. Of the $96 billion in deficit reduction between 1992 and 1995, business cycle strength accounted for $83 billion of it. Little of it was the result of Government policy.

The question we address today is how the economy progresses from here. Yesterday's CBO report reminded us that the current expansion is nearly 4 years long, now older than the average American business expansion. CBO says we should expect economic growth to slow ahead. Moreover, cyclical strength will no longer give us a free ride in reducing the deficit, it's up hill from here on.

Since Government can't continue to rely on the business cycle we should step back and take a longer view. The question is not what will get us through this year, but what we should be doing to lift American prosperity into the 21st century. How should the American economy evolve in order to compete in the 21st century global market place? In a number of ongoing Budget Committee hearings we have been addressing these issues: how government can contribute by becoming more effective, more responsive, and more market oriented—scaling back, devolving, and privatizing.

Today, I hope our distinguished witnesses will outline some of the challenges we face that aren't being reflected in today's sunny economic statistics. For example:

- Owing to hiring uncertainties and regulatory hurdles, workplace overtime is at a record level of 4.8 hours per week. We are not expanding work opportunities to help lift the incomes of all Americans.

- Personal savings, after rising through 1992 to 5.5 percent of disposable income, have been declining ever since, averaging 3.0 percent in 1994—close to an historic low.
- Moreover, partly due to low private saving and still sizable Government deficits, borrowing requirements from abroad have increased by $100 billion since 1992.
- This high borrowing may partly explain the two percentage-point increase in long-term interest rates over the past year and the weak exchange value of the dollar.

With work-place capacity constraints and peaking consumer demands ahead, the most robust part of the current expansion is most likely behind us. As a result, these adverse factors will become even more difficult to overcome. I hope our witnesses can give us some guidance today on what Government policies we should be pursuing in order to turn these conditions around. Specifically, your thoughts on tax system changes and investment and savings enhancing policies would be appreciated.

Chairman DOMENICI. I yield now to Senator Exon.

OPENING STATEMENT OF SENATOR EXON

Senator EXON. Mr. Chairman, thank you very much. And welcome to you, Dr. Greenspan. We look forward to your testimony today on a whole series of issues that are going to go maybe beyond the basic problems with the budget, some of which were just addressed by the Chairman.

As we embark on another round of deficit reduction, I hope, we welcome you here to get your thoughts on this and other matters related thereto.

During consideration of the 1993 reduction package, I found your observations and suggestions to be particularly helpful. But in listening to the questions just put to you by the Chairman as to how we are going to get from here to there and how we can finesse the $1.2 trillion savings that are necessary by the year 2000, as outlined by CBO, we can take into consideration what we would save with interest.

I would simply remind the Chairman and other members of the committee that when many of us went on the line for the Deficit Reduction Act of 1993, we felt that all those good things would happen, too. I would simply say that with the uncertainty of the economy and the role that the Federal Reserve Board plays in that and the role that the Federal Reserve plays particularly with regard to every increasing cost of carrying the huge debt burden that is not the responsibility of the Fed, I suggest, we have got to be awfully careful before we start minimizing in any fashion the magnitude of the problem that we would face by the year 2002 to reduce, hopefully, the deficit and maybe somewhere get on down the line to start addressing the horrendous national debt and the tremendous costs that it makes on the taxpayers and those of us who are trying to bring some balance to the income and outgo of the Federal Government.

I believe your warnings, though, previously helped steer the Congress towards credible deficit reduction and away from the gimmicks of the past, and I for one hope that we will not be resorting to those gimmicks in the future.

Today I have quite a few questions ready both on the monetary and the fiscal policies that are pretty broad-ranging. I hope that we will have enough time to get into at least most of them.

We heard yesterday from Dr. Reischauer that the recovery could fizzle out. That is something that I suspect that you hope will not happen, and you have been keeping an eagle eye, I guess, on the economy, and you have to look months and years down the road, and I respect that.

The opinions of many other reputable economists as well are very much concerned about the future, and many of them have endorsed your interests at the Fed in raising interest rates. I am very much concerned about all of this, that we risk slipping into a period of economic stagnation with minimal GDP growth, if not recession. Some of that was substantiated yesterday in my view from the testimony and the crystal ball that we heard from Dr. Reischauer.

I hope that you will address both the risk of recession and what the impact would be on the deficit for both short term and long term or in the out-years. As you are aware, Congress will also take up a number of budget issues this year, including the legislative line-item veto and the balanced budget amendment to the Constitution. I would hope that you will address the implications of such legislation as you see it from your position of great influence and the role that you have played in the economic forecasting of our country for many, many years.

In this regard, I am also interested in the response of the monetary authority should Congress enact significant deficit reductions this year to offset an austere fiscal policy. Will the Fed use this monetary tool to keep the economy moving? In addition, what do you and the financial markets consider credible when it comes to deficit reduction? How much can we do? And how fast can we do it without having an adverse effect on the economy? What sorts of changes are gimmicks, and what sorts of changes are real hard fact that will get us better straightened out on the road to economic and fiscal reality?

Dr. Greenspan, I am concerned not only with the deficit, of course, but with our $4.7 trillion national debt and the interest we must pay to service that debt, as I referred to briefly earlier. Our annual deficit is roughly equal to the interest payments on the National debt. Since last January, the Federal Reserve has raised interest rates six times. I would like to get your thoughts on the impact of these interest rates on the debt service.

Let me put it another way and say this: I believe it is a fact—and I suspect that you would generally agree—that with the way the Fed is raising the interest rates and, therefore, causing more and more costs to the Federal Government, you know, indirectly you are raising the deficit faster than we are cutting the expenditures of the Federal Government. That is something that I do not believe too many people have looked at, but, you know, I think it is important.

I am not directly criticizing you for making tough decisions that you have to make with regard to keeping inflation under control. I simply want to emphasize that every time you raise the interest rates, as I think you know full well, it makes it that much more difficult for us who are trying to bring the balance between expenditures and income of the Federal Government.

Dr. Greenspan, once again let me welcome you to the committee. We consider you an expert in these matters, and we are very appreciative of the fact that you have taken time from your very, very busy schedule to come over and try and help us out with all of our difficult problems that you have been most helpful in the past about, in at least coming and giving your advice and counsel. I will have several questions on several subjects. We are glad you are here.

Thank you, Mr. Chairman.

Dr. GREENSPAN. Thank you, Senator.

Chairman DOMENICI. Thank you.

Senator Brown?

OPENING STATEMENT OF SENATOR BROWN

Senator BROWN. Your comments in the past have been ominous warnings: the chronicling of lower savings, increased dependency on foreign capital, the potential of the U.S. dollar losing its status as a reserve currency, or at least losing the status it has had in the past. We appreciate your frankness. We hope also this morning we will perhaps extend that frankness to not only a discussion of the problem, but we would, I think, be most interested in recommendations for solutions.

Chairman DOMENICI. Senator Johnston, you were next.

OPENING STATEMENT OF SENATOR JOHNSTON

Senator JOHNSTON. Welcome, Mr. Chairman. I am one who has supported what the Fed has done on its interest rates. I think you have acted early and properly and are heading off this inflation. You are, indeed, an independent voice, and I support the independence of the Fed.

Now, in the spirit of independence, I hope you will use your influence to head off what I think is very obviously wrong fiscal policy, which is to have a middle-class tax cut. Both parties seem to be rushing headstrong against what is the best economic advice that I know of, which is not to have a tax cut to stimulate an overstimulated economy. The reason you have been raising interest rates is because the economy is over-stimulated. And here we are going off in circles in order to have another middle-class tax cut, which I think is wrong, and I hope you will use your independent voice, very respected in this town, to try to head that off.

Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you. I was going to limit the remarks to 5 minutes, but everybody is being so great in their opening remarks. I am just going to let you do what you want.

Senator Abraham, you are next.

Senator ABRAHAM. Well, I might even do you one better, Mr. Chairman. I will pass at this time.

Senator CONRAD. Mr. Chairman, might I just ask? I do not know what the early-bird rule is around here. I was the first one here, but I guess we are off the early-bird rule.

Senator JOHNSTON. Nobody noticed you.

Senator CONRAD. If you are first, you are last under this new system. Is that the way it works?

Chairman DOMENICI. Well, the Lord said if you are last, you are first.

Senator CONRAD. Well, I will be last.

Chairman DOMENICI. Anyhow, let me suggest I did not intend to violate that rule. I thought he was first on your side, and I apologize. We are on that, and we are still going back and forth, which you understand.

Senator CONRAD. Well, I am just saying, of all of us who were here——

Chairman DOMENICI. You are next.

Senator CONRAD [continuing]. I was the first one here, Mr. Chairman, and I now am going to be sixth.

Chairman DOMENICI. Senator Conrad, you are recognized.

Senator CONRAD. No, go ahead. Mr. Abraham has been recognized. I just want to point out, I hope——

Senator ABRAHAM. I already passed to Mr. Conrad, so please go ahead.

Senator CONRAD. You passed?

Senator ABRAHAM. Yes, I did.

Chairman DOMENICI. So we had a lot of talk about nothing.

Senator CONRAD. I thank the Chairman, and I thank Mr. Abraham. I have got two committees going at once. That is why I came early. I have a Finance Committee going on at the same time, and it is hard to have both responsibilities, as well as an Agriculture Committee hearing going on at the same time.

First of all, I find the Chairman's math interesting. He talks about reducing the $1.035 trillion hole to $795 billion by taking out lower interest rates that might result from moving towards balance and adjustments in the CPI. The problem with that calculation is it leaves out the proposed tax cuts that are in the Contract With America. The Treasury Department estimates those tax cuts at $364 billion. So you add that back in, and you are right back at over $1.1 trillion. Then, of course, you have got to add in the defense increases that they are proposing. That is another $82 billion. We are right back at a $1.2 trillion hole to fill in. And that is not million, that is not billion. That is trillion. That is real money even in Washington talk.

Then you look at what they have proposed in terms of spending cuts. So far, on the House side at least, they have put on $277 billion compared to the $1.2 trillion that would be necessary. That is $1 trillion short. So I do not think we should start to minimize the problem here.

In addition to that, in 1993 we passed an aggressive deficit reduction package. We thought it was $500 billion; because of economic changes, we now know it is going to be about $600 billion of deficit reduction over 5 years. Initially, we got reduction in interest rates, but since that time, we have had six increases in interest rates. And yesterday in your testimony before the Finance Committee, you indicated there were what at one point you termed "vague indications of inflation pressure building."

I saw in the New York Times today the headline, "Greenspan Gives Strong Impression That Rates Will Climb." I must say I find that a real concern. When I am talking to people about what is happening in the economy, I am hearing lots of evidence that things are slowing down. Christmas sales were significantly less strong than anticipated. I think the statistics show that. I would be interested in what your perspective is. Home builders are reporting a significant slowdown. Car makers are reporting a slowdown. In fact, I noticed that the Chrysler Corporation is issuing a warning that if you impose another rate hike, you could tip this economy into recession.

I noticed that a group of economists said that instead of a 2.5 percent growth rate in the economy, we could tolerate a 3.5 percent growth rate in the economy, because something has changed here. Something has changed that is fundamental in the economy, because we have had this strong growth going, and yet we see wages remaining relatively flat—in fact, no real increase in wages since 1979, which is one of the reasons there is a lot of pent-up anger around the country.

I am hoping very much that you will comment on these matters as we get into the testimony.

Chairman DOMENICI. Thank you very much, Senator.

Might I just say to my good friend, he is absolutely right. To the extent that you add taxes, you—I am only talking about if the budget—CBO has given a proposal. From what I understand from yesterday, CBO will do the numbers. If we were given a proposal that showed that, net, we changed policies so that we have reduced the amount of spending by seven-point—whatever number I gave you, 790-something—they have to readjust the economic assumptions and the interest rates. After all, we are relying upon a set of interest rates in here that somebody recommended. You know, if the CBO Director is saying they will be different if, in fact, you reduce the deficit by this amount, I am not asking for pie in the sky. I am merely saying send it back to them and ask them what they would give us.

Now, they could be wrong on the interest they have got in there now. They could be wrong on it later, which is one of the difficulties of predicting exactly where you will get and how you will get there in 7 years. That is all I meant.

Senator CONRAD. I would just say to you two things. One, you know, we put in place a deficit reduction package that really worked for once. A lot of these deficit reduction packages did not reduce the deficit. We put one in place that really has reduced the deficit for 3 years, and yet we have seen six interest rate increases since February of last year.

Finally, I do not think anybody has persuaded the other side to give up on these tax increases, unless you are enunciating your view, Mr. Chairman, that we should not have a big round of tax cuts here that just dig the hole deeper.

Chairman DOMENICI. I want to close my remarks and just say, to the extent that I am trying to make a case for economic changes that will occur if we have got enough courage to project a real balanced budget, frankly, I would say if you do not like my logic, then obviously the truth of the matter is instead of 1.2, we are at 1.5, you know, when you add back all those things.

Now, when I add them back, I am going to be at 1.2 instead of 1.5. So however you do it, there is a $250 to $300 billion differential that would come from economic adjustments.

Let's proceed. Doctor?

STATEMENT OF ALAN GREENSPAN, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Dr. GREENSPAN. Thank you very much, Mr. Chairman. It is always interesting to appear here and especially to listen to the colloquy that occurs before the testimony, which I usually find more interesting than my testimony.

Let me start by saying the fairly obvious thing: that the American economy has recorded some really quite notable achievements over the past few years, but there is, nonetheless, much left to be accomplished. The fiscal decisions made by the Congress in the next several months clearly play a critical role in determining the economic welfare of our citizens over the years—indeed, I suspect, decades—to come.

I perhaps should begin with a brief review of the current condition of the economy. In 1994, we had a difficult reversal in monetary policy to navigate. The overhang of debt and the strains that emerged among our financial intermediaries, especially out of the commercial real estate collapse of the late 1980's, required a heavy dose of monetary ease beginning in 1989 to alleviate a significant credit crunch. The danger of overstaying that policy of ease was clear, particularly as we moved through 1993, but the right time to change course was quite difficult to judge.

Looking at the developments of the past year, it appears that our policy reversal last February was timely, but we really will not know for sure, except in retrospect, looking back perhaps a year or two from now.

There is no question that the past year was one of remarkable progress along many dimensions of macroeconomic performance. The official estimates for the fourth quarter are not yet available, but it is clear that the real gross domestic product expanded by 4 percent over the course of 1994—the best gain in some time and one that surpassed most expectations. Importantly, we saw an accelerated expansion of employment as well. Cumulatively, payrolls have now increased roughly 6 million over the past couple of years, belying in dramatic fashion the notion that had developed earlier in this decade that our economy had lost its job-generating ability. With the rapid growth of employment, the National unemployment rate has fallen sharply, to less than 5.5 percent this past month.

Of crucial importance to the sustainability of these gains, they have been achieved without a deterioration in the overall inflation rate. The Consumer Price Index rose 2.7 percent last year, the same as in 1993. Inflation at the retail level, as measured by the CPI, has been a bit less than 3 percent for 3 years running now—the first time that has occurred since the early 1960's. This is a signal accomplishment, for it marks a move toward a more stable economic environment in which households, businesses, and governmental units can plan with greater confidence and operate with greater efficiency. When we consider the probably upward bias of the CPI, it would appear that we have made considerable progress toward achieving price stability.

I have stated many times in congressional testimony, Mr. Chairman, that I believe firmly that a key ingredient in achieving the highest possible levels of productivity, real incomes, and living standards is the achievement of price stability. Thus, I see it as crucial that we extend the recent trend of low and, hopefully, declining inflation in the years ahead. The prospects in this regard are fundamentally good, but there are reasons for some concern, at least with respect to the nearer term. Those concerns relate primarily to the fact that resource utilization rates already have risen to high levels by recent historic standards.

The current unemployment rate, for example, is comparable to the average of the late 1980's when wages and prices accelerated appreciably. The same is true of the capacity utilization rate in the industrial sector. It may be that these pressures will lead to some deterioration in the price picture in the near term, but any such deterioration should be contained if the Federal Reserve remains vigilant.

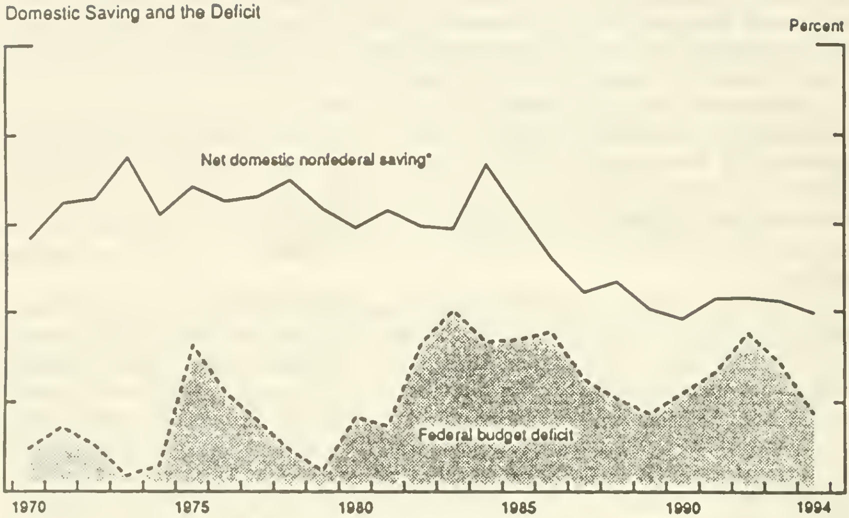
The actions of the Congress and the Administration in the fiscal sphere will also be important to the outlook for prices and the economy. There can be no doubt that the persistence of large Federal budget deficits represents in the minds of many individuals a potential risk. While we certainly have avoided it in recent years, history is replete with examples of fiscal pressures leading to monetary excesses and then to greater inflation. Currently, I strongly suspect that investors here and abroad are exacting from issuers of dollar-denominated debt an extra inflation premium that reflects not their estimate of the most likely rate of price increase over the life of the obligation, but the possibility that it could prove to be significantly greater. This inflation risk premium is costly, because it raises the hurdle that must be surpassed when looking at the expected returns on possible investment projects.

But the influence of the fiscal imbalance of the Federal Government on capital formation is broader than that. The Federal deficit drains off a large share of a regrettably small pool of domestic private saving, thus contributing further—and perhaps to an even greater degree—to the elevation of real rates of interest in the economy. Admittedly, there is some uncertainty about the causes of what seem to be relatively high real long-term rates around the world, as was noted by leaders of the largest industrial nations at their summit meeting last year. But the vast majority of analysts would agree that in the United States the current sizable Federal deficits, and the projected growth of those deficits over the decades ahead, are a significant element in the story.

I am sure that you are aware of the general picture with respect to the flows of saving and investment in the economy, but it may be worth spending a few minutes to review the recent data. I have attached a couple of charts to my statement to aid in following my description.

As you can see in the upper chart, there has been a dramatic decline over the past couple of decades in the ratio of net domestic non-Federal saving to net domestic product. The ratio last year, based on data for the first three quarters of the year, was about 6 percent, as compared with more than 9 percent, on average, during the 1960's and 1970's.

Saving and Investment
(Percent of net domestic product)



* Personal saving, undistributed profits, and state and local government surplus.

In the past few years, net business saving has moved up as corporate profitability has experienced a cyclical improvement, but the personal saving rate has been running at its lowest levels in nearly half a century. The causes of the low private saving rate are hotly debated by economists, and it is fair to say that it is not yet understood. Americans have not always been low savers, but, for whatever reasons, that has been the pattern recently, and it is a reality with important implications for the financial markets.

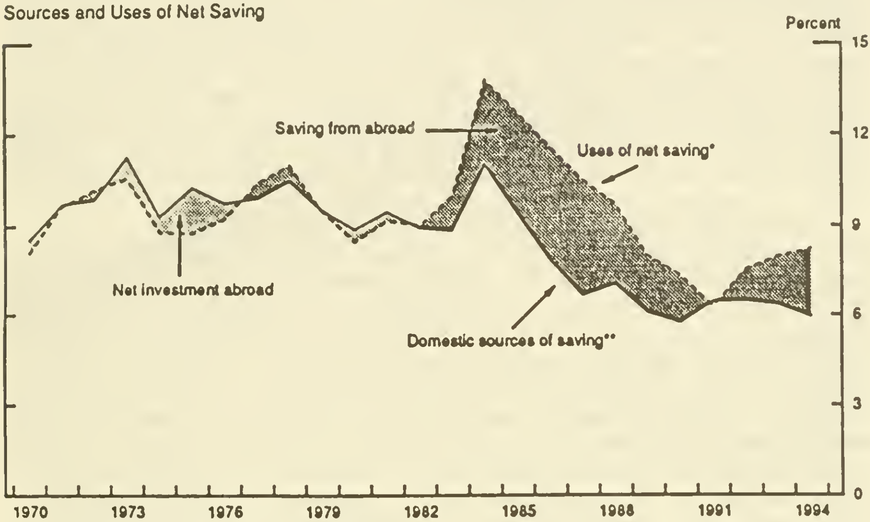
If we were a high saving nation, we might be in a position to better tolerate the Federal fiscal imbalance. But as you can see in the chart, the Federal deficit has generally been absorbing half or more of the available domestic saving since the early 1980's. Even with the decline in the Federal deficit last year, it amounted to almost 45 percent of domestic non-Federal saving.

How, then, one might ask, has it been possible for the United States to experience the impressive growth in business fixed investment that it has of late? There are a number of arithmetic components to the answer, but I shall focus on two particularly central points.

The first is that, while gross investment has been rising rapidly and has been accounting for a substantial share of the gross domestic product, net investment has only recently reached appreciable dimensions. The difference between gross and net investment is, of course, depreciation, and the fact is that depreciation has been rising steeply because of the shift in the composition of the capital stock toward equipment, especially computers, with shorter useful lives.

Another ingredient in the reconciliation of the domestic saving and investment balance is saving from abroad, shown in the lower chart. Our Nation has been running persistent and often sizable deficits in its current account position vis-a-vis the rest of the world; once a leading provider of capital to other nations, we have become a net importer of capital—and a very large one at that, I might add.

Sources and Uses of Net Saving



* Net private domestic investment plus federal budget deficit.
** Net domestic nonfederal saving.
SOURCE: Dept. of Commerce, National Income and Product Accounts, table 5.1.
Data for 1994 are averages of first three quarters.

In today's more open and integrated international capital markets, it is easier to finance investment abroad. And economic efficiency may be served by the tendency for capital to flow across borders to where the potential returns on real investment appear highest and the risks lowest. But this does not mean that we should view the pattern of U.S. external deficits as sustainable in the long run. Looking back at the history of the past century or more, the record would suggest that nations ultimately must rely on their domestic savings to support domestic investment.

The challenge for the United States over the coming decades is clear. We must sustain higher levels of investment if we are to achieve healthy increases in productivity and be strong and successful competitors in the international marketplace. To support that investment, we shall need to raise the level of domestic saving. Absent a rise in private saving, it will be necessary to eliminate the structural deficit in the Federal budget. Indeed, it has long been my judgment that it would be wise to target achievement of at least a modest surplus down the road, as bizarre as that might seem in recent years' discussions.

If the Congress were to pass a balanced budget amendment, the need for aiming at a structural surplus would become even more important. Unless there were a surplus to provide some cushion, the inevitable cyclical fluctuations in economic activity would create pressures either to set aside the requirements of the amendment or to take budgetary actions that are inimical to economic stability. It should not be necessary to raise taxes or cut spending in response to a transitory weakening of the economy.

I recognize that the achievement of structural balance, let alone surplus, is no small political challenge. Moreover, as the Kerrey–Danforth entitlement commission recently documented, the problem that must be addressed is not one with a 2002 endpoint. The outlook is for a mounting fiscal imbalance during the 21st century, given current programs and likely population and labor force trends. We should not be seduced by the mounting trust fund surpluses today into thinking that we can postpone dealing with the entitlement gap. The cost of waiting is going to be far more painful adjustments, which could be avoided by moderate actions legislated today to become effective after the turn of the century.

This longer-range perspective obviously has relevance to the tax and spending measures the Congress will be considering. Some basic economic principles must be observed if you are to maximize the Federal Government's contribution to the fostering of high real incomes and to alleviating the entitlement problem. Most importantly, not all taxes or expenditures are equal in terms of their influence on the productive capacity of the economy. Although, as I testified recently, I would caution against major changes in budget scoring techniques at this time, that does not mean that the Congress should not give a good deal of attention to the effects of its fiscal actions on the incentives faced by private decision makers.

In sum, Mr. Chairman, the recent performance of the macroeconomy has been encouraging. But much of the improvement is in the nature of cyclical developments, and we all have our work cut out for us if we are to extend these gains and foster long-term trends that enhance the welfare of all of our citizens.

The central role of the Federal Reserve today is to ensure that our economy remains on a sustainable, non-inflationary path. For the Congress, a crucial focus should be continuing the process of fiscal consolidation and rectifying the secular shortfall in domestic saving that is limiting the growth of our Nation's productive potential.

Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you very much, Dr. Greenspan.

Senator Brown, I am going to let you start on our side, if you would, please.

Senator BROWN. Thank you, Mr. Chairman.

We have already referred this morning to the fact that deficits have gone down over the past couple of years, and yet interest rates have risen. I think that was the point that Senator Conrad had tried to make. Obviously, there are other factors in the economy, of course, besides what the Federal Government does that influence that. But the common perception is that the Federal Reserve plays the key role in determining what interest rates are in the United States.

I would be interested in your observations on that subject. Are most of the factors that determine interest rates simply market forces? How much discretion does the Fed have? How far can you vary from market forces?

Dr. GREENSPAN. Well, Senator, we can pretty much fix the Federal funds rate, which is the overnight rate for funds deposited at the Federal Reserve banks, within a very narrow range. We have virtually no direct effect on interest rates in the long end of the market.

Because of the way the yield on, say, 20- or 30-year bonds is determined, it is also capable of being looked at as an averaging of all interest rates starting with short-term interest rates all the way out. It has a cumulative effect.

So it is true, to the extent that we affect short-term interest rates, we have some impact on the longer-term rate, but the crucial determinant of that is other factors in the economy: basically what inflation expectations are and what other factors of fundamental supply and demand are.

At the end of the day, I would suspect that the impact that we at the Federal Reserve have most effectively on the longer end of the market is the extent to which we can affect inflation expectations. And in that regard, because of our awareness of the importance of long-term rates, especially as they affect the mortgage market, the best thing that we could do to sustain long-term economic growth is to try to lower that inflation expectation and hopefully eliminate it completely, because if we were able to do that, then the goal which is at the base of Federal Reserve policy—namely, to create a maximum sustainable growth in our economy—can be achieved.

Senator BROWN. Recent reports have indicated a slowdown in retail sales and an increase in inventories. Do you view these as signs—these and others, I guess, to be fair, of an economy that has further growth in it? Or do you see these as a sign that it may be peaking out?

Dr. GREENSPAN. If you look at the various signs, it is clear that the very torrid rate of increase in economic growth which we experienced through the latter part of 1994 is slowing down, and I think that is an important plus for the stability of the economy.

If that were not happening, if we were not getting certain marginal signs of slowing in certain areas which have been growing at very extraordinary rates, I think that would be a cause for quite considerable concern.

So you have to distinguish between signs that we are no longer growing flat out, if I may put it that way; we are much more a type of economy in which one sees fairly good, moderate growth is occurring. There are always pluses and some minuses. What we had in the type of period we went through for a good part of the second half of 1994 was that it was almost impossible to find anything that was on the negative side. That is just absolutely extraordinary and utterly unsustainable. So the slightly more mixed evidence which we are getting, is merely suggesting that the torrid rate of growth is slowing down, it is by no means saying that growth is coming to an end, nor is there any evidence that I can see that the economy is running into difficulty. I think that these are good signs, not bad signs.

Senator BROWN. One last question. I note that while, indeed, the deficit is down from last year, the year prior, that the deficit at this stage of the recovery is significantly higher than it was in the previous recovery. To put it a different way, yes, the deficit is down from a period when we had a recession, but the deficit is dramatically higher than it was at this stage of the previous recovery.

I guess I would ask you to comment on that observation and indicate whether you are comfortable with the level of deficit reduction that we are committed to at this point.

Dr. GREENSPAN. Senator, I think that if you take a look at history and you compare the type of economy that characterized fiscal 1994, that we did not have a surplus in the period is the thing that should surprise us or should cause chagrin, because if you look at what we know about fiscal policy's impact on the economy, if one took the period of October 1, 1993, through the end of the third quarter last year, that is the type of period which I would suspect virtually every economist would say, if you are going to have a surplus in the budget to keep some form of balance, that was the period in which it should occur. So that when you look at the type of deficit we ran up, to be sure it is significantly less than previous fiscal years, it is scarcely something which we should basically be cheerful about, because it is not anything that I find comforting, especially considering the structural problems in the deficit which one very readily sees on the basis of current law and demographics as you project into the 21st century.

Chairman DOMENICI. Thank you very much, Senator Brown.

Senator Exon?

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

Dr. Greenspan, first I would like to ask you this question. I noticed in your testimony that you said something to the effect that we are growing—and I took it as it may be some concern for alarm—net importer of capital in the United States of America. I think that was the message that you were trying to relay to us, right?

Dr. GREENSPAN. That is correct, sir.

Senator EXON. Well, is it not true in that regard that every increase in the interest rates in America tends to encourage that very thing rather than to not encourage it?

Dr. GREENSPAN. No, I would not basically say that. One can argue that over the long run, even though there is a good deal of dispute about this, the higher real interest rates are, the greater the domestic private saving in the system, and the greater the domestic private saving, the less we have to import saving from abroad, so to speak, and, therefore, one does not necessarily draw a close relationship there.

Let me just say here, because there has been a lot of discussion about whether interest rate policy should be focused on the deficit or should be an issue in deficit reduction or should be used to affect the current account deficit and the like, that is terribly important for monetary policy to focus on the crucial goal, which is an endeavor to try to maintain price stability. If we succeed in that, a lot of good things emerge. If we try to have a whole series of multiple goals to be the focus of interest rate policy, my fear is we will achieve none of them. And I do not deny that when interest rates go up, the interest costs of the Federal debt go up—the arithmetic is unassailable.

The question that we have to ask ourselves is: What are the alternatives? In other words, should we endeavor to focus policy monetary policy, on keeping the short-term interest costs of the Federal budget at a low level? I would submit that were we to try to do that, we would actually end up with precisely the opposite, because we would create an inflationary bias in the system, interest rates would rise, and 2 years down the road, we would find that the debt service costs were horrendous, and we would not know how in the world that happened. So we have to be very careful about trying to look at monetary policy as a crucial element in trying to affect the deficit.

Reversing the example that I just gave, Senator, if we keep a steady non-inflationary economy, the levels of interest costs in the budget, given the level of the debt are as low as we will be able to get them.

Chairman DOMENICI. Senator Exon, would you just yield to me for a little bit of housekeeping?

Senator EXON. Yes.

Chairman DOMENICI. I noticed the lights are on, and I am told we have about 5 minutes left on this vote, and the problem we have is that there is another vote, which I believe is on your amendment, Senator, the second one, is it not?

Senator JOHNSTON. Yes.

Chairman DOMENICI. Dr. Greenspan has told us that he has to be out of here at 11:00. Is that correct?

Dr. GREENSPAN. I can go at 11:15.

Chairman DOMENICI. OK. I think I will go vote right now, and you continue. But you will have to come very shortly. I do not know how we can do anything but adjourn at some point for 15 minutes until we can get back here.

Senator EXON. That is the only thing we can do.

Chairman DOMENICI. Dr. Greenspan, I would really encourage you, since we only have such a short time, to make your answers as brief as possible. That is really asking a lot of you, but——

Senator LAUTENBERG. Especially when the questions are so long.

Chairman DOMENICI. Senator Exon's last question was not too long, but, anyway, I just would ask that. If you can, we——

Dr. GREENSPAN. I can be pithy. I am not sure I will be clear. [Laughter.]

Chairman DOMENICI. OK.

Senator EXON. Dr. Greenspan, let me touch on two things. First, at that last meeting, joint meeting of the House and the Senate, I asked you whether or not you thought it would be a good idea to try and incorporate debt ceiling in the budget. We have talked about that. I do not have time to go into it. You have told me that you still have some reservations about that.

You told me at that meeting that you would try and come up with some other enforcement mechanism because you shared my frustration about how easy it was. I would simply ask you to get back to me on that as quickly as you can.

You were quoted in the paper this morning, and I want to quote this:

> Mr. Alan Greenspan, Chairman of the Federal Reserve Board, yesterday warned Congress that failure to pass the $40 billion Mexican loan guarantee package would threaten the global trends towards free markets in the democracy.

I must tell you and Secretary Rubin that if you do not know it, what support there was for the $40 billion loan guarantee is collapsing in a dramatic fashion. The questions that many of us have raised have not been answered. I just wanted to alert you to that. I have not decided how I am going to vote on this, but I want some answers.

One of the problems that I think we are looking at is the fact that we are going to give loan guarantees, and the first people that are going to benefit from that are the money-changers on Wall Street who cast their nets in Mexican waters to reap high interest rates at a time when the interest rates here were in the 3 to 4 percent range, and they were getting 10 to 12 percent in Mexico. At least this Senator and I suspect a lot of my constituents are very much concerned about that. Why, if we are going to bail out those money-changers on Wall Street who made bad investments in Mexico, why shouldn't we bail out Orange County for the same situation?

This is over-simplification, I admit that, but I am telling you that there are big problems. I am trying to get a handle on this. Is there a chance that we could put ourselves in the place of a bankruptcy judge under Chapter 11, where some of those people that have made those bad loans from a greedy standpoint are not the ones that are immediately benefited from the guaranteed bailout?

Dr. GREENSPAN. First of all, Senator, the basic purpose of the loan guarantee is not a bailout. It is essentially a structured loan guarantee with a very large up-front fee paid by Mexico. In looking at the issue of individuals who benefit, it is important to recognize that those who have peso-denominated investments, which is a big part of this, have lost a great deal of money. There is nothing that I can contemplate in this loan agreement which is going to make that money back for them. In other words, those losses will stay, and I do not see any significant way in which they can recoup other than a small amount of that.

The basic problem that we confront is that if it were solely Mexico, we would not be overly concerned about the contagion effect spilling over into other areas. Most importantly, especially in the context in the way you put it, Senator, there is no Chapter 11 or Chapter 9 for sovereign international types of loans. The issue of Orange County is contained, without the contagion, because there is a Chapter 9 which enables an orderly resolution of their debts.

Our concern is without such a formal legal mechanism, we confront ourselves with some degree of considerable financial instability.

Senator EXON. Mr. Chairman, I have to go vote. I have 3 minutes to get over there. We will be back as soon as we can.

The committee will stand in temporary recess pending the return of any Senator who would reconvene the meeting. We know that you have to leave at 11:00. I am sorry we have to leave.

Dr. GREENSPAN. No problem.

[Recess.]

Chairman DOMENICI. Dr. Greenspan, let me ask you if you would just briefly tell us what the Federal Reserve Board thinks about the CPI as we currently use it, both in the Tax Code and for many Federal programs. Do you have an ongoing research project or just where are you in terms of coming up with a Federal Reserve Board evaluation of its accuracy?

Dr. GREENSPAN. The Federal Reserve, per se, is not doing underlying independent research. What we have done, which, indeed, many of our senior staff have been involved in, is to scan the literature, of which there is a considerable amount, on the question of where the biases are.

I think it is fairly safe to say that the consensus of the economics profession is that there is a bias and that the bias is estimated differently by everyone, but all have at least several tenths to going well beyond 1 percent. If one could put a consensus on it, I would say the consensus is somewhere between a half and 1 percent, but there are numbers of estimates which go higher than that. And the point that ought to be addressed is that if it has been the intent of the Congress to hold beneficiaries of numbers of programs whole, meaning adjusting for the cost of living, the question one must ask oneself is if there is this bias in the CPI, is the law actually being adhered to, in the sense that from the best any of us can judge, the actual cost of living is running under where the CPI measures it, by whatever amount one wants to stipulate. It means, therefore, that the benefits are, in real terms, rising.

Now, if the Congress wished to do that, I would suspect the Congress would pass a law which stipulated that those benefits in real terms should rise. My point is solely a technical question with respect to the particular measure that is being employed for purposes of carrying out the will of the Congress in this endeavor to hold the beneficiaries harmless from changes in the cost of living.

Chairman DOMENICI. I want to go on to some assumptions on a balanced budget and a trend line toward it and what positive or negative impacts you might find. I wanted to make an observation for the record. There are still some—I do not know that there are any on this committee, but there are still some around who would like to take away the independence of the Federal Reserve or, in a sense, have politicians tell them what to do. And I would like to make sure the record reflects that we now have a very good modern-day example of that and what happens. Because, obviously, Mexico had a politically motivated monetary policy. Now, I am not saying they motivated it in any pejorative way, trying to be harmful or helpful, but they actually manipulated it, changed it based upon politics. And you see what they got. So I would hope that everybody understands that there may be some down sides, but the Federal Reserve Board has been a stalwart in keeping America solid and having strong money and having the best kind of economic growth we can have under political circumstances that we create, not them.

Having said that——

Senator GRAMM. Mr. Chairman, would you yield very briefly on that point?

Chairman DOMENICI. Of course.

Senator GRAMM. I think the Chairman has made a very important point here. We have now for a decade running, in both Republican and Democratic administrations, had members of both parties make pronouncements about the desirability of having Congress have a say in monetary policy. We have had complaints from time to time that the Fed was imposing interest rates that were too high. We have had complaints that the money supply was not growing rapidly enough. We have had proposals that Congress have a bigger say in setting monetary policy. And I think if you look at Mexico, you have got a perfect case in point about how the Lord is good to us by not giving us what we think we want. Because in 1993, currency and bank reserves in Mexico were growing at 3.5 percent a year. In the first half of 1994, as they built up to their election, their monetary base grew at 23 percent a year. They now have an inflation rate of 20 or 30 percent. That has produced the collapse of the peso. And what they need more than anything else is an independent monetary authority. And, Mr. Chairman, I would just like to say that I think your point is a very important point, that Mexico is a case in point about why it is a bad idea to have politicians control monetary policy.

Chairman DOMENICI. Thank you very much, Senator.

Dr. Greenspan, on this subject for one additional moment, it would seem to me that those who were negotiating with Mexico—and I am not going to spend your time on the Mexican loan guarantees here. If other Senators want to ask about that, that is their privilege. But it does seem to me that rather than ask us to write into the law a mandate with reference to their changing their monetary policy to a more reliable, credible, independent institution, it seems to me that those who want to get the job done ought to ask Mexico to do it on their own. It seems to me we would be in a lot better shape if we could come to the Congress of the United States and say Mexico recognizes this and they have done this and this.

They might do it easier if they are doing it themselves than under a gun from us. So I throw that out. I know you are not a negotiator, but obviously, it seems to me, somebody must be talking to Mexico. I do not believe it is all in the air.

Two questions. I assume that you agree somewhat with the Director of the Congressional Budget Office, Dr. Reischauer, who indicated that the economy will suffer in the next 2 years a slowdown, albeit we will not go into a recession, but we will have less growth this year than we had last year, and less growth the following year, all things being equal.

Is that a fair statement?

Dr. GREENSPAN. Well, Mr. Chairman, I do not want to specifically comment on forecasts which are, of necessity, very difficult to make. I do think, as I said just prior to the adjourning of this committee, that the torrid pace of economic growth that we were involved with was not sustainable, and were it to be sustained, we would create significant imbalances.

So I would say that I certainly hope that we are going to slow down to a more sustainable pace, and from what we can see in recent weeks, the evidence does suggest that that is occurring. I hope it is sustained because it creates a degree of stability which keeps the economy going in a fairly solid fashion for a protracted period.

Chairman DOMENICI. All right. No matter how you say it, I did not intend to indicate that if it slows down but we do not go into a recession for a period of time, I am not suggesting that is all bad. Actually, when you look at the length of this recovery, it has been going on for a long time, comparatively speaking, and that is all upbeat for America, positive for us.

My last question has to do with interest rates, long-term interest rates in particular. I am fully aware that you have some very big persuasion with reference to short-term rates. The Federal Reserve, in the way it has been handling that, it is obvious that short-term rates reflect some action on your part. You indicated long-term rates are not necessarily so related. In fact, I think you said they may be more market-oriented than they are related to the actions of the Federal Reserve. Is that correct?

Dr. GREENSPAN. They are substantially market-oriented.

Chairman DOMENICI. Now, if that is the case, it seems to me that without regard to precision, if the Congress of the United States, bipartisan or partisan, produces a balanced budget amendment and it is out there for the people to ratify, a constitutional amendment, and we produce a budget resolution that is enforceable and that addresses entitlements along with other things, so that we are talking about structural changes, perhaps in the neighborhood of a $450 billion reduction over 5 years, is it fair to assume that that has a positive effect on long-term interest rates? And eventually will not economists make projections with reference to those long-term interest rates based on that? And are they apt to be lower than otherwise?

Dr. GREENSPAN. I would not be so focused on economists. I would say to you, as I have said in the past, Mr. Chairman, that if there is a major credible program toward budget deficit reduction and the authorizations and appropriations are in place projecting us in that direction, I have very little doubt that there will be a significant positive impact in the long end of the bond market in the order of magnitude of—depending on what we are talking about—a percentage point or more.

Chairman DOMENICI. Thank you very much.

Senator Johnston, I believe you are next.

Senator JOHNSTON. Thank you, Mr. Chairman.

Dr. Greenspan, we are all familiar with those estimates of where the deficit goes from here; that is, it goes down toward the end of this year to, I think, 2.3 percent of GNP, and then it begins to go up because of increases in medicare costs, because of increasing medical expenses, the increasing base in medicare, in medicaid as well, medical expenses.

Now, that being so, we are going to have to have, I am sure you agree, big budget cuts or reconfigurations in medicare and medicaid which amount to budget cuts, just to stay even with the board. You agree with that, don't you?

Dr. GREENSPAN. I think the arithmetic does support that.

Senator JOHNSTON. All right. In addition to that, in order to get to a balanced budget by the year 2002, we have various estimates of what we need to do, some as high as $1.5 trillion, depending on the way you increase defense. Now, that being so, isn't it really foolish at this time to talk about a tax cut when we have got so much distance to cover to get wherever we are going, even just to stay even with the board, just to keep it from increasing, much less to balance the budget?

Dr. GREENSPAN. Senator, I argued at the Finance Committee yesterday that deficit reduction is the highest priority; that is, we have to have a significant reduction in expenditures before, in my judgment, it is sensible to even begin to contemplate reducing taxes. I am not against reducing taxes. I would like to see taxes move lower. But it is crucially important that we have major reductions on the expenditure side which get the budget deficit down appreciably, and that would be by far the first priority. And I would say at the end of the day, if there is very successful activity in that direction, there is probably no damage done in adding cuts in taxes. I would much prefer, as I said yesterday, to see marginal tax rates cut, not basically tax credits.

Senator JOHNSTON. But the timing of doing that now, not only doing it before we have reduced expenditures, but to do it while the economy is at least overheated enough that you have seen fit to increase interest rates recently, isn't that timing just altogether wrong?

Dr. GREENSPAN. Oh, I absolutely agree with that, Senator. The issue of tax cuts, which are important for the long-term basic structure of our fiscal policy, has got to be on the agenda. But I think that it would be premature to move in that direction before very substantial progress has been made, real progress on the expenditure side.

Senator JOHNSTON. What we really ought to do is make real progress on the expenditure side and wait until the evidence of the economy slowing down, then we put in the stimulus to cut taxes.

Dr. GREENSPAN. That would certainly be my preference.

Senator JOHNSTON. All right. Now, Dr. Greenspan, you say in your statement that not all taxes or expenditures are equal in terms of their influence on the productive capacity of the economy. Some ways, in effect, of balancing the budget would be less good than others, and some would be downright detrimental, wouldn't they?

Dr. GREENSPAN. I think that is correct, Senator.

Senator JOHNSTON. Well, that being so, shouldn't we insist on knowing how this budget is going to be balanced before we vote for a balanced budget amendment, given that there are some ways that we might do it which would be harmful and some ways that we might do it which would be good?

Dr. GREENSPAN. Senator, there are innumerable ways in which you can bring the budget deficit down very sharply and approach zero. I am not certain that you know in advance precisely what the scenario is. It is going to take a number of years to do that. And the argument that one goes step-by-step and evaluates programs as you do it is probably not unwise. To commit in advance exactly how you will do all the various elements of it I am not sure is the type of program you necessarily want.

Senator JOHNSTON. But don't we want at least a general direction? Don't we want to know whether it is taxes or whether it is means testing of entitlements or whether it is cutting the lower end of the scale like medicaid and food stamps and WIC and those programs?

Dr. GREENSPAN. I think that all of it should be done on the expenditure side. The problem that I would foresee if we started to try to raise taxes to reduce the deficit, is that we would find over the longer run that that might turn out to be counterproductive. But there are a lot of political decisions, all of which relate to this, and all I can suggest to you is what the economic effects of various different strategies are without getting into the details of the programs.

Senator JOHNSTON. Thank you, Dr. Greenspan.

Chairman DOMENICI. Let me remind everyone, through no fault of his own but mostly this committee, he only has about 15 minutes left here.

Senator Gramm?

Senator GRAMM. Thank you, Mr. Chairman.

Alan, we appreciate having you back. I want to take up where Senator Johnston left off. You are, of course, aware, as we are, in looking at the numbers that we face in the Federal budget that if we could freeze government spending at its existing dollar level for 3 years, we would have a balanced budget given the current projections of the economic growth occurring and the revenues that flow from that. If we could limit the growth of government spending to 2 percent a year for 7 years, we could achieve a balanced budget.

If you were looking back at your experience in both the public and the private sector of the economy and you were going to look at America's fiscal problem as a business or a family would look at it, how many businesses in America in the last 20 years, in percentage terms, would you say have faced restructuring problems at least as difficult as the Federal Government faces today and have successfully overcome them?

Dr. GREENSPAN. I would say a large majority, Senator.

Senator GRAMM. If America were a business instead of a country or a family instead of a country, would you call our financial problems from the point of view of a family or a business a modest restructuring or a dramatic restructuring as compared to, say, IBM's problems or General Motors' problems 10 years ago?

Dr. GREENSPAN. I would say small.

Senator GRAMM. So you, in essence, agree with the thesis—it is a thesis that I hold, obviously—that if America were a family, a strong family, or a good business, we would be looking at a modest restructuring and that we would roll up our sleeves, get serious about this problem, and solve it?

Dr. GREENSPAN. Well, Senator, the private analogy is an interesting one. There was a corporate executive president of a firm who said he sent out notices to five of his divisions that they all had to cut back by roughly 20 percent. They all came back and said it is not possible, you know, we cannot do it. He then sent out an edict in which it had to be done or everyone got fired. They did it.

Senator GRAMM. Miraculously.

Dr. GREENSPAN. Miraculously. Nothing happened. The system went on.

Look, we have all dealt internally with our bureaucratic systems. There is an extraordinary inertia that we all confront. It is very difficult. I see it at the Fed. Everyone sees it in every other business. The presumption that you cannot squeeze down without undoing a corporate, government, or other structure is silliness.

Senator GRAMM. Well, I am struck, Mr. Chairman, by the paradox that we are facing a problem as a country that if we were a family or a business, it would be a modest restructuring, and yet what businesses and families do every day we find so difficult to do as a people.

I want to address this issue about being able to say how you would balance the budget before you start to do it. When you went off to graduate school and you were looking at all the courses that you had to pass and all the things that you had to learn, did you know how you were going to do it?

Dr. GREENSPAN. No. In fact, that is precisely the appropriate analogy, Senator. You knew you were going to get there; you knew you had innumerable paths to get there. You did not know what the optimum path was until you approached various different forks in the road. And that is the reason why I would be a little reluctant to put in a locked path at this particular stage——

Senator GRAMM. But we are going to learn something during the process.

Dr. GREENSPAN. That is precisely it.

Senator GRAMM. To sum up, Mr. Chairman, if we only set out to do what we knew exactly how we were going to do, nobody would ever start a business, nobody would ever go off to college, nobody would ever get married. As I said when I asked my wife to marry me for the third time, and I got down on one knee and said, "If you will marry me, I will spend the rest of my life trying to make you happy," she did not say, "How are you going to do it?" She measured was I sincere about it, and, quite frankly, 25 years later I am still working on it.

Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you very much.

Senator Lautenberg?

Senator LAUTENBERG. Thank you, Mr. Chairman.

Dr. Greenspan, we hear the analogies constantly between business, family, and the Federal Government. And while I think it is fairly easy to draw a comprehensive picture of the three situations, there are enormous differences between them. And when you look at the restructuring of companies throughout our economy over the last few years, you see companies having sacrificed huge shares of the market, improve their performance—IBM I think is perhaps the most notable example. IBM no longer has the market share that it used to have. And one cannot measure IBM's progress by the improvement in profit in this last year. There is a sustainability factor that is going to have to be viewed so that we know whether or not their decisions were correct. But they each have capital budgets. They each have depreciation schedules, amortize capital investment, live—are there any corporations that you are aware of that are without borrowing, without credit on the outside? Any of the major corporations? You served on the board of one of the best companies in America. That was ADP. That was my company. Dr. Greenspan was on that board before he came here. But there is no inside track, I assure you.

Dr. GREENSPAN. Observe how well they have done since both of us left. [Laughter.]

Senator LAUTENBERG. I was hoping you would not mention that. But are there any companies that do not rely on credit, on borrowing some place along the way to continue their expansion, their development?

Dr. GREENSPAN. Borrowing for productive investments is clearly a very sensible thing to do. Borrowing for consumption, which is to a very large extent what is done in the Federal Government, I do not think corporations do or should do.

Senator LAUTENBERG. But the net result is, isn't it, that our ability to raise revenues—and I am not recommending it, and I was very interested in your response to Senator Johnston—is unique among entities due to the fact you can raise taxes, you do not have to give reasons except to give up your seat in the Senate or the House, and you go ahead and do it.

The point I am attempting to make here is the vast difference between the way corporate America works and the Federal Government. And the analogy between the two is not worth an awful lot, as I see it, in most instances. Do you agree or disagree?

Dr. GREENSPAN. I disagree in the one specific area which I emphasize, which is the inertia of bureaucratic organizations; that is, it is extraordinarily difficult to get anyone to voluntary cut back, and they are almost always indicating the reasons why, if it is to be done, there is some catastrophe that occurs as a consequence. I think that that is rampant, frankly, in the Federal Government, and it is rampant in a lot of corporations as well. And it is those which have been forced into very major restructuring. I would hope that we recognize that the types of problems that we have with our very large structural deficits which go into the 21st century are enough of a spur for us to take some very dramatic actions which, while dramatic, are not very large.

I happen to agree with Senator Gramm that it is really not a big number. It is politically huge, but analytically it is not that big a number.

Senator LAUTENBERG. If I can, one more question, Mr. Chairman, and that is this: Do you see any risks inherent in a constitutional amendment that says thou shalt balance the budget by 2002, or whatever it is, as contrasted to what needs to be done in the operation of our financial structure with decision making year by year?

Dr. GREENSPAN. Over the years I have been concerned about changing the Constitution to put in fiscal issues which have to be sustainable 50 and 100 years hence. And I am worried, I must say, about enforcement capabilities of strictly the type of balanced budget amendments that we have been talking about. But I have reluctantly concluded that there should be a constitutional super-majority requirement for appropriations, outlays, and expenditures, as well as sunset legislation. But the crucial issue which I think you are raising, with which I agree, is that process or mechanisms are not going to balance the budget. You have to basically get at the roots of the process and change the law. Unless you do that, particular guidelines or various different things which inhibit you from doing things is not going to get it done very readily.

Senator LAUTENBERG. Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Gorton?

Senator GORTON. In a series of questions with Senator Johnston just a few moments ago, I believe that you set out your priorities, Dr. Greenspan, with respect to deficit reduction, spending reduction, and tax cuts. And if I heard you correctly, you said that while you were in favor of tax cuts, they are a lower priority than a reduction in the deficit, in the budget.

Then I think you said, sort of offhandedly, that if there were going to be tax cuts, you felt they should be somewhat different in their structure and their direction than those which are now being discussed.

Am I correct in that? And if I am, would you give me what your priorities would be with respect to economic growth if there were to be tax reductions of a given amount, a significant given amount?

Dr. GREENSPAN. Senator, as I have testified before this and other committees, my first priority would be to address the capital gains tax, which I think has the capability of having the most positive effect on the economy. Any loss of revenue, if there is, in fact, a loss in revenue from that sort of tax, which is quite different from other types of taxes.

Senator GORTON. Expand on that a little bit, if you will. It is your view, then, one, that a reduction in the capital gains tax, at least at certain levels, might have only a very modest impact on revenue loss; is that correct?

Dr. GREENSPAN. The estimating techniques that everyone uses very clearly produce evidence that very small changes in assumptions have very large impacts on what those revenue estimates are. My sense is that since I personally believe that the capital gains tax is an inappropriate means to raise revenue if economic growth is centrally important or a major priority, I would tend to lean in the direction, where we possibly can, of reducing it and ultimately eliminating it.

I cannot give you revenue estimates. I think everyone else can give you revenue estimates down to the last decimal point, and what we have seen is that the ability to forecast revenue changes on changes in the capital gains tax is very, very limited. But if I had to guess, I would say the revenue losses are small.

Senator GORTON. But the justification, then, for changes, for reductions in capital gains, have to do with increased productivity in society, increased economic activity, and, one presumes, increased jobs?

Dr. GREENSPAN. Yes.

Senator GORTON. Now, nevertheless, in spite of this set of priorities, you did have reductions in taxes relatively low on your order of priority. At the same time, much of your written testimony relates to low savings rates, and low investment rates in the United States.

Do you believe it possible to significantly increase our savings rates, given the nature of our current tax system?

Dr. GREENSPAN. I support those endeavors, of which I gather there are many initiatives in the Senate, to move toward the type of tax system which basically taxes consumption rather than saving. I would tend not to assume that a number of these basic tax programs which do not inhibit consumption somehow create saving out of the blue. The only way to increase saving is either to get income going up or consumption going down, or both. And if you can put your tax system where its burden is on consumption, I suspect you will engender a higher level of saving.

I certainly think it is the way to go. If there is support for that, I would very much encourage it.

Senator GORTON. You are an admirer of the Chairman, I take it.

Chairman DOMENICI. Thank you very much, Senator Gorton.

I believe, Senator Hollings, you are next.

Senator HOLLINGS. Thank you very much.

Mr. Chairman, with respect to Mexico in deep trouble, $160 billion long-term debt, $31 billion current account deficits, 20 percent of the bank loans, I understand, are non-performing. The workers down there, of course, over the last 10 years have had a 50-percent cut in their wages, and now with the devaluation of the peso, they have got another 40-percent cut. There is going to be some recession, and the question is how severe.

I look upon the Administration's proposal as really making it extremely severe, devastating, for the simple reason that they are going to have to control imports on the one hand, I am sure you would agree. That is going to cancel out, by the way, the advantages of NAFTA about creating jobs up here. But more particular, with a $40 billion loan guarantee and the security being requested to guarantee the loan guarantee, all of their export revenues are going to debt service rather than development.

Specifically, they need those oil revenues to build schools and hospitals, roads, sewer lines for industry to get the economy going again. How is it that the Federal Reserve has not moved in to peg that peso, take our hits up front, rather than incur this $40 billion obligation? We could get the International Development Bank then to move in with some good loans, the IMF and World Bank, but at least the International Development Bank to start loans.

I want to make sure we help the people of Mexico, not the billionaires. Steve Forbes is up there now testifying before the Foreign Relations Committee and had written in his articles last year that under Salinas, the so-called privatization, I wish I could privatize this Government and give Senators Domenici and Exon and Sarbanes the TV and the telephone and everything else like that. That was the good-ol' boy system. The people never got any advantage. They ought to give the money back.

But be that as it may, rather than go in this way, we could take the hits; they could still have their money and get a chance to work their way out of it. What they do is, as I say, get into a gridlock situation down there financially on the one hand, and we would be the culprit on the other hand. A year from now, 2 years from now, they are going to say the oil revenues, well, we have to pay it to the gringo up north. Dale Carnegie did not design this plan.

Dr. GREENSPAN. Would you repeat your question, Senator?

Senator HOLLINGS. My question is: Why didn't the Federal Reserve move in and take the hits early on here?

Dr. GREENSPAN. You mean, in other words, to support the peso?

Senator HOLLINGS. Yes, sir.

Dr. GREENSPAN. If we were to do that—and I would argue strenuously against it—we would have to be using unappropriated funds, which is all that we have got at the Federal Reserve; and to the extent that we were supporting the peso, we would be accumulating significant quantities of them, which we have no way of hedging. And as a consequence of that, we concluded that that would not be authorizable, if I may put it that way, under the statutes under which we operate.

The reason, actually, that we have supported the issue of going for another approach to this is largely that we do not have authorities, as we see it, either in the Exchange Stabilization Fund at the Treasury or at the Federal Reserve to take that sort of action.

Senator HOLLINGS. Why not ask for that authority?

Dr. GREENSPAN. Because the guarantee authority is very similar. We would be exposing, as far as I can see, the American taxpayer probably more if we were going in with the direct purpose of stabilizing a foreign country's currency than we are, as I understand it, in the type of structure that Treasury is moving forward on, which is to have a loan guarantee facility for which Mexico would be paying a very large up-front fee. The chance of taxpayer loss is greater if we were to do it than in the type of facility that I understand is being negotiated by the Treasury Department.

Senator HOLLINGS. I see my time is up.

Chairman DOMENICI. Thank you very much, Senator Hollings.

Senator Sarbanes?

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

Chairman Greenspan, I understand your time is limited, and I will try to very succinctly put some questions to you.

First of all, I was interested to hear this kind of "Amen" corner for the Fed and its policies from the other side. But one of the points they made is that Mexico would not have had these problems, or perhaps less of them, if they had an independent monetary authority. Do you agree with that?

Dr. GREENSPAN. I do not know enough about precisely how the system was working. That they have a legal independent monetary authority is very clear. There was a law passed last year which created a fully independent institution in a legal structural sense. But as you well know, Senator, it is one thing to have a legal structure and another to make a judgment as to what extent is a monetary authority affected by an executive branch or a legislature. And I am not in a position——

Senator SARBANES. They seem to feel that is important. I wondered whether the conditionality on the Mexican guarantees ought to address that issue.

Dr. GREENSPAN. I would certainly think that any conditionality should focus on such policies.

Senator SARBANES. Now, I want to ask you about U.S. interest rates. The Chamber of Commerce in November, after the Fed last took the rates up, and I quote:

> Apparently, the Fed will not be satisfied until it has seen irrefutable proof of a slowdown, and by then it will most likely be too late. It is clear that the only phones that are answered at the Federal Reserve Board come from the Wall Street area code.

Now, the auto dealers in the last few days have certainly sounded the alarm. Chrysler's chief economist said:

> The Fed could squeeze too hard as it tried to restrain the economy. The Fed is right on the cusp of not flattening the curve, but causing an actual downturn.

That is in yesterday's paper. And Ford, of course, closed some plants and said the reason they were closing them was the dampening effect of rising interest rates on car-buyer plans.

Now, the New York Times has a headline this morning: "Companies are beginning to worry that the Fed is overreacting." Now, you are getting this reaction all across the economic scale here, and I am interested to hear your response to it.

Let me just add one other item. The Finance Minister of Mexico said that the rise in interest rates in 1994 was one of the reasons that international investors began to sour on Mexico, pulling their money out, and uncertainty in Mexico was further increased by revived reports that the Federal Reserve would increase interest rates at the end of the month, thereby draining more investor money from Mexico.

What is the Fed going to do next week in light of all these concerns? Whose phones are you listening to? It is a reasonable point, I think, that the Chamber of Commerce made. I could quote the NAM and the home builders as well, but I know your time is limited.

Dr. GREENSPAN. Thank you.

Senator SARBANES. I want to put one more question to you before you get away.

Dr. GREENSPAN. I will just merely repeat what I said before, Senator. I was not sure whether you had come in. But during the latter part of last year, we had the most extraordinary expansion that I ever recall, not in terms of its orders of magnitude, but in terms of the fact that it was almost impossible to find anything that was negative. And that is extraordinarily unusual for any economy, especially one as complex and diverse as the United States economy.

We are, fortunately, beginning to see some mixed elements within it, which I think is very advantageous in the sense that the unsustainable torrid pace that we were exposed to is now simmering down into what looks to be a more stable, sustainable pace.

That is our judgment as to what we see is occurring, and it is not a question of which telephones we answer, because what we try to do is to find out as best we can, as you well know, what is going on in the economy through every means possible. And I think we do a reasonably good job.

There are innumerable voices that are out there which are always concerned about any rise in interest rates, and I understand that. That is part of the process. We listen very closely for the reasons why people are concerned, and in some instances, we learn a good deal. But it is a very tough set of judgments that we have to make, and we make them on the basis of what evidence we believe is there and try to balance them in a manner which gives us the best policy.

That is the only way I can really answer that question, Senator.

Senator SARBANES. Mr. Chairman, could I put a question on the CPI very quickly?

Chairman DOMENICI. Sure.

Senator SARBANES. Mr. Chairman, you said in some testimony recently that you thought the CPI was overstated.

Dr. GREENSPAN. Yes.

Senator SARBANES. Now, that is being studied. In fact, the Bureau of Labor Statistics has that possibility of revising the CPI under examination.

Dr. GREENSPAN. That is correct.

Senator SARBANES. Your comment, though, provoked Members of Congress, including leading Members of Congress, to say, and I am quoting:

> We have a handful of bureaucrats who, all professional economists agree, have an error in their calculations. But we cannot tell these people to get it right. If they cannot get it right in the next 30 days or so, we zero them out and transfer the responsibility to either the Federal Reserve or the Treasury and tell them to get it right.

Now, is that the way to achieve a sensible revision of the CPI?

Dr. GREENSPAN. Well, Senator, all I can say is what I said at the joint hearing of both Budget Committees awhile back that there is a technical problem in the CPI which creates an upward bias. There is very little dispute in the economics profession that that is true. There are differing estimates of what that may be.

My argument was that because it is so technically difficult to fully get the bias out of the system, since it presumably is the intent of the Congress by law to maintain programs so that the cost of living is fully adjusted for, it was clear to me and I think to others that the CPI was not appropriately meeting that requirement.

What I argued for was to create another index which would essentially be the Consumer Price Index minus an adjustment factor to recognize that particular bias for purposes of indexing programs in the Federal budget.

I think that is an important issue. I do believe that the Bureau of Labor Statistics is working very assiduously to endeavor to make the types of corrections that we are all aware of, and, indeed, many of the areas where there are upward biases, these have been identified by people at the BLS.

Senator SARBANES. Do you think that Congress should zero out the BLS if they do not change it in the next 30 days?

Dr. GREENSPAN. I do not think that was a notion that was meant to be taken seriously.

Senator SARBANES. If it was meant to be taken seriously, I take it you would disagree with it?

Dr. GREENSPAN. I would certainly disagree with that, but I want to emphasize I think it was an issue of emphasizing a particular point, which should be made, but I do not believe that it is meant literally.

Chairman DOMENICI. Thank you very much, Doctor, and I am sorry we kept you over. We look forward to hearing from you throughout the year, and we appreciate your work.

Dr. GREENSPAN. Thank you, Mr. Chairman.

Chairman DOMENICI. Let me proceed, while we are changing here and getting our three next witnesses, to make an announcement for all the staff here, if we could carry it to our respective Senators. I would hope on the minority and on the majority the staff will indicate to members this change.

I have talked with Senator Exon, and what we are going to do in the future on opening statements is the Chairman and ranking member will make only 5-minute opening statements. We will be bound by a clock. And no one else will make opening statements.

However, we will add 2 minutes to each Senator's questioning on the first round so that they can question 2 minutes longer than now. They can include in that some opening remarks or use it entirely for questions. That is going to be the rule until we are persuaded to the contrary, so everybody ought to have that. The ranking member has agreed.

We have three witnesses here. Dr. Allan Meltzer is professor of political economy and public policy at Carnegie Mellon University. His reputation in the field of money and capital markets has brought him frequent assignments with congressional committees, as a consultant to the Council of Economic Advisers, as head of a shadow open market committee.

Dr. Mickey Levy—we welcome you also, Doctor—is a senior vice president and chief financial economist of the NationsBanc Capital Markets, Inc. He is also a board adviser to the Federal Reserve of New York, graduate of the School of Public Policy, University of California at Berkeley. Previously he was on staff at the Congressional Budget Office.

We appreciate, in addition to your appearance here, having received a breakfast presentation that you both gave last year on the state of the economy. You gave us some exciting information and some very worthwhile things to chew on.

Dr. Wyss is research director of DRI/McGraw-Hill, counsels corporate clients on financial issues, produces DRI's financial forecasts. Previously he was on the staff at the Council of Economic Advisers.

I gather you know by the attendance, or lack thereof, we are running late. I would very much appreciate it if we would start with Dr. Meltzer first, and each one take a brief amount of time. We will put your statements in the record. Thank you for being patient.

STATEMENT OF ALLAN H. MELTZER, PROFESSOR, CARNEGIE MELLON UNIVERSITY

Dr. MELTZER. Thank you, Senator, and it is a pleasure to be here before the committee again. I am going to abbreviate my remarks to give you and Senator Sarbanes the opportunity to raise questions.

I have divided my comments into two parts, one having to do with short-term and one having to do with long-term prospects and problems of the American economy.

In brief, the short-term outlook and experience has been very good. As Chairman Greenspan just mentioned, we have had a remarkably good, strong recovery, and we all are happy about that.

Long term, there are some serious problems in the American economy, and I am going to comment on two of them.

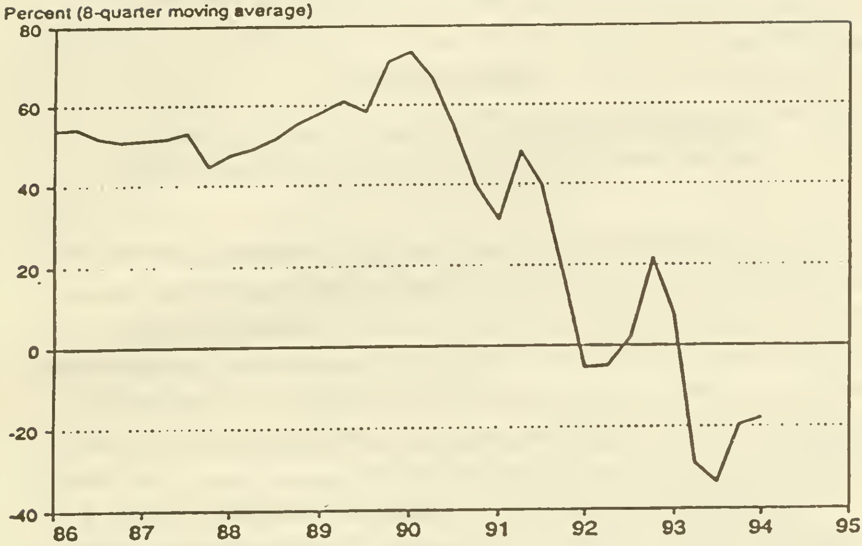
Let me say just a few words about the short term. We had strong monetary stimulus in 1991 through 1993, and this is the principal, but not the only, reason that we have had a strong recovery during 1993 and 1994. The Administration's argument that tax increases spurred the economy by lowering the deficit and lowering interest rates is a mistake. An elementary student in economics taking an elementary economics course would fail for answering a question by saying that raising taxes would be stimulative for the economy. Raising taxes is, of course, destimulating or contractive for the economy, and no amount of argumentation about deficits and interest rates will reverse that conclusion. The economy's strength and the subsequent rise in interest rates has been due to a combination of strong real growth, not only in the U.S. economy but around the world, combined with a restrictive monetary policy that has worked to try to slow down or prevent another round of inflation.

It is not surprising to me that the Administration takes credit for the strong performance of the economy. I think we would all do the same if we were in their position. But I believe they have been wrong to do so.

On the longer-term outlook, I talk about two major problems. The first is that since 1971, the dollar has depreciated 65 percent against the German mark and 72 percent against the Japanese yen. It has been a weak currency in the world, marked by periods of strength. I do not attempt to make a forecast about where the dollar will be in 1 week or 3 months, but I do believe that it has long-term problems, and those problems result, I believe, from two main sources. One is the very low expected rates of return to capital in the United States, which has prevented or slowed the rate at which foreigners are buying U.S. assets and has increased the rate at which Americans have been sending their investments abroad.

I have a chart, which I distributed separately from my testimony that I hope you have, showing private long-term capital market decisions. You can see that during the 1980's we withdrew a large amount of capital from the world. During the 1990's, as the real rates of return, expected and actual, have declined, capital has flowed out of the United States on a net basis. And I think there are many other examples or pieces of data which could support that.

U.S. Net Long-Term Capital Inflows
As a % of the U.S. Current Account Deficit



Source: WEFA

I believe that there is a current weakness, and what we need to do is to raise the expected return to capital and to investment in the United States by improving productivity, by investing in capital, both human and physical, to raise standards of living in the United States for the benefit of our children and ourselves.

The second major problem that I want to point to is that the Administration has pursued a policy of trying to talk down the dollar for a time and has beat on the Japanese to try to reduce their trade surpluses. Their trade surpluses are the principal form of lending to the world economy, and we are a principal beneficiary of that lending. This policy toward Japan, whatever its merits, has the effect of raising real interest rates not only for us but for everybody else in the world, depriving us of capital by removing the principal source of saving on a net basis from the world economy. So that is a second main criticism.

Finally, I recommend some changes to raise living standards in the U.S., and I am pleased that I am able to strongly recommend your proposal, with Senator Nunn, to shift taxation from taxation of income to taxation of consumed income or consumer expenditure, and at the same time expense capital equipment, removing, of course, the interest subsidy at the same time. But I strongly endorse the proposal as moving in the direction of trying to encourage saving and investment which, as you and other members of the committee know, are the only ways to raise living standards long term.

Thank you, Senator.

Chairman DOMENICI. Thank you very much.

[The prepared statement of Dr. Meltzer follows:]

SHORT-TERM ACHIEVEMENTS AND LONG-TERM PROBLEMS

by

Allan H. Meltzer

Carnegie Mellon University and American Enterprise Institute

Prepared for the U.S. Senate Budget Committee, January 26, 1995

It is a great pleasure to appear again before this committee. The committee, has long advocated and worked for a more responsible budget position. The Chairman has co-sponsored an excellent proposal for tax reform that would strengthen the economy and raise standards of living permanently by encouraging saving and investment. The focus of that reform is long-term. I believe that is the proper focus and, as I will comment presently, if we are going to solve our major economic problems, we must focus on the long-term.

Currently the economy enjoys robust growth with low inflation. Growth of employment is strong. Productivity has increased. The budget deficit has fallen.

The administration crows like a cock about these achievements and takes credit for them. It is understandable that they would do so. Anyone of us might be tempted to do the same if we had the opportunity.

They are, nevertheless, wrong to do so. Their major economic achievement has been in trade policy -- their support for Congressional action to approve NAFTA and GATT. Both will have a long-term benefit and, I believe, NAFTA contributed to the growth of exports and output in 1994. But the main contribution of NAFTA and GATT is to future living standards.

The administration's discussion of fiscal policy is entirely focused on the short-run. They make the economically absurd argument that raising tax rates stimulated the economy by reducing the deficit. An economics student who gave that answer would fail elementary economics. It is both sad and disgraceful that the Council of Economic Advisors has become so politicized that it endorses this incredible argument.

The robust recovery came despite, not because of, the 1993 tax increase. The administration's argument that lower interest rates stimulated the expansion is correct, but the reason long-term interest rates fell until October 1993 was the same as the reason they fell in 1991 and 1992. Federal Reserve policy -- measured by growth of bank reserves, the monetary base, or purchases of securities -- turned decisively in first quarter 1991. Rapid monetary growth continued until last winter. Rapid money growth initially lowers interest rates, stimulates spending, and encourages expansion. So it was in 1992 and, 1993. But economic growth and interest rates typically move in the same direction. When growth picked up, so did long-term interest rates. And, when money growth slowed, interest rates continued to increase both because the recovery continued and money growth slowed.

I do not want to concentrate only on these short-term matters. We all give too much attention to forecasts of what will happen next quarter or next year. It should be no secret that economists forecasts are often inaccurate. The sluggish recovery of 1991 and early 1992 led many to believe sluggish growth or a double-dip recession was in the cards for late 1992 or 1993. Instead, the economy entered a period of robust growth. Many economists predicted that the unemployment rate could not fall below 6 or 6-1/2% without inflation. Unemployment is a percentage point lower with only a 1-1/2% increase (to 1.7%) in producer prices and no change in the rate of increase of consumer prices in 1994.

It is a mistake to base policy actions on short-term forecasts. Even if we, economists, could forecast much more accurately, attention should be on a longer horizon than a year or a quarter. Long-term programs are the only way to raise living standards permanently, provide good jobs at rising wages, accumulate the resources to build better schools, offer medical care for an aging population, and contribute to the solution of other social problems. A one-half percent increase in the economy's long-term growth rate from current levels would add $27 billion of real income the first year. But if the increase is maintained, ten years from now there is an additional $350 billion to allocate to consumption investment, and social programs.

Long-term solutions depend on the economy's ability to provide future resources. A longer-term perspective on the performance of the U.S. economy is given by the decline in the dollar. In the 23 years since President Nixon ended the fixed exchange rate system in 1971, the dollar has depreciated 65% against the German mark and about 72% against the Japanese yen. Most of the decline cannot be explained by differences in inflation, particularly in recent years. International Monetary Fund data show that the real (inflation adjusted) effective exchange rate has fallen. The dollar continued to depreciate against major currencies in 1994 despite low inflation and robust growth that typically appreciates a currency.

The most important reasons for the decline are the lower long-term expected return to investment in the U.S. compared to other countries and the gradual decline in the relative importance of the dollar as a reserve currency. I do not want to suggest that intervention is required to stop the decline. It is much better for the dollar to be allowed to depreciate, as the market demands, than for the dollar to be fixed to other currencies. Those who propose fixed exchange rates or coordinated policies to manage exchange rates never take account of the persistent decline of the dollar against the mark, the yen, or the Swiss franc. Nor do they recognize that much of the decline reflects differences in prospective real returns to investment.

The decline in the dollar is in part a measure of the market's judgment about the prospects for U.S. growth relative to growth elsewhere. Supportive evidence comes from investment decisions of domestic and foreign investors. Through most of the 1980s, foreigners wanted to invest here and U.S. investors found attractive opportunities at home. As recently as 1988 or 1989, the net flow of private capital to the U.S. was about $100 billion a year. For 1991 to 1993, the average is about $25 billion. Since the U.S. continues to run a current account deficit, it continues to borrow substantial sums abroad. Voluntary private lending financed the borrowing in the 1980s. In the 1990s, foreign government purchases of dollars, and recently currency depreciation, have become more important. For the 3-1/2 years ending in June, foreign central banks and governments -- mainly in Europe and Asia -- financed half our net borrowing. In 1993, the share was 70%. Preliminary data for 1994 suggest we have borrowed an additional $140 billion. Much of it came from foreign central banks.

Foreign and U.S. investors alike find more attractive opportunities abroad than at home. That leaves foreign central banks and governments three choices. They can buy dollars and increase money growth. They can let the dollar depreciate or, they can run budget surpluses and sterilize money inflows. The last choice would allow the U.S. to determine the domestic budget policy of foreign governments. Few countries will make that choice.

The remaining choices are inflation and currency appreciation abroad. Many countries have done some of each, and no doubt they will continue to do both. Countries like Argentina, Mexico or Hong Kong keep their currencies pegged to the dollar, so they buy whatever dollars come to them. Others pursue a mixed policy, choosing between faster money growth and currency appreciation. If these countries choose to avoid a new round of inflation, they will limit their purchases of dollars. Given our borrowing requirement, the dollar will depreciate over time against major currencies. The depreciation may not, probably will not, be a daily or monthly event. There will be both ups and down, but the long-term trend will continue.

This may seem to be an odd conclusion and one that runs against the popular belief that the U.S. has become more competitive. Whatever the overused term competitiveness means, higher productivity growth, corporate restructuring, NAFTA, higher growth abroad, and the real devaluation of the dollar have boosted exports and retarded imports. At some point, U.S. goods, assets and travel will be so cheap for foreigners that they will both buy more and expand investment here. And foreign goods, assets and travel will be so expensive that U.S. citizens will substantially curtail purchases and investments abroad. In the light of recent private investment decisions that, I suggest, reflect expected rates of return in the U.S. and other countries, the amount of further depreciation appears to be relatively large.

In my view, recent depreciation of the dollar is mainly a nonmonetary event. Federal Reserve policy can not correct for the real problems engendering depreciation. Raising market interest rates to support the dollar would bring a temporary appreciation that would last only until this mistaken policy brought on the next recession. Nor can we count on problems abroad, as in Mexico recently, to have a permanent effect on capital flows.

A second, long-term problem is related to the first. The U.S. is a chronic borrower in international markets, but it is not the only borrower. In fact, the world economy has many borrowers and few large lenders. The principal lender is Japan.

U.S. policy seeks to reduce the Japanese surplus. The administration encourages -- and at times demands -- that the Japanese spend more at home so as to reduce their surplus. This is as counterproductive and short-sighted as any policy can be. A lower Japanese surplus means less Japanese lending to us. Since Japan is the world's principal net lender, higher real interest rates would result. This would reduce investment here, and elsewhere, adding to our long-term problem of improving productivity by investing more in equipment, plant, and education.

The popular, current view of Wall Street economists and perhaps others is that market interest rates have been rising mainly because of fears of inflation. There is some prospect of higher inflation in the U.S. but, in my judgment, neither current nor future inflation can account for the simultaneous rise in interest rates on long-term bonds on all world markets. A better explanation, I believe, is that real interest rates have increased this year in response to the prospective additions to demands on world capital markets from developing and recovering economies. Higher real interest rates reduce some of these demands and slow economic growth here and abroad. I do not believe that current projections for world recovery and expansion in 1995 will be realized at current real interest rates.

Growth helps to solve many of the long-term problems of the U.S. and other countries. Better jobs at higher wages will not be realized without investment in capital and education. The widening spread between high- and low-income earners, and the slow growth of median income, that arouse so much political comment, reflect mainly differences in productivity growth for different parts of the population. A lasting change in the income distribution or a lasting increase in median income will require changes in relative productivity, hopefully achieved while overall productivity increases.

Discussion in Washington mainly concerns policies that shift income around without increasing -- and possibly reducing -- standards of living. The Clinton administration started with the usual redistributive rhetoric. The emphasis was on punishing those who earned the most in the 1980s, or taxing corporate profits and capital accumulation, while spending more for health care, welfare, and other transfer programs. Current talk in Congress and the administration is about increased family allowances or a middle class tax cut. Either of the two would stimulate consumption much more than investment. Whatever their political merits, these proposals do not address long-term problems.

To increase investment and productivity growth, the U.S. as a nation should be reallocating resources to remove the bias in favor of consumption not redistributing income. Increased real returns to investment in education and physical capital will not solve all social problems or even all our long-term economic problems. But the nation will be better able to pay for the promised social security and health benefits, to improve education, to build jails, and raise living standards if we start now to save and invest at a higher rate.

The tax program we should adopt, Mr. Chairman, is the program you have sponsored. It would tax consumption, not saving, and would raise the after-tax, expected return to capital. We should replace the income tax with a tax on consumed income, and allow new investment to be charged as an expense when it is put in place. We should begin to privatize social security, increase the retirement age at which full social security benefits are paid, reduce or repeal the corporate income tax, and increase competition in educational services.

Devolution of responsibility for some social programs to state and local governments is on its way. Devolution eliminates a layer of bureaucracy and recognizes that federal programs and federal rules have been ineffective and at times counter productive. Better programs may develop through competition between local or state governments and through experimentation. But the most costly current and prospective social programs -- social security, health care, and care of an aging population -- will not be solved in this way. These programs will require more resources, both private and public. The only way to avoid the social conflict that will follow attempts to increase greatly the redistribution from young to old now required to pay for past promises, is to increase the resources that will be available in the future. That will require increased attention to future growth -- more saving, more domestic investment, and better quality education for more of the population. The administration has taken a short-timer's view. I hope the Congress will help them to shift their focus and extend their vision.

Chairman DOMENICI Dr. Levy?

STATEMENT OF MICKEY D. LEVY, CHIEF FINANCIAL ECONOMIST, NATIONSBANC CAPITAL MARKETS, INC.

Dr. LEVY. Mr. Chairman and members of the committee, I appreciate the opportunity to present my views today.

I have several points. The first point is the strong rate of economic growth since mid-1993 has been due entirely to the Federal Reserve's earlier monetary stimulus and the healthy foundation provided by the private sector restructuring, while the thrust of fiscal policy has been misguided and has hurt economic performance.

Simply put, the Administration's tax hikes legislated by OBRA in 1993 reduced disposable income and lowered expected returns on investment. They did not deter consumption as much as they lowered private saving; this offset the deficit reduction so that there was little added to net national savings. Thus, effectively, the tax increase simply redistributed wealth from private savers to public uses. This contributed to a higher current account deficit and lower expected rates of return on dollar-denominated assets.

This is a perfect example of how a misguided analytical structure for deficit cutting could fail to achieve its economic objectives and also generate unintended side effects. I will come back to that in a moment.

My second point is the economy now is set to slow. I expect a deceleration of economic growth below 3 percent in the next four quarters and below 2 percent in 1996. Again, monetary policy plays a key role.

The probability of recession now is very, very low. I am just looking for a slowing. But a caution here: The Federal Reserve in the past has tended to continue to tighten until it sees clear evidence of the economy slowing. If it tightens too much now, the probability of recession in 1996 or 1997 rises a lot.

I would like to review the transmission process through which monetary policy affects the economy, suggesting the Fed's tightening will slow economic growth.

In the last year, bank reserves have declined, as have all inflation-adjusted measures of money, while the yield curve has flattened dramatically. Monetary policy always affects financial markets initially, and then the economy with a lag, and it is never a smooth process.

So when we consider major portfolio adjustments, the declines in the bond market, the collapsing European debt markets in early 1994, the unhinging of the mortgaged-backed market and derivatives, Orange County, and the peso crisis in Mexico—all are part of the transmission process through which monetary policy will affect the real economy. So the Fed must be cautious at this point.

Even as the economy begins to slow, we can expect some modest increase in inflation. Monetary policy affects inflation with an even longer lag. But I fully concur with Federal Reserve Chairman Greenspan that we are on the right track toward long-run stable prices.

Real, inflation-adjusted interest rates rose with the strong economic growth in 1993–1994, and the yield curve flattened with short-term interest rates rising faster than long rates as the Fed tried to tighten and constrain inflationary expectations. As the rate of real growth starts to subside in 1995, real rates will fall and the yield curve will start steepening again by short rates falling faster than long rates.

My next point stems from my forecast of slower economic growth; the implications for the Federal budget is the best news on the deficit is occurring right now. Stated differently, if you dissect the significant decline in deficits the last 3 years, it has been due to the reversal of the costs of the S&L bailouts, the legislated tax increases and the robust economic growth. Tax reform has been scant, consequently, the most important and challenging legislative issues facing this committee are yet to come.

In that regard, I would like to consider issues in macroeconomic policies. First and foremost, it is very important for the fiscal policymakers to recognize that fiscal policy is not a substitute for monetary policy. Even though the concept or the notion of changing the fiscal policy/monetary policy mix is very alluring politically, it makes no sense at all. Monetary policy and fiscal policies have very different impacts on short-run economic activity and long-run activity, and they are not interchangeable.

The second point, and perhaps the most important point I would like to bring forth to this committee, as it embarks on fiscal legislation, is when you think about fiscal policy, the objective should be to reform the tax and spending structures underlying the deficit in a way to create an environment conducive to long-run economic growth and increased standards of living. This involves much more than just reducing the deficit. And here I urge the committee to focus on the tax and spending structures and how they allocate national resources.

The way in which the deficit is reduced is more important than the magnitude by which it is reduced. I will go back to a point that Senator Lautenberg made when he questioned Chairman Greenspan on comparing a private corporation to the government. Whether a private corporation or the government, the key issue is not how much debt there is, but what the deficit spending is for. Is it achieving its objective? What is the rate of return on the resources relative to the cost of borrowing?

In this regard, this committee must address the uneven mix of Federal spending. Over the last couple decades, all of the rise in Federal spending and all of the rise in the deficit has been due to increasing spending on transfer payments. These have contributed to higher consumption, while at the same time government spending on investment-oriented activity has been squeezed.

This mix of deficit spending has several results. First, it reduces the long-term capital stock and it reduces national saving. Also, a transfer payment financed by a tax or debt merely redistributes a claim on those resources from the taxpayer to the beneficiary.

On the other hand, a government purchase directly absorbs that national resource. The key point is, insofar as all of the increases in spending have been for transfer payments, taxpayers are paying more and getting less direct government purchases of goods and services for the taxes they pay.

So my recommendations to this committee are to cut spending, to eliminate the tax bias against saving, and that means adopting a consumption-based tax. And when you talk about reducing the deficit, be very, very careful about how you do it, because the way in which you cut deficits is the whole ball game in terms of achieving favorable long-run economic performance.

Thank you.

Chairman DOMENICI. Thank you very much.

[The prepared statement of Dr. Levy follows:]

Economic Performance and Macroeconomic Policies

by
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Prepared for the U.S. Senate Budget Committee
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Mr. Chairman and members of the committee, I appreciate the opportunity to present my views on economic conditions and macroeconomic policies. From my perspective, while recent economic performance has been very strong--output and employment have grown rapidly, incomes are up, and inflation has remained moderate--these positive cyclical conditions will dissipate in 1995-1996, and significant reforms of fiscal and budget policies are necessary to sustain healthy economic growth and rising standards of living. A summary of my remarks are as follows:

- Economic growth has been robust in lagged response to the Federal Reserve's earlier monetary stimulus and the healthy foundation provided by the private sector restructuring, while the thrust of fiscal policy has been misguided and has hurt economic performance.
- Real GDP growth will slow in 1995 and decelerate below 2.0 percent growth in 1996, while inflation will rise modestly in 1995 and level off in 1996. Just as real interest rates rose in 1994 to reflect the strong economic growth, real rates will recede in 1995-1996 with moderating economic growth. Contrary to the Administration's allegations, interest rates have responded to economic activity, not the tax hike-generated deficit reductions.
- The Federal Reserve has tightened monetary policy appropriately in response to accelerating economic activity, consistent with its long-run goal of low inflation, and has built valuable inflation-fighting credibility. Monetary policy now is restrictive, based on sustained declines in bank reserves and real money balances. The Fed must be careful to not tighten much further, keeping in mind the lags between monetary action and economic outcomes. Its historical tendency has been to ignore those lags and tighten too much, generating recession.
- Fiscal policy remains in disarray and requires reform. This committee's focus should be on long-term objectives. The tax bias against saving must be reduced; this is vastly more important than a tax cut that would only fuel more consumption. Deficit spending on consumption-oriented transfer programs at the expense of investment-oriented activities must be reduced. Well-intended but structurally-flawed programs must be reformed.

- Fiscal policymakers must focus on the tax and spending structures and what they imply for the allocation of national resources and economic performance--both in the short and long runs--rather than deficit bean-counting. The way in which the deficit is reduced is more important than the magnitude by which it is reduced.
- The improvement in economic performance is in part a tribute to the flexibility of the private sector and its efficient restructuring. The public sector must now be restructured to sustain economic growth and rising standards of living. Corrective action is best taken in a healthy economic environment like the present.

I. Cyclical Conditions and Macroeconomic Policies

Real Economic Performance. Since mid-1993, economic performance has been very strong, with real GDP growth over 4.0 percent annualized, well above its 2.75 percent long-run trend, corporate profits robust, and inflation moderate. Real GDP growth is projected to moderate to approximately 3.0 percent in 1995, experiencing a marked slowdown in the second half of the year, and decelerate below 2.0 percent in 1996.

Following the gradual recovery, the acceleration in economic growth beginning in mid-1993 has benefited a broad array of sectors and industries. What began as a "productivity-driven" recovery characterized by industrial restructuring and highly visible job layoffs has evolved into an expansion with rapid job growth, historically high average workweeks, and healthy increases in personal incomes. In the last year, nonfarm payrolls have risen 3.1 percent, the fastest rate since 1988, and the unemployment rate has fallen to 5.4 percent, its lowest level in five years. Since mid-1993, real consumption has grown 3.4 percent annualized, with particularly strong sales of motor vehicles and household durables. Corporate profits and cash flows are rising rapidly and are at all-time highs.

Business fixed investment grew 12.0 percent annually in 1993-1994, rising as a share of GDP. Investment in producer durable goods equipment, particularly information processing equipment, has been robust, while investment in structures has stabilized after approximately seven years of adjustment. Business inventories remain low relative to sales and GDP. Investment in residential construction has begun to dip as housing activity is slowly subsiding in response to higher mortgage rates.

Two sectors have subtracted from GDP: government purchases and net exports. Government purchases have continued to decline with the ongoing federal defense downsizing.

Exports have grown rapidly, despite the earlier period of economic weakness among the U.S.'s major trading partners, and have risen as a share of worldwide exports. However, imports have increased more rapidly with the strong growth of domestic consumption. The widening trade deficit has suppressed GDP relative to domestic demand.

Inflation. Inflation has remained moderate, despite the strong economy. The CPI increased 2.7 percent in 1994, and shows scant signs of accelerating. While the PPI for crude goods has risen 17 percent and the PPI for intermediate goods has risen 5.1 percent in the last year, these pressures have not yet appeared at the consumer level. The implicit GDP deflator has increased a modest 2.3 percent, while the largest portion of the acceleration of nominal growth has been real output.

Rapid increases in productivity in the last year (2.2 percent in the nonfarm business sector and over 5.0 percent in manufacturing) and stable increases in employment costs have constrained unit labor cost increases to 0.9 percent, contributing significantly to the moderate inflation environment. While strong product demand growth (nominal GDP has increased 6.8 percent in the last year) has enabled certain industries to raise product prices, attempts to raise prices in other industries have not been successful.

Interest Rates. Real interest rates have risen in response to the strong economic performance and rising expected rates of return on investment, while the Federal Reserve has tightened monetary policy in an attempt to constrain inflation. As a consequence, typical of recent episodes of robust economic growth, short-term interest rates have risen faster than bond yields, generating a flatter yield curve.

The flattening yield curve, firm stock market amid the Fed tightening, and relative stability of gold prices are all indications that real rates have risen while the Fed's inflation-fighting credibility has grown. The Administration's contention that its 1993 deficit reduction (tax hike) package was the source of lower interest rates was greatly overstated; the low rates through most of 1993 primarily reflected weak economic growth and low inflationary expectations.

The Influences of Monetary and Fiscal Policies. The strong economic performance since mid-1993 has been attributable to the lagged impact of the Fed's stimulative monetary policy in 1992-1993 and the healthy foundation for expansion created by the positive private sector restructuring. Meanwhile, fiscal policy has remained misguided and has negatively influenced economic activity.

The excessive liquidity provided by the Fed's accommodative monetary policy and low real interest rates in 1992-1993 served initially to replenish the commercial banking sector and raise prices of financial assets. As the negative impact of some of the structural and noncyclical adjustments that had inhibited the pace of recovery began to unwind (including the defense downsizing, real estate adjustments, and financial balance sheet adjustments), aggregate demand picked up and economic growth accelerated. As the economic expansion has gained momentum it has taken on many of the characteristics of previous demand-driven growth spurts.

Fiscal policy has had a negative impact on the expansion, but it has been offset by the demand-driven tailwinds of monetary stimulus. The Administration's deficit-cutting package of 1993—comprised largely of tax increases--was fiscally restrictive in a cyclical sense and negative for long-run potential growth. The defense downsizing reduced real government purchases and subtracted from GDP, particularly in 1992-1993, when the economy was struggling to recover.

The Administration's argument that tax increases stimulate growth by lowering interest rates was simply political, without economic merit or empirical support. Deficit reduction was largely offset by lower private saving, constraining the increase in net national saving, while the higher taxes on income and capital reduced disposable income and expected rates of return on investment. The higher tax/lower deficit package effectively reallocated private saving to consumption-oriented public uses, contributing to the widening current account deficit and reducing expected rates of return on U.S. dollar-denominated assets relative to assets denominated in foreign currencies. This is a perfect example of how misguided deficit-cutting can fail to achieve its economic objectives while generating unintended negative side effects.

The Monetary Transmission Process. The Fed's monetary policy is now appropriately restrictive, and the unpleasant financial market responses to the Fed's tightening in 1994 have been integral to the transmission process through which the monetary restrictiveness will slow the economy. In the last year, the Fed's hikes in the federal funds rate has involved a 2.4 percent decline in bank reserves and declines in all narrow monetary aggregates in inflation-adjusted terms, their first declines since early-1989. Reflecting the monetary tightening, the yield curve has flattened significantly. All of these have been precursors to recent economic slowdowns and recessions.

Periods of monetary tightening are never pleasant or smooth for financial markets, and the current episode is no different. In 1994, the bond market turned in its worst performance in decades. Sizable portfolio adjustments involved net declines in stock and long-term bond funds, and a rise in short-term money market funds and bank CDs. Bank margins were squeezed as strong loan demand raised bank demand for Eurodollar deposits and lowered demand for government securities. More jarring events included the dramatic deterioration of the European debt markets, the unhinging of the mortgage-backed securities market, huge investors' losses in derivative products, the Orange County calamity, and collapsing currency and debt markets in Mexico and other emerging markets. All of these events are part of the transition between monetary tightening and economic slowdown. Just as the rapid monetary expansion and lower interest rates in 1991-1993 have been the primary factors generating the recent robust economic growth, the Fed's tightening and draining of liquidity will slow growth.

The Outlook for Economic Performance and Financial Markets. Signs of an economic slowdown should emerge by Spring 1995, with GDP growth moderating to 2.5-3.0 percent in the second half of this year, and then decelerating below 2.0 percent growth in 1996. In light of the underlying structural soundness of the economy, chances of recession in 1995 or 1996 are low. However, the longer the economy remains strong and the more the Fed tightens in response, the higher is the probability of a more severe cyclical slowdown or recession unfolding in 1996-1997.

Virtually every sector in the economy presently exhibits strength, but this is not unusual in the mature stage of a cyclical growth spurt. In each recent instance when the Fed has reduced the money stock and the yield curve has flattened dramatically, a slowdown has always followed. Typically, the first signs of economic slowdown appear in consumption of durable goods and housing activity. Initially, GDP growth and employment are relatively unaffected, as the slowdown in final sales is offset by unintended inventory building. However, as businesses lower their expectations of product demand, production schedules are cut back over the next several quarters to achieve lower desired levels of inventories, and this involves decelerating growth of GDP and employment.

That same pattern is expected to unfold this year, as real consumption has exceeded its long-term trend and business inventory building has been very rapid since second quarter 1994. The net export sector will provide a buffer against weaker domestic sales. Real exports, which have grown 12.0 percent in the last year, should remain robust with the strengthening economies in industrialized nations and the weak U.S. dollar, while import growth will decelerate with the moderation of domestic demand. Consequently, the trade deficit will decline and GDP growth will slow by less than domestic demand.

In past episodes of monetary tightening, the Fed continued to tighten until clear signs of economic slowdown emerged. Because monetary policy always affects the real economy with a lag, most recent efforts to achieve a soft landing have proved elusive, as excessive monetary restraint has slowed the economy more than desired.

Inflation tends to lag real economic activity, and modestly higher inflation is projected in 1995, even after economic growth slows. The CPI is projected to rise modestly to 3.5-3.75 percent in 1995 and 1996, before beginning to recede thereafter.

So far in this expansion, the largest portion of nominal GDP growth has been growth in real output, while inflation has not accelerated. Now, with capacity utilization relatively high and the unemployment rate low, pressures on unit labor costs and inflation should begin to mount, and a rising portion of current dollar spending will be inflation. Thus, whereas the 6.8 percent rise in nominal GDP in the last year comprised 4.4 percent real growth and a 2.3 percent rise in the implicit GDP deflator, a slowdown of nominal GDP to 6.0 percent in 1995 may involve 2.75 percent growth in real output and a 3.25 percent rise in the deflator. Consumer prices would rise somewhat faster, reflecting the composition of the CPI.

Real interest rates will recede with moderating economic growth. The most significant impact should be on shorter-term securities that have built in expectations of substantial hikes in the federal funds rate. Bond yields should not fall as much, generating a steepening yield curve. While slower economic growth should ease inflation fears, lingering inflation pressures should limit declines in bond yields. This would reverse recent interest rate trends that have accompanied the strong economy.

II. Implications for the Federal Budget

Under current law, the best news on the federal budget is occurring now. As robust economic growth slows, deficits will rise and the budget's structural problems, mostly involving entitlements, will become more apparent.

No question, there has been significant deficit reduction. The deficit will be less than net interest outlays in Fiscal 1995 for the first time since 1989. But there has been little reform of the structural flaws in tax and spending structures that influence long-run economic performance. Consequently, the hardest and most important legislative challenges remain ahead.

The deficit reduction from its peak of $292 billion in FY1992 to about $180 billion in FY1995 is due to 1) the reversal of government spending for the S&L bailout--those outlays, which peaked at $66.1 billion in FY1991, have shifted to negative outlays since 1993 as the RTC has disposed of assets, 2) the tax hikes legislated by the Omnibus Budget Reconciliation Act of 1993 (OBRA93), and 3) robust economic growth.

Actual budget improvement has been overstated, and the cyclically-adjusted deficit remains high. Tax receipts have accelerated while total spending (excluding the impact of deposit insurance) has continued to rise rapidly. While defense outlays have declined since 1990 and spending on discretionary programs has increased only 2.1 percent annually--a reduction in real terms--spending on so-called mandatory programs has soared, led by double-digit annual increases in Medicare and Medicaid and persistent inflation-adjusted increases in social security.

Also, misguided policies, resulting from politically-motivated deficit reduction efforts, have actually widened the budget imbalance. The Administration's 1993 decision to alter the Treasury's debt management strategy and shorten the duration of government debt was an attempt to lower deficit projections. That short-sighted decision, effectively betting that short-term interest rates would stay low, has backfired, and is proving costly to taxpayers. Net interest costs and their projections have been revised up significantly, uncertainty is higher, and pockets of illiquidity have emerged in certain maturities of the U.S. Treasury and zero coupon markets.

As less favorable economic conditions unfold, the budget imbalance will widen, and the structural deficit will become more apparent. The deficit will rise sharply in 1996, to roughly $215 billion. This will occur primarily as the cyclical slowdown in employment and incomes dampen tax receipts, to approximately 5.5 percent growth from an average of 8.6 percent in 1994-1995. Under current law, the budget imbalance can be expected to widen continuously in later years, even if the economy expands along its long-run trendline.

These adverse budget trends will increase the pressure to cut deficits and make more apparent the structural flows of current tax and spending legislation. They will also move us further from achieving the objectives of balanced budget proposals.

III. Issues In Macroeconomic Policies

This Federal Reserve, perhaps more than any recent Fed, seems fully committed to the objective of low long-run inflation as a necessary foundation for sustained healthy economic expansion. Congress should fully support the Fed's pursuit of this objective. The purpose of the Fed's monetary tightening in response to strong economic growth is not to shut down growth, but rather to create an environment conducive to sustained expansion by keeping inflation low. High inflation is inconsistent with sustained expansion.

This committee must conduct its budget and fiscal policy with full recognition that monetary and fiscal policies have vastly different impacts, each with its own limited capabilities. Monetary and fiscal policy should not be considered substitutes; the politically alluring notion of adjusting the "policy mix" is without economic merit and always leads to poor macroeconomic policies and undesirable economic outcomes.

Monetary policy may permanently shift aggregate demand but is incapable of raising long-run output; accordingly, it may have a temporary impact on real economic activity but in the long-run only affects inflation. In contrast, fiscal policy is incapable of generating a permanent shift in aggregate demand, but instead alters the allocation of national resources between public and private uses, and influences long-run potential output by altering incentives to consume, save and invest. Previous attempts to use fiscal policy as a countercyclical tool to achieve short-run objectives have generally failed and been discredited.

The most pressing task facing fiscal policymakers is to reform tax and spending programs with the broad objective of creating a fiscal environment conducive to healthy sustained economic expansion, job creation, and rising long-run standards of living. Fiscal policy involves much more than the deficit. The allocative affects of tax and spending structures are as important, if not more important. Presently, there is a right way and a wrong way to address the deficit issue. While artificial deficit targets may be required for political discipline, meeting them can cause more harm than good if doing so involves resource misallocation that dampens economic performance.

The current tax and spending structures are inconsistent with long-run economic objectives in several regards. First, the increasingly uneven mix of federal spending, with a rising share for transfer payments, allocates too much national resources toward consumption while discouraging saving and investment. This lowers the future capital stock.

Mandatory spending programs, including social security, Medicare, Medicaid, other retirement and disability and the various welfare programs, presently comprise 55 percent of all federal spending, up sharply from below 45 percent in the 1980s. Since 1990, their spending has risen four times faster than spending on discretionary programs (domestic, international and defense), which are shrinking in real terms and as a share of national output. Under current law, those trends continue.

This mix of spending has important implications for economic performance, quite independent of the deficit issue. Whereas government purchases of goods and services such as defense, infrastructure, transportation, natural resources, as well as state and local purchases for education, police, etc., directly absorb national resources and affect economic performance, transfer payments redistribute claims on resources from taxpayers to beneficiaries and have significant indirect impacts on economic performance through their influences on decisions to work, save, and invest. In particular, the rising tide of transfer payments that redistributes income from savers and investors toward consumption-oriented activities has had a significant and cumulative depressing effect on long-run potential growth.

The magnitude of the shift in this fundamental role of the budget is striking. In recent decades, more than 100 percent of the rise in federal spending and deficits has been attributable to the rise in transfers, while the government's direct absorption of national resources has been declining in real terms. That means that taxpayers are receiving fewer and fewer goods and services from the government for the taxes they pay, while a larger portion of their taxes are redistributed through transfer programs. This redistribution reduces national saving and investment while adding to consumption.

Secondly, the tax system is biased against saving and investment, constraining national saving and reducing productivity. Higher taxes on income imposed by OBRA93 raise the double taxation on saving and reduce expected after-tax rates of return on investment. No wonder national saving is so low.

Thirdly, specific tax and spending programs discourage work effort and labor force participation, in addition to being poorly designed in terms of their intended objectives. As a result, current budget and fiscal policies suppress economic performance and long-run standards of living. The list of programs that are wasteful, generate inefficiencies, are poorly designed is long and costly.

As the basis for fiscal reform I suggest the following rules of thumb:

- The tax bias against saving and investment should be reduced. This involves reducing the double taxation on saving, most preferably through substituting a consumption-based tax for the income tax. Separate taxation of income from capital must apply only to real earnings; that is, the basis for taxation of capital gains must be adjusted for inflation.
- Deficits should be cut largely through reductions in spending.
- The rising share of budget outlays for transfers and the falling share for investment-oriented activity must be halted. Most obviously, no serious plan to close the budget imbalance can exclude slowing the growth of spending on nonmeans-tested entitlements, including social security, other retirement programs and Medicare. All other budget categories have been pared, including defense, domestic discretionary, and many of the means-tested entitlements. Social security admittedly is a political tinderbox, but excluding it from budget cuts heightens the difficulty of reducing the budget imbalance, requires deeper cuts in other programs and creates more inefficiencies, and only postpones necessary reform. In this regard, the budget committee must recognize that the budget process itself reinforces the spending mix bias: under Gramm-Rudman, social security was excluded from sequestration; presently, OBRA93 allows higher spending on entitlements if they do not raise deficits (pay-as-you-go), while discretionary programs face increasingly stringent, binding caps on spending. This bias must be overcome.
- Social security involves long-term budget issues as well as issues of intragenerational and intergenerational distribution, so its reform must be long-sighted and fair. Corrective legislation that is phased in ten years from now would provide older workers sufficient time to adjust, but would still be timely in addressing social security's long-run financing dilemma. In this regard, as the budget deficit rises in the next several years, it will be inappropriate to consider major structural reforms to achieve short-term budget objectives. Current proposals to adjust the CPI are a measurement issue, not a reform issue.
- Correcting the structural flaws in spending programs, concentrating on how changes in the budget allocate national resources, both directly and through (dis)incentives, and eliminating wasteful government activities, are as important as the magnitude by which deficits are cut in terms of achieving long-run economic objectives.

I would be pleased to assist this committee in pursuing these budget and economic objectives.

Chairman DOMENICI. Dr. Wyss?

STATEMENT OF DAVID A. WYSS, RESEARCH DIRECTOR, DRI/McGRAW HILL

Dr. WYSS. Thank you, Senator Domenici.

The economy is now fully recovered from the 1990–1991 recession. But with an unemployment rate of 5.4 percent and growth of 4.4 percent over the last four quarters, I am afraid this is about as good as it gets. We are really at an unsustainable pace of growth, and I expect the economy to slow down over the course of 1995, if, for no other reason, that the Federal Reserve will keep raising rates until it does. I think they are right to do so.

Right now, the slowdown looks like it is coming on schedule. In the past, it has taken an average of 13 months between the time the Fed started to tighten and the economy hit its cyclical peak. The Fed started to tighten last February, and we would expect to see the peak of this economy in March based on that historical average. The slowdown should begin in the second quarter of the year.

So far, we think that it is going to be what the Fed calls a soft landing, that they are going to slow the economy without causing a recession. However, my worries about recession are rising, and they are rising for a very simple reason. If you look at past soft landings—and there have been only two successful soft landings in the post-war period, 1966 and 1986—in both cases you had a major sector moving against the slowdown, which was cushioning the soft landing. In 1966, of course, that was military spending with the buildup to Vietnam. In 1986, it was trade after the dollar took its dive in 1985.

In 1995, we had hoped that the cushion would come from trade again. That little air cushion may have sprung a leak, however, from Mexico. With the collapse of the Mexico peso and the possible collapse of the Mexican economy, our forecast is that, even if this is contained, it will cost the United States about .4 percent off GDP in 1996 and about 350,000 jobs. If it is not contained and if it spreads to the rest of Latin America, those estimates could easily be doubled.

And that makes me worry about a recession, especially when you combine it with the usual reluctance of the Federal Reserve to stop tightening until they see the whites of the slowdown's eyes and a reluctance to start loosening when it does actually slow down.

The question is whether the Fed right to be slowing the economy. At this point, we see no evidence that this economy is capable of sustaining more than 2.5 percent growth or capable of operating at much below a 5.75 percent unemployment rate. Productivity growth during the first 3½ years of this economic expansion has been below the average of the last four economic recoveries. There is no productivity revolution going on.

Real investment has been normal. It has been rising at double-digit paces for the last 3 years, but that has happened in every economic expansion. I do not see any sign of a revolution that would allow us to operate at a higher pace than we have been doing.

What happens next. I think one of the best things we could do to help the long-term growth of this economy is to get the budget back under control. Like a lot of economists, I used to oppose a balanced budget amendment, because it is not the best way to run the government. We ought to allow some room for borrowing and some room for running surpluses. But even though it may not be the best way to run the government, I think it is a better way to run the government. As a result, I have come around to believing that the balanced budget amendment is probably the best thing we can do.

Economically, balancing the budget is not a problem. Frankly, as far as the macroeconomics is concerned, it is easy to offset a tighter fiscal policy with a more accommodative monetary policy. You do not have to get any real increase in the unemployment rate. In the long term, the increased investment that you get and, in my view, with the right tax changes, the right spending changes, the increased labor force that would result, could raise real output over the next 10 years by as much as 1.5 to 2 percent. That is not an insignificant amount of money.

The cuts needed can be made. In our simulation, by reducing the spending numbers that we have in the budget, we were actually able to balance the budget by the year 2002, with the same unemployment rate and a higher level of real income and a higher level of employment. It does require pulling out a lot of stops and being willing to cut a lot of programs. But the side advantage you get from it is that over half of the deficit cuts that we made were accounted for by lower interest payments, as interest rates came down and as the level of debt was lower at the end of that 7-year period.

If the budget is not balanced, we do not stay where we are. It gets worse. Budgets will continue to suffer, as interest payments rise as a share of total government spending. The longer you continue to run deficits, the harder the problem becomes to solve.

Thank you.

Chairman DOMENICI. Thank you very much.

[The prepared statement of Dr. Wyss follows:]

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The Economic Outlook for 1995:
The Impact of Balancing the Budget

Prepared by:
David A. Wyss
Research Director

Testimony before:
United States Senate
Committee on the Budget

Washington, D.C.
January 26, 1995

Mr. Chairman, Senators, and fellow taxpayers:

The economy has now fully recovered from the 1990/91 recession. At 5.4% in December, the unemployment rate is below the full employment level, and at 4.4% over the last four quarters, GDP growth is well above the 2.5% we believe can be sustained in the long run. The economy should and will be slowed over the coming months.

The Federal Reserve has been applying the brakes to the economy since last February. We believe that the slowdown is coming on schedule. An analysis of the postwar cycles shows that the economy has reached its cyclical peak an average of 13 months after the Fed began to tighten. This would imply the peak will be reached this March, with the slowdown or recession beginning in the second quarter. The variation around this timing has been about six months, suggesting the latest the slowdown is likely to appear is September.

Fed Tightening Versus Economic Slowdown

Interest Rate Trough	Beginning of Final Tightening	Economy's Cyclical Peak	Lag (Months)
January 1952	November 1952	July 1953	8
June 1955	August 1956	August 1957	12
June 1958	March 1959	April 1960	13
July 1964	December 1964	February 1966 *	14
June 1967	December 1968	December 1969	12
February 1972	June 1972	November 1973	17
December 1978	July 1979	January 1980	6
June 1980	July 1980	July 1981	12
June 1985	**	February 1986*	7
October 1986	May 1988	July 1990	26
September 1992	February 1994	February 1995	12
		Mean	13

* Not official NBER peak, but growth peak.
** No significant tightening.

The question of timing is related to the more serious question of recession. The Fed is trying to manage a soft landing; that is, the Fed is trying to slow the economy to trend or below without creating an economic downturn. In the postwar era, the Federal Reserve has managed only two successful soft landings - in 1966 and in 1986. We believe they are on a path to make 1995 the third success, but the historic odds suggest otherwise. The fear is that stronger growth in early 1995 will induce the Fed to continue to tighten too long, and turn the soft landing into a recession.

The two successful soft landings were the midpoints of the two longest expansions in our history. In both cases, the year-long slowdowns gave the economy some breathing room, and permitted another cycle. In effect, the 1960s and the 1980s were two back-to-back cycles, separated by a "growth recession" (which is what we used to call a soft landing) instead of a recession. The U.S. economy has never gone more than five years without either a recession or a growth recession.

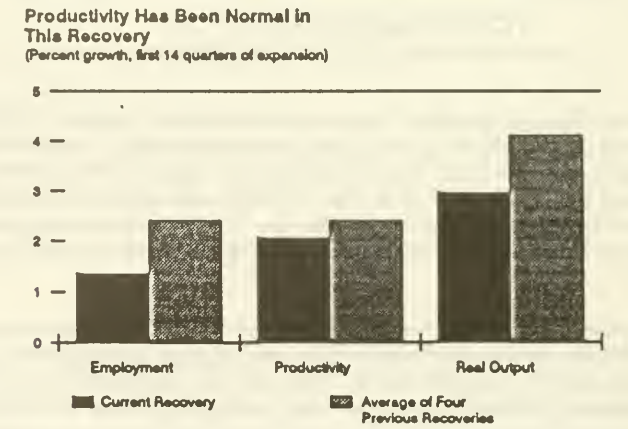
Are we growing too fast?

We believe that the current economic strength is unsustainable. In the past, inflation has begun to accelerate whenever the unemployment rate has fallen below the non-accelerating rate of unemployment (NAIRU, a/k/a "natural rate" or "full employment rate"). The last time the unemployment rate fell below the NAIRU, in the late 1980s, the consumer price index accelerated from 2% in 1986 to 5% just before the 1990 recession.

There is no reason to believe that the world has changed significantly. As yet, there are no significant signs of wage inflation, but there shouldn't be for another few months. There are some early signs in commodity markets and in some manufactured goods, notably paper, chemicals, and nonferrous metals.

On the wage front, the first signs of inflation will appear at the bottom of the income ladder. Higher-paying employers will reach downward to lower-qualified workers rather than raise wages. This has already begun in the areas of the country where labor markets are tightest. The upward move of workers leaves the lowest-paying jobs unfilled, and the first signs of wage pressure are always the proliferation of "help wanted" signs at retailers and fast-food outlets.

We see no sign of any "productivity revolution" that would allow more rapid growth or lower unemployment. In the first three and one-half years of the current economic expansion, productivity growth has been slightly below the average of the last four economic recoveries (excluding the 1980 recovery, which lasted only a year). Productivity has been a higher percentage of total growth during this expansion, but that is almost inevitable because of the slower growth of the labor supply in the 1990s. Total output is employment growth plus productivity growth, so if employment is rising more slowly (echoing the "baby bust" of the 1970s), productivity will be a higher share of growth.



Similarly, there has been no revolution in investment. In nominal terms, investment in the current recovery has risen less than in any of the past four expansions. In real terms, the rise looks large only because of the over-weighting of computers. When we look back on the last three years using 1992 rather than 1987 prices, the period will be revealed as weak, not strong, for equipment spending.

We expect GDP to rise by about 2.5% in the 1990s, about the same as it did in the 1970s and the 1980s. The pattern of growth will shift, however toward stronger productivity growth (1.5%) balanced by weaker employment growth (1%). The weaker employment growth reflects the slow growth of the working-age population in the 1990s.

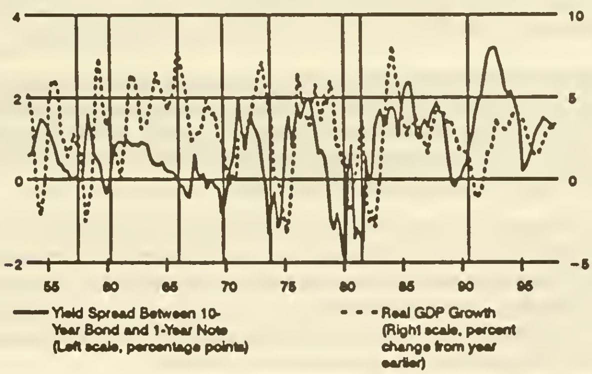
The risk of recession

Whenever the Federal Reserve is trying to slow the economy down, the risk of recession rises. The recession can come not only because of miscalculation by the Fed, but also because the economy becomes vulnerable to exogenous shocks. These outside shocks can turn slow growth into recession, while during a period of stronger economic momentum, they can be ridden through.

The immediate fear is that the Fed will tighten for too long, and be too slow to reverse course when the economy softens. This has been the history of the business cycle; the worry is not that the Fed does too little, too late, but rather too much too late. Since World War II, the Fed has successfully hit only two soft landings; there have been nine recessions.

We believe that the economy will slow in 1995, if for no other reason than that the Fed will keep tightening until it does slow. The risk is that the Fed will tighten for too long, and this risk rises the stronger the economy is in early 1995. The weak retail sales data in November and Decem-

An Inverted Yield Curve Leads Recessions



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ber increase the chances that the Fed will ease off in time. On the other hand, the unusually good December and January weather could boost employment and production, and induce the Fed to overreact.

We expect the Fed to tighten again February 1, the end of the next FOMC meeting. I do not think the next tightening is overly dangerous, but we are getting close to the line between slowdown and recession.

One danger signal is the slope of the yield curve. Before all nine of the postwar recessions, the yield on ten-year Treasury notes has fallen below the yield on one-year bills. A year ago, ten-year yields were over two percentage points above the one-year. In early December, that spread fell to only 0.25 percentage point. It has since widened, but a repeat of the bond rally that came after the November Fed tightening could cause inversion. Only once has the yield curve inverted without recession - just before the 1966 growth recession.

How to hit a soft landing

In both of the successful soft landings, a major sector of the economy was moving "against the flow." This strong sector cushioned the decline in the private domestic economy, and prevented the slowdown from turning into a recession. In 1966, for example, it was the military buildup in Vietnam that cushioned the soft landing. In 1986, the surge in exports that followed the drop in the dollar in 1985 provided the support.

In 1995, the cushion is again expected to be foreign trade. Europe and Japan are recovering after three years of recession, and their growth will boost the demand for our exports. Unfortunately, the collapse of the Mexican peso and the recession that now seems likely in that country could offset most of that boost. Our revised Mexican forecast has cut 0.4% off U.S. real GDP by mid-1996, and cuts 350,000 jobs out of the economy.

Japan could be a slight counterbalance to Mexico. The earthquake will increase GDP in Japan, because of the necessary reconstruction work. Since lumber and other building materials are major U.S. exports to Japan, our sales in those industries will improve. The question is whether we have enough spare capacity, especially in the Northwest, to provide these exports. With a weaker housing market due in 1995, however, we believe the lumber will be available.

Other weaknesses in the economy look modest. The housing cycle, the most interest-sensitive part of the economy, should not fall as sharply as it normally does. The 1994 housing boom was only moderate, and multi-family housing has remained very soft because of the overbuilding of the 1980s. The lack of a boom means that supply is not ahead of demand as much as usual at the peak of a cycle, which should limit the downturn.

Inventories are becoming the major worry. The weak Christmas retail sales and the heavy inventory stocking during the pre-Christmas season suggests that inventories are too high at the beginning of 1995. First-quarter accumulation is also likely to be substantial. The inventory-sales ratios still look moderate, and we are forecasting only a slowdown in accumulation rather than destocking. A more severe inventory cycle, perhaps induced by heavier-than-expected stocking in the first half of 1995, could turn the slowdown into a recession

Balancing the budget

A balanced budget would be a major boost to the long-term growth of the U.S. economy. In the short run, of course, lower government spending or higher taxes would slow the economy. The trick is to balance the tighter fiscal policy with lower interest rates.

Over a five-year period, this can be done with few problems. Today, when the Fed is trying to slow the economy anyway, would be a good time to start. Balancing the cuts would require real interest rates to drop to their lowest levels since the 1970s. The problem is that the Fed and the financial markets would have to have the faith that the budget responsibility would continue, or they would be afraid to loosen this much.

The politics of balancing the budget is more difficult. Relying on spending cuts alone would require the use of virtually every cut examined by the Congressional Budget Office in its recent options book. This would include cutting the indexation of social security and other pensions, either explicitly or by redefining the consumer price increase. All these programs taken together could balance the budget by 2002.

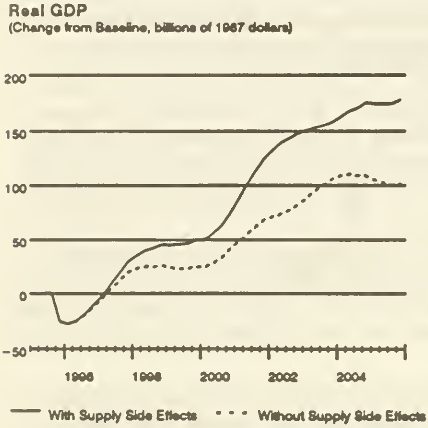
If the supply side of the labor market were stimulated, the process could be speeded up. The three measures we examined were: requiring welfare recipients who are able to work to do so, eliminating the marriage penalty in the tax law, and increasing the limit on the earnings of welfare recipients. These three changes might add as many as 2.5 million workers to the labor force by 2000. Although these workers would be significantly less productive than the average American worker, output could be increased by as much as one percent, permitting the budget to be balanced two years ahead of schedule.

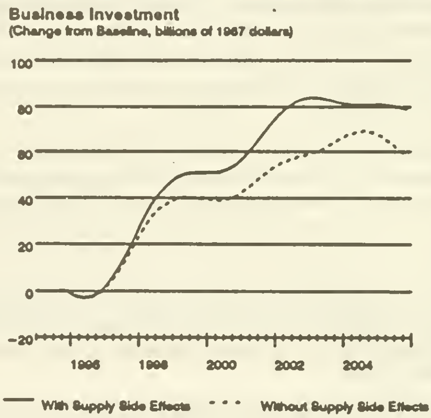
The positive elements of balancing the budget become clear in the longer run. The elimination of the deficit would relieve strain on financial markets, allowing lower interest rates and bond yields. The lower interest rates and reduced borrowing would cut interest costs for the federal government; in fact, by 2002 half the savings in our budget simulations come from lower interest costs.

The lower interest rates encourage private investment, as the federal government ceases to be a drain on investible funds. By 2002, real nonresidential investment could be 4% to 5% higher than with a stable $200 billion deficit. Employment could be up by 2.5 million people, absorbing all the additions to the labor force.

A correctly balanced policy could do this with little macroeconomic pain. The microeconomic adjustments would be significant, however. Recipients of government programs, and today that increasingly means the elderly, would have their benefits cut - or at least not increased. Tax deductions would be reduced, broadening the base of the tax system. Medical costs would have to be controlled. The political process needed to effect the balance would be difficult, but in the long run the sacrifice would pay back the costs, with interest.

If the budget is not balanced, problems increase. The drain on investible funds will further slow productivity growth, and the higher debt and interest costs will further constrain fiscal policy. We would not have a significant deficit problem today were it not for the deficits of the last twenty years. Interest costs now account for 14% of federal spending, and that ratio will continue to rise.





Dynamic budgeting

The issue of dynamic budgeting is clearly critical to this exercise. On a static basis, the cuts are not enough to balance the budget. Only when the secondary impacts of the higher labor force, lower interest rates, and stronger investment and productivity growth are considered does the program succeed. Clearly, dynamic budget estimation is needed to get accurate estimates of the impact of policy shifts.

The problem is that dynamic budgeting is so subject to exaggeration and distortion. It is easy to promise excessive policy impacts, but hard to deliver them. The 1980s were full of supply-side promises that lower taxes would raise revenue and balance the budget; they didn't.

I would prefer that Congress be very conservative in its estimates of secondary impacts. Further tax cuts can always be given if stronger revenues appear. Raising taxes or making larger spending cuts is more difficult.

Dynamic budgeting cannot be used as a shield from the need for budget discipline. Used correctly, it can give better measures of policy changes. Used aggressively, it can permit irresponsible fiscal policy.

Synopsis of the Economy

The strong November employment report and upward revision to third-quarter GDP suggest the economy has more momentum than we believed a month ago. The unemployment rate, at 5.6% in November, is clearly below almost all estimates of the non-accelerating inflation rate of unemployment (NAIRU). The Federal Reserve will brake the economy even harder until it slows.

The forecast is stronger in the near term. Slower growth does not appear until next spring, with most of the slowdown now in the second half of 1995 rather than in the first half. Since the rise in interest rates thus far has not slowed the economy, the Fed will raise them even more until they begin to bite. The typical lag of nine to 12 months between the tightening and the impact on the economy suggests a late-1995 slowdown, since the bulk of the tightening came in the second half of 1994.

Consumers are continuing to spend during the early Christmas season, although debt is becoming a bit worrisome. Car sales are the major swing item. We expect sales to remain firm into early 1995, but then to slow. The baseline forecast is for stable light vehicle sales in 1994 and 1995, above 15 million units.

Business investment remains strong, but orders are beginning to weaken once computers are excluded. The price war in computers is boosting real spending, but nominal purchases appear to be slowing a bit even here. Nonresidential construction was revised upward in the third quarter. Overall, we look for continued investment growth in 1995, but at a slower pace than in 1994.

Housing starts dropped in October, but the good weather thus far in November and December should boost starts, at least on a seasonally adjusted basis. We expect only a marginal decline in residential construction in 1995.

Inventory accumulation was revised lower in the third quarter, but the recent pace of accumulation cannot be maintained. There is no reason to expect destocking, however, since the inventory/sales ratio remains low.

Government spending will be weak in 1995. Federal purchases of goods and services jumped sharply in the third quarter, as agencies attempted to spend their appropriations before they expired with the 1994 fiscal year. Spending will drop sharply in the fourth quarter from the artificial third-quarter peak. State and local governments are also under budget constraints. Although their spending is not likely to fall, neither will it rise very sharply.

The **trade** gap is expected to widen in nominal dollars in 1995. Although real exports will be strong, responding to the stronger growth in Europe, imports are still rising rapidly. Moreover, the terms of trade have turned against the United States, as higher commodity prices and a weaker dollar in 1994 raised import costs.

Employment remains strong with the unemployment rate, at 5.6%, below most estimates of the NAIRU. Our estimate of the NAIRU has been revised downward, however, because of new studies indicating that the difference between the old and new survey methodologies was overstated. We now believe the gap is only 0.2 percentage point between the two techniques.

The Federal Reserve is still struggling to slow the economy. We expect another percentage point on the federal funds rate, perhaps in one move at the January 31/February 1 FOMC meeting. Bond yields have dropped over the last month, suggesting that the market now expects the economy to slow markedly during the coming year. We expect one more rise in yields because some bad news seems bound to appear, but it is possible that the rise is over.

Inflation remains under control. The unemployment rate is only slightly below our new estimate of full employment, suggesting only a mild acceleration in wages. The slower growth in the U.S. economy will restrain any acceleration in inflation, holding consumer price inflation under 3.5%.

The **dollar** has recovered slightly from its summer lows. We expect the dollar to continue to gain through early 1995, especially against the Japanese yen.

The **risk** that growth will be stronger than expected in the short term, and that the Federal Reserve will tighten more sharply, is rising. In the boom-bust scenario (probability=25%), the higher interest rates will force a recession in 1996. Stronger productivity growth and a more confident consumer could permit the economy to grow more rapidly while inflation remains in check. This optimistic alternative (probability=10%) requires that the Fed accept the higher growth without raising interest rates. A stall in the economy also remains possible, although its probability may be diminishing. A weakening of consumer confidence and more pessimism on the part of business could cause the economy to fizzle out (probability=10%).

DRI/McGraw-Hill Forecast for the U.S. Economy: CONTROL0195

	1994			1995				Years				
	2	3	4	1	2	3	4	1993	1994	1995	1996	1997
Composition of Real GDP (Annual percent change)												
Gross Domestic Product	4.1	3.9	3.4	3.2	1.2	1.1	1.3	3.1	4.0	2.9	1.7	3.1
Final Sales	1.8	4.2	3.8	3.0	2.3	2.2	2.3	2.8	3.3	2.8	2.3	2.8
Gross National Product	3.7	3.7	3.4	3.1	1.1	1.1	1.4	3.1	3.8	2.5	1.9	3.1
Total Consumption	1.3	3.3	5.5	3.3	1.5	1.9	1.5	3.3	3.5	2.9	1.8	2.8
Nonresidential Fixed Investment	9.2	14.4	10.9	10.3	8.7	9.0	2.8	12.6	13.2	8.4	2.7	4.1
Producers' Durable Equipment	8.2	17.9	10.0	9.9	9.4	4.9	1.8	16.0	16.9	9.1	2.2	5.6
Office and Computing Equipment	9.9	14.9	29.5	24.3	21.3	18.3	12.1	51.7	26.7	21.0	11.1	15.8
All Other Equipment	4.9	19.1	3.4	3.2	4.8	−0.5	−2.9	9.9	13.6	4.6	−1.7	0.8
Private Nonresidential Structures	20.3	3.1	12.9	15.5	8.2	10.0	8.3	−1.4	2.2	10.8	4.7	−0.7
Buildings	24.9	2.9	15.8	18.3	5.4	11.3	7.7	−1.3	3.7	12.1	8.1	−2.1
Residential Fixed Investment	7.0	−4.5	−0.8	−1.8	−3.4	−7.1	−4.4	8.2	8.3	−2.8	−0.5	8.4
Exports	16.8	12.2	6.3	4.7	5.4	7.1	7.0	4.1	7.8	7.0	7.0	8.4
Imports	19.9	15.6	7.8	8.9	4.9	4.8	0.9	10.7	13.1	8.2	3.3	5.5
Federal Government	−7.8	12.5	−14.9	−3.5	−1.5	−1.2	−1.1	−4.5	−6.2	−3.4	−1.2	−3.1
State and Local Governments	2.9	4.3	3.5	4.2	4.1	4.0	3.1	1.7	2.2	3.9	2.8	2.8
Billions of Dollars												
Real GDP (1987 $)	5314.1	5365.0	5409.6	5451.8	5467.9	5482.3	5500.0	5134.5	5337.5	5475.5	5570.0	5742.8
Gross Domestic Product	[illegible]	6788.5	6879.2	6978.1	7035.3	7094.9	7166.7	6343.3	6732.8	7098.2	7361.4	7778.8
Prices and Wages (Annual percent change)												
GDP Price Deflator (Implicit)	2.9	1.9	2.1	2.7	2.1	2.3	2.2	2.2	2.1	2.3	2.4	2.5
GDP Price Index (Fixed-Weight)	3.2	2.9	2.9	3.8	2.9	3.0	2.7	3.0	2.7	3.0	2.8	3.1
CPI—All Urban Consumers	2.6	3.6	2.8	3.4	3.1	3.2	3.2	3.0	2.8	3.1	3.2	3.2
Producer Price Index—Finished Goods	0.8	3.0	−0.1	4.3	3.2	3.0	2.4	1.3	0.7	2.6	2.5	2.1
Employment Cost Index - Total Comp.	3.7	3.3	3.5	3.7	3.5	3.2	3.2	3.6	3.3	3.5	3.4	3.4
Output per Hour	−2.4	2.9	−0.1	1.1	0.0	0.2	0.9	1.5	2.1	0.5	1.3	2.2
Production and Other Key Measures												
Industrial Production (%ch)	6.0	5.0	5.2	3.2	1.8	0.2	−0.3	4.1	5.3	3.1	1.0	4.3
Nonfarm Inven. Accum. (Billion 1987 $)	51.7	48.3	45.2	51.6	37.4	22.9	10.0	16.5	41.3	30.4	1.3	19.2
Consumer Confidence Index	0.922	0.907	0.920	0.913	0.867	0.863	0.843	0.828	0.920	0.877	0.830	0.851
Housing Starts (Mil units)	1.440	1.466	1.423	1.406	1.337	1.276	1.262	1.293	1.428	1.320	1.284	1.352
Total Light Vehicle Sales (Mil units)	14.9	14.6	16.1	15.5	15.4	15.1	14.7	13.9	15.0	15.2	14.3	14.7
Unit Car Sales (Mil units)	8.2	9.1	8.2	8.8	8.4	8.2	8.0	8.7	8.2	8.3	8.7	8.0
Civilian Unemployment Rate (%)	6.1	6.0	5.7	5.5	5.4	5.5	5.6	7.4	6.1	5.5	6.0	6.0
Nonfarm Empl. (Estab. survey, % change)	3.7	3.3	2.7	2.2	1.8	1.8	1.4	1.8	2.6	2.3	1.4	1.7
Fed. Budget Surplus (Unified, FY, bil. $)	0.2	−53.5	−74.8	−38.8	1.0	−47.8	−72.7	−255.3	−203.4	−190.1	−206.9	−206.5
Foreign Trade												
Current Account Balance (Billion $)	−147.8	−168.7	−187.0	−192.9	−200.8	−203.2	−201.8	−103.9	−157.7	−199.8	−182.8	−175.4
Merch. Trade Balance (c.v.b., bil. $)	−151.8	−164.5	−178.3	−187.2	−190.7	−190.5	−183.3	−115.9	−156.7	−186.0	−175.0	−179.5
Foreign Crude Oil ($ per barrel)	15.77	16.70	16.14	15.92	15.87	16.27	16.57	16.17	15.40	16.15	17.01	17.80
U.S. Dollar Exchange Rate (% change)	−8.4	−12.9	−3.9	1.3	2.1	2.1	−0.8	3.2	−1.9	−1.8	−0.8	4.2
Foreign GDP (% change)	4.0	3.6	3.8	3.7	4.0	3.9	3.8	2.1	3.4	3.8	4.1	4.2
Financial Markets												
Money Supply (M2, billion $)	3592.8	3599.3	3597.4	3621.0	3664.5	3698.2	3737.3	3568.7	3597.4	3737.3	3945.2	4186.8
Percent Change vs Year Ago (Q4/Q4)	2.2	1.7	1.1	1.3	2.0	2.7	3.9	1.4	1.1	3.9	5.6	6.1
AA Corp Utility Rate (%)	8.10	8.41	8.66	9.11	9.19	9.19	9.18	7.43	8.22	9.17	8.40	8.12
Thirty-Year Treasury Bond Yield (%)	7.38	7.59	7.99	8.10	8.25	8.19	8.15	6.60	7.38	8.18	7.44	7.08
Treasury Bill Rate (%)	3.99	4.48	5.28	6.03	6.25	6.09	5.86	3.00	4.25	6.06	5.00	4.80
Federal Funds Rate (%)	3.94	4.48	5.17	6.13	6.51	6.48	6.30	3.02	4.20	6.36	5.41	5.18
Prime Rate (%)	6.90	7.50	8.11	9.13	9.50	9.50	9.40	6.00	7.13	9.38	8.32	8.00
S&P Index of 500 Common Stocks	451	461	460	455	450	445	445	451	460	449	464	513
Incomes												
Personal Income (% Change)	7.7	5.1	8.7	6.7	5.3	3.9	5.1	4.3	6.0	5.9	4.9	5.8
Real Disposable Income (% change)	3.5	2.9	8.5	2.4	2.5	1.4	2.2	1.5	3.5	3.2	2.1	2.7
Saving Rate (%)	4.1	4.0	4.2	3.9	4.2	4.1	4.2	4.1	4.0	4.1	4.2	4.0
Profits After Tax (Year Ago Change)	12.9	14.4	4.0	8.5	−4.0	−8.0	−8.3	12.9	10.1	−3.4	−3.2	9.7
Gross Post-Tax Corp Cash Flow (Bil $)	770.8	781.0	771.2	777.4	778.0	784.2	796.1	720.4	769.8	784.4	821.5	877.3
Percent Change vs Year Ago	9.1	6.0	2.3	2.8	1.0	0.7	3.2	8.6	6.9	1.9	4.7	6.9

Chairman DOMENICI. Senator Sarbanes?

Senator SARBANES. Thank you, Mr. Chairman. I know the hour is late, and I will be very brief.

I want to posit to each of the panel members this question that is based on a hypothetical assumption, namely that you would be a member of the Federal Open Market Committee meeting next week. Would you favor taking interest rates up?

Dr. MELTZER. Do you want me to start?

Senator SARBANES. In whatever order.

Dr. MELTZER. The answer is no, I would not. I would pause and look around and see what happens to the economy. I believe that by almost any measure, whether it is real interest rates or money supply growth or any other measure, monetary policy is tight. The Federal Reserve has a history of overreacting in both directions. I think this would be a wonderful time for them not to overreact, and I do not think a great deal would be lost by waiting.

Senator SARBANES. Dr. Levy?

Dr. LEVY. Based on declining real money supply, and the flattening of the yield curve, I would also be on hold. My concern would be the financial markets might get upset, agree with Chairman Greenspan's concern about the role of the Fed in constraining inflation expectations.

One strategy they may wish to take is to increase rates, but announce that the Fed expects an economic slowdown, suggesting the Fed will probably be on hold for a while, and concerned about not tightening too much.

Senator SARBANES. Dr. Wyss?

Dr. WYSS. Before Mexico happened, I was in favor of tightening at this FOMC meeting. But given the damage that the Mexican recession is likely to do to the U.S. economy, I actually think the Fed might be well advised to wait until the next FOMC meeting before moving, to see what happens with Mexico and with the bill that is in Congress right now.

I am worried, like Dr. Levy, what that would do to the bond market. I am a little concerned that the bond market might see it as backing away from controlling inflation. We are avoiding the tightening, not because of the damage it will do to Mexico, but because of the damage Mexico will do to the U.S. economy.

Senator SARBANES. The Fed tightened all year and the bond market did not do very well.

Dr. WYSS. Why should it? The bond market looks at the same numbers the Fed is looking at. They are looking at long employment rates, they are looking at the risk of inflation, and——

Senator SARBANES. You were very dogmatic about that, and I wanted to ask you about that point. You said that the economy could not do better than 2.5 percent or better than a 5.75 percent unemployment rate, without I take it confronting a major inflation problem. Is that your view?

Dr. WYSS. That is my view.

Senator SARBANES. Are you familiar with the *Business Week* article last May, Why Are We So Afraid of Growth, their lead issue which posited that a lot of things have happened in terms of how the economy functioned, which should enable us perhaps to even have a 3.5 percent growth rate without an inflation problem?

Dr. WYSS. Yes, and I consider it a great example of wishful thinking, just like the front-page article in the Wall Street Journal.

Senator SARBANES. Last year, we had over 4 percent growth and we got unemployment down to 5.4 percent. What was the performance of the CPI last year?

Dr. WYSS. The CPI was exactly the same in 1994 as in 1993.

Senator SARBANES. It is about the best performance in how long, 30 years?

Dr. WYSS. Actually, for 1 year, no. It is the best back-to-back performance in about 30 years. It is the best 1-year performance only since 1986.

Senator SARBANES. We had an exception in 1986.

Dr. WYSS. We had that 1 year where the oil prices went down.

Senator SARBANES. When we had that unique factor, so to speak, with the oil prices. But on any trend basis, would you not say the last 2 or 3 years have been the best in 30 years?

Dr. WYSS. Yes, I said the best back-to-back year since the early 1960's.

Senator SARBANES. How about unit labor costs?

Dr. WYSS. Unit labor costs have been almost exactly flat.

Senator SARBANES. Now, when did we last have a unit labor cost performance comparable to what we have?

Dr. WYSS. The early 1960's.

Senator SARBANES. So we had 4 percent growth, an unemployment rate that came down to 5.4 percent, and yet we had the best performance in 30 years on both the CPI and the unit labor costs. Of course, that is no guarantee that it will continue, but it seems to me it ought to shake these dogmatic assertions that people have. There may be things working in the economy that would give us stronger growth. One percent on the growth rate is worth how much on goods and services, $65 billion?

Dr. WYSS. On real GDP, yes.

Chairman DOMENICI. What was that question?

Senator SARBANES. If we have 3.5 percent growth, instead of 2.5 percent growth, we pick up $55 or $60 billion.

Dr. WYSS. $70 billion in current dollars.

Senator SARBANES. All right, in extra goods and services, which from my point of view is a good thing for the economy, assuming we do not trigger off other problems that we have to confront.

It seems to me that we need a little modesty on everyone's part as we look at the situation. My concern is that we have now gotten into the habit of thinking of taking growth or low unemployment and immediately trying to translate that into restraining the economy, without evidence of a problem either on the inflation front or on the front with respect to the unit labor costs.

It is quite possible that we might be able to have more growth than people have assumed, more than your benchmark at 2.5 percent, and have an unemployment rate better than we have assumed, and yet not run into major problems with respect to either inflation or unit labor costs. And I would like to let the economy work for a while to see whether that is in fact possible.

Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you very much.

Dr. Levy, you wanted to comment on a couple of the propositions that were put forth?

Dr. LEVY. Yes, please.

Senator real interest rates tend to rise with strong economic growth. So when the economy kicked into high gear beginning in fall 1993, there was a natural rise in real interest rates, and the Federal Reserve tightened and reined in inflationary expectations. As a result, bond yields rose much less than short rates, and the yield curve flattened.

Second, unit labor costs rose less than 1 percent in part due to very strong productivity growth. In fact, productivity growth was faster than what most people would agree is sustainable.

My third point is——

Senator SARBANES. How about weak unions and international competition, how does that play in on unit labor costs?

Dr. LEVY. Well, I think it has had more to do with businesses trying to meet strong product demand through controlling employment and costs. The trend in employment the last couple of years has not been as robust as normal expansion.

My third point is, even if that Business Week article is right and potential growth is 3.5 percent, which is far outside the band of expectations of the vast majority of economists, current dollar nominal spending year-over-year now has accelerated to 6.8 percent. Virtually by definition, the underlying rate of inflation is going to approach the extent to which current dollar spending growth exceeds long-run capacity, so that if nominal GDP growth is sustained, inflation would rise. In that regard, the Federal Reserve has appropriately tightened, insofar as the Fed's zero inflation objective requires slowing current dollar spending down toward that potential rate of growth.

My point is, even if you are right on potential growth, current dollar spending has been way too fast and monetary always affects financial markets immediately, the real economy with a lag, and then inflation with a longer lag. I think that is the Fed's top concern, despite the good news on current inflation.

Chairman DOMENICI. Could I ask if you had any comments on any of the questions, Dr. Meltzer?

Dr. MELTZER. I would make a very brief comment to Senator Sarbanes. I think that I share his view in part that we should not predict the inflation rate from the growth rate, nor should we believe that we know what the growth rate is within a half percentage point one way or the other. Therefore, the Federal Reserve should not be playing Philips curve games, nor should anyone else be playing Philips curve games. We should try to keep the inflation rate low by running a sensible monetary policy and let the private sector decide what the growth rate is going to be. I have always been on that side of the issue, and I remain on that side of the issue. I was on that side of the issue when you and I disagreed a year ago, and I am still on that side of the issue, but now we are on the same side.

Chairman DOMENICI. Let me thank of you and thank Senator Sarbanes for his questions.

Senator DODD. Mr. Chairman, may I——

Chairman DOMENICI. I am not going to recess. I was going to ask something.

Senator DODD. I am sorry.

Chairman DOMENICI. Why don't I let you go. I have to stay anyways, so you go ahead.

Senator DODD. Just very briefly. First of all, I apologize, Mr. Chairman. We have had hearings on the National Endowment for the Arts and other such matters, so I apologize for not getting over here earlier.

Maybe I missed this, Dr. Levy and Dr. Meltzer, but I am curious —particularly Dr. Levy, in light of what I felt was a very worthwhile point—how we will reduce the deficit. It is critically important. In fact, I would agree with you, that the manner in which we actually bring it down is more important. If we do it wrong, the implication is wrong. But I am curious as to where you come out on this proposal that is going to be before us very shortly on writing into the Constitution of the United States, the organic law of the country, a balanced budget proposal. Dr. Meltzer, I would like your response.

Dr. MELTZER. Well, I have to preface that, Senator, by saying that I was the author of a balanced budget amendment many years ago for the National Taxpayers Union, and I believe it was introduced in the Congress and voted on. So I was a very strong believer in the balanced budget amendment at the time.

I have since rethought that position, not because I think that balanced budget amendments, or I prefer to say spending limitation amendments, are not a good idea in principle. They have a great virtue, that is they have the virtue of saying I agree to temper my demands on the public spending, if you will agree to temper your demands. We have a binding way of making that agreement. So I think that is very good.

Years of experience have taught me that there are a lot of loopholes, and it is those loopholes that worry me a great deal. There are, for example, things like the Community Reinvestment Act which orders private sector lenders to do things which the Congress might like to do, but which it no longer has the money to do, so it tries to do it through the credit markets. There is the risk of credit allocation. That is one of the loopholes.

A second loophole, of course, is orders the States to spend for some chosen purpose. I am not sure that would be always an improvement. A third and perhaps equally important one is to order the private sector to clean up pollution and to do a variety of other things. So the public purpose that would perhaps be served by spending is now being served in ways which are no less harmful and may be more harmful.

My problem with balanced budget amendments is are that I think they are a very good idea in principle. I have a difficult time seeing the practice that is going to implement the amendment. Having said that, of course, I do believe that it is critical for the Congress to reduce the growth of spending, particularly spending on consumption.

Senator DODD. I could not agree more.

By the way, it is something we all do not do enough of around here. In fact, we look at these issue, having been the author of one and the examiner of it, I admire immensely the fact that you can come forward again and say, having looked at the other factors around here, arrive at a different conclusion. That is something we are all reluctant to do, for obvious reasons. I admire that.

Dr. MELTZER. Thank you very much, Senator.

Senator DODD. Dr. Levy?

Dr. LEVY. The primary impetus toward a balanced budget amendment is to impose political discipline. That in fact could backfire, if once enacted, Congress fails to achieve it: you would lose credibility. Witness Gramm-Rudman I, Gramm-Rudman II, et al.

In pure economics, I have some problems with the balanced budget amendment, not just in a cyclical sense, but also, once again, I look at the budget as a vehicle for allocating national resources, and the mix of spending is crucially important. The general notion that deficits are bad, is not necessarily true, depending on what you are deficit spending for. Similarly, deficit cuts are not unambiguously good for economic performance, depending on how taxes and spending programs are changed and what they imply for the allocation of national resources.

Similarly, the impact of deficit cuts on interest rates depends on how deficit are cut. It need not reduce interest rates. It could increase interest rates, if it raises expected returns on investments. So I have very mixed feelings about the balanced budget amendment, but largely from an economic point of view.

Senator DODD. I appreciate your thoughts, and they express my sentiments strongly. When I offered back in 1982–1983 a pay-as-you-go budget, I got about 20 votes for it. I was the second Democrat after Fritz Hollings to support Gramm-Rudman. I am committed to finding all sorts of ways to do it. I think it is a very important issue to push home. Maybe 10 years from now or 15 or 20 years from now somebody will look at this record of today's hearing, and analyze whether we made the right choices. If we promote consumption and do not promote savings, we are really going to be in trouble.

I will tell you, with the baby-boomers aging and the population growing, I may not be here in the year 2002 or 2004 or whatever it is. I do not know where my pal from New Mexico will be. Hopefully he will be here, because he is a damn good Senator.

I would tell you, if we are forced to make a choice between promoting some business tax cut, or increasing medicare or medicaid, we will increase consumption. That is who is going to win, if those choices are forced on us.

I guarantee that the future Congresses will make dreadful choices, will make pure political decisions on achieving a balanced budget, whether or not they achieve it. I think the business community is going to deeply, deeply, deeply regret it—and I think there is a very good chance it is going to be passed— and we will deeply regret what happens down the road. That evidence will not be available immediately, it will take 7 years, but I promise you that if it becomes the law of the land, the choices that future Congresses make are going to be very detrimental to the growth of this country's savings. The consumption side of the equation is going to be the winner, upon analysis, because that is how this place works. That much will not change.

I thank the Chairman.

Chairman DOMENICI. Let me suggest, just to put a little bit of reality into this for all of you—we heard your views on a balanced budget, but we did not hear yours, Dr. Wyss.

Senator DODD. He did, he stated it.

Chairman DOMENICI. You said you were not for it?

Senator DODD. He said he is for it.

Chairman DOMENICI. You are for it.

Dr. WYSS. Yes, but I said I am nervous about it.

Chairman DOMENICI. All right.

Senator DODD. He is Jim Exon's witness.

Chairman DOMENICI. Here is the interesting thing: Most economists are against it and most economists talk against it, because they are worried about how we might behave, as both of you have, with reference to where we are going to spend our money. We might cut the wrong things and spend on the wrong things.

Let me say I think the public is ahead of us, because they know we are not doing that very well without a constitutional amendment. I mean all of you have told us that the thing wrong today is that we are moving dramatically towards spending on consumption, rather than investment. Now, what makes anyone think that if we do not have a constitutional amendment, we are going to change that? We have been trying to change it and it never occurred.

The last budget, the Democrats hail it, the President did this and that. Nothing was changed on the consumption side, a little tiny bit of an entitlement. The rest of it had nothing whatsoever to do with that.

Senator DODD. You are attacking us.

Chairman DOMENICI. Because you take too much credit for it. You think it was more than it is. In any event, I have come the other way. I was not for it at a point in time. I am for it, because I do not believe we are going to, one, ever really dramatically reduce the deficit and move towards zero and/or surplus, until we have it as the basic law of the land; and, second, I am absolutely convinced that we are just as apt to encourage savings by changing the Tax Code after we have a constitutional amendment than we are before. That is in the mill and moving its way, whether we have it or not, that is changing the incentives in the Tax Code. At least two of you are familiar with my proposal along with Senator Nunn. It is not prefect, but at least it takes the disincentives out.

We look around, and what is the hardest thing to cut, and why are we saying we must have a constitutional amendment? The very things that you all are saying equal a bias towards consumption. Essentially, it is a practical situation for me.

Dr. MELTZER. Senator, I think you made the effective argument for the balanced budget amendment and it was the argument that appealed to me originally, and I believe that it is a strong case for the amendment. I think that there is the other side of the question, and that is why people looking at this will make different judgments.

I do not think it is a black or white thing and I do not share the views of those who say it will have terrible economic effects and all that. But I do believe that there are many problems. You have been here for a long time. I have observed this for a long time. You know that there are many ways in which legislators try to do what they think the public wants them to do. When or if they have a constitutional amendment which blocks one path, they will find other paths that they will be inclined to follow.

The CHAIRMAN. Let me make one other point and then we will yield to you, Dr. Levy.

Dr. Meltzer, you make the point that one of the big loopholes is that we will direct banks to lend money in a certain way, that we may direct States to do it, we may direct the private sector to do it.

Dr. MELTZER. You already do all those things.

The CHAIRMAN. You have got it, we already do those things. But let me suggest, the reason the bill is on the floor with reference to unfunded mandates, and the reason people like this Senator have called it a genuine precursor to a constitutional amendment on a balanced budget is because for the first time in history, when that becomes law, all of those loopholes you concerned yourself with will be presented in a different way to the policymakers of America. Because it is an accountability law.

So we will have to know the impact and upon whom before we do then, and we may then act as crazy as we have been in the past and do it anyway. And it is not a super-majority, it is just a simple vote, because we want to make that debate a very interesting focus, but we do not want to make it impossible to go ahead and do some of these unfunded mandates.

Now, Dr. Levy, you wanted to say something?

Dr. LEVY. Yes, I just wanted to make a comment based on your previous statement Your proposal for a consumption-based tax would in fact reduce long term deficits even if its proposal is deficit neutral, because it would raise national saving which would reduce real interest rates. Replacing the income tax with a consumption-based tax would not only raise national saving, it would reduce real interest rates, raise the dollar, and generate a lot of the positive long run effects you are trying to achieve.

The CHAIRMAN. Did anybody want to make any additional comment? Dr. Wyss?

Dr. WYSS. One thing I would say is that I fully agree with your reasoning, because I used to oppose a balanced budget amendment and on pure economic grounds I think you have to. It is a second-best solution. But it is better than what we are doing now. That is why I have come around to favoring the idea of putting a straightjacket on the budget. It should not be needed. Congress should do this without a balanced budget amendment, but it has not been doing it for the last 15 years.

The CHAIRMAN. Thank you all very much. Great having you here. We are adjourned till call of the Chair.

[Whereupon, at 12:24 p.m., the committee was adjourned.]

PRESIDENT'S ECONOMIC PLAN

TUESDAY, FEBRUARY 7, 1995

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 9:10 a.m., in room SD–608 Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Grassley, Nickles, Gorton, Gregg, Abraham, Frist, Exon, Lautenberg, Dodd, Boxer and Murray.

Staff present: G. William Hoagland, staff director; and Peter Taylor, chief economist.

For the minority: William G. Dauster, democratic chief of staff and chief counsel; and Dave Williams, assistant director for revenue and natural resources.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman DOMENICI. The hearing will please come to order.

Let me first welcome the distinguished Secretary of the Treasury. I understand he is on a tight schedule and has to leave. What was your schedule, 10:30, to go to House Ways and Means?

Secretary RUBIN. Yes, just before that, if you could.

Chairman DOMENICI. We will try our very best to work it out where you are finished. I assume that Economic Adviser Dr. Tyson can stay until noon or so.

Dr. TYSON. Yes.

Chairman DOMENICI. So we will do it one at a time, even though you are both at the table. But let me say that if you need to help. I understand that the Secretary is concerned that he does not have enough information or knowledge to answer some questions. He said he might have to let you do some, so we will——

Secretary RUBIN. No, no. My suggestion was that we would both be fully informed, so you get the benefits of two points of view.

Chairman DOMENICI. In which event, we do not have to hear from both of you, if you both are going to say the same thing. [Laughter.]

We are going to do that. Let me take up a couple of housekeeping announcements. First, we begin today the second phase of our hearing schedule by reviewing the President's 1996 budget submission. Tomorrow, Wednesday, for members of the committee, we will have the OMB Director Alice Rivlin with us. That will start at 9:30, instead of 9:00. On Friday, we will have the Secretary of Defense and the Joint Chiefs of Staff on the Administration's defense budget.

At this time, because the new Secretary of Agriculture will not have been confirmed by next week, we have scheduled only one Administration witness prior to the Presidents' Day recess, and Secretary of State Christopher on the 15th.

When we return from the Presidents' Day recess, we will have the Secretary of the Department of Health and Human Services, a major hearing on tax reform, and the distinguished minority and majority leaders from the House and others, along with a major hearing on the concept of privatization. This should conclude the hearing schedule for the month of February for our committee. It is full and we surely intend to devote plenty of time to it, and I hope the Senators who have specific interests in where we are going and how we are going to get there will come to these hearings.

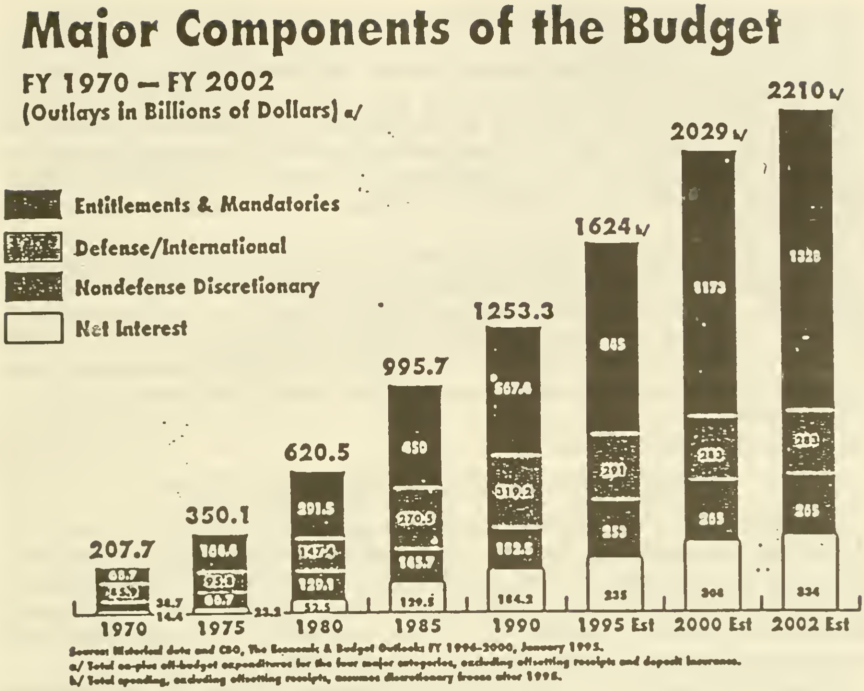
Turning to this hearing, I believe the Secretary and Madam Chairman have heard the initial—I think I have heard the initial reasons and response to the President's budget. I will not belabor the issues, except to make two brief observations this morning.

First, if I am to believe the weekend press reports, it is probably appropriate that Secretary Rubin and Chairman Tyson precede Director Rivlin on our committee, because it seems they have more to do with putting the budget together than the OMB Director. If these reports are to be believed, our witnesses this morning argued for a hold-the-line on the deficit, but not more deficit reduction. Indeed, Dr. Tyson's testimony this morning states that deficit reduction is not an end in itself, but, rather, a means to an end of greater national investment and higher living standards.

While I look forward to this discussion, I must say that one policy I have come to believe we as legislators have a responsibility for and that will increase national savings and therein national investment and economic growth for the future, is the reduction of the deficit. Perhaps we do not disagree on that, but perhaps we disagree in relative terms.

Nonetheless, the reason that I said what I did yesterday about this budget, that it raises a white flag on the Federal deficit and is the surrender, is because I do not believe the basic reason for the deficit has been addressed.

If you do not mind, if you will put up one chart, as you think of the status quo and stay the course, I do not believe this can be denied. The red columns are the Federal deficit if we do nothing with the entitlement programs.



And what it seems like we have done right here, we have cut it off here and said the status quo, when this might have been a year that you could clearly have chopped off the inordinate growth in some of the entitlements, for when you get out here there is nothing left in the budget but for entitlements and interest, and the percent of GDP will be way back up there, which concerns you in terms of your discussions with our President.

So those Federal programs that threaten this future and threaten our grandchildren's future because of what you have just seen there have not even been touched in this budget. I find it somewhat ironic that this year's budget documents drop the interesting section from last year's budget on intergovernmental accounting. That was in there all the time and that is the one that showed the burden of taxation on the next and the next generation.

Further, it is interesting that there is a lack of information, Senator Exon, on the direction the deficit will take after the first 5 years. Normally, we had 6, 7, 8, 9, 10. I think if I were putting this budget together, I would not include 10 years, either, because the hold-the-line does not work after the fifth year, or after the fifth year it starts going up dramatically. In fact, I hope the two witnesses from the Administration will talk to that either in their remarks or in questions.

The President had a bipartisan Commission on Entitlements and Tax Reform. They released their report. In that report, they made it clear that, by the year 2012, projected outlays for entitlements and interest payments will consume all tax revenues collected by the Federal Government. Secretary Rubin, by virtue of your position, you are the managing trustee of social security and the Medicare Board of Trustees.

Last year, the trustees' report made it clear that the Medicare Trust Fund would go broke in the year 2001, and yet this budget takes a walk on any reform in medicare. I understand you will claim some savings, but they are nothing more than extending current law, nothing new, and charging some new fees. I do not think either are calculated to solve the problem of the insolvency of the Medicare Fund.

So for these reasons, it seems we in Congress have our work cut out. Maybe the President is saying, and perhaps you might address that also, you go first. Maybe that is the President's thought in this budget. I am not against that. We will try our very best to do much better. Unless we are willing to confront some of the entitlements, we will make little headway beyond that which you have made in your budget.

I yield to Senator Exon,

OPENING STATEMENT OF SENATOR EXON

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

I want to thank you for your cooperation in outlining the schedule well in advance so that all Members can be advised and arrange their schedules accordingly. We are holding some extremely important meetings leading up to the budgetary decisions that we are going to have to make sometime before the 1st of April.

I want to extend a very hearty welcome to our two witnesses today, Treasury Secretary Robert Rubin and Chairwoman of the President's Council on Economic Advisers, Laura Tyson.

We all have many questions for both of our witnesses, Mr. Chairman, so I will keep my remarks brief. I want to make two observations, though.

First, the economic performance over the past 2 years has been spectacular. You in the Administration deserve more credit than you have received for this great success. We created 5.6 million jobs, 92 percent of which are in the private sector. And over the same period, the Federal bureaucracy was slashed by 100,000 jobs.

In both accounts, we are moving in the right direction, notwithstanding the dire predictions of economic collapse as we passed the President's 1993 Budget Act. We survived, we have made important progress in the right direction since then. The deficit is lower, and the economy clearly has boomed.

However, I see storm clouds on the horizon. I am speaking of some of the reckless economic schemes being advocated by some—many of which are wildly inconsistent and foolhardy. I am very afraid the Congress could jeopardize the recovery.

We learned the hard way in the 1980's that it is impossible to lower revenues, increase spending and balance the budget at the same time. It was this type of voodoo economics that led to a $4.8 trillion debt. Indeed, I would point out that if the interest costs alone associated with the Reagan-Bush deficits were excluded from our current deficit estimate, which they cannot be. But if they were, the budget would very likely achieve balance in 1996. That is just a way to dramatize how foolhardy our policies have been in the past.

Second, I stated yesterday that I do not agree with everything contained in the President's budget submission. In spite of the remarkable progress we have made to reduce the deficit over the past 2½ years, I believe that we are coming up way short of the deficit reduction in this budget, especially if we want to balance the budget by the year 2002. We cannot afford to rest on our laurels.

Mr. Chairman, I share the concerns that you expressed in the chart that you put up. I suggest, Mr. Chairman, that it might be a good idea for the two of us to join together to request a 10-year estimate from CBO and the Joint Tax Committee of both the President's budget that was submitted yesterday and the Republican proposals that have been offered thus far. I think maybe something like that would perhaps put into perspective the difficult choices that we have to make.

It seems to me, though, that if we are going to entertain the notion of a tax cut, any tax cut, when we need $1.2 trillion in savings to balance the budget, the answer is we should not, in my view. I am talking about the Administration's proposal of $63 billion in tax cuts and the Republicans' $196 billion cut, with an additional $120 or $140 billion 2 years down the road from there. I think it is fiscally irresponsible. It is hard for me to follow how anyone who is seriously in support of a constitutional amendment to balance the budget by the year 2002 would even consider such action at this juncture.

I would join with others in saying that if we firmly get on the road or on our way to a balanced budget, I would eagerly support the tax cut for our hard-pressed middle-class families. We must look at the repercussions, too. Is it not likely that the Federal Reserve would raise interest rates even higher to counter such a tax cut? That is what they have done in the last year. Will the average American save a few dollars in taxes, only to have to pay more in higher interest rates? That is not a very happy thought.

Chairman Greenspan told the Budget Committee, "Deficit reduction should be our primary goal, even though we all like to cut taxes down the line." Those words should be carved in stone on the Capitol. We must continue down the path of a solid, credible deficit reduction established by the 1993 Deficit Reduction Act.

I would like the witnesses to address these issues. I trust that they will all speak to the long-term benefits of a major overhaul of the Tax Code that has been suggested by some. As you can see, we have a wealth of issues to deal with this morning. I am sure that your testimony will enrich the discussion, the debate and help us in making our decisions.

Thank you very much, Mr. Chairman.

Chairman DOMENICI. Thank you very much.

Pursuant to the proposal as to how we proceed, which Senator Exon and I have heretofore stated for the committee, we will proceed to the witnesses now. Each Senator, in turn, as they inquire in their first round will have 2 additional minutes over the regular amount for any opening statement or comments they would like to inject into their questions.

So we are going to take the Secretary of the Treasury now. Secretary Rubin, we have your detailed statement. You can proceed as you see fit. We would indicate it is being made a part of the record.

STATEMENT OF HON. ROBERT E. RUBIN, SECRETARY, UNITED STATES DEPARTMENT OF THE TREASURY; ACCOMPANIED BY LAURA D'ANDREA TYSON, CHAIR, COUNCIL OF ECONOMIC ADVISERS

Secretary RUBIN. Thank you, Mr. Chairman.

What I would like to do is to present a much abbreviated version of the written statement in order to present the philosophy of the President's budget. But you raise a number of questions or issues in your opening statement which I would very much like to respond to, so I hope you will return to those after I complete my statement.

Chairman Domenici, Senator Exon and members of the committee, we are very pleased to appear here today to present the President's budget for 1996. We are presenting a budget that continues the process of cutting the deficit begun at the start of this Administration and that cuts taxes and increases public investments, both in ways designed to increase future productivity. OMB Director Rivlin will testify tomorrow and provide details on the spending side of the budget.

President Clinton, from the very beginning of this Administration, has had a broad-based economic strategy to stimulate and then protect the recovery, to position the country for the long term, and to increase the incomes of working Americans. This strategy consists of fiscal discipline, private and public investment, increased long-run productivity, opening markets, reforming government and reforming regulation, and achieving health care and welfare reform.

Our threshold issue when we first took office was to bring the deficit under control after a long period of large and increasing deficits and facing projections for large and increasing deficits going forward. Working with Congress, we enacted a powerful deficit reduction program. As a result, the deficit has come down from $290 billion in 1992 to what we now project as $193 billion this year.

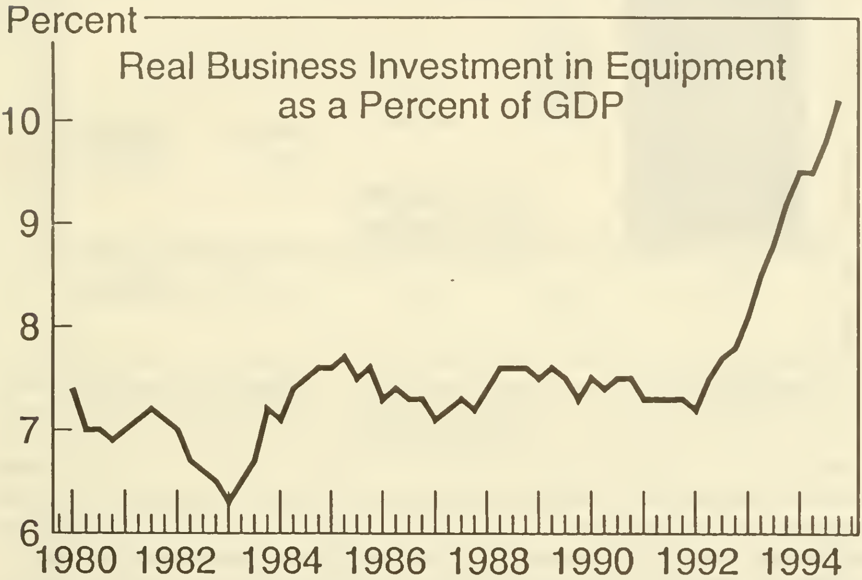
Or, to use a starker contrast and to show I think much more dramatically how much has been accomplished in the 2 years that we have been here, the budget deficit has come down from a projected $400 billion for 1998, a projection based on the last numbers released by the prior Administration, to the of $194 billion projected for that same year under this budget. The deficit as a percentage of GDP, or the total economy, goes from 4.9 percent in 1992 to a projected 2.7 percent for this year and a projected 2.1 percent of GDP in the year 2000.

Fiscal discipline has been reestablished after a long period of ballooning deficits and projections of ever increasing deficits. The deficit has been reduced by more than one-half, as the President promised it would be, both in absolute terms and as a percentage of GDP.

I worked in financial markets for 26 years and I have no doubt that our aggressive deficit reduction program was in large measure, not totally, but in large measure, responsible for the decline in interest rates in 1993, which in turn was the key to jump-starting the economy in that same year and producing the results that Senator Exon spoke of.

Rates have now increased, reflecting growth. But the deficit premium, which in my judgment was the critical impediment to growth, is largely gone. We now have a strong investment-led recovery that is creating jobs. Business investment in machinery and equipment has increased dramatically, and as a percentage of GDP, business investment in machinery and equipment is at an all-time high. The chart shows the percentages. That is a big plus for future productivity.

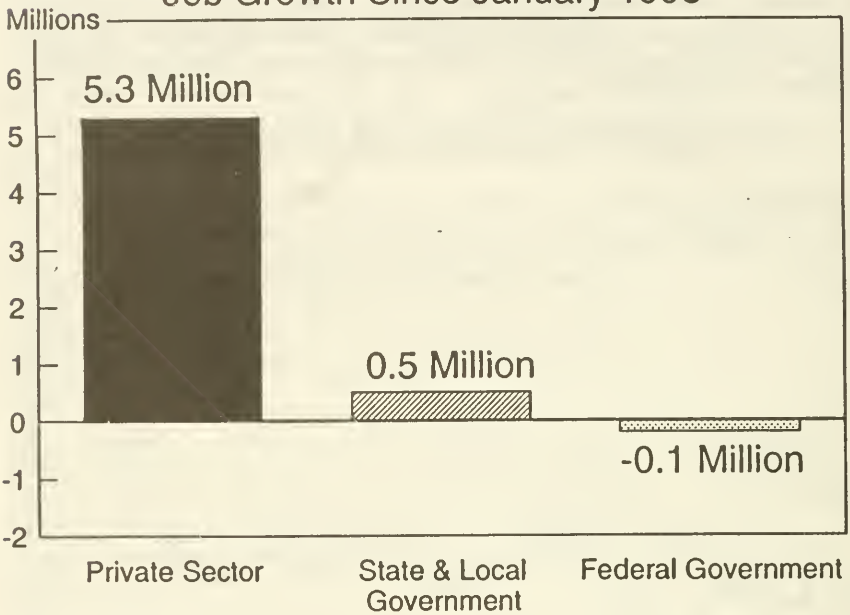
Business Investment Has Surged



The economy has created 5.7 million jobs, 5.3 million in the private sector. The unemployment rate has declined from 7.1 percent to 5.7 percent. And even with the strength of the current recovery, the increase in the Consumer Price Index has come in under 3 percent for each of the past 3 years. It is, taken altogether, about the best economic performance that I can remember in a long, long, long time.

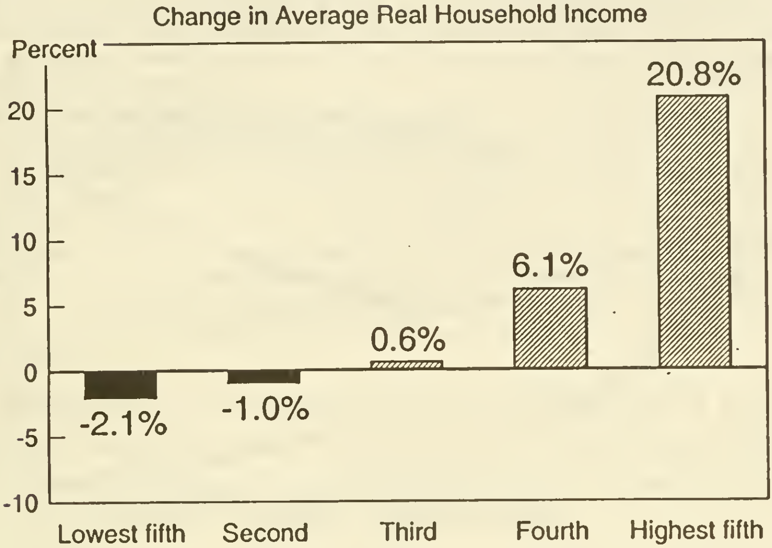
93 Percent of the 5.7 Million New Jobs Have Been in the Private Sector

Job Growth Since January 1993



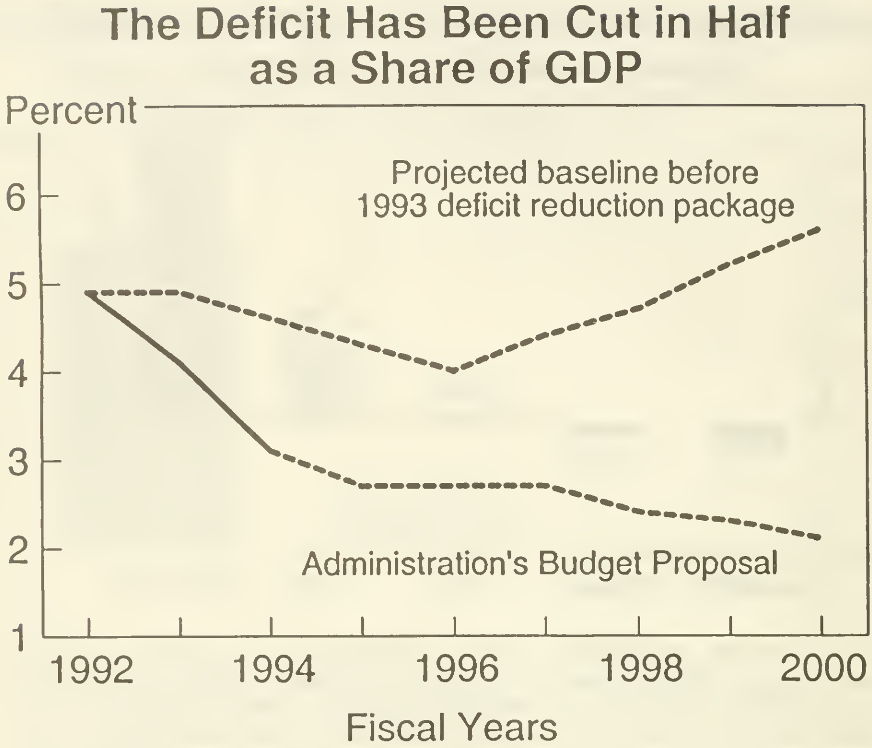
In the longer term, however, the success of our economy will depend on raising productivity growth. Productivity growth has been extremely slow for a generation, and this has contributed to slow growth in workers' incomes. Slow growth in average wages has been accompanied by unequal distribution of income gains. In the past 15 years, those with incomes in the lowest fifth of American households have seen their real incomes fall. Those in the top fifth have seen their incomes rise, and the middle has stood still.

Middle Class Incomes Were Stagnant, 1980-93



This budget emphasizes a three-part strategy to promote growth and improve the incomes of working Americans: one, maintaining fiscal discipline and continuing the process of deficit reduction; two, providing tax relief for the middle class that is targeted to also promote individual activity that will increase future productivity; and, three, increasing public investment in workers through education and training.

First, maintaining fiscal discipline. On a 10-year basis, as I said a moment ago, we project that this budget will reduce the budget deficit to 1.6 percent of GDP. And while 10-year numbers are not in the budget, we would be happy to submit them in writing in response to the comment that the Chairman made.



We continue reducing the deficit, while lowering taxes at the same time, by making substantial spending cuts in three areas. Restructuring government saves $26 billion, savings that come largely from five agencies: the Departments of Transportation, Energy, and Housing and Urban Development, the General Services Administration, and the Office of Personnel Management.

We save $80 billion by further lowering the discretionary caps in 1996 through 1998, and extending them for 2 years beyond their scheduled expiration in 1998, and in the budget we provide specifics for all of our spending cuts. Thirty-two billion in savings come primarily from the mandatory side of the budget, through continuing some existing health care savings and various other items.

Chairman DOMENICI. How much was that, $32 billion?

Secretary RUBIN. Thirty-two billion, that is correct.

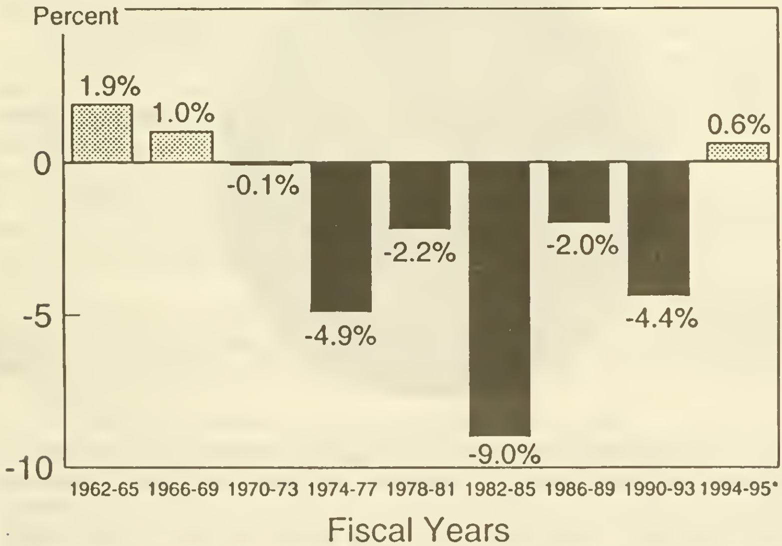
The remaining $5 billion in deficit reduction comes primarily from lower debt service as a result of our success in lowering the deficit. All of these programs put together save $144 billion from 1996 through the year 2000. The President has proposed using $63 billion of these savings to provide tax relief to middle-income families.

The deficit is projected to continue to fall as a percentage of the economy for the next 10 years—and in our view that is the economically most valid and significant way to look at the deficit: its size as a percentage of total GDP, of the total economy. Eventually, the deficit will turn up, as the Chairman pointed out. The problems are an increasingly aging population and rapidly rising health care costs. To maintain fiscal discipline over the long run, we must reform health care as soon as possible. The President spent the last 2 years addressing that subject. It was not accomplished. As he said in the State of the Union Address, he wants to return to that effort and work with Congress to reform the health care system and thereby contain Federal health care expenditures.

Before I leave our deficit discussion, let me make two additional points. Under President Clinton, and Chart 4 shows this, for the first time since the 1960's, expenditures on government programs are less than the taxes paid by the American people. In other words, our deficit results from the burden of paying interest on the debt accumulated primarily by the deficits of the 1980's. In fact, were it not for interest on the debt, we would actually have a small surplus.

Spending on Government Programs Is Less than Taxes for the First Time Since the 1960's

Revenues Minus Program Spending as a Share of GDP



*Fiscal year 1994 and projection for fiscal year 1995.

I might also observe that in our budget, discretionary spending in every year covered by the budget is less than it is in 1995.

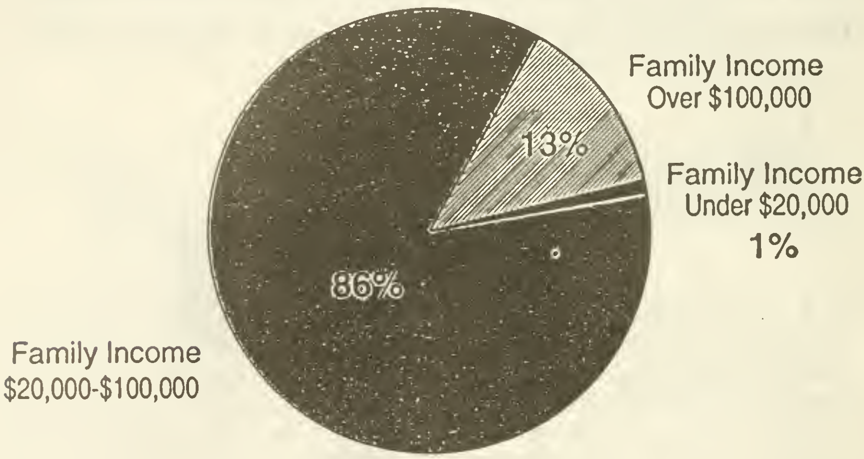
The second general point I would like to make is that we believe the way to achieve deficit reduction is through deliberate and thoughtful policy choices, not through a balanced budget amendment that substantially increases macroeconomic risk and involves spending cuts that have not been specified at the time the decision on a balanced budget amendment is made.

Now let me turn to middle-income tax relief. On December 15, 1994, President Clinton announced his Middle-Class Bill of Rights. A middle-class tax cut has been an explicit goal of this President from the beginning of this Administration, in fact from the days prior to the Administration.

Many working American families have lagged behind, as I have already discussed, even in the last 2 years, when growth has been brisk. Not only do these tax cuts provide immediate relief to financially strapped middle-income families, but these tax cuts also serve an important economic purpose by helping these families save and invest and become more productive and enjoy higher future standards of living in the years ahead.

We have targeted tax reduction squarely at middle-income families, and Chart 5 shows that. Eighty-six percent of the benefits of these proposals will go to families with incomes of between $20,000 and $100,000. Let me go through tax cuts very briefly.

Tax Cut Targeted to Middle-Income Families



First, the $500 child tax credit for children under 13. This credit is designed to help younger families, where economic pressure tends to be greatest, to provide better child care, after-school activities, and the other requisites for good child rearing. This credit would reduce the Federal income tax burden of a typical two-child family with an income of $50,000 by almost 21 percent, once the credit is fully phased in. This is an investment in children, the future of our country.

Second, a $10,000 deduction for post-secondary education and training expenses. This deduction can be used by all members of the family, including spouses and children, and will help middle-income families to obtain the eduction and skills that will equip them to succeed in the modern economy, again people investing in themselves.

Third, expansion of individual retirement accounts. This program will substantially increase the availability of individual retirement accounts by raising the income ceiling to $100,000 for joint filers and to $70,000 for individuals. Under the President's plan, the flexibility of the individual retirement account is greatly enhanced, which we believe will increase its use and, thereby, savings. It is our judgment that the savings rate in this country is one of our critical economic problems.

An individual can either deduct the amount deposited up front or forego this deduction in favor of tax-free withdrawal of all accumulated earnings after 5 years. Also, an individual may save for a broader range of purposes. Penalty-free withdrawals may be made at any time for specified purposes, such as education, a first home, or certain medical expenses. This increased availability with respect to the uses for which savings can be made will in our judgment have a good chance of greatly increasing the uses of IRA's, and increased use will induce financial institutions to advertise more. You can get a cycle going, which in our judgment will have a real chance of increasing savings.

Finally, turning to taxes, one of the Administration's priorities is to implement fully the Internal Revenue Service's Tax Systems Modernization plan to reduce the administrative burden on businesses and individuals and to raise compliance.

Finally, public investing for the future. The President's public investment program, critical to future productivity, is one that he has talked about many times. It is many-faceted. In this budget, it focuses on his GI Bill for America's workers, which consolidates and streamlines a patchwork of 70 training programs to provide skill grants to lower-income and displaced workers.

To conclude my statement, Mr. Chairman, this budget is the next step in carrying forward the President's economic strategy designed to raise standards of living for all Americans now and for the long term.

We believe a great deal has been accomplished in the last 2 years, but much remains to be done. We welcome the opportunity to work with you on a bipartisan basis to continue moving forward.

Thank you.

Chairman DOMENICI. Thank you, Mr. Secretary.

[The prepared statement of Secretary Rubin follows:]

For Release Upon Delivery
Expected at 9:00 a.m.
February 7, 1995

STATEMENT OF ROBERT E. RUBIN
SECRETARY OF THE TREASURY
BEFORE THE SENATE BUDGET COMMITTEE

Mr. Chairman and Members of the Committee:

I am pleased to appear before you today to present the President's proposed Budget for the 1996 Fiscal Year. I've been in office less than a month, but I am doing something not many Treasury Secretaries get to do: presenting a budget that cuts the deficit and cuts taxes. I am also doing something that you would have to go back 16 Treasury Secretaries to sometime in the Truman Administration to find: announcing that our budget deficit will decline for three years in a row.

As Treasury Secretary, my testimony will focus on broad policy issues and on the revenue proposals set forth in our budget. OMB Director Alice Rivlin will testify before you tomorrow. She will provide greater detail on the program side.

Every Administration's agenda is contained in its proposed budgets. President Clinton, from the beginning of this Administration, has had a broad-based economic strategy to stimulate and then protect the recovery, to position the country for the long-term, and to increase the incomes of working Americans.

Prior to joining Treasury, I assisted the President in setting our overall policies. I know how deeply he feels about continuing to move forward on his full economic strategy, which includes fiscal discipline, boosting both private and public investment to increase long-run productivity, opening markets, reforming government and regulation, and achieving health care and welfare reform.

This morning, I would like to summarize briefly what we have achieved, where we are now, and where we are headed, with special attention to the President's proposed

Middle-Class Bill of Rights.

What Have We Achieved to Date?

When the President came into office, the economy may have been in recovery, but the recovery was weak and uncertain. Employment growth, in particular, had lagged far behind normal expectations. Large federal budget deficits, which were increasing rapidly as a percent of GDP even as the economy was recovering, created an unstable economic environment. Escalating structural deficits were a clear signal that the chances of an eventual severe financial crisis were on the rise. Prudent business people were reluctant to hire or to invest in this unstable environment. As a result, Americans were experiencing a jobless recovery.

Thus, the first necessary economic move was to bring the deficit under control. Working with Congress, we enacted a powerful deficit reduction program. The $505 billion deficit reduction package was achieved largely through spending cuts of $255 billion over five years, including freezing discretionary spending at 1993 levels, and raising income tax rates on only the 1.2 percent of Americans with highest incomes.

We also introduced plans to reduce the size of government. The President's Reinventing Government initiative called for reducing the federal work force by 272,900 over five years, bringing government employment back to levels not seen since John Kennedy was President.

At the same time that we were cutting spending and government employment, we were able to reduce taxes for millions of lower- and moderate-income working individuals and families, and to offer tax relief for small businesses.

The net effect of our plan was to bring the deficit down from $290 billion in 1992 to what we now project as $193 billion this year. The deficit as a share of GDP went from 4.9 percent in 1992 to a projected 2.7 percent for 1995.

I worked in financial markets for 26 years, and I have no doubt that our aggressive deficit reduction program was, in large measure, responsible for the decline in interest rates which in turn was key to jump-starting the economy in 1993. Deficit reduction also reduced uncertainty about our fiscal future and restored confidence conducive to investment.

In addition to addressing the deficit problem, we also made sure that American businesses had access to the credit they needed. When President Clinton took office, small- and medium-sized businesses were facing a "credit crunch." In response, President Clinton announced a program of regulatory and administrative changes to reduce impediments and increase the availability of credit.

The combination of these policies, a sound fiscal environment and increased availability of credit, has paid off. We now have a strong investment-led recovery that is creating jobs. The first chart at the end of this statement shows that business investment in equipment has increased dramatically under the Clinton Administration. As a percent of real GDP, business equipment investment is at an all-time high.

Most important, as we have cut the deficit and reduced federal employment, the economy has created 5.7 million jobs, putting an end to the jobless recovery. Note that 5.3 million, or 93 percent, of these jobs were created in the private-sector (see attached chart). At the same time, the unemployment rate has declined from 7.1 percent to 5.7 percent. Some say that all these new jobs are in low-paying industries, but that view is incorrect. Over the past year, the number of jobs in construction, which pays 30 percent more than the average wage, has surged by some 325,000. The decline in manufacturing jobs has turned around: factory employment is up 290,000. The high-paying wholesale trade and transportation and public utilities industries provided an additional 295,000 jobs.

All this investment and employment growth has occurred in an environment of low inflation--an absolutely critical objective of this Administration. Even with the strength of the current recovery, inflation has remained under control. The increase in the consumer price index has come in under 3.0 percent for each of the last three years. We see virtually no evidence of cost-push inflation pressure from wages. Growth of the employment cost index--the most reliable measure of labor costs--was lower in 1994 than it had been in 1993.

We have also established the basis for growth of future wages and living standards through our trade liberalization policies. We worked hard to enact NAFTA and GATT because we believe American workers will benefit. In an increasingly integrated world, we are going to have to look outward rather than inward if we are going to stay on top. Moreover, jobs in export industries are more productive than average and pay about 10 to 20 percent more than average. That means shifting the composition of GDP toward more exports automatically shifts the economy toward better paying jobs.

Where Are We Now?

As successful as economic performance has been in the last two years, getting the economy moving and creating jobs in the short term was only part of the challenge. In the longer run, the key test of this Administration will be whether it has succeeded in raising productivity growth--because that is the only way to create higher wages and higher standards of living.

I want to emphasize that productivity growth is not an academic abstraction. In the final analysis, increases in workers' incomes cannot be sustained without increases in productivity--in the amount produced per hour worked. Productivity growth has been extremely slow over the past twenty years. And slow productivity growth has meant slow growth in workers' incomes.

This slow growth in average wages has been accompanied by an unequal distribution of income gains. As you can see from the attached chart, in the past fifteen years, those with incomes in the lowest fifth of American households have seen their real incomes fall below the levels attained by their counterparts in 1980; those in the top fifth have seen their incomes rise by 21 percent; and the middle has stood still.

The unequal distribution of income gains over the past fifteen years has put very real pressures on middle-class families. Their standards of living have failed to match their legitimate expectations. Dealing with this problem is at the heart of the President's budget and his Middle-Class Bill of Rights.

Where Do We Go from Here?

This budget emphasizes a three part strategy to promote growth and improve middle-class incomes: 1) maintaining long-term fiscal discipline, 2) providing tax relief for the middle class, and 3) increasing investment in workers through education and training, as well as in machines and buildings. This is the approach that the President has outlined in his budget.

Maintaining Fiscal Discipline

This Administration fought hard to break the back of the cycle of ever-increasing deficits. But it is not enough to reduce the deficit for three years in a row. We are concerned both about the pattern of projected deficits over the next five years and also about the pattern after the turn of the century.

For the next five years, this budget maintains the progress on deficit reduction made in OBRA '93. As I said earlier, our projections show the budget deficit dropping in 1995 for the third straight year, this time to $193 billion. After 1995, the deficit, measured in dollar terms, fluctuates in a narrow range before falling back to $194 billion in 2000.

More important than stabilizing the deficit in dollar terms is reducing the deficit as a share of GDP. Between 1995 and 2000, the deficit-to-GDP ratio falls from 2.7 percent to 2.1 percent. We haven't seen numbers in that range since 1979.

Further, the attached chart shows that the deficit as a share of GDP has been cut in half from what was projected before passage of the 1993 deficit reduction package, fulfilling the President's promise.

This year, we continue our deficit reduction efforts and lower taxes by making

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substantial cuts in spending. Budget cuts come from three areas. Restructuring government saves about $26 billion. Most of that $26 billion is the result of fundamental changes in five agencies--the Departments of Transportation (DOT), Energy (DOE), and Housing and Urban Development (HUD), the General Services Administration (GSA), and the Office of Personnel Management (OPM). Additional efforts are aimed at terminating certain agencies and programs and restructuring others. In addition, we propose to turn over to the private sector or to state governments activities that they are well positioned to carry out themselves.

We have already had real success in this area. The President's reinventing government initiative has already reduced the federal work force by 102,500 positions. Currently, the federal work force as a share of total employment is at its lowest point since the 1930's. In addition, Congress has enacted $63 billion of the $108 billion in reinventing government savings proposed by the Administration. The goal is to make government even smaller and to make it work better for all Americans.

In addition, further lowering of discretionary spending caps from 1996 through 1998 and extending them for two years beyond their scheduled expiration in 1998 produces an additional $80 billion in savings. The budget contains specific proposals to achieve these savings. The net result of extending the caps and making the cuts will be to keep discretionary spending virtually constant in nominal dollars from 1996 through 2000.

Finally, $32 billion in savings comes primarily from the mandatory side of the budget through continuing some existing health care savings, imposing user fees for the lucrative electro-magnetic spectrum, accelerating student loan savings, and reducing certain agricultural programs. The remaining $5 billion of deficit reduction comes primarily from lower debt service, as a result of our success in lowering the deficit.

Together, our program cuts and projected debt service reductions save $144 billion between 1996 and 2000. The President has proposed using $63 billion of these savings to provide tax relief to middle-income families as part of his Middle-Class Bill of Rights. The remaining $81 billion is for deficit reduction.

If our proposed policies are continued beyond the year 2000, we now project that the fiscal year 2005 deficit will be only 1.6 percent of GDP. This good news comes from two developments. First, for the ten-year period from fiscal year 1995 to fiscal year 2005, the President's budget proposals produce substantial deficit reduction. Second, our new budget baseline projects lower spending for Medicare and Medicaid, based on the latest growth rate estimates from the actuaries at the Health Care Financing Administration.

Administration estimates of deficits in the out-years are noticeably lower than estimates that have been recently produced by the Congressional Budget Office. There are several reasons for this.

First, CBO's baseline, by convention, does not include any deficit reduction proposals. The President's budget proposes substantial deficit reduction over the next ten years.

Second, the Administration's baseline estimates include recent revisions to projected costs of Federal health care programs made by the actuaries at the Health Care Financing Administration. I do not believe that the latest CBO estimates incorporate the full revisions from the actuaries.

Third, over the long term, the Administration has a slightly more optimistic rate of growth for productivity--by one or two tenths of one-percent--than does CBO. By 2005, even very small differences in projected growth rates materially affect deficit projections.

In other words, there are straightforward explanations of the differences between our numbers and CBO's, and we are very comfortable with all our projections.

While we are confident that the deficit outlook for the next ten years is good, all observers agree that the deficit will eventually turn upward. The problems are an increasingly aging population and rapidly rising health care costs. We cannot do anything about the projected demographic shifts, but we need to do something about health care as soon as possible. If we want to maintain fiscal discipline over the long run, we must reform health care.

Before we leave our deficit discussion, let me make two additional points. First, let me refer you to an enlightening chart. This chart shows the difference between program expenditures and revenues for the Clinton Administration and for each of the last eight Administrations. Under President Clinton--for the first time since the 1960s--expenditures on government programs are <u>less</u> than the taxes paid by the American people. We have a deficit solely because of the burden of paying interest on the debt run up largely as a result of the deficits of the 1980s--not because we're overspending today.

The second general point I'd like to make is that I believe the way to achieve deficit reduction is through deliberate and thoughtful policy choices, not through a balanced budget amendment that greatly increases macroeconomic risk in our economy and involves spending cuts that have not been specified at the time the decision on a balanced budget amendment is made.

Providing Tax Relief for Middle-Income Americans

Let me now turn to the centerpiece of the President's budget. On December 15, 1994, President Clinton announced in an Oval Office address his "Middle-Class Bill of Rights." A major piece of his initiative is providing tax relief for middle-income families.

A middle-class tax cut has always been a goal of this Administration. In 1993, however, the Administration faced a deficit crisis larger than had been predicted at the start of 1992. Bringing the deficit under control, and directing tax relief to lower and moderate income Americans were our first priorities.

Due to strong, effective leadership and tough choices, the deficit reduction program has been even more of a success than expected. However, incomes of many working American families have lagged behind--even in the last two years, when growth in the economy has been brisk.

The President's tax cuts will not only provide immediate relief to financially-strapped middle-income families but also will help these families save and invest so that they will become more productive and enjoy higher future standards of living. Individual tax relief coupled with savings and investment will boost American productivity, providing the foundation for sustained increases in real incomes.

The Administration's tax cut is targeted squarely at middle-income families. The attached chart illustrates that a full 86 percent of the benefits of this tax cut will go to families with incomes between $20,000 and $100,000.

The tax cuts in the President's Middle-Class Bill of Rights have three elements, aimed at strengthening families, promoting education, and encouraging savings.

$500 Child Tax Credit: This credit is designed to help younger families, where economic pressure often tends to be greatest, to better provide child care, after-school activity, and the other requisites for good child rearing. This is an investment in children--the future of our country. A $500 (when fully phased in) non-refundable credit will be allowed for each dependent child under 13. Between 1996 and 1998, the maximum credit would be $300. This credit would reduce the federal income tax burden of a typical two-child family with an income of $50,000 by 21 percent. The credit will be phased out for taxpayers with initial Adjusted Gross Incomes (AGI) between $60,000 and $75,000. No credit will be available to taxpayers with AGI in excess of $75,000.

Deduction for Post-Secondary Education Expenses: This deduction can be used for education and training expenses for all members of the family, including spouses and children, and should better enable middle-income families to obtain the education and skills that will equip them to function effectively in a modern economy. This deduction is used in determining a taxpayers AGI (that is, taken above the line) and is, therefore, available to those who do not itemize their deductions as well as to those who do itemize. The maximum allowable deduction would be phased out ratably for taxpayers filing a joint filers with AGI (before the deduction) between $100,000 and $120,000 ($70,000-$90,000 for individuals). The maximum deduction would be $5,000 in 1996-1998 and $10,000 thereafter.

This proposed tax deduction of up to $10,000 in tuition and fees can be taken for study at any college, university, or vocational program eligible for federal assistance.

Expansion of Individual Retirement Accounts: This program will substantially increase the availability of individual retirement accounts by raising the income ceiling to $100,000 for joint filers and to $70,000 for individuals. Today, only couples with AGI up to $40,000 and individuals with AGI up to $25,000 can make fully deductible contributions. Moreover, the flexibility of the individual retirement account has been greatly enhanced: an individual can either deduct the amount deposited up front, or forego this deduction in favor of tax-free withdrawal of all accumulated earnings after five years. The President's proposal would allow penalty-free withdrawals immediately for specified purposes such as education, first homes, long-term unemployment, or certain medical expenses.

Other Revenue Proposals

In addition to the President's proposed middle-class tax cuts, the budget contains certain other provisions that affect revenues. An Appendix to my testimony provides further details. But let me note that we are proposing two additional empowerment zones, thus enlarging empowerment zone tax incentives; reducing a tax on vaccine manufacturers; denying the Earned Income Tax Credit (EITC) to undocumented workers, and to those with significant unearned income; changing the tax treatment of those who renounce their citizenship or use foreign trusts to shelter income; and supporting the extension of the taxes that finance the "Superfund" that cleans up hazardous waste sites.

Also, on the subject of taxes, one of the Administration's priorities is to fully implement the Internal Revenue Service's Tax Systems Modernization (TSM) plan to reduce the administrative burden on businesses and individuals and to raise compliance.

<u>Investing for the Future</u>

Fiscal discipline and middle class tax relief are necessary elements of any coherent economic strategy. Yet, by themselves, they are not enough to ensure higher standards of living for all Americans.

Additional investment in the skills and capabilities of America's workers and in physical capital have always been an integral part of the President's agenda. Today's investments will translate into stronger productivity growth and higher living standards for years to come. Boosting public investment is an important step towards a rising standard of living for all Americans.

Let me focus on three areas: investment in human capital; investment in science and technology; and investment in infrastructure.

Human Capital: The President has consistently emphasized the importance of "lifelong learning" in an economy which favors the highest skilled workers. The budget proposes $47.3 billion in 1996 for investment in education and training. This represents a $5.4 billion increase, or 13 percent, over 1993 levels. Working with Congress, the Administration has already launched legislation from expansion of the Head Start program to cutting the cost of higher-education loans for students.

This year, the President will focus on better opportunities for adults already in the work force. The President's proposal--the "G.I. Bill for America's Workers"--will consolidate and streamline a patchwork of some 70 job training programs. The "G.I. Bill" will offer dislocated and low-income workers "skill grants" through which they can make their own choices about the training they need to find new and better jobs.

Two other Presidential initiatives also deserve mention here.

Welfare reform fits into the over-arching strategy of raising economic growth. The current welfare system costs taxpayers a great deal of money and actually discourages work by participants. This Administration wants to work with Congress to make welfare a temporary safety net only, through time limits and through making work pay. If we succeed, we will both raise the standard of living of participants and lower the tax burden on average Americans.

Similarly, health care reform is not only essential to maintaining long-term fiscal stability, but also important for the take-home wages of the average American. If employees' health insurance costs keep rising, workers' wages won't. Health care cost containment will pay off in higher wages as well as in a more stable fiscal environment.

Science and Technology: We know that the rates of return for R&D are high in the private sector. Industry R&D may have accounted for as much as a quarter of overall productivity growth in recent decades. Commercial firms cannot reap the entire rewards of basic research, however, because other firms easily learn and use the knowledge generated. Despite high rates of return, the private sector does too little basic research to meet all of society's needs.

Thus, the federal government plays an important role in promoting and investing in R&D. Federal spending accounts for nearly 40 percent of the nation's R&D spending. This budget proposes $69.4 billion in 1996 for research and development--an increase of $3.74 billion in nondefense R&D over 1993.

Through the President's National Science and Technology Council, the Administration seeks to support the best possible science on a tight budget. The science and technology program pursues advances in health, business, the environment, information technology, national security, and basic science itself.

In addition, because of the importance of R&E to the nation's economy, we support the extension of the R&E tax credit on a revenue neutral basis, and we will work with Congress to pay for it.

Infrastructure: Infrastructure is one area where the government must play an important role--the private sector could not profitably run many of our nation's roads and bridges or the treatment plants needed to provide clean water. The budget proposes $58.8 billion for 1996 for infrastructure investment--up $8.6 billion from 1993.

While infrastructure spending can be among the most effective ways to boost productivity, projects must be chosen carefully. The Administration proposes to restructure the Transportation Department, consolidating its infrastructure activities into a single transportation block grant. Local governments will have more flexibility to direct resources to areas which best address community needs. Our goal is more and better infrastructure, at less cost and with less red tape.

Conclusion

In conclusion, let me make three points:

First, you can read the priorities of this Administration in its budget. This President is committed to raising standards of living for all Americans, and the policy objectives pursued through the budget--deficit reduction; the middle-class tax cuts; public investments in workers, in knowledge, and in infrastructure; Reinventing Government--are all aimed at attaining that goal.

Second, this budget maintains the ground won in the struggle to reduce the deficit in 1993. We project that, with the deficit-reduction policies in the budget, the federal deficit will remain below $200 billion in nine of the next ten years, and will shrink to 1.6 percent of GDP in fiscal 2005. We as a country simply cannot afford to return to the days of rising, uncontrolled deficits of the 1980s or early 1990s. This budget will keep us on a sound trajectory that reduces the deficit.

We do this by taking step-by-step reductions in spending programs and in cutting the size of government itself. Reinventing government not only saves money, but also makes government efficient. As a result of the Administration's actions to date, we are reducing the deficit and do not need a balanced budget amendment to enforce fiscal discipline. This is the right way to cut the deficit.

Third, we take a crucial step toward addressing the economic concerns of working families by cutting their taxes. Our proposals are targeted to the people who need them the most when they need them the most. These cuts will help families with young children, people who are paying for education, and those who want to save for the future.

This budget builds upon what has been achieved. It is the next step in the logical sequence of policies designed to raise the living standard for all Americans. It reinforces fiscal restraint. It provides tax relief to millions of Americans who have seen their incomes stagnate for a generation. And it invests in education, infrastructure, and technology.

Much has been accomplished in the past two years, but much remains to be done. I look forward to working with you on a bi-partisan basis to continue moving forward.

APPENDIX: OTHER REVENUE PROVISIONS

Additional Empowerment Zones. The Secretary of Housing and Urban Development would be authorized to designate two urban empowerment zones in addition to the six urban and three rural zones designated on December 21, 1994. This would have the effect of extending the empowerment zone tax incentives to these additional areas. Other current-law limitations, such as those regarding population, size, poverty, and application requirements, would be applicable to these areas.

Reduce Vaccine Excise Tax. Under current law, a manufacturer's tax is levied on vaccines used to prevent diphtheria, pertussis, tetanus, measles, mumps, rubella or polio. These taxes are deposited in the Vaccine Injury Compensation Trust Fund and provide a source of revenue to compensate individuals who sustain certain injuries or to families of individuals who die following administration of these vaccines. Because of large balances in the trust fund, the Administration proposes a reduction in revenues from these taxes. The decrease will allow continued program compensation while lowering the costs of vaccines to both public and private purchasers.

Earned Income Tax Credit

EITC denied to undocumented workers. Under this compliance proposal, only individuals who are authorized to work in the United States would be eligible for the earned income tax credit (EITC). When claiming the EITC, taxpayers would be required to provide a valid social security number for themselves, their spouses, and their qualifying children. Only social security numbers that are valid for employment purposes in the U.S. would enable the individual to claim the EITC. In addition, the proposal would modify the IRS procedure for processing returns with erroneous or missing taxpayer identification numbers so as to reduce improperly claimed credits. These proposals would be effective in 1996.

EITC denied if interest and dividends exceed $2,500. Under current law, an individual must have earned income in order to be eligible for the EITC. Because the EITC is designed to benefit low-income workers, the amount of the credit should decrease as the taxpayer's income increases. A taxpayer with relatively low earned income, however, may be eligible for the EITC even though he or she has significant interest and dividend income from investment assets. Under this proposal, taxpayers would not be eligible to receive the EITC if their combined interest and dividend income for the year exceeds $2,500. This proposal would be effective in 1996.

Tax responsibilities of Americans who renounce citizenship. The proposal would tax the untaxed gains of U.S. taxpayers who renounce citizenship. The tax would also apply to aliens who have been lawful permanent residents for at least ten years and then cease to be subject to U.S. tax. This tax is intended to apply only where very substantial gains are involved and, thus, an exemption is provided for up to $600,000 of gain. U.S. real estate and pension assets would also be exempt.

Foreign Trusts. The foreign trust proposal is designed to increase compliance for taxing two categories of people. First, U.S. persons sometimes transfer their assets to foreign trusts and rarely pay tax on the trust income. The proposal would impose enhanced information reporting requirements (with penalties for failure to comply) on U.S. persons who transfer assets to foreign trusts. The second category of taxpayers are U.S. persons who are members of wealthy foreign families. Foreign families often establish foreign trusts for the benefit of U.S. family members. Under current law, the United States treats such trust assets as owned by the foreign family, and any distribution of income earned by the trust to the U.S. beneficiary is treated as a nontaxable gift to the U.S. person. The proposal would tax this trust income.

Extension of Superfund Tax. Four different taxes are imposed under present law to fund the Hazardous Substance Superfund (Superfund) program including a corporate environmental income tax equal to 0.12 percent of the amount of modified alternative minimum taxable income in excess of $2 million, and excise taxes on domestic or imported crude oil or refined products, certain hazardous chemicals, and certain imported substances. These taxes are scheduled to expire generally after December 31, 1995. The Administration supports the extension of the corporate environmental income tax through taxable years beginning before January 1, 2001, and the Superfund excise taxes through December 31, 2000.

Chairman DOMENICI. We are going to rotate back and forth and I am going to let Senator Nickles take my opening round of questions, and then I will come back to mine after Senator Exon.

Senator Nickles?

Senator NICKLES. Mr. Chairman, I am just wondering what kind of time?

Chairman DOMENICI. Seven minutes.

Senator NICKLES. Thank you, Mr. Chairman.

Secretary Rubin, welcome before the committee. I want to make a couple of comments and then ask a couple of questions. I am concerned when I hear the President's State of the Union Message—and this is a quote—"I cut spending by $250 billion." And I look at the spending levels in 1992, less than $1.4 trillion, in 1994 it was $1.461 trillion, almost $1.5 trillion, and this year it is over $1.5 trillion, and next year's budget is over $1.6 trillion. Next year's budget is about $1.7 trillion, and it goes up to $1.9 trillion. The spending goes up half a trillion dollars, and yet we hear the President say I cut spending by $250 billion. Spending has gone up every year. The President also said, "And reduce the deficit by $600 billion." I have heard that by many Administration witnesses.

Mr. Chairman, I have a chart—and I am going to send this to all committee members, because I talked to Dr. Reischauer about this, because we have heard a lot of people say because of the 1993 tax bill, we cut the deficit by $500 billion.

These are CBO's numbers. These are not Don Nickles' numbers. We got them from the Congressional Budget Office, trying to find out where the deficit reduction is. We are comparing CBO's baseline in 1993 and CBO's baseline in 1995. The differences are about $600 billion in the two, if you add the totals for 1993 through 1998.

But it is interesting to notice, tax and fee increases, $262 billion of the difference; technical and economic and debt service, $213 billion; and spending cuts, $88 billion. Of the spending cuts, there are no spending cuts in 1993, 1994 or 1995. All the spending cuts are projected for 1996, 1997 and 1998. Actually, spending increases the first 3 years.

My point being these are CBO's numbers. When you compare the baselines and see the differences when they projected enormous deficits in their 1993 forecast to this Congress, the deficits were very large. Now they are saying the deficits are going to be in this range, and the Administration is taking credit for that.

Again, if you look at the figures, there are no spending cuts the first 3 years, 1993, 1994 and 1995, compared to CBO. The only real changes were big tax increases and changes in technical and economic and debt service.

I just think we should use some truthful figures or something to make sure people realize that spending has been going up every year under this Administration. The deficit is not as bad as it was projected, but I do not know if the Administration can take credit for it, and certainly not from the spending reduction side.

One final comment, and that is this Administration's budget this year really seems to be a white flag on deficit reduction. I know I heard Secretary Rubin say we continue to cut the deficit, but I am looking at their own figures and the deficit next year is projected to be $193 billion. The next year it is $197 billion, and the next year it is $213 billion. That is the deficit increasing.

I know Secretary Rubin said, well, as a percentage of GNP, but the deficit near 2000 is still about $200 billion. So they seem to have given up on deficits and totally taken a walk on entitlements. Secretary Rubin says, well, we are reducing discretionary spending.

I look at that $144 billion that the Administration says it is going to cut over the next 5 years, but that is out of a total of over $10 trillion. That is about 1.2 percent of total spending you are talking about reducing. We are going to spend over $10 trillion in that period of time, and you are going to cut $144 billion. It is interesting to note that $81 billion of that $144 billion is in the year 1999 and the year 2000, and that is just by extending the caps. That is nothing. There is nothing there. You did not do anything on entitlements.

Senator Exon, I think we have got to do better, and I think we have to do better in a bipartisan fashion. But it amazes me that when you have discretionary spending of a little over $500 billion, the only area this Administration seems willing to cut is in defense. They have cut defense by another $20 billion between 1995 and 1996. So you have spending going up by $80 billion between 1995 and 1996, you have total spending going up by $80 billion; they cut defense by $20 billion, so you have total non-defense spending going up by about $100 billion.

Mr. Chairman, I think this budget is going to have to be rewritten, and rewritten substantially. I look forward to working with you.

Mr. Secretary, I want to ask you a specific question. I heard some of your statement that I agree with. I am glad to hear you say that you wanted to see some expansion in the IRA's. But why did the Administration not do anything on entitlements? How could you take a walk on entitlements for the next 5 years?

Secretary RUBIN. Senator, let me respond to that in a slightly broader way, if I may. We inherited a true fiscal mess, and I think it was very much reflected in markets and in bond rates and particularly the premium that existed in the interest rates on longer-term bonds.

I think the best judge of whether we accomplished something—and I think we accomplished a great deal—on deficit reduction and fiscal order is how the markets reacted to the things that we have done. Interest rates, if I remember correctly—I may be a little bit off my recollection—long-term interest rates came down from roughly 7.7 percent when we were elected, to a touch below 6, and now they are back up to about where they were when we were elected. When we were elected, there was a very high rate of unemployment, there was virtually no growth, and there was enormous pessimism about where the economy was going.

Senator NICKLES. Mr. Secretary, I am running out of time, but let me just make a statement. Was it not correct in the fourth quarter of 1992 that the economy was growing at about 4.-some-odd percent, and interest rates were at an all-time low in the fourth quarter of 1992?

Secretary RUBIN. No; actually, the fourth quarter of 1992 I think makes my point, rather than contradicts my point. I think what you will find if you look in the fourth quarter of 1992 is that it actually breaks down to 3 months, and it was the second 2 months that were very strong. It is very interesting. If you look at the consumer confidence index in the last 2 months of that quarter, what you find is it shot up after the election. I think what really happened is I think people were encouraged by change, and change fueled growth, and that is what created most of the growth in that quarter.

Rates came down, and they have now come back up to about where they were, but they have come back up in a very different environment, an environment of solid growth and low unemployment. So it is a very different long-term interest rate that we have today.

On the specific question with respect to entitlements, Senator, the President has said from the very beginning of this Administration, correctly, I believe, and agreeing with Chairman Domenici, that we must deal with entitlements. Among entitlement programs as they affect the deficit, the problem is primarily in health care, and what he is attempting to accomplish is health care reform as the mechanism, as the means for getting at the matter of slowing growth of Federal health care expenditures. He is fully committed to carrying forward that objective with Congress.

Senator NICKLES. There is nothing in the budget that would——

Secretary RUBIN. No, and I will tell you why, Senator, because we tried for 2 years to put forth a comprehensive health care reform program, and it was not a successful effort. The judgment that we made, and I think the correct judgment, was that this time we should aim for exactly the same objectives, but to work hand-in-hand with Congress and develop our program and to go as far forward as we possibly could in this year, but to work cooperatively with Congress. If we are going to do that, it would have been inconsistent to put proposals in our budget which would get us ahead of Congress.

Senator NICKLES. Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

Chairman DOMENICI. I can hardly wait, but anyway I must. Go ahead, Senator Exon.

Secretary RUBIN. I would like to go a little further, too.

Chairman DOMENICI. Let me just make one statement. It is incredible to me that you, as a Wall Street economist, businessman, and with your background, would truly sit before us and say that the President's campaign promise all by itself has brought the markets under control.

Now, if you were not saying that, then remember we did not get any action on any budget until 1993, and there are the interest rates coming down. They are coming down from 1992. As a matter of fact, they start up after the President's budget, the long-term interest rates.

Secretary RUBIN. Mr. Chairman, could I respond to that?

Chairman DOMENICI. Of course.

Secretary RUBIN. I remember that period fairly well. I think what you basically had was a period of relatively little growth during the Bush era, and I think even at the end of the Bush era there was a general sense of pessimism about future growth. Interest rates came down, but they were still very high relative to the then circumstances.

What happened when we took office is that word started to get out about what we were planning to do in terms of deficit reduction. I remember particularly one Sunday talk show when then Secretary Bentsen started talking a little bit about the kinds of things we were thinking about.

And when the markets began to believe that we were serious about deficit reduction, something which I think they had for a long time been very skeptical that government would understate, interest rates then really began to come down, not because of slow growth and recession, but, rather, because they really believed for the first time in a long, long, long time that there was an Administration that was serious about fiscal discipline. That I think is the story of 1993 and 1994.

Senator GORTON. Mr. Chairman?

Chairman DOMENICI. Yes.

Senator BOXER. Could we have regular order, Mr. Chairman?

Chairman DOMENICI. We will not be short-changed at all.

Senator GORTON. Mr. Chairman, if the fourth quarter of 1992 was so good because of people's optimism about the election, would you not say that maybe the fourth quarter of 1994 was so good because of people's optimism about the election, and now that they know that they have got the President left, growth is going to go down?

Chairman DOMENICI. I think that is a pretty logical conclusion, but perhaps Wall Street would not look at it that way.

Secretary RUBIN. No, I think I would offer an alternative——

Senator GORTON. I bet you will.

Secretary RUBIN [continuing]. Analysis of where we are today.

Chairman DOMENICI. Senator Exon?

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

Mr. Chairman, with due respect, I suggest that since the Republicans had what I think is equal to two shots, I am going to ask what, to me, is one important question, and then I would hope that we could have next up on our side, if you would agree with that. I know that you want to be fair, and I am making that suggestion, but it is up to your decision.

I suspect our two witnesses and those watching this on television sense some acrimony, some minor disagreements here or there on some of these matters that we are going to hear a great deal about.

So I guess the so-called budget debate has begun. Its tenor reminds me of the mating dance of the whooping crane, a lot of movement, but nobody touches anyone. [Laughter.]

Chairman DOMENICI. That is pretty good.

Senator EXON. I would certainly hope that after we finish our talk and political diatribe back and forth on each side of the aisle, we can then begin, after we go through all of that, the cooperation that is going to be necessary in my view to get something done.

Now, there has been something said about elections here. The people clearly sent a message, but the Republicans have only 53 votes in the United States Senate and the Democrats have 47. I would suggest on that narrow a split that it is going to take some cooperation, because neither side has the 60 votes necessary to move things through.

So I note once again, that after we get through with our criticisms, we have got to get back to working to a compromise. To that end, I would like to follow up on what I said in my opening remarks to see whether or not you agree, Mr. Secretary, with my conclusions.

I think it will be very easy for you to answer this question, because the scenario that I will outline is not very likely to happen. I am using this to make my point with regard to the tax cuts that I emphasized in my opening remarks.

Let us say, for example, that this Budget Committee decided in the interest of further reductions in the deficit that we rejected both the President's tax cut proposal and the Republican tax cut proposal, and on that basis we convinced Senator Dole, the majority leader, and Senator Daschle, the minority leader, Congressman Gingrich, Speaker of the House, and the minority leader there, Mr. Gephardt, and Senator Domenici and I walked down and we knocked on the White House door and we say we have all concluded in the interest of trying to reduce this deficit that we should drop all of our tax program. Would you agree?

I assume under that scenario that the President would certainly call the Secretary of the Treasury and his Chief Economic Adviser in and say, What do you think of their proposal? If the President would put that proposition to you, what would be your answer, Mr. Secretary, or recommendation to the President?

Chairman DOMENICI. Let me make sure we understand hypothetically you assume the Republicans beyond me. I mean you have got the leader and everybody else on that hypothetical.

Senator EXON. If you had been listening, Mr. Chairman, I think I spelled out——

Chairman DOMENICI. I just want to reiterate that.

Senator EXON. I spelled out who that would be. I am not saying you would be there, but I said just part of the mating dance.

Chairman DOMENICI. Now we have got it.

Senator EXON. Could we get your answer to that unlikely scenario? What would you say, Mr. Secretary?

Secretary RUBIN. We will take that as a hypothetical, however unlikely, which I think is the way that you presented it.

My recommendation, Senator, would be the same as my recommendation was when we put together the budget, which is that it is a complex budget, it involves different initiatives for different purposes. Ours is an economy with many problems and they need to be addressed in different ways. And I think we found the right balance between first, trying to reverse some of the income inequality that the middle-class has suffered over the last 15 years; second, and I think very, very importantly, providing incentives for people to do the kinds of things that will prepare them for the world that we are part of and going to be ever more part of as we go forward—incentives for education, training, more savings, investing in their kids; and finally at the same time continuing on the track of deficit reduction which we started in 1993.

Rather than having sort of a one-sided budget directed entirely toward one purpose, I think we found the right balance. So my recommendation to the President would be to reject the bipartisan suggestion.

Senator EXON. Therein lies, I think, the heart of the difficulty that I am trying to get at. Both sides are locked in cement. I tell the Republicans, I tell you that if that kind of an attitude prevails, we are going to have nothing but a mating dance and nothing is going to happen.

I will reserve the balance of my time and yield, Mr. Chairman.

Chairman DOMENICI. Do you feel we should go to one person on your side?

Senator EXON. I think we should. I was very short and I think you had the——

Chairman DOMENICI. Mrs. Boxer, you are next.

Senator BOXER. Thank you, Mr. Chairman.

I would like to say to the witnesses that when I got my economics degree many years ago, I learned at that time that anyone could be an economist. It is real easy, because no one is sure what is going to happen looking down the road. The problem for those people is eventually down the road comes and you see what happens.

So as my friends on the other side have been rather harsh, I would say, on the Administration, as is their right. After all, they disagreed with the President with his 1993 package, and I expect them to disagree with this package. It is part of what the ranking member here calls the mating dance. It is why we are here. We disagree on basic fundamental policy.

So I think it is important to look back and note that not one Republican voted for that economic plan. But more than that, they talked about it, and I am going to put on the record here what they said about it, because I think it needs to be put in the context of what they say today about this package, and then the American people can decide for themselves who they trust in this respect.

Senator Nickles said this, meaning the package,

> Is going to greatly hurt our economy, if not suffocate and damage our economy and make deficits even larger in the future.

He also said,

> I hate to say it, but these tax increases that are proposed are going to put a lot of people out of work.

Senator Gramm said

> I oppose the President's budget for two simple reasons: Number one, it will not work, it will not reduce the deficit, it will not improve the state of the economy.

Senator Nickles also said

> I believe very strongly that if we enact this economic package, you are going to see the number of employees decline and you are going to see the gross domestic product decline, because you are going to put a lot of people out of work.

And Senator Gorton said

> These are very large tax increases on some of the wealthier in our society,

and he goes on to say, in fact,

> The behavior of these people will change markedly, so markedly that we will be lucky to get one-quarter of the increased revenue which is predicted in the President's budget, that, of course, behavior changes when rates go down, and behavior will change when rates go up.

So I just want to, because I think it is important to now look at what happened, make sure that I am clear on exactly what happened. We created in this country over 5 million new jobs since that package. Is that correct, Secretary Rubin?

Secretary RUBIN. Approximately 5.7 million jobs, of which a little over 90 percent are in the private sector.

Senator BOXER. Did the revenues that come in to the government go down or go up or hold steady?

Secretary RUBIN. Our revenues have gone up with the solid growth that we have had in the economy.

Senator BOXER. And the inflation rate?

Secretary RUBIN. The inflation rate has remained under 3 percent.

Senator BOXER. And the deficit as a percent of GDP?

Secretary RUBIN. Very importantly, the President, as I said before, inherited a fiscal morass, a fiscal mess and one was that widely perceived as a fiscal mess around the world, and he has put us in a position so when I went to the G–7 Finance Ministers meeting this past Friday in Toronto and we discussed how various countries are doing, we are now viewed as a country that has its fiscal house in order. I believe if we stay on the deficit reduction track that the President has set forth and make the tough choices that he proposed in order to keep us on that track, we will continue to be so perceived.

Senator BOXER. I well remember when President Bush went to Japan and I well remember it was a trip where he was supposed to tell the Japanese to get their economic house in order. Instead, the world looked at us and said: shape up, America. I have to say that we did. When I cast that vote, that was a tough vote. I took a lot of heat for that vote. But I can truly say there is a difference between talking about a balanced budget amendment to the Constitution that will take effect in 7 years, which may or may not be good for this country—I have my own views on it—and casting a tough vote to make the tough choices.

I would like to ask Dr. Tyson a question about the deficit reduction, because I think Members on both sides of the aisle have questions about it. The President's goal was to get that deficit cut in half from where it was projected to be.

Why is it that you do not think it would be good for the economy, Dr. Tyson—and Secretary Rubin, if you wish to add at this point—to continue that kind of massive deficit reduction and, rather, stabilize the deficit at this point?

Dr. TYSON. I think that Secretary Rubin said it fairly clearly. The goal of our government budget or fiscal policy, it should be understood as basically to improve living standards, and there are many ways to do that.

One way is through deficit reduction for precisely the reasons that Senator Domenici alluded to in his opening remarks. That is, the government, when it runs a deficit, is dis-saving and, therefore, taking savings out of the society that could be used for investment purposes. So it is important to keep progress on the deficit.

It is also important, however, to make sure that we invest in our future directly through education and training programs, through science and technology programs, through programs that build the foundations for future prosperity.

We also believe that, given what had happened to the distribution of income in the United States, because one of the things the G–7 nations, the OECD and other international observers say about the United States is the widening disparity of income distribution is actually a major problem in our society. We want to do some tax relief for the middle-income class. So this is trying to do a balanced approach to a series of problems.

We finally say that what I have emphasized a number of times and emphasize again, deficit reduction by itself, whether through spending cuts or tax increases, is contractionary. It slows the economy down. You should do it gradually, so that you have time for monetary policy and interest rate changes to replace the poor momentum of the economy, which deficit reduction is taking away.

Senator BOXER. Thank you very much. I will hold until the next round.

Thank you.

Chairman DOMENICI. Senator Grassley?

Senator GRASSLEY. I think the President's budget reflects an abdication of leadership. It not only fails to put us on a glide path towards a balanced budget, but I think it fails even to meet the President's own promise and goals that he made. If you remember, that was to cut the deficit in half by 1996.

It is kind of a farcical sort of scene of how this budget must have been sent up here to Capitol Hill. It seems to me that the President's team lined up along Pennsylvania Avenue and punted copies of the budget one by one. After the January 24th State of the Union Address of the President, I remarked then to people that asked me, that it seemed to me that President Clinton seemed willing to follow the leadership of Congress, and that was a responsibility that was given to us by the electorate last November.

Today, though, I think through his actions on this budget, the President confirmed my suspicion and submitted a budget that says let Congress lead, let Congress make the tough choices. According to reports, several of the President's high-level advisers counseled that since the Administration has failed to get credit for previous deficit reductions, then there is little wisdom in proposing further deficit reductions. Mr. Chairman, I hope that this is not the case, for if it were true, there would be no clearer signal of the absence of leadership from the White House.

Just last month, Administration officials were boasting about achievements on the deficit front and bemoaning the fact that the message simply was not getting out that the President had accomplished a great deal. Why are they now then abandoning a virtuous policy, instead of working on getting the message out, if they want to be viewed with any credibility? I think the answer is that, because in abandoning their goal of lower deficits, the Administration has also abandoned its promise to the American people of cutting the deficit in half by 1996. As a consequence, I think the President has lost the moral authority to lead.

Clearly, the President has chosen to play defense with this budget, and that is why the President's team has punted to Capitol Hill. They are saying to us you call the plays now, so it is your turn at the ball and let us see if you can do better. Of course, I believe that

Congress can do better, and we have to do better for the sake of our children and grandchildren.

The President has followed the lead of the American people who spoke in November. Thus, I think he has passed that mantle of leadership to us to make the tough decisions. With that leadership, the Republican Congress has already delivered on making Congress more accountable to the public and to State governments, and now we will work towards making Congress more accountable to the next generations.

The first question I have, to set the stage for it, I want to note that concern about the deficit, at least from the press reports out since yesterday's arrival of the budget up here, has been not a partisan matter. Senator Exon and Senator Bradley have both highlighted the need to cut the deficit and to do better. Of course, as far as this last Congress was concerned, Senator Exon and I, when I was in the minority, we put together a bipartisan effort to cut spending. That was the only effort to successfully cut the President's budget the last time. So I look forward to this committee moving ahead with bipartisan leadership in working to cut the deficit.

Dr. Tyson, along that line, the Administration has a long section devoted in last year's budget to what was referred to as "generational accounting," which discussed at length the tremendous burden of the deficit on our children and grandchildren born today, a burden equivalent to a lifetime tax rate of over 80 percent.

This section on generational accounting is nowhere to be found in this year's budget. Now, I could say perhaps this is because the Administration's budget never gets to be balanced, does not even come close. Is it the Administration's position that it is unnecessary to try to balance the budget, that we should not worry about the burden we are placing on future generations? I ask that because you do not have in this budget a section on generational accounting like you had in last year's budget.

Dr. TYSON. I think we have a clear track record on being serious about deficit reduction. We were the Administration that offered a $505 billion package. We were the Administration that was coming back with an additional $81 billion. We are the Administration that found $144 billion of additional savings to finance a modest, but targeted, middle-class tax cut. We are not the Administration that is proposing $700 billion of tax cuts which was released today in the Joint Tax Committee's estimate of the Republican contract proposal for tax cuts. We have a serious track record on deficit reduction.

I really want to go back to the chart that Secretary Bentsen had, showing that for the first time—excuse me. Secretary Rubin.

Secretary RUBIN. That is all right. I borrowed it from him. [Laughter.]

He lent it to me and I brought it here.

Dr. TYSON. I am so used to thinking about Bob as the NEC Chair. Secretary Rubin.

Senator GRASSLEY. Since you cannot get it out, you were quoted in the Washington Post Saturday as saying——

Dr. TYSON. Cannot get what out, Senator?

Senator GRASSLEY [continuing]. As saying Laura Tyson took up opposing views in the meeting, arguing there was no need to cut the deficit so severely. Rather, she said Clinton only need be able to show the deficit declining as a percentage of the total economic output, rather than absolute terms. That says you are abandoning getting to a balanced budget.

Dr. TYSON. First of all, that was a press account. The person who wrote that account was not in the meeting. You are not going to ask me, I assume, and I am certainly not going to reveal what goes on in discussions between private advisers of the President on economic issues.

I will stick by what I have said before. We are searching for a balanced package that continues deficit reduction, that holds the deficit down relative to the size of the economy during the entire 10-year horizon, and we will provide numbers which show the deficit is not, contrary to what someone said, rising between 2005. It is simply not.

But this balanced package continues progress on the deficit and, frankly, it is the only package that is before us. There is no alternative package before us. People are talking about getting the deficit down, and they are talking about getting entitlement spending under control. There is not a single proposal. You have one proposal for it before you and you have our older, our $505 billion from our previous package, and the economy has done extremely well under those packages.

Chairman DOMENICI. Would the Senator yield for a moment?

Senator GRASSLEY. Yes, I will.

Chairman DOMENICI. Are you suggesting, Dr. Tyson, that you want to wait to see what we propose before you come up with some conclusions on entitlements?

Dr. TYSON. What I am suggesting is that we presented a package and our package is our best judgment of what is good for the economy in the next 5 years. Of course, others will suggest alternative packages. I just want to emphasize that we presented our first package, OBRA 1993, we presented that package 27 days after we took office. The Republican majority has been in control for more than 27 days. There are many people working in the Republican majority who have been allegedly interested in deficit reduction for years. I do not understand why there is not a package right now.

Chairman DOMENICI. Senator Dodd, you are next. Let me just say, Dr. Tyson, I hope that is not directed at the Senate Budget Committee. You might direct it wherever you like——

Dr. TYSON. That was just——

Chairman DOMENICI [continuing]. But it is impossible for you to equate what the Administration has at its disposal to put a budget together and what Congress has. One is major league and the other one is not even minor league. We do not have the ability in 3 weeks or 3 months to look at the whole budget and come up with a detailed plan. We will come up with one. It is the responsibility and it has been for as long as I know that the President submit his first, and you did.

Dr. TYSON. And we defend ours as the balanced best approach for continued economic prosperity.

Chairman DOMENICI. Senator Dodd?

Senator DODD. Thank you, Mr. Chairman.

I am certainly not going to suggest this committee is minor league. I want you to know that.

Chairman DOMENICI. I think in comparison to OMB and everything else——

Senator DODD. I understand. I am trying to lighten this up a little, Mr. Chairman.

First of all, thank you both for your testimony. Let me pick up on where Senator Boxer was speaking. You have got three of us here on this committee that were around in 1981, 1982, and 1983, and it is important to lay some background here.

In 1981, when President Reagan was sworn in, the deficit for that fiscal year was $79 billion, and the public debt of the country was $785 billion. I can go back and look at the record as to the statements that were made about how we were going to balance the budget by 1984. We applied some economic ideas that yielded significant tax cuts and defense spending increases.

I think it is important to lay this out. After 12 years, we ended up with a deficit in fiscal year 1993 of $255 billion, and we quadrupled the public debt to $3.3 trillion, from $785 billion. There are 11 of us here who voted against the 1981–82 economic package, because it did not make any sense at all. I think a lot of people would like to have those votes back, if they could.

So the train wreck that this Administration inherited did not happen by a miracle. It happened because we approved the Reagan broad guidelines of the Bush economic and budget requests. Congress actually approved budgets at the end of 11 of the 12 fiscal years that cut the total spending that was requested by either President Reagan or President Bush when they were in charge of submitting budgets to Congress. That is a fact. I am not making those numbers up. Those are facts. So we find ourselves coming into fiscal year 1994 with that mess on our hands.

By the way, interest rate creep was, in fact, due to a lack of confidence in the ability of this town to deal with the fiscal mess. That is what was at issue there. You have got interest rate creep today for an entirely different set of reasons. The economy is too strong and may be heating up. I think many of us have severe reservations about the latest increases in the interest rate by the Fed, but, nonetheless, there is a totally different rationale for interest rate increases than existed back in the early 1990's.

So what we have now is 3 years of deficit reduction. Is it enough? No. Would all of us like to see more? Absolutely. But we have all seen the rhetoric in this area, and yet when it comes right down to actually doing some things, this town has difficulty with it. This Administration, however, because of its policies in the last couple of years, has put us on a good glide path to balance. For the first time in years the economy is growing faster than the deficits and I want the Secretary to confirm that. Before, deficits were growing faster than the economy. Now we have an economy that is growing faster or rising faster than debt is in the country. That is not insignificant.

I mentioned 3 years of deficit reduction, the lowest combined rate of inflation and unemployment in 25 years. I want confirmation of that, if that is not the case. That is not insignificant. People care about inflation and unemployment. The combination of those two numbers are lowest they have been in a quarter of a century.

So I think those basic facts needs to be emphasized as some background, and an indication of what actually has been accomplished.

Now, the Chairman of the committee says that we do not have an opportunity yet to put together a budget. This much we do know. Our friends on the other side have said we are not touching social security, defense is going to go up, we must, of course, pay interest payments. As I understand it, that is roughly 50 percent of the budget.

Now, it seems to me if you got control of the House and Senate on November 8, almost 4 months ago it is not unreasonable or unfair to ask you to further spell out in some detail how you are going to balance the budget. All we have had is a proposal to cut taxes by $200 billion, and no indication at all of how you will pay for it, no indication.

So I think it is important to lay the background for that. I will come back to my question, and that is would you confirm for me whether or not those numbers regarding inflation and unemployment are accurate, and also whether or not for the first time in years we have actually seen the economy growing faster than our debt.

Secretary RUBIN. Senator, I am prepared to confirm those numbers and the analysis that went along with them. [Laughter.]

Senator DODD. Thank you, Mr. Chairman.

Chairman DOMENICI. You did better than he would do. Thank you very much, Senator.

Secretary RUBIN. Well, I do not know if I with all of that—I agree with the analysis, but not necessarily the evaluation. [Laughter.]

Chairman DOMENICI. I am the neutral observer. [Laughter.]

Senator BOXER. Can we have a vote on that?

Chairman DOMENICI. Yes, we win 12 to 10. [Laughter.]

Senator Abraham?

Senator ABRAHAM. Thank you, Mr. Chairman.

I just want to point out to all those who are viewing this that I was not here during any of these previous—— [Laughter.]

As I observed in the Committee on Labor the other day, although I have only been in office 4 weeks, I already find my constituents holding me accountable for the entire $4.8 trillion all the rest of you ran up in the previous few years. So I have quickly learned how fast the responsibility shifts to the new members.

I just would observe—and I may reserve the opportunity to submit something for the record—that the one thing that is consistent is the deficits grew. And Senator Dodd alluded to the growth of deficits during the 1980's, and there is one pattern that was quite consistent, and that was the amount of tax revenues that the government received.

It seems to me that as you check the percentage of GDP that was received in revenue, it remains pretty constant at about 19 percent of the economy. It is the spending side that continued to increase. The government sector side, I believe, grew during that period of time, and I think we ought to take note of that as we are trying to look at the way that we might best direct ourselves at bringing the budget under control; that it has been spending—it is not the consequence of tax cuts or anything else—that created the deficit growth in the 1980's. It was the consequence of increases in spending.

My question for Dr. Tyson is this: In your opinion, should we attempt to bring the budget into balance, or do you feel it is preferable to try to limit the size of our deficits to a certain percentage, decreasing perhaps, but a percentage of GDP? Which, in your judgment, is the preferable option?

Dr. TYSON. I want to emphasize that I believe, as I think Secretary Rubin has said and others in the Administration have said, that we believe what this budget does is build on the progress of OBRA 1993, keep the deficit under control, keep it coming down relative to the size of the economy. But we are not satisfied. We have said from the beginning—indeed, President Clinton said to me the very first time I met him in Little Rock in August of 1992, he said we have some very serious work to do on the deficit. We can do some of that through cuts in discretionary spending. But we are going to have to reform the health care system.

Now, I don't know how many times the Administration has to make this point. Almost 40 percent of the increase in spending that will go on in government spending between now and the end of this decade is from projected increases in Federal health care spending. But we have also made it very clear that we don't believe that any arbitrary methods to cap that spending in the absence of health care reform can work. Because if you try to cap the Federal spending on health care, the costs will be shifted to the private sector. We already see significant cost shifting going on. There would just be more of it.

In addition, arbitrary capping in the absence of meaningful health care reform would result in real cuts of real services to real people. Let's not kid ourselves. So our position has been, yes, we want more progress on the deficit; it needs to be done, first and foremost, through meaningful health care reform. And that is what we have tried to work on with the Congress in the past 2 years. We obviously did not succeed.

The problem did not go away. The numbers don't go away. The facts are inexorable here. So sooner or later, serious efforts at further deficit reduction must engage that issue.

Senator ABRAHAM. But the point you are making, just to go back to my question, is it your view, is it the Administration's view or maybe just your view, that we should try to bring the budget into balance?

Dr. TYSON. It is my view that we should make further progress on the deficit working towards balance, but the next way to do that is through meaningful health care reform. That is my view.

Senator ABRAHAM. OK. Have you tried to develop a plan that would bring the budget into balance?

Dr. TYSON. We tried in the past 18 months, as you well know, to work on the issue of health care reform. The Congressional Budget Office, which did an analysis of our proposal, did show that in the course of a 10-year period it would begin to bring health care spending under control at the Federal level.

We did not succeed with that package. But we have been developing those kinds of proposals.

Senator ABRAHAM. My question to either of you, though, is this: Is there tucked away somewhere, in either the Council of Economic Advisers or the Department of Treasury, a plan to balance the budget?

Secretary RUBIN. Senator, could I make one comment? I think there is not as much difference in some respects as some of the discussion suggests. This President believes very strongly in getting the deficit under control, in fiscal order, and I think we have accomplished an enormous amount in the time that we have been in office.

On the other hand, there are a lot of other purposes that he feels need to be achieved if we are going to have a productive and successful economy of the years ahead.

If you take a look at that chart,[1] I think maybe it is the best answer to your question. If you take this budget and add it to the economic plan we put in place in 1993, what you wind up with is a deficit that will come down from 4.9 percent of the total economy to 1.6 percent of the total economy early in the next century.

If you then deal with health care, you start to get very close to a balanced budget.

Senator ABRAHAM. Yes; I am not questioning anybody's motives. My question is just this: Has the Administration at any point sat down and said, look, I am for public consumption, but for private consumption, you know, let's do this and see what it looks like, and then when it was done you said, boy, we had better not show that to anybody? Or have you not ever done that?

Secretary RUBIN. I have actually, I think, responded to at least the thrust of your question, albeit maybe not to the precise balance. But if you can get down to 1.6 percent without dealing with the health care problem—and the health care problem is the component of the budget that really drives the deficit—if you could deal with health care reform in an effective way, you get yourself very close to a balanced budget.

Senator ABRAHAM. So your position is that basically you have come down as far as you think it is feasible to come down toward balance without addressing health care, and you feel that you could get a balanced budget if health care was effectively addressed?

Secretary RUBIN. I think Dr. Tyson said it exceedingly well. We have brought the deficit down as far as we think it is economically sensible to bring it down, given the trade-offs that you have to make on the discretionary side to get it down further. We think when you tackle health care reform; you can then get the deficit down to where it is relatively immaterial in terms of financial markets.

Senator ABRAHAM. But neither of your offices has actually developed a budget that says zero at some fixed date?

Secretary RUBIN. I think for practical purposes I will go back to what I just said. You can get yourself in a position——

Senator ABRAHAM. The answer is no, though; right?

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[1] See p. 118.

Secretary RUBIN [continuing]. Where what is left of the deficit is not meaningful in terms of how the economy performs.

Dr. TYSON. Excuse me. Could I say one thing about this? As you well know, there are many ways one could do what you would like. I think the issue is what would be their economic effects. What we are trying to say here is that we believe that going down towards 1.6 percent of GDP and then adding meaningful health care reform on top of that is our plan for moving the economy towards a balanced position, while preserving the health of the economic expansion. That is——

Senator ABRAHAM. Well, I appreciate that, and my point here, Mr. Chairman, is only that we are being asked every day on the floor of the Senate, produce your plan that gets the budget into balance. And I just wanted to ascertain whether or not anybody in the Administration has done that. And I guess the answer is—at least so far the answer is no.

Senator DODD. If my colleague would yield, there is a distinction there: those who are advocating a balanced budget amendment to the Constitution and those who are opposed to it. If you are in favor of it, I think you have an obligation to meet it.

Senator ABRAHAM. Well, no. I think you have the same obligation if you believe the budget ought to be balanced.

Senator DODD. No; the Administration doesn't support the constitutional amendment on a balanced budget.

Chairman DOMENICI. He is not advocating——

Senator ABRAHAM. No; there is a distinction, Senator, between——

Senator DODD. Well, if you are advocating a constitutional amendment to balance the budget, you have an obligation to meet——

Senator ABRAHAM. No; you do not want to hear what I am saying. What I am saying is there is a distinction between an amendment and a desire to have the budget balanced, whether you do that without an amendment. A number of us here support an amendment; some say, though, that we should balance the budget without one. But I think you have the same obligation, if there is, in fact, the right to know, to produce or to have attempted to produce a balanced budget if you believe that ought to be a goal.

It is my impression that the Administration has it as a goal. I am just trying to determine whether there is such a plan.

My time is up, Mr. Chairman. I thank you.

Chairman DOMENICI. Thank you very much.

Senator Murray?

Chairman DOMENICI. Senator Murray?

Senator MURRAY. Thank you, Mr. Chairman, and thank you, too, Secretary Rubin and Dr. Tyson.

We have had an incredible amount of discussion here in Congress about the balanced budget amendment. I think everybody agrees we need to work toward deficit reduction. I don't think that is an argument today, but I have to tell you I am very concerned. Despite the good news that the deficit has been reduced over the last few years and that 6 million jobs have been created, I hear that everyone is really fearful they are going to lose their jobs. That is the number one concern in my State. They may have one today, but whether they are a grocery store clerk or an attorney, they are worried that they won't have one tomorrow.

As we talk about reducing this deficit and the balanced budget amendment, is anybody doing an analysis of how many jobs are going to be lost if the resolution is adopted? I don't think you can say that you can reduce the deficit this way without putting people out of work. Has anybody done an analysis of that?

Dr. TYSON. Well, let me say a couple of things. I think you can distinguish what you might call the transition path between where we are and going to balance and then the effects of basically handcuffing the economy through a balanced budget amendment requirement evermore.

Let me take the issue of having a balanced budget amendment which would require year-by-year balance. What we have done is tried to ask ourselves the question what would that mean if the economy were hit by a cyclical downturn, and in the work that we reported today in the Washington Post we just looked at 1991, which was a recent year, and we concluded that the cyclical downturn that year probably meant that the deficit automatically deteriorated by about $70 billion just from the slowdown in the economy.

If you had tried to offset that in a balanced budget world by either tax increases or spending cuts within that year, it is our estimate that you would have lost something like more than an additional point of GDP, and perhaps as many as 800,000 extra jobs would have been lost in what was already a recession.

So, clearly, we feel that the loss of what is called the automatic stabilizers—the ability of a budget to respond to a cyclical slowdown by allowing revenues to fall and spending on certain cyclically sensitive programs to rise—that those stabilizers would become destabilizers. The amendment would require the budget to destabilize the economy as opposed to stabilize the economy, and it would leave, therefore, all of the responsibility for moderating what are well-known cyclical ups and downs in the American economy to the Federal Reserve, to a single actor, through monetary policy. Although the Federal Reserve might be able to do it, there are a number of reasons why they would find it very difficult.

On the issue of the transition from here to a balanced budget—suppose we are trying to cut the deficit to get to balance by the year 2002. I think, again, what I would say is most projections for the United States economy for the next 5 years or so have it growing at about 2.5 percent. It is slowing down for reasons that I will talk about when I give my oral statement.

Any amount of additional deficit reduction during this period will, by itself, be contractionary. In principle, that can be offset by interest rate declines. In principle, that can be offset by Federal Reserve policy and long-term interest rates, but people need to be aware that if you compress a whole lot of deficit reduction into a short period of time, you are increasing the downside pressure on the economy and you are putting a lot of pressure on interest rates to respond fast enough and sufficiently enough to offset that, and so you are adding some risk and uncertainty to an economy.

Senator SARBANES. Patty, would you yield for just a second?

Chairman DOMENICI. Just a moment. I want to make sure we are doing what we said at the beginning. Your question was directed specifically to Dr. Tyson?

Senator MURRAY. Correct.

Chairman DOMENICI. I thought we were directing our questions directly at the Secretary because he has to leave in about 6 minutes, and we will get back to her for the rest of the morning. I think that is what everybody assumed.

Senator MURRAY. I can pass it and come back to that.

Chairman DOMENICI. I am not trying to keep you from doing it, nor you, Senator Sarbanes.

Senator SARBANES. I will just take 30 seconds, and I want the Secretary to see this chart as well.

Chairman DOMENICI. Well, let's just say you might not do that. I mean, I am running the committee. Could you at least ask me if you could?

Senator SARBANES. I asked the Senator to yield on her time, not my time.

Chairman DOMENICI. Well, are you asking the Secretary of the Treasury questions, or who are you asking questions of?

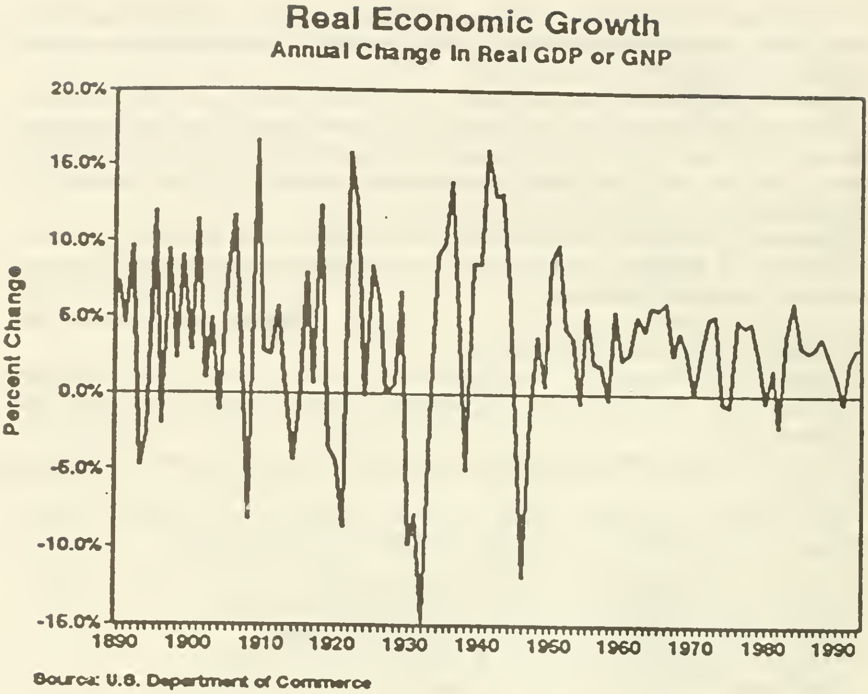
Senator SARBANES. I am asking the gentle lady to yield out of her time so I could just make a point about this chart.

Chairman DOMENICI. OK. Go ahead, go ahead.

Senator SARBANES. Is there a problem with that?

Chairman DOMENICI. No; 30 seconds is fine. Go ahead.

Senator SARBANES. This chart shows the fluctuations in real GNP. What it shows is that during the post-World War II period, when we have had fiscal stabilizers, we had smaller fluctuations between boom and bust. We had negative growth, but at a much lower level than prior to the fiscal stabilizers.



Now, Mr. Secretary, aren't the fiscal stabilizers working?

Senator RUBIN. Senator, the answer to your question is yes and, as you know, one of the very grave concerns we have about a balanced budget amendment is that it undermines—or rather, it eliminates the automatic stabilizers that have had precisely the effects that you have just described.

Senator SARBANES. So it may throw us back into the boom and bust?

Secretary RUBIN. We think it creates very serious macroeconomic risks for the economy, both for the reason that you have stated and also because trying to compress so much deficit reduction into such a short period of time, as Dr. Tyson just described, creates its own macroeconomic risks.

Senator SARBANES. Thank you.

Chairman DOMENICI. Thank you, Senator. The reason I raised the issue is some of us have been here 1½ hours and have not asked any questions. I see them on your side, too.

Go ahead, Senator.

Senator MURRAY. I yield back my time.

Chairman DOMENICI. Do you want to ask any further questions of the Secretary?

Senator MURRAY. No.

Chairman DOMENICI. Thank you very much.

I guess what I want to do is not waste an awful lot of time on the past, except to make a couple of points, Mr. Secretary. You are going to have to do a little better in talking about how much the President has reduced the deficit because the highest the deficit ever was—you can talk about projections of $400 billion, but the highest it ever was $290 billion, the last of President Bush's budgets—$290 billion, not $400-and something. The next year, it was $255 billion in 1993, and the next year it was $203 billion.

Incidentally, for those who are interested, after all we have gone through and all the claims of deficit reduction, if my numbers are right we have reduced the deficit $90 billion, from $290 billion to $200 billion. That is what we have done. I don't know that that is a great achievement. We called an economic summit to try to fix the problems of our country when we had a $195 billion deficit.

Having said that, if ever I would like to be in a position to take credit for things that one hardly had anything to do with, I would like to be the two of you because you are in a marvelous position. Do you know, when the deficit went from $290 billion to $255 billion, we didn't do anything? Isn't that interesting? We did nothing and it went from $290 billion to $255 billion—no budget changes.

Then we went to the next year, which is 1994, and it is at $203 billion, I say to my friends, and I am just looking at a recap of it. Now, unless the entire marketplace really responded to the fact that the President was saying he was going to do things, let me make sure we understand that in the year of 1994 policy changes that reduced the deficit were $28 billion. That is the taxes. There were no other policy changes effected that year.

Now, give me the chart[1] on interest.

I am not so concerned about short-term interest rates, like everybody seems to be, other than they are a precursor or forerunner to long-term. But just so we have this part straight, I think economists say the most important thing we ought to try to do for our kids and for the next generation and for growth is to get long-term interest rates down. That is what stymies the economy. It is business paying more than it should for long-term investments. It is mortgages, long term, are higher than they ought to be. It is all the things that farmers have to buy over 10 or 15 years.

Well, look, this long-term interest rate started down in 1991. It is interesting that our friend, Senator Sarbanes, puts up a chart saying we have got some stability; it doesn't go up and down so much the last 3 years. Guess why? I mean, most people will tell you it is not the budget; it is the Federal Reserve Board, which he takes to the floor and attacks viciously, that we ought to tell them what to do. The Federal Reserve Board is responsible for keeping it kind of cool and not moving around too much. In fact, they are trying to make sure we get a soft landing.

But look at this. Long-term interest rates have started down. Here is an election and they are already on the way down. They go down for one more year and, interestingly enough—and I don't know that this is a direct one-for-one, but since credit is being taken as if everything flows one on one, look here. Right after we pass the President's budget, long-term interest rates go up.

One can say that was the Federal Reserve Board intervening, but look, long-term interest rates came down because the Federal Reserve Board started loosening money policy. So, essentially, one

[1] See p. 111.

might say long-term interest rates went up immediately after the passage of the President's budget.

Now, I am not going to sit here and tell you that that was because of that budget, but neither am I saying that anybody in this country ought to believe that the prosperity that abounds in this country today is because of a President's budget that essentially to this point is all tax increases.

Secretary RUBIN. Mr. Chairman, could I respond to that?

Chairman DOMENICI. Well, let me finish.

Secretary RUBIN. OK.

Chairman DOMENICI. You will get a chance. You all have been talking a lot here today, your side has, and I have said nothing to speak of.

Second, let me just make it clear that the big problem we have in this country is what is going to happen to health care and the excessive, inordinate increases. Now, if you want to really say what the President did, let's narrow it down. We keep saying he put a white flag up on the deficit and all these nice words.

What he did is he did not even begin to solve the problem of ever-increasing health care costs. That is the surrender, that is the surrender, because if you are wondering where we are going—and I would think our President and his Secretary of the Treasury and his Economic Adviser ought to be worried about this.

The reason the deficit is going to go this way even after you adopt his budget, if you would, is because we aren't controlling health care costs. What is going to happen is our children are going to have nothing left over here. Now, one would say wait until he gets his health care reform package through, and that is amazing, and I am amazed that the Chairman of the Council of Economic Advisers could say that.

The worst nightmare of the last budget was that you put on the largest tax increase ever and you didn't get the deficit under control. That is the nightmare, and that is true. The President's health care reform package says more taxes. How many more taxes? His health care plan says to get health care under control, we spend $300 billion in new taxes; in other words, another tax on the American people.

I have the plan in front of me. To the year 2004, health alliance spending would go up under the President's health care plan $428 billion, new taxes of $300 billion, and, interestingly enough, in addition to the deficit of $126 billion. So how would we ever get the deficit under control?

Now, having said that, let me just make sure I understand. We are entitled to your advice, too, Mr. Secretary and Chairman of the Council of Economic Advisers. To get the budget to balance in the year 2002, in your opinion, is not good for the American economy, is that correct?

Secretary RUBIN. I think, Mr. Chairman, that one has to answer that in context, if I may.

Chairman DOMENICI. Of course.

Secretary RUBIN. I don't think that there is any question—and I think if you discuss this with people in the financial community, they will confirm this—that at the end of the prior Administration there was a general sense of fiscal disorder, enormous pessimism, skepticism that this institution of government would ever reestablish fiscal order.

I think similarly, without question, if you ask people in the financial community, what they will for the most part tell you is that the President's 1993 economic plan had enormous credibility, that it was in large measure responsible for the decline in interest rates that occurred through 1993. In fact, the reduction in the deficit that you referred to in 1993, which you said had nothing to do with what we did, I think you will find, if you look at it, that it was largely a function of the decline in interest rates, which was in response to the budget that we put forward and the reaction in the financial community to that budget.

I also think that——

Chairman DOMENICI. Well, let me just say you take a look when you get back and then we will compare notes. I believe it was principally technical readjustments that had nothing to do with economics.

Secretary RUBIN. There was interest rates and there was a related factor, I believe, of RTC payments, and those had to do, again, with a healthier economy and lower interest rates which were favorable for the S&L industry. We can compare those notes. It is a relatively minor point.

We also were in a position where the programs that we had inherited from the prior Administration—and I think the projections are all-important, Mr. Chairman—those programs, if allowed to go on without reduction, would have produced a budget deficit of $400 billion in 1998. What we had to do was to put in place a massive program of spending cuts.

We put in place a program of $250 billion. If you like, we can resubmit in writing the description of those cuts. It was the Deficit Reduction Program that produced the interest rate declines which, in my judgment, and I think in the judgment very largely of people in the financial community, were responsible for the improvement in the economy in 1993 and the healthy economic path that we have been on since.

Looking forward, as both of us have said a few moments ago, we are as concerned as you are, Mr. Chairman, about the long-term deficit. I think that in one sense we have a bit of agreement. We both want an effective—I shouldn't say you and I, but the Administration and you, Mr. Chairman, and Senator Exon all want to see an effective deficit reduction program going forward.

It is our judgment that this budget, if enacted, would put us on that path, and if you don't believe we have made serious cuts, my suggestion would be to speak to people like Secretary Cisneros, Secretary Peña, and Secretary O'Leary as they struggle with the extraordinarily difficult cuts that we have imposed on their agencies.

But, now, you are right about——

Chairman DOMENICI. But, Mr. Secretary, wait a second.

Secretary RUBIN. No, wait; one more sentence.

Chairman DOMENICI. When you speak of cuts, you have got to have net cuts, not just because Cisneros took a hit. What happened to the overall? It didn't go down any.

Secretary RUBIN. No; the overall discretionary side of the budget, will be lower in every year going forward than it was in 1995. The problem is the one that you identified on your long-term chart and the same one Dr. Tyson and I have talked about and which the President talked about for the last 2 years; it is health care reform.

We made a massive effort to accomplish health care reform. It did not succeed congressionally. It seemed to us that the sensible way to go forward now, and I think this was a correct judgment, is to work with Congress toward the same ends, and that is what we are fully prepared to do.

Senator GORTON. Are you going to answer the Chairman's question? His question was if we went to a balanced budget by 2002, would it hurt the economy?

Secretary RUBIN. Now, let us go from this last point to the response to that question. I think Dr. Tyson actually did answer that question. The way to go forward with deficit reduction, in our judgment, is to continue on precisely the path and process we have been on, which is every year to make very tough decisions and decide what makes sense in the context of the economic circumstances of the particular year.

I don't think, Mr. Chairman, that you can judge at this point whether reaching a balanced budget by 2002 will be good, bad, or indifferent to the economy because you don't know what the circumstances will be. If, for example, we had a very serious slowdown, you would then very much wish to have the automatic stabilizers in effect. But if you have a balanced budget amendment, you will have lost the automatic stabilizers.

Chairman DOMENICI. No, no, no. We are not asking the question about whether we need stabilizers. We are assuming that if we put a balanced budget amendment in place, we will adopt implementing language that will have some kind of stabilizer in it.

We are really asking, just from both of your standpoints, if you reduce the deficit by an amount in installments from now to 2002, is it your testimony the economy could not take that kind of reduction, that it would be harmful? That is the question.

Secretary RUBIN. Let me express it and then let Dr. Tyson express it. I think to do that on an arbitrary basis is unsound economic policy. I think the right economic policy is to continue on a downward path with respect to the deficit and do it in a deliberate, thoughtful, serious fashion in the context of the circumstances of each year.

Chairman DOMENICI. OK. So if we assume that we are doing it in a thoughtful and enlightened manner——

Secretary RUBIN. Then each year we can have this discussion, which I think is a good thing to have, and Congress and the Administration together can decide how much we should do each year, what the tradeoffs are, what the economic impacts are, and we can make serious, thoughtful decisions each year.

Chairman DOMENICI. Thank you for not answering the question.

Doctor, would you try, please?

Dr. TYSON. Well, I wouldn't characterize Secretary Rubin as a non-answerer. I think he answered the question, but let me try the same kind of answer, and probably it won't be satisfactory to you.

I would say two things about that. Number one, what I said very clearly was that going on any kind of tightly specified path to reduce what is, after all, a large remaining deficit problem which requires cuts in the range of $1.2 trillion of spending cuts before any tax relief—that is a lot of spending cuts in a short period of time.

Whatever anyone protests to the contrary, that does add contractionary risk to the U.S. economy. You can go to any major macro model of the U.S. economy and you will see that cuts in government spending of that magnitude tend to slow the economy down. They can be offset, as I have said very clearly, by interest rate declines. We have no control over that; you don't and we don't. That is the response of the Fed and financial markets to what we do. So, that is the first part of my argument. Yes, there is contractionary risk imposed by this.

The second part is there is no way to evaluate whether it is good for the economy or not good for the economy to go to balance by the year 2002 without knowing exactly what it is that would be proposed to get us there. If, to get us there, it requires that the government essentially abolish training and education programs, get out of Head Start, get out of WIC, stop providing student loan programs, stop providing support for research and development, stop providing tax relief for investment, I would say that that is not a clear winner for the U.S. economy.

We might get to balance by 2002 and the U.S. economy could actually be worse off. So it depends very much on the package of actions that would be taken to get us there. We think the right package of actions is to move with health care reform. If you look at the budget, there is a very important chart in the budget and it shows that on the glide path we are currently on, if per-beneficiary health care spending were to increase only at the rate of nominal per capita GDP we would be in balance by 2003.

Chairman DOMENICI. He has to leave, so just one moment. I just want to state for the record so we understand, you talked about discretionary spending, a small part of the budget. But, you see, when you have caps and they go off and come on, you can kind of play games. The truth of the matter is in the year 2000 discretionary spending will be $550 billion, and believe it or not, in 1996, it is $550 billion, the same amount.

Now, frankly, you can talk about inflation, but I think the public thinks when you are trying to get to a balanced budget that you really reduce the expenditures in major parts of the government. It will be identical in 2002 as it is today.

Secretary RUBIN. Mr. Chairman, if we could somehow or other keep Federal spending constant while the economy grew, then, in fact, you would reach the point where the deficit was an immaterial percentage of GDP.

Chairman DOMENICI. But the problem is when you do this and you are having health care go up at 11 percent, this is gone.

Secretary RUBIN. Mr. Chairman, we absolutely agree with you. We look forward to working together with you on all aspects of this, including health care reform.

Chairman DOMENICI. Fine.

Secretary RUBIN. On health care reform, we are prepared to start this afternoon. We have got one——

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Chairman DOMENICI. When are you going to tell us how much we might look forward to in savings in health care?

Secretary RUBIN. On health care reform?

Chairman DOMENICI. We are going to spend all the savings, aren't we, under your proposals?

Secretary RUBIN. Are you talking about health care reform?

Chairman DOMENICI. The White House's health care proposals.

Secretary RUBIN. No; what the President has said consistently is that the rate of growth of health care entitlements must be slowed, but it must be slowed in the context of health care reform, and we are prepared to start working with you any time that you would like to join with us in what is really a noble and important effort.

Chairman DOMENICI. You have got to go, and I will just say I have not seen any proposal by this Administration wherein savings from health care would go to deficit reduction. I see it going to health care reform, and that is spending, spending what you save, and that will keep that chart going just like it is.

Secretary RUBIN. Well, I will cite you the President's comments, which are to the same effect of what I have just said—that we need both to get universal coverage and to constrain the costs of health care, and the way to do it is in the context of health care reform.

Chairman DOMENICI. Well, thank you very much for coming. We appreciate it.

Secretary RUBIN. Mr. Chairman, thank you very much.

Chairman DOMENICI. Senator Lautenberg, did you want to ask questions?

Senator LAUTENBERG. Well, Mr. Chairman, I would like to raise a point of order. I want to do it because I think, by virtue of your own opening remarks, we were going to allot time based on the clock, and you had the opportunity, as you should, Mr. Chairman, for your opening statement; Senator Exon as the ranking member had the opportunity to make an opening statement. You therefore qualified it—and the record I assume will show—by saying that thereafter, because others of us have been deprived, we would have 7 minutes, and you said—I thought you said you would take only 5, but the clock was not even running. And I was anxious—not that I want to dismiss the opportunity to question Dr. Tyson, but I did want to talk to the Secretary of the Treasury, and watched the clock go by, and he is gone.

Mr. Chairman, I would say something else, too, and you and I have worked together for a long time, and there is mutual respect and, as a matter of fact, I think, mutual affection and friendship as well. So what I say is in the context of the committee relationship and certainly not a personal relationship.

When I see the handout prepared by the staff of the U.S. Senate Budget Committee, and they opinionate here by opening the comments with, "A white flag from the White House"—now, if this is intended to be a partisan document, it ought to reflect——

Chairman DOMENICI. It is.

Senator LAUTENBERG. Oh, it is a partisan document?

Chairman DOMENICI. No—it is prepared by the majority.

Senator LAUTENBERG. I know it is, but the majority can prepare it still with a degree of objectivity. If they report the numbers, they can report opinions on the numbers, but to raise the specter of a white flag, we are then turning this committee into a political debating society.

Chairman DOMENICI. Come on.

Senator LAUTENBERG. Well, I think we are.

Chairman DOMENICI. You don't think the President's budget is political?

Senator LAUTENBERG. I think the President has a right to submit a budget——

Chairman DOMENICI. Absolutely.

Senator LAUTENBERG [continuing]. And you have a right to criticize it, and I have a right to defend it, and I am going to do that——

Chairman DOMENICI. That is correct.

Senator LAUTENBERG [continuing]. And I do not need committee staff, Mr. Chairman, to tell me whether or not the President has surrendered in his responsibility. That is the kind of thing we have been running into—people calling names and then calling for partisan cooperation. But it does not work that way.

I do not remember any time in the years that—and both you and I have been on this Budget Committee for a long time—I do not remember at any time seeing commentary in a majority submission that characterized the President's budget. Maybe your staff will remind you that we did, and if we did, I already apologize.

Chairman DOMENICI. We are in recess for 5 minutes, because you need a rest, Dr. Tyson, so we will do that. Let us make it 10 minutes. We will be back in here at 11 o'clock.

Senator LAUTENBERG. Do you want to charge that time to me, Mr. Chairman?

Chairman DOMENICI. No. I will give you 10 minutes.

[Recess.]

Chairman DOMENICI. Senator Lautenberg?

Senator LAUTENBERG. Thank you, Mr. Chairman.

Dr. Tyson, now that both of us are left in the room here——

Dr. TYSON. I will try to answer if I can for Secretary Rubin.

Senator LAUTENBERG. Please use the microphone.

Dr. TYSON. OK, I will. As I said, I will try to answer Secretary Rubin's questions as well as my own.

Senator LAUTENBERG. Well, I am sure—and I did not want to suggest any less competence. We have great regard for your expertise.

One of the things under fairly active discussion right now is the balanced budget amendment, and what is being proposed is a requirement a three-fifths vote to increase the debt limit to help stem the tide of government red ink.

What controls government borrowing? Is it the debt limit that controls rates and availability of capital to the government?

Dr. TYSON. I think our view on the debt limit is the following. There are ways—the real issue here is controlling spending, and that is what we should be talking about. The dangers of having a super majority involved in passing on the debt limit I think are the dangers involved in having a super majority make decisions on a whole host of fiscal policies.

The government has a substantial amount of debt it must turn over on a regular basis. As the Secretary noted, much of that came from the policies of the 1980's, but we have this debt, and even balancing the budget, if that is what is proposed, will actually not retire that debt; it simply will not. It will slow down the additions to the debt, but the debt will remain and will need to be turned over.

So the issue of the debt limit, the concern we have, is that since the government has to do that, if you put a super majority vote on it, you can imagine increasing the uncertainty in financial markets—is the super majority going to allow the debt limit to be raised when it needs to be raised, or is there going to be an interruption in the Treasury's ability to refinance its debt? That uncertainty in financial markets we believe will increase the interest cost, the interest rate that the government has to make available to service its debt. So in fact there could be a higher debt-servicing burden in a world in which you had super majority control over the debt limit.

Senator LAUTENBERG. Many proponents of the balanced budget amendment reference State commitments to balance budgets. But most States have, I believe, capital budgets which they amortize over a period of time. If we were to use capital budgeting, what might the deficit look like? Do we have projections that can be easily summarized to talk about what the consequence of amortizing capital investment might do to the budget deficit?

Dr. TYSON. I do not have numbers with me today. We certainly can provide you some numbers. I will tell you the complication in making the projections.

It is absolutely correct that States by and large that have balanced budget requirements in their constitutions also have the ability to borrow for capital investments. So there is spending that is going on in these States off of the budget that is being balanced. It is for investment in such things as roads and infrastructure and clean water, and a number of things which people, I think, in terms of how they experience their life in a State, benefit from.

The important point, if we move toward a capital budget at the Federal level, what you would need to do in that case is to have on the operating budget—not the capital budget, but on the operating budget—the amount to which the capital stock is depreciating. And the only challenge here in coming up with the kinds of numbers you are requesting is that you have to determine the length of the existing Federal capital stock, apply various depreciation schedules, and come up with a measure of the operating budget.

We can do that for you. Our back-of-the-envelope calculations suggest that with a capital budget right now, the deficit might be $50 to $60 billion lower. It depends on your definition of capital and on the rates of depreciation you apply to that capital.

Senator LAUTENBERG. I commend the President's interest in giving some relief to the middle class, the focus that includes the education credits, the tax credits for children.

The so-called Contract for America or on America also includes proposals to cut taxes. How would you summarize what we have seen thus far of the contract's proposals compared to the President's recommendation?

Dr. TYSON. Well, first of all, the contract proposals are much more costly in terms of foregone revenues. As I said, today it was reported in the Wall Street Journal that the Joint Committee on Taxation has estimated the 10-year cost of the contract tax proposals is $700 billion of lost revenue. And the lost revenue——

Senator CONRAD. Over what period is that?

Dr. TYSON. Ten years, 10 years, 1996–2005.

Treasury estimates suggest that the cost of the capital gains tax reduction by itself exceeds the cost of all of the President's proposals over a 10-year period. The President's proposals were modest and were meant to be modest given the size of the deficit problem which has been so well-addressed in the first part of this testimony.

There is grave concern about the deficit, and nonetheless many of the people who are expressing grave concern about the deficit are at the same time proposing $700 billion of tax cuts. And I think those two things do not fit together very well.

The other thing that distinguished the President's proposal is that we tried to target these tax cuts to the middle class. I think I want to make clear what our reason for these tax cut proposals, our basic reason, was.

We looked at the course of the economy over the past 20 years, and one disturbing trend was the build-up of the government debt in the 1980's and the build-up of the deficit line.

Another disturbing trend was the fact that if you look from the late 1970's to 1993, you see that only the top 20 percent of the family income distribution sought any real gains in their income. The bottom 80 percent saw decline or stagnation. That is not very good performance for the average American family, and it is particularly dramatic when you think about the fact that we have had 2 very good years in the American economy, and nonetheless many American families do not feel very good.

So we tried to come up with some targeted tax relief for the middle class to help them get some education and training for themselves and their children, to save for their future, and to help them really when they are young in their child-rearing and child-bearing parts of their life cycle. I think that distinguishes both why we want to do the tax cuts, the fact that they are targeted, and they are modest.

Senator LAUTENBERG. Thanks, Mr. Chairman.

Thank you very much, Dr. Tyson.

Chairman DOMENICI. Senator Conrad?

Senator CONRAD. I thank the Chairman, and I thank the witness for being here.

I feel compelled, really, to go back over some of the ground that has already been plowed, because the Chairman in his last presentation before Secretary Rubin left, I think was really engaged in rewriting of history. I must say that to you in respect, that I really think you were rewriting history in a fundamental way.

If we go back to the time when we passed the 1993 deficit reduction plan, the folks on the other side of the aisle, who all voted no, said it would crater the economy, said it would not reduce the deficit, said it would be devastating. They were wrong—not just a little bit wrong; they were dead wrong.

The facts are very clear. What has happened is the deficit has been reduced. Instead of $500 billion, we now know the deficit has come down $600 billion over the 5 years. The deficit measured against the size of the economy has been cut in half, from 4.9 percent of gross domestic product to 2.5 percent of gross domestic product. And my own view is—and I think the evidence shows very clear—that because there was the anticipation and then the reality of that deficit reduction plan, interest rates came down. And when interest rates came down, this economy took off like a scalded cat. There have been 5.5 million jobs created. We have seen a dramatic reduction in unemployment. We have seen the strongest economic growth in 10 years in this country.

And now, interest rates are starting to go back up because of that economic growth. And I would ask Dr. Tyson if that is not her view. Isn't the fact that interest rates are going up a product of the strong economic growth that has occurred since the deficit reduction package was put in place?

Dr. TYSON. Yes; well, I certainly agree with that analysis, and let me note that the graph that was put up before by the Chairman, which shows the interest rate decline and then the interest rate increase, on the interest rate decline side, you know, the Administration is not the only source on the interpretation that Secretary Rubin made this morning of why interest rates declined in 1993. You can listen to what Chairman Greenspan has said before the Congress on this issue. You can listen to very diverse Wall Street economists, Allen Sinai and others, who made the point that the anticipation and then the enactment of the Administration's gradual, serious, credible and significant deficit reduction program was a major part of what happened to those interest rates.

Now, what has happened since then? Interest rates are determined by many things. They are determined by anticipated borrowing needs of the government, which have come down significantly as a result of the deficit reduction package; but they also come from anticipated and actual borrowing needs of the private sector. The private sector has been booming. The investment chart which Secretary Rubin had up there shows that we are at an all-time post-war high in terms of equipment investment by the private sector. In that kind of environment, you are going to see higher interest rates. It is because of a booming economy, touched off in part by the lower interest rates which reflected the reduced borrowing needs of the government, which have led to the increase in interest rates.

This is a consistent story, and it is not a story which just the Administration tells. There is widespread support in the economics community for that story. That is pretty much the interpretation.

Senator CONRAD. If I could, though, let me turn to you because I must say there is a part of this in terms of the plan going forward that I question. It strikes me, if the analysis that I gave before is correct, that the fact we had a strong deficit reduction plan that really has worked—unlike most of the other deficit reduction plans that have been put in place since I have been here that did not work, this one did work, and it has resulted in strong economic growth, it has resulted in strong job creation—why isn't it the case that more of that same medicine is advisable?

It just strikes me that we ought to make further steps at deficit reduction, frankly, more aggressive steps in reducing spending than the President has proposed. And I say that because, while it is quite true that to the extent Federal spending is investment, that helps us with economic growth for the future, but the fact is most of the Federal budget is consumption.

So why isn't it the case that—if the analysis that I gave for what has worked before to help us spur this economic growth, why isn't it the case that we need more of the same medicine in this environment?

Dr. TYSON. Well, let me just go back to the notion of a balanced package as opposed to any particular year of balancing the budget.

The President ran on, and the economic team that he has worked with has always supported the notion, that in making our budget proposals, we were dealing with three objectives. One was progress on the deficit; two was a continued shift in government spending toward investment programs and even some additional spending in areas of education and training, as an example; and three, tax relief that would be for American working families.

What we have done this time around—the first time, in the major package that came out of our 1993 deliberations—frankly, the deficit course we were on, we did not believe was a sustainable course. We believed there was a threat of financial market disturbances; there was certainly the threat of continued sluggish growth, because even though long-term interest rates at that time were coming down, they were still extremely high by the standards of the weak economy.

Long-term interest rates are not supposed to be as high as they were in 1992 in an economy as weak as it was in 1992. So we felt that the first go-around, we had to deal with getting the deficit on a reasonable downward path. We therefore did a little bit of tax relief under the earned income tax credit, and we made some adjustments in what we might have wanted to be a more ambitious set of education and training programs.

Two years later, we have seen an economy which has outperformed anyone's forecast. We have a deficit reduction on track not for $505 billion, but for $600 billion——

Senator CONRAD. But doesn't that tell you we ought to do more of what works so well?

Dr. TYSON. It told us that we should do more—we did do more. We have done more in this budget. There is $81 billion in addition to the $600 billion which we are anticipating for the first package. So we did do more. Your question is should we do even more.

It was our judgment that this proposal should take some time to do some additional middle class tax relief, and that the real remaining problem on the deficit was health care reform. And I think both Secretary Rubin and I have said that very clearly. We would like to work with the Congress. As you know, I was engaged in the health care reform effort in the Administration. I believe that we should work together with the Congress.

One of the things that I think the debate has to reveal to the American people here is that basically, where the government budget is in trouble is on—well, interest payments on the debt, something we cannot really control, except by getting the deficit under control. We have social security, we have health care spending, and we have defense. Those are the big items. Together, they sum up to over 70 percent of what the government budget is about

When people talk about spending cuts, they should understand that if all of those things are left off the table, then all of the other programs that any Americans want—for example, in the education and training and student loan programs, just as an example—will essentially have to be decimated because you cannot balance the budget if you do not go into those big components that make up 71 percent.

Our interpretation has been all along let us do a component of this through health care reform. So we are serious about the deficit.

Again I refer you to the chart[1]—I think the most outstanding chart in terms of a sort of mesmerizing effect in the budget is the one which shows that if you take our current glide path—and we are on a glide path; the deficit-to-GDP ratio is coming down, and it was not coming down before—on that glide path, if we were somehow able to institute a health care reform which brought health care spending by the Federal Government in line with the growth of the economy, the budget would be in balance, and it would be in balance early in the next century.

Senator CONRAD. Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Gorton?

Senator GORTON. Chairman Tyson, I am going to start with the proposition that everything that is submitted in this budget is submitted in good faith and with the goals that you have outlined; I do not think arguments over that subject at this point serve any particular purpose, but I would like to ask some questions about how you arrived at it and some of the assumptions that are connected with it, and one other, which is a follow-up to Senator Conrad and to Senator Abraham.

I believe you have said that we could get to balance by 2002 if major health care reform were a part of the package. Is that a statement that had we passed either the President's original health care proposal, or Senator Mitchell's health care proposal last year, that with all of the assumptions in this budget, you would project a balanced budget by roughly the year 2002?

Dr. TYSON. We did not—those packages, as you know—the President said very clearly in the State of the Union speech that he believed that we had bitten off more than we could obviously chew last year. We were not assuming that the Congress was going to move forward with those specific packages. We made the observation that if one could develop a health care reform program that slowed per-beneficiary Federal health care spending to the rate of growth of the economy, that that would restore balance by 2003. We did not analyze any particular program.

We want to work—look, health care reform is only going to work—we have one big lesson from the previous 18 months, and that is health care reform is only going to work if it is started and ended in a cooperative spirit.

Senator GORTON. OK. But then, if we did some kind of health care reform that you regarded as comprehensive and that met the

[1] See p. 118.

requirements that Secretary Rubin set out, we could in fact get to that zero balance early during the course of the next session?

Dr. TYSON. I am saying that would make a major contribution.

Senator GORTON. And would that health care reform include very significant new taxes or burdens on the private sector in the amounts outlined by the Chairman?

Dr. TYSON. You are suggesting that we have a health care reform proposal that somehow we are holding back, which includes tax increases that we are about to reveal. We do not have a health care reform proposal. You know yourself that at the end of the last Congress, there was actually widespread agreement on certain parts of what might ultimately make up a package of health care reform proposals, including insurance reform, including proposals to help people between jobs who lose a job to maintain their insurance, including proposals to restore or to move up the tax deduction for self-employed health insurance programs to 100 percent.

There are things that we can begin to work with on a cooperative basis, and in the context of that reform to slow the rate of growth of health care spending.

The thing that the President said clearly yesterday in introducing the budget is that his budget—the reason we are serious about our budget is because it does a number of things at once. It cuts taxes. It cuts——

Senator GORTON. OK. We have gone over that. I have only got 5 minutes——

Dr. TYSON. But there is one important point——

Senator GORTON [continuing]. And we have heard that, but I would like to ask a couple more questions now. You obviously are not going to answer my question about the impact of last year's proposal or whether you will have taxes in this year's proposal.

But with respect to health care, you do make one specific suggestion, it seems to me—and I want to know whether it is—you assume that we will not extend even the modest 25 percent tax deduction for self-employed health insurance expenses or the research and development tax credit; am I correct in that regard?

Dr. TYSON. As you know, we have supported increasing the 25 percent deduction for self-employed to 100 percent, and in 1993——

Senator GORTON. But in your budget——

Dr. TYSON [continuing]. We supported making the R&D tax credit permanent.

Senator GORTON. Dr. Tyson, please answer my question. You assume in this——

Dr. TYSON. We support both of those tax measures.

Senator GORTON. But they are not in your budget.

Dr. TYSON. No, they are not.

Senator GORTON. OK. How much will they increase the deficit if we extend——

Dr. TYSON. Oh, I think we should look—no, no, no——

Senator GORTON [continuing]. That 25 percent in the R&D tax credit?

Dr. TYSON [continuing]. No, no. The President has made a condition for any tax relief, including his own, very clear. We will not support any tax relief, including our own, that is not fully paid for by spending cuts or by——

Senator GORTON. Please answer my specific question. How much over this period of time is represented by those two proposals? Do you have a figure for that?

Dr. TYSON. I can get you a figure for that. We probably can get a figure right now——

Chairman DOMENICI. Let me—do you know the number? He is merely asking you for a number.

Senator GORTON. I am just asking you for a number.

Dr. TYSON. I do not—OK——

Senator GORTON. What does this represent?

Dr. TYSON. OK. I do not have the number off the top of my head. I am happy to get it for you, and we may get it for you before I finish.

Senator GORTON. In any event, they would cost——

Dr. TYSON. I am not trying to hide the number; I just do not know it.

Senator GORTON [continuing]. They would cost something. They will add to the deficit numbers that you have here in this budget.

Dr. TYSON. We would not allow them to add to the deficit.

Senator GORTON. Because you would not allow them to take place independently.

Dr. TYSON. No, because we would presume that the Congress would finance them.

Senator GORTON. Now, also in this budget, there is no assumption of any welfare reform, I take it.

Dr. TYSON. That is right. We made a decision—we have a welfare reform proposal which we gave to the Congress last year. There are clearly many competing welfare reform proposals like this out there——

Senator GORTON. But in this budget, none is assumed.

Dr. TYSON. None is assumed.

Senator GORTON. All right. And the proposal which the President made last year, if passed with nothing else, would add to this budget deficit.

Dr. TYSON. Now, when we made our proposal last year, we were coming up with a way to finance the proposal itself, and the proposal was financed and would not add to the deficit.

Senator GORTON. But it would cost money. We would spend more——

Dr. TYSON. Yes, our welfare reform proposal did cost money.

Senator GORTON. OK. That is——

Dr. TYSON. But it was paid for with a series of proposals.

Senator GORTON. And my final question—because I have only a few seconds left—is that our committee majority staff has concluded that because you have $60 billion worth of tax cuts and mandatory spending, cut only by slightly less than half of that, that even this year, your budget if passed absolutely unchanged, would cause a pay-as-you-go sequester. Is that correct?

Dr. TYSON. I—that question is probably—I do not think that is correct. That is a better question for OMB Director Rivlin tomorrow. She did say yesterday in her statement in the opening of the budget that we were paying for our tax cut proposals with discretionary spending cuts, and we would have to be able to move those cuts over to the pay-go part of the balance. She did say that.

Senator GORTON. Well, thank you, Chairman Tyson.

Dr. TYSON. I think we have the numbers that you wanted, though.

Senator GORTON. OK.

Dr. TYSON. Let me tell you, for the health insurance deduction for the self-employed, 1995 to 2000—this would be for extending the 25 percent, not going to 100—that would add $3.1 billion over that 5-year period. The credit for research and development would add $8.1 billion, and then there are rules for allocating expenses for research and experimentation which are related to that; that is another $3 billion. So you are talking about a 5-year cost of $14 billion.

Senator GORTON. Just one last, brief question. Your roughly $200 billion deficits, not only for the year 2000 but for the year 2005, are based on OMB figures, not on Congressional Budget Office figures, in spite of the commitment that was made in 1993 that we were not going to argue figures anymore, and we would always use CBO; is that correct?

Dr. TYSON. Well, we did not say we would always use CBO figures. What we said—and I believe at the time, it was viewed as somewhat controversial on the other side of the aisle—we decided to use CBO numbers in our first budget. We have since then been using OMB numbers, as a matter of fact, and let me say that our view is that our economic forecast is actually the more credible forecast if you look at——

Senator GORTON. You have higher growth and lower inflation than OMB.

Dr. TYSON. Yes, we do. But if you look at our forecast and you compare it to other private sector forecasts, our growth rates are comparable to the private sector.

The other difference between the CBO and the OMB forecasts at this point is that we are using, as has traditionally been the case in OMB, estimates of projected health care spending from HCFA. That is their responsibility to give us those numbers, and they have given us their numbers.

But we only really use the CBO numbers in our very first budget. Since then, we really have used OMB numbers.

Senator GORTON. And the difference, at the end of the line, at least, is more than $100 billion a year in deficit; is it not?

Dr. TYSON. Yes, it is, it is.

Senator GORTON. Thank you.

Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Gregg, you are next, but could I just do a bit of business and then yield to one of you to close up the session—perhaps you, Senator Brown; you arrived late enough that you might stay long enough to close things up. Does that sound reasonable?

Senator BROWN. Thank you, Mr. Chairman.

Chairman DOMENICI. First, I want to say that I am not very pleased myself with the distribution of time today. I am very desirous of having members have a chance to ask questions. In fact, I used that to encourage our members to come. It did not work that way today. I perhaps in the second round used more time than I should have, and for Senators on this side who needed time, I apologize for that.

We were working under some strange conditions in that we set the hearing early at the request of the Secretary of Treasury, and then he said he had to leave earlier; we tried to understand that, and so that put things in a little bit of a more difficult position than normal. But I will try to do better in terms of making sure Senators do get their chance to ask questions.

Senator EXON. Mr. Chairman, may I make one suggestion in that regard, just briefly?

Chairman DOMENICI. Of course.

Senator EXON. I do not believe that we have timed or had the lights on for the Chairman and the ranking member. I would certainly suggest that possibly one way around this timing problem, since we do have opening statements and have the right to ask questions first, is that we be timed like any other member? I do not think we have been, and if I am wrong in that, I stand corrected. But there was probably no way for the Chairman to know he was going way over time because the light was not on.

Do you have any objection to that?

Chairman DOMENICI. I think we ought to reserve that. I myself have been yielding before I ever start mine as one way of trying to accommodate. So let us try to stay within the 5, but let us not set that today.

Senator EXON. OK.

Chairman DOMENICI. Before I leave, I want to make one other comment. Senator Exon, in your remarks, you talked about the "dance" that occurs. You probably said it as well as any. I personally want to say to you and to Democrats and to the Administration that I would hope we could work together to improve this budget. If I were to improve it, I would tell you that there is no doubt in my mind that it is short-term in existence and not long-term in its projections, because the deficit is going to go back up very, very high, soon—not 20, 30 years from now, but soon—and the sooner we do something on a program like medicaid, which is growing in your budget at 9.5, and that is speculative—last year, it was 11.5—the sooner we do something about that, the better we can handle deficits in the future. And perhaps we cannot do that in a bipartisan manner, but I would hope we could look at that kind of thing this year, not after the next Presidential election, because if we do not do it this year, I think it is gone for a couple of years, and it is pretty important.

Senator GREGG.

Senator GREGG. Thank you.

Well, there has been a lot of discussion here, and Chairman Tyson, you have been very courteous in participating and listening and answering with intensity many of these issues.

But I guess Chairman Domenici touches the core issue for me, which is that—although I could ask you a lot of technical questions about the President's submission, and I have serious reservations about it—its credibility, number one, and its direction, number two—but I guess the bottom line becomes if we are unwilling to address the entitlement accounts—and you noted in your answer that the medicare account is not addressed, that the President has taken that off the table, that the medicaid accounts are not addressed, the welfare accounts are not addressed, and I presume the CPI and the COLA is not addressed, which means the pension accounts are not addressed, the veterans are not addressed—if we are not willing to address the entitlement accounts, then how are we going to ever legitimately address the issue of the deficit, since by the terms of I think everyone—and I would just here quote the Democratic staff preparation document where they say, "the dominant force that maintains the structural deficit is the rapid growth in spending in major health care programs." You have acknowledged that, also. Health care is only one element of it, actually; it is a variety of entitlement accounts.

If we are not willing to address the entitlement accounts, or the Administration is not willing to address the entitlement accounts, in this exercise, going forward—I will acknowledge that in the past the Administration has brought forward proposals on welfare, they have brought forward proposals on health care, they have brought forward a budget proposal, which I did not agree with, but it has reduced the budget because it raised taxes—but in any event, we are looking prospectively. If in the future, you are not willing to engage on the field of entitlements, if the Administration is not willing to engage on the field of entitlements, if you are not willing to address medicare and you are not willing to address the welfare accounts and the COLA issues and the driving factors which are creating this deficit, as is reflected in the budget as it is submitted, and the Republicans come forward with proposals which do address those items—if we legitimately raise the issues of entitlement, medicare, medicaid, welfare reform—is it going to be the Administration's position that it will not in any way cooperate, that it will not allow any action to occur, that it will oppose any sort of medicare reform which might reduce spending in those accounts?

Dr. TYSON. Well, first of all, I think it is important to again put a little bit of historical perspective here——

Senator GREGG. No, I am not interested in historical perspective. We have had a historical perspective for the last 1½ hours. What I would like is a prospective perspective of what this Administration is going to do, because what you have put before us——

Dr. TYSON. We did, though——

Senator GREGG [continuing]. Is a prospective document which does nothing on entitlement issues.

Dr. TYSON. But the point is recently, as recently as just a few months ago, in both the Senate and the House, there were discussions going on on health care reform because the President had put them before the American people, before the Congress.

The most serious discussion of entitlement on health care ever raised in the Congress was raised in the past 2 years because the President led on that issue. The issue did not——

Senator GREGG. Excuse me, excuse me. Let me——

Dr. TYSON [continuing]. The original resolution—but to question the seriousness——

Senator GREGG. I gave you credit for all that. The President in his State of the Union said medicare was off the table. The budget that is presented has no effort at all in the area of entitlements.

Dr. TYSON. All right. Now I will speak about the future, because you asked if we would cooperate. The answer is that we will cooperate, we would like to cooperate. We have said clearly in our testimony today and in the document itself that we believe the next progress on government spending should be made in the context of addressing health care spending through health care reform. What the President said in the State of the Union was that he would not engage in medicare cuts to finance tax cuts.

Remember, there is another whole issue out there, which is $700 billion of tax cuts. So we have been engaging here on the issue of the deficit and spending, but there is another issue of if you are going to move forward with that kind of tax cut proposal, how you find the finances.

Now, what I would say is that the Administration is prepared to cooperate. What the President has said again and again is that he believes that in the context of health care reform, one could make progress on health care spending.

What he is opposed to is arbitrary cuts in programs which actually hurt the served population, the beneficiaries, in order to either finance some arbitrary deficit reduction number or to finance major tax cuts. That is what he has said he is opposed to.

Chairman DOMENICI. Would the Senator yield, and we will not charge his time.

Senator GREGG. Of course, I would yield to the Chairman. Do I have a choice?

Chairman DOMENICI. Yes, you do. You have control.

Senator GREGG. Just kidding.

Chairman DOMENICI. Let me say something I have not said heretofore. You know, in the President's budget, he is very careful to expand certain domestic programs that he calls "investments," and he is very careful in some other areas where he wants to do this or that.

Frankly, I believe the longer we leave entitlements off the table, the more the discretionary accounts are going to get shredded. And I believe that just as sure as we are here. Until we get them on and therefore can show some real 5- or 6-year projections that are meaningful, that one pot of money is going to be looked at because it is appropriated every year, and the President is not going to be able to do anything about that. I doubt he will veto appropriation bills that have $5 or $6 billion more out of them, and those are all discretionary accounts. So I think there is a second reason aside from the reality of getting the deficit under control, and that is where we are going to cut.

Thank you for yielding, Senator.

Senator GREGG. I certainly agree with that assessment.

So as I understand your response, it is that the Administration is willing to look at medicare reform, which involves the reduction in spending in medicare accounts as long as it is not used to pay for tax cuts; it is willing to look at it for the purposes of paying for deficit reduction and structural reform of the deficit?

Dr. TYSON. I would add one thing, which I said very clearly, and that is, any attempt to do this through arbitrary caps on the growth of medicare and medicaid in the absence of complementary health care reform in the rest of the system would be something that we would oppose, because that approach will mean—however you play with the numbers, what it will mean is a decline in the services to the served population, which the President is opposed to. And what it will mean is a shifting of those costs.

The sick people do not go away; the sick people are here. And if you cap the programs, and they cannot finance the services to those sick people, those will show up someplace else. Let us not kid ourselves. They will show up in the private sector, they will show up in the local budgets, they will show up in the community budgets, and they will show up in the States budgets.

So we have to figure out a way to do this which does not simply shift the burden around the system.

Senator GREGG. If I understand your answer, it is that the President's proposals as they came forward in his health care package, which would have involved a cap which would have generated somewhere in the vicinity of $130 billion in cuts in medicare, is no longer a procedure that the President subscribes to.

Dr. TYSON. That was in the context of a whole host of other changes in the health care system.

Senator GREGG. But you are now projecting——

Dr. TYSON. No, and because of those changes, it was our view that the served population in medicare and medicaid would in fact see the same quality of services and the same provisions.

Senator GREGG. Well, we would presume that any proposal we bring forward would improve the quality of care that seniors would get.

Dr. TYSON. That would be even better; that would be even better.

Senator GREGG. Is my time up, Mr. Chairman?

Chairman DOMENICI. You have got another question.

Senator GREGG. OK. Looking at some of the numbers in this proposal, what is the National debt as of today, the Federal debt—approximately?

Dr. TYSON. It is on the order of about $4.3 trillion—$4.7 trillion—we can dig it out. It is in that order, $4.5 trillion. Let us say $4.5 trillion. That is a perfectly good estimate for our working assumptions.

Senator GREGG. And the debt at the end of 5 years will be?

Dr. TYSON. Let me get the table out. We can read this off the OMB chart. Let me say something about it while we are digging this out.

What has happened to the debt—Secretary Rubin emphasized very much the importance which economists feel must be linked between the size of the deficit and the size of the debt and the size of the economy, and let me just say why we do this all the time. I——

Senator GREGG. Well, I appreciate that. I would rather just have an answer to the question.

Dr. TYSON. All right. Well, while we are looking at it——

Senator GREGG. At the beginning of the 5 years, it is $4.5 billion; the debt at the end of the 5 years is approximately $5.7 billion to $5.9 billion.

Dr. TYSON. And the debt as a share of GDP is approximately constant, as is the interest——

Senator GREGG. I did not ask that question. What I would like to know in gross terms——

Dr. TYSON. Well, I would like it for the record.

Senator GREGG [continuing]. I think it has already been put on the record—in gross terms, the debt will go up $1 trillion over the 5-year period.

Dr. TYSON. Right.

Senator GREGG. And you stated at the beginning—and this is where you can get into your answer as a percentage of GDP—but you stated at the beginning of your testimony to I think Senator Gorton that the serious trends you were worried about, the serious trends you were worried about, involve the dramatic increase in build-up in government debt. And I presume that that is because debt has to be serviced, and interest rate costs go up. And as we look at the rate of growth of functions of the Federal Government, the cost of interest and the servicing of interest is probably second only to health care in its escalating rate of growth.

If you add $1 trillion of new debt to the basic deficit, how much do you increase the servicing costs—that is rate of growth as a percentage, or in a gross number.

Dr. TYSON. Of course, it depends on your interest rate forecast. With our current forecast, which we have not had a chance to discuss, in fiscal year 1996, we have net interest as a percentage of total outlays of just about 16 percent; net interest as a percentage of GDP, just about 3.5 percent. If you go to fiscal year 2000, the last year of the budget, percentage of outlays, that is, government outlays, of net interest payments, have risen from about 16 percent to 16.3 percent; as a percentage of GDP, they have actually fallen from 3.5 to 3.4 percent.

What has happened is that basically, we have stabilized the size of the debt relative to the size of the economy, so the huge increase in the percentage of outlays associated with interest payments which you saw as a result of the fiscal irresponsibility of the 1980's is over; that is over. We are in a different world now, where the deficit is declining relative to GDP, the debt is constant relative to GDP, and therefore the huge ballooning of the interest payment burden has stabilized.

Now, does that mean we should not do more? I think one of the things I really want to emphasize at the end of this hearing again and again is that we are not satisfied—we think this is the best budget for right now. I think there is vast agreement in this room that the problem we face is not the immediate deficits, but it is the outyear deficits, and those are associated with entitlement, and they require that we address those programs seriously. And I think that health care should be the place we start.

So I am willing to say we have made a lot of progress, but there is certainly more to be done.

Senator GREGG. I agree with your summation. Unfortunately, I think the document that you presented as a budget clearly does not address entitlement, does not address the outyear driving factors, as you call them, in the area of the debt. It adds $1 trillion to the base, which we may be able to finance it, but it is still an increase in the interest that has to be used to pay it. And there appears to be nothing in this document which is willing to move us toward correcting the structural problems, which are entitlement and underlying debt.

Mr. Chairman, thank you for your courtesy.

Senator BROWN [presiding]. Thank you.

Dr. Tyson, we are about to wind up this session. I see the Senator from Maryland has joined us. Would you care to ask questions at this point?

Senator SARBANES. Unless Dr. Tyson has something pressing——

Dr. TYSON. I am happy to stay.

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

First of all, I think it is very important as we consider whether the budget is in balance to recognize that we do not have a capital budget in the Federal budget as we do our accounting.

A couple of Governors testified before the Joint Economic Committee about 2 weeks ago on the balanced budget amendment, and they were all for it. Then they said, our State has a requirement for a balanced budget, and because of that requirement, we think it helps us to attain a very good credit rating—which of course then prompted the question: If you balance your budget, why do you need a good credit rating? And the answer to that was: We have a capital budget which we fund through borrowing.

And I think it is important to recognize that State and local governments do not in fact balance their budgets if they keep their books as the Federal Government does, namely, without a capital budget component for which they borrow. They go to the bond market and borrow in order to fund their capital budget. Businesses and individualss do exactly the same thing. There are very few Americans who do not run a huge deficit in the year in which they buy a home or buy a car, because most people buy a car or a home by borrowing, and then they pay it out over the useful life of the asset. Everyone regards that as a prudent way to do business.

I make that point because when we talk about bringing the budget to a zero balance, it needs to be recognized that we would then be paying fully for all the capital items in the budget right now, even though those capital assets would be available to us for 20, 30, 40, 50 years, whatever the life of the asset is.

I do not think you ought to borrow to cover current consumption, but borrowing to cover investments that have a future return I think is a different category altogether.

I think one point that ought to be made is that our deficit as a percent of GDP is the best performance of any of the advanced industrial countries. I would ask the Chairman if this is correct.

I understand it, we brought the deficit as a percent of GDP down very significantly. I would like to ask you to chart out for us how much it has been brought down—to the point where we now have the best performance of any of the major industrial countries. Is this correct, and second, what is the path, the trend line, that has brought us to what I think is a pretty good performance, although it is by no means the end of the process.

Dr. TYSON. Those numbers are correct. If you do it a slightly different way, I believe, in terms of how you handle social security, the United States might turn out to be number two rather than number one. But the point is that rather than being at the bottom of the pack, the United States now either leads or is second, and this reversal has happened in a very short period of time, and the rest of the world that used to regularly complain, I think justifiably, that U.S. fiscal policy was out of control, has in fact praised us for our efforts.

The OECD report this year on the American economy made a big point of how much "fiscal consolidation"—that is the term they use—has occurred in the U.S. economy in the past 3 years.

Senator SARBANES. Let me ask you about the fiscal stabilizer, because I think this is an extremely important point, and if we do not address it carefully, we may end up creating immeasurable damage to our economy.

This chart[1], shows the percentage change in our real GNP since 1890. What it shows is that once we started building in the automatic stabilizers, which essentially was after World War II, we were able to significantly limit the fluctuations in the business cycle, the ups and down, the boom and bust cycle, and in particular to limit the downturn so that rarely did we go into negative growth.

We still get fluctuations, but they are less sharp, and most of them take place, including the downturn, above a negative growth rate; so we are still getting some positive growth although less positive growth than we had the year before.

It is my concern that if you eliminate the automatic stabilizers, which I think a balanced budget amendment would do you will turn economic downturns into recessions and recessions into depression. Automatic stabilizers work automatically, so you do not have a to make a conscious decision that you are in a recession. People counter the need for automatic stabilizers by saying that we would waive the requirement with the 60 votes. Leaving aside whether you get the 60 votes, automatic stabilizers work before you ever face the problem. If you rely on the waiver you would already be on a downward slope. The waiver would be too little too late. And I would like to ask you what your perception of that is.

Dr. TYSON. Well, Senator, I share your concern, and I believe that the majority of professional economists share this concern. One of the great accomplishments of the post-war period was the use of fiscal policy, along with monetary policy, both of them working together, often cooperatively, but independently, to achieve greater moderation in the business cycle. What the balanced budget amendment does is it does not just take away the automatic stabilizers; it forces budgetary policy to be destabilizing. It throws the automatic stabilizers into reverse. It requires that the Congress get together in a slowdown and do things which will slow down the economy even more.

And I think that we do not need a balanced budget amendment to balance the budget. What the balanced budget amendment does is it takes away the automatic stabilizers. If people want to balance the budget, they should come up with a package to balance the budget, but they should leave the automatic stabilizers functioning because they have done a very good job for us, as your chart shows.

Senator SARBANES. Thank you.

Mr. Chairman, my time is up. Thank you.

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[1] See p. 152.

Senator BROWN. Dr. Tyson, we appreciate you taking the time to share with us today.

I had a few questions, but before we get into that, I wanted to ask that your statement be entered into the record. If there is no objection, we will do that.

Dr. TYSON. Yes. Thank you.

[The prepared statement of Dr. Tyson follows:]

Remarks by Laura D'Andrea Tyson
Chair of the Council of Economic Advisers
before the Committee on the Budget
United States Senate

Tuesday, February 7, 1995

Mr. Chairman, before I get started, I want to thank you and the Committee for the opportunity to testify today. It is indeed a pleasure to be here as a member of this Administration to discuss both the economic success story of the past 2 years and the encouraging prospects for the future.

Last year we witnessed an economic payoff to the tough fiscal decisions embodied in the Omnibus Budget Reconciliation Act of 1993 (OBRA93). The deficit shrunk by $52 billion in fiscal year 1994 due to the initiatives set forth in OBRA93 ($72 billion if special factors such as receipts from the sale of assets acquired from failed thrifts are excluded). And we anticipate a cumulative total of more than $600 billion in deficit reduction from the pre-OBRA93 baseline through 1998. Of this amount, $505 billion comes from spending cuts and revenue increases contained in OBRA93; the remainder is due to technical revisions and the improved economic climate which, in part, resulted from OBRA93. The Administration's 1996 budget package adds another $81 billion in budgetary savings through 2000. This Administration has clearly demonstrated to the American people that fiscal responsibility is not just political rhetoric but a linchpin of our entire economic agenda.

My testimony today consists of three parts: a review of the economy's performance in 1994; a presentation of the Administration's economic forecast for 1995; and an overview of the Administration's economic strategy -- embodied in its 1996 Budget -- for improving the living standards of all Americans.

The Economic Situation in 1994

The U.S. economy in 1994 enjoyed a balanced and broad-based expansion. Real gross domestic product (GDP) grew 4 percent, the highest annual growth rate since 1987. Payrolls increased by 3.5 million, the largest annual increase in employment since 1984. Consequently, the unemployment rate dropped over a full percentage point during 1994. Since the Administration took office in January 1993, about 5.6 million jobs have been created; of these 93 percent are in the private sector. The consumer price index (CPI) increased by only 2.7 percent, about the same rate of increase as for the past 3 years. When the volatile food and energy components are removed, however, the core rate of consumer inflation registered its smallest increase in 28 years. The combination of strong economic growth and low inflation makes 1994 one of the best macroeconomic performances on record.

This strong performance took place in an environment in which the Federal Reserve increased short term interest rates several times in an effort to moderate the economy's growth to prevent future inflation. While these rate increases should put a brake on economic growth, we are optimistic about the future prospects for the economy. Business confidence appears strong, as evidenced by high levels of business investment in 1994. Similarly, consumer confidence remains strong, as purchases of durable goods grew rapidly over the year.

While the overall economy appears to be performing well, we are concerned that many Americans are not full participants in the growing prosperity. For instance, real median family income in 1993 is about the same level it was in 1973, despite an increase in real aggregate income of 57 percent during the same time period. Additional evidence of the trend of stagnant incomes for many Americans is the fact that hourly compensation in 1994 (as measured by the employment cost index) increased only 3 percent over the year, barely outpacing the 2.7 percent increase in the CPI. The actual increase in hourly compensation was lower than expected, based on a statistical relationship between the unemployment rate and the growth rate in hourly compensation. This is statistical confirmation of the feeling of many Americans that they are working harder for less.

The stagnation of family incomes has been accompanied by an equally disturbing trend of increasing income inequality. In contrast to the years 1950-1973, when average real family incomes increased throughout the income distribution, between 1973 and 1993, the spread in income inequality has gotten larger. As an example of this fact, Chart 1 shows the share of aggregate income received by families in different parts of the income distribution in 1973 and in 1993 (the most recent year for which these data are available). This Chart indicates that each of the four lowest quintiles of the income distribution saw their share of aggregate income decrease, while the share for the 20 percent of the population with the highest incomes increased substantially (and much of this increase was concentrated in the top 5 percent).

Over the past 2 years, the economy has grown at an average annual rate of 3.6 percent, as aggregate demand rebounded from the 1990-91 recession and the lackluster growth that initially followed it. In part, the current expansion was accomplished through an increase in the quantity and quality of the labor force and through net additions to the capital stock. To a significant extent, output was able to meet strong increases in demand through re-employment of workers who had been unemployed or underemployed and through the utilization of capital that had been idle or underutilized. By the end of 1994, however, both labor and capital utilization rates were in ranges that suggested little remaining slack. When this happens, the economy's growth rate becomes increasingly constrained by the growth rate of the labor force, net additions to the capital stock, and the productivity of labor and capital. Over the long run, these factors determine the economy's potential for growth or what economists refer to as the growth rate of potential GDP. Based on current information and the economy's most recent historical performance, most mainstream economists believe that the economy's growth potential is around 2.5 percent per year. This estimate of long-run real growth potential is shown by most major economic forecasts and the Administration forecast reflects this view.

The Administration's Economic Forecast

This Administration prides itself on making realistic forecasts of economic conditions and we believe the evidence of the past 2 years suggests that our forecasts have been conservative as well as credible. In fact, when I testified before this committee last year, I said that "the economy is poised for a sustained expansion." Forecasting may be an inexact science, but it is definitely satisfying when your forecasts prove correct. Indeed, the major surprise in the performance of the U.S. economy in 1994 was that real growth exceeded the forecast by a significant amount, even though interest rates were much higher than predicted and inflation slightly lower than predicted.

This year's economic forecast continues the conservative tradition of our prior forecasts. We are forecasting a moderation of growth in 1995 as the effects of increases in interest rates spread more broadly through the economy. For 1995 as a whole, we are forecasting that real GDP will grow by 2.4 percent relative to 1994. Then in 1996, the economy is expected to settle onto a path consistent with its long-run growth potential of 2.5 percent, a so-called "soft landing". We forecast the economy to maintain real output growth in line with the growth of potential output through the year 2000.

Inflation is forecast to rise slightly during 1995. Consumer prices are projected to increase by 3.2 percent in 1995. Thereafter, consumer price inflation is forecast to remain at 3.2 percent through 1998, before falling to 3.1 percent in 1999 and 2000. More broadly, inflation as measured by the GDP price deflator is forecast at 2.9 percent this year and next. Then we expect inflation to settle at about 3.0 percent over the remainder of the forecast horizon.

The Administration forecast used in preparation of the budget predicts that the unemployment rate will average around 5.8 percent in each year between 1995 and 2000. Since that forecast was made in November, more has been learned about the behavior of the actual unemployment rate. In the upcoming Economic Report of the President, the Administration presents a forecast range for the unemployment rate of 5.5 percent to 5.8 percent for each year from 1995-2000. We forecast a range both because we are unsure about the impact of the 1994 improvements to the Current Population Survey used to compute the unemployment rate and because some structural change may be underway in the labor market. An important characteristic of our employment forecast is that it incorporates a belief that economic growth over the next several years will be sufficient to absorb all new entrants to the labor force. Therefore, we anticipate little upward pressure on the unemployment rate during this period.

Our forecast anticipated a 50 basis point increase in short-term interest rates (three-month Treasury bill rates) during the first quarter of 1995. As growth moderates during the year, we expect short-term interest rates to fall about 50 basis points by early 1996 and remain there throughout the remainder of the forecast horizon. The forecast for interest rates on 10-year Treasury notes was revised upward for 1995 to 7.9 percent from last year's lower level. Our forecast predicts a decline in these interest rates to an average of 7.0 percent between 1997 and 2000. This forecast reflects the belief that the spread between short and long term interest rates will return to a more traditional range than the one experienced in 1994, as the inflation and risk premiums built into long-term rate gradually shrink.

Table 1 attached to my testimony compares the Administration's economic forecast to the Congressional Budget Office and Blue Chip forecasts. While there are some differences between these forecasts, the differences tend to be small, and Table 1 indicates a high degree of consistency in these different forecasts.

There are always some risks to any economic forecast. The possibility exists that the interest rate increases engineered by the Federal Reserve will not dampen growth as quickly as anticipated. If this occurs, real economic growth in 1995 could exceed the predicted 2.4 percent rate. A higher than predicted growth rate in turn could result in higher than anticipated interest rates, which could slow future economic growth more than expected.

Similarly, there are risks that the economy may grow more slowly than forecast. For instance, the interest rate increases already in the pipeline may slow economic growth sooner than anticipated or by more than anticipated. Compounding this risk is the possibility that foreign economic growth may stall, reducing foreign demand for U.S. exports. In addition, the large inventory accumulation by businesses over the past year may not have been entirely intentional. If this proves to be the case, then production could be scaled back to reduce an inventory overhang, lowering growth. Finally, the course of the economy depends on budgetary and other policy decisions made by Congress. This year there is an especially high degree of uncertainty about future Congressional actions in matters that can affect output, growth, deficits, and interest rates over the short, medium, and long term.

A Strategy for Improving Living Standards for All Americans

The Administration's economic strategy for raising the living standards for all Americans has three components. The first is to establish a sound fiscal foundation for the Federal Government. Getting the Nation's fiscal house in order required a deficit reduction plan that is balanced and gradual, yet large enough to be credible and to have a significant positive effect over time. The Administration's initial budget plan enacted as OBRA93 met this test, and this year's budget follows up on that legacy by providing further deficit reduction. To see the effects of these deficit reduction initiatives, consider that in 1992, the Federal deficit had reached 4.9 percent of GDP. For fiscal year 1996, the deficit is expected to be about 2.7 percent of GDP. And, by 1998, we project it to fall to 2.4 percent of GDP, less than half its 1992 level.

Economists often prefer to focus on the structural budget deficit, which adjusts the deficit computations by eliminating the effects of the business cycle. By this measure, the burden of the Federal budget deficit has declined steadily since 1993, with much of the credit for this improved fiscal picture attributed to OBRA93. Chart 2 attached to my written testimony shows the structural budget deficit as a share of GDP and indicates the substantial effect that OBRA93, along with the additional deficit reduction in this year's Budget, has had on it.

The second component of the economic strategy is a set of policies to help American workers and businesses realize the opportunities that flow from changes in technology and the global economy. The common theme of these policies is investment: both public and private. On the public side, the Federal Government is shifting spending away from current consumption and toward investment in children, education and training, and science and technology. On the private side, the Administration supports targeted subsidies to complement market incentives and encourage investment by individuals and businesses in physical, scientific, and human capital. Throughout, the Administration recognizes that government must not only spend less, it must also spend better, by focusing more of its resources on the Nation's future.

A third component of the Administration's economic strategy is tax relief for working families. The Administration first focused tax relief initiatives on those working Americans with the lowest incomes. The result was the substantial expansion of the earned income tax credit in OBRA93. This refundable tax credit increases the after-tax income for many lower-paid workers and is an important step toward ensuring that families with full-time workers will not live in poverty. This year's budget includes a second round of tax relief, this one aimed at middle class families. The package of tax cuts introduced by the President in December will help Americans meet the costs of raising their families, acquire more education and training, and save for a variety of purposes.

The Role of Deficit Reduction

When viewed in the context of the three components of the Administration's economic strategy, it is clear that deficit reduction is not an end in itself, but rather a means to the end of greater national investment and higher living standards. Deficit reduction has the beneficial effect of increasing national saving (by reducing the negative saving of the Federal Government). This increased national saving is available to private entities for investment in physical capital like machinery and equipment, which in turn can increase labor productivity. But squeezing worthwhile public investments out of the budget to make room for private investment is the wrong way to reduce the deficit. Moreover, one should recognize that deficit reduction by itself is contractionary fiscal policy and constrains aggregate demand. Therefore, there are limits to the amount of deficit reduction that the economy can be expected to withstand in a short period without endangering economic growth. Over the long run, deficit reduction makes room for more private investment, but in the short run it depresses aggregate demand and can even depress private investment. For all these reasons, the Administration prefers to engage in gradual and measured deficit reduction. Our success to date in reducing the deficit is one reason why the Administration opposes a balanced budget amendment to the Constitution.

Shortcomings of a Balanced Budget Amendment

First, everyone should be aware that the proposed amendment by itself would not reduce the Federal deficit by even one dollar. All the hard choices about cutting expenditures or raising revenues (through either taxes or fees) would still remain. Congressional consideration of a balanced budget amendment without first specifying the changes to expenditures and taxes required to bring the budget into balance provides no evidence of the fiscal discipline necessary to achieve real deficit reduction.

One of the great fallacies behind the logic for a balanced budget is the premise that the size of the Federal budget deficit is purely the result of deliberate policy decisions. This is not the case: the pace of economic activity has a major role. An economic slowdown automatically depresses tax revenues and increases spending on programs such as unemployment and Food Stamps. Consequently, the deficit automatically widens and the additional disposable income made available to consumers cushions the effects of the recession.

During economic expansions, the process works in reverse, and the deficit automatically narrows. These effects are termed "automatic stabilizers" because they act by themselves to moderate the effect of business cycles.

But a balanced budget amendment would throw these automatic stabilizers into reverse. Congress would be required to raise taxes or cut spending in the face of a recession, to counteract temporary increases in the budget deficit. Rather than moderate the ups and downs of the business cycle, fiscal policy would be forced to aggravate them.

With fiscal policy deprived of its counter-cyclical role, monetary policy, conducted by the Federal Reserve, would be the only tool available to stabilize the economy. But even well-executed monetary policy (which assumes the Federal Reserve promptly recognizes changes in the business cycle and aggressively acts to offset the effects) cannot completely compensate for the lack of fiscal policy flexibility. In part, the inability of monetary policy to fill the void reflects the fact that monetary policy acts with a long, and uncertain, lag. Moreover, the Federal Reserve could become handcuffed in the case of a severe recession, its scope for action limited by the fact that it can reduce interest rates no lower than zero, and probably not even that low in practice. Moreover, the more aggressive interest rate movements necessary to offset macroeconomic fluctuations could actually increase the volatility of financial markets -- something the Federal Reserve would probably try to avoid.

The role that fiscal policy can play in smoothing economic fluctuations is one of the great discoveries of modern economics. A balanced budget amendment to the Constitution would eliminate the automatic stabilizers from fiscal policy, and would essentially remove an important element from the economic policy toolbox.

The Role of Investment

The Administration is embarked on an ambitious agenda to increase investment in many types of capital. One aspect is to increase the stock of human capital, by improving the education and training prospects for all Americans. Examples of Administration initiatives in this area are: increased funding for Head Start, Goals 2000, the School-to-Work transition program, AmeriCorps (the National Service Program), and the income contingent student loan program. All these programs support human capital development throughout a person's lifetime.

In the area of science and technology, the market itself may not provide sufficient incentives for development of all socially desirable investments. This is because the benefits of research do not always accrue to the inventor, but rather to society as a whole through the dissemination of scientific and technological advances. The Administration recognizes the importance of scientific research, an area that has long received bipartisan support in budget decisions. While total discretionary spending remains approximately fixed in nominal terms, Federal spending on science and technology has edged upward during this Administration.

The Administration policy toward opening foreign markets complements its emphasis on investment. Exports play an increasingly important role in the livelihood of American workers since over 10 million American jobs now depend on exports and export-related jobs pay substantially higher than average wages. In addition, the reduction of barriers to trade raises the standard of living by providing a wider variety of goods to American consumers at lower prices. And foreign competition can lead to greater efficiency and productivity in U.S. businesses. Four examples of the Administration's commitment toward opening foreign markets to U.S. goods and services are: NAFTA, the Uruguay Round of the GATT, and the trade discussions that took place at the Summit of the Americas and the recent meeting of the Asia Pacific Economic Cooperation (APEC) forum.

The Unfinished Agenda

Over the next 2 years the Administration plans several major policy initiatives. One of these, middle-class tax relief, was announced by the President in December. There are three main elements to the initiative -- a child-based income tax credit; a deduction for some of the costs of post-secondary education; and an expansion of individual retirement accounts. All of these proposals are intended to help average Americans cope with the demands of today's economy. Secretary Rubin, in his testimony, will go over these in detail.

A second initiative was detailed by the President last week -- an increase in the minimum wage. This proposal reflects a determination to ensure that working families can lift themselves out of poverty, as well as a recognition that inflation has substantially eroded the real value of the minimum wage. The proposed increase of [illegible] cents per hour, phased in over 2 years, would go a long way toward reversing the effect of inflation, without any discernible impact on employment prospects.

Other Administration initiatives include welfare reform and health care reform. In both these areas, the Administration proposed legislation in 1994. We intend to work with the Congress in a bipartisan manner to ensure that progress can be made in each of these crucial areas this year.

One last ongoing Administration initiative is the effort to reinvent government -- the National Performance Review (NPR), under the direction of Vice President Gore. Through the end of 1994, the Administration's reinventing government reforms had reduced the Federal workforce by about 100,000 employees and had made substantial progress in the area of government procurement. A second round of NPR reforms was announced in December 1994, with projected savings of $26 billion over 5 years. While the NPR generates savings in Federal spending, this is not the only reason to undertake reinvention. The goal of the NPR reforms is to improve government and to provide services that are in the national interest. That is, we want to create a government that is leaner, not meaner.

Conclusion

As you know, 1994 was a very good year for the American economy. The solid economic growth, combined with a low rate of inflation and declining unemployment made for the best overall economic performance in a generation. But there are many challenges before us, the most fundamental of which is restoring the American Dream to all families in a world of changing technology and increasing competition.

Some important foundations to achieve the goal of higher living standards, broadly shared, have already been put in place. The fiscal 1996 budget represents another step. We look forward to working with you and the American people in this common endeavor.

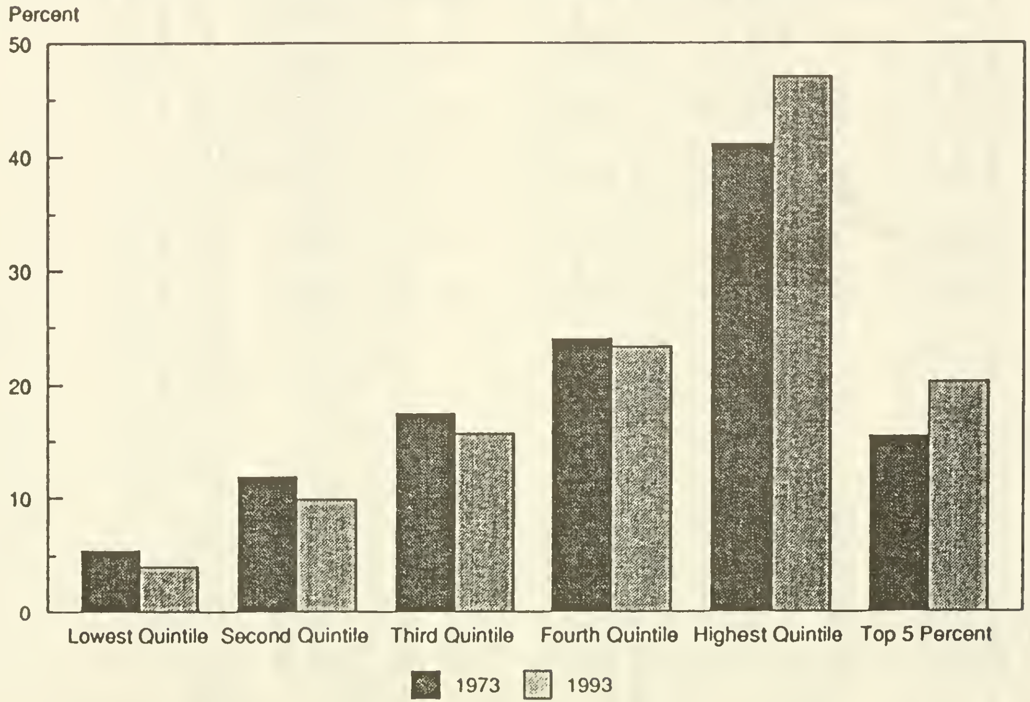
Table 1
1995 Forecast Comparison
Annual Detail

	1993	1994	1995	1996	1997	1998	1999	2000
Real GDP, 4Q/4Q growth (%)	3.1	4.0						
CBO			2.5	1.9	2.4	2.3	2.3	2.3
Blue Chip			2.5	2.2	(2.2)	(2.3)	(2.6)	(2.4)
Mid-Session Review (July)......			2.7	2.6	2.5	2.5	2.5	NA
Administration Forecast........			2.4	2.5	2.5	2.5	2.5	2.5
GDP Deflator, 4Q/4Q growth (%)	1.8	2.3						
CBO			2.8	2.8	2.8	2.8	2.8	2.8
Blue Chip			3.1	3.2	(3.3)	(3.1)	(3.1)	(3.0)
Mid-Session Review (July)......			2.8	2.9	3.0	3.0	3.0	NA
Administration Forecast........			2.9	2.9	3.0	3.0	3.0	3.0
CPI-U, 4Q/4Q growth (%)	2.7	2.6						
CBO			3.2	3.4	3.4	3.4	3.4	3.4
Blue Chip			3.5	3.5	(3.7)	(3.6)	(3.5)	(3.4)
Mid-Session Review (July)......			3.2	3.3	3.4	3.4	3.4	NA
Administration Forecast........			3.2	3.2	3.2	3.2	3.1	3.1
ANNUAL AVERAGES								
Civilian Unemployment Rate (%)	6.8	6.1						
CBO			5.5	5.7	5.8	5.9	6.0	6.0
Blue Chip			5.6	5.7	6.2	6.3	6.2	6.1
Mid-Session Review (July)......			6.2	6.1	6.1	6.1	6.1	NA
Administration Forecast..........			----------------- (5.5 to 5.8) ---------------					
Three-month T-bill	3.0	4.3						
CBO			6.2	5.7	5.3	5.1	5.1	5.1
Blue Chip			6.2	6.1	5.2	4.9	4.9	5.0
Mid-Session Review (July)......			4.7	4.8	4.8	4.8	4.8	NA
Administration Forecast........			5.9	5.5	5.5	5.5	5.5	5.5
Ten-year T-note	5.9	7.1						
CBO			7.7	7.0	6.7	6.7	6.7	6.7
Blue Chip			8.7	8.5	8.0	7.8	7.8	7.8
Mid-Session Review (July)......			7.0	7.0	7.0	7.0	7.0	NA
Administration Forecast........			7.9	7.2	7.0	7.0	7.0	7.0

* Numbers in parentheses are year-over-year figures.
* Blue Chip forecasts for 1995 and 1996 were made in January 1995, and forecasts beyond 1996 were made in October 1994.
* A Blue Chip forecast for the 10-year rate is not available. The corporate rate is given instead. The corporate rate is usually about 60 basis point above the comparable government rate.

Chart 1. Share of Aggregate Family Income by Quintile

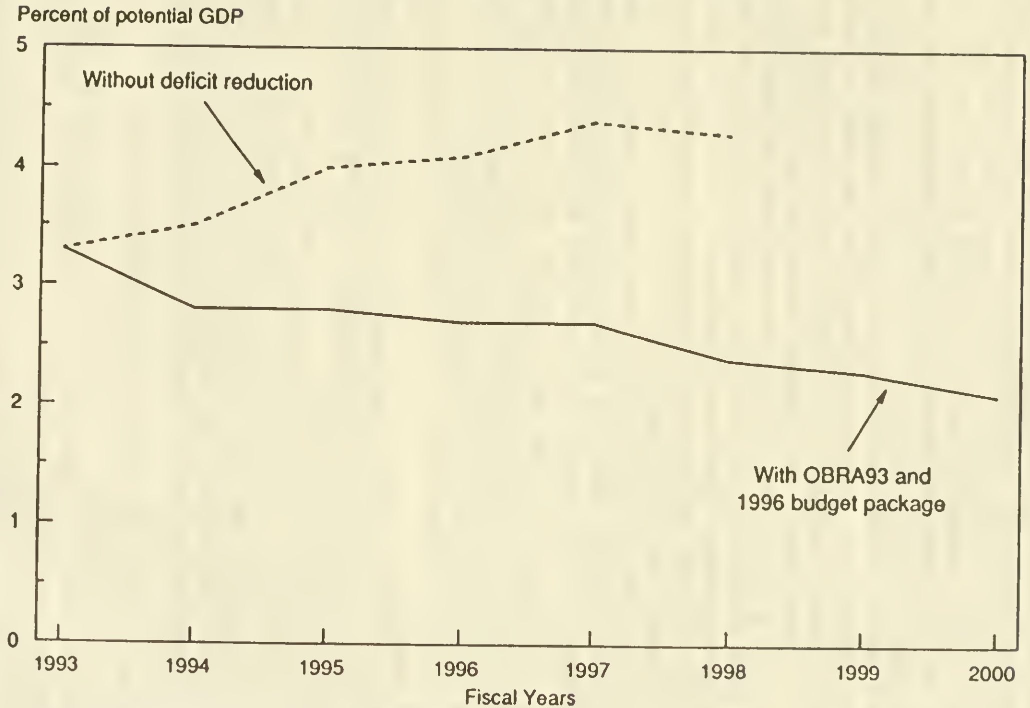
Between 1973 and 1993, the share of money income received by the 20 percent of families with the highest incomes rose substantially. The shares for all other quintiles fell.



Source: Department of Commerce.

Chart 2. Structural Budget Deficits

Policy changes enacted in 1993 arrested the upward trend of the deficit, and the President's proposed budget for fiscal 1996 will achieve even more deficit reduction.



Note: Structural deficit excludes cyclical revenues and outlays.

Sources: Council of Economic Advisers and Office of Management and Budget.

Senator BROWN. First, I would appreciate your thoughts on the nature of this budget which is presented. The President has indicated that he opposes the balanced budget amendment because he feels it should be done statutorily by actions of Congress and that it is not needed to be put in the Constitution.

With that in mind, your budget calls for a $73 billion increase in spending next year, and deficits on into the future and the outfuture rising.

How do you reconcile the two? At one point, you say you are going to do it, and at another point you do exactly the opposite. Where does this come together?

Dr. TYSON. I think what we have said all along, and from the very beginning, our position has been that we want to make sustained, gradual progress on the deficit. And this budget continues what we have done in that regard. It adds to the $505 billion package an extra $81 billion. It continues to keep the deficit on a decline path relative to the size of the economy. That is the objective we set for ourselves. Our view is that——

Senator BROWN. Do you consider that over the 10-year cycle, or are you saying over the 5-year cycle?

Dr. TYSON. No; over the 10-year cycle, over the 10-year cycle. Actually, the numbers show the deficit continuing to decline relative to the size of the economy over the entire 10 years. And I want to point out that just 2 years ago, when we presented our first plan, the deficit-to–GDP ratio was projected to come down a little bit and then to shoot up in 1998. If you look at our new budget, what you see is the deficit–GDP ratio is constantly declining.

We had the chart earlier, but Secretary Rubin took it to the other hearing.

Senator BROWN. Well, I just mention that because it strikes me that that is based on your assumptions, and the CBO assumptions show a much different picture.

Dr. TYSON. Well, I also addressed that. We use CBO assumptions in our first budget. We have subsequently used OMB administration assumptions. We believe that our assumptions are more credible, frankly. We believe our economic forecast will prove to be the more appropriate economic forecast, and the other major difference between——

Senator BROWN. Dr. Tyson, we are limited in time.

Dr. TYSON. OK, fine.

Senator BROWN. I appreciate your thoughts, but I need to stay focused on questions, if we could.

Dr. TYSON. Go ahead.

Senator BROWN. With regard to the forecast, you have suggested there be a 2.5 percent increase in real GDP in 1996. CBO says 1.8. The independent Blue Chip indicators indicate 2.2. How is it that you come up with significantly higher growth next year than either CBO or the independent blue chip forecasters?

Dr. TYSON. I think I would first start out by saying the difference between 2.5 and 2.2 is probably not, relative to the size of difference, is not——

Senator BROWN. That was not my question. My question was——

Dr. TYSON. But you think this is a significant difference——

Senator BROWN. Dr. Tyson, if you want to testify, that is great; if you do not, just let me know, and we will end this right now.

Dr. TYSON. I was answering your question. Was your question not that this is a big difference? I was pointing out I did not think in the realm of forecasting that this is a great difference.

Senator BROWN. My question was how do you account for the difference.

Dr. TYSON. OK. We account for the difference because we believe that the course of both fiscal and monetary policy that we have seen in 1994 have put the economy on a glide path for a soft landing. And 2.5 percent is the consensus view of what the economy can do once its margins of excess reserves are largely used up. That is where we are now.

Senator BROWN. The same would apply to the Consumer Price Index, where you are four-tenths under?

Dr. TYSON. Well, you know, we looked at the performance in 1994, and frankly, the economy did better on inflation than anybody predicted. And if you look at the newest numbers we just got out on unit labor cost yesterday, for example, this economy has really outperformed forecasts on inflation, and that has led us to believe it will continue to do very well on inflation this year.

Senator BROWN. But you assume a stronger economy than the blue chip indicators but assume less inflation, even with a stronger——

Dr. TYSON. Yes; what happened in 1994 is the economy grew much faster than predicted, and inflation actually came in under what was predicted. So building on what we see as the underlying strength of the economy exemplified in 1994, we feel comfortable with that kind of forecast for 1995.

Senator BROWN. Let me ask this. As I understand it, the Consumer Price Index and the GDP price deflator have different impacts and have a different relationship in the way you do your long-term forecasting. The Consumer Price Index obviously is part of what you used in forecasting the entitlement expenses, and the income side picks up the GDP price deflator.

One of the things I notice is that the Administration only shows a two-tenths of 1 percent difference between the CPI and the GDP price deflator, whereas the CBO shows a six-tenths difference between the two. The net effect of that is to show significantly smaller deficit, the way you have done that relationship.

Have you changed policies in any way in your calculating those, or relationship of those two?

Dr. TYSON. No; I think what we did—as we look back over the past several decades, we don't see any sign of a persistent substantial gap between inflation as measured by the CPI and inflation as measured by the GDP deflator, and we do not see any reason why we should forecast any substantial gap between inflation as measured by the CPI and inflation as measured by the GDP deflator, based on the history of this economy.

So again, we feel comfortable with our forecast in terms of what the economy's normal, historical performance has been.

Senator BROWN. The effect of what you have done compared to the CBO is to significantly reduce the amount of the forecasted deficits, though, isn't it?

Dr. TYSON. I cannot give you the amount of money by which this is the case. There may be some of that, but I—the reason I cannot give you the amount of money is because the forecast was not based with that in mind. The forecast was based on looking at our best projection of CPI over the next several years and our best projection of the GDP deflator.

Senator BROWN. But the question I asked was different. The question was what is the effect of having the two-tenths difference versus the six-tenths difference——

Dr. TYSON. My answer is I could give you a calculation; I do not have it off the top of my head.

Senator BROWN. Let me finish. The difference between the two-tenths difference and the six-tenths difference that the CBO comes up with—my question is: Isn't the effect of that to show a smaller deficit than the CBO figures?

Dr. TYSON. That is probably the case, but I cannot tell you by how much, and I am happy to give you a calculation.

Senator BROWN. I was not asking for an exact figure.

Dr. TYSON. On the other hand, it is in the context of a totally different forecast, so we should look at each part of our forecast and compare the effect of each difference between our forecast and the CBO forecast on our projected deficit.

Senator BROWN. The light is on, but I would just share this view with you. I was very critical of President Reagan's budget forecast. In my view, they played with the numbers, and it did a great deal to undermine the integrity of their budget forecast because it lent the opinion that people were playing with the underlying indicators as a way of hiding the size of the deficit. It struck right at the heart of their credibility.

I offered amendments to change those in the House Budget Committee when I served there. So being critical of phony forecasts is not new to me. I was also very critical at times of the Bush forecasts, although frankly, they were a little better, I thought, than the Reagan forecasts.

There is no reason for you to remember, and I do not know that you were here for the first Clinton indicators, but I must tell you, frankly, that the first budget forecasts that President Clinton came to us with I thought were very sound and did more than simply forecast numbers. They lent some credibility and added some confidence to people that we were going to face up to the problem.

But I will tell you this as straightforwardly as I can. These forecasts are phony. They do not hang together. They destroy the credibility that I think this Presidency built when he first came to the Hill. And I think the loser in this is the American people, because it undermines the confidence that we can have in trying to make these numbers work, and I think it sends a signal that we are not sincere about trying to face up to this problem.

I say that in the hope that as you think through these, you will focus on the need to build confidence, because I must tell you I think these numbers destroy the confidence that both the Administration and this Congress ought to want in our budgets.

Dr. TYSON. My reaction to that, since I am the person who is responsible for these numbers, is to first register a strong protest to the notion that these are phony numbers.

They may prove to be incorrect. Forecasting is an inexact science. But these numbers were put together with the best possible information to make the most sensible forecast we could come up with about the economy. They were in no way doctored.

We did not know what the deficit implication of these numbers would be. We provide the forecast to the Treasury and to OMB, and they run the numbers. We do not adjust our numbers. We do not believe they are phony. They are not phony. They may prove to be incorrect. But I want to conclude by saying we have established 2 years of an excellent track record of forecasting this economy in a cautious way. The errors in our forecasts have proved to be errors where the economy has actually done better than what we forecast; that is the kind of error that we have made. And in fact, our forecast in the past 2 years was better than the CBO forecast; we out-forecast the CBO.

So we are extremely proud of our forecasting record, and I just want to make sure that you understand that I protest strongly the use of the word "phony."

Senator BROWN. Well, I appreciate you putting that in the record and your saying it. Let me say that I share your praise for the early years, and I mentioned it at the time and I felt it at the time. But just so the point is not lost, your figures for GDP growth are significantly above CBO's and above the blue chip indicators, overstating income—at least, if those other figures are correct. Your figures for the Consumer Price Index show a lower figure than either the CBO or the blue chip indicators. The GDP price deflators are different, and frankly, the relationship between GDP price deflators and the Consumer Price Index, that relationship is significantly different, thus under-rating what could be the forecast for future deficits.

And I simply would repeat my hope that putting together these estimates be viewed as an opportunity to restore credibility to the process.

The meeting is adjourned.

Senator SARBANES. Mr. Chairman, before you adjourn the meeting, since I think this subject is of some moment——

Senator BROWN. We already have.

Senator SARBANES [continuing]. I think you have made a very unfair charge against Chairman Tyson. I do not think these are phony figures.

Senator EXON. Mr. Chairman.

Senator SARBANES. Now, you may differ on her projections and assert that some other projection is more reliable, but these figures are not way out of line. Just looking at them, it is clear that no game is being played here, and I think that that ought to be put in the record.

Senator BROWN. Would the Senator like to make a little bet?

Senator SARBANES. I do not know how it is going to turn out or not, nor does the Chairman. And she said it is an art. On the price deflator, they are right in the middle. They are at 3.0—CBO is 2.8——

Senator BROWN. I simply offered the Senator an opportunity to put his money where his mouth is.

Senator SARBANES. I do not believe we can when we are in a Senate committee room.

Senator BROWN. These numbers are significantly different than what the economic forecasters have come up with.

Senator SARBANES. No, they are not significantly different. The difference between 2.5 and 2.2 real GDP growth——

Senator BROWN. We are talking about hundreds of billions of dollars.

Senator SARBANES [continuing]. Is not a significant difference.

Senator BROWN. You are talking about hundreds of billions of dollars over the course of the budget.

Senator EXON. Mr. Chairman.

Senator SARBANES. Well, look, a difference of one point on the growth rate is $65 billion in goods and services. Now, they differ from blue chip by three-tenths of a point. Now, three-tenths of a point is not a significant difference. It is a difference. If anything looks to be out of line here, it is the very low estimate by CBO as to what the growth will be.

Senator EXON. Mr. Chairman, do you customarily adjourn—have you adjourned the meeting?

Senator BROWN. Yes.

Senator EXON. Do you customarily adjourn the meeting when the ranking member has been sitting through this thing, before you came, from 9 o'clock this morning until now? Do you customarily do that?

Senator BROWN. No, absolutely not. I would say to the Senator I did not realize that that was the case, and I would certainly want him accorded that.

Senator EXON. Well, I would hope so.

Senator BROWN. With the permission of members here, we will reopen the meeting and extend it for such time as you would like to proffer questions.

Senator EXON. I have been very patient with my time and listening to all of these things this morning. I was about to say what my friend from Maryland just said. I do not think it is correct, Senator, to say that the figures are significantly different. The difference is between 2.5 and 2.2.

I happen to feel that probably the figures that we are receiving are about as close as we have ever seen OMB and the other forecasting agencies come up with. I believe that is true. There may be have been some times when they were closer. But I just do not think it is fair to say to the Administration and their witnesses here that they are fudging on figures.

You know, there is an old statement we have made very often: Figures do not lie, but politicians sometimes fudge figures. And I would simply say that, talking about fudging figures, I just want to put in the record if I might that all the talk that we have heard here today by and large has not done very much to balance the budget, but it sure has provided a lot of political heat.

I do not want to open it all up, but I have been patiently waiting to insert in the record—I will not mention any names, but people on that side have been trying to discredit the tough vote that the Democrats made in 1993. That was the only meaningful deficit reduction in the last 20 years, and it happened on that particular vote.

I get a little weary of people continuing to run that down, the very same people who said if you pass this budget, it is going to ruin the economy. Well, I hope we can all agree now that at least it did not ruin the economy. I do not think I am fudging on figures as a politician when I say that.

I also heard comments today where there has been an attempt to minimize what we did with that 1993 Act, which is described as the biggest tax increase in history. Well, actually, that is not true. The biggest real tax increase in history was back in the Reagan years. I am talking about inflated dollars against real dollars. In real dollar terms, the 1993 bill was not the biggest tax increase in history. But even if it was, it was the biggest tax increase in history on about 1 percent of all the people in the United States of America, other than the very small, minute contribution that was made by all of us with regard to gasoline taxes.

I ask unanimous consent to enter into the record at this time the chart entitled, "Change in Deficits Since Pre-OBRA Baseline." This is a CBO table, and it shows that had we not passed OBRA, which was that vote where we got not one Republican vote in the House and not one Republican vote in the Senate, the baseline deficit would be $387 billion in 1998, against $209 billion. So it has been a significant difference.

Now, you might say, well, those figures have been fudged a little bit. It is pretty hard to fudge from $400 billion down to $200 billion in the size of the deficit. So I submit that table for the record.

I also want to submit a table for the record—and again, I do not enjoy doing these things. As I said earlier, I think we should be using these hearings to try to come together and reach some agreement. But we have witnessed this morning some wholesale political announcements, time and time again. I did not start it, but I must say that I want to enter into the record a table that shows "The Budget Would have been Balanced in 1997 Without the Interest Owed on Debt Incurred over the Past 12 Years."

Dr. Tyson, this is my last question. I would like to ask you if it is true, in your opinion—and I think you have a lot of credibility around here even though you are a Democrat—that the budget would have been in balance by the year 1996 or 1997 had it not been that the Clinton administration had to budget for the interest on the National debt that accrued in the 12 years that I have referenced?

Dr. TYSON. It is true, and I have to tell you the first time I saw those numbers—we worked on a set of these numbers inside the Council of Economic Advisers—I was shocked at the extent to which the debt problem we have inherited is really driving all of our budgetary problems right now.

We are basically financing our current spending. The problem is that because our predecessors failed to finance their current spending, and because they asked for even more spending than the Congress gave them, that we as a Nation are now stuck with the problem of trying not just to finance our own spending, but to make up for those mistakes.

Senator EXON. Well, I ask unanimous consent that that chart be entered into the record also. I thank you very much.

Senator BROWN. Without objection, so ordered.

Senator EXON. In order to conserve time now, Mr. Chairman, I will not ask further questions. Thank you for being here.

Senator BROWN. Thank you, Dr. Tyson.

Dr. TYSON. Thank you.

Senator BROWN. The meeting is adjourned.

[Whereupon, at 12:10 p.m., the committee was adjourned.]

THE PRESIDENT'S FISCAL YEAR 1996 BUDGET

WEDNESDAY, FEBRUARY 8, 1995

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 9:38 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Grassley, Bond, Brown, Gorton, Gregg, Snowe, Abraham, Exon, Hollings, Lautenberg, Simon, Dodd, Sarbanes, Boxer, and Murray.

Staff Present: G. William Hoagland, staff director; and Anne Miller, director of budget review.

For the minority William G. Dauster, democratic chief of staff and chief counsel; and Sue Nelson, director of budget review and analysis.

Chairman DOMENICI. Since Senator Exon is not here yet, with your concurrence, Members, why don't we just do something different this morning and let the witness testify. Then we will make opening statements. That might be a welcome change. How about that?

Senator GREGG. Great idea.

Senator GRASSLEY. You are in shock, aren't you?

Chairman DOMENICI. You do not have to listen to us. We are here to listen to you, at least at first. Your testimony will be made a part of the record. We will hold our opening remarks until after you have spoken, and then we will have our chance to inquire.

STATEMENT OF ALICE M. RIVLIN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Dr. RIVLIN. Thank you very much, Mr. Chairman. I have a statement for the record, which I will summarize rather briefly.

I am very happy to be here with the Senate Budget Committee to start a dialogue on the 1996 budget. Both the Administration and I look forward to working with the committee. Making a budget, as you all know, is a very hard job. The Administration has worked hard on this budget. The President made tough decisions. We believe this is a good budget. I would like to talk briefly about the budget and leave most of the time for questions.

The Clinton administration's budget for fiscal year 1996 has a major theme which runs through it, and it is a theme that has run through the Clinton economic strategy from the beginning—that is, raising living standards for average Americans, both now and in the future. I presume we all share this goal.

In the first 2 years of the Clinton administration, we worked to achieve the goal of raising living standards by emphazing deficit reduction, which deficit is extremely important to achieving that goal.

But deficit reduction was not the only thing we emphasized. We also believe that public investment in people, skills, technology, and infrastructure makes a major contribution to raising future living standards.

This budget continues the fight to provide average people with higher wages and better living standards. It is reflected in our proposal for a middle-class tax cut that is focused on working families with young children. Unlike the Contract's tax cut, our tax cut goes to working families with children under age 13. These families are often struggling and need tax relief. Our tax cut also does not go to high-income people. It phases out between $60,000 and $75,000 adjusted gross income.

This budget also emphasizes education and training for better jobs in the future. This emphasis is reflected in our tax proposals, with a tax deduction for education and training expenses. It is also reflected in our proposal for broadening the individual retirement account so that people can use their money not only for retirement, but for education extraordinary medical expenses, or the purchase of a first home.

But the education and training emphasis is not just on the tax side. It is also reflected in our proposal for a GI bill for American workers. This proposal would combine and add to funds currently devoted to a myriad of different training programs. The funds, $5 billion over 5 years,would be used for two things: skills scholarships to help dislocated workers and low-income workers get the training they need for better jobs, and more flexible grants to allow States and localities to provide those workers with better information about job opportunities.

The theme of raising living standards is also reflected in our continued emphasis on some of the most important investments in young children and education. This budget devotes extra money to Head Start, the WIC Program, School-to-Work, and Goals 2000 as well as are science and technology investments that will improve productivity in the future.

This budget also continues the Clinton administration's tradition of fiscal responsibility. When we came into office, the deficit was out of control. The deficit was $290 billion in fiscal year 1992 and growing. It was confidently predicted that, under the policies in place at that time, the deficit would grow to heights of $300 and $400 billion.

But President Clinton and his economic team put together a plan to get the deficit under control. At the beginning of our Administration, on February 17, 1993 in fact, we presented a plan to the Congress for cutting the deficit and shifting expenditures toward investment. That deficit reduction plan provided for an almost even split between specific spending cuts and revenue increases. The President had the courage to propose the plan and the Congress had the courage to vote for it.

The deficit reduction plan has been extraordinarily successful. At the time of its passage, we estimated the plan would result in $505 billion of deficit reduction. We now think that given the economy's better than expected performance, the plan will result in $616 billion of deficit reduction.

The economy has responded to the President's deficit reduction plan. Interest rates came down and we have had very rapid economic growth in the last 2 years. We also have created nearly 6 million jobs. We think the plan has been a considerable success of which we can all be proud.

In this budget, we continue to propose deficit reductions. We have $144 billion of deficit reduction, less than half of which we are using to pay for the middle-class tax cut. Most of the $144 billion, $101 billion, comes from cuts in discretionary spending. We have emphasized paying for the middle-class tax cut, and additional deficit reduction, by making drastic cuts in discretionary spending.

We do not, however, believe in slashing Government indiscriminately. We believe there are many things that Government should do, but it should be doing them in a more effective ways. That brings me to the second theme that runs through this budget and has run through the Clinton strategy from the beginning—fashioning a Government that works better. This theme has been an emphasis of the National Performance Review and it is something we are now accelerating in this budget.

In December, we announced the drastic restructuring of five agencies: Transportation, Housing and Urban Development, Energy, the General Services Administration, and the Office of Personnel Management. Those restructurings, which we believe will make the agencies work better, are reflected in this budget.

We have terminated 131 small programs and consolidated 271 grant programs into 27 performance partnerships. We believe the performance partnership concept is a new and very important one. This is not just a new term for block grant. The performance partnership concept will enable the Federal Government to work in active partnership with States and localities. In these partnerships, the Federal Government will work with States and localities to determine what the goals are, how they should be measured, and what the results should be for the funds expended. All levels of Government will be held accountable to the taxpayers. The emphasis will be on performance and measuring the results, not on hamstringing States and localities with all kinds of rules and regulations about how they achieve the desired results.

The Vice President likes to talk about trust and accountability. We trust States and localities to use the money in ways best adapted to achieve results for their localities. But there must be results and we must know what those results are if we are to be held accountable to the Federal taxpayer and the wider public.

The third theme that runs through thid budget is American leadership which, again, has been part of the Administration's strategy from the beginning. We not only need a leaner, more effective domestic government, we also need a leaner, more effective military. We have continued to restructure our armed forces in the wake of the cold war. That restructuring is almost complete. As we have restructured, we have emphasized bolstering the readiness and effectiveness of our armed forces.

This budget reflects the decision announced in December to add $25 billion to defense, in part to fund Secretary Perry's quality of life initiatives that will make us better able to attract and retain the most qualified individuals and enable us to modernize the force toward the end of the decade.

In conclusion, Mr. Chairman, I am happy to be here to open a dialogue on the fiscal 1996 budget. We look forward to working with this committee, and the Congress on the things that are in this budget, and on some things that are not in the budget. We have made clear that we are in favor of welfare reform. We think there is a welfare reform agenda on which both parties share a lot of common ground. We are working not only with the Congress, but with Governors and mayors to fashion a welfare reform proposal. That proposal is not reflected in this budget. We sent the Congress a welfare reform proposal last year, but now we want to work with the Congress on crafting a new one.

Similarly, on health care, this Administration has been second to none in the concern it has shown for the health care problem. We believe the problem has not gone away. We need to come back to health care reform. Health care reform is the key to additional future deficit reduction, and we want to work with the Congress on that.

We did not put medicare and medicaid reform in this budget because we believe that reforming those two programs must be done in the context of the wider health care reform. We want to work with you on that. We do not believe that medicare cuts should be used for tax cuts, and we did not do so in this budget.

Over the next few months, we will all have an opportunity, Mr. Chairman, to serve the public. We believe we need to work with you to produce a budget that is fiscally responsible, that preserves and strengthens the activities people want from their Government, and eliminates those activities that are no longer necessary.

It is going to be a hard job, and we are here to work with you. Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you very much.

[The prepared statement of Dr. Rivlin follows:]

TESTIMONY OF
ALICE M. RIVLIN
DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET
BEFORE THE
SENATE COMMITTEE ON THE BUDGET

FEBRUARY 8, 1995

Mr. Chairman, members of the Committee, thank you for inviting me to offer the Administration's views on the President's fiscal 1996 budget. For the third straight year, the President has proposed a detailed plan to create a smaller, more effective Government for average Americans -- that is, to help create his "New Covenant" between the Government and the American people.

Executive Summary

The President proposes to build upon his strong record of achievement. With the help of his economic plan, which Congress passed in 1993, the President helped to jump-start a weak recovery. The result was lower interest rates, little inflation, and the creation of more than 5.6 million new jobs.

With a plan that called for a record $505 billion in deficit reduction over five years, and has in fact produced over $600 billion in deficit reduction, the President has reduced the deficit from $290 billion in 1992 to $203 billion in 1994. We expect the deficit to be under $200 billion this year. By 1998, the deficit will fall to its lowest level as a percentage of GDP since 1979.

At the same time, the President has made great progress in reinventing Government through the National Performance Review. We have reduced the workforce by 102,000 positions while streamlining departments and agencies, cutting red tape, and providing better service.

Now, we plan to go further. The President has proposed $144 billion of budget savings -- $63 billion to finance the middle class tax cut that I will discuss in a moment and $81 billion to reduce the deficit further over the next five years. As part of those savings, he proposes to terminate 130 programs and consolidate 271 others into 27 new "performance partnerships."

Not everyone has shared in the economic recovery. As a result, the President proposes a Middle Class Bill of Rights, which will cut taxes for middle-income Americans and give unemployed or dislocated workers grants to purchase the job training they need.

He also is continuing to reduce the Federal bureaucracy and will, by the end of this decade, cut it to its smallest size since John Kennedy was President. As part of Phase II of the National Performance Review, he has proposed to restructure the Departments of Housing and Urban Development, Energy, and Transportation, the General Services Administration, and the Office of Personnel Management.

In the coming months, also as part of Phase II, the President will examine every other program and activity to determine which to terminate, which to restructure, and which to shift to the States, localities, or private sector.

Major Themes

This budget revolves around three major themes -- themes that have dominated the President's economic strategy for the past two years.

1. Raising the standard of living for average families, now and in the future: The President is proposing a Middle Class Bill of Rights. For the short term, it will provide needed tax relief to help millions of average families raise their living standards now. And for the long term, it will give those families the tools they need to raise their living standards in the future.

The Middle Class Bill of Rights:

* Provides a $500 per child tax credit for middle-income families with children under 13;

* Expands eligibility for Individual Retirement Accounts (IRAs) and allows families to make penalty-free withdrawals for a range of educational, housing, or medical needs;

* Offers a tax deduction for the costs of college, university, or vocational education; and

* Creates a G.I. Bill for America's Workers by consolidating 70 job training programs and using the money to offer "Skill grants" through which dislocated and low-income workers can choose and pay for the training they need to find new and better jobs.

The President proposes to build upon his investments in human and physical capital -- investments that will help to raise national productivity and, in turn, living standards for the future. Overall, he proposes to increase investment spending by $9.7 billion in fiscal 1996 over 1995.

The G.I. Bill for America's Workers is a new element of his continuing agenda for improving the education and skills of America's workers, enabling them to compete for high-wage jobs in the new economy. In the last two years, the Administration has enacted the Goals 2000 bill to encourage States and localities to reform their educational systems; revamped the student loan program to make post-secondary education affordable to more Americans, and pushed successfully for the School-to-Work program that enables young Americans to move more easily from high school to training or more education.

In this budget, the President proposes a 10 percent increase for the Special Supplemental Feeding Program for Women, Infants, and Children (WIC), to $3.8 billion; an 11 percent increase for Head Start, to $3.9 billion, and an 86 percent increase for Goals 2000, to $750 million.

The President's budget also emphasizes investments in science and technology to improve future productivity and U.S. competitiveness in the new economy. It proposes a 13 percent increase for the Defense Department's core Technology Reinvestment Project (TRP), to $500 million; a 4 percent increase for biomedical research at the National Institutes of Health, to $11.8 billion; a 20 percent increase for the Commerce Department's National Institute of Standards and Technology, to a total of $1 billion; and a 4 percent increase for the National Science Foundation, to $3.4 billion. The President seeks to strengthen the Administration's coordinated efforts to promote science and technology through the National Science and Technology Council and to improve the payment system for federally-sponsored research at colleges and universities.

The budget also continues the Administration's strong commitment to deficit reduction. When we arrived, the deficit was a clear threat to future living standards. It was projected to rise from $290 billion in 1992 to more than $300 billion immediately, and then to near $400 billion a few years down the road. The deficit was absorbing a huge share of national saving that could otherwise be spent on the kinds of investments that increase productivity.

Working with Congress in 1993, we enacted a five-year budget plan designed to reduce the deficit by a cumulative $505 billion from 1994 to 1998. Because the economy has performed better than expectations, we now expect to generate $616 billion in deficit reduction over that time. The deficit measured $203 billion in 1994 -- a huge drop from the $290 billion of two years earlier.

Except for an anomaly in 1997, we expect it to remain below $200 billion for the rest of this decade.

More importantly, we have reduced the deficit from 4.9 per cent of Gross Domestic Product (GDP) when we arrived to a projected 2.7 percent this year. Clearly, we have brought the deficit under control.

But we are not satisfied. In this budget, we propose to reduce the deficit between 1996 and 2000 by another $81 billion. More importantly, our budget would bring the deficit down to 2.1 percent of GDP by the end of this decade -- its lowest level since 1979.

We are proposing $144 billion in new budget savings -- $63 billion to pay for our middle class tax cut and $81 billion for more deficit reduction.

How did we generate the $144 billion in savings?

Most of them, $101 billion, come in discretionary spending cuts. Of the $101 billion, $21 billion comes from Phase II of the Administration's effort to reinvent Government through the National Performance Review. This includes the restructurings of the Departments of Housing and Urban Development, Transportation, and Energy, the General Services Administration, and the Office of Personnel Management. The rest of the savings are outlined in the program-by-program detail in the budget for the years 1996-2000.

Also as part of Phase II, the Administration has begun an intensive effort to examine the other Federal departments and agencies to determine which functions and activities to continue, which to terminate, and which to shift to the States, localities, or the private sector. We anticipate that, through this effort, we will revise our five-year, program-by-program plan and offer proposals to restructure agencies in the same way that we have for those cited above.

The budget contains $29 billion of mandatory savings. Most of it comes from extending the Medicare and Veterans reforms of the 1990 and 1993 budget reconciliation acts, accelerating our successful direct student loan program, expanding the principle of user payment for the electromagnetic spectrum, and other smaller savings.

The budget also includes tax compliance savings of about $9 billion, including about $0.4 billion from reinventing Government.

Finally, the budget includes a small amount of savings that does not score for budgetary purposes, including net spending reduction from the Administration's non-emergency supplemental appropriation proposal for fiscal 1995, interest savings associated with the direct student loan program, and debt service savings from all of the other proposals. Partially offsetting these savings are bookkeeping costs due to personnel cuts; reducing the size of the Federal workforce means that the Federal Government and its employees make smaller contributions to the pension funds.

In sum, these proposals fully offset the tax cuts and leave enough additional savings to keep the deficit under control beyond the five-year budget window. While the economy is growing, the deficit is not.

2. Projecting American Leadership: Our funding proposals for international affairs, $21.2 billion, and national defense, $258.3 billion, support American leadership around the world. These two elements are synergistic: we design and prepare our forces and programs to support our national interests and foreign policy goals. Together, they create the foundation for our leadership. I will turn first to international affairs, then to national defense.

However critical to promoting our vital national interests, funds for international affairs programs and institutions constitute only 1 percent of our total budget, requiring that we carefully focus on their most effective use in supporting our most important goals and objectives.

Our budget promotes and defends our vital interests in regions that have long been central to our national security: Europe, the Middle East, and Asia. Our budget includes $788 million to support economic and democracy programs in the new independent states (NIS) of the former Soviet Union. In Central Europe, our budget supports the missions of supporting democracy, free markets, and peace by providing $480 million in funding to help healthy, market democracies emerge. The budget also maintains our long-standing support for the peace process in the Middle East, requesting more than $5.2 billion to assist countries participating in that process.

A strong and growing world economy that incorporates an increasing number of nations is essential to our own economic growth. Our budget provides increased support to strengthen our trade position in the global market and especially in Central Europe, Russia, and Ukraine through such agencies as the Export-Import Bank.

Our leadership is important to prevent and provide a humanitarian response to crises and conflicts that have so visibly divided many nations in recent years. Our budget supports this leadership effort by providing $1.7 billion for refugee, humanitarian feeding, and disaster assistance programs.

The Nation has built, and this Administration continues to support, a powerful military capability. Our defense budget, which is significantly higher than that of any other nation, supports one of the world's largest military forces, with a superior level of quality and talent. It continues our commitment to maintaining high levels of training and readiness of that force and to equipping it with a technology second to none.

In discretionary spending, the budget requests $258.3 billion in budget authority and $262.2 billion in outlays for the National Defense Function. The outlays represent 16 percent of all spending in the budget.

The Administration continues to place its highest priority on the readiness of U.S. defense forces -- ensuring their ability to mobilize, deploy, and operate effectively in the face of varied challenges of the post-Cold War era. The Defense Funding Initiative, providing $25 billion in higher spending from 1996 to 2001, supports our commitment to high levels of readiness, as does the requested defense supplemental appropriation for 1995. For 1996, the budget proposes funding of $91.9 billion for Operations and Maintenance, the principal readiness-related account.

This budget also contains several initiatives to improve the quality of military life: a 2.4 percent military pay raise and an increase in military community and family support, including more child care facilities, family counselors, and improved recreational facilities.

Superior technology is the hallmark of the U.S. armed forces. In particular, we expect investments in information technologies and sensors to give our forces major advantages in gathering, processing, and acting upon information from the battlefield. The budget proposes $7.8 billion for science and technology programs.

The budget also enables us to maintain stewardship over our nuclear capability. The budget proposes $11.2 billion in total Energy Department spending on defense activities. It includes $6.6 billion of cleanup and disposal of wastes from prior nuclear weapons activities, $0.7 billion for developing nuclear reactors for Naval vessels, and $0.7 billion for nonproliferation, arms control, and other activities.

Intelligence remains a critical ingredient of our national security posture. To support it, we propose to keep the Intelligence budget at the 1995 level. To plan for the future, the President and Congress established a commission of distinguished Americans that will spend the next year reviewing the roles and capabilities of the Intelligence Community. Their conclusions will help to guide future decisions on goals and resources.

Wise investments with dual-use technologies support national defense. They allow defense systems to draw on leading-edge commercial developments in such areas as computers and communications, and they allow investments in defense programs to accelerate commercial progress in such areas as advanced materials and space systems. The Administration's dual-use investment strategy focuses heavily on electronics and sensors. The Technology Reinvestment Program is a key component of this strategy. It awards Federal funds competitively, on a cost shared basis, to enable industry-led projects to create new dual-use technologies. Since the start of the TRP program in 1993, over 15,000 companies have submitted over 3,000 proposals to participate; the program has made over 250 awards. The budget requests $500 million for the TRP program.

The Defense Department's main challenge with its facilities is to tailor them to the downsized force structure. DOD is working to ensure that base closure and realignment decisions will generate a more efficient use of the remaining defense infrastructure. The budget provides $3.9 billion in 1996 to implement closure and realignment decisions. At the same time, DOD is committed to assisting the economic redevelopment of communities affected by base closures. In this effort, the budget increases funding for DOD's Office of Economic Adjustment (OEA) to $59 million, $20 million over 1995, to help Base Realignment and Closure Commission communities plan for economic redevelopment.

3. **Making Government Work:** The President is building on his initial success in making Government work and moving out in dramatic, new directions.

Through the National Performance Review (NPR), which the President created two years ago, the Administration has improved service to Government's "customers," cut red tape, empowered Federal employees, and eliminated programs that no longer serve a useful purpose. We have sought to ensure that Federal programs achieve real results -- e.g., cleaner air -- rather than merely spend taxpayer dollars.

We streamlined Federal agencies, cutting management layers and excessive controls. Already, we have reduced the workforce by 102,000 full-time equivalent (FTE) positions. Continuing the President's effort, the budget proposes 1.976 million FTE. By the end of 1996, the President will have cut FTE by 173,300, reducing the Federal Government to its smallest size in 30 years. He also will be nearly two-thirds of the way toward the required reduction of 272,900 by 1999, as outlined in last year's Federal Workforce Restructuring Act.

In its first phase, the NPR, under the direction of Vice President Gore, mostly examined the "how" of Government -- the human resource management, procurement rules, and other processes by which the Government operates. In general, it did not focus on the more basic question of "what" the Federal Government should, and should not, do.

With this budget, the President has begun to tackle this very fundamental question. He is proposing a major restructuring of three Cabinet departments -- Housing and Urban Development, Transportation, and Energy -- and two major agencies -- the General Services Administration and the Office of Personnel Management. We expect these restructurings to save $23 billion over the next five years.

We also are proposing to consolidate 271 programs into 27 "performance partnerships." In exchange for giving States, localities, and other providers more flexibility in how they spend Federal funds, we are seeking more accountability for that spending by focusing on actual performance. Rather than merely calculate the inputs of a program -- i.e., funding levels -- we are focusing on outputs -- what the programs actually accomplish.

The consolidated programs include 70 to create the G.I. Bill for America's Workers, mostly from the Departments of Education and Labor; 108 from the Public Health Service; 60 from the Department of Housing and Urban Development; 30 from the Department of Transportation; and three from the Department of Health and Human Services.

More importantly, these restructurings and consolidations are the first step in a Government-wide examination of departments and agencies, which the President has asked the Vice President to lead. This effort is designed to sort out responsibilities among the Federal, State, and local levels of government, and between Government and such private sector providers as businesses, non-profits, and community groups. Working with the NPR, OMB, the President's Management Council, and the White House policy councils, Federal agencies will examine every program, determine which to continue, which to eliminate, and which to shift to the States, localities, or private sector.

Program Detail

Restoring the American Community: American communities embody our sense of place, belonging, and togetherness -- the very security on which we depend. But our communities face the pressures of great challenges that threaten the ties that bind us together. Violence and drug related crime are tearing at our social fabric.

This budget would invest in our communities, by increasing funding for programs that help to strengthen our communities -- Americorps, empowerment zones, and the urban and rural economic development initiatives. It would continue to commitment undertaken in last year's crime bill, providing the funding necessary to continue making progress towards the goal of putting 100,000 police on the streets and providing increased funding for other crime control efforts.

Americorps: The 1996 budget proposes to increase funding for the President's national service initiative to $1.1 billion. This is a $290 million increase from the prior year, and would permit the expansion of the program to 47,000 participants. This would keep the program on the President's goal of reaching 100,000 participants over three years.

Empowerment Zones and Enterprise Communities: On December 23, the Administration designated nine Empowerment Zones and 95 Enterprise Communities, plus two additional urban enterprise zones. The Administration designated Atlanta, Baltimore, Chicago, Detroit, New York City, and Philadelphia/Camden as urban EZs, enabling each to receive $100 million in flexible block grants. We designated Kentucky Highlands, Mississippi's Mid-Delta Region, and Texas' Rio Grande Valley as rural EZs. Los Angeles and Cleveland were designated as supplemental urban EZs. The budget contains the funding necessary to continue these commitments.

Urban and Rural Economic Development: We propose $4.8 billion in 1996 to fund a new Community Opportunity Funds program to help local and State governments address the most critical needs of distressed communities. We also propose funding the Rural Development Initiative at a level of $5.8 billion to continue to support grants, loans and loan guarantees -- an increase of $716 million over the prior year.

Controlling Violent Crime and Drug Abuse: Our proposed $21.5 billion in discretionary spending in 1996 represents an increase of $3.4 billion from 1995 to fight violent crime. The largest share of the increase would go to help State and local law enforcement agencies.

Community policing: The President is committed to putting 100,000 cops on the streets, and this budget contains $1.9 billion in funding -- an increase of 45 percent from 1995. This additional funding will make significant progress toward meeting the goal, bringing the total number of new officers funded to over 40,000 by the end of 1996.

Crime Control: Overall, the level of funding for the Administration's major violent crime control initiatives increases from $2.4 billion in 1995 to $4.3 billion in this budget -- an increase of $1.9 billion.

Drug Control: Drug control spending will increase by $1.3 billion, from $13.3 billion in 1995 to $14.6 billion. The budget targets additional funding to treatment, prevention and education, and criminal justice.

Reforming the Nation's Immigration System: This budget reflects the Administration's continued commitment to controlling our Nation's borders and sharing the national burden of costs associated with illegal immigration.

Border Security Initiative: The budget includes $656 million in new funding to support the border security initiative. These funding increases will strengthen border control and management activities of the Immigration and Naturalization Service and the Customs Bureau, and strengthen enforcement through the INS and the Department of Labor to apprehend and deport illegal immigrants. The budget proposes to finance this initiative, in part, through a modest border services user fee.

Helping with the Costs of Illegal Immigration: The budget also contains an additional $370 million to assist States with particularly heavy burdens associated with illegal immigration. This increase is divided among three programs: State Criminal Alien Assistance Program; Medicaid discretionary grants to States; and the Immigrant Education Program.

Ensuring a Clean Environment: The Administration has developed several new approaches to advance the President's commitment that a healthy economy and a healthy environment go hand in hand. The budget targets spending to ensure that we make the Government a partner working with local citizens, not an overseer.

Ecosystem Management: Funding levels reflect the high priority that the Administration places in maintaining ecologically diverse and health environments along with economically viable communities -- $390 million to continue the Northwest Forest Plan; $99 million for the South Florida

Ecosystem Restoration Initiative; and $70 million in joint Federal-State mandatory spending related to the Restoration of Prince William Sound.

Climate Change Action Plan: The budget proposes $336 million, an increase of $104 million -- 45 percent -- to fulfill the President's commitment to reduce greenhouse gas emissions to 1990 levels. This funding is designed to promote a public-private partnership rather than relying on command and control mandates.

Superfund: In each of the past three years, the Superfund program has cleaned up more sites than in its entire first decade. The budget proposes $1.8 billion for Superfund, a $332 million increase over 1995.

Investing in Science and Technology: Investing in science and technology is the key to assuring our Nation's economic well-being for generations to come. During the Cold War, most Federal spending on research and development (R&D) was defense-related. This research not only produced the most advanced military technology in the world, but the most technologically advanced economy in the world. Today we face a no less serious challenge that requires us to improve our competitiveness through a balanced mix of civilian and defense, public and private R&D.

NASA: The budget proposes $159 million to begin research to produce a reusable space vehicle. This continues our Nation's leadership in space exploration and, at the same time, expands the opportunities for a commercial space launch market.

ARPA/TRP: The Technology Reinvestment Project implements the Defense Department's dual use technology strategy -- a critical investment in transferring technology to commercial applications. The budget proposes $500 million for TRP in 1996, a 13 percent increase from 1995.

NIST: The Commerce Department's National Institute of Standards and Technology has two core programs -- the Advanced Technology Program (ATP) and Manufacturing Extension Partnerships (MEP). The budget proposes $491 million in 1996 for ATP, $60 million more than 1995, and $147 million for MEP, a $56 million increase from 1995.

NIH: Proposed funding for biomedical research is $11.8 billion, a $468 million increase from 1995. This 4 percent increase includes targeted increases, such as those for HIV/AIDS-related research, breast cancer research, minority health initiatives, prevention research, environmental cancer research, and gene therapy.

Continuing the Commitment to Health Security: The President remains committed to reforms that will guarantee insurance coverage to every American and contain costs for individuals, businesses, and Government.

The President believes Congress can and should address the unfairness in the insurance market; make coverage affordable for and available to children; help workers who lose their jobs keep their health insurance; level the playing field for the self-employed by giving them the kind of tax treatment other businesses enjoy; and help the families provide long-term care for a sick parent or a disabled child. We are committed to working with Congress to achieve these objectives and put America on the road to health security.

At the same time, we are proposing major increases for high-priority programs:

Ryan White Act -- HIV/AIDS Funding: The budget proposes $723 million for the Ryan White program, which provides HIV/AIDS treatment services. Since this Administration took office, funding for the Ryan White program has increased by 82 percent. Our proposal for 1996 will more than double Ryan White funding since 1993.

Immunizations: We propose $844 million for immunizations in 1996 to support the purchase of more vaccine to distribute through public health clinics and continued improvements in infrastructure to enable the Childhood Immunization program to meet its goal of immunizing 90 percent of the Nation's children by the year 2000.

Special Supplemental Feeding Program for Women, Infants, and Children: The budget proposes $3.8 billion for WIC, which will raise the annual average WIC participation levels to 7.4 million individuals, up from 5.9 million in 1993.

Long-Run Budget Outlook

This budget preserves and builds upon the deficit reductions that the Administration accomplished in its first two years. We expect the deficit to drop again in 1995, this time to $193 billion. After that, it will fluctuate in a narrow range -- rising to $197 billion in 1996 and to $213 billion in 1997 (due to several anomalies in the budget numbers), then falling to $194 in 2000.

More importantly, the deficit continues to decline in relation to GDP. It drops from 2.7 percent of GDP in 1996 to 2.1 percent in 2000. By this measure, the deficit reaches its lowest level since 1979.

Current law requires that the President submit budget estimates through 2000. By enacting the policy proposals in the budget, however, we can preserve the improvement in the deficit for at least the next 10 years. Looking beyond the year 2000, we anticipate rough stability in the dollar amount of the deficit through 2005. As a share of GDP, however, the deficit likely will continue its gradual decline, falling below two percent early in the next decade.

The major upward pressure on the deficit continues to come from health care. Although the reforms enacted in the President's economic program and administrative efforts to control costs have helped, the projected growth of Medicare and Medicaid spending remains very high. We project that Medicare will grow at an average annual rate of 9.1 percent over the next five years, and that Medicaid will grow at 9.3 percent.

This rapid growth comes in part from the corresponding rapid growth in the elderly population. Medicare benefits go primarily to the elderly, and almost 70 percent of Medicaid spending benefits the indigent elderly, blind, and disabled. Thus, the growth rates of these programs are not surprising. However, at those rates, Medicare and Medicaid spending will double every eight years, and will rise from 3.4 percent of GDP in the year just ended to 4.2 percent by 2000 and 4.9 percent by 2005. The growth in all Federal health programs, of which Medicare and Medicaid are by far the largest, accounts for almost 40 percent of the total increase in Federal outlays between now and the year 2000.

We expect the number of people participating in Medicare and Medicaid to increase, bringing insurance protection to some of our most vulnerable citizens. The Medicaid population will grow at a projected average annual rate of 3.8 percent between now and 2000.

But this expansion in covered populations explains a relatively small part of the increased Federal spending for Medicare and Medicaid -- and could be accommodated without undue pressure on the deficit. More important, from a fiscal standpoint, is that Medicare and Medicaid expenditures per beneficiary keep rising faster than inflation -- indeed, faster than inflation plus the general increase in real per capita GDP. These increases in health care costs cannot be solved in isolation from reform of the broader health care system.

What would the deficit be if health care costs did not rise disproportionately? If Medicare and Medicaid expenditures rose to accommodate increases in the beneficiary population, but the per capita expenditures were limited to the general rate of inflation and increase in per capita output, the deficit would fall to zero by 2005.

Conclusion

This budget builds on the President's success to date in strengthening the economy, investing in the future, projecting American leadership around the world, and making Government work better.

It will reduce the deficit, increase investments in important domestic and military programs, cut taxes for middle-income Americans, and begin a serious, cross-Government examination to sort out Federal, State, and local responsibilities.

We look forward to working with you, Mr. Chairman, and this committee on these proposals.

Chairman DOMENICI. For the Senators who arrived after Dr. Rivlin started, I decided today to let her testify first rather than have any opening statements. That is rather good. Now we have had our witness testify, and it is not yet 10 o'clock. So now we will proceed.

I will attempt today, with the concurrence of the ranking member, to have the lights turned on for you and I, also, Senator Exon, 5 minutes.

Senator EXON. Thank you, Mr. Chairman. That is a good idea.

Chairman DOMENICI. Maybe we will get more Senators in. To the extent that was not done yesterday, I think it was unavoidable, and we will try to do better in the future so more Senators can come. I want the Senators to come, and obviously, if they don't get a chance to get involved, they may not be as interested

Senator EXON. Mr. Chairman, I assume that you will follow what you suggested yesterday. You and I will have opening statements, and then go along with everybody else on the 5-minute rule. However, those who do not make opening statements would have 7 minutes in their opening round. Is that right?

Chairman DOMENICI. I think what we are going to try today, if you don't disagree, is just take 5 minutes for me right now, and that will include opening and questions.

Senator EXON. Fine.

Chairman DOMENICI. Then 5 minutes for you, opening and questions. Everybody gets 5 minutes that includes their opening and questions, and maybe we will even get a second round for the two of us that way.

Senator EXON. Thank you.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Let me first welcome back before the committee the distinguished former Director of the Congressional Budget Office and now the Director of the President's Office of Management and Budget.

As the committee will recall, Dr. Rivlin appeared before us recently to discuss the legislative line-item veto. At that time I believe she very diplomatically said the President supported the strongest measure he could get.

Just for the record, Senator Exon, I note that if the President had line-item authority today as reflected in this budget submission, he would be proposing about $2.2 billion in budget authority items to be eliminated, the largest being $703 million in the Department of Defense.

Of course at the same time the President is proposing an increase in emergency spending authority of nearly $10 billion that would more than offset the reductions from the line-item authority if he had it. Maybe we can discuss this more in the questioning period.

I want to begin this hearing today on the President's 1996 Budget—looking forward—not backward.

Clearly, yesterday I and the committee spent significant time discussing the past—and clearly there is a significant difference of opinion about what happened or did not happen in the past.

But today I hope we can accept the fact that the deficit for the current fiscal year as estimated in this budget is $193 billion—not significantly different from last year's $203 billion figure—and that it will remain—measured in absolute terms—around $200 billion each year through the year 2000.

Those are the facts presented in this budget, and there should be no dispute about that.

I also want to say that the President's budget while not achieving the level of deficit reduction some of us would like, it nonetheless has items that I think both Republicans and Democrats can focus on for both good public policy and maybe even good budget policy.

I am thinking particularly about your proposals for **Performance Partnerships**, the consolidation and block granting of Federal assistance programs back to State and local governments.

I hope we can talk about broader use of this concept, and I am surprised that there is no spending reduction estimated from this proposal, but the concept is good.

Based on your excellent book *Reviving the American Dream* I believe this concept of restructuring responsibilities between the Federal and State government must have been personally championed by you in this budget submission.

I am also pleased that the concept of privatization has taken hold in your budget. Again I think we can go further and we will be looking at other areas as we try to craft our own budget proposals.

But as you and the President must surely know by now, the issue some of us see in this budget is one that goes well beyond the 5-year budget window.

The failure to make any major proposals to control the non-Social Security entitlement programs in this budget, is a concern for many of us.

Without bold proposals in these entitlement programs, some of which you Dr. Rivlin outlined last October, we will never reach balance.

I say to my fellow committee members, Republicans and Democrats alike—we know the President's budget goes not achieve balance by the year 2002.

I will be frank to say that I do not know if we Republicans acting alone and without the balanced budget amendment, can reach our goal by the year 2002. But we will try.

I will also say that even working together—the President, Democrats and Republicans—we may still not meet that goal.

But I feel confident in saying that without the balanced budget amendment, without the President's support, without changes to entitlement programs, it will be difficult if not impossible to reach the goal.

So Director Rivlin welcome. You have been a long-time champion of controlling the Federal deficit. You even had plans that would have fixed the DC budget some years past.

I hope we can build on your proposals today and continue to work toward that goal I think we, the American public, and most importantly our children's future demands.

Chairman DOMENICI. Dr. Rivlin, I am only going to talk about two things. First of all, I really think that we have decided, at least in the Congress, that we want to use the Congressional Budget Office because they are as neutral as you can get in terms of deciding what is going on in the budget.

Now, I have really tried hard to find out where your discretionary cuts come from, and let me just read this statement to you. I think it will point out the big difference between your budget and the Congressional Budget Office in terms of savings. I think it is a rather major item.

The 1990 Budget Enforcement Act requires that OMB adjust caps to hold discretionary spending harmless for changes due to inflation. That means the caps would go up if inflation changes from the inflation that is in the base. To the extent actual inflation differs from what is projected in 1990, OMB is required to adjust the caps accordingly.

Now, fellow Senators, using the same methodology that has been used by OMB and CBO since 1990, Senator Simon, CBO determined that the caps should be reduced this year by $3 billion in outlays. OMB has interpreted the law differently this year and used this authority to increase the caps by $67 billion in outlays. By inflating those caps, OMB can show a very large savings that the Congressional Budget Office would not even take into account. And the amount is $67 billion, almost the entire extent of the discretionary savings that are alluded to in the President's budget.

Now, frankly, I don't believe we ought to do that, and let me tell you, unless this committee wants to look good, I don't think we are going to do that. I think we are not going to look very good if we inflate the caps and then cut, and we haven't cut anything.

Let me give you the numbers so we will have the actual numbers, Dr. Rivlin. OMB's caps, current services is 550, 554, 573 for the years 1995, 1996, 1997, and 590 for 1998 and 610 for 1999. The CBO cap baseline with discretionary inflation after 1998—and let me give you the differences. Where you have 590, they have 547. Where you have 610, they have 566. Where you have 630, they have 585.

So the difference there is that you are going to take credit, to go from that high line, to a line that they say should not even be there. That is a very large amount of money.

In real terms, let me give you the dollars. Discretionary programs in the President's budget in 1995 will be $553 billion, I say to my friend, Senator Dodd. In 2000, it will be 550, a difference of $3 billion. That is how much the difference is. But the Administration would say that is $80 billion in cuts. So I need you to explain that, and then I need just one other question. Would you explain that quickly, please?

Dr. Rivlin. Yes, it is quite simple. The Congress amended the law in 1993, via OBRA 1993 but the Congressional Budget Office failed to reflect this change in their analysis and went on using the old methodology in the 1990 law.

The specific provision of the 1993 change, section 251(b)(1)(b)(3), reads as follows: For a budget submitted for budget year 1996, 1997, or 1998, the adjustments shall be those necessary to reflect the changes in inflation estimates since those of March 31, 1993, set forth on page 46 of the House Conference Report 103–48.

We just read the law. We thought the law meant that you look at the difference between the inflation numbers reflected in the conference report and current inflation estimates.

Inflation didn't increase much over that period, we simply took the difference between the current estimates and the estimates that appeared in the conference report. They were 0.6 of a percentage point for 1996 and 0.8 of a percentage point for 1997 and 1998.

We merely did what we thought the 1993 law required. We do not know why CBO ignored the 1993 law and kept to the 1990 methodology. We never discussed it with them. We just did what we thought was in the law.

Chairman DOMENICI. We need to move right on. Thank you for your answer.

Let me just say I think that CBO will testify that they knew about the law change and they interpreted it precisely the way they say here, and you interpreted it at a higher level.

Dr. RIVLIN. It is hard for me to see how they could have interpreted the law in any other way because it says "estimates." It doesn't say "actual."

Chairman DOMENICI. Senator Exon?

Senator EXON. Mr. Chairman, I will yield to my colleagues who were here before me. I believe Senator Simon was here first and then Senator Boxer. Would you yield in my place at this time to Senator Simon?

Chairman DOMENICI. I would be glad to. Senator Simon?

Senator SIMON. I thank the ranking member for that generosity. I appreciate that.

There is much that is good in this budget. But let me ask you this: Let's say Frank Lautenberg was the Governor of New Jersey today.

Dr. RIVLIN. I think he would be a very good Governor.

Senator SIMON. He would be an excellent Governor. But if Frank Lautenberg was the Governor of New Jersey and he had a serious deficit problem, would you recommend that Frank Lautenberg ask the people of the Legislature of New Jersey for a tax cut?

Dr. RIVLIN. I don't know. I would have to know a lot more about New Jersey than I do now.

Senator SIMON. But I think the point I make is fairly clear, and that is, I have a hard time justifying a tax cut when we are trying to get a hold of the deficit. And what we are doing with a tax cut is giving me a little bit of a break, giving other people a little bit of a break, but harming my three grandchildren. At least, that is how I look at it.

You can defend the various tax cuts individually, but not overall. Obviously we are in a bidding war with the Republicans on this. I think both sides are wrong.

I am interested in your response.

Dr. RIVLIN. Well, let me respond to that, Senator Simon. I can match you in terms of grandchildren. I have three as well, and I care about them and their future.

I think that deficit reduction is a very important policy. We have had much success with deficit reduction, and we are in favor of continued deficit reduction.

But I don't think deficit reduction is the only way to help the economy produce a good life for our grandchildren. We also need to emphasize education and training so that they will have good jobs. Our budget emphasizes education and training, both on the tax side and on the spending side.

In our economy, people cannot compete unless they have a good education. We need to emphasize that.

We also need to invest in our children, not just in your grandchildren and mine, but in those who are much less privileged. We believe that Head Start, Goals 2000, and other investments in children and their future are extremely important.

All of these things are trade-offs. We have brought the deficit under control, and we think it is important not only to continue fiscal responsibility, but to give tax incentives for education and emphasize education on the spending side as well.

Senator SIMON. If I could just respond, I applaud what you are doing on Head Start and Title I, for example, in the field of education. We clearly have to be doing that. And I would applaud a budget that says, instead of having tax cuts, let's put more money into those things.

I have a hard time, frankly, justifying the tax cut. And since I see that yellow light on, is there any long-term plan to get the budget in balance?

Dr. RIVLIN. First, the deficit under our budget with no further changes—and we hope there will be further changes—comes down in relation to the size of economy, as a percentage of the gross domestic product. You can see the downward line here. Here is where we started, and we have brought it down dramatically. The deficit will continue to decrease in the foreseeable future as a percentage of gross domestic product.

But that is not enough. We need to take additional steps to bring the deficit down. The most important thing we can do for outyear deficits is to get health care spending, both in the Federal budget and in the private sector under control.

We do not believe that controlling the cost of medicare and medicaid by themselves is a viable policy, and we did not put medicare or medicaid cuts in this budget. We don't believe the savings from medicare and medicaid reform should be used for tax cuts. We also don't believe that medicare and medicaid reform should be done separately from overall health care reform.

The President has made very clear that health care reform is still very important to this Administration. As a tactical matter, we didn't put health care reform in the budget because we thought it better to work with the Congress on coming up with a mutually agreeable next step toward reform. But, clearly, if we are concerned about outyear deficits, we have to focus on the areas of the budget that are growing the fastest, such as medicare and medicaid.

Senator SIMON. Let me just say I agree with you on the need for health care reform. I would point out that CBO's deficit projection for the year 2030 is now 18 percent of GDP and not 2 percent. And I gather, in specific response to my question, when I ask does the Administration have a long-term plan for balancing the budget, the answer is no.

Dr. RIVLIN. We have not put in this budget a long-term plan for balancing the budget, but we want to work with the Congress on the problems that are driving expenditures upward. The most important problem is that of raising health care costs.

Senator GRASSLEY [presiding]. Senator Abraham?

Senator ABRAHAM. Thank you very much.

Dr. Rivlin, I wanted to focus on just the size of the deficit. My understanding is that when we talk about the numbers, the $190 billion deficit, that does not calculate in—or, rather, it includes the surplus generated by Social Security; is that correct?

Dr. RIVLIN. That is correct.

Senator ABRAHAM. About what is that number for the time frame that is involved in the 5 years here?

Dr. RIVLIN. Well, in 1996, the off-budget surplus, which is mostly Social Security, is $65 billion. For the 5 years——

Senator ABRAHAM. Roughly.

Dr. RIVLIN. I do not have an exact total on that, but it is——

Senator ABRAHAM. It gets larger; correct?

Dr. RIVLIN. It grows. Somebody can calculate this, but it's roughly $395 billion over 5 years.

Senator ABRAHAM. I also was looking at the CBO's projections beyond for the next couple of years, the sixth and seventh year, and it looks to me like it continues to rise for at least the foreseeable future. I know there is a point we have been——

Dr. RIVLIN. It depends how far you can foresee. It begins coming down again.

Senator ABRAHAM. Right, it begins to come down.

By my calculation, just looking at the CBO numbers, it looks like that in the next 7 years that total will actually—their projection is somewhere over $600 billion over a 7-year period because it keeps getting larger, as you point out.

My question is this: If we were to take Social Security completely out of the calculus, it would mean that the budget deficit for the period of time that we are talking about would be increased by some $600 billion.

Dr. RIVLIN. Right.

Senator ABRAHAM. Assuming that we took Social Security—and some are advocating, as you may know, in the discussion about the balanced budget amendment that we simply would exclude it from the calculus. If you assume that you would also pay the interest on the National debt, which we will do, I am wondering what percentage cut or reduction in the remaining portions of the budget would be required, roughly, over this period of time of 5, 6, 7 years to actually have a balanced budget? Do you have an estimate there?

We are being told, right now, as you know, in the balanced budget amendment debate that, including Social Security but not cutting it, we would have to cut the other areas 30 percent or so. But if you take Social Security——

Dr. RIVLIN. That is right. But if you were to take Social Security out of the budget calculation and try to balance the budget, then the cuts would have to be even larger.

Senator ABRAHAM. They would have to be more like 40 or 50 percent.

Dr. RIVLIN. Right.

Senator ABRAHAM. Is that correct?

Dr. RIVLIN. Yes; I think they would have to be around 40 percent. We could check on that number.

Senator ABRAHAM. OK. Well, I would be interested in it because we are being told, I think, you know, that the cuts would have to be draconian to bring us into balance by people who say: But I would support a balanced budget amendment if we simply take Social Security out of it. It seems to me if we take Social Security, the surplus out, the advocates who are on the one hand condemning draconian cuts but saying they are for a balanced budget amendment without Social Security would be talking about an even larger amount of cuts. Is that correct?

Dr. RIVLIN. That is correct. Balancing the budget is difficult. The Administration, as you know, opposes putting a balanced budget amendment——

Senator ABRAHAM. Right, and I am not asking you to change that position.

Dr. RIVLIN. But either way, balancing the budget is a difficult proposition. If you leave Social Security in as part of the calculation and exempt it from cuts you have to cut everything else by a large amount. If you take Social Security out of the calculation, you have to cut everything else by a much larger amount.

Senator ABRAHAM. Right. Well, that is the point I guess I wanted to establish, Mr. Chairman, because I have been having a hard time understanding how you can reconcile the removal of Social Security from the calculus in terms of the surplus and say I am for a balanced budget amendment, and at the same time be critical of the kinds of cuts that would be required if it is included. Because if you exclude it, the cuts that would be called for would be even far greater, and it seems to me that there is a real inconsistency there.

I just wanted to ascertain that my calculation of that difference is correct. That really was the question I wanted to get at. Thank you very much.

Senator GRASSLEY. Senator Boxer?

Senator BOXER. Thank you, Mr. Chairman, and thank you, Senator Exon, for your time.

Senator EXON. You are welcome.

Senator BOXER. I wanted to pick up on Senator Abraham's point, but before I do that, I wanted to pick up on Senator Simon's point, when he said he is worried about his grandchildren, he doesn't think there ought to be any tax cuts at this time because of passing on the deficit. And since I am going to be a grandmother——

Dr. RIVLIN. Terrific. Welcome to the club.

Senator BOXER [continuing]. I think I can participate in this conversation in the context of that great event about to happen.

As I look at the middle-class tax cuts that the President is proposing, they are very much pro-children, and I wanted to make that point. It is a $500 per child tax credit for families with children under 13. Is it incomes less than $75,000 or $100,000?

Dr. RIVLIN. The per child tax credit phases out between $60,000 and $70,000.

Senator BOXER. Up to $70,000.

Dr. RIVLIN. Right.

Senator BOXER. And then there is an expanded eligibility for IRA's and penalty-free withdrawals for education, housing, and medical needs, which, of course, could impact children, especially the educational need; and then a deduction, as I understand it, for up to $10,000 on post-secondary education and training expenses. So I just wanted to put on the table that, in fact, this middle-class tax cut is quite targeted, and I think it is a legitimate debate as to whether or not it ought to be done. I personally would like to see it happen.

I would say that with 87 percent of these cuts going to families with incomes under $100,000, this is clearly targeted at the middle class; whereas, if you look at the Republican tax cuts that they have proposed, as I understand it, 46 percent of the tax cut goes to families with incomes under $100,000, and you have, again, a large amount going to those over $200,000. And, frankly, I think it has been established that those folks, we are doing just fine, and I would like to see us target anything we do to the middle class. And I hope the President will stand strong on that point, because if he gets anything that rewards those wealthiest Americans at a time when we are fighting these deficits, I think it would be a mistake to sign such a bill.

I also want to ask you this question. I am a little surprised to hear Senator Abraham's talk which indicates to me something different than the Republicans voted for unanimously, which is that they would not touch Social Security. During the unfunded mandates debate, we talked about removing Social Security from the balanced budget amendment, which I strongly favor. It is a trust fund entrusted to us for those future retirees and present retirees. And my colleagues on the Republican side were uncomfortable voting on that, so they had a substitute that said they would not touch Social Security. Now Senator Abraham indicates that if that is the case, it would put greater emphasis on everything else.

I just want to make this point and then ask you this question. As I understand the Republicans' position—and I have written a letter to every Republican in the leadership who supports the balanced budget amendment, and I wrote many weeks ago. I have yet to receive an answer.

Show us your budget. You have shown it. You have been honest. You said, look, we can't get at the deficit without destroying the economy—rather, to balance without destroying the economy and health care is the key. You have laid it out. Some people are criticizing that on both sides of the aisle. That is a fair debate. But you have put your cards on the table. They refuse to put their cards on the table. I have yet to receive one response.

Now, as I understand it, defense is off the table with them. As a matter of fact, they in the contract want to increase spending. There is a whole new Star Wars Program and all that, even though we are spending between 2 and 5 times more than all our potential enemies combined.

So defense is off the table. They may even raise it. Social Security is off the table, I assume, even with Senator Abraham's comments, and I don't want to take them out of context. They have said Social Security is off the table.

They certainly can't control the interest up front. Eventually, the interest costs will come down. And they have a $700 billion tax proposal over a 10-year time frame.

I am asking you, with your experience and that situation that I have enunciated, all those things off the table plus a $700 billion tax cut, tell me what America is going to look like with a balanced budget.

Dr. RIVLIN. America would look very different. Under the scenario you described, we would have to make very drastic cuts in everything else. National parks, children's programs. All of the things we care about would have to be cut by more than a third.

Senator BOXER. Thank you very much, Dr. Rivlin.

Senator GRASSLEY. It is my turn now, so I am going to make some reaction to the point that the Administration is trying to make about cutting the deficit in half.

First of all, for you, Dr. Rivlin, I think I know you well enough, over more than a decade now, to have a high degree of confidence that you desire to make Government smaller and more effective, and I think that includes bringing down the deficit. But I also realize your position in the White House, and it is not always easy to prevail against politics as usual. Nonetheless, let me commend you for what you have stood for for a long period of time during your lifetime of Government service.

Having said that, though, I don't intend to be so charitable with the position of the Administration as a whole. I am taken aback, quite frankly, by the Administration's defense of its deficit numbers in regard to the President's promise in the election that he was going to cut the deficit by half. Instead, I think you are being too cute by half, and I don't mean you personally. I mean the Administration.

The promise to the American people was to cut the absolute number in half, as I understand that during the campaign. Whether it was stated that way or not, no one outside the Beltway knows what deficits are as a percentage of GDP. So I think that is simply a disingenuous argument.

So I think there is a trust factor that comes in here, and I want to say a word about deficits. The White House had been complaining that they weren't getting credit for deficit reduction. I referred to that yesterday when the Secretary of Treasury was here. And, of course, huge deficit numbers aren't really understood by the average American. But it is not so much the size of the deficits that is important to the people. What really is important to them is whether elected officials keep their promise.

You may not have gotten credit as an administration for deficit reduction because the public perceives that this Administration doesn't keep its promises, and this is one example.

Now with this argument here that you have cut it in half as a percentage of gross national product, it seems to me that you have broken yet another one. The public can see what is being done. They see that you are kind of doing a soft-shoe routine around the President's campaign promise. They see, I think, a bait and switch. And suddenly, without cutting the deficit, somehow it is just cut in half, and that is because you changed the rules of the game in midstream using now, instead of absolute number, using a percent of the gross national product, instead of actual numbers, which I think it should be.

So before I ask my first question, I just simply want to say that and hope that you will take that message back to the White House, because somehow, deep down in your heart, I don't think that this meets your own personal goals for what you would like to accomplish.

Now, you would expect a person from a State like mine to bring up about agriculture.

Dr. RIVLIN. I would.

Senator GRASSLEY. Before I bring up about agriculture, I want to make it clear. I have never said during this entire session or the last year's debate on it that agriculture can be a sacred cow, that agriculture doesn't have to have a proportionate cut. But the 1990 and 1993 budget agreements, one was a Republican, one was a Democrat, I think it treated agriculture unfairly from the proportionate standpoint.

Now, I know that the Administration is not proposing cuts in the first 2 years in this budget that you sent up here. But you are saying that there are going to have to be dramatic cuts in the outyears, something like $11 billion, I think, down to $7 billion or something like that. The Administration hasn't said where those cuts must come.

Now, here is sort of another disingenuous approach to the Administration. They say that we Republicans are supposed to show where we are going to cut the budget by the year 2002 if we are going to pass the constitutional amendment. Here the Administration, just on a little part of the budget, just the agriculture part, less than 1 percent, you can't tell us where you are going to cut the agriculture programs for the third, fourth, and fifth year.

Where are you going to get the money?

Dr. RIVLIN. As you know, Senator Grassley, the Congress will be reauthorizing the farm bill this year. We want to work with the Congress on the farm bill, as administrations always do. But farm bills are written up here. They aren't written in the Department of Agriculture. There is usually a lot of back and forth, and there probably will be with this reauthorization.

We didn't want to prejudge the farm bill, and what we did was put into the budget for the years 1998 through 2000 a saving of $500 million a year, or $1.5 billion for the 3 years. We thought that was a reasonable estimate of what the Congress and the Administration, working together, could come up with in the way of a new farm bill. We want to work with you on this piece of legislation.

We don't think that $1.5 billion for 3 years is a high estimate. It is a low estimate, actually. But that is the estimate we want to work on.

Nineteen ninty-eight isn't here yet. This doesn't affect the 1996 budget. Frankly, we didn't want to get out ahead of the Congress and prejudge the discussion on the farm bill. So we just put a reasonable estimate in there and said we will work with you in the outyears.

Senator GRASSLEY. We Republicans want to work with you on getting to a balanced budget by the year 2002, but that has not—it is all on our shoulders as far as the White House is concerned.

Senator Dodd?

Senator EXON. I beg your pardon, Mr. Chairman. I believe that this member——

Senator GRASSLEY. Well, I was just going by this. Sorry.

Senator EXON. Were you here before I was, Senator Dodd?

Senator GRASSLEY. Senator Exon, it doesn't matter how you handle things on that side. If you want the floor, you can have it.

Senator DODD. Why don't you go ahead, Jim? I will wait.

Senator EXON. I thought that I was trying to be fair and reasonable by recognizing the people on this side who preceded me here.

Senator DODD. I came in after you, Jim.

Senator EXON. Thank you.

Senator GRASSLEY. I stand corrected. You do not have a number by your name, and so you probably are right.

Senator EXON. I am always right. [Laughter.]

Senator GRASSLEY. I stand corrected.

Senator DODD. No, no. You are never in doubt. Sometimes you are right. [Laughter.]

Senator GRASSLEY. I am very sorry, Jim.

Senator EXON. I am sure the Chairman of the Democratic Party would not indicate that one of his members was not always right. We ought to establish that for the record.

Let me ask, Mr. Chairman, that my full statement be incorporated into the record as if read.

Senator GRASSLEY. It will be, Senator Exon.

[The prepared statement of Senator Exon follows:]

OPENING STATEMENT OF SENATOR JAMES J. EXON

I too want to welcome Dr. Rivlin back to the Budget Committee for your second appearance this year. I always look forward with great interest to your testimony and today is no exception.

Dr. Rivlin, we have a lot of ground to cover this morning so I will limit myself to a few observations on the President's budget that was released on Monday.

First, I commend you and the President for the progress you have made during the past 2 years to reduce the deficit. Between 1993 and 1998, deficits have declined by $638 billion. Measured as a share of the total economy, deficits will decline to 2.1 percent in the years 2000—the lowest since 1979. Indeed, if the interest costs associated with the Reagan-Bush deficits were excluded from the deficit, the budget would nearly achieve balance in 1996.

Dr. Rivlin, you and I know that it has been an uphill battle to cut spending and reduce the deficit. Unfortunately, we appear to be losing traction with this budget.

As much as I appreciate the Administration's past efforts to reduce the deficit, I find this budget to be wanting. I had hoped that the Administration would build even further on the fiscal discipline of the 1993 Reconciliation Budget Act. I won't hide my disappointment that there isn't more deficit reduction. I won't disguise my hope that you will jettison the tax cut.

A few weeks ago, Dr. Reischauer came before this committee and told us in no uncertain terms that to balance the budget by the year 2002, we will have to make $1.2 trillion in savings.

However, that was without any of the ill-advised tax cuts that have been bandied about recently. In the President's proposed budget, we start out with $144 billion in deficit reduction over 5 years. But then we lose $63 billion through the tax break, leaving us with only $81 billion in deficit reduction. Dr. Rivlin, we're heading in the wrong direction!

The Republican tax breaks are worse—$133 billion worse than anything proposed here. I am all for a tax break for our hard-working middle class, but first things first. Moreover, we should not pay for tax cuts with cuts in annual spending bills. This does not conform with the law, and does not make common sense.

Dr. Rivlin, I believe that there is a lot to praise in this budget, but I fear that we have lost sight of the prize: Balancing The Budget. It bears repeating Dr. Greenspan's warning to the committee: "Deficit reduction should be our primary goal, even though we all like tax cuts down the line."

Dr. Rivlin, I hope that you will take my comments in the spirit they are given. I believe that there is much good work here. I also believe that there is room for improvement. It is my highest hope that we will be able to work together—Democrats and Republicans—to craft a final budget that addresses all of our concerns.

Senator EXON. I appeal again today for not so much rhetoric and talk, but for getting down to the situation at hand. I would simply point out that with all of the talk and charges on both sides of the aisle on this issue, we have got to do something more than we have done about balancing the budget in the future. We have been talking about it for a long, long time, and I will get into that in just a moment to cite a little bit of history.

Let me simply say that all of this talk about the failure of the Administration to come up with more deficit reduction and possibly not being very reasonable with their tax cut proposals, which I don't think the Administration has, the only thing I would say by comparison, as badly as I think the Administration has done with regard to reducing the deficit, they have not been nearly as irresponsible as the Republican efforts to have tax reduction.

I would simply cite for the record—and I think it is accurate—that the Joint Tax Committee just delivered their estimate of the 10-year costs of the tax cuts in the Contract With America, which is not a Democratic initiative. They estimate that the contract will worsen the deficit by $704 billion over the next 10 years, 1995–2005. So when we talk about how irresponsible the Administration has been, when we put that in comparison with what is proposed—those who signed the Contract With America should be asked by the press to live up to their commitments as some people here on this committee are saying that the Administration has broken their commitment, broken their promises.

Breaking commitments and promises is not the unique situation with regard to either Democrats or Republicans in either the House or the United States Senate.

Let me talk about history a little bit to try and sum up where I think we are coming from. In the first instance, I see that there is a gradual shift to the concept of balancing the budget, not by balancing the budget in real terms dollar-wise, but to somehow finesse it to something else called a percentage of the gross domestic product.

Now, I think there are legitimate arguments on both sides of that. I simply say, though, that I am somewhat suspect, as we go through this process, to say we are going to change the rules of the game while the game is in process.

I am reminded of a traditional football analogy from my State of Nebraska. Nebraska has traditionally been a team that takes the ball down the field 10 yards at a time; you know, first and 10, do it again, first and 10, do it again.

It seems to me that we must concede that if we are going to change the definition of a balanced budget, Nebraska would be much benefited if we could do that in football. First and 10, to the 50-yard line, then the closer we get to the opponent's goal, it would be first and 7, and then first and 6. And then when we get down to the 1-yard line, it would be first and 1.

It seems to me that if we are going to have moving targets on what our goals are, we are never going to reach the goal. The difficulty of that can best be described, I think, by looking back into history.

In 1979 or 1980, you were there, Director Rivlin, Senator Domenici was there, I suspect that Senator Grassley was there, I was there, Senator Hollings was there. I don't know of anybody else on this side of the aisle that was there, then, but I simply say that we all were called down to the White House, and there was a grand problem with the fact that we were going to bust through $70 billion in deficits for that year, and we were approaching the place where we might go over the $1 trillion amount in total borrowing of the Federal Government.

I am wondering if you remember that time, Alice.

Dr. RIVLIN. I do, Senator.

Senator EXON. I am sure you do. I simply bring this up to show how far we have been behind the curve. It was a calamity at that time. I remember very well that the chairman of the committee at that time was Senator Muskie, and we had the distinguished gentleman from the State of Oklahoma, Henry Bellmon, who was ranking. We were all together. I was a new member of the committee at that time, and I was shocked and amazed.

I simply bring that up because if we were shocked and amazed then, then why wouldn't we be shocked and amazed now? That is why I happen to think, with regrets, that we have to have a balanced budget amendment to the Constitution in some workable form. We have proven without any question over the last 14 years, Democrats and Republicans alike, that we do not have the will to do what is necessary, despite what I think are some improvements made by the Administration.

Do you remember that time? And would you not agree with me that we certainly have not accomplished very much in the last 14 years, and that we have got to have more discipline than, obviously, we have demonstrated both as Democrats and Republicans?

Dr. RIVLIN. I agree with that, Senator, and so does the President. We need more discipline and fiscal responsibility. We believe that we have taken a major step forward on deficit reduction, but we don't believe it is enough.

Let me make three points about the goal of balancing the budget, if I may, in answer both to you and Senator Grassley. I don't think we are moving the goalpost, but we started in a deep hole. The deficits run up in the 12 years between 1980 and 1992 put us in a deep hole. If we were not paying the interest on that debt that ran up in those 12 years, the budget would be in balance now.

But that is history. We have to deal with it.

The Clinton administration came into office facing a deficit that was out of control in every sense. We knew we had to get it under control.

Let me address the President's campaign statement about cutting the deficit in half. He didn't say exactly what that statement meant, but let me give you two possible interpretations.

First, we need to ask some key questions. What would the deficit have been if we hadn't done something? Where was the deficit headed? By our calculations, the pre-OBRA 1993 baseline, would have given us a deficit of $387.7 billion in 1998. The budget that we are proposing would cut that 1998 deficit figure in half.

Nineteen ninety-eight is a year later than 1997. Maybe 4 years meant 1997. But we certainly will have cut the projected deficit in half by 1998.

Second, to use a different calculation, we have brought the actual deficit down as a percentage of the gross domestic product. That is a real measure. As a percentage of GDP, the deficit will have declined from almost 5 percent (4.9) in 1992 to half of that amount

(2.4) by 1998. While we may be a year late, We have made major progress. We all have to make more progress.

Chairman DOMENICI [presiding]. Senator Gregg, you are next.

Senator GREGG. Thank you, Mr. Chairman.

Director Rivlin, you wrote an excellent memo, which I congratulated you for at the time, which received a fair amount of notoriety back in October.

Dr. RIVLIN. It did.

Senator GREGG. I felt it was the type of initiative that we needed to see, and I felt that if we are going to be successful, these initiatives need to be bipartisan. And even though we were in the middle of an election cycle, I was perfectly happy to say you had the courage to come forward and point out the issues.

That memo, which was entitled "Big Choices," listed a whole series of things that needed to be done to get the deficit under control, and you argued that getting the deficit under control was very significant and very important.

You listed in the entitlement area COLA reductions. You listed in the entitlement area cap proposals for medicare, cap proposals that might have impacted Social Security, although not necessarily. You listed income-related proposals in the entitlement area that would have affected people's—which would have tied the amount of benefits which people receive under entitlements to their amount of income, so that high-income people wouldn't be subsidized by moderate-income people who are out there working.

You listed a whole series of specific cuts which would have impacted the health care accounts in the entitlement area. In addition, you put forward some proposals for outyear reform of Social Security so that people under age 50 would have to retire at a later age. I believe you put forward enough so that you actually had the Social Security System realizing actuarial balance in the outyears, something which it is not in right now. It is going to be a disaster. In the year 2015 we essentially go bankrupt as a nation if Social Security goes down due to demographics.

All of those entitlement initiatives, which were entitled "Big Choices" and which I strongly congratulate you for having the courage to come forward with, not one of those choices, not one of those big choices is included in this budget.

Dr. RIVLIN. I didn't check the list, but first——

Senator GREGG. Well, the list is here, and I can give you a copy of it. But the entitlement list is not in the budget, is it?

Dr. RIVLIN. Let me make clear what the memo was. The job of a budget director is to keep the President informed about the problems facing the country, both in the short run and long run. The budget director is also suppose to keep the President informed about the options that are available to solve these problems. I wasn't making recommendations in that memo, as the memo itself makes very clear. I was merely putting before the President, as I thought was part of my job, some of the options that were being talked about for bringing long-run problems—like the long-run imbalance in Social Security and the Medicare Trust Fund problem—under control. I did this to keep the President apprised of what was being talked about.

Senator GREGG. I congratulate you for that, but my question is very specific. The proposals which you outlined in this which were defined as big choices, none of those big choices was undertaken in this budget.

Dr. RIVLIN. What we have not done in this budget is cut entitlement programs. We have not raised taxes, and we have not cut major entitlement programs. Social Security and medicare are not cut in this budget.

That does not mean we don't understand that there is a problem of long-run growth in entitlements. Everybody knows that there is. With respect to the most rapidly growing entitlements, medicare and medicaid, we have made very clear that we want to work on those in the context of overall health care reform.

But you are correct. We have not cut major emtitlement programs in this budget. The Congress and the Administration must face that issue together.

Senator GREGG. But you can't address the deficit issue unless you address the entitlement issue. Is that not an accurate statement?

Dr. RIVLIN. No, I don't think that is correct——

Senator GREGG. You can do it through——

Dr. RIVLIN. We think we have addressed the deficit issue. We have not put forward a plan for long-run balance. To achieve long-run balance, one has to reform the most rapidly growing entitlement programs—namely, health care.

Senator GREGG. Now, there is one item in this budget, however, that might impact medicare, and I don't think it ha been explained, so I would like your explanation of it.

As I read this budget, you engender a pay-go sequester, and that sequester would have to be applied to mandatory accounts and would lead to an entitlement—would lead potentially to a reduction in medicare account spending.

Dr. RIVLIN. I don't think so, Senator. We need more explanation of that.

Senator GREGG. You have got a $55 billion tax cut, but it is only offset by $29 billion of mandatory savings.

Dr. RIVLIN. Oh, wait a minute——

Senator GREGG. Cuts in mandatory accounts, which means you have a gap there. As you know, under the pay-go provisions, you have got to pay for tax cuts with mandatory savings.

Dr. RIVLIN. But we aren't paying for our tax cut with mandatory savings at all. We are proposing to lower the discretionary caps. We want to pay for the tax cut with discretionary savings and we have more than enough to do that. We are proposing to lower the caps and transfer the money to the pay-go account to pay for our tax cut.

Senator GREGG. Is that appropriate under the present budgeting process?

Dr. RIVLIN. We believe it is.

Senator GREGG. It would take a law change.

Dr. RIVLIN. No; we believe it does not take a law change. We certainly want to work with the committee but we believe it is possible to do this under the current law.

Senator GREGG. Mr. Chairman?

Chairman DOMENICI. Yes, Senator?

Senator GREGG. I would appreciate it if we could get from our staff an assessment of whether or not we are on the same wavelength here, because I think there is a passing in the night here of the philosophy of the way the law works.

Chairman DOMENICI. Yes.

Dr. RIVLIN. We certainly want to work with you on that. Our intention is to do what we thought was permissible under the law. But we intend to pay for the middle-class tax cut with cuts in discretionary spending—making the Government work better and cost less.

Senator GREGG. But I think the way you do it, you engender a sequester. That is the question.

Dr. RIVLIN. Well, we certainly all want to avoid that.

Chairman DOMENICI. Senator, might I just comment? I have been informed by both minority and majority staff that what the Administration says they are going to do is not doable under existing law. The law would have to be changed. That doesn't mean it can't be changed, but——

Dr. RIVLIN. If that is true, we would recommend changing the law.

Chairman DOMENICI. You are finished, are you not?

Senator GREGG. Yes, I am.

Chairman DOMENICI. Your time is up.

Senator GREGG. My light is on. You were courteous to give me a couple more seconds.

Chairman DOMENICI. Senator Dodd?

Senator DODD. Thank you very much, Mr. Chairman. Thank you, Dr. Rivlin, for being here.

I would just make an observation. I appreciate the questioning of you regarding a memo with a list of various ideas on how we might deal with Federal spending. I think I was guilty, probably, a few weeks ago of having some fun at my colleague from New Hampshire's expense because of a similar list that ended up in the public domain about a proposed series of ideas that one might——

Senator GREGG. We hope you will join us in signing on.

Senator DODD. Well, I was told at the time that there were merely some ideas out there that we might examine and that it wasn't really intended to be a specific list of cuts. Instead, it was really meant to provoke thought as to what we might have to consider. So I appreciate the fact that there was the memo that examined some ideas.

I want to get to kind of a fundamental question here, it seems to me. I think we seem to be circling each other on the notion of what is really important at the end of the day. Is it deficits or is it the economy of the country? Obviously, if the economy of the country is doing well and deficits are still high, then there are going to be those who are going to want to focus on the problem rather than on the information that indicates that, in fact, we are doing better in a lot of areas.

It seems to me that what most people want to know at the end of the day is how the economy is doing. The deficit plays a critical role, it seems to me, in answering that question, but it is not the only question that people are asking when the issue is raised. How will the economy be doing in the year 2002 or 2005 when constitutional amendments may become operative or people want to use a particular date to make some judgments?

Obviously, spending, taxes,and the growth of the economy all will play into that decision. How is the economy doing? What does that mean? Are people working? How is their confidence level? Are they being educated? What are our interests I suppose, in all of that?

I want you to address that issue, because I think, it seems to me, there are two legitimate questions. Is your end goal here is to merely deal with the deficit issue or is it also to try and have a strong and healthy economy?

I think there is some confusion in the minds of many people in this country as to what is our responsibility here in Washington as part of the Federal Government. Is it to strengthen the economy, or is it merely to reduce deficits?

It seems to me that they need to be addressed in that context. I wonder if I might just take whatever time remains to address that more fundamental question.

Dr. RIVLIN. I would be happy to, and I do think it is the fundamental question, Senator.

We should have our eye on a strong and healthy economy. But let me go beyond that, because the economy could be growing and inside it other things could be happening.

The reason the President's budget emphasizes raising living standards for all Americans is because we perceive that, although the economy is growing—more jobs, more profits, and so forth—and some people are doing very well, average Americans are not sharing in the recovery. And so what we have tried to do in this budget is to say not only how can we have a strong and healthy economy, but how can we be sure average working Americans share in recovery, both now and in the future. That emphasis—on raising living standards for all Americans—is what animates this budget.

The tax cut proposals, as I said earlier, are very much targeted toward average working Americans, not rich people. The tax cut proposals also help to move us toward the goal of helping people get the education and training they need for the future. Our whole budget aims to help average working Americans do better in the future.

Bringing the deficit down further will also help raise living standards, but it is not the only thing that will help.

Senator DODD. I thank you for that.

Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you, Senator Dodd.

Senator Bond?

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

Dr. Rivlin, welcome. As others have said, I have great respect for your ability as a budget director, but with Senator Gregg, I wish that you had put together this budget, because it reflects, in my view, a very cynical punt on the effort of cutting spending.

Let me focus with you today on what I think is the biggest management and budgetary disaster in the Federal Government. That is the Department of Housing and Urban Development. We have already had several hearings in the Appropriations Subcommittee about the problems in that Department, and I think there is no question that the functions of HUD are very important.

There has been talk about reinventing HUD and getting its finances under control, but nothing in the budget submitted gives me any confidence that that has been done.

May I ask you when did OMB receive the HUD budget proposal, and in what detail did you receive it?

Dr. RIVLIN. I can't answer that question because we worked back and forth with HUD. As you know, HUD was one of the agencies we chose in December for accelerated reinvention. We already had the HUD budget in December because all budgets were due into OMB in September. But we had been working back and forth with HUD cn their budget submission.

We looked at the HUD budget submission and decided it wasn't good enough. We then—and the Vice President was part of this—began work on an accelerated restructuring of HUD.

In early December, we went into crisis mode—Saturday meetings, Sunday meetings, the whole bit—to work with HUD on restructuring their budget. On December 15th we announced the outline of the proposals that are done in more detail in the budget.

Senator BOND. Director, are you prepared to discuss the specific items in the HUD budget, or is there someone on your staff who would be helpful? Because in the second round of questions, I have some real problems with this budget. Are you prepared to discuss the major concepts?

Dr. RIVLIN. I am prepared to discuss the major concepts, and we can certainly give you all the detail that you want.

Senator BOND. Let me say, following up on the analogy by my good friend, the fan on the Number 1 Cornhuskers—he has stepped out. But as I look at that HUD budget, I see a double reverse, where to halt spiraling costs, we consolidate 60 HUD programs, but still come up with $1.7 billion extra in the name of greater efficiency. We have a mouse trap block where we encourage budget balancers to take on reduced terms Section 8 contracts, but then we hit them with a $10.8 billion slug on renewal costs in fiscal year 1998. We have a drop kick where the Administration acknowledges the spiraling costs of Federal housing programs, and at the same time, we kick in an additional 50,000 units.

This is a version of the Statue of Liberty where you watch the quarterback——

Dr. RIVLIN. I am old enough to remember that.

Senator BOND. If you don't follow the ball, you wind up in trouble.

Let me ask the big question——

Dr. RIVLIN. Senator, I am a big football fan, but you have gone beyond the limits of my knowledge with the mouse trap block. [Laughter.]

Senator BOND. OK. Well, that is what happens when you sucker punch with the 2-year contracts. I will explain it to you in football terms later.

Dr. RIVLIN. OK.

Senator BOND. But let me ask, as my staff and I have tried to make sense of this budget, at a time when there is a hard freeze in discretionary spending, the budget that you present today, as we calculate it, has an overall increase over 5 years of $20.5 billion in budget authority and $14 billion in outlay above the hard freeze. Is that a fair characterization of the budget that you have presented?

Dr. RIVLIN. No, it is not a fair characterization of discretionary spending. Are you talking about total spending?

Senator BOND. No. I am citing page 213 and 214 of this thing called the budget. If you look on Table S–14, you see Housing and Urban Development BA is $25.6 billion in 1995; it gets up as high as $36 billion in 1998. Flip the page, you get outlays. It is $31 billion this year, and it drifts up to $33 and $35 billion. That, as we calculate it, is $20 billion in BA and $14 billion in outlays.

Chairman DOMENICI. Above the freeze.

Senator BOND. Above the freeze. Above where we are right now.

Dr. RIVLIN. For HUD alone?

Senator BOND. Just for HUD alone.

Dr. RIVLIN. Well, that is correct. We aren't saying that we're freezing discretionary spending in every department.

Senator BOND. But you are going to take that much out of other programs?

Dr. RIVLIN. Yes; we believe that HUD needs to be restructured. We don't believe that its mission is no longer important. We need to aid cities; we need to find a better solution to low-income housing. But there are costs associated with making these improvements.

We are restructuring HUD, which will save some money from what we would have spent in the absence of restructuring. But the numbers do reflect some increases. There are other increases in our budget. We aren't putting a hard-freeze on everything.

Senator BOND. Thank you, Mr. Chairman. In the next round, I want to explore areas where I don't think you have fully accounted for the costs.

Dr. RIVLIN. OK.

Chairman DOMENICI. Thank you very much, Senator.

Senator Lautenberg?

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

Dr. Rivlin, thanks for the endorsement for Governor, but I am secure here for the next 6 years.

Dr. RIVLIN. I'm glad to hear that.

Senator LAUTENBERG. I want to ask you to just review a scenario and see if you were designing a brand new fiscal program for our Nation whether you would recommend having an annual deficit as a percentage of GDP as an ideal. Or would you rather view it in absolute terms and not discuss it in terms of the ratio of the deficit vis-a-vis the GDP?

Dr. RIVLIN. I think I would always want to view the deficit and the debt in the context of the whole economy. There is no absolute right number. If you are comparing the economies of two countries and you say what is the deficit in one of the countries, you need to know about the size of that country's economy to determine whether the deficit is a problem.

As an economist, I would always prefer to look at the deficit in the context of the whole economy.

Senator LAUTENBERG. So you are satisfied to use this as a measure as opposed to—because the debate that is going on around here and around the country right now is whether or not there has been a change in structure such that instead of looking at a zero deficit 1 day off in the future—and I am inclined to agree that we can achieve that in the near term—whether this serves efficiently as a yardstick for where we would like to be.

Dr. RIVLIN. Where we would like to be depends on a lot of things. It depends on what is happening to the economy, and on what you would have to do to get to a particular goal.

Senator LAUTENBERG. So is the answer yes——

Dr. RIVLIN. I don't believe that the budget deficit has to be zero in every year. That is why I am opposed to a balanced budget amendment. I don't think it would be good for the economy to write into the Constitution, or even into legislation, a provision that required us to achieve balance in every year.

That doesn't mean, however, that I am against bringing the deficit down. I think we should bring the deficit down.

Senator LAUTENBERG. We have heard football terminology thrown around here fairly actively, and one of the questions that I would like to put to you now may be charged on the field as pulling the face mask. And I would like to unmask this thing for just a moment and ask you whether or not you think it is important that our friends on the other side proposing their answer to budget deficit reduction ought to be specific. We have heard little about whose benefits the Republicans would cut and whose taxes they would increase, what happens with Social Security, whether payroll taxes for ordinary Americans will go up. And I don't want to ask you to be the moral judge here, but what happens if we give the middle-class tax cut as contrasted to reductions in capital gains tax, et cetera, taxes that apply, let's say, to the higher income group in our country? What happens to the economy as a result of those kinds of reductions, either middle-class versus a capital gains or tax reductions for the wealthier individuals?

Dr. RIVLIN. I think there are two important points about our version of the middle-class tax cut. I believe Senator Boxer discussed them earlier. First, our tax cut is smaller than the Contract's proposed tax cut; it doesn't grow as rapidly in the outyears. Second, our tax cut is much more targeted to benefit average people and children.

If we were to go with the Contracts proposed tax cuts, one consequence would be an income shift toward upper-income people. The Contracts tax cuts would benefit high-income people. They also grow much more rapidly in the outyears. Paying for the Contract's tax cuts would require much bigger cuts in other spending than the cuts that would be required to pay for our middle-class tax cut.

Senator LAUTENBERG. Mr. Chairman, I assume that we will be able to submit questions for the record.

Chairman DOMENICI. Of course.

Senator LAUTENBERG. That is what I would like to do with the remainder.

Chairman DOMENICI. Thank you very much, Senator.

Senator Snowe?

Senator SNOWE. Thank you, Mr. Chairman.

Dr. Rivlin, the refrain from the Administration has been that, well, Republicans haven't offered specifics. You were quoted in yesterday's Washington Post as saying, "We haven't seen anything yet," from Republicans. But I served on the House Budget Committee the last 2 years.

Dr. RIVLIN. Yes, I remember.

Senator SNOWE. And we offered a specific plan in terms of deficit reduction. We were challenged to offer specific line item reductions, which we did, in the form of the Kasich plan that provided for $435 billion in specific spending reduction.

The Administration chose not to support that plan. In fact, the Administration chose to increase taxes as a way of reducing the deficit.

The following year, we also provided a specific spending reduction plan, and that was also defeated. In the interim, of course, the Penny-Kasich plan was offered on the floor for $100 billion in specific deficit reduction in terms of line item spending cuts. The Administration lobbied against that package, and it was defeated by a handful of votes.

I think the point of all of this is we have a different approach. We wanted to reduce spending to make some structural changes in the Federal budget because we see it as the only means by which we are going to control future Federal spending and ultimately the deficit.

As I look at what the Administration has done in terms of actual spending cuts thus far, before this plan was submitted, it amounts to only $88 billion in spending cuts out of a $1.6 trillion budget based on CBO's calculations. If you multiply that savings over 5 years—it is infinitesimal relative to the total amount of spending that will occur during that period of time. There is no way we can control the Federal deficit under that scenario. That is why the Administration is accepting the economic status quo.

Now, under the President's budget that has just been submitted, we are talking about $81 billion specifically for deficit reduction over 5 years.

The real issue is, if we are going to get serious about deficit reduction, the Administration's plan doesn't represent a serious approach to actually to achieving it. Recently, the CBO upwardly recalculated the deficit by $25 billion each year for the next 5 years. Even under a hard freeze, they calculate a deficit of $243 billion in the year 2000. With your sort of so-called—I guess "soft freeze" you would call it—you calculate a deficit of $194 billion in the year 2000.

So that is the bottom-line problem here. The tax increases of 1993 didn't even get the revenues the Administration projected, and that accounts for some of the partial increase in the deficit. So what we are talking about is getting serious about cutting some spending.

Now, we have offered spending cuts. The Administration has not chosen to accept those spending cuts in the past.

Dr. RIVLIN. But now you are in charge, Senator, and you can weigh in and pass those spending cuts. I testified yesterday before——

Senator SNOWE. Well, do you mean the Administration wasn't willing to work with us because we weren't in charge, that we didn't have the majority? It shouldn't have mattered.

Dr. RIVLIN. We had a deficit reduction plan which we have no apologies for. Spending cuts made up half of the plan and it has been extremely successful. That is why the deficit has come down.

While we did not support the Penny-Kasich bill, you will find many of its spending cut proposals in our budget. There is a lot of commonality between the deficit reduction and spending cut proposals that we have in our budget, and some of those on the Penny-Kasich list.

I testified before Chairman Kasich yesterday. He was asked when he would put his list of spending cuts on the table. I think the answer was April or May. We are very eager to see it.

Senator SNOWE. We will be providing our own budget package, but that was the line last time: "Provide us with our spending cuts." So we did, but they weren't accepted. In fact, they were rejected. So it shouldn't have mattered whether or not we were controlling the House or the Senate. It should have mattered to control the deficit. And that was through——

Dr. RIVLIN. We did control the deficit.

Senator SNOWE [continuing]. Spending cuts because I think it would have made a difference in the ultimate picture. Because, according to CBO, the deficit picture is still growing. It may decline slightly in some of the out-years and then it goes back up. That is a fact. That is the problem that we are facing. And I think the Administration's package does accept the economic status quo, and, believe me, we did support some hard cuts. I heard about it in my last campaign. So to dismiss those is rather frustrating, given the fact we worked very hard on a specific line item package of spending cuts. And if the Administration had worked with us on that issue, we would have seen a different deficit picture in the out-years.

Dr. RIVLIN. Well, as the President likes to say, would have been, could have been, should have been. We are here now in 1995. We are not dismissing anything. We have put a package on the table that keeps the deficit under control and offers very specific cuts. We are very eager to see your package. We haven't seen it yet.

Chairman DOMENICI. Thank you, Senator Snowe.

Senator Hollings?

Senator HOLLINGS. Right to the point, I am reading from the budget itself 10 pages of program consolidations, program eliminations, and program reductions. There are some 131 killed and 271 consolidated all in all. I am seriously opposed to several of them, but I think that is a serious attempt to try to cut spending.

Now, when you come to the promises made, the distinguished witness says that the Chairman of the House Budget Committee says April. No, no. He said in January, and I quote on December 18, "In January, I am going to bring to the floor a revised budget resolution." They could have cared less what you had in mind or what President Clinton had in mind.

In fact, he said we will provide the spending savings. We already have outlined them in the menu list. We already have two or three budgets. Then we are going to put the move on the glide path to zero, but first we are going to take the savings by cutting spending first, and we are going to put them in the bank so nobody across this country, nobody on Main Street, no one on Wall Street is going to think that what we are going to do, whether we are going to give out the goodies without cutting the Government first. We are going to put them in a lock box. There's a lock box. I got it. [Laughter.]

I opened the lock box, and what have they got in here? Social Security IOU's to the tune of $500 billion. There, that is their lock box.

April? Don't give me April. Give me January. They didn't care what you had, and they are miffed that you didn't put in medicare and medicaid cuts further.

Now, you made the good college try. They ridiculed the President and the First Lady in trying to get health reform where they included medicare and medicaid tax cuts. So they got it their way, and they got to the election, and they won it. And they got the Supreme Court, they got the House of Representatives, they got the United States Senate, and let's get going with the Government. You all got the Government. The poor President is trying his best, but you got the bills over here. He doesn't introduce any bills.

I am waiting on the Kasich lock box that he is going to put those spending cuts in December, and the Contract With America that he continues to talk to.

But right to the point, Dr. Rivlin, 20 years ago you and I started on this path, and if I had to write the history of the budget, I would answer in one line. Dr. Alice Rivlin at CBO gave integrity and credibility to the budget process heading up the CBO.

I am a little dismayed to see you in contravention of CBO practices. I think Senator Gregg is right. Under the Budget Act, to offset tax cuts you have got to have tax increases or entitlement cuts. And you used discretionary cuts. There is a point of order under the Budget Act.

With respect to medicare and medicaid outlays, you use a figure of $50 billion less than CBO. The caps you have raised by 3 percent. CBO says no. You have used asset sales as receipts, which CBO says no.

Now, you haven't made the reputation of CBO where Republicans and Democrats both around here said let's get with CBO, let's stick with CBO, don't go over there and violate CBO. What is your response?

Dr. Rivlin. While I have great respect for CBO, we have not always agreed on every detail. You have mentioned several areas in which we differ.

With respect to the use of discretionary savings to offset the cost of the tax cut, we want to work with the committee, and with the House side, to make sure that the law is changed if it requires change. We have been very clear with what we are proposing. As we interpret it, the law does not need to be changed. But there could be differences on that.

With respect to the cap adjustment, I have already discussed that with the Chairman. We simply read the law differently than the CBO. We thought the law required that we adjust the caps for changes in the inflation estimates since 1993. We did that and are prepared to defend our action.

There are always some differences in outyear calculations. The biggest one between the Administration and CBO at the moment is, as you point out, on the rate of growth for medicare and medicaid. Everyone agrees that medicare and medicaid are growing too rapidly. This year we made a downward adjustment in our outyear estimates, as we have in past years, because the growth rates for medicare and medicaid, while very high, has slowed down due to changes in the economy.

We adjusted our outyear growth rate for medicare and medicaid from about 10.5 to about 9.1 percent per year. That is still a high rate of growth. CBO's growth rates are a little higher. We are basing our estimates on information from the actuaries in HHS. They are very experienced people, long term professionals. The HHS actuaries make these calculations every year and we use their estimates. CBO has a history of following our revisions on this but they are not quite there yet.

Senator HOLLINGS. I appreciate you listing the 10 pages of cuts there in your budget. The Contract With America's cuts that were supposed to be in here by January has got nothing but Social Security IOUs. That is all it has got. Where are the cuts? I am waiting for them. It is February 8.

Chairman DOMENICI. And ticking.

Senator HOLLINGS. And ticking. And we cannot wait till April.

Chairman DOMENICI. Senator Murray, you are going to be next. I just want to make a report to the committee and staff here, if you would please take this to your members. We are going to have a markup next Tuesday afternoon on line item veto. Now I am going to call around and see if I can adjust it to be—if many of you can meet at 3 o'clock and not so many at 2 o'clock, we will do some adjusting. I do not think we need more than a couple of hours. And everybody is going to be nice and loving anywhere, Senator Gorton, because it is Valentine's Day, right? You are going to be very nice, are you not, Senator Boxer?

Senator BOXER. I am thinking about it. [Laughter.]

Chairman DOMENICI. Good.

Senator BOXER. Depends on what is in that box.

Chairman DOMENICI. Depends on what somebody says over here, right?

Senator MURRAY.

Senator MURRAY. Thank you, Mr. Chairman. We will at least wear red.

I thank you, and Dr. Rivlin, it is good to see you here today. It is always difficult to follow Senator Hollings. Maybe I should just say amen and pass the mike.

But it is disturbing to me as I listen to the debate in Congress. The talk today is deficit reduction. I think we all agree we need to reduce the deficit. But I think the question Senator Dodd posed is very critical: should we looking at how we make our economy strong for the future, or should we only have the discussion in the Congress about budget deficit? I appreciate the budget that you have put before us because I do think it does talk again to investing in people. Certainly Federal spending is one way to improve people's standard-of-living, especially in my region where we have been affected greatly in our natural resource areas.

I do have some specific questions. But we are talking more generally today, so I will submit them to you, specifically on our timber package. We are trying to get people back to work in the timber communities. In the salmon crisis, we have a serious decline in stock. People from my region have had to spend a great deal of money to restore stock, and I want to submit a question about cost sharing with the Federal Government.

But we are more in a general mode here so let me just ask you in general terms about block grants. I feel a trend coming at us which we are trying to move towards block-grant spending. It sounds fair and it sounds like the right way to work, but I am concerned about it when I look at the budget. For example, HUD has proposed eliminating its special purpose grants. I know in my home State, the city of Tacoma had a $2.5 million grant that they have really put to work in one of our most violence torn communities. It is a good program and I am worried about that.

Also the women in Apprenticeship Occupations and Non-traditional Occupations Program that you are consolidating under the Job Training Partnership Act. Or, the Ryan White Care Act that is slated to be reauthorized this year. We know that AIDS is the leading cause of death in this country for people between the ages of 25 and 44. These are some of areas in the budget that I hear are slated for block grants.

I want to ask you, did the President and OMB take some of the criticisms we have heard in the past about block granting into this formulation? And just what your general philosophy is about block granting?

Dr. RIVLIN. A very good set of questions, Senator Murray. On your more specific ones, we would be happy to work with you on the things that affect your area of the country.

We have thought a lot about consolidations. We have not used the term block grant in this budget. The term that you will see is performance partnerships. That is not just a gimmicky term. It means something different from block grants and revenue sharing. We believe there have been too many specific programs and categorical grants. Many of these programs and grants had good purposes, but Tacoma and other cities were often faced with different pots of money and Federal bureaucrats telling them how to spend it.

We believe performance partnerships are a better alternative. With performance partnerships, you can combine multiple grants that are used for similar purposes. This system would give cities like Tacoma, and States like Washington, more flexibility to meet their needs in ways they deem most appropriate.

But performance partnerships do not create a scenario in which the Federal Government puts the money on the stump and runs. Performance partnerships will enable the Federal Government to work in partnership with States and localities in deciding what results we want to get, how you measure those results, and what type of measures to use.

People are always getting upset about changes in grant programs because they are afraid that the specific purpose for which their categorical grant was created will drop out of the conversation. But

I don't think it has to. If the particular purpose is very important in that areaof the country, it will remain important.

With respect to Ryan White, we have put more money into the Ryan White Program and we are certainly very conscious of the AIDS crisis.

Senator MURRAY. I appreciate that. I do see that I am running out of time and I have several other questions. One of them quickly is on Impact Aid. This is very important to my State where the Federal Government has made a decision to move people to our State for the purpose of defense. This movement of people has a tremendous impact on our school systems. I wondered why the Administration suggested cuts in that area and narrower targeting of that money.

Dr. RIVLIN. Our impact aid proposal provides for a narrower targeting to the areas where the defense establishment has a specific impact on the schools. Actually, it is a perennial proposal to reduce the scope of impact aid and prevent it from going to communities where the Federal establishment benefits the schools, because the affected children and their families live in the community, not on the base, and add to the tax base. In effect, our impact aid proposal targets those communities that need impact aid most because they are negatively impacted by the defense establishment.

Senator MURRAY. I thank the chair.

Chairman DOMENICI. Thank you, Senator. Senator Gorton. And let me see if I can kind of set things. Senator Sarbanes, you are next and last. Then we will have another round. It worked very well. We are not anywhere near 12 noon and we have all had a turn. Senator Gorton?

Senator GORTON. Thank you. Dr. Rivlin, I would like to start by expressing my admiration for you in all of the positions you have held or hats that you have worn, and your constant dedication to fully understanding the budget and to dealing with it in a responsible manner. I guess I admire you particularly for being here and so eloquently defending a budget when it seemed obvious, at least from the press, you disagreed with it internally and wanted to do more. It certainly would be difficult to find anyone who could defend a punt any better than you have in respect to this budget.

But I have not heard all of the questions here today. I was not here at the beginning of the hearing. But the Chairman does tell me there is one set of technical questions that have a very large impact on projections that I would like to ask you about.

It starts this way. The CPI determines cost-of-living-adjustments to entitlement programs, while the GDP deflator determines the level of income and, therefore, the tax base and revenues for estimating purposes. For statistical reasons, the CPI measure of inflation is higher than the GDP deflator. But the closer together the two measures are, the lower the effect of entitlements on the projected deficit because the greater are incomes and revenues to pay for the entitlements. Is that true? Is that an accurate statement?

Dr. RIVLIN. Yes, all other things being equal, that is right.

Senator GORTON. The Administration projects the CPI to be only one or two-tenth higher than the GDP deflator, reducing the deficit effects of entitlements in this budget. But over the past year, I understand that the CPI has been five-tenths, half a percentage point higher than the GDP deflator. The Administration shows a two-tenths smaller gap relative to last year's Administration forecast and is half a percentage point below the CBO's estimate. Is this reduced CPI estimate an attempt to take into account recent statements by Chairman Greenspan that the CPI is biased by up to as much as 1 percentage point?

Dr. RIVLIN. No, the reduced CPI estimate has nothing to do with Chairman Greenspan's statement. It is related to our perception of what is happening to the CPI and to likely changes in CPI relative to the GDP deflator over time. We actually think the gap between CPI and GDP will narrow. The BLS has been making some methodological improvements in the CPI and it is scheduled to bring the newly recalculated CPI online in 1998. We are projecting that the CPI will rise at least 2/10ths less rapidly than we thought it would, because those improvements are likely to show that the CPI has been slightly overestimating inflation.

Senator GORTON. Have you played a role in that? Do you believe that the CPI does in fact overstate inflation? And is there any possibility that any changes will be made before 1998?

Dr. RIVLIN. We are not in favor of legislating changes in the CPI. What we are reflecting here is what we——

Senator GORTON. I understand. I am not advocating that. I am asking what you are attempting to do internally.

Dr. RIVLIN. The BLS has already made some methodological improvements in the CPI. But what we all know that the BLS recalculates the CPI every 10 years. The BLS will do that in 1998, and we are simply reflecting an estimate of what that recalculation will be like.

Senator GORTON. But you do not intend to do anything internally to accelerate that change?

Dr. RIVLIN. We do not intend to do anything other than the technical, professional recalculations that the BLS is empowered to do. They are the technical experts. They recalcilate the CPI and they do it very well.

Senator GORTON. But in any event, this narrowing of the gap helps——

Dr. RIVLIN. Reflects our estimate of what will happen.

Senator GORTON. And it does help with this budget deficit estimate, does it not, as against what the differences have been historically?

Dr. RIVLIN. A little bit, yes.

Senator GORTON. Thank you very much.

Chairman DOMENICI. Thank you very much. I did not get a chance to thoroughly understand the statement, but I think it is an important discussion and we will certainly follow up and see what that means for us.

Dr. RIVLIN. We would be happy to talk about it further outside the hearing.

Chairman DOMENICI. Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman. Dr. Rivlin, I am pleased to join with my colleagues in welcoming you to the committee.

I am interested in the chart that you have there that shows the actual and then the projected deficits as a percentage of the GDP.

Dr. RIVLIN. That is correct, Senator.

Senator SARBANES. If we went back a few years the trend line would actually have been going up, would it not?

Dr. RIVLIN. That is correct, and we actually have a chart of that. This chart shows, in dollar terms, the projection of what the deficit would have been if it had been allowed to continue according to previous trends and what has happened to the deficit since 1992.

Senator SARBANES. Do you have one that would have shown it earlier as a percent of GDP?

Dr. RIVLIN. I do not.

Senator SARBANES. Because the deficit could go up in dollar terms and yet go down as a percent of GDP, could it not?

Dr. RIVLIN. Absolutely. If the economy is growing more rapidly than the deficit is rising, the deficit as a percentage of GDP would decline.

Senator SARBANES. If we could put that first chart back up. Is it not also possible that if you are not growing the economy, in fact your percentage could go up even though the dollar amount of the deficit, at least initially, did not change very much?

Dr. RIVLIN. Absolutely, Senator.

Senator SARBANES. What I want to explore with you is the assumption that some seem to make that if you set out to reduce the deficit only, that that will in fact reduce the deficit, if you do not take into account what is happening to the economy as you try to do that. Now if you embark on such a deficit reduction program in its intensity that you cause a downturn in the economy, maybe even a recession, is it not possible that your very well-intentioned deficit reduction efforts will actually result in an increase in the deficit because deficit because of a soft or sagging economy?

Dr. RIVLIN. That is absolutely right, Senator. That is precisely why building a particular deficit target into the Constitution worries many of us. If you tried to achieve balance in every year, you could have bigger swings in the economy and more intense recessions.

Senator SARBANES. So what you need to do is to work down towards a zero deficit and a balanced budget over time in a way that the economy can continue to grow; is that not correct?

Dr. RIVLIN. Yes.

Senator SARBANES. Because if the economy stops growing or starts downward that will increase the deficit in and of itself, will it not?

Dr. RIVLIN. That is right.

Senator SARBANES. Now suppose that starts happening and in order to avoid a deficit you either cut spending further or raise taxes further. In other words, the economy is going down. Because the economy is going down, the deficit is going up. Since the deficit is going up—let us assume you are operating under a stricture that does not allow deficits. You therefore have to cut spending more, or raise taxes, or some combination of the two, which I take it would then, if you are on the downturn, drive the economy even further down.

Dr. RIVLIN. And increase the deficit further.

Senator SARBANES. So the whole thing would end up working at cross-purposes, would it not? You would set out to do something;

namely, reduce or eliminate the deficit. But because you did not do it in the context of what was happening to the economy, you would end up boosting the deficit. Is that correct?

Dr. RIVLIN. Yes, there is that danger. The context always has to be kept in mind.

Senator SARBANES. We have built in automatic stabilizers in order to ease the downturn. We have markedly avoided the boom and bust fluctuations that occurred in the latter part of the 19th century and throughout the first half of this century. Would you say that the automatic fiscal stabilizers, which actually start running deficits when we go into a downturn, are an important contributor to the ability to ameliorate the depth and length of the fluctuations in the business cycle?

Dr. RIVLIN. I would, and I believe that if we were forced to achieve balance every year we would have wider swings in the business cycle and bigger fluctuations in the economy than we have had in recent years.

Senator SARBANES. Mr. Chairman, I would just make this observation. In this the post-World War II period, the fluctuations in the business cycle have rarely gone into negative growth; just barely. They have fluctuated as positive growth figures. In the latter part of the 19th century and the first half of this century it used to fluctuate very widely. In fact, we would go in a negative growth of 8, 10, 12 percent at various times. And of course, the Great Depression was above 15 percent.

Chairman DOMENICI. Interesting, Senator. Now we are barely fluctuating, for a lot of reasons, as you have indicated. But for those who were wondering about the Mexican situation, I do not know if you ever heard the economic experts say that in 1 year they would have suffered a 16.5 percent reduction in their GDP. It is a pretty interesting number, is it not? If that were to have happened. That is probably, in today's world, truly a chaotic situation. I just raise that.

Yesterday, I mistakenly commented on a chart you had up because I did not get a chance to look at it. I made a mistake. I thought it was a short term chart and it was a long term chart. I made statements about it that the Federal Reserve was involved in that stabilization, and if it is what you just said, my statement was wrong and I would so indicate in the record.

Senator Brown?

Senator BROWN. Thank you. I am always fascinated with the discussion of economic policy when it comes to justifying deficits. I think it is widely accepted that we do play a role in terms of evening out the cycles. But is it your view that moving to balance the budget would engender a recession? Is that what I am hearing?

Dr. RIVLIN. That question that cannot be answered in the abstract. One would have to know what is happening with the economy and how fast you were moving toward achieving balance. In general, I believe that the deficit should be lower than it is and that the budget should be roughly balanced over the business cycle. But Senator Sarbanes is clearly right; if you are going into a recession and you are not in balance, moving toward balance makes things worse.

Senator BROWN. During a recession.

Dr. RIVLIN. During recession or as you are sliding into a recession. One of the problems we have is that we are not very good at predicting when we are sliding into a recession.

Senator BROWN. Indeed. I do not know of anyone who has a perfect record in that area.

Help me understand what your thoughts are with regard to moving towards the balanced budget over an entire business cycle. How is that reflected in the figures that you have sent up to us?

Dr. RIVLIN. At the moment the economy is growing strongly. We think it will slow down, but we are not predicting a recession. We are projecting deficits which, if the Congress enacted our plan, would come down slowly as a percentage of the gross domestic product over the next few years if you assume that the assumptions underlying our budget are correct.

I do not think that is enough deficit reduction, and neither does the President. We think we should return to the question of deficit reduction by looking at the rapid growth of health care costs, in the context of overall health care reform. If we could do that, if we could control the growth rate of health care spending so that it was not growing faster than the rest of the economy, we could get to balance quickly. I am not sure we can do that. But certainly, the big challenge for additional deficit reduction is addressing health care spending.

Senator BROWN. I am relieved to hear you say that. I think it is encouraging that you have in mind additional efforts to try and reduce the deficit. My impression is that the private sector is beginning to get a handle on this. There are some encouraging results from managed care.

Dr. RIVLIN. We think so too, and that is partially the reason for why the outyear numbers are not quite as scary as they were; but they are still very bad.

Senator BROWN. We, as I think everybody in Congress has been doing, have been trying to look for areas where we can save funds. One of the frustrations though in going through it is the way we keep our books. I am sure it must be a source of some concern to you as well. We are told as we go through it that different departments have different accounting systems, or at least different bases. We do not have a clear break-out of some of the administrative costs and so on. We do not have, at least at this point we have not developed a standard set of accounts for the Federal Government.

Any thoughts in this area? Are you planning to move toward a standardization of accounts and a way to get a tighter control over administrative cost?

Dr. RIVLIN. Yes, we are moving very rapidly on this. Our new Comptroller-designate will be working very hard on this. The Government is moving toward a standard set of accounts that will be auditable. We have made a good deal of progress on that.

We also have made a few changes in this budget that we think are good accounting practices. One is to charge agencies, not the Government as a whole, for the cost of fringe benefits, including retirement, for adding an additional employee. So we are working hard on this.

Senator BROWN. I am relieved to hear that. We have been working on trying to develop alternatives for the committee to consider in terms of deficit reduction. One of them was to deal with overhead cost, and we literally had to go back and develop a definition of overhead cost because it was not in the accounts.

Dr. RIVLIN. Yes, it is a problem.

Senator BROWN. But we think we are going to have something interesting for the committee to look at in that area in terms of big, big savings. Thank you.

Chairman DOMENICI. Thank you very much. I think it is my turn. Let me just tell you, Dr. Rivlin, all the accolades you have received you are entitled to and you deserve. I want to tell you, however, it is pretty obvious to me that this is not a serious deficit reduction budget. It may have a lot of other goals. Obviously, you submitted the things that would really affect the deficit over time and none of them were accepted.

But I think we have to continue to focus ourselves on our children and grandchildren. I think for us to talk about an American dream as it applies to us is less than half a loaf. If you were to take the deficit and not use your GDP relationship—interesting, you did this one out to 10 years, but when it came to the deficit in dollars you only went 5 years.

Dr. RIVLIN. We can do both.

Chairman DOMENICI. We would like to have that, and then we will show you CBO's, because everybody talks about how well we have done as a nation in the past few years on deficit reduction. I do not intend to reopen history. Let us let it go. But the largest deficit, real deficit that occurred was $290 billion in 1992. It has not been that high since.

Now you want to take credit for it coming down and for not reaching the projection. But the truth of the matter is, that by the year 2002, CBO says this deficit will be $321 billion. So it will be $50 billion higher than the highest deficit we have had in dollar terms. But it also says that by 2005, which is where you carry your line there, that it will be up to $420 to $430 billion.

Now they are entitled to their projection just like you are yours, and we are going to use theirs. It just seems to me, when look at that and then from that point on, regardless of the complexity of estimating, there is no doubt that without major change it is from that point on up, up and away. You have seen those charts and you know that.

Now I want to ask you a couple of questions. I do not necessarily want you to agree with that, although I think in general terms it is hard to disagree with that. But I want to ask you, you have said and the President has said, unless you get health care costs under control, you cannot get the deficit under control.

It is a very precise question. If in fact this committee and the Unites States Congress were to work with you all on a program like medicaid and we were to show you that there can be savings made just by reforming the program and making it more managed care and HMOs than what we have got now, would you agree that we ought to take credit for those savings, or do you have something else in mind for those savings?

Dr. RIVLIN. We would be very happy to work on saving money in medicaid and medicare with you and the other committees that have jurisdiction over the health care area. But we want to work with you on reforming medicaid and medicare in the context of a whole health care reform.

Chairman DOMENICI. But let me just make the point. Are you really saying that we cannot, you will not work with us on getting deficit reduction from health care programs being changed unless we have some kind of comprehensive health care to go with it?

Dr. RIVLIN. Yes, we think health care programs should be looked at in the context of health care reform.

Chairman DOMENICI. So the exercise is one in futility.

Dr. RIVLIN. We do not think so.

Chairman DOMENICI. Let me tell you from our standpoint. If we think medicaid will save money you are suggesting, we might want to spend that money for health care reform.

Dr. RIVLIN. No, I am not saying that. I am saying that we have to look at all of these health care programs together.

Chairman DOMENICI. Let me suggest to you, we also have a Medicare Fund going broke.

Dr. RIVLIN. Yes, and that is a problem.

Chairman DOMENICI. In 6 years.

Dr. RIVLIN. That is a problem and we have got to address it.

Chairman DOMENICI. When is the right time to address it, Miss Budget Director?

Dr. RIVLIN. I think it is a problem we have to address together and we need to talk about when is the best time to address it.

Chairman DOMENICI. So you think 6 years that that is too far out for us to be concerned about in this year's budget.

Dr. RIVLIN. We did not put medicare cuts in this budget for the reasons that I have explained. We do not want them to be used to pay for tax cuts. But I am not saying that we should wait 6 years to look at medicare. This is a problem and we all have got to talk about it.

Chairman DOMENICI. Now I have been thinking of how I could explain for people to understand your big cuts in discretionary programs. Let me see if I can do that this way. A good merchandiser, at least today it seems like this is good merchandising. It did not use to be, but it looks like it today. You raise the price of what you have for sale. So you really want to sell this thing for $50, but you raise it to $70. And you let everybody say, it is $70, and then you have a sale and you reduce it to $50.

Now that is precisely what I understand the raising of the discretionary caps and then take credit for the savings when you reduce them. Because essentially you make them go up first, just like that super salesman, from where they are increase them, and then you reduce it back to where they were and you say, we have a big savings. Now again, you have a different explanation. It is clear as could be to me that that is the case with reference to discretionary.

Let me make two other observations, if the committee would just bear with me. Frankly, there is a lot of talk about the constitutional amendment and how it will and it will not work. I thank Senator Exon for his comments here today. We may not have enough votes, but his comments here today would indicate to me, with all the shortcomings for a constitutional amendment, that we are not going to get where we ought to be without it. I gather that is what you have indicated here today.

Frankly, two things. If we do not get a constitutional amendment we will continue indefinitely with gimmicks or real cuts in discretionary programs because nobody is going to have the courage to do anything about the entitlement programs. So I amazed, on the floor of the Senate, those who are proponents of appropriated accounts are arguing against the constitutional amendment. They almost can be guaranteed that without it Congress will constantly look at those programs, including defense, but all the other appropriated ones, because there will be no courage, just as there is no courage in this budget to take on medicare, medicaid, any of the entitlements of any significance.

So I want to suggest that from our standpoint—I am speaking now as a chairman here and as a Republican—if we do not get the constitutional amendment to balance the budget and we do not have that as the hammer that we need to get things done, it is going to very, very hard to ever get to a balanced budget by the year 2002, 7 years from now. In fact, it may be hard to get there in 2003 or 2004, because essentially without the power and pressure of that it is almost impossible to get there.

I hope we pass it, and I hope after that we will get Presidential help, because you cannot get a balanced budget without a President also. That is the beauty of a constitutional amendment; Presidents cannot sit on the sidelines. They would have to join in the quest for a balanced budget.

Thanks for the extra 1½ minutes, committee. I am sorry I took that. Now we will go back to you, Senator Exon, and go around.

Senator EXON. I believe Senator Boxer would be next.

Chairman DOMENICI. All right. Senator?

Senator BOXER. Thank you again, Mr. Chairman. I want to sit back and just put everything I have heard in the last 2 days into context because, as you know, we had Secretary Rubin here and we had Chairman Tyson here, and Dr. Rivlin, you are the third. I just want to say, the quality of the people that have come before us, in my mind, is something to be proud of whether you are a Democrat or a Republican. I want to say that.

When Jimmy Carter left office, as I understand it, the yearly deficit was about $70 billion. Is that approximately right?

Dr. RIVLIN. Yes, I think so.

Senator BOXER. When George Bush was in office, the deficit, as I understand it, almost hit $300 billion. Is that correct? I believe it was $290 billion.

Dr. RIVLIN. Yes; $290 billion was the highest number.

Senator BOXER. So we go from approximately $70 billion to approximately $300 billion, and now President Clinton gets that deficit down to $192 billion in this——

Dr. RIVLIN. Yes, under $200 billion.

Senator BOXER. Under $200 billion. Now as a percentage of GDP we have seen a dramatic drop and that is very important. As I understand the President's position, it was his promise to cut the deficit, and cut the deficit approximately in half. And he believes, it his philosophy and his Administration's belief that we need to make continued progress on this deficit. We need to get it down, particularly as a percentage of GDP. But we cannot forget the overreaching goal of the strength of this economy, the numbers of jobs created, the ability to give the American people what they need to respond to disasters, to respond to emergencies, to respond to recession, et cetera.

I would go further than that and say, in picking up on your answer to a question, that is it good to have a balanced budget? The answer that you give us is, some years it may be fine. It might work perfectly well. But in other years, it might not work, which gets us to Senator Sarbanes' historic perspective on the need for flexibility.

Now as I understand it, and we went over this before, the Republicans have stated they want to give a $750 billion tax cut over the next 10 years. They want to certainly not decrease defense spending, probably increase it. They say they do not want to touch Social Security. I say, let us take them at their word. I frankly think I will take them at their word.

Now in addition, we know that interest on the debt is something you cannot really control. So I have a chart here that I want to make part of the record and I want to talk about it. I asked you, assuming Social Security is off the table, defense is off the table, and tax cuts to the tune of $750 billion are on, that it would require a 30 percent cut in every other program. That is what you said.

Dr. RIVLIN. Yes.

Senator BOXER. Cutting one-third; crime fighting, immigration control, breast cancer research, highways, you name it.

Now I am assuming there are certain programs that are pretty tough to cut. If you would cut all veterans programs off the table—and I guarantee you, if there is a vote to do that it will pass. That means a 31 percent cut. If you take military retirement off the table—and I guarantee you that would pass the United States Senate and the House. These are people who risked their life and limb, were willing to die for their country. They are not going to get their retirement cut. That is a 32 percent cut. If you take civilian retirement off the table—after all, we have a contract there and if we are taking Social Security off, that will probably pass; 34 percent cut.

Now you come down to where medicare is going to get a 34 percent cut, and I guarantee you, the senior citizens of this country would be lining the streets here—you take that off the table, you get to a point where you have got to cut everything in half. That is havoc. That is havoc.

I just hope the American people will tune in on this. If we do not have a flexible balanced budget amendment, we should not pass it.

I have two fast questions for you which really deal with my State. I was disappointed at the low number for reimbursement to States for illegal immigration. You and I had discussed it. You went farther than any other Administration. Indeed, you are the only Administration that ever even put anything in there.

But I need to tell you publicly, on the record, it is costing us $350 million a year in California for incarceration. That is your whole yearly reimbursement level. You are putting $100 million into immigrant education. It is costing us $1.6 billion to educate illegals in our State. We just simply cannot go on with this. We spend $395 million each year on health care for illegals, and that is your entire program. So I just want to say to you, that disappointed me very, very much.

The other thing was the fact that there is no extension of the R&D tax credit. If you could just quickly respond to those then I will be finished.

Dr. RIVLIN. On the first point, we are very conscious of the problems of illegal immigration. We believe the Federal Government's first responsibility is to put a stop to it, so we have put $1 billion into additional measures to close the borders.

Senator BOXER. And I praise you for that greatly.

Dr. RIVLIN. We also realize that some States—California, Florida, and a couple of others—have prior burdens from illegal immigration that has already taken place. We have additional money in the budget to help States deal with some of those aspects. Clearly, you feel that it is not enough in the case of California, which has a particular burden.

Senator BOXER. And the R&D tax credit?

Dr. RIVLIN. We unambiguously favor the extension of the R&D tax credit. We did not put it in the budget, but we will work with the Congress on it and on how to pay for it.

Senator BOXER. Thank you.

Senator BOND [presiding]. Thank you, Senator Boxer. Director Rivlin, if we do something in Congress that triggers an outlay from a Federal fund, specifically the FHA fund, do we not have to score that as an outlay?

Dr. RIVLIN. I assume so. Scoring is always an esoteric area.

Senator BOND. It is not esoteric, because I want to refer you to HUD's proposed mark to market program. Under the project-based subsidies, in many areas we are paying more than 140 percent of the fair market rental. And one of the savings that HUD has proposed has been to mark these projects to market. In other words, write them down to what their fair market value would be and then pay reduced Section 8 subsidies for the people living in those units.

However, when they do that, there will either be direct payments from the FHA special and general insurance risk fund, or projects could be forced into bankruptcy. There would be a major expenditure because there are some 41 percent of the units, or 390,000, that are FHA insured. How much will that cost the FHA fund under the HUD proposal?

Dr. RIVLIN. I do not know, Senator. We can work with you on those numbers.

Senator BOND. Well, you are claiming a savings of $1.7 billion from the lower Section 8 subsidies. But as far as I can tell, you have not accounted for how much of a hit that would be to the FHA insurance fund. We are talking large dollars. Has HUD even given you those figures?

Dr. RIVLIN. I do not have those figures in front of me.

Senator BOND. I will tell you the problem. Because we had the inspector general of HUD before our Appropriations Subcommittee and she said that even HUD does not know where those projects are, or what the value is, or what their condition is.

Now you are asking us to assume on faith that somehow we are going to get a savings, but you do not even have the figures on how much the cost is going to be to the FHA insurance fund. I am deeply troubled by that.

Second, I am deeply troubled by the fact that approximately 300,000 of these Section 8 project-based units are financed by State housing agencies. Are you projecting that the State housing agencies would eat the lost Section 8 subsidies? Would we be bankrupting State housing agencies?

Dr. RIVLIN. We certainly do not intend to bankrupt State housing agencies. These proposals are designed to get the Federal Government out of the very complicated and difficult situation that it is now in with respect to subsidized housing. We want to do it in a more rational way. We would like very much to talk with you about how the specific scoring on this works and the numbers we used, but I do not have those numbers here.

Senator BOND. I am very much concerned about this proposal because it could be a major unfunded mandate on the States, if we are busting the State housing finance agency contracts which will threaten the viability of their bonds. And I am also very much concerned about the level of hit that is going to be absorbed by the FHA insurance fund.

Let me ask you another question about this budget. If you had not used the gimmick of shortening Section 8 renewals to 2 years—and traditionally they have been 5 years. We have gotten into the problem because we have collapsed the period of these renewals to 3 years and now 2 years. Is it fair to say that had we continued the normal practice of 5-year renewals it would have shown a $10 billion increase in HUD's budget authority for fiscal year 1996?

Dr. RIVLIN. I do not know the figure, but shortening the contract period does reduce the outlays.

Senator BOND. But shortening the contract period does not lessen the need to spend that money in the future. I have been advised that, particularly when you add in the incremental units that HUD is asking for, that we are going to be paying some—we are going to have to have $20 billion in budget authority by the year 2000 for the annual cost of Section 8 certificates.

Where are we going to get the money to add the new contracts?

Dr. RIVLIN. I would like to sit down with you and go over the HUD budget with somebody from HUD and somebody from my shop who has expertise on this complicated set of issues. We would be very happy to do that.

Senator BOND. Director Rivlin, I have great respect for you, as I have said before, but I believe that we have a real fiscal crisis as well as a management crisis. I do not believe this budget accurately reflects the cost of the HUD proposals and we are going to have to do something about it. Maybe you can work with Secretary Cisneros so he can give us next week in Appropriations some answers.

Dr. RIVLIN. We would be happy to do that.

Senator BOND. My apologies, Senator Exon.

Senator EXON. Mr. Chairman, thank you very much. Senator Bond, I am glad you brought up the whole housing problem. It is a very difficult one. We are going to have to get into that and I am pleased to see that Dr. Rivlin and her expert would be glad to meet with you on that.

Every time I hear about Section 8 housing I think back to World War II and what Section 8 meant. In those days, before it was a housing program, Section 8 was a type of discharge that you received from the armed services. Section 8 meant that you were mentally incompetent or crazy. And every time I have heard the Section 8 program, and what little I know of it, I think it is crazy from the standpoint of fiscal responsibility, although it is designed to do good.

I also would like to also stake out a claim. There have been many members of the committee on both sides of the aisle today who have presented themselves as people very much concerned about grandchildren and I appreciated those remarks. I wanted to set the record straight that I believe this member with eight grandchildren is the champion grandfather of those on either side of the aisle. I just wanted to say to those people who were bragging about one or two, my interest in that area is increased eight-fold; just for setting the record straight.

Let me get to something else that I am very much concerned about. Let us talk about the interesting point that Senator Boxer made. Senator Boxer introduced into the record here today what I used in a Senate floor speech about 10 days ago. I am glad that she put that in here.

I was with a group of people yesterday, they were talking about the balanced budget amendment which I intend to support. But I was amazed to see some of the people who were supporting that ducking the issue about what that is going to require in cuts. The chart that Senator Boxer introduced here and that I introduced on the Senate floor about 10 days ago accurately reflects the magnitude of the cuts. I am not ducking those, but I think the people have a right to know.

One of the problems in the support of the balanced budget amendment that I am most concerned about is that many people are waving the flag for the balanced budget amendment and not wishing to level with the American people about the magnitude of the cuts.

Last but not least, I would like to ask you this question, Dr. Rivlin. I have known you for a long time and I have admired your talents and your spunk and your dedication to get things done. In addition to that, you have been a good soldier for the President. Supposing this committee would agree that given the magnitude of the problem, and if we are going to balance the budget by the year 2002, how are we going to do it with the problems that face us?

It seems totally irresponsible to me, either the $60 billion decrease in taxes that you and the Administration are offering, or the $200 billion being offered under the Contract With America on the House side and by some Republicans. I would simply say that that $200 billion estimate is only for the first 5 years. It could be $300 or $400 billion on top of that for the outyears. It seems to me irresponsible, if we are going to start balancing the budget and reduce the deficit as all of us want to do.

Let us assume that there was unanimous support in the House and the Senate, and let us assume that the majority leader and the minority leader of both the House and the Senate, and Senator Domenici and I, the Chairman and ranking member of this committee knocked on the White House door and said, we believe, Mr. President, that this tax reduction talk has gotten clear out of hand. Would you agree, to drop your suggestion for a $60 billion middle income tax decrease if all such proposals for tax decreases would be dropped on the Hill?

The President would undoubtedly call upon you for a recommendation on that. Under that scenario, as unlikely as it is, what would be your recommendation to the President if he asked for your opinion?

Dr. RIVLIN. It is such an unlikely hypothetical, Senator, that I don't believe I could respond to it. Certainly, without tax cuts it is easier to get to a balanced budget. But it will still be very difficult to get to a balanced budget even without tax cuts. We believe that our middle class tax cut, which is paid for with spending cuts, is the right way to go. We certainly will look forward to seeing whatever scenario unfolds up here.

Senator EXON. One last question then. I do not intend for you to disclose negotiations between you, and the President on budget matters. I simply say, that the concept of a tax cut did not emanate out of the Office of Management and Budget.

Dr. RIVLIN. The Office of Management and Budget is not in charge of taxes. We are in charge of the spending part of the budget. But I do not think it matters where the tax cut proposal came from. The tax cut proposal is an Administration position. The President campaigned for a middle class tax cut, and this is something we believe in.

Senator EXON. And you do not think it is wise for you to answer my question as to whether it emanated out of your department or not?

Dr. RIVLIN. No, I do not.

Senator EXON. You do not what?

Dr. RIVLIN. I cannot answer that question.

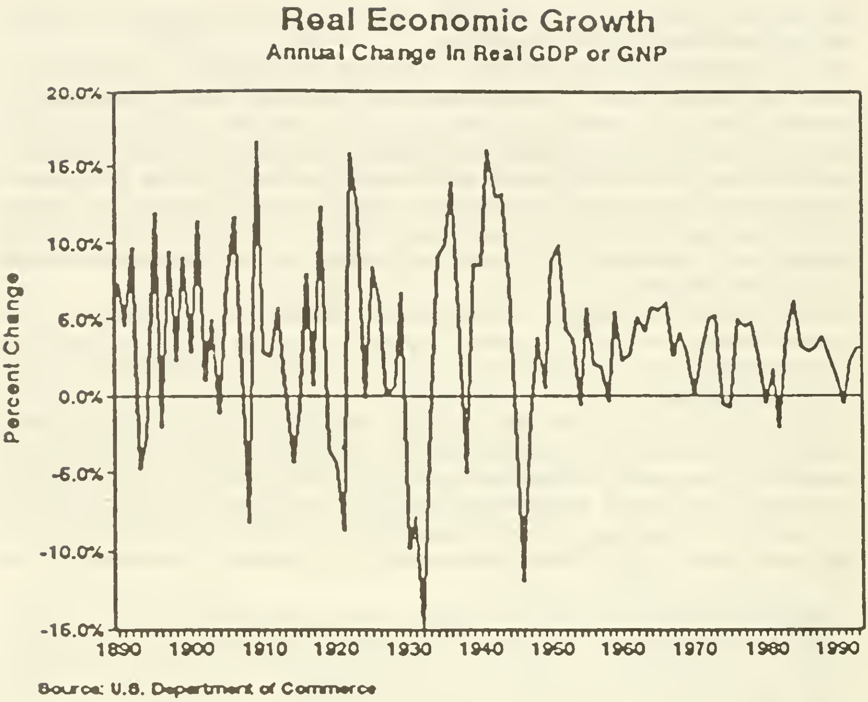
Senator EXON. Thank you, Doctor. Thank you, Mr. Chairman.

Senator BOND. Director Rivlin, you had indicated that you needed to leave at noon, but Senator Sarbanes has some questions. Can you——

Senator SARBANES. I have just about a minute.

Dr. RIVLIN. I can make myself available to Senator Sarbanes for a minute or two.

Senator SARBANES. All I wanted to do, Mr. Chairman—because I have the chart here that I made reference to yesterday and I just want to discuss it briefly with Director Rivlin. What this chart shows beginning in 1990, which is the dateline across the bottom of the chart, and coming up to date is the percentage change in real GDP. This large decrease at the end of World War II when we really did not know how to do the transition out of the defense economy. That was, of course, the period when we began putting in the fiscal stabilizers so that we would offset a downturn.



What it shows is a dramatic improvement in the sense that we no longer have the boom and bust cycles. In fact, not only do we not have the boom and bust cycles, the really steep up and down, but we have managed to keep the fluctuation—above this is positive GNP growth and below is negative. We have only gone into a negative mode a couple of times, and then not very deeply. So in a sense, the fluctuations have been in, more or less, positive growth.

Now it seems to me that this is a dramatic demonstration of the benefits of counter-cyclical fiscal policy. Clearly, this kind of situation is much to be preferred over what was happening before when we would have the busts and the panics. Indeed here, when we went way down, the Great Depression.

It is my understanding that while it is not the sole factor, that it is generally accepted that the built-in fiscal stabilizers and the counter-cyclical fiscal policy is a major contributor to having achieved what I would regard as a very important advance. First of all, do you regard this as a very important advance? And second, do you see the counter-cyclical fiscal policy as a major contributor to doing this?

Dr. Rivlin. I do think the absence of boom and bust cycle is a major advance. I don't think anyone can argue with that dramatic chart. We have had smaller fluctuations in the post-World War II period, and there have been very few times, as you point out, when we have had negative growth for more than a quarter or two. That was not the case before World War II. The automatic stabilizers in the Federal budget—the size of the Federal budget and the fact that it stabilizes the economy—have been a very important part of that successful record.

Senator SARBANES. Now if we had a balanced budget amendment to the Constitution which constitutionally required us to have the budget in balance each year—not over the business cycle, but each year—would that not mean that as we went into a downturn, instead of offsetting the downturn as we now do by running a deficit which helps to hold up purchasing power, we would have to intensify the downturn because we would have to take measures to try to keep in balance?

And of course, as you did that you would contribute to driving the economy further down and you are going to start getting then the kinds of fluctuations that we used to have in the first part of this century, including—the most dramatic of those which was the very deep fluctuation for the Great Depression. Would that not be the case?

Dr. RIVLIN. Yes; I agree that we would have bigger fluctuations. My colleague Laura Tyson, who testified here yesterday, made that point quite eloquently in an op-ed to the Washington Post this week.

Senator SARBANES. In fact, she said not only would we lose the fiscal stabilizers, we actually would be throwing them into reverse.

Dr. RIVLIN. Yes.

Senator SARBANES. The consequence of that would be not only that we would not be checking the downward trend, we actually would be intensifying and contributing to it.

Dr. RIVLIN. Yes, that is right. If you were either raising taxes or cutting spending during a recession, you would make the recession worse.

Senator SARBANES. That is right. Now the other final question I have is that it is asserted by some, this has an escape clause in it; we can waive it with 60 votes, and therefore we could obviate the necessity of requiring the balance. The difficulty with that, it seems to me, is that now when we start into a downturn we start automatically making the adjustments.

Dr. RIVLIN. Right.

Senator SARBANES. When we may not even fully recognize that we are into a downturn. Now if you have to fully recognize it and then finally act on it, you may be well into the downturn, and the momentum carrying the economy downwards may have picked up. So it will then be much more difficult to turn the thing around. Is that a reasonable analysis?

Dr. RIVLIN. That is a reasonable analysis, Senator. We do not always recognize when the economy is turning around. Economists are not very good at predicting, and budget decisions are not made continuously; they are made every once in a while. The situation could worsen before you recognized what was happening.

Senator SARBANES. Right. Thank you very much. I declare the hearing now adjourned.

[Whereupon, at 12:07 p.m., the committee was adjourned.]

WRITTEN QUESTIONS FROM SENATOR DOMENICI TO DR. RIVLIN AND THE RESPONSES

Question. Why has OMB changed its policy with respect to supplementals for State Department Peacekeeping activities and requested that these resources be designated as "emergency requirements"?

What it the Administration's rationale for funding these supplementals outside the spending cap when these operations have been ongoing for quite some time and could be captured in the regular, annual budget request for these Federal departments?

Answer. The Administration has not changed its policy in fiscal year 1995 with respect to the $672 million supplemental request for State Department peacekeeping activities. In fiscal year 1994, outlay headroom was available within the discretionary caps to offset the peacekeeping supplemental requested for that year. However, we had considered the fiscal year 1994 peacekeeping supplemental to be no less of an emergency requirement than the fiscal year 1994 Defense Supplemental request, which did have emergency designation. Both supported related and essential national security and foreign policy interests.

This year, available headroom did not permit State's fiscal year 1995 peacekeeping supplemental to be offset. However, the Administration continues to support the position that these costs are emergency in nature. As a member of the United Nations, the United States is obligated by international treaty to pay its assessment on peacekeeping activities. The United States is currently in arrears on its payments. Failure to meet our financial obligations could lead to curtailment of UN missions in areas of vital importance to United States interest, such as the Middle East. Further, it would result in loss of U.S. global leadership, which often is enhanced through the United Nations and UN Security Council action. Insuring the viability and continuation of UN peacekeeping activities, which serve United States interests and have been supported by U.S. votes in the UN Security Council, is in our national interest.

Question. Should the Congress decide, as the House Appropriations Committee evidently has, that some, or all of this spending should not be approved as "emergency" expenditures, but rather offset with other program reductions, would you support that action?

Answer. The Administration continues to believe that these are appropriately designated as emergency expenditures. The Administration is committed to reducing low-priority programs to be terminated. Rather, it allows the Congress to grant termination authority directly to the Secretary of the affected Department or Agency.

Under a rescission proposal, the President may withhold funds for affected programs from obligation for 45 days in order to give Congress a chance to act on the proposal. The President may not withhold funds under a negative supplemental.

Question. The budget documents indicate that the Secretary of Defense, if granted this authority, would direct the permanent cancellation of $703 million in funding that does not directly contribute to military capabilities. How would you define such funding?

A reading of the requested legislative language that would allow the Secretary of Defense to make these funding reductions does not specify that the Secretary must cancel funding that does not contribute to military capabilities. How would Congress ensure that this would be the final result should this authority be granted?

Answer. The proposed supplemental rescission language would require the Secretary of Defense to notify the Congress prior to cancelling funds. The Secretary of Defense is currently reviewing the defense program to identify those programs which, in his best judgment, should be terminated because they do not directly contribute to military capabilities.

You can be assured, however, that this Administration's defense budget will continue to meet our national security needs by supporting a strong military capability at high levels of readiness.

Question. Is it not, in fact, the case that the Administration would proceed to cancel funding for congressional priorities that have been included in the Defense Appropriations Act but not requested by the President?

If so, how would this differ from the traditional practice of proposing rescissions for funding items the Administration does not necessarily see as a priority?

Why would the Congress give the Administration carte blanche to cancel spending authority provided to the Departments of Defense and Transportation when the existing process provides such proposals to the Congress, and when, in fact, Congress is about to give the President legislative line-item veto authority to ensure that his rescission proposals are enacted upon by the Congress?

Answer. Programs recommended for termination, may in fact include items which were added by the Congress but not requested by the Administration.

It would be advantageous for the Congress to grant termination authority directly to the Secretary of Defense in order to achieve needed budgetary savings in a timely and effective manner. When the budget was prepared, the Administration had no assurance that a line-item veto authority would be enacted. Even though the Administration strongly supports passage of the line-item veto, program cancellations needed to achieve the required savings would not be realized quickly enough through the current rescission process.

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THE PRESIDENT'S DEFENSE BUDGET

FRIDAY, FEBRUARY 10, 1995

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 9:33 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Grassley, Lott, Gorton, Snowe, Abraham, Frist, Exon, Hollings, Conrad, Dodd, Sarbanes, Boxer, and Murray.

Staff present: G. William Hoagland, staff director; and Roy Phillips, senior analyst for national defense.

For the minority: William G. Dauster, democratic chief of staff and chief counsel; and Randy DeValk, assistant director for national defense.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman DOMENICI. The committee will come to order, please.

We are going to shock the witnesses today and make sure that their testimony is on the record before we give our long-winded speeches. So we are going to try what we did in our last hearing, I say to the distinguished witnesses, and we thank you all for being here.

General it is a pleasure to have you here today, and, Secretary Perry, it is good that you are here.

If you would not mind, could you proceed? Make your testimony as short as you can, and we will put the rest in the record. Thus, we will hear from you before we comment. Thus, you will perhaps be finished and we can get out of here at a reasonable hour and everybody gets some questions.

Please proceed, Mr. Secretary.

STATEMENT OF HON. WILLIAM J. PERRY, SECRETARY, UNITED STATES DEPARTMENT OF DEFENSE

Secretary PERRY. Thank you very much, Mr. Chairman.

I am pleased to be here to testify to the Senate Budget Committee. I do have a statement for the record which I would like to enter for the record, and I will mention only highlights from that. Let me start off using the charts to illustrate my points.

This is the budget which I submitted to you and on which I will present some detail in answer to your questions. At this point I would only like to give you the rationale or the background we had and why we arrived at these results.

These are the three primary factors driving our consideration in preparing the budget: the proper use of military force for our contingency operations, preventing the reemergence of nuclear threat, and managing the drawdown. The management of this Defense Department is difficult enough, at best, but with the kind of drawdown we have faced for the last 10 years, it is very difficult, and I will be talking about that issue.

Defense Challenges

- Managing Use of Military Force in Post Cold War Era
- Preventing Reemergence of Nuclear Threat
- Managing Drawdown in Post Cold War Era

On the first point, managing the use of military force, the budget we are proposing sustains the force structure for two nearly simultaneous major regional conflicts. I will not talk about that further. General Shalikashvili will have something more to say about that. It maintains our overseas presence. We have this week 300,000 people deployed overseas, to give you an estimate of how important that aspect is. General Shalikashvili will talk about the contingency operations we have mounted already in the past year, and we will talk at some length about the fact that we do have a high level of readiness.

During the cold war, a principal portion of our budget had to do with building and maintaining nuclear deterrence. Our Nuclear Posture Review, just completed last year, observed that the major nuclear threat—namely, from the former Soviet Union—is gone but that, nevertheless, it is important to maintain a hedge strategy which does retain some elements of nuclear deterrence.

In this budget, we have about $7 billion for the nuclear deterrent force. That is not a small amount of money, but it is only a fraction of what we spent during the cold war. So there has been a major reduction here.

We also have a Ballistic Missile Defense Program, and I will be happy to answer any questions that you may have about either the theater missile defense or the National missile defense component of this program.

We have about $380 million requested for this Nunn-Lugar Program which we call the Cooperative Threat Reduction. This is a program which, over the past year, for example, has resulted in the dismantlement of about 1,000 nuclear weapons which were pointed at the United States. We think this is an extremely important program and urge your continued support for that. Then——

Chairman DOMENICI. How much money do you have for that?

Secretary PERRY. It is $380 million, in round figures.

In the counterproliferation field, the most significant event last year was the framework agreement we made with North Korea to stop the North Korean Nuclear Program. There are two important points I want to make about that relative to this budget. The first is there are no funds requested in the Defense Department 1996 budget for implementing this agreement. What funds are involved in that are in budgets of other departments, not the Department of Defense. Second is that were this agreement not to be implemented, we would require more funds. We would have to come back for a supplemental, because last June, before we had this agreement, we were in the process of augmenting our forces in South Korea to deal with the North Korean threat. We would be back to that position if this framework agreement failed, and in that case we would have to come in for additional funds.

Now I am getting to the major part of our budget preparation, managing the drawdown. There are four elements, and I will say something briefly about each of the four.

Managing Use of Military Force in Post Cold War Era

- Sustains force structure to support two nearly simultaneous MRCs
  - Nimble Dancer
- Maintains overseas presence
  - 300,000 Forces Deployed Overseas
- Provides capability to mount contingency operations
  - Vigilant Warrior
  - Uphold Democracy
- Ensures continuous readiness of forces

This budget does sustain the force structure which was called for in the Bottom-Up Review and which is capable of conducting two near-simultaneous major regional conflicts. Second, it does protect readiness, and I hope I can make that point convincingly to you today. It ensures the quality of life for the military forces, and it undertake the beginning planning for the recapitalization of the equipment and weapons systems which our military forces have in the field.

I am not going to dwell on this chart, Mr. Chairman, in the interest of time, but I did want to point out to you that the force structure called for in the Bottom-Up Review is essentially reached in this 1996 budget. In particular, I point out that the ten active Army divisions called for will be reached in 1996; the 20 wings called for in the Air Force will be reached in fiscal year 1996; the 12 carriers (11 active and 1 reserve) will be reached in 1996; and all but 19 of the drawdown on the ships will be reached in 1996.

Corresponding with this stabilization of the force structure, there will be a corresponding stabilization in personnel. In fiscal year 1996, the drawdown in active military personnel will be only half of what it had been in previous years. And by the end of the year, we will be essentially completed with the drawdown in active military personnel.

This is very important from a management point of view because it means that the turbulence associated with that drawdown will be behind us by the end of 1996.

This may be the most important chart that I can present to you this morning since there has been an ongoing controversy about whether our military forces are ready and whether this budget will prevent them from being ready in the future. I am going to leave the current readiness point to be discussed by General Shalikashvili.

In brief, our conclusion here is that our forces, particularly our forward deployed forces and our lift forces, are in historically high states of readiness.

The burden of this chart is to demonstrate for you that the budget which we are submitting to you does protect that readiness and will sustain it at high levels.

The first point is that the fiscal guidance which I sent to the services before they even put their budget together stated explicitly on page 1 that readiness would be the first priority and that they could trade off any other requirement that I made against readiness. Therefore, it was the first priority, and that was reflected in the budget submission. They fully funded all of the features which I required in this budget.

As a consequence of that, the budget submissions that came in were higher than the fiscal constraints which had been set by the President; therefore, I had to go back to the President and request an additional $25 billion over the course of the Future Years Defense Program in order to support the high readiness and the high quality of life for our military forces. The President accepted that judgment and did grant us that $25 billion increase in top-line authority.

Therefore, as a consequence of that, then, we were able to fully fund all of the elements that are crucial to the current readiness, in particular operational training and the depot maintenance.

Chairman DOMENICI. The $25 billion, my staff reminds me, is through the year 2001.

Secretary PERRY. It is the 6 years in the Future Years Defense Program, beginning with fiscal year 1996.

Chairman DOMENICI. Thank you very much.

Secretary PERRY. Now, in my review with the service chiefs of this budget before I submitted it to the President, I sat down with each of the chiefs and asked them: Does this budget protect high levels of readiness in the future? Their answer to me, each of them, was "yes, but," and the "but" was unless funds are diverted from that budget after they are appropriated to support unplanned contingency operations. Therefore, it was necessary to also have a plan for dealing with that possible exception, and so we have requested an emergency supplemental, $2.6 billion, that funds the contingency operations that began at the beginning of fiscal year 1995 and projected them to continue to the end of fiscal year 1995. That is that projected $2.6 billion. If we get those funds, then the readiness will be fully protected. If we do not, then we have to fund those operations out of operational training and depot maintenance funds.

Finally, because there is a possibility that an unplanned contingency will arise in the last few months of the year, we will be requesting an authority from the Congress to transfer funds to deal with those problems while we are waiting for a new supplemental to deal with that problem.

Dr. Hamre can give you more information about this one, if you care to.

Finally, managing this process is an ongoing, dynamic process. It goes on on a day-to-day basis. We monitor this through a Senior Readiness Oversight Council, which General Shalikashvili will tell you more about. I manage it by a standard technique in industry known as MBWA, management by walking around. I go to bases all over the country and overseas and meet with not only the commanders but also the senior enlisted of each of those bases to get a continuing feedback from them on the readiness of the forces. On the basis of that feedback, I take appropriate actions.

We have in this budget a new quality of life initiative which pluses up the funds which have previously been budgeted for the quality of life for the military forces. This fully funds—in fact, for the rest of this decade—the full legal pay raise permitted by Congress, protects the medical benefits, adds some child care, day care, and recreation facilities, and I think most importantly, has a substantial increase in the dollars for housing, both family housing and barracks.

I am not going to dwell on this at this point, Mr. Chairman. I will point out to you that I believe we are in a very poor condition relative to housing for our military personnel. We got there for two reasons.

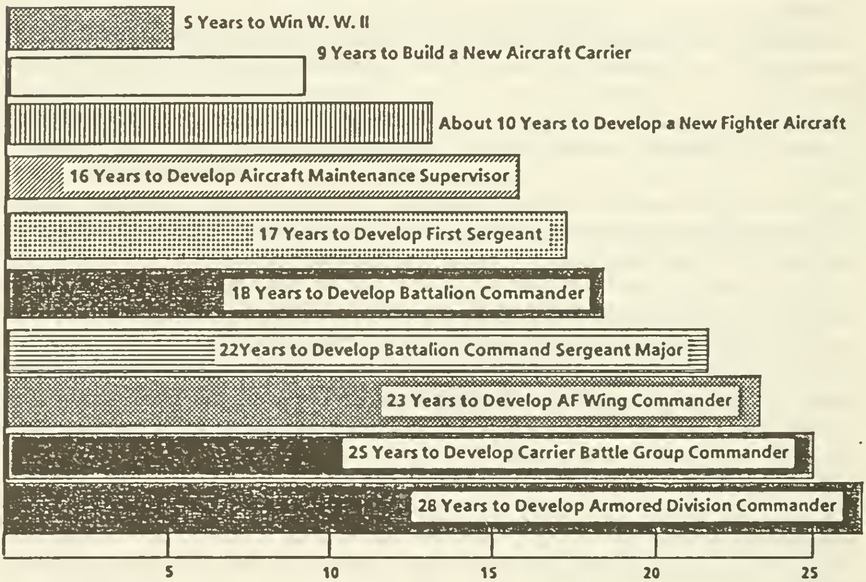
First of all, there is a change in demographics in the last 2 decades as we went from a draftee force to an all-volunteer force. A much higher percentage of our military personnel, instead of being in the force for a year or two, are now in it for 10, 12, 15 years. Consequently, many more of them are married, so we have a much greater demand for family housing. Family housing has not expanded during that period, so we have a substantial shortage of family housing.

In the meantime, all during this period, even during the high defense budgets during the 1980's, the so-called Reagan build-up, money was being put in many other accounts. It was not being put in to deal with this housing problem. This has been neglected now for several decades.

The increase in this budget is a step, a small step, in the direction of fixing that problem. It is not a large enough step. I will be coming back to the Congress during the year with a housing initiative to make a major improvement in this problem.

Our interest in quality of life is not for a sentimental reason. It is because we truly believe that the capability of the people in the military force is the most important asset that we have, and it is an investment that we make. This is a point that is not well understood, but this chart is intended to illustrate that. While it takes us 9 years to build a new aircraft carrier, 10 years to develop a new fighter aircraft, these are long-term investments. The investments we make in training our military personnel are even longer than that. It takes us 16 years to develop an aircraft maintenance supervisor, 18 years to develop a battalion commander, and 28 years to develop an armored division commander.

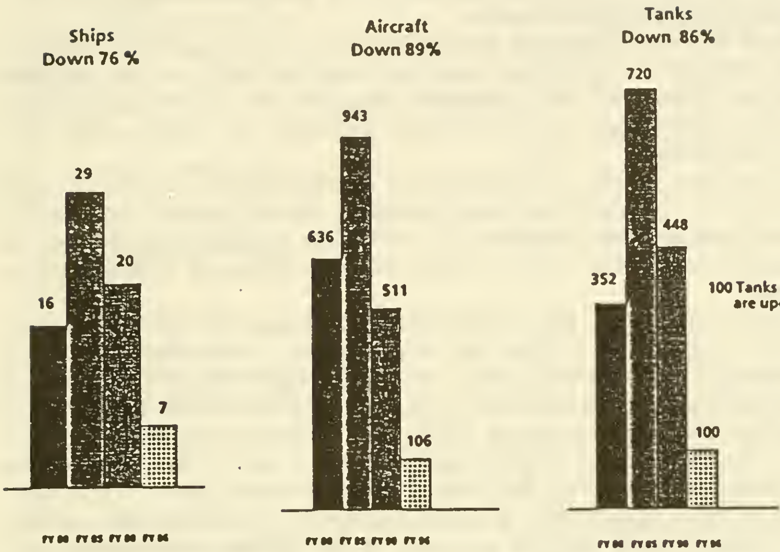
PEOPLE, OUR MOST IMPORTANT ASSET



Therefore, to maintain quality of the force, we have to retain the best people in this force. The whole rationale of our approach here is training and retaining—and our readiness budget does that. Training and retaining are the keys to having a high-quality military force, and this budget accommodates both of those.

I will now get into the last component of the budget, which is the modernization of the equipment. The first point I will make to you is that the budget which we are submitting here for modernization is at a historical low. It is the lowest in real terms for modernization that we have had in the last 50 years.

Historical Procurement Trends



It has been low for the last 4 or 5 years, and the reason we have been able to get away with it being low is that the force was being drawn down. We were taking equipment out of the force; therefore, we took the older equipment out, of course. As a consequence, we were able to manage the average age of the equipment in the force. So even though we were not recapitalizing at the necessary rates for steady state, we were still able to actually decrease the average age of selected equipment in the force and mitigate aging problems for many other systems.

I will come back to that point——

Chairman DOMENICI. Mr. Secretary, does the word modernization mean just replenishing what you have got, or does it include new technology?

Secretary PERRY. It includes both. My point here is it's not only replenishment, buying more F–18's, for example. Here I am telling you that because of the problem I have described, because of the opportunity I have described, we have had a pause in this recapitalization over the last 4 or 5 years. But I earlier told you that the drawdown is essentially over in fiscal year 1996; therefore, we have to now start building it up again.

So the first point is that we have had an opportunity to pause in the recapitalization. We have done that the last 4 or 5 years. That is over. We have to start building it up, and I will show you in the budget how we plan to do that.

But this recapitalization does not require one-for-one replacement because of the point that you are suggesting, Mr. Chairman; namely, the introduction of high technology and the introduction of new systems gives us an opportunity to do things more effectively and more efficiently and, therefore, reduce the unit costs and, more importantly, the life cycle cost of a system.

Nevertheless, we do have an increase in the outyears in this budget in the modernization account, and the resources to do that come from three different areas.

First of all, the Congress passed last year an acquisition reform bill. We have not scored the benefits from that bill in this budget. We believe there will be significant benefits. We do not know how to quantify them yet, and, therefore, we have not taken credit for that in this budget.

On the other hand, in reducing the infrastructure, which is coming primarily through the base closings, we do score that, and I will just give you two numbers to convey to you the significance of this base closing and other things we are doing to reduce infrastructure.

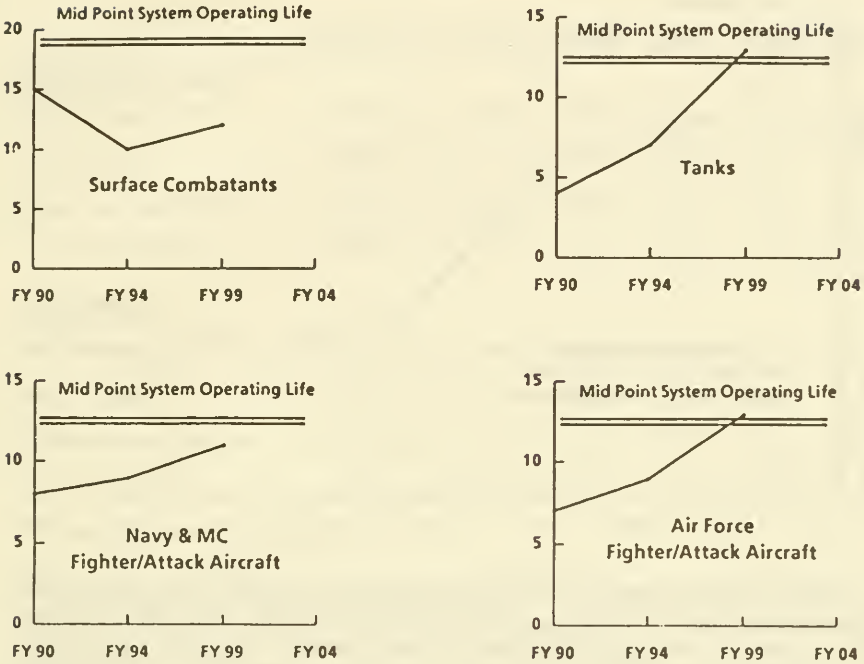
In fiscal year 1996, the budget which is being submitted to you, we have a cost of $4 billion, in round figures, associated with the base closings that we are doing. So while base closing is intended to save us money, the near-term impact of it is a cost, and a very substantial cost. In fiscal year 1996, it is costing us $4 billion.

Now, in the outyears of this budget, by the end of the decade the base closing will save us $4 billion on an annual basis; therefore, relative to this question of getting money to do the modernization in the future, there will be a swing of $8 billion from fiscal year 1996 to fiscal year 1999, from an investment of $4 billion to a savings of $4 billion. So that is a swing of $8 billion. All of the money then in this program is planned to go into increasing our modernization.

Finally, in this budget, in the last few years of the budget, there is an increase in the top line projected. All of that is going into modernization.

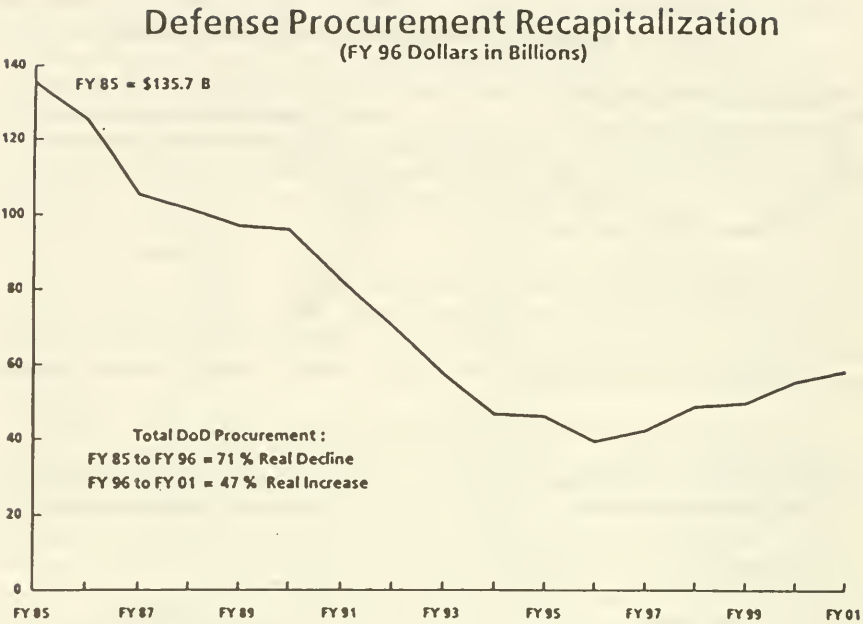
That is summarized. This is the first point that I was making to you about aging of equipment. I put a chart on here to show you that for each of four major categories—surface combatants, Navy aircraft, Air Force aircraft, and tanks—I am plotting the average age of the equipment that is deployed. You can see from this chart that even though we have not been buying much equipment from 1990 to 1996, which is depicted here, in some cases the average age is decreasing and in other cases it is more or less holding its own. But, in all cases, as we go into the outyears, that average age goes up, in some cases goes up precipitously.

Average Ages of Selected DoD Weapons



The danger point on this curve is the double red line on top. That represents the midpoint system operating life. And so when you have this average age over the midpoint system operating life, you know then that you are in trouble and that you are having an equipment obsolescence problem.

These charts I am showing you here reflect the increase in recapitalization that I showed you in the last budget. It deals with the problem adequately in most cases, but we still see problems developing here by the turn of the century. This represents the increase in dollars in the procurement account to deal with this recapitalization. That is about a 47-percent real increase from fiscal year 1996 to fiscal year 2001.



Finally, I will get to the chart perhaps I should have shown you first, which is the budget, and this is fiscal year 1996, $246 billion, as a contrast with $252 billion in fiscal year 1995. The fiscal year 1995 figure is not only the amount appropriated by the Congress, but I have assumed in this figure the emergency supplemental that we are requesting. So I have added the emergency supplemental funds to this.

NATIONAL DEFENSE TOPLINE
(Current $ Billions)

	1995 *	1996	1997	1998	1999	2000	2001
BUDGET AUTHORITY							
DoD military - 051	252.6	246.0	242.8	249.7	256.3	266.2	276.6
DoE & other	10.9	11.8	10.6	9.9	9.9	9.9	9.9
Total national defense	263.5	257.8	253.4	259.6	266.3	276.0	286.5
% Real change	-1.9	-5.3	-4.1	-0.1	-0.2	+ 1.1	+ 1.2
OUTLAYS							
DoD military - 051	260.2	250.0	246.1	244.2	249.6	257.9	261.6
DoE & other	11.4	11.4	10.9	10.3	10.0	9.9	9.9
Total national defense	271.6	261.4	257.0	254.5	259.7	267.8	271.5
% Real change	-5.4	-6.6	-4.4	-3.6	-0.6	+ 0.6	-1.2

* Assumes FY 1995 $2.6 supplemental

So that shows a decrease of about $6 billion from 1995 to 1996, a further decrease of about $3 billion from 1996 to 1997, and then in our projections, the budget in nominal terms increases from 1998 on.

As I mentioned to you before, that increase is used to fund the increase in modernization in the procurement account, which I indicated in the budget.

This simply reflects historically the defense budget as a percentage of the Federal budget. You see the very high outlays: the Korean War, 57 percent of the Federal budget was defense; very high outlays in the Vietnam War, 43 percent; relatively high outlays during the Reagan defense build-up when defense was 27 percent of the defense budget.

In the projections which I have shown you on the last chart, that number will drop to 13 percent of the Federal budget by the end of the decade, the end of the century. And this year, fiscal year 1996, it will be 15.5 percent.

So in terms of your discussions on dealing with the deficit and reducing Federal spending, this paints a picture of where the major decrease in Federal spending is actually occurring.

I would like to end now with a final chart which summarizes my conclusions Mr. Chairman. We have funded readiness in this budget as our highest priority, and it reflects our judgment that the people come first, not for sentimental reasons but for good military reasons. Second, we believe this is the right force structure, the right strategy, and even though capitalization is at an all-time low, we have a plan for accommodating that in the outyears of the budget.

Overall Budget Assessment

This budget preserves our national security

- DoD funded readiness as its highest priority;
  - People come first
- The right force structure for the right strategy
- DoD plans outyear recapitalization

With that, I would like to ask General Shalikashvili to make some comments and then turn it over to the committee for questions.

[The prepared statement of Secretary Perry follows:]

STATEMENT OF

SECRETARY OF DEFENSE
WILLIAM J. PERRY

BEFORE THE

SENATE BUDGET COMMITTEE

IN CONNECTION WITH THE FY 1996-97
DEPARTMENT OF DEFENSE BUDGET

10 FEBRUARY 1995

**STATEMENT OF SECRETARY OF DEFENSE WILLIAM J. PERRY
IN CONNECTION WITH THE FY 1996-97 DEFENSE BUDGET
SENATE BUDGET COMMITTEE
FEBRUARY 10, 1995**

Mr. Chairman, members of the committee, it is a pleasure to be here to discuss President Clinton's fiscal year (FY) 1996-97 Department of Defense (DoD) budget.

We meet halfway through the first decade after the end of the Cold War. We have seen enough of this new security era to know that serious dangers persist, as well as great opportunities to advance peace and democracy. How best to counter those dangers and pursue those opportunities can generate honest debate. However, I believe there also is a tremendous basis for consensus, and it is in that spirit that I come before you today.

How best to handle the dangers and opportunities of the post-Cold War era has been exhaustively studied by the Department of Defense. Our strategy calls for a force structure that will be capable of fighting and winning two nearly simultaneous major regional conflicts, and conducting a wide range of other military operations. During the past year we have rigorously revalidated our strategy's major military requirements, and they are supported by the new budget and the FY 1996-2001 Future Years Defense Program (FYDP), whose implementation the budget begins. Our plans reflect my department's best judgment as to the strategy, force posture, and programs needed to protect U.S. interests and sustain America's crucial global leadership role. In explaining how they do that, I will organize my statement around three dominant defense challenges facing our nation in this new era. (Chart 1)

MANAGING THE USE OF MILITARY FORCE

The first challenge is managing the use of military force. (Chart 2) To support this challenge, the budget and FYDP:

• Sustains the force structure called for by our strategy. DoD has intensively and extensively validated the key assumptions underlying its strategy and force planning in rigorous ways, such as our comprehensive wargame Nimble Dancer.

• Maintains a robust overseas presence. This week, as a snapshot, we have 300,000 military personnel deployed overseas: approximately 100,000 permanently assigned to Europe, a similar number in the Pacific, and the remainder are today participating in contingency operations or are deployed at sea. We anticipate that we will continue about this same level during the budget period.

• Provides the capability to mount contingency operations. In FY 1994 our forces demonstrated this capability, especially during two operations: Vigilant Warrior, in which forces were deployed to Kuwait and Saudi Arabia, thereby deterring Iraqi aggression and demonstrating our resolve to fulfill our commitments in that region; and Uphold Democracy, in which we deployed a substantial force to Haiti, to help reinstate the democratically elected president and government and provide a secure and stable environment for the return of functional governance.

• Ensures the continuous readiness of U.S. forces, as I will detail later.

DoD's thinking on managing the use of military force is reflected in our basic operational concept for major regional conflicts. (Chart 3) An overseas presence of forward-deployed forces contributes both deterrence and quick reaction. Sufficient strategic mobility enables the rapid projection of blocking forces into the conflict area. Cooperation with a coalition of nations can yield both allied help, as well as political pressure against potential aggressors. Superior technology and modernization enables us to apply decisive air power, combat technology, intelligence, and more. Committing overwhelming counter-offensive forces promotes rapid victory, with the least possible casualties. And providing the foundation to this operational concept for regional conflicts must be high readiness of U.S. forces.

The ability of U.S. forces to react to contingencies was vividly demonstrated in operation Vigilant Warrior. Some 121 aircraft deployed to the Persian Gulf theater in less than 7 days. A forward deployed amphibious readiness group moved into the area in one day. A mechanized infantry brigade deployed to Kuwait and was ready for combat in 3 days--demonstrating both our airlift capabilities and the benefits of having heavy equipment already in the theater. Another Army unit linked up with its equipment from prepositioned ships in 15 days. Finally, the George Washington carrier battle group moved from the Adriatic Sea to the Red Sea in 3 days. The impact of this rapid projection of military power: deterrence of new Iraqi aggression.

PREVENTING REEMERGENCE OF NUCLEAR THREAT

The second challenge is to prevent the emergence of a serious post-Cold War nuclear threat. (Chart 4) The cornerstone of our response was DoD's 1994 Nuclear Posture Review, whose recommendations were approved by the President last September. The Review called for reductions in strategic programs to reflect actual U.S. needs, thereby setting an example for other nuclear powers; plus a hedge strategy, which retains a U.S. force structure sufficient for deterrence. The new budget and FYDP retains this credible nuclear deterrence, although spending on strategic nuclear programs is much lower than during the Cold War. The NPR's hedge strategy also includes our approach to ballistic missile defense, detailed below.

Another element of our nuclear prevention challenge is the Cooperative Threat Reduction program, which focuses on the weapons in the former Soviet Union, which will be discussed in more detail later.

A third element of this challenge is counterproliferation--preventing the spread of nuclear, biological, chemical, and missile capabilities, a growing threat to U.S. global interests. Regarding one such effort--the Framework Agreement with North Korea--I want to stress that there are no funds in this budget for the Agreement, because it does not call for any DoD funds. Additionally, our budget assumes that implementation of the Agreement will be successful; in the absence of this Agreement, we would be back to the position we were in last June, when we were planning to reinforce our defense posture in Korea. Should the Agreement not be implemented, reinforcements will be required, at a significant additional expense.

Ballistic missile defense is part of our hedge strategy as well. (Chart 5) Our highest priority continues to be theater missile defense, which addresses the immediate threat to U.S. forces deployed throughout the world. We have three core TMD programs, whose funding is shown on the attached chart. We are also proceeding with a National Missile Defense technology program aimed at achieving readiness to deploy such a system in a few years, if the threat requires.

The funding and objectives of the Cooperative Threat Reduction (CTR) program are shown on the next chart. (Chart 6) The slight decline in funding through FY 1997 does not reflect a decrease in DoD emphasis, but rather the timing of different aspects of the program. Indeed, I believe that this program will remain one of our most important. Some people have called CTR a nondefense program, but I call it defense by other means. How better to deal with weapons of mass destruction, than to dismantle them?

MANAGING THE DRAWDOWN IN POST-COLD WAR ERA

A final post-Cold War challenge is managing the drawdown of U.S. forces. (Chart 7) The new budget and FYDP maintain the force structure needed to support our defense strategy, protect readiness, ensure quality of life for military people and their families, and advance our plans for recapitalization. I will elaborate on each of these.

The drawdown of forces to the level called for by the new defense strategy will be nearly complete by the end of FY 1996. (Chart 8) At that time, DoD will have reduced active military personnel and force levels by over 30 percent since the beginning of FY 1990, the fiscal year in which the Berlin Wall fell. The ending of the drawdown will bring a welcome end to personnel turbulence.

Reflecting cuts in forces and infrastructure, personnel end strength continues to decline. (Chart 9) By FY 1998 active military end strength will level off at just under 1,450,000--about 32 percent lower than at the end of the Cold War. DoD civilian end strength will decline to 729,400 in FY 2001--also a 32 percent decline, but it lags behind the active duty drop by a few years. In FY 1998 Selected Reserve end strength will hit its goal of 893,000--about 24 percent below its 1989 peak of 1,170,600.

READINESS IS PROTECTED

In formulating the new budget and FYDP, my department accorded the highest priority to preserving force readiness. Regarding our current readiness, there are several reasons why I am convinced that it remains high. (Chart 10) The most important indicator is that our Commanders in Chief (CINCs) report to me that they are ready to execute their current missions. This readiness was manifested by their successful execution of complex operations in Haiti, Iraq, and Rwanda. The professional skill demonstrated by our military men and women was superb.

Our military commanders also forward to me regular statistical reports. These show that our early-deploying forces are maintaining the high rates of readiness that they have been at for the last decade or more. The readiness problems of some of our late-deploying units, which became evident at the end of FY 1994, will be fixed by April 1995.

What about future readiness? (Chart 11) The FY 1996-97 budget protects readiness. My guidance for the formulation of this budget was that readiness should be the first priority and that other objectives could be traded off to ensure it. That guidance was followed. Additionally, the $25 billion added by President Clinton late last year enabled us to support the readiness and quality of life measures we wanted in the budget. When I reviewed the FY 1996-97 budget with the military service chiefs, they confirmed for me that it fully funds needed operational training and the depot maintenance required to support our strategy.

However, the service chiefs also warned that the diversion of funds for unplanned contingencies would affect readiness. To prevent readiness problems, we are requesting speedy approval of an emergency supplemental appropriations to help pay DoD's FY 1995 costs for unbudgeted contingencies now underway. In this supplemental, we are also requesting a Readiness Preservation Authority, which would enable the Secretary of Defense to avoid diverting money from readiness to pay for contingency operations late in the current fiscal year. This authority would operate like overdraft protection on a checking account, enabling DoD to protect readiness in anticipation of later funding.

To preserve readiness in the future, DoD will monitor it carefully and continually, as it is doing now. Our vehicles for doing this include the Senior Readiness Oversight Council, chaired by the Deputy Secretary of Defense. It meets once a month and has the authority to solve problems. In addition, we will stay on top of readiness through MBWA, "management by walking around". That means going out to military bases and talking with people. I and other senior DoD leaders do this all the time. No management tool is more important.

The central tenet of our readiness philosophy is that people are our most important asset. (Chart 12) As shown on the attached chart, it takes many years to develop first-rate leaders. People come first, not simply for sentimental reasons, but because they are our most productive investment. The superiority of America's armed forces derives primarily from the unsurpassed quality of our officers and noncommissioned officers, as well as the subordinates they train and lead. The most important part of my job is to develop these future leaders as a legacy for my successors, the 21st century Secretaries of Defense.

A key to readiness and effectiveness therefore is keeping quality people. (Chart 13) How do we plan to do that? First, by training realistically, which the new budget supports. For example, it funds 12 brigade rotations per year at the National Training Center, as well as superb exercises such as Red Flag, Bright Star, and Roving Sand.

Another contributor are the real missions, on which our forces deploy. Some people worry that such deployments hurt readiness. But for many units these operations are tremendously beneficial. For Army units at Fort Stewart, the Vigilant Warrior deployment to the Persian Gulf was the best possible training for its wartime missions. In Haiti our Special Operations people are actually carrying out civil-military activities, rather than merely training to do them.

The critical point is this: As long as we manage and fund them wisely, contingency operations need not degrade our force readiness. Indeed, most operations will likely provide very realistic training, as well as many intangible benefits of real-world experience. Real missions enable our military people to demonstrate the professionalism they have honed, and can be a great source of pride--especially when those missions deter aggression, save lives, promote democracy, and help people in need.

Keeping quality people also means that we must reenlist families, which leads to discussion of quality of life programs.

QUALITY OF LIFE PROGRAMS

Providing a good quality of life (QOL) for service members and their families is both the right thing to do and crucial to sustaining the readiness of U.S. forces. (Chart 14) Reflecting this conviction, the new budget funds the full military pay raises provided for under law: 2.4 percent for FY 1996 and 3.1 percent for FY 1997. The budget also protects medical benefits. These are very important to people, and we could not have protected these benefits without the $25 billion added by President Clinton.

Community and family support programs are central to my quality of life emphasis. Our plans call for a 23 percent increase in child care spaces by FY 1997. The FY 1995 and FY 1996 budgets include $56 million for 20 new/expanded child care centers. Also planned are 18 new recreation centers, chapels, and fitness centers.

Finally I must talk about housing, which is the number one topic in every one of my base visits. At U.S. bases all around the world, housing is inadequate. Partly that is because of changed demographics. We no longer have a conscript force, and many more of our people are married. Additionally, housing programs have not kept pace with housing needs--including during the 1980s, when defense funds were more plentiful.

Our plans call for a 13 percent increase in housing dollars per active duty person (FY 1996 over FY 1994). But that is not enough. We cannot solve our housing problems just by seeking increased budgets, so we are looking at a housing initiative that seeks alternative ways of getting more housing for our people.

Beyond these traditional concerns, I recognize that quality of life can deteriorate when military people spend excessive time away from their home station--such as for lengthy contingency operations. We are taking steps to ensure that DoD standards for length of deployments for service members are maintained, except for unavoidable circumstances. For example, I have directed the greater use of reserve forces to relieve active duty units that have excessive commitments.

MODERNIZATION/RECAPITALIZATION

The modernization of weapons and other systems is important to readiness, not this year or next, but 5 or 10 years from now. (Chart 15) To ensure that U.S. weapons will remain qualitatively superior to future adversaries, the new FYDP begins the recapitalization of America's armed forces--an undertaking that will continue well into the next century.

The drawdown of U.S. forces has allowed a delay in this recapitalization. As the force structure came down, the remaining units could be equipped with modern systems already fielded. But now we must now begin a new phase of modernization, in order to sustain the quality of the force over the long term.

Still, recapitalization will not require one-for-one replacement of major systems. Technology will help us find ways to do things better and smarter. We may not need as many systems. We should be able to sustain our equipment longer in the field by upgrading it with new technology. This will cost money as well, so in the end we need increased funding.

Resources for recapitalization will come from:

• Acquisition reform. We are confident that this will bring more efficiency, enabling us to lower the unit cost of buying new systems and lower the cost of sustaining those systems over their full life cycle.

• Reducing infrastructure. Base closures are the primary example of our efforts. By the end of this decade, base closings from 1988, 1991, and 1993 should yield savings of about $4 billion a year.

• Outyear real budget growth.

Before looking at that outyear growth, it is important to consider where we are today. Procurement of key weapons like ships, aircraft, and tanks are at historical lows. (Chart 16) Still, because of the force drawdown the average age of some key systems in the field has gotten better. (Chart 17) For battle force ships the average age of the fleet has dropped, as has the average age of ships retired each year. On the other hand, the average age of our tanks, fighter and attack aircraft, and surface combatant ships, while still in good shape, is increasing--reflecting the need to begin recapitalization. (Chart 18)

Requested budget authority for procurement in FY 1996 is $39.4 billion--which, adjusting for inflation, is a decline of 71 percent from FY 1985 and the lowest level since 1950. (Chart 19) Budget authority for procurement in FY 2001 is projected to be 47 percent higher than in FY 1996.

DEFENSE BUDGET TRENDS

This increase for procurement is reflected in our topline data. (Chart 20) For 1996 the President's budget requests $246.0 billion in budget authority and $250.0 billion in outlays. FY 1996 budget authority is, in real terms, 39 percent below FY 1985, the peak year for inflation-adjusted DoD budget authority since the Korean War. By FY 1997 the cumulative real decline since FY 1985 will reach 41 percent.

The continuing decline in defense spending is reflected in other budget trends. (Chart 21) As a share of federal budget outlays, defense expenditures will fall to 13.5 percent by FY 2000--half the share in FY 1986. (Chart 22) Defense outlays as a share of the Gross Domestic Product will fall to 2.8 percent in FY 2000--less than half 1980's levels.

CLOSING

In sum, President Clinton's FY 1996-97 budget preserves our nation's security robustly and at reasonable cost. (Chart 23) My department funded force readiness as its highest priority and used as its guide: People come first. Our plans support the right force structure for the right strategy for this post-Cold War era. And to keep those forces second to none, DoD plans begin their recapitalization.

The past year has confirmed again the importance of America's global leadership and military power. With that in mind, I look forward to working with all of you toward the goal we all share: preserving the readiness, quality, morale, and superiority of our nation's armed forces--a continuing source of great pride for all our citizens.

Defense Challenges

- Managing Use of Military Force in Post Cold War Era

- Preventing Reemergence of Nuclear Threat

- Managing Drawdown in Post Cold War Era

1

Managing Use of Military Force in Post Cold War Era

- Sustains force structure to support two nearly simultaneous MRCs
  - Nimble Dancer
- Maintains overseas presence
  - 300,000 Forces Deployed Overseas
- Provides capability to mount contingency operations
  - Vigilant Warrior
  - Uphold Democracy
- Ensures continuous readiness of forces

2

Basic Operational Concept for MRCs

- Forward Forces → Presence
- Rapid Projection of Blocking Forces → Mobility
- Allied Help → Coalition/Cooperation
- Apply Air Power/Technology/Intelligence → Technology/Modernization
- Overwhelming Counter-offensive Forces → Total Force

All Elements → Readiness !

3

Preventing Reemergence of Nuclear Threat

- Nuclear Posture Review
  - Hedge strategy
    - Retains nuclear deterrence
    - Ballistic Missile Defense
      - TMD
      - NMD
- Cooperative Threat Reduction
- Counterproliferation
  - North Korea Framework Agreement

4

BALLISTIC MISSILE DEFENSE

(Dollars in Millions)

	FY 1995	FY 1996	FY 1997
Budget Request	2,739.6	2,912.9	3,038.2

- Theater Missile Defense (TMD) continues to be highest priority.
  - Core TMD programs:

	FY 1995	FY 1996	FY 1997
Patriot Advance Capability Level-3 (PAC-3)	603.0	666.9	583.4
Theater High Altitude Area Defense System (THAAD)	624.1	589.9	740.9
Navy Area Defense (AEGIS/SM-2 Block IVA)	154.1	254.4	285.2

- National Missile Defense (NMD) technology program achieves readiness to deploy in a few years

	FY 1995	FY 1996	FY 1997
	390.0	370.6	399.0

COOPERATIVE THREAT REDUCTION

(Dollars in Millions)

	FY 1995	FY 1996	FY 1997
Budget Request	400.0	371.0	364.4

Primary objectives of cooperative threat reduction:

- Assist the former Soviet Union in destroying nuclear, chemical, and other weapons of mass destruction.
- Transport, store, disable, and safeguard weapons in connection with their destruction.
- Establish verifiable safeguards against the proliferation of such weapons.
- Facilitate demilitarization of defense industries and conversion of military capabilities and technologies.

Managing Drawdown in Post Cold War Era

- Maintains Force Structure
- Protects Readiness
- Ensures Quality of Life
- Plans for Recapitalization

7

Force Structure

	Cold War Base 1990	Base Force	1996	Projected Goal
Land Forces				
Army active divisions	18	12	10	10
Reserve Component Brigades	57	34	47 *	42 *
Marine Corps (3 Active /1Reserve)	4	4	4	4
Navy				
Battle force ships	546	430	365	346
Aircraft carriers				
Active	15	13	11	11
Reserve	1	-	1	1
Navy carrier wings				
Active	13	11	10	10
Reserve	2	2	1	1
Air Force				
Active fighter wings	24	15.3	13	13
Reserve fighter wings	12	11.3	7	7

* Includes 15 enhanced readiness brigades (equivalent to 5 + divisions)

8

DoD PERSONNEL
(End Strength In Thousands)

	FY 94	Change	FY 95	Change	FY 96	Change	FY 97	Goal
Active Military								
Army	541	-31	510	-15	495	-	495	495
Navy	469	-30	439	-11	428	-19	409	395
Marine Corps	174	-	174	-	174	-	174	174
Air Force	426	-26	400	-12	388	-3	385	382
Total Active	1,611	-88	1,523	-38	1,485	-21	1,464	1,446
Selected Reserves	998	-33	965	-38	927	-26	901	893
Civilians	901	-34	867	-38	829	-30	799	729

Current Readiness

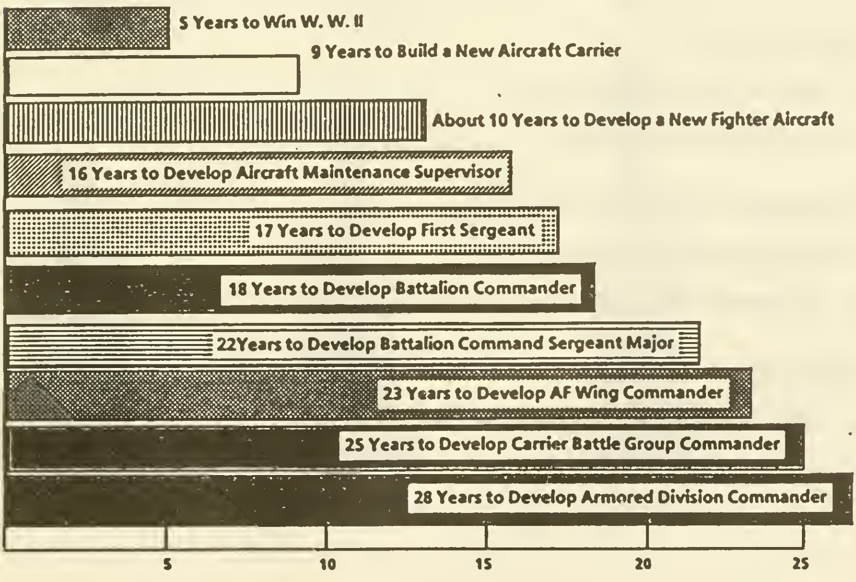
- CINCs report ready to execute current mission
- CINCs demonstrated readiness for current mission
  - Haiti
  - Iraq
  - Rwanda
- Statistical reporting system shows early deployers at historical high rates of readiness
- FY 1994 problems of late deployers to be fixed by April 1995

Future Readiness

- Budget protects readiness
  - Guidance made readiness first priority
  - President added $25 billion
- All Service Chiefs confirm FY 1996 budget fully funds:
  - Operational Training
  - Depot Maintenance for 2 MRCs
- Diversion of funds for unplanned contingencies would affect readiness
  - Emergency Supplemental
  - Readiness Preservation Authority
- Will Monitor readiness carefully and continually
  - SROC/JMRR
  - MBWA

11

PEOPLE, OUR MOST IMPORTANT ASSET



12

Keeping Quality People

- Train realistically
  - 12 NTC Brigade rotations per year
  - Red Flag exercise
  - Bright Star exercise
  - Roving Sand exercise
- Deploy on real missions
  - Vigilant Warrior
  - Uphold Democracy
- Reenlist Families

13

QUALITY OF LIFE PROGRAMS

COMPENSATION

- Fully funds legal pay raise
- Protects medical benefits

COMMUNITY AND FAMILY SUPPORT

- 20 new child care/day care centers
- 18 recreation/fitness centers and chapels

HOUSING

- 13% increase in housing dollars per active duty (FY 1996 over FY 1994)
- Will propose housing initiative

14

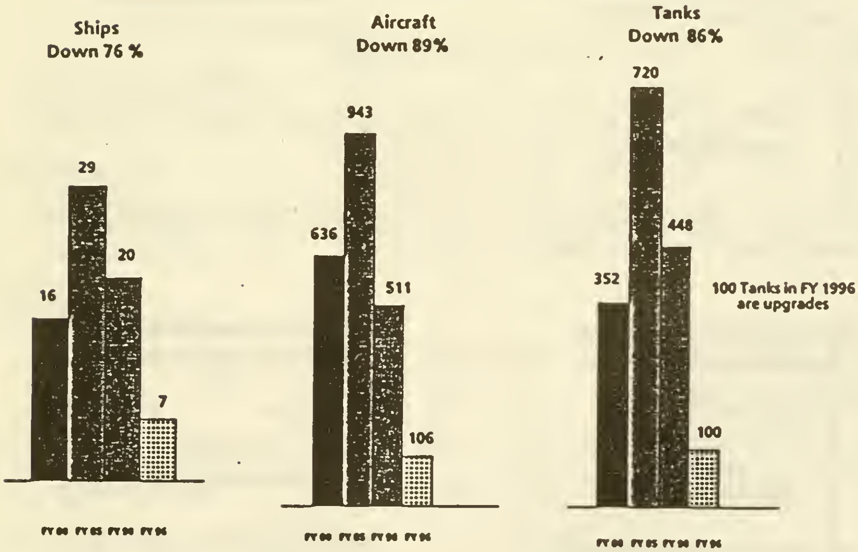
MODERNIZATION/RECAPITALIZATION

- Force drawdown has allowed delay in recapitalization
- Modernization rate will require increase to sustain force over long term
- Recapitalization will not require one-for-one replacement
- Resources from:
  - Acquisition reform efficiency
  - Reducing Infrastructure
  - Outyear real budget growth

15

perry

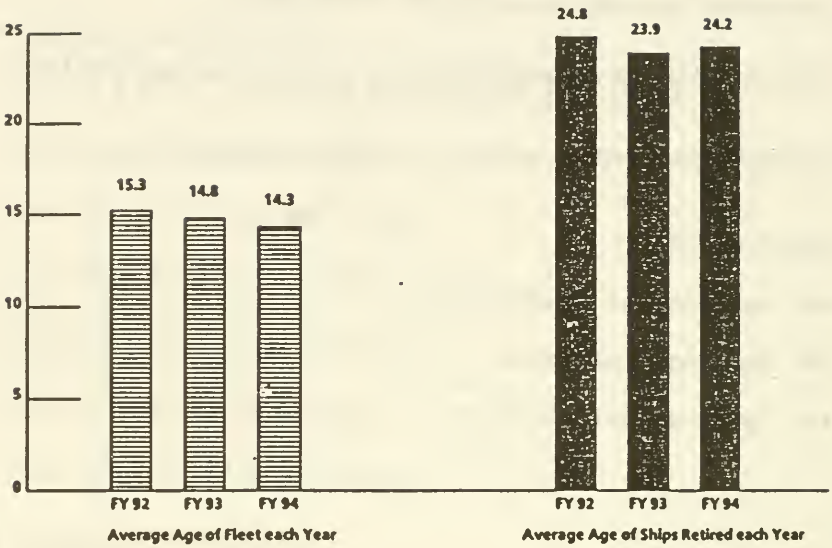
Historical Procurement Trends



16

DoD Battle Force Ships

(Age of Fleet vs Age at Retirement)



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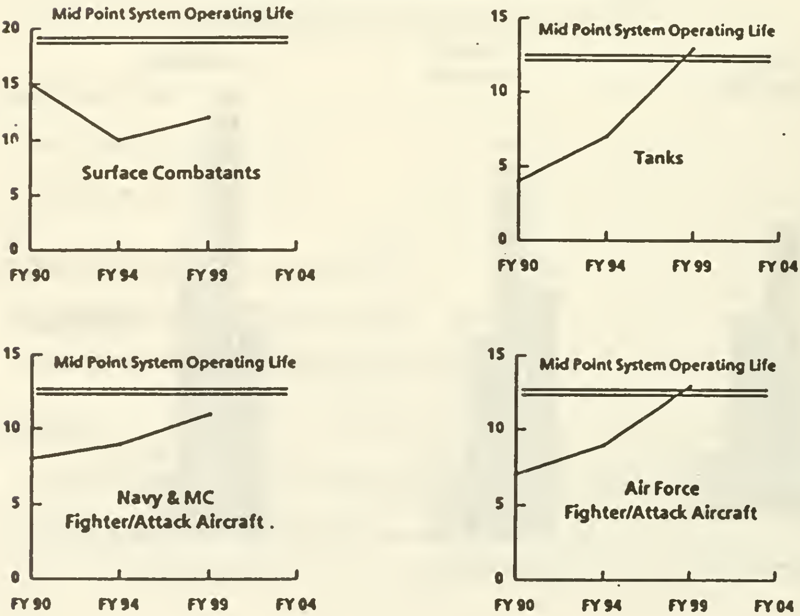
Average Ages of Selected DoD Weapons



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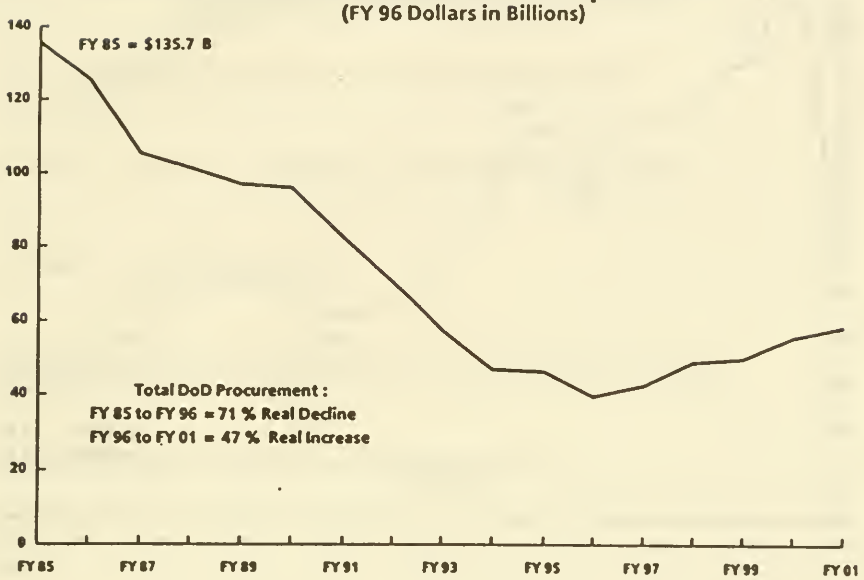
Defense Procurement Recapitalization

(FY 96 Dollars in Billions)



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NATIONAL DEFENSE TOPLINE

(Current $ Billions)

	1995 *	1996	1997	1998	1999	2000	2001
BUDGET AUTHORITY							
DoD military - 051	252.6	246.0	242.8	249.7	256.3	266.2	276.6
DoE & other	10.9	11.8	10.6	9.9	9.9	9.9	9.9
Total national defense	263.5	257.8	253.4	259.6	266.3	276.0	286.5
% Real change	-1.9	-5.3	-4.1	-0.1	-0.2	+ 1.1	+ 1.2
OUTLAYS							
DoD military - 051	260.2	250.0	246.1	244.2	249.6	257.9	261.6
DoE & other	11.4	11.4	10.9	10.3	10.0	9.9	9.9
Total national defense	271.6	261.4	257.0	254.5	259.7	267.8	271.5
% Real change	-5.4	-6.6	-4.4	-3.6	-0.6	+ 0.6	-1.2

* Assumes FY 1995 $2.6 supplemental

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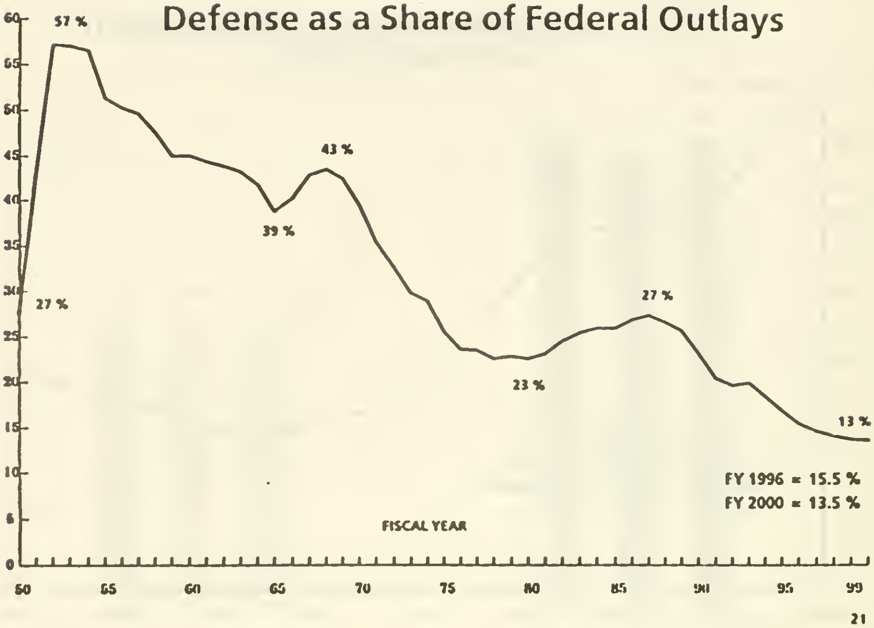
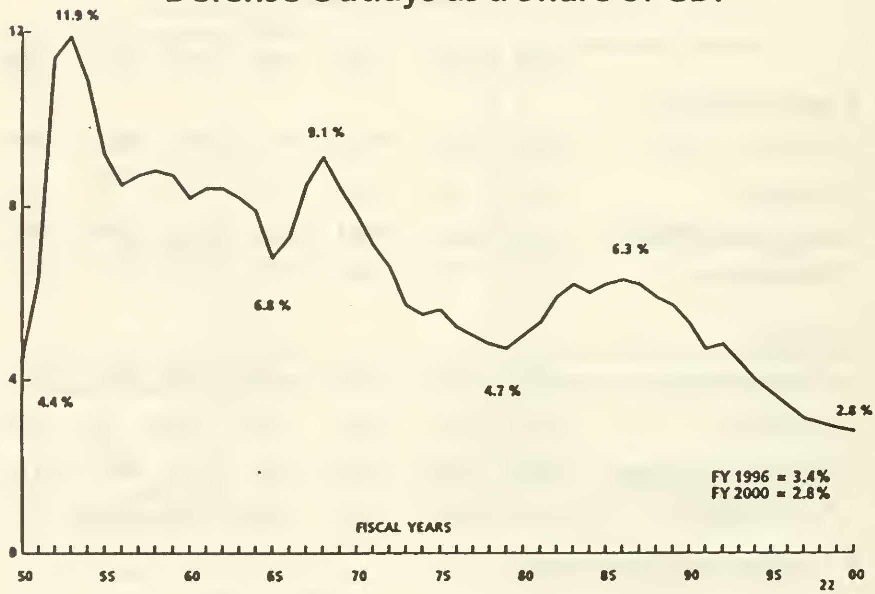
Defense as a Share of Federal Outlays



Defense Outlays as a Share of GDP



Overall Budget Assessment

This budget preserves our national security

- DoD funded readiness as its highest priority;
  - People come first
- The right force structure for the right strategy
- DoD plans outyear recapitalization

Chairman DOMENICI. Let me just say to the committee members who arrived shortly after I made the announcement, we are going to let them both go first. They have agreed to make their testimony brief. Then we will start the questions.

General please proceed.

STATEMENT OF GENERAL JOHN M. SHALIKASHVILI, CHAIRMAN, JOINT CHIEFS OF STAFF

General SHALIKASHVILI. Mr. Chairman, thank you very much for giving me the opportunity to state my view on the state of America's Armed Forces and to reinforce some of the points that Secretary Perry just made.

Now, looking back over this past year at events in Bosnia, in Somalia, in Rwanda, and Haiti, the challenges in the Gulf, and in Korea, and everything else that our Armed Forces have been involved in, it has, of course, for us been a difficult and demanding year. And there are some lessons from that year that are worth mentioning.

What stands out foremost is the caliber of the men and women in our Armed Forces. There is no need to chronicle everything that they have done in the places that Secretary Perry and I have just mentioned. You know what they have done, and you know how extraordinarily well they have done it. The certain lesson is that they remain our most precious asset.

The second lesson we learned is that we are in an era in which we are going to have to retain a very powerful and a very ready military force. Only 4 months ago, at a time when we were only 3 weeks into our operation in Haiti, several of Saddam Hussein's readiest divisions bolted very suddenly from their garrisons and began a very threatening movement to the south towards the border of Kuwait. A rapid decision was made to order our forces to deploy to the region to position themselves to block yet another attack on our Gulf ally.

Once the order was given, an amphibious-ready group was in position in 1 day. Two days after this, the George Washington carrier battle group had moved from the Adriatic to the Red Sea, and an army mechanized infantry brigade had deployed to Kuwait to draw its pre-positioned equipment. Seven days after the order, 121 aircraft were on station, and in 15 days, an Army task force had joined the infantry brigade and was ready to fight using equipment that had been placed in prepositioned ships. No sooner had our forces began arriving than we watched Saddam Hussein's divisions first slow, then halt, and then return back north to their garrisons.

The warning I think was very clear. What stood between Iraq's division and our ally was the readiness of our forces to deploy over extended distances very rapidly.

This past year has given us a snapshot of another lesson that we learned—that is, uncertainty. And we found out that uncertainty is exploding nations such as Yugoslavia, Rwanda, and Somalia; it is Russia, still struggling to progress on a path of reform, but with events like Chechnya, leaving Russians and Americans alike wondering whether the struggle for democracy was going to succeed.

Uncertainty is also nations like North Korea and Iran threatening their neighbors and threatening attempts to control weapons of mass destruction. And the reality is that we are going to be worrying about uncertainty around the globe and about the course of reforms in Russia and Eastern Europe for some time to come. So we are going to have to preserve a strong military. We are going to have to remain ready for the unexpected.

There is a third lesson from this past year as well. The events of this period validated the strategic planning that framed the Bottom-Up Review. We were correct to choose Korea and Southwest Asia as the places where we might face two nearly-simultaneous regional contingencies. This year, we saw tensions in Korea reach a very dangerous stage, and as I already noted, we actually deployed forces to Southwest Asia.

But there were many times during the year when we were balancing very serious tensions in two or three different theaters simultaneously. Our deployment to Southwest Asia occurred in the midst of our operations in Haiti and certainly, as you look at all these events this past year, proved the necessity to be able to fight and win in two nearly-simultaneous regional conflicts.

But I think for some, a very legitimate question is whether the force recommended in the Bottom-Up Review and in this budget is large enough and powerful enough to fulfill this strategy.

While some further analysis is still ongoing, the Joint Chiefs, the CINC's—the war-fighting commanders out in the field—and I have been involved in an effort of many months to include analytical analysis, assessments and war games, to include a just completed, 2-day-long conference, all under the name of Nimble Dancer. And based on this extensive work, the Joint Chiefs and I share the view that as we field the enforcement identified in the Bottom-Up Review, we will, in fact, be able to fight and win two nearly-simultaneous regional conflicts with an acceptable risk; that is, the force, we believe, is large enough if we invest in enhancing the force and if our units stay ready and continue to be manned with the same high quality of people that we have in uniform today.

To this end, our highest priority, as Secretary Perry mentioned, must remain retaining these extraordinary men and women and recruiting more like them.

As Secretary Perry already stated, included in this budget is a request for additional funding, the start of a $25 billion increase that will be added over the next 6 years. Part of the $25 billion will go towards improving the pay and quality of life that we offer our people.

Much has been said about the readiness of our force, and rightfully so, for none of us wants to see a return to the hollow forces of yesteryear. Several months ago, when some of our forces, to include three Army divisions, reported that their readiness had declined, it raised questions in the media and here in Congress about the overall readiness of our forces. I would like to place that incident in context and offer my views on the state of readiness today and projected for tomorrow.

The reduced readiness of those units was a direct consequence of the operations and maintenance funds that had to be diverted to pay for unexpected contingency operations. As a result, the unit commanders were compelled to cancel important training and to defer needed maintenance on their equipment, which caused their readiness ratings to sag. This was a very predictable outcome, and we did, in fact, predict in advance that unless we supplemented these accounts in time, there would be readiness problems. I am gratified that when these problems did occur, our commanders did call them honestly.

Today, the Department, the Joint Chiefs, the CINC's and I are watching readiness more closely and in more ways than at any time that I can remember. As the Secretary already mentioned, he has established a monthly Senior Readiness Oversight Council. We have also formed a joint readiness review consisting of senior military leaders that occurs monthly, as well, to examine the state of our readiness. And while the service continues to measure the readiness of our units, we have developed and begun to implement a joint readiness system that allows us for the first time to examine the readiness of our forces to perform joint operations.

What these more extensive and better focused reviews, all of which are based upon readiness data submitted by commanders in the field, what they indicate is that today the readiness of our forces deployed and those designed first to fight continues to be high. One of the three Army divisions just mentioned will soon regain its former readiness rating, while the other two divisions are starting their scheduled inactivations. The readiness of all other forces is essentially at historic levels.

There is one other point I would like to note about readiness. There is some concern that recent contingencies and deployments have degraded the readiness of our units and crews that we have sent to perform these missions. Again, I would like to put this in perspective.

Very often when we send units to these operations, although it means that they will not participate in the normal peacetime training cycles, it does not necessarily mean that the unit is not going to do the right kind of training.

For example, when a carrier is sitting in the Red Sea to deter Iraq, its pilots and crew are experiencing the best training possible, and certainly there is no degradation of their skills. But there are some deployments, such as the mission that the 10th Infantry Division was doing in Haiti, where over time the unit could lose its edge for its most important mission, that of being able to fight and win our wars.

In those cases, we try to rotate units through, as we have just done in Haiti, by replacing the 10th Division with the 25th, so that we can return the 10th Division to proficiency in its war-fighting skills.

But, regardless, prolonged and dangerous deployments do put great strains on our families. That is yet another reason why the improvements that Secretary Perry detailed when he explained why we need an additional $25 billion are so very critical. When our forces deploy, we owe it to our men and women that they can feel comfortable that their families left behind are safe and well cared for.

Now, what concerns me as much as our near-term readiness is our need to ensure our long-term readiness. And by this I am referring to modernization and the fielding of enhancements that were part of the Bottom-Up Review. The past 8 years of declining budget outlays caused the cancellation, the stretch-out, or rescheduling of many of our modernization programs. As Secretary Perry said, the end of the cold war justified a number of these actions, because we were left with a large inventory of modern equipment that we purchased in the 1980's that in many areas will see us through the end of the century. But that time is now fast approaching.

Over the past few years, we restructured our modernization plans, streamlining as we did so, to both ensure that our forces remained technologically unmatched and to ensure that we don't reach a point where vital systems become obsolete or too expensive to maintain or are simply worn out by age. To prevent this, we have to follow through on our needed modernization programs.

Moreover, the heart of the Bottom-Up Review was to reduce our forces, but also to compensate for these reductions by enhancing the capability of our smaller forces, making them faster to deploy and ounce-for-ounce more capable and effective once they arrive. Included among these enhancements: more strategic lift; pre-positioned equipment sets in selected forward locations; improved and expanded command, control, communications, and intelligence systems; and an increased number of long-range precision systems and munitions.

These enhancements have to be fielded. We have to stay the course, because without these enhancements, the risk to our forces could very well become unacceptably high. Thus, our challenge now is to balance today's readiness with the need for investment in the future. We must make prudent investment in modernization if we are to ensure that tomorrow's readiness is equal to tomorrow's challenges.

With that, I thank you very much, Mr. Chairman, and I believe Secretary Perry and I are prepared for your questions.

Secretary PERRY. Mr. Chairman, I would point out I also have Dr. Hamre with me, and the three of us are prepared to answer your questions.

Chairman DOMENICI. Thank you very much, General Shalikashvili.

[The prepared statement of General Shalikashvili follows:]

JOINT

CHIEFS OF STAFF

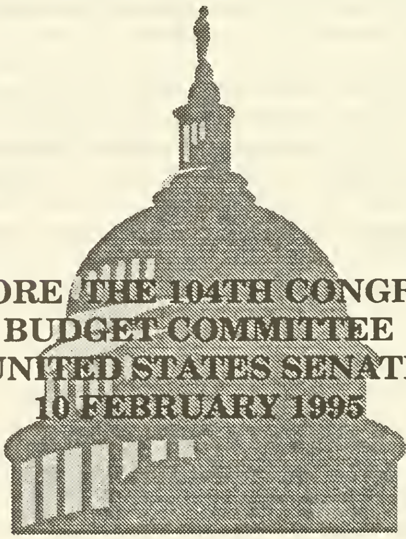
POSTURE STATEMENT

BY

GENERAL JOHN M. SHALIKASHVILI

CHAIRMAN OF THE

JOINT CHIEFS OF STAFF



BEFORE THE 104TH CONGRESS

BUDGET COMMITTEE

UNITED STATES SENATE

10 FEBRUARY 1995

I am pleased to be here today to share my views about the state of our Armed Forces.

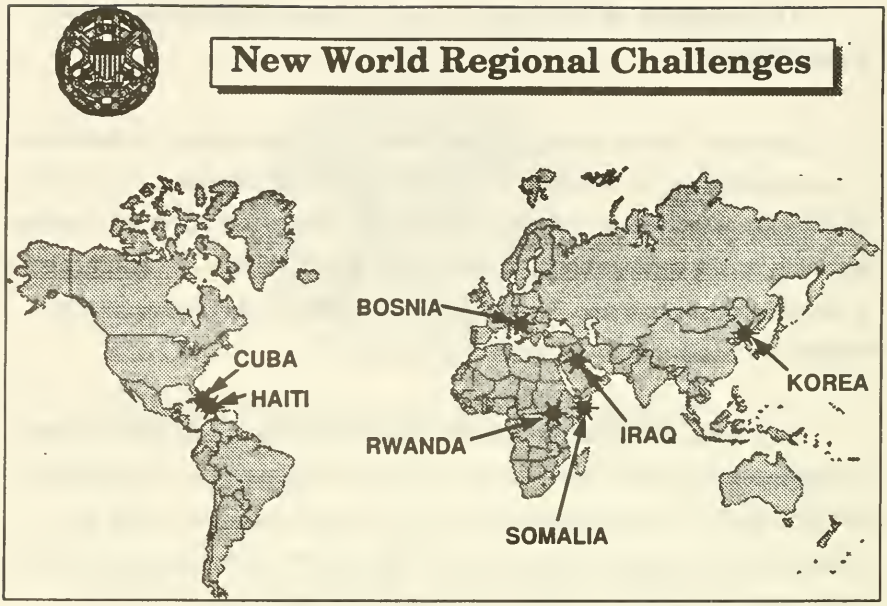
Last year, I remarked that our discussions were set against the backdrop of a serious debate. At that time, some believed that our defense budgets were still too high, while others were convinced we had already cut too much. Twelve months later, the debate seems to have gained added stridency. It also appears to have found a new center. The question we seem to be asking this time is whether we've added enough back in.

Ever since we began this still ongoing round of reductions, all have been mindful that every time in this century America has drawn down, we blundered and did it badly. This happened after the First and Second World Wars, after Korea, and after Vietnam. Each time, after ignoring the warnings of past failures we repeated the same remorseful cycle: we cut too deep and we reduced too fast. Not long afterward we regretted it dearly.

So we need this debate and it should be vigorous. We must not repeat the tragedies of the past. I only hope that what I have to offer is helpful as you make decisions on the issues before you.

Looking back over the past year, at events in Bosnia, Somalia, Rwanda, Haiti, the challenges in the Gulf and Korea, and everything else that our forces have been involved in, it has been a difficult and demanding year. What have we learned from this year? I think there are three distinct lessons worth your attention today.

What stands out foremost is the caliber of men and women in our Armed Forces. There is no need to chronicle everything they've accomplished in all of the places just named. You know what they've done and you know how extraordinarily well they've done it. They remain our most precious asset.



But dwell for a moment on the great magnitude and complexity of tasks we asked of them. In the last year, the Transportation Command executed the equivalent of five Berlin airlifts. At one time or another, four nations depended on our forces for humanitarian supplies. At Guantanamo Bay and Panama, we constructed tent cities and kept their populations clothed and fed. In Rwanda, it took our forces less than three weeks to build an airbridge into one of the world's most remote and underdeveloped regions and deliver enough clean water, food and medicines to push back the flood of dying.

Many of these operations were dangerous. Twice, we deployed major forces for combat operations. The first was to Haiti, when in a tense evening we launched an invasion just as a last-ditch diplomatic effort became hopelessly stalled and on the verge of failure. In a "remarkable" turn of events, the moment that Haiti's rulers were alerted that our forces were in the air and heading their way, our negotiators watched three years of defiance rapidly melt away and a bloodless transition to democracy was promptly arranged. This was the first time in our history that we launched an invasion and then recalled it in midstream. As the Secretary of State remarked the next morning, it would be hard to imagine a more exquisite marriage between diplomacy and force. It would be even harder to imagine a more suspenseful marriage.

Then, only three weeks later, we detected three of Saddam's divisions bolting from their garrisons and maneuvering toward Kuwait. Without hesitation, we alerted a large combat force and almost overnight began deploying that force with orders to fight, if necessary. Again, in a dramatic turnabout, as the first of our forces moved swiftly into theater, we watched Saddam's divisions first slow, then halt, and then hurriedly reverse direction and return to their garrisons. It was a striking illustration of successful deterrence at its best; swift decisions, a powerful response by ready forces, and such rapid execution that we were there before the breach was made.

Not since the Second World War have we engaged in so many operations in such a condensed period. At times, up to six separate Joint Task Forces were in the field. To make this happen took an unprecedented degree of decentralization. As well, the unique character of many of these operations diluted the advantages normally afforded by our superior equipment and advanced technology. What separated success from failure came down to one vital ingredient. That was the remarkable qualities of our people: superb and thoughtful leadership; and courage, grit, and improvisation at all ranks.

We often talk about how great our military is. It is indeed great, in fact, the very finest in the world. This past year, our men and women demonstrated precisely why they deserve this reputation.

Then, there was a second lesson. Several years ago, when we first referred to uncertainty as a threat, one member of Congress pointedly asked, "And just how many tanks does uncertainty have?" It was a shrewdly couched question that penetrated to the core of our quandary. Every year, for half a century, we grew used to generals and admirals coming here to the Hill and pointing with complete confidence at the same habitual threat, a threat we grew to know and understand in great detail.

Yet, even with such complete confidence and clarity, we still debated at length about what we needed to defend ourselves. How could we possibly measure and agree on our needs against something as shadowy and fathomless as uncertainty?

We still may not be any closer to knowing how many tanks uncertainty has, but the past few years have shed some light on its shadows. It is unstable, violent and dangerous, with a large arsenal of exploding nations, ethnic outbursts, and clashing nationalisms. Caught in its grip are several powerful nations struggling to remain on a path of reforms, right beside dozens of smaller, newly founded, and threadbare nations simply struggling to survive. And from this uncertainty are other nations building, or trying to build, weapons of mass destruction. We also now understand that this uncertainty is not going to go away quickly: it is going to be with us for a while, perhaps well into the next century.

For Americans, there is this reality: out of the stream of events unfolding around us, an entirely new world order is being forged. We are experiencing the kind of enormous upheaval that comes only once every few generations.

And from this comes the third lesson. The profusion of Operations Other Than War (OOTW) has elicited a stream of ideas about how to restructure or reorient our forces specifically for this purpose. This would be wrong. We cannot become confused about the fundamental purpose of our Armed Forces. That purpose is their readiness to fight and win our nation's wars. No other purpose is as vital to our security. As we reshape and train our forces, it must be for this purpose above all others.

It is an often quoted fact that throughout our nation's history no man or woman has ever completed a 20-year military career when this nation did not engage in armed conflict at least once. In the past eight years, no man or woman has even completed a term of enlistment without this happening.

The warning is clear. Our forces must stay ready to fight and win.

THE FUTURE FORCE

Since 1991, we have been through four exhaustive assessments of how many and what kind of forces we need. Most recently, the size and mix of our conventional forces was established through the Bottom Up Review, and the even more recently completed Nuclear Posture Review established our strategic force posture for entering the next century.

While the process of finding a new endpoint attracted the lion's share of the public's attention, a great deal more has been done to reorient our forces and to reorder the other elements of our defense. A new military strategy was developed and is now in its second stage of refinement. New approaches to readiness, sustainment, and modernization have been implemented. All of the Services have adapted their doctrines and are well on the way toward adapting their forces to the challenges of a different world. And the progression of jointness has accelerated.

Within the strategic nuclear area, we have already cut our investment by some 75%, made major changes in our alert posture and weapons targeting, and are well into a major force reduction as we move toward START limits.

Driving these changes is our response to three revolutions that are sweeping us into the next century. The first of these is the changing world order set in motion by the end of the Cold War. This has caused profound changes to our strategy, our military posture, our missions, and our doctrines.

We have shifted from a global strategy against a global foe, to a global strategy focused on regional threats. We are nearly done repositioning large numbers of our forces and are still in the process of prepositioning equipment and warstocks to align with this new strategy. Significant numbers of forces have returned home from their overseas Cold War garrisons to support a new global power projection strategy. Our force building priorities have been reordered to meet our new needs. At the same time, we are adjusting our overseas force -- around 100,000 in the Pacific and approximately 100,000 in Europe -- to help preserve stability in these two vital regions as well as retain forces an ocean closer to potential trouble spots. We have begun reorienting our alliances to new challenges. For example, in NATO, we have developed and implemented the Partnership For Peace (PFP) Program, an active program to reach out to our former adversaries through military-to-military contacts, and have opened International Military Education and Training (IMET) to foreign militaries of many of the same nations. These programs are invaluable for building new security architecture in a Europe that was divided for forty-five years and in emerging democracies worldwide. All of this is being done in response to this first revolution: the changing world order.

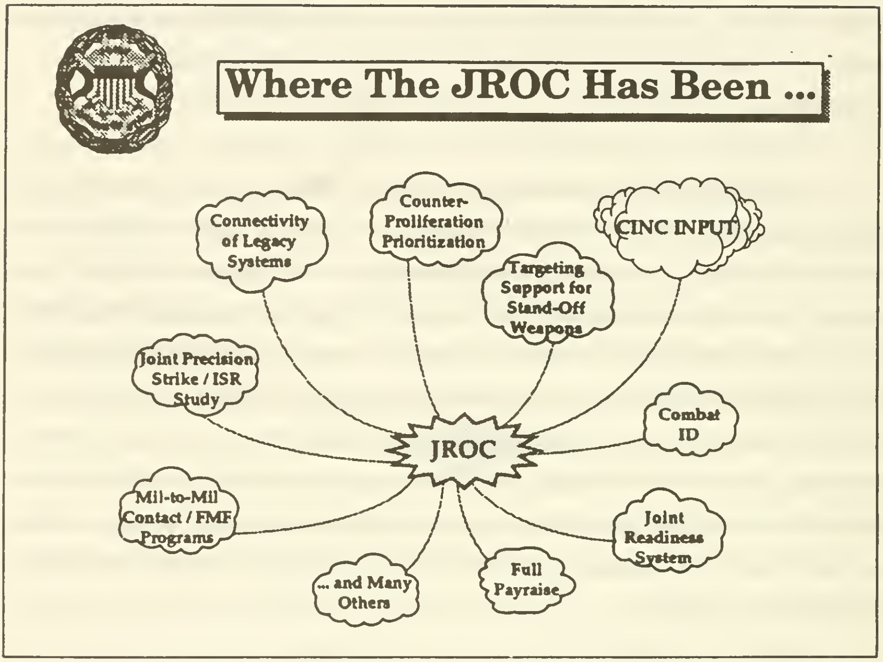
The second revolution is the result of defense budget outlays that have been shrinking for eight consecutive years. It is not just the fact that our budget has been shrinking. This revolution is framed by the fact that by 1999 our force will be one third smaller than it was in 1988, but in real terms our budget will be around 40% less than what it was that same year.

What these figures suggest is that we are going to have to be revolutionary in our thinking and in finding new ways to lead and manage our forces. We are going to have to look for every feasible way to do our business more efficiently, whether that is how we procure our equipment, how we house and care for our forces, or even how we use our forces to accomplish our missions.

In response, we are pursuing a number of initiatives, mostly through greater jointness. The joint reforms that Congress ordered back in 1986 have been implemented. Due largely to assistance from the Congress, another proven tool for maintaining and improving our joint warfighting capabilities is the Joint Professional Military Education (JPME) Program. Our Unified Commands are now staffed with the best-educated men and women we can offer, fully versed in the joint arena, and able to effectively combine the unique capabilities that each of our Services has to offer. JPME has become one of the foundations of our joint operations capabilities by producing officers who can respond rapidly to short-notice crises as well as develop visionary strategies -- leaders who think creatively and critically.

This year, we established the Joint Warfighting Center as the locus of world-wide joint exercises and joint simulations. This new center will support our CINCs in continually refining joint exercises and training through the use of joint simulations that improve the readiness of our commanders and staffs.

We are now carrying the same spirit embodied in Goldwater-Nichols to spearhead new ways of looking at our warfighting responsibilities. The Vice Chairman of the Joint Chiefs and the Vice Chiefs of the Services meet weekly as the expanded Joint Requirements Oversight Council (JROC). The JROC cuts across compartmentalization and traditional service turf to examine every battlefield and strategic function, to look for ways to employ our forces more efficiently and effectively, and to determine the best way to spend our precious research, development, and acquisition dollars to modernize and improve our existing forces.



One of the most important products of this expanded JROC is the sharing of ideas and technologies and the imposition of joint interoperability standards. Another product is that our Services are working together to build common and mutually supportive approaches. The result will be a future force that is more and more streamlined by jointness.

In the Gulf War in 1991, our forces had very few joint manuals to guide their efforts. Today, we are publishing new doctrinal manuals at a rate of four per month. In the Haiti operation, our invasion force included Army forces and Army helicopters poised on Navy carriers. Remembering back to Grenada, where Army helicopters were at first not even permitted to land on Navy carriers, you can appreciate the magnitude of cultural change. But it remains, and I suspect it always will remain, a work in progress.

Another way we are adding effectiveness is to continue to examine how we divide the roles, missions, and functions between our forces. By next summer, the Congressionally-mandated Commission on Roles and Missions is scheduled to report back to Congress. As news accounts have accurately reported, the Services, the CINCs, and the Joint Staff are working with this commission and providing candid views and analysis about what should and should not be changed.

Then there is the third revolution, which runs counter to all of the downward pressures exuded by the second. This one is the battlefield revolution that we ourselves ignited with our doctrinal and technological innovations. The Gulf War showed a snapshot of this revolution in progress.

What we set in motion is an entirely new era in warfare. It is not a quickfire revolutionary change catapulted by any one invention or one idea. Instead it is a quickly moving progression of advances across a broad front of concepts, technologies, and functions. The radar evading technologies of a few squadrons of stealth aircraft are spreading to other systems. Our inventories of long-range precision weapons are growing. Faster, more capable computer chips, digital systems, and other advances are creating staggering improvements that effect every function of modern battle. The combination of what is being done in military research and development in our partnership with civilian industry and their laboratories is creating a host of promising technologies. Our improving capabilities to fight at night and in poor weather, and our dominance in space that ensures that our commanders have extraordinary situational awareness, are giving our forces the ability to drive the tempo and depth of battle beyond the endurance and capability of any potential enemy. What is changing is the very nature of modern battle.

As we proceed into the next century, in one way or another, it is these three revolutions that drive our every effort.

FORCE STRUCTURE

The force recommended in this budget bases its size and capabilities on the National Security Strategy. That strategy calls for a triad of strategic nuclear forces, and a mix of strategic and non-strategic nuclear systems positioned at home and deployed overseas, of sufficient size and capability to deter any future hostile nation with access to nuclear weapons from using these weapons against our interests. That strategy also requires us to be able to fight and win two, nearly simultaneous, major regional conflicts. The past year has thoroughly validated this "two MRC" requirement.

Each time when we were on the verge of committing forces to a contingency, foremost on our minds was looking over our shoulders to ensure that the remainder of our forces were ready and postured in the event a conflict erupted elsewhere. Early in the year, tensions with North Korea rose to such a point that they could only be described as edging toward war. Later in the year, we actually had to deploy forces against Iraq. Aside from validating that we were right to select these two nations as the current adversaries for our two contingency force, this past year also validated the plausibility that we could find ourselves enmeshed in two nearly simultaneous regional conflicts. Many times, we were balancing tensions in two or three different regions at once. Even though Haiti was not a major conflict, we were in the midst of that operation when we sent our forces to protect Kuwait. Anybody who sat in my chair this past year wouldn't have any reservations whether or not the requirement for "two-MRCs" is the right strategic choice. We cannot afford less.

But even as you accept that this is so, you might still question whether the force size is right. Should it be larger? Could it be smaller?

U.S. Force Structure

Forces	FY 1990	FY 1993	Bottom-Up Review
Army			
Active Divisions	18	14	10
National Guard Division Equivalents	10	6 (+2 Cadre)	5+
Navy			
Aircraft Carriers	15 + 1	13 + 0	11 + 1
Active/Reserve Airwings	13 / 2	11 / 2	10 / 1
Ships	546	443	346
Air Force			
Active Fighter Wings	24	16	13
Reserve Fighter Wings	12	12	7
Marine Corps			
Active Endstrength	197,000	182,000	174,000
Reserve Endstrength	44,000	42,000	42,000

I am confident that the force and capability objectives we are building toward are about right. Once we reach the force and capability objectives, and field the enhancements that came out of the Bottom Up Review, we will be able to fight and win two nearly simultaneous regional conflicts at an acceptable risk.

On the other hand, I am convinced that a smaller, less capable force would most probably suffer unacceptable casualties, our forward deployed forces would be extremely vulnerable, the allies we are committed to protect could experience far greater damage, and a great deal more time and mobilization would be required to build to the force levels needed to win.

These are "risks" that I believe we must avoid. The force recommendations that emerged from the Bottom Up Review, with its programmed enhancements, decreases these "risks" and I would not recommend anything smaller.

With the previous, larger Base Force, the Joint Chiefs, the CINCs, and I were convinced we could support a reasonable number of Operations Other Than War, such as peacekeeping and sanctions enforcement operations, and still have enough additional forces to fight and win two MRCs. But the smaller force that emerged from the Bottom Up Review eliminated this latitude. Under ordinary conditions, there will be enough forces to perform Operations Other Than War. But in the event we become involved in a major conflict, we will have to withdraw our forces committed to Operations Other Than War in order to restore our posture to respond to a second major conflict. That is about as lean as I believe we can afford to be.

This past year we also completed the Nuclear Posture Review, that thoroughly examined our strategic and non-strategic forces, and the capabilities needed to support the maintenance of an effective and credible nuclear deterrent. It reaffirmed the importance of a strategic Triad, the need to keep some non-strategic nuclear forces deployed overseas to protect our allies, and it outlined an affordable and sustainable strategic nuclear force structure which will be in compliance with the expected future implementation of START II. It also identified cost-saving changes in our non-strategic nuclear force posture, necessary improvements to our C4I infrastructure, and a series of measures to promote the safety, security, and reliability of our nuclear stockpile.

Post START II
Force Structure 2003

- **SSBNs**
  - **14 SSBNs (retire 4)**
  - **All with D-5 missiles**
  - **Retain 2 bases (Kings Bay and Bangor)**
- **Bombers**
  - **66 B-52s (28 fewer)**
  - **Non-nuclear role for B-1**
  - **No more than 20 B-2s required for nuclear mission**
- **ICBMs**
  - **Maintain three wings of Minuteman III ICBMs (500/450 missiles)**

While our nuclear forces are substantially smaller than they used to be, no other part of our forces is as vital. We must continue to make the investments needed to maintain these forces at the right levels and with the right capabilities to deter the worst threats to our nation. There are still tens of thousands of nuclear weapons in the hands of other nations today. Over the long term, both our survival, and our ability to contend with conventional threats to our interests depend on a strong and well-maintained nuclear force.

The key watchword of our force plans is balance. All of the key elements of our forces -- people, readiness, modernization, force structure, sustainment, and our infrastructure and industrial base -- must be maintained at the right scale to support the whole force. The sum will be no stronger than its weakest part. For example, readiness without adequate sustainment sentences any operation to a very short half-life. As we continue toward the future, we must maintain balance among the critical elements of our forces. But we also have to balance today's readiness needs against tomorrow's, and modernization is the linchpin of this future readiness.

PEOPLE

Of all the elements of our force, none is more important than our people. It is never the best tank that wins wars, it is the best tankers.

Today, we have extraordinary people in our ranks. It was their ingenuity that overcame the obstacles that were defeating the relief agencies in Rwanda; their discipline and intellect that have made the Haiti operation far more successful than many anticipated; and their courage and fighting prowess that caused Saddam's divisions to turn back north to return to their garrisons.

But we can't afford to be sanguine. In the past few years we have put great strains on our people. The pressures and separations of so many operations have been hard on them and hard on their families. At the same time, we were "down-sizing," through a combination of voluntary and involuntary separations that proceeded by the thousands nearly every month since we started. Since 1991, we have reduced by some 625,000 uniformed military and nearly 177,000 civilians.

Fortunately, the Congress has broken the cruel pattern of past drawdowns by offering our people better separation benefits than in the past. Between separation allowances and early retirement packages, this time around we have been able to at least soften the blow to the men and women who served this nation so very well for so many years and then suddenly had to be told that their service was no longer needed.

What we need to do now is focus our attention on keeping the million and a half men and women who remain with us today, and attracting people of the same quality for our force of the future. This is our highest priority.

The President's recent decision to request $25 billion more over the next six years will help fix some of the problems that I believe are most troublesome. It will fund pay raises that slow the growth of the pay gap. But it will not bring military pay to levels of "comparability" with the civilian sector. The increase also begins correcting another key concern: our obligation to ensure our people live in safe and affordable housing. For those forced to live off-base, this means fixing another pay problem: the Basic Allowance for Quarters. Our policy is to reimburse our people 85% of the costs of their off-base housing; today, we fail to reimburse even 80% of those costs. I fully support the legislation that will allow us to begin reducing this gap, starting with a 1% reduction this year. For those living on-base, we are taking steps to reduce the large backlog of deferred housing and barracks maintenance. Part of the $25 billion increase will go toward renovating some 5,000 barracks spaces most in need out of the over 600,000 barracks spaces we own.

Today, we are dipping into the pockets of our men and women, and their families, by making those who are forced to live off-base absorb more of the costs than they should, and by failing to ensure that some of our military bases and facilities are maintained at proper standards. As we anticipate future spending increases, we must continue to put additional funds into the programs that benefit our people; adequate and fair compensation, steady and dependable medical benefits, a stable retirement system, and safe and affordable housing. If we continue the long decline that we started in these areas over a decade ago, we will find it more and more difficult to attract and retain the remarkable people we have in our force today.

READINESS

In the last quarter of 1994, in order to find funds to support our forces deployed to contingencies, the Army leadership took operations and maintenance funds from three later-deploying divisions. This forced the commanders of these three divisions to make hard choices. They canceled some major training events and imposed constraints on repair parts. As a result, these three Army divisions reported that their readiness had degraded to the point that they would need additional time to train to acceptable standards before they could be deployed.

Aside from the fact that this was an undesirable way to learn this point, among other things this incident proves that our readiness "checks and balances" are working. First, as I promised you in last year's testimony, our commanders will honestly apprise you when readiness problems develop. That is exactly what happened in this case, and I was gratified to see that the Administration and Congress responded with speed, concern, and the necessary resources to address the problem.

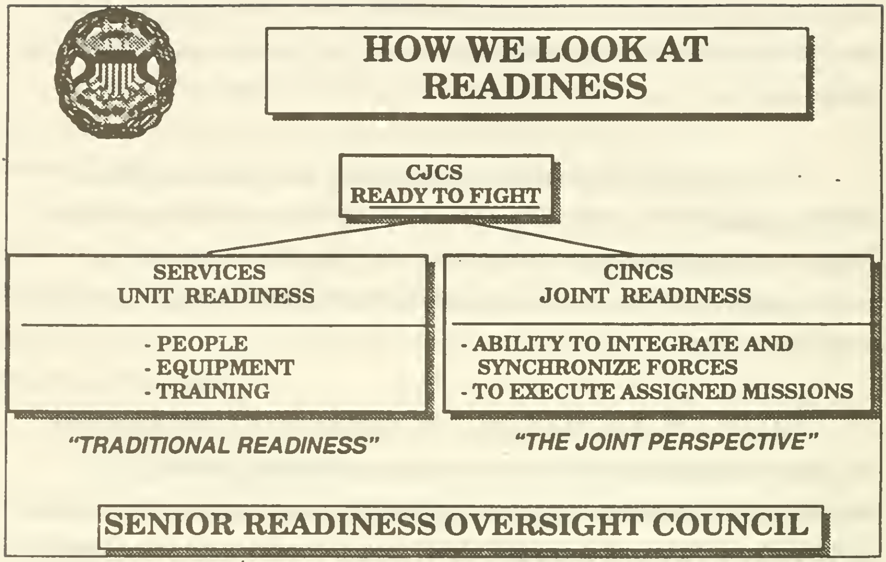
Secondly, last year, I pointed out the pitfalls of diverting from service operations accounts to pay for contingencies. I also promised you that we would do our best to predict readiness issues before they become a problem. Months before these division commanders submitted their reports, we did warn that unless the Army's operations account was supplemented in a timely manner, before the fourth quarter, there would be readiness problems. Again, our systems for tracking and reporting readiness worked properly.

If we divert funding from Service readiness accounts, as we have had to do for FY94 and FY95 to support unplanned contingencies, the price is paid in canceled training events, needed repair parts not purchased, and ultimately, degraded wartime skills. Even if the money is later replaced, many times the opportunity to go back and reschedule canceled training events is lost. And, it may take longer to rectify the readiness problem than it did to create it in the first place.

To help resolve this problem, Secretary Perry has asked Congress to establish a readiness preservation authority. It will help prevent a recurrence. On top of other systemic fixes, it will provide the Department with standing authority to mitigate the impacts on readiness from funding contingencies that arise late in the year.

But this is not all we have to do. The Joint Chiefs, the CINCs and I are watching readiness more closely and in more ways than any time I can remember. We are also building new safeguards. One of these safeguards is a Joint Readiness Review that meets monthly to examine the state of our forces. In addition, and following up on last year's testimony, I stated that we intended to create a new system to assess joint readiness. The Services' readiness systems, as you know, track unit readiness. What we have always lacked is a clear picture of how ready our forces are to engage in joint operations.

Over the past year, we designed such a system and it is now in being. We assess and report both the readiness of our forces to conduct joint operations, and the readiness of selected critical systems and capabilities. This system is still at an early stage and considerable refinement is needed. But it is already affording us greater visibility and a more complete picture of the state of our forces.



Another readiness trend we are trying to correct is the problem caused by today's high operations tempo and the corresponding effect on personnel tempo. Selected units and capabilities, particularly in some of the support forces, have been overextended -- we recognize that and are working to correct it.

In some cases the solution is to add more of the capability or type units that are in high demand. But it takes time to build and train, for example, more AWACS crews. As well, when we add more of something, we have to take something else out. We have to be sure that what we are adding to make us more capable of managing our peacetime and Operations Other Than War commitments doesn't come at the expense of a capability we need in war. Other approaches to address this problem include making more effective use of our Reserve Component in augmenting units committed to these Operations Other Than War, spreading the burden of these commitments and operations among nearly all of our commands worldwide, simply adjusting our exercise requirements, or combinations of all three approaches.

However, the key point is this. In the final analysis, continued readiness to fight depends on adequate, stable funding of readiness accounts; commitment to a well educated, highly trained, quality force; investments in force enhancements; and rapid restoration of funds and resources expended for unplanned contingency operations. If we stay on this path, our near-term readiness will not suffer.

MODERNIZATION AND ENHANCEMENTS

A problem I am equally concerned about is protecting our long-term readiness. In the past eight years, continuing budget reductions have caused us to cancel, stretch out, or revert to prototype many modernization programs. The end of the Cold War justified many of these actions, because it left us with a rich inventory of modern systems and equipment large enough to see us through the end of the century. But the end of the century is now approaching, when we will no longer be able to rely on what we built in the early eighties.

Recently, we've begun practicing what our corporations call recapitalization: part of which is the process of terminating or diverting funding away from programs that are either less promising or less valuable so that we can re-invest the funds into programs that have more punch. This has driven us to thoroughly reconsider old R&D efforts and modernization programs to see if they still offer the value we once thought was there. On the whole, it is a good practice and we will continue to pursue it. But, recapitalization must be fed with new funding as well.

CRITICAL FORCE ENHANCEMENTS

- Additional Army prepositioned equipment
- Additional airlift/sealift
- Improved anti-armor and precision-guided munitions
- More early-arriving Navy air
- Improve Army National Guard combat brigade readiness
- Improve Army Guard and reserve support force readiness
- Improved Command, Control, Communications and Intelligence assets

When the Bottom Up Review was done, we reformulated the entire basis of our modernization plans to fit the future. The core philosophy that guided this effort was to balance our future strategic requirements against a still shrinking force. The counterweight was the combination of planned service modernization programs and selected force enhancements, the sum of which would make our forces faster to deploy and more effective and lethal when they go to battle. The idea is to "grow our force down" without allowing the force to become too weak.

But as we do this, we must carefully watch two trends. The first trend is one of pushing modernization programs down the road year after year through a process of new delays, stretchouts, and schedule changes. This could cause an unsupportable swelling of the modernization funding needed early in the next century. Second, some of the systems in our inventory are approaching their expected lifespan. Our modernization plans are structured to upgrade or replace old systems before they become obsolete or worn out. These plans must be supported. We must bring replacement systems on line before the systems they are designed to replace or upgrade reach the point where problems begin to occur.

I can think of no programs more vital than those that are designed to enhance the strategic deployment of our forces. To fit our new strategy, we planned for a combination of pre-positioned equipment in strategically vital locations, additions to our Ready Reserve Fleet, and the procurement and fielding of the C-17, or a mix of Non-Developmental Airlift Aircraft, that would expand our airlift and replace our aged C-141 fleet. In making these decisions, we drew on the lessons we learned from the Gulf War that showed how seriously deficient we were in our ability to move our forces quickly to that conflict. When that conflict ended, the strain that had been put on our C-141's forced us to ground significant parts of that fleet for major structural repairs. It took well over a year before those repairs were completed. Some of our sealift broke down enroute also, causing some units and capabilities to arrive late. The awareness that these problems caused at the time has dissipated somewhat and needs to be rejuvenated.

In order to respond to a major regional contingency, most of our Armed Forces will be deployed from the United States. Units will rely on airlift, such as the C-17, C-5 and C-141 to deploy their personnel and limited amounts of equipment, while the major portion of their combat equipment will move by fast sealift ships and large, medium-speed, roll-on/roll-off ships. However, sealift alone cannot meet the required response times for Southwest Asia. To do so requires us to deploy our initial forces by air to link-up with equipment pre-positioned in theater. Already we have one pre-positioned site with an armored brigade set of Army equipment in Kuwait. Plans are proceeding to position a second brigade set in the region. I urge you to support this requirement.

Some of the enhancements that I mentioned earlier include those that are needed to keep our forces ahead of the third revolution that I described; the revolution on the battlefield. There are three broad parts of this revolution that we must push ahead on.

The first two of these three, sensor systems and command, control, communications, computer, and intelligence systems (C4I), with their supporting space systems, are intertwined. Sensor and C4I systems enable us to detect and evaluate threats to our security and to then maintain effective command and control over our forces through every phase of our operations. Our stunning victory in the Gulf War showed the extraordinary effects these systems can have on the battlefield. They enabled our commanders to see the full depth of the battle area, to "sense" what the enemy was doing long before contact was established, and to prepare their forces accordingly. No one should doubt the value these systems gave our forces.

MILSTAR is one of the key programs in our evolving C4I architecture. Although we have access to commercial systems, MILSTAR provides secure, survivable, and protected support, from the tactical through the strategic level. It is a crucial part of our Global Command and Control System that ties together our deployed forces in our overseas theaters, those outside the theater that provide their support, and the National Command Authorities.

The third area of this revolution we are emphasizing is the fielding of more long-range, advanced, precision strike air, ground, and sea delivered munitions. Just as our sensors and C4I afford our commanders the ability to see to much greater depth, these systems complement this advantage by allowing our forces to strike at greater depths and with greater accuracy and lethality.

Finally, we also need to stay on track with the development and fielding of a Theater Missile Defense system. The Gulf War underscored our vulnerability to proliferating missiles, even in the hands of less developed nations. All of us remember the searing image of our forces scouring the remnants of a destroyed building, looking for American survivors after a SCUD missile made it through our Patriot defenses. We must prevent this, or worse, from happening again.

CONCLUSION

Some twenty years ago, in the aftermath of the Vietnam War, our military was at its lowest state since before the Second World War. Readiness was languishing, morale was low, recruiting and retention goals were habitually missed, and disciplinary problems were evident all around. From this poor state, with the support of Congress and the American people, we built the finest Armed Forces in the world.

Protecting that excellence depends on our firm commitment to our people, on adequate and stable funding of readiness accounts, investments in force enhancements and modernization, and balance in how we fund operations, infrastructure, depot maintenance, modernization, and force structure.

Our challenge now is to balance readiness today with tomorrow's modernization. To accept the force decreases that have been enacted over the past five years, but fail to purchase the enhancements and modernized systems upon which the reduction decisions were based, would invite great risks early in the next century.

I am confident that our goal to maintain this balance is the right way to proceed. We must provide the resources to achieve this goal.

Let me close by again emphasizing how very proud I am to represent the truly magnificent men and women of our Armed Forces. Looking back on this past year, I have never been prouder.

Chairman DOMENICI. Let me tell you what I know about the schedule. We are going to have a vote, I understand, at 11:30 on the Dole second degree amendment, or whatever his amendment is. I would hope we would each in the first round stick to 5 minutes. If we all stay with 5 minutes, we will get through one round.

If we have to come back after the vote, I will be glad to come back. I have a number of questions, and I can't get them in in the first round. But I am going to yield to Senator Grassley on our side, and then to whomever Senator Exon wants to yield to next.

Senator Grassley?

Senator GRASSLEY. Mr. Perry, you are requesting $2.6 billion for the fiscal year 1995 supplemental. This is a readiness supplemental. You have had to, of course, respond to our obligations in Bosnia and Haiti and Cuba, et cetera, by robbing the readiness accounts to pay for these unfunded contingencies.

You have testified that if you don't get the money by March, there will be drastic cutbacks in training and readiness; maintenance would be deferred, and supplies of repair parts will dwindle to unacceptable levels. For example, Air Force flying hours would have to be reduced by 50 percent for at least 12 weeks. The Navy would have to cut flying four wings and top-gun exercises. Similar restrictions, I understand, would be imposed upon the Army and Marine Corps.

It is kind of like saying the Pentagon is running out of gas, and I think that is the message you are trying to send.

The unfunded contingency operation; though, may not be the only culprit. I would like to raise a question with you. I happen to believe that big chunks of readiness money are being wasted. As an example, I will refer to the wasteful and arrogant use of special airlift aircraft by Air Force General Ashy and possibly other senior Air Force officers. I have asked the Inspector General (IG) to investigate General Ashy's travels and extravagant rearrangement at his new headquarters. I expect the IG to complete that investigation by April.

At this point, we don't have all the facts, but we do have some sketchy details. I think we know enough to know that General Ashy has helped to drain some of the DOD gas out of the tank. He helped burn up big chunks of O&M money, and, of course, that is the money used to train the force and to keep it ready for combat. That is the money used to buy fuel and repair parts. That is the money that you so desperately need.

We also know that General Ashy's conduct is part of a broader pattern of waste. General officers use military aircraft to travel like corporate CEO's. I have done some back-of-the-envelope calculations to see how this money could be used to meet some of the needs, and I used DOD cost data. I have made a rough estimate of how much more readiness could be bought with the money wasted by General Ashey. It would be enough to pay for 2½ weeks of field training for one Army M–1 tank battalion. That would be 58 tanks. It would be sufficient to train one Air Force F–16 fighter squadron. That would be 18 to 24 aircraft for 3 days. And I suppose I could go on and on.

Simply put, that is a lot of training, and that is a lot of readiness.

As I said, we think that General Ashy's behavior is part of a much broader pattern of wasteful use of money. If we would assume that all 10 Air Force 4-star generals are doing what General Ashy did, as we have been told, we are talking about really big bucks. We are talking about enough money to train an M–1 tank battalion or an F–16 squadron for a month or more.

My question would be in regard to a pattern set by President Clinton in regard to actions like this. Last year President Clinton disciplined several White House officials for using a military helicopter on a golf outing. One person was forced to resign and forced to reimburse the government for the cost of the flight.

If you would find that General Ashy—now, I know this is strictly hypothetical, and it doesn't preclude a person's right of innocence. But if you would find that General Ashy or others broke the rules or behaved in wasteful ways, would you hold Pentagon generals to the same White House standards?

Secretary PERRY. Senator Grassley, as you noted, the Inspector General has an investigation ongoing of General Ashy. The Department and I will fully support that investigation, but I will not make any comments about that investigation——

Senator GRASSLEY. I wouldn't expect you to.

Secretary PERRY [continuing]. Or any other investigation while it is still going on.

Senator GRASSLEY. I wouldn't expect you to. I would expect you, though, as head of the Defense Department and a person that sets a standard for the people who are under him, would you hold your own high-level people to the same standard as the President of the United States when it comes to misuse of taxpayer money, when it comes to reimbursement and their resignation if they have done something that sets a bad standard?

Secretary PERRY. Our standards of accountability in this regard at the Defense Department are the same as those of the White House.

Senator GRASSLEY. I would conclude then by saying with respect to General Ashey or anybody else, it is not a question of whether the law was or wasn't broken or whether the guidelines were technically followed. The simple fact is that I think there is a waste of money. I think I have demonstrated how that money could be used for readiness, and that money is squeezing out readiness funds for our troops. And I think that we can't have that sort of use of the taxpayers' money.

Chairman DOMENICI. Your time has expired, Senator.

Senator Exon?

Senator EXON. Mr. Chairman, I am going to yield my time to the members on this side that were ahead of me. Just let me make a brief comment, if I might.

Senator Grassley, I hope that we can keep this matter in proper perspective. The newspapers and others have been beating up on General Ashey. The facts of the matter are somewhat different than what have been played in the press, from what I know about it. And I do not know a great deal. The facts of the matter are that the plane that took General Ashey from his previous command to his new command was directed to move him without his knowledge, as I understand it.

When you start talking about all the savings that you have just outlined, Senator, I would remind you that I think that those savings are not accurate, because the facts of the matter are the planes that were involved in this, while there is some legitimate criticism of the way it was handled, are required to fly so many hours, to do so much in the way of practice, to carry out their mission.

So I think it is wonderful for us to sit here in Washington, excluding ourselves and some of the perks that we have, and attack General Ashey, who has distinguished himself for many years as a top military leader. So I think this, frankly, is more headline-seeking than it is providing money to improve readiness.

I yield, and I believe the Senator from North Dakota is next.

Senator CONRAD. I thank the Chair and I thank the ranking member.

Welcome, Secretary Perry and General Shalikashvili. It is good to have you here. I think you have made an excellent presentation.

There has been a great deal of discussion——

Chairman DOMENICI. Senator, I wonder if you might just indulge me for 1 second. I didn't know that Senator Exon was going to respond to his testimony. Would you mind if I would yield him a minute to respond?

Senator CONRAD. That is fine.

Senator GRASSLEY. Well, I would hope for the benefit of the taxpayers' and wise expenditures of taxpayers' money that what Senator Exon says is right. But everything I have looked into, I don't think we have had a wise use of the taxpayers' money from the standpoint of money being used to train people, and they were involved in those operations. My understanding is that the crew of the 141 involved, they were already over-trained from the standpoint of the standards set by the military, and the exercises that they normally have to go through.

It is my understanding that at that point they were exhausted, and it is my understanding that all of their training requirements at that point were up to date.

Now, I don't know that absolutely for certain, and we will know that when the IG report gets out. But that is my understanding of it, and those statistics I used I just got 2 days ago from the Department of Defense of what it costs for regular training. And all you have to do is take what it costs for that trip and apply it to the hours and the man/woman-power involved in that training, and you come up with those figures that I came up with.

Senator EXON. May I have 30 seconds?

Chairman DOMENICI. Indeed. You can have it of your own time.

Senator EXON. You may well be right, Senator Grassley, and I do not know any of the details. I have not received any inside information from the Defense Department or others. I just simply say that to begin the questioning on an important matter like the whole defense structure on what General Ashey did puts a bad light on the whole military, and I think there are much more important things that we have to decide here than that particular matter. I think it is not a proper thing to bring up as the first matter out of the box with regard to the defense budget, and I would simply say that it would be well for all of us to restrain ourselves from headline seeking for the moment until we know more about this situation.

Senator GRASSLEY. First of all, from the standpoint——

Senator CONRAD. Mr. Chairman——

Senator GRASSLEY [continuing]. Of what my motives might be——

Senator CONRAD [continuing]. May I reclaim my——

Senator GRASSLEY [continuing]. I have conducted myself the same under Republican Presidents as under Democrat Presidents on this issue. And if you see this as a partisan attack, Senator Exon, I——

Senator EXON. I didn't say that.

Senator GRASSLEY [continuing]. Think you have got a short memory.

Chairman DOMENICI. All right. We are finished with this discussion.

Senator you may proceed.

Senator CONRAD. Well, can I go back and start over again, Mr. Chairman? [Laughter.]

Chairman DOMENICI. I would hope you would, please.

Senator CONRAD. I would like to again welcome the witnesses. [Laughter.]

Senator CONRAD. This isn't going to be so bad. Again, I think you did an excellent job of presenting the budget.

I would like to direct your attention to a column that recently appeared in the Washington Post written by Larry Korb, former Assistant Secretary of Defense in the Reagan administration. In commenting on the discussion that we have got a defense budget that is too low, there have been a lot of arguments advanced that the defense budget is much too low, Mr. Korb pointed out that the 1995 defense budget is still about 85 percent of its average cold war level, and actually higher, in inflation-adjusted dollars, than it was in 1955 under President Eisenhower and in 1975 under Nixon when the Soviet empire was alive and well.

Is that a correct calculation by Mr. Korb?

[The article referred to by Senator Conrad follows:]

The Republicans Up in Arms

The National Security Restoration portion of the Contract With America promises that Republicans will increase defense spending above the level proposed by President Clinton. Estimates of the size of the Republican increase over the next 5 years to Clinton's $1.3 trillion defense program range from $40 billion to $100 billion.

Ostensibly, Republicans perceive that Clinton has allowed overall defense spending to be reduced to such a low level—and has squandered so much of the defense budget on civilian purposes—that the readiness of the armed forces to execute our national strategy is imperiled. Rep. Floyd Spence (R-S.C.), the new Chairman of the House Armed Services Committee, even argues that a downward spiral of readiness has already begun, and former defense secretary Richard Cheney asserts that the Clinton administration has an inadequate strategy paired with inadequate resources.

But before the Republicans start throwing billions at defense, the ought to examine carefully the premises on which their perception is based. If they look behind the rhetoric in at least five areas, members of the new GOP majority will find that the demise of the American military has been greatly exaggerated.

First, it is true that the defense budget has indeed been reduced for the past 10 years and now is 35 percent below its 1985 level. But 1985 is a misleading year with which to make comparisons. It was the peak year of the Reagan buildup, which was based not on military need but upon a strategy of bankrupting the Soviet

Union. If the Reagan administration had budgeted only for military purposes, the 1985 budget would have been some $80 billion less. The 1995 defense budget is still at about 85 percent of its average cold war level, and actually higher (even in inflation adjusted dollars) than it was in 1995 (under Eisenhower) and in 1975 (under Nixon), when the Soviet Empire and Soviet Union were alive and well.

Second, it is true that the size of the Clinton defense budget is below that of Bush as well as Reagan. But these measures are inappropriate. Bill Clinton's armed forces are not going to war with the forces of Bush or Reagan. Good Republicans should look at the competition. In 1995, the United States by itself will spend almost as much on defense as the rest of the world combined, and four times more than any other nation in the world. Spending by the United States and its allies in Europe and Asia accounts for more than 80 percent of the world's total military expenditures.

Third, it is true that in the last quarter of 1994, three of the Army's 12 divisions were rated "not ready" and that there is anecdotal evidence that units in the other services are experiencing some readiness problems. But readiness is not a synonym for military preparedness or capability, nor is it an end in itself. Rather it is an esoteric and subjective concept that measures only one of the four components of military capability and can easily be manipulated by the uniformed military to frighten unwary political leaders. Moreover, readiness in the current budget is, if anything, overfunded.

In 1995, Clinton will spend almost $4 billion more on readiness than the outgoing Bush administration had projected. Readiness spending per capita today is 20 percent higher than it was in 1985, and 50 percent more than in 1980 when we had a readiness crisis. It is even 15 percent above where it was when we went to the gulf in 1990. The readiness gap of the 1994 campaign is similar to the missile gap of the 1960 campaign, a political slogan divorced from military reality.

Fourth, it is true that the U.S. forces cannot carry out the strategy of conducting two major regional wars, one in the Persion Gulf and one in Korea, simultaneously, as those contingencies are defined by the Joint Chiefs of Staff. But the military's estimation of the forces necessary to defeat Iraq and North Korea is exaggerated. For example, in calculating that it would take 400,000 American troops to prevent North Korea from overrunning South Korea, Pentagon planners assigned each U.S. soldier a value of 1.0 and a South Korean soldier 0.7. But the Chiefs calculated the effectiveness of each North Korean as 1.0, the same as an American and 30 percent greater than a South Korean. Since the North Korean army trains much less and has much older equipment than the United States and South Korea, a value of 0.5 would seem to be more appropriate. This would reduce the demand for U.S. forces to 200,000. Similarly, the military has us fighting the pre-1990 version of Iraq without any contributions from our allies. It is not surprising that the Chiefs would take such a somber view of the gulf and Korea. After all, they estimated that 10,000 Americans would die in evicting Iraq from Kuwait. The actual number was less than 150.

Fifth, it is true that some of the money in the defense budget goes for purposes that contribute little to national security. But it is not the funds for areas such as environmental cleanup that are the real culprits. Rather it is spending on cold war relics such as the Seawolf submarine, the B–2 bomber, the CVN–76 aircraft carrier, the MILSTAR communications system, and 100,000 unnecessary reserve forces that are consuming billions each year.

In looking at how much to spend on defense over the next 5 years, the GOP legislators can take either of two Republican giants as their model; that is, either Eisenhower or Reagan. Ike kept both the military-industrial complex and the budget deficit under control, Reagan lost control of both.

The writer, Lawrence J. Korb, a senior fellow at the Brookings Institution, was an assistant secretary of defense in the Reagan administration.

Secretary PERRY. Senator Conrad, I did not read Mr. Korb's article, and I am not prepared to give you a seat-of-the-pants reply to the numbers in that article. I would be happy to supply those for the record.

I will say, though, that the issue of the general thrust that he is making is that we may be spending too much money on readiness.

[The following was subsequently supplied for the record by Secretary Perry:]

In his February 26, 1995 article in *The New York Times Magazine*, Lawrence Korb attempts to make the case that his assessment of U.S. force readiness is superior to the collective judgment of the military leaders closest to problems, senior DOD officials whose conclusions have been supported by visits to military units, and most Members of Congress familiar with today's defense challenges. Mr. Korb tries to quantify his assertion with comparisons of data that are not comparable. For example, he notes that since 1990 Operation and Maintenance spending has not declined as much as force levels. Among other things, this fails to take into account that O&M funds more than readiness, and some of that other spending—most notably for environmental requirements—has been driven upward.

Mr. Korb does correctly state that last year's budget request for fiscal year 1995 O&M budget authority ($93 billion) was $5 billion above fiscal year 1994 levels ($88 billion). However, when it left office in January 1993 the Bush administration did not publish any projections for fiscal year 1995 O&M spending, so there is nothing with which to compare our request for fiscal year 1995.

My view is that assessment of force readiness continue to be made competently by military and civilian officials charged with that responsibility. Using faulty analysis, Mr. Korb's article impugns the integrity of those officials and insults the professionalism of our uniformed military leaders.

Senator CONRAD. Well, let me get to that. The second point that he makes is that the United States by itself will spend almost as much on defense as the rest of the world combined. Is that accurate?

Secretary PERRY. That is accurate.

Senator CONRAD. He also says that we are spending 4 times more than any other nation in the world. Is that accurate?

Secretary PERRY. That is accurate.

Senator CONRAD. He goes on to say that in 1995 the Clinton budget will spend almost $4 billion more on readiness than the outgoing Bush administration had projected. Is that accurate?

Secretary PERRY. I would have to check that for the record. I don't carry numbers like that in my head.

Senator CONRAD. He goes on to say that readiness spending per capita today is 20 percent higher than it was in 1985 and 50 percent more than in 1980 when we had a readiness crisis.

Do you have any judgment on whether those numbers are accurate?

Secretary PERRY. I don't know if those specific percentages are accurate, but I do know and I have testified that on a per-unit basis, per-personnel basis, our readiness is at very high levels now, including much higher than in those years.

Senator CONRAD. I appreciate that. I just would say that those who are arguing that we are at dangerous levels of military spending might want to keep in mind we are spending more than the rest of the world combined, or about as much as the rest of the world combined. I think that is an important fact to keep in mind.

If I could turn, though, to another area, can we put——

Secretary PERRY. Senator Conrad, we do have our Comptroller here. He may be able to comment further.

Mr. HAMRE. I think the numbers are accurate, but I need to say it is not what they are spending on defense; it is what they put in our budget that they label defense budget. Other countries budget for other things differently than the way we do in defense. So we put all of our retirement benefits, for example, in our defense budget. Other nations don't do that.

So I don't think it is accurate to say we are spending more than the rest of the world combined. It is more than the rest of the world's budget in their defense budget. But that is a very important distinction.

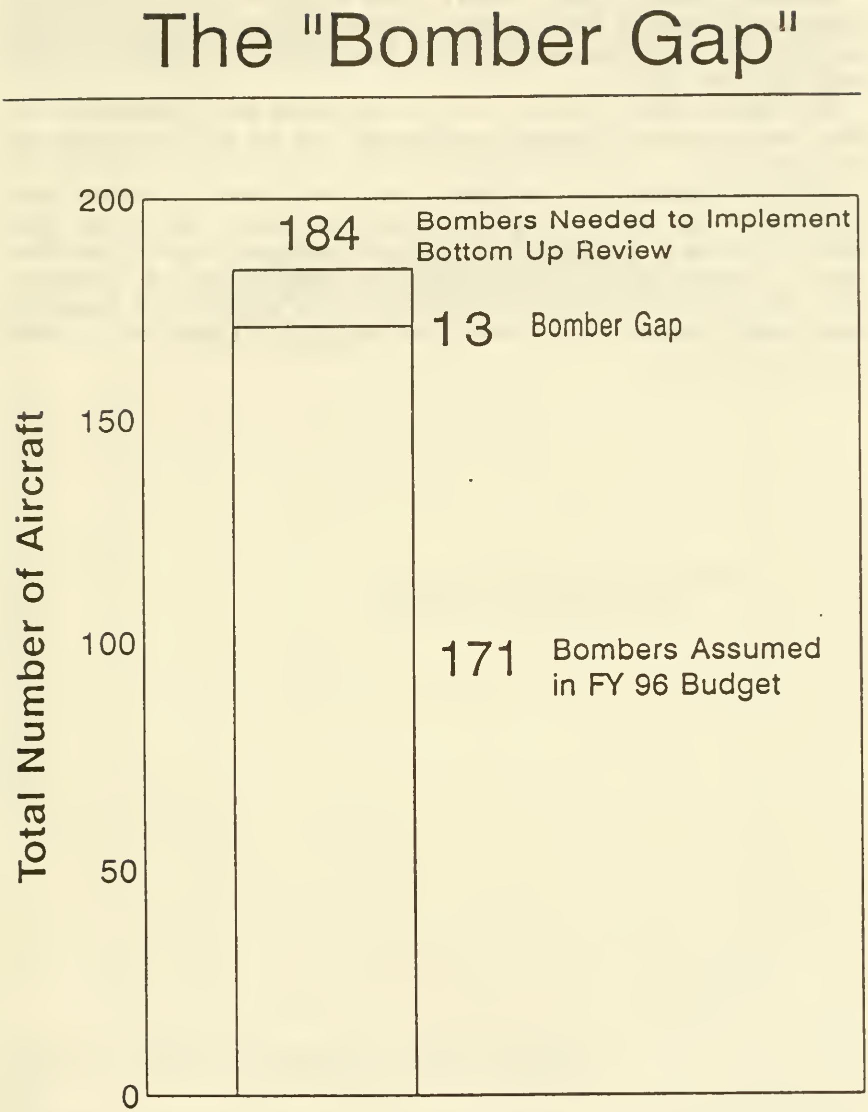
We, for example, have environmental cleanup costs in our defense budget because that is part of the law of the land. Other countries don't do it the same way, so we have to be very careful about that gross——

Senator CONRAD. Making these comparisons?

Mr. HAMRE. Yes, sir.

Senator CONRAD. Nonetheless, it sounds to me that Mr. Korb, who was Assistant Secretary in the Reagan administration, is making the argument that we are still spending high levels on defense.

I would like to turn very quickly to the question of what I call a bomber gap. The Bottom-Up Review said we need 184 heavy bombers. In this budget, we have 171 funded, bringing us 13 short of what the Bottom-Up Review called for.



Source: Bottom Up Review, FY 96 Budget

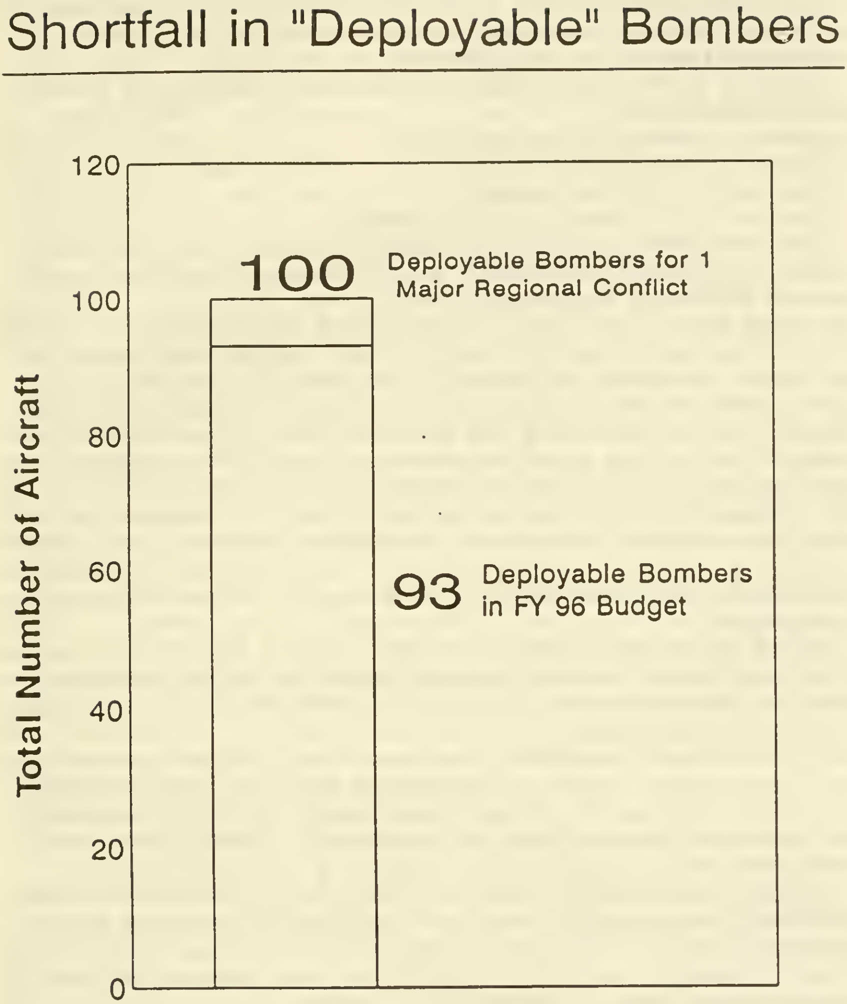
Can you tell us why you submitted a budget that is 13 bombers short of what the Bottom-Up Review called for?

Mr. HAMRE. I think that a year ago, in our plans for fiscal year 1996 and the outyears, we indeed were going to be below the Bottom-Up Review. I think we have restored those bombers in this year's budget, and I don't believe we are below the Bottom-Up Review any longer, sir.

Senator CONRAD. Well, I don't think that is what the numbers shows, very frankly. The numbers in your budget say you are going to be at 171 heavy bombers in fiscal year 1996. The Bottom-Up Review calls for 184.

Mr. HAMRE. Sir, I think we may be confusing total aircraft inventory versus primary aircraft authorized. But we will be glad to go through——

Senator CONRAD. No; we have been very careful to make this analysis on an apples-to-apples basis. That leaves us in the next chart showing a shortfall in deployable bombers. Again, the Bottom-Up Review said 100 deployable. In your budget, it comes up with 93 deployable, which would give us a shortfall in terms of deployable bombers of 7. And I just ask you if there isn't a need to close this gap.



Source: Bottom Up Review, FY 96 Budget

Secretary PERRY. Senator Conrad, without commenting specifically on those numbers, let me say that I am very much concerned about the issue of enough deployable bombers. We have, as you know, a very comprehensive study underway right now chaired by Under Secretary Kaminski on the bomber question, in particular, and we expect to have the conclusions of that by mid-April.

I will be not only happy to brief this committee, but I know of your interest in the subject, and I will give you a detailed briefing on that.

Senator CONRAD. I am very interested in the subject. I am hopeful that if that study shows that we are short, you will come up here and make the appropriate adjustment.

Secretary PERRY. We are prepared to come into the Congress to request adjustments, depending on the outcome of that study.

Senator CONRAD. I appreciate that very much.

Secretary PERRY. This will be a very comprehensive and, I assure you, objective study.

Senator CONRAD. I appreciate that.

Chairman DOMENICI. Thank you very much, Senator.

Senator Frist, you are next.

Senator FRIST. Thank you, Mr. Chairman.

Secretary Perry, General Shalikashvili, thank you for being here. I have enjoyed the opportunity I have had personally to be with you and talk about these issues.

I would like to turn briefly to the area in the budget for research and development. General Shalikashvili, in your testimony, you talk about the third revolution in your text. As you point out, it runs counter to all the downward pressures exhibited by the previous, the second, and even the first, that you point out in your testimony. And you say that this one is the battlefield revolution that we ourselves ignited with our doctrinal and technological innovations, talking about setting in motion the entirely new era in warfare. Then on down, you say the combination of what is being done in military research and development in our partnership with civilian industry and their laboratories is creating a host of promising technologies.

In looking at the budget as proposed and in real dollars—or in inflation-adjusted dollars, it appears that the budget provides for about a 25 to 30 percent drop in R&D budget once those dollars are adjusted for inflation.

I would like for you just to comment on that and comment on how that money relates to the money that has been applied to readiness. And can we today, talking about this third element of the revolution, are we going to be prepared 6 years from now, 10 years from now, to maintain the superiority we have today?

General SHALIKASHVILI. Yes, sir. First of all, I am satisfied, Senator Frist, that we do, in fact, have sufficient R&D money to carry forward all our requirements. In specific reply to your question on what I referred to, our ability here in the near future to have a significant breakthrough, specifically in the area, for the first time, of gaining a dominant awareness of the battlefield, and thereby allowing us for the very first time not only engage an opponent on the battlefield as far out as we can see and then have forever lesser vision of him as we go deeper and deeper into his rear, for the first time we will have this ability to see the full battlefield. I make the analogy to a chess game. For the first time we will be seeing the full chess board as we engage him, as opposed to up to now where we just see his pawns up front. That will give us a significant step forward.

Much of that technology is found in AT&T, in other corporations out there that are looking at these sorts of issues. And so I think we have the possibility, through some very cooperative efforts with civilian industry, to be able to capture what is being done out there at a significantly reduced cost to the Defense Department.

In the past, all of these sorts of things have been done in our own laboratories. I think we have the opportunity now to widen our horizon and capture that kind of work that is now being done on the outside.

So, in total, I think we are in satisfactory shape on the amount of money we put into research and development.

Senator FRIST. And how much of that sort of thinking goes into the $35 billion in R&D in 1995 falling to $30 billion in the year 2000? Is that fall part of this cost savings of reaching out to private industry in joint ventures, or is it actually a cutback in the amount of research being done?

General SHALIKASHVILI. I don't think there is any cutback in this important area of reconnaissance and surveillance and intelligence, this whole functional area, where I expect a significant breakthrough. I think that is sufficiently funded, but I cannot give you the specific figure. I don't know if you can, Mr. Hamre.

Secretary PERRY. Senator Frist, let me just comment on several of the related issues here. The drop in R&D that you see in this budget is primarily because we are not developing as many major weapons systems during that period of time as we have in the past. The technology-based component of the R&D budget, about $8 billion, is protected at a very strong level all through this budget, and that is one of the keys to achieving this revolution that we are talking about.

The other key is the one mentioned by General Shalikashvili, which is drawing on the commercial industries in semiconductors and computers and software, where most of the advanced research is going on. And in that regard, I would say our Technology Reinvestment Project is absolutely critical, giving us access to bridging the gap between what goes on in our defense laboratories and what goes on in industry. That is a program which is requested in this budget, but which is under some attack.

Senator FRIST. Thank you. Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you very much, Senator Frist.

Senator Dodd?

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

I want to begin by thanking our witnesses this morning for their excellent testimony. It is a pleasure to have both of you back before the committee again.

If I can, let me touch on a couple of quick questions first, and then I will try to get as much in as I can in 5 minutes.

First of all, I am very impressed, Mr. Secretary—and you have made this point over and over and over again, not just today, but talking about the quality of life programs for people in our military. Just to read from your testimony, "Providing a good quality of life for service members and their families is both the right thing to do and crucial to sustaining the readiness of our U.S. forces." I think that needs to be stated over and over again. You can have the fanciest systems and the best research and development, but if we don't have the best possible people who are secure in their own personal situations, then there can be trouble.

To that extent, I want to just raise these issues. I understand we are making some precedent-setting decisions regarding families. I don't want to dwell on this, but I think it is important to note, as I understand it, in the area of child care, for instance, with, again, the growing number of women in uniform, the sensitivity of our services, and particularly the Department of Defense, in trying to make it possible for service people to be able to manage their lives, that is, perform their military functions and responsibilities while not over-burdening them in terms of their family obligations as well.

I wonder if you might just comment briefly on some of the steps that are being made in that area.

Secretary PERRY. First of all, in the child care area, it is a problem even if we did not have women in the service, because it is a problem for families as a whole, not just women in the service.

We have made a significant increase in the amount of funds devoted to child care and day care centers, with the idea of trying to overcome the problem that people are now on 9- and 12-month waiting lists to get into the child care centers.

The request for funds in this budget will improve that situation, but by no means fix it. But it is an important step in that direction.

Would you like to comment further, Dr. Hamre?

Mr. HAMRE. Sir, we are building 20 new child care centers over our plan last year in this year's budget. I have been to seven bases in the last year. At every single base we have a child care center under construction right now. I also would tell you that you will see communities in the area coming to our bases to find out standards for child care.

Senator DODD. I know that, yes.

Mr. HAMRE. I think the Department of Defense has done a very fine job in child care.

Senator DODD. Historically that is the case, by the way. As someone who authored with Orrin Hatch the child care legislation here a few years ago, we used the standards that the military has had for years. A little known fact, but one that ought to be better known by people. So I commend you for efforts in that regard.

Secretary PERRY. When I go to bases and talk with the senior enlisted about the problems at that base, child care is always high on the list, and housing is high on the list. Those are the two principal issues I hear about over and over.

Senator DODD. Well, I commend you for your efforts in that regard. That really goes to the heart of keeping the best possible people we can have, retaining them and so forth.

The second one is I have raised the issue over the years with you on defense acquisition reform. This is a subject that can glaze over the eyes of people, I suppose, but when you start talking about real savings, defense acquisition reform can play a critical role.

I wonder if you might just highlight some of the steps that are being taken to proceed in terms of streamlining and saving dollars in the acquisition area.

Secretary PERRY. I think this year, this calendar year, is going to be a critical year in acquisition reform. The Congress gave us the legislative authority last year. We have our process action teams that have been at work now for a year. Our entire acquisition team, from the new acquisition executive, Dr. Kaminski, to the three service acquisition executives, all have this as their first priority.

I met with each of them when they went into the jobs and said this is the primary test by which I will measure your success in this job, how well you implement this acquisition reform.

I have testified today that I am not yet able to score it—that is, to put dollars to it. I expect by the end of this year to be able to do that, and I will be able to give you a much more detailed picture of what the potential savings will be.

Senator DODD. I appreciate that.

Secretary PERRY. I think it is going to be large, though.

Senator DODD. That is good news.

Mr. Chairman, I am going to ask unanimous consent to put in the record two items, if I can: an article in the Wall Street Journal yesterday, China buys Russian submarines, raising tension level in the region; as well as a GAO report on Navy ships, lessons of prior programs may reduce new attack submarine cost increases and delays.

It will not come as any great shock to my colleagues that I am raising the issue here this morning, and I am pleased that the Department of Defense has included money for the acquisition of a third Sea Wolf submarine.

[The article and GAO report follows:]

THE WALL STREET JOURNAL THURSDAY, FEBRUARY 9, 1995

China Buys Russian Submarines, Raising Tension Level in Region

Purchase of 4 Vessels Spurs Concerns by Neighbors On Rising Naval Power

By KATHY CHEN
Staff Reporter of THE WALL STREET JOURNAL

BEIJING – Raising the military stakes in the world's most dynamic economic region, China has purchased four diesel-powered submarines from Russia, Western diplomats and military analysts say.

The estimated $1 billion deal, believed by analysts to be one of Beijing's biggest military acquisitions in recent years, comes amid rising concerns in Southeast Asia over China's naval influence in the South China Sea.

Only yesterday, Philippine President Fidel Ramos accused China of stationing vessels that "looked like warships" in a region of the Spratly Islands claimed by the Philippines. He said he beefed up Philippine forces in the area in response. The Spratlys, a chain of potentially oil-rich islands, reefs and shoals is claimed in whole or part by China, Vietnam, Taiwan, the Philippines, Malaysia and Brunei.

Turning Up the Heat

China's purchase of four so-called kiloclass Russian submarines is likely to heighten such tensions, analysts said, especially with Taiwan. Beijing considers Taiwan a renegade province and could use submarines in a potential blockade against the island in the event that Taiwan gave up its claim that it is the dispossessed ruler of all of China and declared itself an independent country.

Analysts said the submarine purchase is part of a major Chinese push to upgrade its armed forces, especially the navy, using funds generated by the economically ascendant country's increasingly prosperous military. "This transfer would serve to underpin the Chinese navy staff's increasing operational aspirations," says Derek da Cunha, a senior fellow at the Institute of Southeast Asian Studies in Singapore. "They have aspirations to deploy a bluewater fleet in the longer term and all the pieces of the jigsaw are now fitting nicely into place."

China agreed to buy the submarines in November, said Robert Karniol, Asia-Pacific editor of Jane's Defense Weekly. The first is en route from Russia aboard a Chinese ship, he and Western diplomats in Beijing say. China is expected to take delivery of a second submarine within a year and the others later.

Modern by Comparison

A Chinese Foreign Ministry spokeswoman wouldn't confirm or deny the purchase. But she said China and Russia are friendly neighbors with normal exchanges and cooperation in different fields, including the military. "China's engagement in military and technical cooperation with other countries is totally for the purpose of enhancing its own defense capabilities," she said. Russian Embassy officials in Beijing declined to comment.

The kilo-class diesel subs, which can stay at sea for several weeks, represent a "major generational jump" from China's current fleet, says one diplomat in Beijing. China has more than 100 submarines, but like much of the People's Liberation Army's arsenal, they are based on obsolete 1950s technology and are rarely used. Even though the Russian subs probably won't become fully operational for several years, they will enhance the Chinese navy's ability to deal with maritime contingencies, analysts say.

Moreover, the analysts and diplomats say, Beijing and Moscow are believed to be discussing the purchase of several more kilo-class subs and for China to engage in licensed production of the vessels.

With Communist Party chief Jiang Zemin seeking to shore up his power base ahead of the death of paramount leader Deng Xiaoping, which is expected soon, the Chinese military has been getting more generous central-government funding and a larger say in foreign affairs. China has boosted its annual defense spending over the past few years, though much of it has been swallowed up by inflation and increases in soldiers' living expenses.

United States General Accounting Office

GAO

Report to Congressional Requesters

October 1994

NAVY SHIPS

Lessons of Prior Programs May Reduce New Attack Submarine Cost Increases and Delays

UNITED STATES GENERAL ACCOUNTING OFFICE

GAO/NSIAD-95-4

GAO

United States
General Accounting Office
Washington, D.C. 20548

National Security and
International Affairs Division

B-257866

October 20, 1994

The Honorable Edward M. Kennedy
Chairman, Subcommittee on Regional
Defense and Contingency Forces
Committee on Armed Services
United States Senate

The Honorable John Conyers, Jr.
Chairman, Legislation and National
Security Subcommittee
Committee on Government Operations
House of Representatives

As you requested, we assessed the Navy's plans to incorporate lessons learned from prior submarine programs, particularly the Seawolf SSN-21 program into the design and construction of the NSSN, a new class of nuclear-powered attack submarine. According to the Navy, the NSSN is to be smaller, less costly and less capable than the Navy's Seawolf submarine; it will also be expected to perform a variety of missions.

Several factors make the NSSN both an excellent opportunity and a challenge for the Navy to control acquisition costs and to improve the quality of the design and construction process. These factors are (1) a reduced antisubmarine warfare threat, which has resulted from the breakup of the former Soviet Union; (2) the U.S. defense budget, which has been more tightly constrained each year; and (3) the early stages of the NSSN acquisition cycle, which allow an agency to apply lessons of past programs to future programs.

Background

Believing that high Seawolf submarine program costs would lead to inadequate force levels, the Department of Defense (DOD), in October 1991, established a requirement for a more affordable new attack submarine. According to the Navy, the NSSN's estimated displacement weight will be about 7,100 tons, 2,000 tons less than the Seawolf's. The NSSN's missions include battlegroup support, covert strike warfare, covert intelligence, special warfare, covert mine warfare, antisubmarine warfare, and antisurface warfare operating in both open ocean and littoral (coastal) areas.

In August 1992, the Defense Acquisition Board authorized the Navy to initiate concept exploration and definition (milestone 0) studies. A project office was established to set out the basic design and to develop an acquisition strategy that included the schedule of detail design and production. The Navy initially planned for the Board to approve the NSSN acquisition strategy in August 1993, as part of the milestone I decision to enter the demonstration and validation phase. However, the milestone I meeting slipped until January 1994. That meeting resulted in requesting the Navy to perform additional studies and analyses. These were completed and submitted to the Board.

On August 1, 1994, the Board approved milestone I, and on August 18, 1994, issued an Acquisition Decision Memorandum. The memorandum directed the Navy to submit an updated documentation package for the Board's approval within 60 days. The package is to include an acquisition strategy report, reflecting the Navy's plan to initiate detail design and lead ship construction at Electric Boat. The Board also directed the Navy to initiate (1) advanced procurement of the lead ship's nuclear reactor in fiscal year 1996 and (2) lead ship construction in fiscal year 1998. Further, the Board directed the Navy to update the submarine's combat system acquisition strategy to reflect "a significant degree of private sector involvement in planning an open system architecture," which contains commercially available hardware and software that meet broad industry standards.

A September 1993 cost and operational effectiveness analysis prepared by the Center for Naval Analysis estimated the cost for comparison purposes of procuring 30 NSSNs and procuring 30 Seawolf submarines at 1 ship per year. In constant fiscal year 1994 dollars, the procurement cost for the NSSN was about $45 billion ($1.5 billion each) and for the Seawolf about $56 billion ($1.9 billion each).

Results in Brief

The Navy may be able to avoid some design and construction costs and schedule delays by applying the following five management lessons from prior submarine construction programs, which we have distilled from the reports of our reviews over the past decade: (1) contracting with a single shipyard to both design and construct the lead submarine, (2) delaying lead ship construction until the ship's design is substantially mature, (3) strengthening the specification development and approval process, (4) identifying critical components and supply vendors early in the program, and (5) reducing submarine combat system development risks.

While the Navy's project manager has said that he intends to incorporate these management lessons into the program's acquisition strategy, the extent to which they will be applied cannot be assessed until DOD approves the strategy and makes it public for evaluation.

The Navy has evaluated a number of technical lessons learned from past submarine construction programs and has approved plans to incorporate some of them in the NSSN program. The Navy estimates that NSSN procurement cost savings from these lessons could range from $90 million to $100 million.

Because of the importance of applying both management and technical lessons, we believe the formal DOD approved acquisition strategy should explicitly address how the Navy will avoid repeating the problems of prior programs.

Applying Management Lessons May Reduce Costs and Avoid Schedule Delays

By incorporating management lessons into the NSSN program, the Navy may avoid repeating many of the problems that caused Seawolf detail design and lead ship construction cost increases and schedule delays. In recognition of Seawolf problems, the NSSN project manager told us he intends, subject to DOD approval, to incorporate the five management lessons into the multibillion dollar NSSN program. However, because of the absence of a DOD approved acquisition strategy, the extent to which the NSSN acquisition strategy will include these lessons cannot be assessed now.

Use a Single Shipyard to Design and Construct the Lead Submarine

Under the split design/construction strategy used for the Seawolf program, Tenneco's Newport News Shipbuilding and Drydock Company was responsible for the overall design and detail design of the submarine's forward end, while General Dynamics' Electric Boat Division was responsible for designing the submarine's aft end and for constructing the SSN-21 and the SSN-22. The split design approach, with a requirement that design data be suitable for use at either shipyard, was originally instituted to instill competition for building 29 SSN-21 class submarines. This approach, which required additional time and resources as well as a high degree of coordination between the two shipbuilders, caused design and construction cost increases and additional time to approve design data and to resolve design drawing problems.

Electric Boat, to construct the SSN-21, still had to convert Newport News Shipyard's generic design data into Electric Boat specific work packages (instructions and materials). According to Seawolf program office officials, the two shipyards were unwilling to open their operations to one another. In addition, the Navy's Seawolf program office occasionally had to mediate the resolution of design drawing problems between the two shipyards. Confusion between the two shipyards over design drawing delivery schedules was one factor that led to late delivery of design drawings to Electric Boat, the shipbuilder, in 1990 and in the first 6 months of 1991.

A Seawolf program office official noted that the Seawolf program office has learned that having one shipbuilder design and construct the submarine can save time and money. The August NSSN Acquisition Decision Memorandum shows that one shipyard will design and build the lead NSSN.

Delay Lead Ship Construction Until Design Matures

The high degree of concurrent development and lead ship construction caused cost increases on Seawolf. The Navy awarded Newport News Shipbuilding the overall Seawolf detail design contract in April 1987. Construction of the first Seawolf, the SSN-21, started in October 1989, with delivery originally scheduled for May 1995.

In some cases, this concurrency required developing and issuing drawings before system designs were fully mature. Although this approach provided the shipbuilder with design data earlier, it also caused a higher degree of design rework and, in some cases, construction rework. For example, the Navy's data requirement lists developed during the early phase of Seawolf design were based, as was the case with prior submarine efforts, on providing the shipbuilder with engineering drawings as the basis for performing construction tasks. It was later discovered that because Seawolf submarines required a significantly greater level of modular construction and outfitting, new and more detailed sectional construction drawings were needed to initiate modular construction tasks. As a result, in June 1990, 8 months after SSN-21 construction started and about 37 months after detail design started, the Navy rebaselined and increased Newport News' original $303 million detail design contract by $168 million. The rebaselining was for Newport News to prepare and to provide Electric Boat with more detail design data and incorporate final submarine specifications into the detail design.

A September 1993 NSSN cost and operational effectiveness analysis found that an additional investment of between $105 million and $175 million in research and development funds to review the NSSN's specifications and to complete design before lead ship construction contract award could reduce procurement costs by $141 million to $173 million per ship.

Starting lead NSSN ship construction with a more mature detail design could result in a more cost-effective and efficient approach than that used under the Seawolf submarine program. In June 1994, the NSSN project manager stated that the Navy plans to begin lead NSSN construction when the detail design matures. However, lead ship construction will still begin in fiscal year 1998, despite the 1-year slip of milestone I. Under the current NSSN schedule, detail design is scheduled to begin in July 1995, with lead ship construction beginning about 27 months later in October 1997. However, we question whether the detail design will be mature enough to avoid repeating similar problems the Navy experienced with the Seawolf program. The Seawolf program experienced design and construction rework, significant cost increases, and schedule delays, despite a 30-month interval between starting detail design and lead ship (SSN-21) construction.

Strengthen Specification Development and Approval Process

Deficient government specifications for welding HY-100 strength steel[1] have increased SSN-21 construction costs and have delayed the submarine's delivery from May 1995 until May 1996. In June 1991, Electric Boat experienced problems welding this new steel. As a result, Electric Boat notified the Navy that it had discovered weld cracks where two hull rings were joined together. Further investigation revealed additional unacceptable welds on the SSN-21's pressure hull and on at least 21 government-and contractor-furnished items. By August 1991, all HY-100 welding had been stopped.

The chemical composition of the welding metal, among other things, had resulted in cracking and unacceptable metal yield strengths and ductility. Ultimately, however, the welding cracks were traced to deficient government HY-100 welding specifications. Electric Boat and the Navy took corrective action; all welding resumed by December 1991. As a result of this problem, the Navy paid Electric Boat $77.8 million (in then-year dollars) to fix the cracks. It also caused a 1-year delay in the SSN-21's delivery.

[1]HY-100, a high-yield steel used to construct the SSN-21's pressure hull, allows the submarine to achieve deeper diving depths. Prior to the Seawolf program, a U.S. submarine's pressure hull was constructed using primarily HY-80 strength steel.

During the determination of defective government specifications, the Commander, Naval Sea Systems Command, requested an independent assessment of the system for developing, preparing, and approving specifications. The assessment, completed in March 1992, showed that weaknesses in developing and qualifying specifications were caused by a lack of management priority and oversight, inadequate and untimely availability of funds, and a shortage of personnel needed to develop and update specifications. In addition, the assessment showed that only 39 percent of the specification parameters were supported by historical performance data and less than 5 percent of the parameters were supported by test data.

The NSSN project manager said he plans to incorporate a review process that supports developing specifications. In addition, he indicated that the Navy plans to work with critical NSSN vendors early during design to coordinate specifications, including revisions, whenever necessary. Moreover, according to the NSSN project manager, the NSSN, to the extent possible, will incorporate existing systems and components from prior submarine programs and off-the-shelf, commercially available technology. Nevertheless, some existing systems may require varying degrees of reengineering for installation into the NSSN.

Earlier Identification of Critical Components and Supply Vendors

DOD has identified the decline of the submarine industrial base and the resulting uncertainty surrounding submarine component vendors as key factors contributing to Seawolf cost and schedule delays.

Early identification of critical components and supply vendors can help determine whether to buy or manufacture some components in-house and can help reduce potential procurement problems. For the SSN-21, Electric Boat had to manufacture certain systems and components that it was originally planning to buy. This was due either to a lack of qualified vendors or the cost and schedule risks inherent in using a vendor for complex components that were under development (i.e., the weapons storage and handling system). Collectively, the absence of sufficient vendors contributed to Seawolf design and construction cost increases and schedule delays.

The Navy's March 1992 assessment showed an apparent incomplete coordination with industry and inadequate notification to and consultation with industry regarding major changes in Seawolf specifications as required by the Naval Sea System Command's specification process. The assessment also showed that vendors were generally dissatisfied with government feedback to their comments during specification development and modification.

According to the NSSN project manager, Electric Boat will identify and obtain critical suppliers earlier than was done on the Seawolf program. To improve coordination with vendors and to identify issues that can affect the NSSN's design and construction, Electric Boat has assembled a team of 100 designers, construction trade people, and key vendors. However, the commitment to and the success of this effort will not be assessable until a later phase of design.

Reduce Combat System Development Risks

The Navy experienced problems developing the AN/BSY-1 combat system[2] for the Improved SSN-688 class submarine and the AN/BSY-2 combat system for the Seawolf submarine. Because the time to correct AN/BSY-1 combat system design and development problems was insufficient, the AN/BSY-1 became the major factor in delays to the Improved SSN-688 construction program. These problems resulted in an additional $82 million in contract costs for five Improved SSN-688s. In addition, the first nine Improved SSN-688s equipped with AN/BSY-1 systems were delivered to the Navy an average of 17 months late.

The AN/BSY-2 combat system scheduled for installation on the SSN-21 experienced cost increases and schedule delays. Changes to the system's design caused a portion of the submarine to be redesigned at an additional cost.[3] The Navy originally provided Newport News with general space and weight information for the system that the shipyard used to begin designing its portion of the Seawolf. The Navy later provided the shipyard with more specific information that caused considerable redesign of the submarine and increased design costs, according to Newport News.

The Navy estimated in August 1994 that system development would cost $123 million more than the original contract target cost of $1 billion. Our November 1992 report[4] showed that delivery of the system's first phase capabilities (all hardware and the majority of software) had been delayed from its original November 1993 delivery to between late March and June 1994. Because the HY-100 welding crack problem delayed the submarine's

[2]A submarine combat system detects, classifies, localizes, tracks, and destroys enemy targets

[3]Status of SSN-21 Ship Construction Program (GAO/NSIAD-90-163, Apr 19, 1990)

[4]Status of SSN-21 Design and Lead Ship Construction Program (GAO/NSIAD-93-34, Nov 17, 1992)

delivery 1 year, until May 1996, the Navy revised the AN/BSY-2 system's first phase delivery to February 1995. According to a February 1994 Defense Acquisition Executive Summary prepared by the Seawolf program office, maintaining the AN/BSY-2 software development schedule to support lead ship delivery remains a challenge. The AN/BSY-2 hardware is complete and ready for delivery to Electric Boat.

To reduce combat system cost, schedule, and technical risks the Navy encountered developing the systems for the Improved SSN-688 (AN/BSY-1) and Seawolf (AN/BSY-2) class submarines, the NSSN project manager stated that whenever possible, the NSSN's combat system will be developed using what he termed an open systems architecture, which consists of commercial, off-the-shelf hardware and software. The Acquisition Decision Memorandum specifies a combat system acquisition strategy that involves "a significant degree of private sector involvement in planning an open system architecture." Nevertheless, some existing systems may require varying degrees of reengineering for installation into the NSSN.

Applying Technical Lessons May Save Millions of Dollars

The NSSN project office compiled a database that identified about 1,350 primarily technical lessons from prior Navy programs. Electric Boat, Newport News, and other Navy organizations provided the input for this database. Personnel transferring into the NSSN project office from earlier submarine programs also provided some lessons. After consolidating duplicate lessons, the Navy reduced the database to 954 lessons. The NSSN project office's evaluation process is ongoing, and new lessons are added to the database periodically.

Of these 954 lessons, 290 had been approved for incorporation into the NSSN design as of May 1994. Examples of approved lessons are (1) centralizing the ship's service hydraulic power plant, (2) simplifying the ship's deck design, and (3) simplifying the ship's pipe hangers. These three lessons are expected to save over $10 million in acquisition costs. The Navy estimates that NSSN savings from all approved lessons could range from $90 million to $100 million. However, because individual lessons' costs can offset each other, savings must be assessed on a lesson-by-lesson basis. The potential exists for additional savings because the project office has not completed its review of almost 600 lessons. (See table 1 for status of the lessons.)

Table 1: Navy's Disposition of Technical Lessons Learned as of April 1994

Status	Number of lessons
Approved for incorporation into NSSN design	290
Deferred until a later stage of development	84
Open until additional reviews are completed	504
Rejected for NSSN purposes	76
Total	**954**

The NSSN's project manager noted that the Navy plans to incorporate the 290 technical lessons into the submarine's preliminary design during the submarine's demonstration and validation phase.

Recommendation

To allow an assessment of how the Navy will avoid a repetition of past problems, we recommend that the Secretary of Defense ensure that the formal NSSN acquisition strategy explicitly documents how the Navy is to address and incorporate the management and technical lessons from prior submarine programs.

Agency Comments and Our Evaluation

In commenting on a draft of this report, DOD generally concurred with the report and indicated that the Navy intended to apply the lessons learned from the prior programs. However, DOD did not believe it was necessary to explicitly document in a formal acquisition strategy how the Navy is to address and incorporate those lessons. DOD stated it was confident the current process provides adequate emphasis on lessons learned from prior programs.

After considering DOD's position, we continue to believe that implementation of our recommendation is warranted. This is a multibillion dollar program; the lessons that should have been learned have already been identified; therefore, it seems that documenting how they are to be incorporated is merely a completion of the cycle—a way of better assuring that the Navy avoids a repetition of cost and scheduling difficulties. Further, we believe such documentation will serve as a valuable tool for guiding the implementation of the program.

DOD comments are presented in their entirety in appendix I. DOD's suggestions for improving the clarity of the report have been incorporated in the text where appropriate.

Scope and Methodology

To determine the types of experiences the Navy should apply to the NSSN effort, we reviewed our prior products on the SSN-21, SSN-688, Trident, the combat systems, and other organizations' reports on lessons learned. We held discussions with Navy program officials for the Seawolf program, the AN/BSY-1 and the AN/BSY-2 combat system programs, and the SSN-688 and the Trident submarine programs. We held discussions with the Supervisors of Shipbuilding in Groton, Connecticut, and with Naval Undersea Warfare Center officials in Newport, Rhode Island. We also held discussions with Navy officials responsible for planning the NSSN's development in Washington, D.C.

We reviewed the NSSN project office's database of technical lessons learned experiences or suggestions and reviewed and analyzed Navy studies and assessments. We obtained, reviewed, and assessed suggestions provided by Electric Boat, Groton, Connecticut; and Newport News Shipbuilding, Newport News, Virginia. Electric Boat provided more detailed information on views on selected lessons learned that should be applied to the NSSN program, but Newport News Shipbuilding did not because of other business pressures.

We conducted our review from June 1993 to June 1994 in accordance with generally accepted government auditing standards.

We are sending copies of this report to the Secretaries of Defense and the Navy and to congressional oversight committees. We will also make copies available to others upon request.

Please contact me at (202) 512-4841 if you or your staff have any questions concerning this report. The major contributors to this report are listed in appendix II.

Brad Hathaway

Brad Hathaway
Associate Director, Systems Development
and Production Issues

Contents

Abbreviations

DOD	Department of Defense

Appendix I

Comments From the Department of Defense

OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON
WASHINGTON DC 20301-3000

ACQUISITION AND TECHNOLOGY

16 SEP 1994

Mr. Frank C. Conahan
Assistant Comptroller General
National Security and International
Affairs Division
U. S. General Accounting Office
Washington, D. C. 20548

Dear Mr. Conahan:

This is the Department of Defense (DoD) response to the General Accounting Office (GAO) draft report "NAVY SHIPS: Lessons of Prior Programs May Reduce New Submarine Cost Increases and Delays," dated August 2, 1994 (GAO Code 707017), OSD Case 9705-A. The DoD partially concurs with the report.

While the DoD generally agrees with the information reported by the GAO, the Department would like to provide clarification of two important points: (1) the savings applied to the lead and follow ship costs as a result of acceptance of a previous class lesson and (2) the extent to which a design must mature prior to initiating lead ship construction. With regard to the lead and follow ship costs, it should be recognized that savings from some Navy technical lessons from prior programs are already included in the overall New Attack Submarine (NSSN) ship cost estimates. Adding the savings from each of the technical lessons contained in the NSSN program database should indicate the maximum possible savings. In some cases, the cost savings from one lesson may offset those from another and hence, the total savings may not be a summation of the cost savings from each lesson.

With regard to the design maturity element, the draft GAO report points out that the more mature the design product, the more successful the construction effort. The DoD agrees. To benefit from that concept, producibility review of the specifications and design package will be conducted during their development to assess production readiness. Prior to initiation of lead ship construction, a Defense Acquisition Board review of program progress, prior to lead ship construction initiation, will also be conducted. That review will focus on the design maturity to verify readiness for production.

The DoD does not agree that there is a need for a formal Navy NSSN acquisition strategy that explicitly documents lessons learned from prior submarine programs. Under the present Integrated Product and Process Development (IPPD) approach, program management already monitors and incorporates both management and technical lessons learned from past submarine programs. The DoD is confident that through use of the IPPD and acquisition review processes, there is adequate insight into the lessons learned from prior programs.

Although the Milestone I Defense Acquisition Board review was not held at the time originally planned, in early 1994 the Assistant Secretary of the Navy for Research, Development, and Acquisition directed that the program office continue with the IPPD efforts, thereby permitting the seamless design approach to proceed. That action contributed to continued progress toward lead ship construction beginning in 1998.

In August 1994, the Defense Acquisition Review Board met to consider Milestone I approval of the NSSN program. As a result of that review, the Principal Deputy Under Secretary of Defense (Acquisition and Technology) authorized, on August 18, the NSSN program to enter the demonstration and validation phase to support lead ship construction in FY 1998 at the Groton, Connecticut, shipyard.

The detailed DoD comments on the GAO recommendation are provided in the enclosure. The DoD appreciates the opportunity to comment on the draft report.

Sincerely,

George R. Schneiter
George R. Schneiter
Acting Director
Tactical Warfare Programs

Enclosure

GAO DRAFT REPORT - DATED AUGUST 2, 1994
(GAO CODE 707017) OSD CASE 9705-A

"NAVY SHIPS: LESSONS OF PRIOR PROGRAMS MAY REDUCE NEW SUBMARINE COST INCREASES AND DELAYS"

DEPARTMENT OF DEFENSE COMMENTS ON THE GAO RECOMMENDATION

* * * * *

Now on p. 9

o RECOMMENDATION: The GAO recommended that the Secretary of Defense ensure that the formal New Attack Submarine (NSSN) acquisition strategy explicitly documents how the Navy is to address and incorporate the management and technical lessons from prior submarine programs. (p. 14/GAO Draft Report)

DOD RESPONSE: Nonconcur. The DoD does not agree that there is a need for a formal process to document lessons learned from prior submarine programs. Under the current approach, the Navy Integrated Product and Process Development effort, together with the established acquisition process, monitors and incorporates into the NSSN program the management and technical lessons learned from prior submarine programs. That approach was recently certified as part of a Defense Acquisition Board Milestone I review of the NSSN program. On August 18, 1994, the Principal Deputy Under Secretary of Defense (Acquisition and Technology) authorized the NSSN program to enter into the demonstration and validation phase to support lead ship construction in FY 1998.

Major Contributors to This Report

National Security and International Affairs Division, Washington, D.C.	John D'Esopo David Fisher
Boston Regional Office	Jeffrey Rose Ralph Tavares Alson Castonguay

List of SSN-21 GAO-Related Products Since 1991

GAO has performed work on the Seawolf program since 1985. The following chronology presents products issued since 1991.

- Navy Ships: Seawolf Cost Increases and Schedule Delays Continue (GAO/NSIAD-94-201BR, June 30, 1994).
- Navy Ships: Problems Continue to Plague the Seawolf Submarine Program (GAO/NSIAD-93-171, Aug. 4, 1993).
- Navy Ships: Plans and Anticipated Liabilities to Terminate SSN-21 Program Contracts (GAO/NSIAD-93-32BR, Nov. 27, 1992).
- Navy Ships: Status of SSN-21 Design and Lead Ship Construction Program (GAO/NSIAD-93-34, Nov. 17, 1992).
- SSN-21, Seawolf Contract Terminations (GAO/NSIAD-93-41R, Nov. 6, 1992).
- Navy Shipbuilding: Effects of Reduced SSN-21 Procurement Rates on Industrial Base and Cost of Program (GAO/NSIAD-92-140, Apr. 8, 1992).
- Submarine Combat System: BSY-2 Development Risks Must Be Addressed and Production Schedule Reassessed (GAO/IMTEC-91-30, Aug. 22, 1991).
- Submarine Combat System: Status of Selected Technical Risks in the BSY-2 Development (GAO/IMTEC-91-46BR, May 24, 1991).
- A May 24, 1991, letter to Representative Herbert H. Bateman discussing cost projections of several SSN-21 procurement scenarios.

Senator DODD. My colleague from Virginia yesterday in the Armed Services Committee raised some questions about a single supplier, and I wonder if you might for the record, Mr. Secretary, state what the DOD position is and the rationale for that decision on a single supplier.

Secretary PERRY. Simply when you look at our needs and a probable procurement of submarines over the next few decades, the numbers required are not sufficiently large to support two separate submarine builders. On the other hand, from an industrial base point of view, we want very much to have two nuclear-capable yards, and that is the logic that led us to the course we are proceeding on, the desire to preserve an industrial base which has two nuclear-capable yards as well as one of those two yards being able to build submarines.

We believe that attack submarines will be a crucially important part of the U.S. military for the foreseeable future. Therefore, we must have this capability.

Senator DODD. I thank you for that.

Mr. Chairman, I would recommend to our colleagues here on the committee, there is a briefing that members can received called, I think, "The Bear Still Swims," if I am correct. It is about a 20-minute briefing that members can receive from the Pentagon, and it is really worth your while to get it. I know this is going to be a debate coming up, and before people decide to lock themselves in on views, they really ought to see it.

This Wall Street Journal story is just one piece of it, frankly, not the most serious or pressing in the short term. There are other issues that, frankly, would, I think, raise the issue of this. Obviously, coming from Connecticut, people will not be surprised I am interested in this program, but my interest goes far beyond the employment picture in Connecticut. It is a critical piece of technology for the future, and really, if you hear that DOD review on "The Bear Still Swims," I think you will reach many of the same conclusions others of us have. So I would urge the members who are interested in this—and we will obviously have to be at some point, because there will be a debate on this, I gather—getting that briefing can be really helpful, I think, in helping you draw your own opinions about where we ought to be going.

I apologize for going over, but I wanted to raise that. Thank you, Mr. Chairman.

Senator EXON. Mr. Chairman, if I might just add something, I would like to say that the Senator from Connecticut has made a good point. I had a briefing the other day on the third Sea Wolf. And while there may be great build-up to cancel that third Sea Wolf, from the information that I have, which I am going to check into further, it may end up that we would cancel that third Sea Wolf, and with the money we have in it now, it would be extremely penny-wise and pound-foolish. So we ought to take a look at it.

Senator DODD. Coming from Nebraska, that is an enjoyable set of comments. [Laughter.]

Chairman DOMENICI. Senator Snowe is next, but on this overall subject of nuclear deterrence and the nuclear stocks of the former Soviet Union, might I make an observation, Senator Exon, and perhaps you would join me, and maybe we could have a joint briefing.

I guess it was about 3 weeks ago that, believe it or not, "60 Minutes" had an in-depth analysis of Soviet nuclear missile capability and literally went over there and talked to the Russians and saw everything they have got, and I assume, General Shalikashvili, you have seen that and probably your people have told you about it. But there were some pretty interesting things in it, like, you know, our President tells the American public they don't have those weapons directed at us anymore, but they asked the Soviet commander of nuclear missiles, what does that mean? And he said it means that it takes us 6 minutes to direct them at America, which was a pretty interesting thing for me to hear.

They indicated they were still building weapons, and they also had a map up, Senator Dodd. They had a map up on the wall on "60 Minutes," and they said, well, there are your submarines. They just pointed to them. We know where they are, and we think you are still trying to encircle us, et cetera, et cetera.

So I would think we ought to have you all brief us on Soviet nuclear missile power. I am not suggesting "60 Minutes" should be the source of anything to anyone. [Laughter.]

Essentially, I was pretty shocked the Soviets would give them as much as they gave them, and it caused me to wonder whether we ought not be briefed in one of our sessions where you can tell us everything. I am going to try to set that up if——

Senator EXON. Mr. Chairman, may I say that I have been in on all this as the Chairman of the Strategic Subcommittee forever, and I think your suggestion is a good one. It would obviously have to be a closed brief.

Chairman DOMENICI. Of course.

Senator EXON. And I think that probably all of the members of this committee who are going to make a very important recommendation with regard to the total budget should have a better understanding of all of this than they read in the newspapers.

Chairman DOMENICI. Thank you.

Yes, General?

General SHALIKASHVILI. Mr. Chairman, may I make just one observation on what you said?

Chairman DOMENICI. Of course.

General SHALIKASHVILI. In reference to the de-targeting of both Russian missiles and ours, I think the major point on that issue is not how long it takes to re-target, but the fact that on a day-to-day basis these missiles are not targeted on each other's cities. And so in the event of an accidental launch, those missiles would fall harmlessly into the sea and not hit either one of our cities or vice-versa. So that should be a very important point of that.

Chairman DOMENICI. Senator Snowe?

Senator SNOWE. Thank you, Mr. Chairman. I want to welcome our witnesses here today and I am pleased to have had the opportunity to talk with you earlier in the week. And one of the issues that I raised, of course, at that time was the Aegis Destroyer Program and the procurement rate included in the Administration's budget of two, two-and-a-half a year. I am not clear of whether it is two or two-and-a-half. I know you mentioned that it was two-and-a-half.

But nevertheless, the Defense Acquisition Board indicated that at least it should be three per year if we are to have a surface combatant force of 134 beyond the turn of the century. So I would hope that you would look at that, and I know Senator Cohen raised that issue with you yesterday before the Armed Services Committee, because I do really think it is important if we are going to preserve our ship building industrial base for the future.

And it leads me to the other question in terms of the Administration's Bottom-Up Review, Mr. Secretary, because there have been a number of articles written about the fact and, of course, more recently by the Congressional Budget Office, that the Bottom-Up Review, as outlined by the adminstration in terms of its force structure with its mission, is underfunded by $47 billion, even including the increase by the Administration of $25 billion in the defense budget.

And I really would like to have you address that issue because obviously it is a concern as to whether or not we can meet the two-war strategy, and we discussed that the other day. But again, it seems that between the cost of implementing the force structure and the missions as outlined by the Administration and what is being suggested in terms of funding analysis does not square. So I would really like to have your comments on those issues.

Secretary PERRY. I will make a brief comment, and then ask Dr. Hamre to comment further. The most important thing I wanted to say is that the 6-year plan we have submitted to you, the Future Years Defense Program, is priced out to the best of our ability and is done honestly and objectively. There is no smoke and mirrors in this budget.

Having said that, let me observe that there is plenty of room for debate and controversy about how much money it takes to do a program as big and as complex a this. Two specific areas where there can be changes, different interpretations or even changes: one is what the inflation will be 6 years ahead, since that figures intimately into the calculation each year and can have a big swing on the budget and, second, whether there will be overruns in the cost of building equipment.

And various people who have estimated this budget make different estimates. Some were optimistic, some were pessimistic about whether equipment building programs over the next 6 years will have big overruns, small overruns or no overruns at all. So those are the areas of objective uncertainty in the course of preparing this budget.

John, will you answer the question?

Mr. HAMRE. Senator Snowe, there has been a lot of discussion because of the GAO report and others that the Department of Defense needs more money. I think one needs to separate out the policy choices. Do you want to spend more because you want us to be doing more things than we are currently doing versus the honesty with which we have put a budget together?

GAO has criticized us because they think we have not covered the cost overruns that they think we will have in procurement. I know that Congress would not tolerate it if I put an entry in every weapons system for expected cost overruns. People tend to live up to expectations. We are not going to identify where we think that is the case. We actually honestly think that we are putting in our best estimate.

Now, if people want us to buy more weapons systems, that is a policy choice. But that is not the case of what GAO is raising. They said we should be budgeting for overruns, and we do not feel we should do that.

Senator SNOWE. Well, have you examined the CBO analysis?

Mr. HAMRE. Yes, ma'am. Yes, ma'am, we have. And I would be glad to go through that and provide to you an assessment. CBO said that they expected we had an inflation problem. We fixed that in this budget. CBO said that they thought that we had a pay problem. We fixed that in this budget. CBO said that we were probably were going to have higher environmental cleanup costs. What we have done is funded the legal requirement in our budget. If people want us to clean up faster, beyond what the law requires, that is again a policy choice. But we have funded the legal requirement for cleanup bills in this budget.

CBO has said that, again, there could be cost overruns on weapons systems. Should cost estimates—and we budget to most likely cost in our budget. I would be glad to go through all of that. I think we have honestly and fairly budgeted.

Senator SNOWE. No, I appreciate that. And I think it would be helpful, Mr. Chairman, if we had this analysis in response to the CBO——

Mr. HAMRE. I would be very happy to provide that to you.

Senator SNOWE [continuing]. For the committee, as we begin to consider the budget, as well.

Mr. HAMRE. I would be very pleased to provide it.[1]

Senator SNOWE. In addition, I would just like to ask one other question. The supplemental, how much of that is devoted to peacekeeping? Is it all including the peacekeeping? Does it include the State Department's contribution to peacekeeping missions?

Secretary PERRY. The supplemental that we requested is to simply provide the funding for the ongoing contingency operations. That is, the forces that are in Southwest Asia, the forces that are in Haiti. There is a whole set of these forces. This is not a peacekeeping supplemental as much as it is funding ongoing military operations.

Mr. HAMRE. That is correct, ma'am. Ninety percent of the supplemental that we are submitting is for O&M dollars for ongoing operations, whether they be in Bosnia, Somalia or wherever. It is for the Department of Defense. We are not requesting funds for any other department. It is purely for our operations budget request.

Senator SNOWE. Thank you.

Chairman DOMENICI. Senator Murray?

Senator MURRAY. Thank you, Mr. Chairman, and I join my colleagues in welcoming our witnesses this morning.

Mr. Secretary, when the President sent over his fiscal year 1996 budget, I was very pleased to see his commitment again to improving women's health by adding research dollars to NIH and to the Department of Defense for breast cancer and ovarian cancer.

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[1] Information unavailable at press time.

Part of that commitment is found in the defense budget, I assume, because of the great work that is done at Walter Reed, at Bethesda Naval Hospital and other locations. And I know we have great work to do here because one of nine women is stricken with breast cancer and this research has not been funded well in the past. Now finally, thanks to the work of many of my colleagues, we are making a commitment in this Nation to deal with these issues.

The other issue is AIDS which is, as we know, the leading cause of death in this country for people between the ages of 25 and 44. I assume that an overwhelming majority of military personnel falls between those ages. So I was kind of surprised this morning to see an article in The Washington Post that says that $30 million earmarked for AIDS research and $150 million for breast cancer research may not be spent this year by the Defense Department because it does not consider them essential parts of the military's Medical Program.

I wonder if you could share with me how that decision was made and where that money is going to go if it is not spent on the research for AIDS and breast cancer.

Secretary PERRY. Yes; let me ask Dr. Hamre to comment first on laying out the facts of the case, and I will be happy to comment further.

Mr. HAMRE. Senator Murray, I think the facts are slightly different than were reported this morning. The Department of Defense has not requested the additional funds for breast cancer research. That has been added by the Congress over the last several years.

Senator MURRAY. Correct, because we wanted it spent on AIDS and breast cancer research.

Mr. HAMRE. And our only position—we think it is perfectly understandable that the Congress wants greater research done. And it is a very important area. It is just that it is not primarily a defense mission. And there is an organization, the National Institutes of Health, that is really structured to do that sort of thing and it is our view that it really ought to be more in those accounts.

And I think that you would note when the budget was transmitted here, we have proposed to transfer those funds to NIH, to have them execute it rather than to have the Department of Defense execute it. If Walter Reed has particular skills that are useful in this area, I am sure that they would be recognized by NIH and they would continue to do that work. But it does not primarily constitute a defense——

Senator MURRAY. So that $30 million will be transferred to NIH?

Mr. HAMRE. That was the breast cancer research, Senator.

Senator MURRAY. Correct.

Mr. HAMRE. The case with HIV is different. As the article pointed out, we do indeed budget for AIDS research in the Department of Defense. Now, there are some very particular military issues. For example, medical—out in the field, if people need blood, we do not have blood banks. They are walking around, and we do direct transfusions.

It is very important for us to be able to have a quick test, within minutes, whether someone is HIV positive or not before we transfuse their blood into a patient. It is very important for us to do that kind of research in the Department of Defense. And we are undertaking that kind of research in the Department of Defense.

What people have asked us to do is to go beyond that and do broader analysis that involves vaccines and things of that nature, not primarily a defense need. We do feel there are HIV and AIDS research needs that the Department of Defense should budget for, and we do indeed do that.

Senator MURRAY. So the $150 million for breast cancer research that you are not going to spend in the Department of Defense, is that being transferred to the NIH or is that money lost?

Mr. HAMRE. Ma'am, I believe that is in our supplemental request. We have proposed that the Congress.

Senator MURRAY. That it be transferred, that $150 million, be transferred to NIH?

Mr. HAMRE. I believe that is the situation. I will go back and check.

Senator MURRAY. I would like to know the answer to that question.

Mr. HAMRE. I shall, ma'am.

Senator MURRAY. And, in addition, the $30 million?

Mr. HAMRE. No, ma'am, we have not acted on that one way or the other. I do not believe that has been proposed for moving.

Senator MURRAY. I would like the answers to those questions. In my remaining time, I just wanted to ask you quickly on the housing initiative, I hear a great deal from my constituents about quality of life. And I wanted you to just comment quickly on the housing initiative.

Secretary PERRY. We have, in this budget, a substantial increase in funds for both improving family housing and barracks. It is an interim measure, though, because it is all relative to the needs out there. I will be coming back to the Congress this year yet and proposing a major new housing initiative.

I am hoping that we can find an initiative which will not require additional appropriated funds. In particular, we are looking at legislative authority which will allow us to bring private developers to build using their own funds on military lands, and then leasing the property as a result of this. This will give us an opportunity to make a major short-term increase in the large-scale fixing of this problem. And therefore, what I would expect to do is to have a proposal later to this Congress. The most likely proposal will be for legislative authority to allow us to do this private development. If that fails, for whatever reason, then we would be seeking more funds.

Senator MURRAY. Thank you, Mr. Chairman. I do have additional questions, if I could submit them for the record.

Chairman DOMENICI. Yes, you may. In fact, we will be back after the vote, if you would like to return. I assume we will.

Senator Lott?

Senator LOTT. Thank you, Mr. Chairman, and thank you, good to see you again, Secretary Perry, General Shalikashvili. And, Dr. Hamre, good to see you again. Let me ask you to put that chart up we had yesterday in the Armed Services Committee. Sergeant, the next-to-the-last chart, the one that shows the freefall in the cuts for defense as a percent of GDP.

Secretary PERRY. We have a chart as a percent of Federal budget.

Senator LOTT. Oh, did you take the one out we had yesterday? [Laughter.]

Secretary PERRY. We have that one available, if you want it.

Senator LOTT. Well, if you have got it, let us put it up there.

Secretary PERRY. Yes, we have them both there.

Senator LOTT. The fact is that we are down to about the 1950 level of defense outlays as a percent of GDP. And it is going on down by the end of this decade to 2.8 percent, the lowest in many, many, many decades.

So I only have two problems with your budget: one, I think it cuts too much and, two, I think there are some serious problems with your priorities within a budget that has already been cut too much. And I think I hear you saying that you may come back up here later on this year, perhaps with things that I would agree with, but asking for more money. And I really am wondering if we are seeing the real budget or if we are going to get it in pieces later on?

After the study on bombers, which I am very interested in and which I think we need, I think the numbers are very scary. I do not think we have 93 deployable bombers. But without getting into a numbers argument, you say you may have to come back as a result of that study, and you may have to ask for some more money for bombers.

Then I thought I just heard you say that you may have to come back and ask for more money for housing. Now, you are looking for innovative ways to provide that housing and I commend you for that, and I want to help you make that happen if you can. But you are going to have to maybe come back for more money for bombers, more money for housing. Are we seeing the real budget here?

So, that is just my opening comment. And then, I want to refer to articles that are in the paper today about how that money is being spent. We are talking about housing for Ukrainian soldiers, officers, while they are continuing to build more submarines. And you are talking about—how much have you got for environmental cleanup in this budget, $5 billion?

Mr. HAMRE. No, sir. We have got about $1.6 billion for cleanup. In the regular accounts, we have got about $450 million for cleanup in bases that are being closed. And then we have got about $2.2 billion for compliance, and about $350 million for pollution prevention, so that we do not have a cleanup problem.

Senator LOTT. I think it adds up to about $5 billion, if you total all that up.

Mr. HAMRE. Yes, sir. Oh, yes, sir.

Senator LOTT. So we are providing funds for Russian or Ukrainian officers' housing. We are talking about $5 billion for environmental cleanup. Do we have in here $17 million for land near the 14th Street bridge for a museum?

Mr. HAMRE. Yes, sir, that is included in this budget.

Senator LOTT. Do we have $325 million in here for medical research on breast and prostate cancer, osteoporosis, lymph disease and AIDS?

Mr. HAMRE. That was added by the Congress in fiscal year 1995. That was not in our budget request.

Senator LOTT. Is it in the budget this year?

Mr. HAMRE. No, sir, that was added by the Congress.

Senator LOTT. Did you put anything in here that would go to the Small Business Adminstration?

Mr. HAMRE. That was added by the Congress last year, sir.

Senator LOTT. So you would appreciate it if we would not keep putting money in here for SBA and for museums, and communication equipment for the Red Cross. A lot of that was added by the Congress.

Mr. HAMRE. Added by the Congress, yes, sir.

Senator LOTT. When you couple what we add with some of the priorities you have in here, it makes the bad numbers look even worse. Congress has been using you for a cookie jar. And so, you do not have enough funds. And then you have some questionable requests in these low level of funds. And Congress even dips in it even more.

I guess all of this really is a statement that I have made. But how do you respond to all of that, Mr. Secretary?

Secretary PERRY. First of all, I would like to separate out the two rather fundamentally different issues, which are the programs which the Congress submitted in the 1995 budget and, I think, you make a good point on those. And, indeed, those will be a subject of debate as to whether they should be rescinded as part of the supplemental request. I am sure that will be an important debate within the Congress.

The other is what we have in the 1996 budget in terms of requests, which have none of those particular kinds of funds. It does have a large amount of funds, aggregating $5 billion in the environmental area. This environmental cleanup we are doing is legislatively required; in fact, some of it is court ordered. It is not as if it is a discretion on the part of the Defense Department as to whether it does it.

It may be a discretion as to whether those funds go in the defense budget or some other part of the Federal budget. But that the work has to be done, there is no doubt.

Senator LOTT. I think you just made a key point, sir.

Secretary PERRY. The only alternative we have is pushing those out and pushing the problem downstream so they are faced by some other adminstration as opposed to doing it now. But there are two other rather small issues in the budget, very small compared to the environmental, but just let me mention them anyway.

The Nunn-Lugar Program has succeeded in dismantling more than 1,000 nuclear warheads last year. That money serves a very important defense need. A part of that effort, a very small part of it but still an important part of it, had to do with allowing the contracting for an American company to transfer prefabricated technology to a Russian company so they could build housing for the officers, the strategic rockets force, which were discharged from the service.

This is an integral part of getting those nuclear weapons removed and dismantled. It is a small investment for a very high payoff. And finally, the museum; I understand that is going to be a debate point, that is, the funds to buy the land. The museum itself would not be built with appropriated funds. The AUSA, the Association of the U.S. Army—is proposing to raise the funds to build the museum.

Senator LOTT. My time has expired. We will be seeing you later.

Secretary PERRY. I am sure. [Laughter.]

Senator LOTT. Thank you for your time.

Chairman DOMENICI. Thank you, Senator Lott.

Senator Boxer?

Senator BOXER. Thank you, Mr. Chairman.

Secretary Perry, I want to compliment you on your steady and certain leadership of the Department of Defense. It is indeed a pleasure to work with you and to watch you. And I really do believe that most Americans feel very confident when they see you, as well as General Shalikashvili, handling some very complicated missions. I just want to say that. I may have differences with you on a number of issues, but let me say I am very proud of the job that you are both doing.

Secretary PERRY. Thank you, Senator Boxer.

Senator BOXER. I think this whole idea of walking around to the bases and really seeing what is going on is terrific, and I am glad you brought that with you from the private sector. And after we spoke, you gave me that idea for myself. And I have gone out, as you know, and it probably resulted in many more phone calls to you, and complaints, I am sure.

Secretary PERRY. Yes.

Senator BOXER. But I went to about a dozen bases in California. As you know, California is the size of a country, 31 million people, and we have so much to be proud of there in terms of the military. We have been having a difficult time, handling about 40 percent of the personnel hit in the cuts due to base closure. So we have been struggling, we have been hurting. And I, without asking a question, would hope that you keep that in mind because I think the cumulative economic impact that we are feeling is pretty tough in terms of the base closure. And I support California taking its fair share, that I support, but not an unfair share.

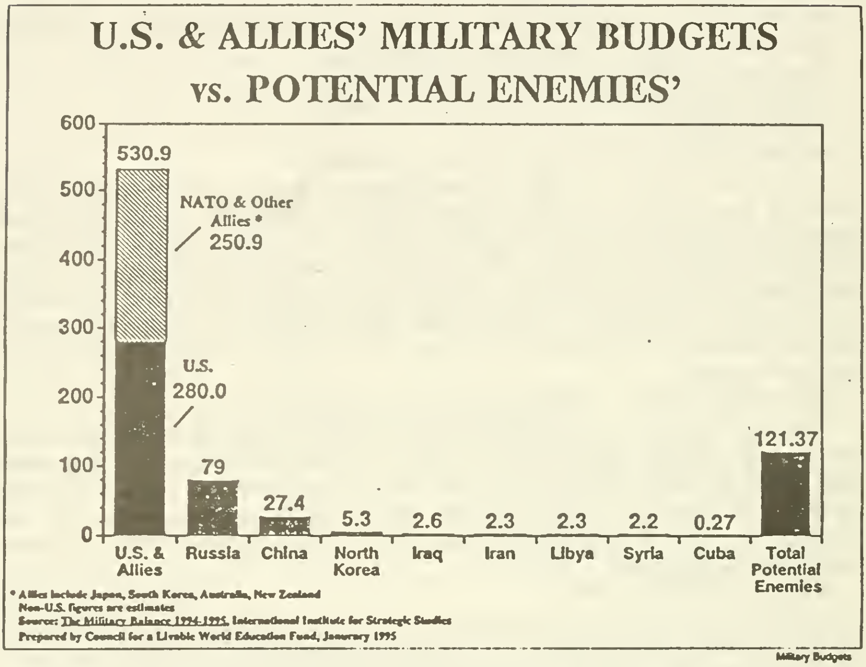
I would say, Mr. Secretary, in terms of the size of your budget, what you heard here from Senator Lott, and some from Senator Conrad and others, you can see that there are some differences here. And I guess you feel a little bit like Goldilocks and the three bears; some say it is too little, some say it is too much and some say it is just right.

Secretary PERRY. There is not anybody saying it is just right yet. [Laughter.]

Senator BOXER. No one has said that, you are right, and I am not, either. I, of course, feel that we need to put all of this in context. And, of course, if we have a bomber gap or if we have some quality of life problems, I want to be right there and help you solve it. But I think what Senator Conrad did in his presentation, I would like to pick up on.

In 1994, the U.S. military budget, compared to all of our enemies, is quite interesting to look at. And if you add Russia, China, North Korea, Iraq, Iran, Libya, Syria and Cuba, all of the Nations I can think of that would be our enemies, they are on a chart here prepared by the International Institute for Strategic Studies. I ask unanimous consent that this chart be made part of the record.

Chairman DOMENICI. Without objection.



Senator BOXER. Thank you, Mr. Chairman. What you can see here is we spend more than all of our other NATO and other allies combined. And when you take what we spend compared to all of our enemies, it is two-and-a-half times as great. And if you add our allies onto it, we are spending five times more than all enemies. So I would hope that—you know, we say we have in the Senate deficit hawks and military hawks—I hope the military hawks would look at this, because I think it is a very important point. And I do not think we can just close our eyes to the realities, because there are new realities.

And, yes, of course, the military budget is going down as a percentage of GDP because, thank God, we won the cold war. And we have many threats facing us, but they are very different threats.

I would like to ask a couple of questions and take your answers. I want to defend Senator Grassley just a tad here. Senator Grassley has been, in fact, equally concerned about what he considers to be waste—and I share that view with him—in the military through Democratic Administrations and Republican. So I hope that we will all keep that in context. He has been consistently on the side of ferreting out waste, fraud and abuse. And I think he is right. And I am not talking about this issue. I do not know a thing about this issue.

But I want to talk about another issue which you know, Secretary Perry, I have been on top of, which is the fact that the military pays convicted felons their full pay. If you are an enlisted person—listen, you have been convicted of a heinous crime subject to discharge and immediate confinement, and we are not talking about shoplifting here. We are talking about rape, murder, the worst things you can imagine, sexual assaults of all kinds.

We know we have to change the law. I have got a bill to do that and I have got some help coming from my colleagues. We have to change it. Right now, if you are an enlisted person, you get full pay up until your first appeal. If you are an officer, you get full pay until your last appeal, and that could be 8 years. There is no time limit.

As we seek to reign in the criminal justice system in the civilian sector, some people say you ought to have your last appeal within a year of your conviction. These guys are going on for 8 years, pulling down full salaries. And now we find out, just yesterday, they get out on parole, they double-dip. They pull down a whole salary from the private sector. These criminals are making more money than a straight and narrow military person. It is a disgrace.

Secretary Perry, I have worked with you continually on this. I am a little frustrated at how long it is taking. We are working on the law to change it. But you could unilaterally, as we understand it, as a condition of parole, stop that military pay for those parolees. So I will stop at this point. But could you please tell me where you stand on all of this?

Secretary PERRY. We, first of all, thank you for bringing this problem to our attention. When you brought it to our attention, I established a legal and policy working group, both to consider what we could do within the law to make improvements and changes in procedures, and second, to determine what requested amendments to the law we will submit to the Congress.

This group is scheduled to report to me on the February 28, which is, what, 2 weeks from now. And I will report promptly to the Congress after I get that report.

Senator BOXER. On the parolee question——

Secretary PERRY. Both questions.

Senator BOXER. I think you can act on it unilaterally without changing law.

Secretary PERRY. I can act on it. I want their recommendation on it.

Senator BOXER. Fine. Thank you.

Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Exon, do you want to proceed for awhile?

Senator EXON. Yes, Mr. Chairman, thank you very much. Is it now my turn?

Chairman DOMENICI. Yes, I will take some time after you finish.

Senator EXON. Gentlemen, I listened to your presentation yesterday in the Armed Services Committee. I thought it was a very good one. It is very easy to criticize the work that other people lay down, but especially when they lay it down in some detail. You open yourself up immediately to people second guessing, and much of the second guessing, I say, is in order. I mean, we have an obligation, I think, at the Budget Committee and certainly in the Armed Services Committee, the authorizing committee in this instance, to take a close look at things.

I have listened to 16 or 17 straight years of budget presentations by the military, and I must say that while I do not agree with everything that you have said, I think this is as good, if not the best, presentation on balance that I have ever seen under some extremely difficult situations.

Secretary PERRY. Thank you, Senator Exon.

Senator EXON. Let me see if I cannot just straighten out some of these things that I feel are vitally important. Yesterday in the Armed Services Committee and to some extent today in the Budget Committee, we have talked about the Nunn-Lugar initiatives that were designed—and I think have been quite successful thus far under the expert management of yourself and General Shalikashvili in making Nunn-Lugar work.

Nunn-Lugar is designed not to help the Russians, Nunn-Lugar is designed to help us help the Russians in dismantling their vast nuclear inventory. Let me state that again. I think you and the military have done a good job in not giving away money to the Russians, but have used the Nunn-Lugar money for the very vital, worthy purpose of dismantling, helping dismantle the Russian military. And most of the money, as I understand it, has gone to American sources, American contractors, to carry out the worthy task of dismantling the Russian inventory that still remains a concern to many of us.

So Nunn-Lugar is for dismantling, dismantling, dismantling the Russian nuclear inventory. And if that is not good for the National security interests of the United States and the free world, then I do not know what is. There are many legislative arguments, pro and con, on many of the things that you are suggesting, and some of them I agree with.

I basically say that I support the $25 billion plus-up that the President has recommended over previous out year recommendations under a 6-year scenario for the military. Now, it might well be that we need more than that. We certainly have to approve the supplemental that you have sent up here already, and I hope we can do that in a faster fashion than we have thus far.

I would simply say, though, that those who want to pick and choose on all these things, those who propose vast expenditures in defense, on one hand, while accompanying a balanced budget on the other without spelling out where the details are and how this is all going to match up, I think, are not doing the process a great deal of good.

So I say that I hope that you will continue to work and consult with us on both sides of the aisle over-and-over and time-and-time again. We have some extremely important issues to discuss. We have not begun to talk about the B–2 yet, but I know that is under consideration now and we are waiting for your recommendation on that. Some of that was touched by Senator Conrad.

I say to you gentlemen that I hope everyone can understand that the primary role, as I see it, of the Federal Government, above everything else, is to provide for the National security of the United States of America. That is what you have been doing. I hope that we can stay away from some of these partisan attacks that are being made now, especially on the lack of readiness of the forces.

I have had a long conversation about this with Admiral Borda, who serves on the Joint Chiefs along with our distinguished chairman, who is with us today. I have talked to other military people. We have heard witnesses in the Armed Services Committee. I just hope that while I think we all want to improve our readiness and improve overall our national defense structure, let us keep away as much as we can from partisan attacks on readiness, on any hollow army, that old phrase that is used over again, the old window of vulnerability that the Democrats used, I think, at one time without proper foundation.

All of these things do not help the very difficult task that you have, you, Chairman of the Joint Chiefs and you, Secretary of Defense, the awesome responsibility that you have at this particular juncture. And I say again, I hope we can keep our focus on the important issues and not be sidetracked by a lot of other things that, while they should be addressed, have such a minor part to play in the overall responsibility that we have, that I think we should place our responsibilities first and foremost. And I pledge my support to you as best I can, although we have not always agreed.

We did not agree, obviously, last year on the so-called Exon–Grassley cuts that Senator Grassley and I combined on. I frankly think you overblew that objection a great deal. But, you tend to overblow things to make your point of view from time-to-time. And I must say that I suspect that there are those of us upon this side of the dais that may overblow the situation from time-to-time. And we both seek what I think most of us want to do, that is to provide for the common defense.

That is a statement rather than a question, but if I could impose upon both of these gentleman for brief remarks on that whole series of matters that I brought up to make sure that at least you and I are on the same glide path.

Chairman DOMENICI. Can we keep the answer as brief as possible? Can we do that?

Senator EXON. On a brief glide path.

Chairman DOMENICI. Yes, brief.

Secretary PERRY. Two brief comments. I try very hard, Senator Exon, not to overblow but to blow just right. And on the Nunn-Lugar, I thank you for your very instructive and very accurate comments, on not only the nature of that program but the very high importance of that program to our national security.

Chairman DOMENICI. General, do you want to make some observations with reference to his observations?

General SHALIKASHVILI. If I may, Mr. Chairman, particularly on Nunn-Lugar. I mentioned yesterday at the Senate Armed Services Committee hearing on the same subject that I have been fortunate enough to be involved with the Nunn-Lugar Program in the previous Administration and again now, and was on the team that first went to Russia and continued going back, and to Kazakhstan and Belarus, and Ukraine.

I think when you consider the number of warheads that this program has helped move back to Russia and dismantle and move in a safe way, the fact that here in the very near future we will remove Ukraine and Belarus and Kazakhstan from the status of countries that posses nuclear weapons, I think that is an extraordinary accomplishment. And I think that is a heck of a lot better way of dealing with this nuclear threat than having to deal with it in a defensive or offensive military way. So I am a great supporter of that, and I thank you, Senator Exon, for your kind comments.

Chairman DOMENICI. Thank you very much, Senator Exon.

We will have a vote in 15 minutes, but I think that means some of us can wait until 5 minutes into the vote, and I would like to make some inquiries now. Since I have not asked any, I will take my first round and my second round together, and then we will proceed after that.

First, let me suggest that while this committee is not charged with the responsibility of coming up with the details and passing judgment upon the details of a defense budget, I hope everybody understands that the money for defense, the budget authority and outlays, will be voted out by this committee and probably remain about where this committee says, it would be my best guess. And so I think it is very important that we continue to work together through our markup in an effort to reach some consensus on this committee as to where we are going and what numbers we ought to provide.

I thank you for your testimony today, and from my standpoint, it is very rational and reasonable, but I would like to ask some questions because, frankly, we are now charged with preparing budgets that are very, very tight. I will make my philosophical notions known.

Of all the budget, everything we do in our budget, there is only one major endeavor that is solely and specifically the United States Congress' responsibility. You can look at all the rest of the things we do, and there is really very little that the Constitution of the United States says we ought to be doing, and most of that little part is our is defense. So defense is different from the rest of the budget because the rest of the budget can be done by others. Some can be done by the private sector, some can be done by cities, some doesn't have to be done at all. So we will take defense into consideration here with that understanding, that this is the single most important function of the National Congress.

Having said that, let me talk about dismantling for a minute and ask you for some evidence. Frankly, you will never hear this Senator say that the dismantling efforts, whether they be under Nunn-Lugar or some more expansive program or some better program or some more cooperative program with other departments of the government, it is clearly a defense mission. There is probably no bigger return to the American taxpayers by way of security than what we receive for assisting Russian dismantlement and authentication and verification of their nuclear weapons. They have much looser controls than we had. To dismantle, they need better controls.

I am not at all sanguine about how the Defense Department has carried out Nunn-Lugar. Maybe you are doing a great job the last 6 months, but I would ask you, for the record, to honestly evaluate, year by year, what happened with Nunn-Lugar money with reference to dismantling. My recollection is just 8 or 9 months ago—and we can ask the Comptroller—we had hardly obligated any of the money, and Nunn-Lugar had been in effect for 3, 3½ years. We couldn't get the job done for some reason.

Where are we now? How much is authorized? How much is obligated? And how much is provided in this budget? Any of you.

Secretary PERRY. Yes; well, let me just make a preface comment that Nunn-Lugar has been in the law now for, what, 4 years, I believe.

Chairman DOMENICI. Right.

Secretary PERRY. The first 2 years, under the previous Administration, there was nothing obligated, and the reason for that were many-fold, but I think they didn't fully support the program and they were not willing to reprogram funds to get it done, because the funds were not appropriated, only authorized.

We requested the funds, so we requested authorized funds to do it. The authorization bill comes along with some very substantial certification requirements and getting agreements signed with the Russians, for example, and then getting those agreements posted with the Congress.

It took us a long time to get going. We were not as fast at starting it as I would like to have been even with those restrictions.

That program, I would say, for the last 6 months is in very high gear now, very high rate of obligation, and a very high rate of effectiveness. Let me ask the Comptroller to give you the actual numbers.

Chairman DOMENICI. Will you be kind of brief at that? So I was about right. Six months has been the period of time——

Secretary PERRY. You were about right, yes.

Chairman DOMENICI. All right.

Mr. HAMRE. We will provide it for the record because I don't personally have those numbers in my head. But we are doing very well on getting those dollars obligated now, and all of them have been committed to projects, specific projects that have been negotiated.

[The following was subsequently supplied for the record by Mr. Hamre.]

As of the end of January 1995, against a total program availability of $1.27 billion since fiscal year 1992, obligations for the Cooperative Threat Reduction Program are $488 million. This compares with obligations of $105 million as of the end of fiscal year 1993.

Chairman DOMENICI. I would just make one further observation on that. I don't think you ought to spare the technical resources of this country for this effort. I think if the National laboratories, who are most respected by the Soviet national laboratories that build and maintain Soviet weaponry, if they can be involved more, you ought to pull them into it. It is obvious to me that they know more about what is going on over there than anybody else, and I hope they can be utilized to the maximum extent.

When we speak of putting money in the defense budget in appropriations that is not defense money, I wonder. I want to say to the Senators first I intend to try to establish a firewall again between defense money and the rest of appropriated accounts. I think it will pass now, and we will say whatever the defense dollars are, you can't use it for anything else and there will be a point of order against doing that. Firewalls will lend some stability to your budgets, and we won't be taking it out of there for anything else.

If we cut defense, it goes to the deficit, not to other appropriated accounts. I don't ask you to support that because I understand our President has never been in support of the firewalls. I don't understand why, but I think even though you don't come forward and support it, you will be very much hoping that it passes. I don't even want to ask you that, but I can tell by the way your faces look that you would like that to happen. [Laughter.]

Thank you.

Secretary PERRY. Let the record show I am keeping a poker face.

Chairman DOMENICI. Yes.

Senator GRASSLEY. I will be with you on that effort.

Chairman DOMENICI. And I understand Senator Grassley is going to be with us on that, and that is going to be very helpful.

I also believe we are in for some different times in terms of supplementals, and so I would share with you a great concern. I am not sure we will pass the supplemental without it being offset. I don't suggest it has to be offset with all defense cuts, because I think you all have been put in a bind. But I think the days are numbered when we will bring a supplemental from defense or anything else to the floor and easily declare it an emergency and thus avoid the rigidness of caps.

I think you ought to know that. I think I know what I am talking about there. I think you had better try to find a way so we don't overspend defense money on missions that Presidents might want us to go into unless we have found a way to pay for it or Congress understands that they are going to have to pay for it with some degree of specificity.

It is just difficult the way it is. We want to be helpful. We don't want you to rob preparedness and other mission work to pay for Haiti or Bosnia or somewhere else. And you don't want to do that either. But then you come back up here after it is done, and it is always a crisis. I don't think the crisis is going to fall on willing ears very much longer. We have got to find a way between the State Department, the executive branch in toto, and you in the Defense Department to either give us some reserve funds for these every year, even if you don't use them, and be square with us.

Would you just comment on that, please, Mr. Secretary?

Secretary PERRY. We have in this supplemental request sufficient funds for all of the operations now underway projected through the rest of this fiscal year. And so I think that should take care of the problem for this fiscal year, barring completely unexpected emergencies that might come up during the year.

If such emergencies come up, we would certainly come to the Congress immediately and lay out what it is we were planning to do or proposing to do about it.

I fully understand your point about the importance of getting a commitment on the funding for those operations. I will certainly take that fully into account as we discuss this with the Congress.

Chairman DOMENICI. You indicated that while we may be short in this budget on research and development money, you used the phrase, Mr. Secretary, about a swing of $8 billion. Tell me what is going to swing to what, again.

Secretary PERRY. We have in the fiscal year 1996 budget approximately $4 billion that are involved in the closing funds, expended in the closing of bases involved in the 1988, the 1991, and the 1993 BRAC. So those are the front-end costs to get those bases closed.

Those same bases by the end of this decade will be showing a savings of $4 billion of avoided costs, and, therefore, there will be— the swing I am talking about is from the cost of $4 billion to the savings of $4 billion, for a total of $8 billion. Our plan in this program is to divert that money to the increased modernization procurement.

Chairman DOMENICI. Well, I thought that is what you said, and frankly, I am very skeptical of that approach. I haven't seen very much savings in base closures, and everything about them has gone up in cost. Cleanup has gone up, but we don't save any money. Frankly, I think modernization is way too important to predicate its future upon this swing.

Besides, I think once Congress sees the money coming in on the base closures, it is very apt to not want to spend it on anything. And I am doubtful about it, and I just want to state that to you right up front. And I also want to say I hope your estimates are better than they were on the first round of base closures, because we didn't save very much and got big liabilities that we didn't know we had.

Do you think you are doing better on estimating that, and will you do better on the second round of BRAC?

Mr. HAMRE. Sir, we have net positive savings of $500 million in this year's budget from BRAC Round 1, and we would be glad to go over and document that. We will be positive after this year on BRAC Round 2.

Chairman DOMENICI. Does that include all the cleanup costs.

Mr. HAMRE. Yes, sir. Yes, sir, it does. We will be glad to go through all of that.

Chairman DOMENICI. I would like to have that. If you could write it up in a little report?

Mr. HAMRE. Absolutely, yes, sir.

Chairman DOMENICI. We will make it part of the record.

Mr. HAMRE. We would be delighted to.

[The follows was subsequently supplied for the record by Mr. Hamre:]

In the initial round of base closures we were overly optimistic on our projections of costs and savings. However, as we have progressed through round three, our estimates of costs and savings have matured and are now closely tied to actual experience over the last 4 years. As a consequence, we project steady State savings, exclusive of environmental costs, of $4.3 billion annually after the 70 major bases are closed. The table below illustrates the current projected costs and savings anticipated for each round as of the fiscal year 1996/1997 budget submission.

BRAC Financial Summary -- DoD Wide
($ in Millions)

	BRAC 88	BRAC 91	BRAC 93	TOTAL
BRAC Savings	2,352	6,306	7,630	16,288
BRAC Costs	1,931	3,296	6,320	11,547
Net Savings	421	3,010	1,310	4,741
Environmental Costs	819	1,342	1,705	3,866
Annual Savings*	685	1,599	2,043	4,327

* After 6-year implementation period.

Chairman DOMENICI. I think it is Senator Sarbanes' turn now.

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

Mr. Secretary, I want to welcome you and your colleagues. When will the U.N. forces assume the responsibilities in Haiti?

Secretary PERRY. In Haiti?

Senator SARBANES. Yes.

Secretary PERRY. The end of March.

Senator SARBANES. End of March. Will that operation then be paid for by the United Nations?

Secretary PERRY. Yes, it will.

Senator SARBANES. The United States makes a contribution towards that United Nations payment but it does not bear the entirety of it; is that correct?

Secretary PERRY. That is correct.

Senator SARBANES. In economic terms will it be cheaper for the United States once the United Nations take responsibility for the operation in Haiti?

Secretary PERRY. Very much cheaper.

Senator SARBANES. Very much cheaper.

Secretary PERRY. Very much, yes.

Senator SARBANES. That then leads me to a broader question that I wanted to put to you. We hear a lot of criticism of the U.N. peacekeeping efforts around the world and the American participation in them. I want to leave aside for the moment the question of the United States participation defined in terms of involvement of American forces, and I just want to talk about United States participation in terms of financially contributing to the U.N. peacekeeping effort.

Is it fair to say that almost invariably the peacekeeping done through the United Nations by U.N. forces in financial terms would be cheaper than if the United States were to do the operation directly?

Secretary PERRY. It will always be cheaper for the operation to be done by the United Nations under U.N. funding with United States participation in the operation. The only proviso I would put on that is providing that this is an operation which the United States supports and would have done on its own had the United Nations not done it. There would undoubtedly be U.N. operations done which the United States would not have had national interest in and would not have chosen to undertake. So, without exception, I would say your statement is exactly correct.

Senator SARBANES. Since we have a veto, isn't it unlikely that the United Nations would be doing an operation that we weren't supportive of in a policy sense. Isn't that correct?

Secretary PERRY. That is correct.

Senator SARBANES. Do you have a view whether, given all of this, it is reasonable that the costs of peacekeeping undertaken by the United Nations should be set against the Defense Department's budget?

Secretary PERRY. What we think is reasonable to be set against the Defense Department budget is that part of the peacekeeping costs that relate to those operations involving U.S. military forces. And that is a significant part of the total, but those are the parts which seem to be appropriate defense operations, defense costs.

Senator SARBANES. Now, am I correct that in some of these peacekeeping efforts U.S. forces are on occasion under command of non–U.S. commanders?

Secretary PERRY. Yes, many of the U.N. peacekeeping operations are under the command of generals from other countries. In the larger operations, the ones involving complex and difficult military operations, we have taken the position that our participation is contingent on there being a U.S. commander or a NATO commander, and the only ones that are currently being considered now will be limited to those criteria.

Senator SARBANES. General?

General SHALIKASHVILI. U.S forces do not participate in any U.N. operations where total command is relinquished to a United Nations commander, regardless of what nationality. In those few operations where our troops participate, only operational control, which is a subject of command is, in fact, given to the U.N. commander. But the——

Senator SARBANES. We did that in World War II, didn't we? It is not unheard of that when we participate in multilateral operations with the forces of many other countries, that U.S. forces are on occasion at the command and control level, under U.N. command. U.S. forces are not under United Nations control at the total command level. For example, in World War II Eisenhower was the Supreme Commander. So at the ultimate level, you had an American commander. But weren't there many instances in which U.S. forces would be under commanders of other countries?

General SHALIKASHVILI. In World War I, World War II, as recently as Desert Storm, we have had American units under the operational control of non–U.S. commanders. So it is, in fact—NATO is a prime example. During my time as Supreme Allied Commander in Europe, of course, U.S. forces trained for and were prepared to and continued to operate under the operational control of other than U.S. commanders.

Senator SARBANES. Thank you very much.

Chairman DOMENICI. Senator Conrad?

Senator CONRAD. Thank you, Mr. Chairman.

If I go back to the discussion Senator Lott initiated with respect to his assertion that you have cut too far and this defense budget is too small, I go back to the Korb column and again note that Larry Korb was the Assistant Secretary of Defense in the Reagan administration, certainly not an Administration unfriendly to spending on defense. And in the Korb column, he points out that the United States by itself will spend almost as much on defense this year as the rest of the world combined and 4 times more than any other nation in the world.

Part of the answer that was given to me as to whether or not those are accurate numbers from Mr. Korb in his column was that, yes, they are accurate, but that there are included in our defense expenditures retirement funds, for example, that may distort the overall picture.

I am interested, of the $260 billion that is in this budget, how much is budgeted for the retirement accounts?

Mr. HAMRE. $11 billion, sir.

Senator CONRAD. $11 billion. So even with that taken out, we would be at a level of outlays of about $250 billion. Can you give me some idea of how that compares with the rest of the world's defense expenditures for this period?

Mr. HAMRE. Well, sir, I think to do a fair comparison, we would have to normalize for pay. We pay military in the Department of Defense a decent wage. I can't say that that is the case in Iraq. I don't know that that is the case in Libya. We insist on retirement. We provide health care for everybody in the military. I don't know what the case is in China.

We want intelligence capabilities so we know what is going on inside Iraq, and Iraq wants intelligence capabilities so that they know what is going on inside Iran. We could limit ourselves to only what is going on inside Mexico, but——

Senator CONRAD. Yes, I understand. Can I go on and ask, can you tell us what you anticipate Russia is spending on defense in this next year on a fair-comparison basis?

Mr. HAMRE. I would be delighted to work on that and provide that to you, sir.

Senator CONRAD. Do you have any sense of what it is?

Mr. HAMRE. No, sir, I don't. During the height of the cold war, they advertised only spending $30 billion on defense, when we knew that it was 8, 10 times that.

Senator CONRAD. For 1994, I have numbers that suggest they spent $79 billion on defense on a fair-comparison basis. Does that sound reasonable?

Mr. HAMRE. I don't know if it is a fair comparison. It may be how they budget. We will have to do a fair analysis. And I would be glad to supply this for the record.

[The following was subsequently supplied for the record by Mr. Hamre:]

The figure is reasonable. We estimate that Russia spent $76–$96 billion 1993 U.S. dollars on defense in 1994.

This assessment comes with several caveats. It represents what it would cost in the United States at prevailing U.S. prices and wage rates, and using U.S. manufacturing technologies, to duplicate Russia's military effort.

The estimate is based on dollar costing assessments done in the late-1980s of Soviet defense outlays. This work was terminated in the late 1980s. The estimate for 1994 is based on the late-1980s dollar costs brought up to 1994 using an index of real defense growth based on costing work done in constant rubles.

The estimate's range captures uncertainty inherent in the dollar costing approach, inflation in the Soviet and Russian economies, and the preliminary nature of the estimate for 1994.

Senator CONRAD. What do we know about what is happening with Russian defense expenditures? Are Russian defense expenditures going up or are they going down?

Mr. HAMRE. They have been cut sharply.

Senator CONRAD. Been cut sharply. When you say cut sharply, what percentage?

Mr. HAMRE. I don't know, sir. I would be glad to provide that for you.

[The following was subsequently supplied for the record by Mr. Hamre:]

If we compare estimated Russian defense outlays in 1993 with Soviet outlays at their peak in 1988, Russia had cut its defense spending to about 30 percent of the Soviet peal level. Additional reductions occurred in 1994, but our assessments have not yet been completed. We anticipate the Russians will make additional real defense cuts in 1995.

Senator CONRAD. General Shalikashvili?

General SHALIKASHVILI. If I may, Senator Conrad, first of all, the degree to which they are cutting defenses can be seen in a very graphic way: what happened in Chechnya. Troops that have not trained for 3 years, troops that do not have the best equipment any longer because they can't maintain it, will have a performance as we saw. And we shouldn't be surprised, because if you could not spend money on defense like they have for some time and still go in and do a very credible job, then you probably have a good reason to look at how much we spend on training.

[The following was subsequently supplied for the record by General Shalikashvili:]

We estimate that Russia will spend $68–$86 billion 1993 U.S. dollars on defense in 1995.

This assessment comes with several caveats. It represents what it would cost in the United States at prevailing U.S. prices and wage rates, and using U.S. manufacturing technologies, to duplicate Russia's military effort.

The estimate is based on dollar costing assessments done in the late-1980s of Soviet defense outlays. This work has terminated in the late 1980s. The estimate for 1995 is based on the late-1980s dollar costs brought up to 1995 using an index of real defense growth based on costing work done in constant rubles.

The estimate's range captures uncertainty inherent in the dollar costing approach, inflation in the Soviet and Russian economies, the preliminary nature of the estimate for 1994, and an estimate for decline in 1995 of 10 percent.

General SHALIKASHVILI. The second thing is when you compare what they pay their soldiers on the draft and what we pay and what high percentage of our budget is for pay and quality-of-life associated issues, how much it costs to build a tank in the United States or an F–18 vis-a-vis in Russia, those are issues that we can estimate, but very difficult to get to the bottom of. But we do know instinctively that the differences are vast, really.

Senator CONRAD. Can you just give me a final characterization? How would you characterize our forces versus Russian forces at this stage, General Shalikashvili?

General SHALIKASHVILI. I will tell you that it is my feeling that, without a doubt, we are the finest military force in the world. I think we saw the performance of the Russian forces in Chechnya.

Senator CONRAD. Which was a pretty dismal performance.

Yes, Secretary Perry?

Secretary PERRY. I would like to make an additional comment on this. Whatever the comparison of costs turns out to be—and as Dr. Hamre said, it is difficult to get an apples-to-apples comparison—the United States is a superpower that has a unique budget because it has unique military capability. That unique capability is designed to meet military requirements which no other country in the world is prepared to meet.

When Iraq sends forces into Kuwait, we are the ones who respond to that. If North Korea were to go into South Korea, our forces are going to be crucial to stopping that. There is no other country in the world that has the requirements that we are confronted with. Unless we are willing to back off those requirements and go into an isolationist stance, then we will have a uniquely high military budget. And I don't think it a relevant comparison with Russia because the Russia today has nothing like the requirements that the United States has, nor are they expecting to be fighting us nor are we expecting to be fighting them.

Senator CONRAD. I would just say this to you, Secretary Perry. When we are putting into perspective what we are doing on defense, and some assert that we have cut far too much, the fact that we are spending as much as the rest of the world combined I think has some relevance.

Secretary PERRY. I understand.

Senator CONRAD. And we have got to put into perspective for the American people what it is we are doing with respect to defense expenditures and where we rank and how our forces match up. And I think you have done a very good job, along with General Shalikashvili, of explaining that our forces are without equal in the world today. And I assume that is your characterization as well, Secretary Perry.

Secretary PERRY. My characterization exactly. I would be willing to put that perspective in, but I also would like the perspective of how well are these forces are able to meet the missions which we are laying out for them. And we can debate whether the missions are appropriate and also debate whether our judgment that these forces are neither too much nor too little for those missions is right.

Senator CONRAD. I thank you both. I thank the Chairman.

Chairman DOMENICI. I wonder if for our record you might give us how much of our budget goes to all matters relating to personnel. Do you know that off the top of your head?

Mr. HAMRE. Well, sir, I think it is in the neighborhood of $80 billion, but that is not all of our costs because we have family housing, for example. Let me do an analysis for you, sir.

Chairman DOMENICI. To set at rest that there are really apples and oranges when you compare ours and other militaries. I think if we could get all the costs related to personnel and the personnel's family, it would be very good for us to know and have that available when we talk about our defense.

We made a decision to go all volunteer. When we made that decision, we literally in the record—you can read it here in the Senate—said we are going to pay these people, not the conscript price but a standard of living equivalent to comparables out there in the American society so we can keep them for a long time.

Now, when we did that, we knew we would have to pay for it. And the commitment was a big one. If we don't want to pay for that part, then we have to go back to the draft, otherwise you are not going to keep them in.

Mr. HAMRE. Yes, sir.

Chairman DOMENICI. Mr. Secretary, let me once again stress supplementals and costs that are incurred during a year that we didn't budget for. I don't know that I quite made the right request of you, but I am looking at the budget request for peacekeeping in the 1996 budget. What I really would like to have is a lot of hope and faith that your numbers at least cover what you know about. I think we ought to start—at least from my standpoint, I am not going to concede an inch on supplementals in the future in terms of emergencies or paying for them without reference to budget. If there was any real chance that the Administration, Defense Department, or State Department could have estimated better what those costs were. We have only a half a year's worth of Yugoslav funding, the peacekeeping for Yugoslavia in this budget. I assume that means that——

Secretary PERRY. In the Department of State budget, Senator. Not in ours.

Chairman DOMENICI. But I am saying that is all part of the same—you get married up in a supplemental because you have some defense that you have to put in some of these, and I very much would like to send this signal, and I will do it with the Secretary of State also. We just ought not to be cheating short on that side, thinking that it is going to come through up here in supplementals. That is going to be very tough in the future.

My last question. Senator Boxer raised an issue about continuing to pay military men and women who were convicted of a crime. I want you to know that I trust you when you say you are going to have a task force, but I just want to tell you the task force was put in place to look at the reverse of that. The reverse of that is, after a long time in the military and you have a wife and three kids, and you commit a crime—the male part of that marriage commits a crime, the theory of the military is when you are discharged you sever all relationships with the military. That was part of the philosophy. So what we did is sever all relationships to that family, so that family didn't get any pensions, didn't get any health care, and I worked on that. This is my fifth year, and you are still not there. You are still looking at it.

I really think somebody might just ask how long does it take to make some of these recommendations, and this is not picking on anybody. I am just saying it takes too long sometimes because sometimes the people in the military are very reluctant to lay the cards on the table. And I think you ought to lay them on the table on that one, but I think on issues like I just raised, you ought to lay them on the table rather quickly and let us make some choices.

I have no further questions.

Senator EXON. Mr. Chairman?

Chairman DOMENICI. Yes, Senator Exon.

Senator EXON. I have to go vote. I just want to take 60 seconds, if I might. I hope that you will persevere in your efforts to factually talk about what is the start date to clean up these bases that we are going to close. That is a legitimate part of the defense budget. I also say that I hope that you will not make significant reductions in the amount of money that is necessary to get on much faster than we have so far with the nuclear cleanup, which is a national disgrace around the United States. The military created it. The military has the responsibility to clean it up.

Those people who say that shouldn't be part of the budget don't seem to understand. We have three old World War II facilities, bomb-making facilities in Nebraska, that have polluted with highly toxic waste the underground water system. That is a responsibility of the military to help clean up. It has to be part of your budget, as much as I wish that it were not, given the bind that we are in. But we have got to pay for past grievances as well. Please understand that. And I will be consulting with you on it.

Thank you, gentlemen.

Senator GRASSLEY [presiding]. Senator Exon, I know you have to go. I would like to have your staff report to you. I am going to make a comment on what you said. I don't think you will disagree with what I am going to say.

Senator EXON. I will stay.

Senator GRASSLEY. No; please go, because it is not controversial——

Senator EXON. No; you have forewarned me, Senator. [Laughter.]

Senator GRASSLEY. OK. Well, anyway, when Senator Exon in his last comment, when I left after my first questioning and then I came back, he was talking about partisanship. And I think I don't disagree with Senator Exon on this point. I am not going to join the partisanship of my party who wants to add an additional $60 billion to defense. I am not going to join the partisanship of my party that is going to have the Congress become the commander-in-chief and establish our national security policies. I think that we make broad policy; that is too specific policy for us to make. So I won't be joining that effort, and that is all I wanted you to hear. You can hear anything you want to hear, but that is—go ahead.

Senator EXON. Have you voted?

Senator GRASSLEY. Yes, I voted.

Senator EXON. Well, just let me say that, as usual, the Senator from Iowa and I do not see—are very far apart on very many things, and I do not agree with anything you just said.

Senator GRASSLEY. You mean you disagree? [Laughter.]

I was so careful how I said it. Also, Mr. Perry, first of all, I don't have any more questions about Ashey. I do have some questions of Mr. Hamre. They deal with accounting. I would like to have you hear them. I think he is going to have to answer most of them. But I just want to say in regard to what I did say about Ashey that that is not the issue in and of itself. It is a broader issue, as I see it, and that is why I asked you about your policy vis-a-vis the White House. And it is kind of a standard that is set, and the extent to which that standard is set then sets a standard all the way through the bureaucracy.

It is the same way with us in politics. If we are not cautious as political leaders, then we set a bad ethic for people in our profession. And it is in regard to whether or not we are going to tolerate abuse and waste of the taxpayers' money and what that says to the people in the lower ranks. That is all I have to say on that.

Now I would like to go to the business of accounting. Again, I started out with a supplemental bill, but it is because you have asked for specific legislative authority there in that supplemental bill, and that is in Section 1863 of the bill. It calls for a readiness preservation authority.

Mr. HAMRE. Yes, sir.

Senator GRASSLEY. You said, Mr. Hamre, the new authority would allow the Pentagon to "open a line of credit to pay for training and other direct readiness activities." I say, Mr. Perry, to get your attention, I don't expect you to maybe answer this, but it seems to me that the purpose of this provision is clear. It would allow the Pentagon to obligate and spend money that has not been appropriated. That may not be the intent, but this approach bothers me because of my relationship—wait until I set the basis for my question.

The Pentagon leaders I see would be free, would have free access to the treasury. The provision appears to be inconsistent with Section 9 of the Constitution which says, "No money shall be drawn from the treasury but in the consequence of appropriation made by law." The provision also seems to me inconsistent with the Anti-Deficiency Act, which makes it a felony to obligate money before an appropriation is made. It appears to duplicate the Feed and Forage Act, Section 11, Title 41, U.S. Code. You suggest that the new provision would "operate like overdraft protection on a checking account."

To me, now, that is exactly how the $50 billion M account was used. The M accounts were used to cover up and conceal overdrafts or violations of the Anti-Deficiency Act, and they were used to cover cost overruns beyond the view of Congress.

Because of those kinds of abuses, Congress then, as you know—and before you came here—passed a law in 1990 to close those M accounts, and now we understand that the Anti-Deficiency Act violations are popping up everywhere, and you have heard me speak about that. I have even visited with you about that over breakfast, et cetera.

A large number of DOD accounts are in the red. Numerous investigations are underway. You promised that the new authority "would not give DOD more money." And as you can tell from my tenor, I kind of disagree with those statements. They may be well intended, but I don't think that is the end result of them. The new authority would allow you to spend money that you don't have. And I think you could come to Congress and demand the money, and we would have no choice but to give it to you. And to me, that is just simply more money being appropriated after it is spent.

This idea appears to undermine, as I see it, our control of the purse strings and our process of checks and balances. But I don't fully understand the proposal, so I have asked the American Law Division to examine it and render an opinion. I need to understand how it squares with the Constitution, Title 31 of the U.S. Code, and the Feed and Forage Act. And once I have this report, I should be in a better position to make a final judgment.

Question: You say that the new provision "would not give DOD more money." I don't understand that statement. You spend the money. Then Congress bails you out after the fact with an appropriation. That sounds like more money.

Second, under the provision, would Congress have the choice of approving or disapproving the request? What would happen if Congress denied the request? Could the authority be used to pay for flights like the one—I am just using this as an example, taken by General Ashy? And, fourth, if the authority were granted, what is the maximum DOD could spend in fiscal year 1995? And for the record—and this is something you will have to do for the record—I would like to have you provide me the total amount of money obligated and spent under the Feed and Forage Act since 1972, and that is an update of the table on page 17,368 of the Congressional Record of June 5, 1975.

Can you help me understand that you aren't going to spend money that we haven't appropriated?

Mr. HAMRE. I am not as bad a bum as you think I am.

Senator GRASSLEY. OK. Go ahead.

Mr. HAMRE. Let me go through a few of these things.

First of all, Feed and Forage, we did trigger Feed and Forage last year for Haiti. That was $124 million. By law, we must ask for a supplemental to cover that, and that is in our supplemental request this year. So part of the $2.6 billion is the $124 million for food and forage from fiscal year 1994.

Sir, you asked about what was the maximum in fiscal year 1995? We don't anticipate needing anything because we anticipate Congress will approve our supplemental. So we feel there will be no need to trigger it in fiscal year 1995. We are asking for it as an emergency, but we don't anticipate that it would be needed at all.

On Ashy, I can unequivocally assure you it would not be used for that, because this was only applicable to O&M funds that are funded in budget activity 1, in the O&M accounts. And, of course, the flight that he took is funded through the airlift subsidy to the DBOF Program. So it wasn't related to that, and it wouldn't be financed through this kind of an activity, this kind of an authority.

Can Congress say no? Absolutely, Congress can say no. We would have to come to you with a request for a supplemental. As you read the language, you will see that it currently would require that we have to submit to the President offsetting rescissions. It would be up to the President whether he would submit those rescissions to the Congress. We have a lot of reservations about that inside the Department, but in any event, the Congress could demand rescissions. That is current law.

This authority would grant nothing other than current law as it comes to supplementals and rescission.

Is it a coverup as with the M account? No, sir. I actually was on the committee that removed the M account. I was on the Armed Services Committee. We drafted that language. It is not a coverup because we would have to make explicit accounting and come to you within 3 months to delineate that accounting that we have used under the authority.

You mentioned accounts in the red. Yes, we do have accounts in the red. It was my action in March that froze all spending on accounts in the red. And we are not spending out of funds that are in the red technically in accounts. I am holding up about $1,100 payments right now to contractors around the country where we have accounts in the red. It is a very painful thing. The first one I held up was in the district of the Chairman of the House Appropriations Committee. It was a very painful experience to tell him I would not release that until we cleared the account, and we did not release it until we cleared the account.

Does it violate the Anti–Deficiency Act? No, sir, it wouldn't because we would only be using it from the O&M account. And the line of credit that I refer to is the unobligated funds in the O&M account that constitute the collateral for that line of credit. I use this as an analogy. That is exactly what happens in law right now with Food and Forage.

Is it free access to the treasury? No, sir, because we would—again, there are very precise limits. It could only be used in the third or the fourth quarter of the fiscal year. We would have to come to you and get offsetting—we would have to get a supplemental, and we would have to supply to you rescissions, if that is what you ask for.

So, sir, I honestly think we have honored the prerogatives of the Congress in this, and I would be glad to work with you. I would be glad to go through any of this. We feel it is perfectly neutral as to the congressional control of the purse, which I honor. I worked up here for 16 years, and I believe that. And we have not tried to circumvent that in any way, sir.

[The following was subsequently supplied for the record by Mr. Hamre:]

Since 1972, the Feed and Forage Act has been used as follows:

Year	Event	$ Millions
1972	Vietnam	136.5
1978	Escalating Foreign Currency Rates	80.4
1980	Middle East Oil Crisis	663.7
1990	Gulf War	1,642.9
1994	Haiti	126.3
		2,649.8

Senator GRASSLEY. OK. I will quite now. I will just say in conclusion I hope you are right, of course. I am going to wait, as I indicated in my statement about the law review that I get of your proposal. I still have some concern about DBOF, as you heard me speak about.

Mr. HAMRE. Yes, sir. I know you do, sir.

Senator GRASSLEY. And that things aren't totally right there.

I will continue my dialogue with you. And, Secretary Perry, I am glad that you heard some of my concerns face to face. And Mr. Hamre has met with me several times to discuss them. I think that you are trying to make big changes. I hope you can make the big changes in accounting that he wants to make.

I have tried to compliment him when I thought he has made progress, and where I thought that things came up short, I have said so as well.

For the entire committee, to all of you people who are in charge of our national defense—and I have never been a member of the military, and so I come to the table here with some trepidation about never defending my country myself, criticizing people who do defend the country. But I want you to know that we appreciate what you stand for and what all the men and women in uniform stand for. And we are going to help you accomplish your goal. I suppose the only difference of opinion I have, I just want to make sure that my Republican colleagues—I speak to my Republican colleagues more than maybe my Democrat colleagues on this point. I think it is just wrong for people in my party to complain about waste and fraud and abuse in education, in social welfare, and other domestic programs, and somehow condemn Democrats when they want to throw money at a problem as if money solves that problem, and then seem willing to give to the Defense Department money without the same sort of—not strings attached—but the same sort of accounting that we would hold for other departments of government.

I hope that we can be more consistent in that, and my end is to see that that is accomplished in a very macro-management approach, hopefully not in a micro-management approach.

I thank you for being here today. Once again, thank you for your service to the National defense and our country. Thank you very much.

Secretary PERRY. Thank you, Senator.

Mr. HAMRE. Thank you.

General SHALIKASHVILI. Thank you very much.

[Whereupon, at 11:59 a.m., the committee was adjourned.]

WRITTEN QUESTIONS FROM CHAIRMAN DOMENICI TO SECRETARY PERRY AND THE RESPONSES

Question. The Congressional Budget Office, last month, concluded that the Bottom-Up Review Program was underfunded by $47 billion through 1999. Last summer, the General Accounting Office concluded that the Bottom-Up Review Program was underfunded by more than $100 million.

Does the Department of Defense disagree with the conclusions of the CBO and GAO studies? Where, specifically, does the Department disagree with CBO and GAO?

Answer. Yes, we disagree. A year ago when the President released the fiscal year 1995 defense budget, we noted that the fiscal year 1995–99 Future Years Defense Program was underfunded by $20 billion, because of higher than anticipated inflation. If one had added in full by-law pay raises, in expectation of Congress approving them, then the shortfall would have been about $40 billion. Both reports include these two sources of underfunding, but they also asserted several others, with which we disagree—including weapons systems cost growth and base closure costs.

There is now a new FYDP covering fiscal years 1996–2001; it contains no funding shortfall, thanks primarily to the $25 billion added by President Clinton last December.

Question. In addition to the $2.6 billion emergency supplemental included in the budget submission, the request includes a "negative" supplemental of $703 million in budget authority and $200 million in outlays for 1995.

What is the definition of a negative supplemental? How would cancellation of funding differ from existing rescission authority, which also provides for the cancellation of budget authority with the approval of Congress?

Answer. There is no difference. The negative entries in the supplemental request reflected our plan to submit to the Congress details of our proposed recissions. However, that plan was overcome by events and dropped when the House Appropriations Committee approved its own package of rescissions.

Question. The Administration's requested $2.6 billion emergency supplemental is largely for peacekeeping missions. What is the Administration's rationale for funding this supplemental outside the discretionary spending cap when these operations have been ongoing for quite some time and could be captured in the regular, annual budget request?

Answer. First, Senator Domenici, let me say that I believe it is inaccurate to cast the DOD emergency supplemental as largely for peacekeeping operations. The $2.6 billion emergency supplemental covers all contingency operations, not just peacekeeping. The two largest cost categories in the supplemental request, totaling more than $900 million, are for VIGILANT WARRIOR and ENHANCED SOUTHERN WATCH, the United States response to Iraqi aggression last October and our continuing enforcement of sanctions against Iraq. The supplemental requests $122 million for PROVIDE COMFORT, the contingency effort to protect the Kurds in Northern Iraq and another $59 million for the U.S. military build-up in Korea. Operations to house the flood of refugees from Cuba cost the Department another $367 million that is reflected in the supplemental request. These five contingency operations, none of which were peacekeeping operations, constitute over half of our supplemental request. I realize that peacekeeping was not the point of your question, Senator, but I think it is important for us to dispel the notion that the Department is spending all of our time and money on peacekeeping operations.

As to why funding for contingency operations is not captured in our annual budget request, the reasons are that it is very difficult to accurately project the costs of contingency operations, requiring adjustment at the end of the year even if operations are budgeted and, more importantly, that the Congress has not permitted the Department of Defense to do so. In fiscal year 1994, the Department attempted to create a budget line to reimburse the services for their incremental costs of participating in peacekeeping operations. Congress did not support that effort, largely out of concern for the Congressional prerogative to approve on a case by case basis the funding for the use of United States military forces. Since Congress did not support the creation of such a fund within our annual budget, the Department has had to continue to seek supplemental funding for contingency operations.

Currently, the costs of contingency operations are paid primarily from Service operations and maintenance accounts until supplemental funding is received from the Congress. The time lag generally associated with seeking and receiving supplemental funding, given the fact that when the supplemental request is usually generated after the contingency response has already begun, can degrade the readiness of our forces, particularly if such contingency operations occur in the 3rd and 4th quarter of the fiscal year. The Administration's fiscal year 1996 annual budget request includes a proposal to create a new Readiness Preservation Authority that would provide the Department with a special fiscal authority modeled after the Feed and Forage Authority. While not a contingency operations fund, the new authority would permit the Department to obligate funds to service O&M accounts in the 3rd and 4th quarters beyond the amount appropriated in order to preserve the readiness of the force in the event that an unexpected last minute contingency operation arises. This money would ultimately need to be reimbursed via a rescission. I encourage you to support this important effort.

Question. What is the status of the fiscal year 1995 Counterproliferation effort? What are the Department's plans for fiscal year 1996?

Answer. The fiscal year 1995 Defense Appropriations Act (PL–103–335) and Defense Authorization Act (PL–103–337) supports a range of programs to significantly improve United States counterproliferation capabilities. Prior to obligating funds, Congress required a report outlining the plan for how monies would be used. This report was submitted on December 10, 1994. Monies for the efforts outlined in the *FY95 Project Overview* have been distributed, and since the fiscal year 1995 program is designed to leverage existing efforts, work started upon notification of funding. The Department will fully obligate all authorized funds supporting counterproliferation activities.

The FY96 President's Budget contains a $108.2 million request to continue, and build upon, the fiscal year 1995 counterproliferation efforts. With the May 1994 "Deutch Report" as our roadmap, as validated by the Joint Requirements Oversight Committee, the Department will continue to focus on military preparations necessary for our forces to operate against an opponent who possesses, threatens, or uses nuclear, chemical, and biological weapons in conjunction with sophisticated or nontraditional means of delivery. Some examples are:

• Enhancing our capability to respond to BW and CW terrorists and paramilitary threats consistent with today's capabilities to respond to nuclear terrorism or paramilitary activities.

• Developing the capability to defeat hardened underground WMD storage and production facilities with particular attention to reducing the collateral affects associated with these attacks.

• Developing the capability to remotely and identify the BW and CW threat clouds coupled with improvements in personnel protection and decontamination.

READINESS PRESERVATION AUTHORITY

Question. The President's budget request includes a general provision that would allow the Department of Defense "to make obligations in excess of its total budget authority during the last two quarters of 1995."

If the general provision were adopted: How much would DOD be able to spend above those funds already appropriated in 1995? What would these additional funds be used for? What role would the Congress play in the decision to expend these funds?

Answer. Before answering your specific questions, I would like to discuss the importance of this authority. For the past several years, the Department of Defense has been involved in a number of contingency operations. These operations, by definition, cannot be costed and budgeted in advance. Neither has Congress agreed to provide lump sum funding in the budget for undefined contingencies. Therefore, DOD begins each year with only enough operation and maintenance funding to maintain the military's readiness to fight but without the funds to actually conduct warfighting or contingency operations. Any contingency operation must be accommodated through in increase in tctal operation and maintenance funding or through the reapplication of funds from budgeted operation and maintenance activities (training, spare parts, etc.)

Augmenting operation and maintenance funding requires either a supplemental appropriation or a transfer (reprogramming) from other DOD appropriations. Since the former requires approval by both Houses of Congress, it cannot be obtained in a timely manner. Transfers must be approved by the Defense Oversight Committees, which is also a lengthy process. In addition, sources from which funds may be reprogrammed are constrained, and it is frequently difficult to obtain Congressional approval of the reprogramming sources.

The following responds to the specific quetions addressed above:

Question. If the general provision were adopted: How much would DOD be able to spend above those funds already appropriated in fiscal year 1995?

Answer. The proposed general provision (Section 1883) limits the amount that the Department would be able to spend to 50 percent of the funds included in Budget Activity 1 of the Operations and Maintenance Title. In fiscal year 1995 this amount would be $17 billion. While this is a large amount, the more realistic measure of funding is the size of contingency operations, which have not exceeded $2.6 billion in recent years. However, this provision would not give DOD more money. It requires that the liquidation of obligations incurred under this authority must be subsequently accommodated by an offsetting rescission unless the President determines that emergency conditions exist which preclude rescission of Defense funds.

Question. What would these additional funds be used for?

Answer. This authority would be limited only to obligations that in the judgment of the Secretary of Defense are required for essential readiness functions and activities. Examples of such activities are mission critical proficiency training, scheduled unit exercises and acquisition of mission critical spare parts.

Question. What role will Congress play in the decision to expend these funds?

Answer. The proposed provision requires that the Department notify the Congress when funds are made available for obligation under this authority.

WRITTEN QUESTIONS FROM SENATOR GORTON TO SECRETARY PERRY AND GENERAL SHALIKASHVILI AND THE RESPONSES

Question. Although you frequently come and testify before the Senate, you don't seem to want a prominent role for Congress in the national security decisionmaking process. For instance, the Administration went out of its way to gain United Nations approval for the Haiti operation, gaining endorsements from friends and allies before proceeding with the invasion. The intent here obviously to gain support from world leaders, as well as public opinion. Why wasn't there the same sort of effort put into gaining Congressional approval? How does a body of foreign States warrant more attention than the legislative body of the U.S. Government? It is ironic that Congress suddenly becomes important once the bill is due—why is that?

Answer [Secretary Perry]. We sought the backing of the U.N. Security Council for our initial deployment to Haiti because we believed and, in fact, have been proven right that such backing would allow us to garner broader participation in the Multinational Force (MNF) as well as broader international political support for the mission. In addition, United Nations support reassured the people of Haiti about the intention of the operation and paved the way for the transition from the U.S.-led MNF to a U.N. force that will both substantially reduce our costs and allow our troops to come home sooner.

The President has consulted very closely with Congress concerning United States decisions to support or participate in the Haiti operation and concerning peace operations generally. In the past year, Administration officials have consulted with the Congressional leadership in each case involving potential deployments of U.S. forces and the initiation of every major new peace operation. We are committed to continue working closely with the Congress to improve our consultations, while sustaining the President's constitutional powers as commander-in-chief.

STRATEGIC AIRLIFT CAPABILITIES

Question. Let me focus on that last question. In Desert Storm, we learned the value of being able to rapidly transport thousands of troops and their equipment over great distances. Strategic airlift capabilities are a national asset.

Isn't it true that if we were to fight two major regional conflicts, our airlift would in fact be our greatest weakness? And is our airlifting experiencing a readiness problem? If the answers to these questions are "yes," does the Department have plans to use commercial derivative aircraft to resolve this shortfall?

Answer [General Shalikashvili]. It is not accurate to say that airlift would be our weakness if we were involved in two major regional contingencies. A strategic deployment involves a synergistic relationship between airlift, sealift, and pre-positioning. To focus on one aspect, while ignoring the other two, will provide a distorted picture of our real deployment capabilities. The resources needed to meet our deployment requirements were extensively studied in the soon to be released Mobility Requirements Study Bottom-Up Review Update (MRS BURU). The original MRS concentrated on improving our sealift posture by recommending the procurement of 19 Large Medium Speed Roll-On/Roll-Off (LMSR) ships and 19 additional Roll-On/Roll-Off ships for the Ready Reserve Force. Eight of the LMSRs were to be used to establish an Army heavy brigade and theater opening support capability afloat. The Bottom-Up Review concentrated on pre-positioning, and recommended that two Army heavy brigade sets be pre-positioned in Southwest Asia and one in South Korea. These initiatives will be achieved within the future years defense program (FYDP). Given the improvements planned for sealift and pre-positioning, the MRS BURU conducted a detailed review of our airlift requirements, and will recommend a slight increase in airlift capacity for support of two major regional contingencies (MRCs).

In August 1993 our airlift readiness was severely degraded by C–141 flight restrictions resulting from structural cracking in wing weep holes. Aggressive Air Force and contractor efforts repaired the damage and the entire C–141 fleet was restored to full, unrestricted operational capability by December 1994. The C–141's programmed retirement by 2006 is approaching, however, and the weep hole problem demonstrated the potential for the next major inspection to identify another problem that could permanently ground or restrict the C–141 fleet. The Air Force is also putting additional resources into the C–5, its other primary airlifter, and has achieved some success in raising its mission capable rates.

The optimum composition of the future airlift fleet will be determined following the Strategic Airlift Force Mix Analysis (SAFMA) study and the November 1995 C–17 Milestone III Defense Acquisition Board (DAB). This analysis is based on airlift cargo requirements determined by the MRS BURU; other ongoing anaylses will complement the effort and address military unique core airlift requirements such as airdrop, air refueling, and delivery of outsized cargo at forward, austere airfields. Integral to the SAFMA analysis is an assessment of non-developmental airlift aircraft, including commercial derivatives, and their ability to meet deployment requirements. Depending on the aircraft mix determined at the C–17 DAB, the MRS BURU-required airlift capacity can be achieved in the future, resulting in a synergistic combination of airlift, sealift, and pre-positioning to meet strategic deployment requirements to fight two MRCs.

WRITTEN QUESTIONS FROM SENATOR MURRAY TO SECRETARY PERRY AND THE RESPONSES

Question. Does the Department continue to view research universities and university affiliated research laboratories, including the Applied Physics Laboratory at the University of Washington, as essential components of the national defense infrastructure? Please describe the value of these vital research universities and laboratories to the Department's national defense mission.

Answer. Research universities have and continue to be viewed as essential components of the national defense infrastructure. They perform the research that is the source of the innovations that have given our military technological superiority.

University research has led to major developments such as the Global Positioning System, night vision (low light level TV, night goggles, thermal imaging), computers/information processing, modeling and simulation capabilities that will enable improved readiness. Research funded by DOD at universities has also provided the trained scientists and engineers that serve our military needs. The emphasis of this research is in the areas of electronics, materials, physics, computer science, oceanography and biomedical sciences, which are clearly relevant to the defense mission. Without DOD support, militarily relevant research in these areas would be severely curtailed; continued DOD support of research in these areas is considered essential.

University affiliated research laboratories, including the Applied Physics Laboratory at the University of Washington, are critically important contributors to our military capability. These laboratories are essential components of the national defense infrastructure. The Applied Physics Laboratory at the University of Washington conducts research in oceanography, polar phenomena, acoustic reconnaissance systems, and other related underwater areas. These institutions provide assistance to meet urgent and high priority DOD research requirements. DOD access to leading academic institutions and a pool of excellent graduate students provides DOD a continuing source of talented scientists and engineers for advanced research.

ACQUISITION REFORM

Question. Secretary Perry, as the Department is required by law to eliminate wasteful, fraudulent practices, is the Department fully committed to acquire the necessary, high quality research products in the most cost effective manner possible (including minimizing all unnecessary costs, paperwork, and contract forms and other contracting, administrative and/or bureaucratic delays)?

Answer. Absolutely. We are aggressively identifying and adopting ways to streamline DOD business practices in all phases of research, development and acquisition.

In the development and purchase of high-technology products, for example, we're instilling a new culture of buying commercial items. Where the commercial item's performance is comparable or better than for an item specifically developed for the military, this strategy means that technology needed to support military systems is more affordable and readily available off-the-shelf when world events require us to rapidly acquire additional capability.

Throughout the research, development, and acquisition arena, we're expanding the use of electronic commerce. This includes use of electronic data interchange (EDI) for more efficiently soliciting contract and grant proposals, receiving proposals, and making awards. It also includes use of EDI and electronic funds transfer to make timely payments. Electronic commerce is still in its infancy, and there are tremendous savings in time, effort, and money still to be realized from its increased use.

COMANCHE

The Comanche Program is one of the best managed programs the Department of Defense has had in years—despite it being restructured three times under DOD direction. Since April 1991, when the contract was signed, the program has been within 3 percent of schedule and 3 percent of cost. It is a well directed undertaking, using advanced technologies, both in design and in the manufacturing process. It has been brought to my attention that OSD has decided to withhold $120 million of last year's appropriation for the Comanche.

Question. Why? More importantly, when do you plan to release these funds so that this Congressionally-approved program can move forward?

Answer. The $120 million is withheld at this time because the program has been directed to be restructured to a 2 prototype development effort. The fiscal year 1996–1997 Biennial Budget reflects the restructured program with $199 million and $299 million requested in each year respectively. The $488 million appropriated in fiscal year 1995 was for a far more ambitious program and is under review. A Defense Acquisition Board review of the revised program is scheduled for March.

THE PRESIDENT'S BUDGET: FOREIGN AFFAIRS

WEDNESDAY, FEBRUARY 15, 1995

U.S. Senate,
Committee on the Budget,
Washington, DC.

The committee met, pursuant to notice, at 9:40 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Grassley, Brown, Gorton, Gregg, Snowe, Abraham, Exon, and Lautenberg.

Staff Present: G. William Hoagland, staff Director; and Greg Vuksich, senior analyst for international affairs.

For the minority: William G. Dauster, democratic chief of staff and chief counsel; and Randy DeValk, assistant director for national defense.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman Domenici. The committee will come to order. We are going to try very hard to get opening statements out of the way quickly. Mine is about 3 or 4 minutes, and then I will yield to Senator Exon. Then we will get right to you, Mr. Secretary.

First, I want to welcome you to the Budget Committee this morning. It is the first time in several years that the Secretary of State has actually testified before this committee.

Your schedule is an intense one, and we all appreciate that. We thank you for making time for our committee.

The President's budget request for discretionary appropriations for international affairs for fiscal year 1996 is $21.2 billion. This compares with a fiscal year 1995 enacted level of $20.2 billion and represents a 5-percent increase over the previous request. The Clinton administration has also submitted a supplemental request for fiscal year 1995 for $1.1 billion.

The message from last November's election, as I view it, at least, is that the American people believe that it is time for a complete review of what government does and how it does it. Many of us believe that the issue is not how to improve the marginal effectiveness of certain programs and organizations but, rather, to fundamentally reassess the functions that Washington undertakes and the structure for doing the job.

With the vast changes in the international community over the past few years, a reassessment of the international affairs structure of the budget is long overdue. The disintegration of the Soviet Union substitutes regional instability. For global conflict as our principal national security concern. The importance of global markets and exports to America's economic well-being has become very clear. These and other major changes in the world around us demand comparable changes in our programs and structures.

We need to understand better the role of resources in foreign policy, so let us make sure that we get rid of one red herring in advance. This is not a discussion of isolationism versus international engagement, at least not from this Senator's standpoint. It is a serious attempt to assess where and how limited sums of discretionary dollars can best be spent in support of America's international interests and our leadership role in the world.

I am reminded that some of my constituents in New Mexico have to make decisions every day about where they are willing to put their limited resources. I think we must do the same with reference to all functions of the government, including the State Department. The implementation of our foreign policy through foreign aid programs and the like all must be reviewed.

In our discussion today, I don't think we necessarily want to focus on bits and pieces of individual programs. I hope we will take a broad look at the rationale for international affairs in this budget. This hearing will have been worth our time if we leave here today with a clear notion of the principles upon which your budget is based. Mr. Secretary, we may disagree, but the committee needs to understand how this all ties together.

With that, I would ask that the remaining few remarks in my statement be made a part of the record.

[The remainded of Chairman Domenici's opening statement follows:]

I understand that you have been seen around the White House wearing this button—asking for just 1 percent of the Federal budget for international affairs. A more relevant button might read "Just 8 percent of non-discretionary" which goes to international affairs.

This Senator has never sought to balance the Federal budget and reduce the deficit on the back of our international affairs accounts alone. I will not do it this year, either. Achieving balanced budgets is an effort which will require us to look at every source of government spending for need and effectiveness.

I am not sure whether the appropriate amount for international affairs is more or less than 8 percent of non-defense discretionary spending, but whatever it turns out to be, it must be a piece cut from a much smaller pie.

Again, Mr. Secretary, we welcome you here and look forward to your formal remarks and the subsequent exchange of views.

Chairman DOMENICI. I yield to Senator Exon, the ranking member.

OPENING STATEMENT OF SENATOR EXON

Senator EXON. Mr. Chairman, thank you so very much. Welcome to you, Mr. Secretary. We are delighted that you came over to talk to us about a very, very important matter that I am sure is going to receive a great deal of attention. We are looking forward to your testimony and replies to our questions today.

Let me ask that my full statement be included in the record, if I might, Mr. Chairman.

Chairman DOMENICI. Without objection.

[The opening statement of Senator Exon follows:]

Opening Statement of Senator Exon

Thank you Mr. Chairman, and I too want to welcome Secretary Christopher to today's hearing. Mr. Secretary, I look forward with great interest to your observations and insights on our foreign operations.

In the current economic and political climate, every program in the Federal budget faces increased scrutiny. That's how it should be. The American taxpayer deserves no less. Moreover, if we pass the balanced budget amendment, as I believe we should and will, the pressure to cut Federal spending will only increase. To balance the budget by 2002, and do so in a responsible manner, no program or department can be immune from scrutiny.

This is the perspective that I bring to our hearing this morning. I note that the Administration is requesting $21.2 billion for international affairs in 1996, and over $100 billion for the next 5 years. It is difficult for many Americans to understand why we shouldn't invest this $100 billion at home, rather than spend it abroad.

Having said this, it's only fair to note that under the Administrations proposed budget, spending on international affairs will decline to about two-tenths of a percent of our gross domestic product—the lowest level in the 40 years, and perhaps longer.

Indeed, the United States will be spending a smaller percentage of its budget on international programs than virtually every other western industrialized power. In fact, outlays for international programs constitute only 1 percent of total Federal outlays. Much to the surprise of many, we could eliminate all spending on these programs and barely make a dent in our annual deficits.

On the specifics, I am largely supportive of the Administration's foreign policy priorities—with one major exception. I strongly object to the Administration's proposals for the Food for Peace Program, this country's major Foreign Aid Food Program.

At a time when the Administration can come up with funding increases for multilateral development banks; aid to the former Soviet Union; aid to Eastern Europe; and international narcotics enforcement, why must it cut Food for Peace by $108 million in this budget?

As proposed, this program will have been cut by over 31 percent since 1994—the largest single reduction in the foreign aid budget. This is one of the few foreign aid programs that works both for us and for the recipients. I fail to understand the Administration's reasoning in this area and I look forward to your explanation today.

These are austere times for all Federal programs, international programs included. With Federal dollars so scarce, every program will have to meet tough, exacting standards. I believe that there should always be a place for international aid. The United States cannot crawl back into its shell. Humanitarian needs and our national security interests are furthered through foreign aid. Foreign aid saves lives, period.

Let's also not forget that 70 percent of every foreign aid dollar is spent in the United States. For Food for Peace, 100 percent of the money is spent in the United States. But we must be sure that each and every foreign aid dollar is invested wisely, can be accounted for and will produce the desired results. I'm ready to work with you, Secretary Christopher, and AID Administrator Brian Atwood to restore public confidence in a leaner, yet more effective public assistance program.

Senator Exon. Let me summarize, if I might very briefly. In the current economic and political climate, every program of the Federal Government faces increased scrutiny. That is how it should be. The American taxpayers deserve no less. Moreover, if we pass the balanced budget amendment, as I believe we should and will, the pressure to cut Federal spending will only increase.

To balance the budget by the year 2002, and do so in a responsible manner, no program or department can be immune from scrutiny. This is the perspective that I bring to our hearing this morning. I note the Administration is requesting $21.2 billion for international affairs in 1996 and over $100 billion for the next 5 years.

It is difficult for many Americans to understand why we shouldn't invest this $100 billion at home rather than spend it abroad. Having said that, it is only fair to note that under the Administration's proposed budget, spending on international affairs will decline—will decline, I emphasize—to about two-tenths of 1 percent of the gross domestic product, the lowest level in the last 40 years, and perhaps even longer.

Indeed, the United States will be spending a smaller percentage of its budget on international programs than virtually every other Western industrialized power. In fact, outlays for international programs constitute only 1 percent of the total outlays.

In that regard, just let me cite something that I heard from one of my colleagues within the last week. There was a hearing of some kind or a meeting of some kind where a group of people were called in to give their views on how we are going to balance this budget. One of the first things that came up, of course, was foreign aid. The question came up from the audience, what percentage of our total Federal budget is invested in foreign aid?

Well, they weren't sure, but it finally came down that somewhere around 18 percent of the total budget must be invested in foreign aid. When asked as a collective group what they thought it should be, they suggested that it should be brought way down, from what they thought was 18 percent down to around 5 percent. When they were advised that it is about 1 percent of the total budget, it began to put all of this into perspective.

I would simply say that I believe somewhere around 70 percent of that foreign aid money that we talk about goes directly to the United States or United States companies or individuals. And what this is all about is not giving away money to foreign governments, but making an investment in the National security interests of the United States.

Therefore, I am pleased that you have made some reductions in the program. I think they are in order. We will look at those very closely. But your being here in front of the Budget Committee today indicates to me that you have grave concerns about all of this. We will be asking you a series of questions, hoping that we can not only enlighten ourselves but, along with that, the American public as to the goods, the bads, the do's and don't's, the fruits and the uncollectible fruits of our overall foreign aid assistance, which above everything else goes back to the National security interests of the United States and the position that we hold as the sole superpower in this troubled world of ours.

I welcome you, Mr. Secretary, and we are looking forward to your testimony.

I thank you, Mr. Chairman.

Chairman DOMENICI. Mr. Secretary, you may proceed. We will make your entire written statement a part of the record. It has been our custom here for the last three or four hearings to give Senators ample time to ask questions so that the sessions become fruitful for them, also. So we would very much appreciate it if you could, in your good manner, abbreviate your statement so that we can inquire of you.

Thank you very much for appearing, Mr. Secretary.

STATEMENT OF HON. WARREN CHRISTOPHER, SECRETARY, UNITED STATES DEPARTMENT OF STATE

Secretary CHRISTOPHER. Thank you, Mr. Chairman and Members of the committee. I am pleased to appear before this committee for the first time in my tenure as Secretary of State. I am glad to have an opportunity to give you an overview of our proposed 1996 budget and, particularly, to highlight the foreign policy objectives that it supports.

As the Chairman suggested, I will very much abbreviate my statement so as to maximize the amount of time for questions.

The American people have a right to expect that their government will do what it must do to protect their security and prosperity. Clearly, no American wants to live in a world in which nuclear weapons have fallen into the wrong hands or in which the United States has abandoned its economic leadership or in which the post-cold war momentum toward peace and freedom has been reversed.

At the same time, as both of you said, the American people demand that we apply the most rigorous standards to Federal spending, and we have sought to be very tough-minded in putting together what I believe is an austere budget.

As has been said this morning, our international affairs budget is $21.2 billion, representing about 1.3 percent of total Federal spending. In real terms, this budget has absorbed substantial cuts over the last decade. Despite the challenges we face—and we have been given some new responsibilities—our 1996 spending request is essentially what we are spending in the current year when you take into account the supplementals.

We believe that the request that we have made is the rock-bottom minimum that we need to support our Nation's vital interests.

In the last 2 years, our relatively small international affairs budget has helped to make each and every American more secure and to give them new opportunities for prosperity. Just consider with me for a moment, if you will, what it would have been like in the last 2 years without determined American leadership. We would almost certainly have had four nuclear states in the former Soviet Union, instead of one, with Russian missiles still targeted at our cities and towns and homes.

We would have had a full-throttle nuclear program in North Korea. We would have had no GATT agreement to expand world trade, and we would have had brutal dictators still terrorizing Haiti.

Very likely, we would have had Iraqi troops back in Kuwait and a Mexican economic crisis threatening our borders and threatening to destabilize our entire hemisphere.

Last November's elections certainly changed a great deal, but they were not a license to lose sight of our global interests or to walk away from our worldwide commitments. The budget we put forward advances those interests and maintains our commitments. By approving it, the Congress will be facing a stern test of our willingness to dedicate the resources necessary to protect the security and prosperity of the American people.

I would like to say very succinctly that our strategy is driven by four basic principles:

First, that we continue to engage and to lead. American leadership is very essential in the world;

Second, that we maintain effective relations with the world's greatest powers. I think something that we ought to take advantage of at the present time is that no great power regards another as an immediate military adversary, and that is something we ought to work to keep;

Third, we must adapt and build institutions that will promote our economic and military security;

Fourth, we must also continue to support democracy and defend human rights.

I am going to focus on the first two of those underlying principles for just a couple of paragraphs because they touch on budgetary issues of immediate importance.

American leadership requires that we be ready to back our diplomacy with credible threats of force. When our vital interests are at stake, we must be prepared to defend them alone but sometimes, by leveraging our power through alliances in institutions like the United Nations, we can achieve better results at a lower cost to treasure and in risk to human life. That is the kind of sensible bargain that I know that the American people support.

This Administration has worked hard to try to ensure that peacekeepers have realistic objectives, that money is not wasted in peacekeeping operations, and that tough questions are answered satisfactorily before new missions are approved. Having said that, I want to indicate that we strongly oppose efforts in Congress that threaten a lethal blow at peacekeeping, threaten to require us to remove peacekeepers from troubled spots around the world, and leave the President of the United States with an unacceptable choice when a crisis occurs, a choice between acting alone or doing nothing.

As Secretary Perry and I indicated yesterday and the day before, we will recommend to the President that he veto legislation that, in our judgment, undermine national security by infringing on the powers and responsibilities of the President.

In connection with our principle of maintaining good relations with the world's most powerful nations, let me take a moment to discuss our relations with Russia, which I know is a subject of great interest. Like each of you, we have been greatly concerned about the conflict in Chechnya, about the tragic loss of life, the excessive and indiscriminate use of force, and the corrosive implications that that has for democracy in Russia. We have strongly emphasized to the Russian government that the fighting must end and a process of reconciliation must begin. Indeed, those were points that the President reiterated very strongly to President Yeltsin when they had a telephone call on Monday.

However, tragic as the situation is in Chechnya, it has not altered our fundamental interest in helping Russian reformers build a nation that is finally at peace with itself. Our assistance program supports that effort. It supports programs ranging from Russia's vitally important free press to jury trials to small business development. Of the total request of $788 million to support reform in the former Soviet Union, less than half would go to Russia itself. More than half would go to the other new independent states such as Ukraine and Kazakhstan.

Cutting assistance now to Russia would hurt the friends of democracy in Russia, the very forces that have been most critical of the Chechnya operation.

Mr. Chairman and Members, I thought it might be helpful if I told you of the five areas that I intend to focus on during 1995: first, advancing open trade and American jobs; second, developing a new European security order; third, helping to achieve a comprehensive peace in the Middle East; fourth, combatting the spread of weapons of mass destruction; and, fifth, fighting international crime, narcotics, and terrorism.

Let me say just a few words about each of those priorities or opportunities for 1995.

First, we must sustain the momentum we have generated toward the open trading system that is vital to American exports and American jobs. We will implement the Uruguay Round. We will develop a blueprint with our APEC partners for achieving open trade and investment in the Asia Pacific region. And we will begin to implement some of the Americas Action Plan for open trade in our hemisphere.

While we are doing these things, though, we must be sure that American workers and American companies are in a position to take advantage of the opportunities that these negotiations create. That is why I sit behind what I call the America Desk at the State Department and why I am determined to keep our economic and commercial diplomacy right at the center of our Department's work.

In the last 2 years, I believe we have developed a new spirit of cooperation with American business, and I hear that over and over again from American business leaders. Our embassies around the world are working harder than ever to help create opportunities for Americans to win contracts, to safeguard their investments, and to support U.S. firms and U.S. jobs.

In fiscal year 1996, we are requesting $900 million to sustain this effort to promote U.S. jobs and business around the world.

In the second area of priority or opportunity, we are taking concrete steps to build a new security architecture in Europe. We will focus on maintaining strong relations with Western Europe, consolidating democracy in Central Europe and the former Soviet Union, and engaging Russia as a responsible partner.

The budget request we are putting forward meets the President's commitment made last July in Warsaw to help Europe's new democracies participate in the Partnership for Peace and to help potential members prepare for the obligations they will assume if and when they join NATO.

A third area of priority is advancing peace in the Middle East. Our budget allocates $5.2 billion to sustain our efforts at what is really a decisive moment in the peace process in the Middle East.

Last Sunday, President Clinton convened an unprecedented meeting at Blair House, attended by ministers from Israel, Jordan, and Egypt, and the Palestinian Authority. One of the remarkable things about the new world in the Middle East is that we can sit down with Israelis and Egyptians and Arabs in the same meeting in a way we never have in the past.

I believe last Sunday's meeting helped to improve the atmosphere between the parties and to put their negotiations back on track.

In the declaration that came out of last Sunday's meeting, Israel and the Palestinians vowed that there could be no turning back on the peace process, and the Palestinian Authority underscored its commitment to preempt terror, punish those responsible, and deny safe havens to those who plan and carry out terrorist acts.

I also want to emphasize that we must sustain the momentum for a comprehensive peace that includes Syria. Peace without Syria would leave Israel still under a strategic threat and would also prevent the completion of normalization in the Middle East. President Clinton and I intend to do all we can to help the parties reach the kind of breakthrough needed on the Syrian-Israeli track.

Our fourth area of emphasis, Mr. Chairman, is to intensify our efforts to stop the spread of weapons of mass destruction and their means of delivery. Our global and regional strategies for 1995 comprise, I believe, the most ambitious non-proliferation program in history, beginning, as it must, with our effort to seek an indefinite and unconditional extension of the Non-Proliferation Treaty.

Our 1996 budget dedicates $166 million to meet the threat posed by proliferation. It provides assistance to the International Atomic Energy Agency—an agency who will have a very important purpose, among other things, in the implementation of the Agreed Framework with North Korea. This budget also supports the Arms Control and Disarmament Agency, including funds for implementation of the Chemical Weapons Convention. And it replenishes the Non-Proliferation Fund which we use to combat nuclear smuggling, enforce export controls, and to help pay for the dismantling of missiles.

Turning to the fifth area of opportunity, we plan to implement a comprehensive strategy to combat international terrorists, criminals, and drug traffickers. Altogether, our budget requests $240 million for these efforts, and as the President announced last week, we will be proposing legislation to combat alien smuggling and illegal immigration.

I am glad to say that I think we have made substantial progress against terrorism in just the last few weeks, ranging from the President's Executive order which freezes the assets of terrorist groups in the United States to the arrest of Ramzi Yousef, the alleged mastermind of the World Trade Center bombing, after a long, long search.

The President also transmitted to Congress our proposed Omnibus Counterterrorism Act of 1995 which will give the executive branch new tools to improve prevention, investigation, and prosecution of terrorism.

Beyond these five areas, I ought to stress that we will continue to address many other issues important to our Nation's interests and to this Congress, issues such as promoting stability and democracy in Asia, Africa, and Latin America.

American engagement in the world is also reflected by our willingness to take on global challenges that call for international partnerships, where only the United States can provide the leadership. We cannot escape the consequences any longer of environmental degradation, unsustainable population growth, and destabilizing poverty beyond our borders.

That is why this Administration is dedicated to restoring America's leadership on sustainable development, an approach that recognizes the links between economic, social, and environmental programs. We are putting this global challenge back where it belongs—in the mainstream of American foreign policy.

The President's fiscal year 1996 budget request includes funds for the multilateral development banks, the IMF, the Peace Corps, and our bilateral and multilateral assistance programs—all directed toward sustainable development.

I believe strongly that the funds we seek here will yield lasting benefits for the American people.

Finally, Mr. Chairman, and Members, our Nation's ability to achieve all these foreign policy objectives depends upon the dedicated men and women who serve our Nation's international affairs agencies. Our diplomatic posts around the world serve as sentries for the American people. Like our soldiers, they must be trained and equipped to fight for American interests. They must have access to modern communications technology and must work in facilities that help and not hinder their productivity.

I must say, Mr. Chairman and Members, that the tendency in the Congress to cut back on our funds for operations whenever we get in a budget pinch has caused a great deal of difficulty in the area that I mention, and it has kept us from modernizing our communications. I would like to mention just a couple of things that so graphically indicate how far behind we are falling.

Our computers at the State Department are so old that we can no longer buy spare parts for them and cannot get a maintenance contract on them. Not long ago our international telephone system in our Operations Center, which maintains our operations 24 hours day and night had some operational difficulties. When we brought in technicians from AT&T, they said the system was so old they had to go back to Bell Labs to find out how to help us fix it. That is some indication that when we cut back on operational funds, we are really hurting the future capacity of our men and women to operate in the foreign affairs field. So I hope that when we get around to making the budget cuts this year, we don't go for what sometimes looks like the easy cuts in operations budgets, but remember what is happening to our capacity to be effective.

Our request to support the State Department both at home and abroad is $2.6 billion for next year. I noted earlier, Mr. Chairman, we have some remarkable opportunities in the post-cold war period, but it is most important to remember that many of these opportunities come only with United States leadership and are the product of United States leadership.

It is good to remember that most of our closest allies and friends at the present time are nations that we helped to rebuild after World War II. The structures and institutions through which we advance our interests today, structures like GATT, NATO, the U.N., and the Bretton Woods Institutions, were largely created through American leadership. As we talk about the promising markets for American jobs overseas, it is useful to remember the very strong role that the United States and United States assistance had in creating those markets and creating those opportunities for American jobs and exports.

For example, look at Korea, once the recipient of large amounts of U.S. aid, now an aid donor to other nations in its own right, and a tremendous market for us. There is the Philippines, long a treaty ally, and another recipient of American assistance, which is now entering the dynamic mainstream of Southeast Asian economies.

There is Poland and South Africa where our support for human rights helped to end a dictatorship and where our support for democracy is encouraging remarkable reforms and, once again, potential strong markets for the United States.

Look also at Mexico and Brazil, as well as these other countries, where our support for open trading has been an incentive and a catalyst for market openings and economic growth.

In short, when we look at this budget, we have to remember the United States is one of the few countries on Earth with the power to create its own opportunities. With your support, we will continue to use that power to build a world in which American interests and values will flourish, a world of open societies and open markets.

Thank you very much, Mr. Chairman.

Chairman DOMENICI. Thank you, Mr. Secretary.

[The prepared statement of Secretary Christopher follows:]

Secretary Christopher's Testimony Before The Senate Budget Committee

February 15, 1995

Good morning. I am pleased to appear for the first time this year before the Senate Budget Committee. I am here to provide you with an overview of our proposed 1996 budget, and to highlight the foreign policy objectives the budget supports.

We live in a world that has been profoundly transformed by the end of the Cold War and by the triumph of democracy over dictatorship in many nations. We live in a world that is taking shape in ways that are remarkably consistent with American ideals and conducive to American interests. Indeed, we live in a world that has been shaped by the successful use of America's power-- and the power of American principles.

But we must not be complacent. Aggression, intolerance, and tyranny still threaten political stability and economic development in vital regions of the world. Challenges as diverse as nuclear proliferation, terrorism, and environmental degradation still threaten our security and prosperity.

The American people have a fundamental expectation that their government will do what it must to protect their nation's interests in the world. No American wants to live in a world in which nuclear weapons have fallen into the wrong hands; or in which the United States has abandoned its economic leadership; in which the post-Cold War momentum toward peace and freedom has been reversed.

At the same time, the American people rightly demand that we apply the most rigorous standards when we decide how to spend their tax dollars. We have been tough-minded in putting together what is a very austere budget.

The International Affairs budget of $21.2 billion now represents only 1.3 percent of federal spending. It has absorbed substantial real cuts in the last several years, and is now 45% lower in real terms than it was in 1984. Despite the extraordinary challenges we face, our 1996 spending request is essentially what we are spending in the current fiscal year. Indeed, the resources we are requesting are the rock bottom minimum we need to advance our nation's vital interests.

In the last two years, our relatively small International Affairs budget has made each and every American more secure, and given all our citizens new opportunities for prosperity. Consider what the world would be like if we had not had determined American leadership in the last two years. We would have four nuclear states in the former Soviet Union instead of one, with Russian missiles still targeted at our homes; we would have a full throttle nuclear program in North Korea; no GATT agreement to expand world trade; brutal dictators still terrorizing Haiti; very likely, Iraqi troops back in Kuwait; and a Mexican economic crisis threatening instability along our border.

Last November's elections certainly changed a great deal. But they were not a license to lose sight of our global interests or to walk away from our commitments in the world. This budget advances our interests and maintains our commitments. Approving it will be a stern test of our willingness to dedicate the resources necessary to protect the security and prosperity of the American people. It will be a test of our commitment to lead.

Our strategy is driven by four principles: that we continue to engage and to lead; that we maintain effective relations with the world's great powers; that we adapt and build institutions that will promote economic and security cooperation; and that we continue to support democracy and defend human rights.

As several of our recent accomplishments suggest, American leadership requires that we be ready to back our diplomacy with credible threats of force. To this end, President Clinton is determined that the U.S. military remain the most powerful and effective fighting force in the world -- as it certainly is now.

When our vital interests are at stake, we must remain prepared to defend them alone. But sometimes, by leveraging our power and resources, and by leading through alliances and institutions, we can achieve better results at lower cost to human life and national treasure -- and that is a sensible bargain I know the American people support.

That is why the Administration believes that UN peacekeeping can be an important and effective part of our overall national security strategy. In this budget, we are requesting $445 million for our assessed share of UN peacekeeping operations.

This Administration has worked hard to ensure that peacekeepers have realistic objectives, that money is not wasted, and that tough questions are answered satisfactorily before new missions are approved. But we strongly oppose efforts in Congress that threaten to strike a lethal blow to peacekeeping: to remove peacekeepers from vital trouble spots around the world, and to leave the President with an unacceptable choice each time a crisis occurs -- a choice between acting alone and doing nothing. As Secretary Perry and I indicated yesterday, we will recommend to the President that he veto legislation that, in its current form, would undermine national security in this and other important ways.

The second principle driving our strategy is the central importance of constructive relations with the world's most powerful nations: our Western European allies, Japan, China and Russia. These nations possess the political, economic, or military capability to have an impact -- for good or for ill -- on the well-being of every American. The relatively cooperative relations that these countries now have with us <u>and</u> with each other is unprecedented in this century, but it is not irreversible.

Our strategy toward the great powers begins with Western Europe and Japan. We must revitalize our alliances with this democratic core. We must also seize the opportunities to build constructive relations with China and Russia, countries that were not too long ago our fiercest adversaries. Both are undergoing momentous, though very different, transformations that directly affect American interests.

Our partnership with Japan is the linchpin of our policy toward East Asia, the most dynamic and fastest-growing region in the world. This Administration has placed the Asia-Pacific at the core of our long-term foreign policy approach. Realizing President Clinton's vision of a stable and prosperous Pacific Community will continue to be a top priority. Moreover, the region figures prominently in many of the central areas of opportunity that we are pursuing in 1995.

It is also imperative that we reinforce our security and political ties with Japan -- as well as with South Korea and our other treaty allies in the Pacific. It is equally essential that the strength of our economic ties with Japan matches the overall strength of our relationship. During this year marking the fiftieth anniversary of the end of World War II, we will highlight and heighten our close cooperation on regional and global issues -- while continuing to press for greater access to Japanese markets.

With China, we are pursuing constructive relations that are consistent with our global and regional interests. The President's strategy of comprehensive engagement is designed to address a broad agenda with Beijing and to maintain momentum in certain areas even as we face problems on other issues. We want China to be fully integrated into the international community. For that to happen, it must accept the obligations that come with membership in international institutions and adherence to international norms.

We are encouraging China's participation in regional security and economic organizations. We are supporting its accession to the World Trade Organization on proper terms. We are seeking its full commitment to global nonproliferation regimes. And we are encouraging China to demonstrate greater respect for human rights -- an interest that is clearly connected to the issue of intellectual property rights because both depend on the rule of law.

The widespread pirating of computer software, videotapes, and compact discs in China is unacceptable to the United States and incompatible with China's responsibilities as an emerging economic power. The President has indicated his willingness to act. Let me add that every business leader I have heard from on this issue supports our course of action. And let me emphasize that China's leaders must understand that attracting foreign investment and sustaining long-term growth depend on their willingness to meet global standards in this key area.

We are working to resolve our differences on this issue. But we are not overlooking the other commercial and overall strategic interests that we are pursuing with China. We will continue to pursue a strategy of comprehensive engagement where it is possible and where it is in our interest to do so-- such as North Korea, Cambodia and the control of narcotics. It will take time, but our goal remains to cultivate a broad and full relationship with a stable, open and prosperous China that is a full and constructive member of the international community.

The United States, of course, has an enormous stake in the outcome of Russia's continuing transformation. A stable, democratic Russia is vital to a secure Europe and a stable world. An unstable Russia that reverts to dictatorship or slides into chaos would be an immediate threat to its neighbors and once again a strategic threat to the United States.

Like each of you, we have been deeply concerned about the conflict in Chechnya -- about the tragic loss of life, the excessive and indiscriminate use of force against civilians, and the corrosive implications this episode can have for the future of Russian democracy. That is why we have emphasized strongly to the Russian government that the fighting must end-- a point that President Clinton reiterated in a telephone call to President Yeltsin yesterday. A process of reconciliation must begin that validates Russia's commitment to democracy and takes into account the views of the people of Chechnya.

Tragic as the situation in Chechnya is, it has not altered our fundamental interest in helping Russian reformers build a nation that is finally at peace with itself and its neighbors. We have undertaken a wide range of programs to advance democratic and economic reform in Russia. Our assistance supports programs ranging from Russia's vitally important and newly free press to jury trials to small business development. Most of the assistance has gone to private organizations and to local governments outside Moscow. Those funds that do go to the central government primarily support the institutional reforms necessary for democracy and market reform, such as election assistance, the drafting of commercial codes and the setting up of privatization programs. And of our total request of $788 million to support reform in the former Soviet Union, less than half would go to Russia itself.

Precisely because the future of reform in Russia is not assured, we must persevere in our support of the people and institutions struggling on its behalf. Cutting assistance now would hurt the friends of democracy in Russia -- the very forces that have been most critical of the Chechnya operation.

There are also many vital security issues on which we are working with Russia, such as Nunn-Lugar programs to secure dismantled warheads, arms reductions agreements and cooperation on regional conflict. This aspect of our relationship has paid off for every American -- from reducing the nuclear threat to advancing peace in the Middle East.

Chechnya has raised questions about Russia's commitment to democratic processes, economic reform, and international standards of conduct. Our approach is designed to reinforce democratic trends in Russia and to encourage the government in Moscow to pursue policies consistent with these principles. We will assess Russia's actions in Chechnya, its domestic programs and international initiatives in light of this objective and we will adjust our policy accordingly.

The third principle guiding our overall strategy is that if the historic movement toward open societies and open markets is to endure, we must adapt and revitalize the institutions of global and regional cooperation. After World War II, the generation of Truman, Marshall, Acheson, and Vandenberg built the great institutions that gave structure and strength to the common enterprise of western democracies: promoting peace and economic growth. Now, as President Clinton said in his recent meeting with German Chancellor Helmut Kohl, "We will consider how to move toward NATO's expansion to Europe's new democracies and how to adapt the international institutions to serve us for the next 50 years."

At the President's initiative, we and our G-7 partners will chart a strategy in Halifax this June to adapt the post-war economic institutions to the more integrated post-Cold War world. We will assess what changes need to be made, and determine how to modernize these institutions for the future. We are also helping regional institutions and structures like the Organization of American States, ASEAN, and the Organization of African Unity to support peace and democratic development. Our 1996 budget includes $934 million in contributions to the UN and to other international bodies, as well as $2.2 billion to the multilateral development banks.

The fourth principle is the fundamental role that democracy and human rights have in this Administration's foreign policy. Our commitment is consistent with American ideals. It also rests on a sober assessment of our long-term interest in a world where stability is reinforced by accountability and disputes are mediated by dialogue; a world where information flows freely and the rule of law protects not only political rights but the essential elements of free market economies.

Since my last appearance before this Committee, the State Department has issued its 19th annual report on human rights practices worldwide. The first reports were prepared under my direction in 1977 during my first year as Deputy Secretary of State. Those early reports were small in scale and narrow in scope compared to today's effort. The Country Reports help us to shape our diplomacy, assistance and trade policy. We use them as we work with foreign governments, international organizations, and NGO's. They are also important in their own right, because they shine a bright light on human rights violations that might otherwise be shielded by a veil of secrecy and indifference.

In FY 1996, we are requesting $480 million through the SEED program to maintain our assistance for democratic and economic reform in Central and Eastern Europe. These funds will support social sector reform in areas like health and housing. They will help build accountable, responsive public administration at the central and local levels. And they will promote small business development to spur job creation.

Our budget requests $220 million for Countries in Transition such as Haiti, Cambodia, and Angola. In Haiti, our $90 million of continued support will help consolidate democracy and promote the economic development that will enable the majority of Haitians to overcome poverty and raise their living standards. Cambodia has struggled, so far with encouraging success, to overcome a tragic legacy of war, repression, and genocide. We have designated $39.5 million to support democratic and market reform, including the implementation of transparent legal and judicial reforms. Angola is trying to lift itself up from the bitter terrain of Africa's longest running conflict. Our $10 million request can make a difference on behalf of democracy and stability.

Approximately $18 million of the $220 million we request will go to other African countries in transition to support credible elections, respect for the rule of law, and good governance. And $33.5 million will support a wide variety of programs in Latin America and the Caribbean to promote and strengthen democratic institutions, local government, police training, the media, and grass-roots non-governmental organization development.

Mr. Chairman, the Summit of the Americas demonstrated that this hemisphere has committed itself to democratic institutions, respect for human rights, and free markets. Only one country out of 35 was not invited to the Summit, the one country that rejects the shared goals of those who came to Miami in December. That country is Cuba.

The fundamental goal of our Cuba policy is a peaceful transition to democracy, respect for the human rights of the Cuban people, and an open economy with opportunity for all. This Administration is committed to a vigorous pursuit of that objective. We believe the best means of achieving this goal is the course outlined by the Cuban Democracy Act. We believe the enforcement of the embargo, and the pressures it brings to bear on the regime in Havana, are hastening the day when democracy will return to Cuba.

OPPORTUNITIES FOR 1995

As we are guided by these basic principles, in 1995 I intend to focus on five key areas that offer particularly significant opportunities: advancing the most open global trading system in history; developing a new European security order; helping achieve a comprehensive peace in the Middle East; combatting the spread of weapons of mass destruction; and fighting international crime, narcotics, and terrorism.

Open Trade, Exports and Jobs

First, we must sustain the momentum we have generated toward the increasingly open trading system that is vital to American exports and American jobs. A core premise of our domestic and foreign policy is that our economic strength at home and abroad are mutually reinforcing. I believe that history will judge this emphasis to be a distinctive imprint and a lasting legacy of the Clinton Administration.

This year, we will take steps to implement the Uruguay Round and ensure that the new World Trade Organization upholds essential trade rules and disciplines. We will work with Japan and our other APEC partners to develop a blueprint for achieving open trade and investment in the Asia-Pacific region. We will begin to implement the Summit of the Americas Action Plan for open trading in our hemisphere. And last week, Ambassador Kantor announced that we will also begin to negotiate Chile's accession to NAFTA.

At the same time, American companies and workers must be in a position to take advantage of the opportunities that these negotiations are helping to create. That is why this Administration is sparing no effort to make sure that our companies can compete on a level playing field. That is why I continue to sit behind what I call the America Desk at the State Department, and why I am determined to keep economic and commercial diplomacy at the core of the Department's work.

Our embassies around the world are working harder than ever to help win contracts, safeguard investments and support American firms and American jobs in every way they can. This Administration has achieved an unprecedented degree of focus and coordination in our export promotion efforts.

Exports have been the driving force in our economic recovery. They must remain the driving force for long-term growth. Over the past two years, our export promotion efforts have created more than one million high-paying American jobs. This budget will help sustain that performance.

In FY 1996, we are requesting $900 million to promote trade and investment opportunities for American businesses through programs run by the Export-Import Bank, the Overseas Private Investment Corporation, the Trade and Development Agency, and others. These programs produce concrete economic benefits for the American people. They also reinforce our other foreign policy goals. They strengthen free markets and modernize vital sectors in developing economies. They lift living standards and multiply future demand for American goods. And they contribute to stability in new democracies struggling to overcome legacies of repression and conflict.

Let me add a word about an issue that has occupied the attention of the Administration and the Congress in recent weeks: the Mexican financial crisis. Two weeks ago, the President decided that the situation had to be addressed without further delay. With the support of the congressional leadership of both parties, he took decisive action to safeguard the prosperity of our people, the security of our borders, and the stability of our closest Latin neighbor and of other emerging markets in which we have a growing stake.

In the long run, of course, stability in Mexico will depend on the Mexican government's ability to consolidate economic and political reform. As you know, President Zedillo last week ordered the arrest of the leaders of the rebel movement in Chiapas. We recognize that the Mexican government, indeed all governments have a responsibility to protect their citizens against violence and lawlessness. We are pleased to note that President Zedillo also called for a special session of the Mexican Congress to address the underlying problems in the region. The United States agrees with President Zedillo that, in his words, "a solution to this conflict should come through full respect for the law, through political channels and through conciliation."

European Security Architecture

In our second area of opportunity, we are taking concrete steps to build a new European security architecture. Deep political, economic, and cultural bonds continue to make Europe's security and prosperity essential to ours. Our efforts will focus on maintaining strong relations with Western Europe, consolidating democracy in Central Europe and the former Soviet Union, and engaging Russia as a responsible partner.

We are pursuing these goals through continued development of NATO and its outreach to the east, strengthening the Organization for Security and Cooperation in Europe, building our relationship with the European Union, and developing a cooperative NATO/Russia relationship in promoting European security.

NATO remains the anchor of American engagement in Europe and the linchpin of transatlantic security. NATO has always been more than a transitory response to a temporary threat. It has been a guarantor of European democracy and a force for European stability. That is why its mission has endured, and why its benefits are so attractive to Europe's new democracies.

NATO has previously welcomed new members who shared its purposes and who could add to its strength. With American leadership, NATO agreed last December to begin a steady, deliberate process that will lead to further expansion. We have already begun to examine with our Allies the process and objectives of expansion. We intend to share our conclusions with the members of the Partnership for Peace this fall so that at the December Ministerial we can evaluate the results of our consultations and be ready to consider next steps.

Our strategy encourages new democracies to become responsible partners in a new European security order. The Partnership for Peace is a critical tool for cooperation between NATO and partner states. It is also the best path to membership for countries wishing to join the Alliance. The President's budget request meets the commitment he made in Warsaw last July to help the states of Central and Eastern Europe participate in the Partnership for Peace, and to help potential members prepare for the obligations they will assume if they join NATO.

Our step-by-step approach to NATO expansion is designed to ensure that each potential member is judged fairly and individually, by its capacity to contribute to NATO's goals and the strength of its democratic institutions. By following this approach, we give every new democracy a powerful incentive to consolidate reform. We remain convinced that arbitrarily locking in advantages for certain countries, or setting specific timetables, could discourage reformers in countries not named and foster complacency in countries that are.

The tragic war in Bosnia underscores the importance of building an effective new architecture for conflict prevention and resolution in Europe. Together with our partners in the Contact Group, we are seeking a negotiated solution. The Contact Group plan with its 51/49 territorial division must be the basis for a settlement, and Bosnia's territorial integrity and independence must be respected.

As you know, a ceasefire and formal cessation of hostilities have been achieved and are largely holding. We are taking advantage of this opportunity to intensify our diplomatic efforts to bring an end to the war. Last week in Munich, Defense Secretary Perry and Assistant Secretary of State Richard Holbrooke met with Bosnian Muslim and Croat leaders to bolster support for their planned confederation.

Now we and our Contact Group partners are working intensively to bring the parties to the negotiating table. We believe the French proposal for a conference involving the Bosnian, Croatian and Serbian Presidents -- if properly structured -- could advance our overall goals for the former Yugoslavia, including political settlements in Bosnia and Croatia. We would want the conference to be held in the context of the Contact Group efforts. And we would not favor participation of the Bosnian Serbs until and unless they have accepted the Contact Group plan. Prior to holding any such conference, however, there should be a firm commitment to genuine mutual recognition among all the republics of the former Yugoslavia.

I remain convinced that only a negotiated settlement has any chance of lasting. I am committed to pursuing that goal. What we must not do is to make the situation worse by unilaterally lifting the arms embargo. We have always believed that the embargo is unfair and we have worked to end it multilaterally. But going it alone would lead to the withdrawal of UNPROFOR and an escalation of violence.

Such a course would leave Sarajevo and the enclaves extremely vulnerable to Serb offensives. It would effectively Americanize the conflict, and lead others to abandon the sanctions on Serbia. It would undermine the authority of all UN Security Council Resolutions, including resolutions that impose sanctions on Iraq and Libya.

Middle East Peace and Security

Our third area of opportunity is advancing peace in the Middle East. Our budget allocates $5.24 billion to sustain our efforts at a decisive moment for the peace process. Over the past few years, we have seen an extraordinary transformation in the landscape of the Arab-Israeli conflict -- one of the century's most intractable. Clearly, however, there are still many horrible vestiges of the past that must be eradicated. The terrorist outrage in Israel on January 22 is a painful reminder of the challenges still to be overcome.

Last Sunday, President Clinton convened an unprecedented meeting at Blair House, attended by ministers from Israel, Egypt, Jordan, and the Palestinian Authority. I believe this meeting helped to improve the atmosphere between the parties and get negotiations back on track. At the end of the day, the parties produced two important documents. The first came out of my meeting with Israeli Foreign Minister Peres and Nabil Sha'th of the Palestinian Authority. In it, Israel and the Palestinians vowed that there could be no turning back in the peace process. And the Palestinian Authority underscored its commitment to preempt terror, punish those responsible and deny safehavens to those who plan and carry out terror.

The second document was the Blair House Communique, reflecting the discussions of the full ministerial. The ministers identified a series of cooperative goals that must be met in four key, related dimensions: the peace process, security, economics, and people-to-people. The ministers directed their experts to work urgently on implementing their recommendations.

For our part, President Clinton on Sunday proposed that the United States extend duty free treatment to products from future industrial zones on the West Bank and Gaza and free trade zones in Taba, Eilat, and Aqaba. This proposal can probably do more over time to help the region's struggling economies than any aid program. We look forward to further consultations with the Congress on this important matter.

The momentum for a comprehensive peace must be maintained. Israel's negotiations with Syria are entering a crucial phase. We have made progress in narrowing the gaps between the parties. But if a breakthrough is to be achieved in the next few months, critical decisions must be made and the process must be accelerated. President Clinton and I will do everything we can to help the parties reach such a breakthrough.

Non-Proliferation

Our fourth area of emphasis is to intensify our efforts to stop the spread of weapons of mass destruction and their means of delivery. We face a year of decision for global nonproliferation. Indeed, our global and regional strategies for 1995 comprise the most ambitious nonproliferation effort in history. We will carry out that effort in close consultation with the Congress.

The centerpiece of our strategy is to obtain the indefinite and unconditional extension of the Non-Proliferation Treaty, which is up for renewal this year--and which I think history will record as one of the most important treaties of all time. Achieving this objective is a key priority of our diplomacy around the world.

With the agreements President Clinton signed last December in Budapest, we can also begin to implement the START I nuclear reduction treaty. Prompt ratification of START II will in turn enable us to complete the work we began with START I. Its elimination of missiles with multiple independently targeted re-entry vehicles will further enhance stability and lower the chances of a massive nuclear conflict. At the same time, it will enable us to retain a strong and capable deterrent.

Mr. Chairman, North Korea is also central to our non-proliferation objectives. Let me emphasize today that we have stressed to the North Koreans the need to accept South Korean light water reactors and to resume North-South dialogue. Both conditions are essential to full implementation of the Framework Accord. We are holding talks with North Korea to ensure implementation of the Framework.

We will also continue close consultations with our allies. I met last week with the new Foreign Minister of South Korea. He reaffirmed South Korea's determination to move forward with the accord. We agree that we must remain vigilant. But careful implementation of the Agreed Framework is far preferable to the alternatives we were facing: a North Korea going forward with its nuclear program, a return to the Security Council for sanctions, and a costly military build-up.

Our 1996 budget dedicates $166 million to meet the threat posed by proliferation. It provides assistance to the International Atomic Energy Agency -- an organization vital in our non-proliferation efforts and especially in the implementation of the Framework Accord with North Korea. It supports the Arms Control and Disarmament Agency, including funds for implementation of the Chemical Weapons Convention. And it replenishes the Non-Proliferation Fund we use to combat nuclear smuggling, enforce export controls, and ensure missile dismantlement.

Crime, Terrorism, and Drugs

Our fifth area of opportunity for 1995 is combatting international terrorists, criminals, and drug traffickers. This Administration is aggressively fighting these threats at home. But we recognize their global dimensions, and we are actively mobilizing other nations to help us defeat them.

Altogether, our budget requests $240 million for these efforts. It more than doubles our funding to fight international crime. And it will support a comprehensive global strategy that we are developing with our colleagues at Justice, Treasury, and other law enforcement agencies.

This strategy will include intensive diplomacy to ensure that other nations fulfill their international obligations; broader international cooperation in asset forfeiture and money laundering; and consideration of tougher requirements for obtaining U.S. visas. And, as the President announced last week, the Administration will be proposing legislation to combat alien smuggling and illegal immigration. We will be consulting closely with Congress as we put the final elements of this strategy together.

The budget also supports our battle against international terrorism, in which we have made substantial progress in just the past few weeks. The President's Executive Order freezing the assets of certain terrorist groups and individuals sent a message that we intend to cut off the financial pipeline that supports their activity. The spectacular arrest of Ramzi Yousef, the alleged mastermind of the World Trade Center bombing, in Pakistan and his transfer to the United States reminds those who target Americans and America that they cannot escape forever the long arm of American law enforcement. Also last week, the President transmitted to the Congress our proposed Omnibus Counterterrorism Act of 1995, which, if enacted, will give the Executive Branch new tools to improve prevention, investigation, and prosecution of terrorism.

* * *

Beyone these five key areas of opportunity for 1995, I want to stress that we will continue to address many other issues important to our nation's interests and to this Congress, such as promoting stability and democracy in Asia, Africa, and Latin America. American engagement in the world is also reflected in our willingness to take on global challenges that call for international partnership, but require the leadership that only the United States can provide.

We can no longer escape the consequences of environmental degradation, unsustainable population growth, and destabilizing poverty beyond our borders. Increasingly, they threaten not just our continued prosperity but our security. Countries with persistent poverty, worsening environmental conditions, and feeble social infrastructure are not just poor markets for our products. They are likely victims of conflicts and crises that can only be resolved by costly American intervention.

That is why the Clinton Administration is dedicated to restoring America's leadership role on sustainable development -- an approach that recognizes the links between economic, social and environmental progress. We are putting this global challenge back where it belongs: in the mainstream of American foreign policy and diplomacy. The President's FY 1996 budget requests $5.2 billion for Promoting Sustainable Development. That includes funding for the multilateral development banks, the International Monetary Fund, the Peace Corps, and our bilateral and multilateral assistance programs. I believe strongly that every dollar of this money will yield lasting dividends for the American people.

Supporting the developing world's efforts to promote economic growth and alleviate chronic conditions of poverty serves America's interests. Nearly $1.4 billion of this budget will fund through USAID and multilateral programs activities that will, among other things, promote economic growth and free market economies; improve basic education; lessen the suffering and increase the survival of children; and treat and prevent HIV/AIDS. By helping nations to emerge from poverty, we can help them become stable pillars of regions at peace, and closer partners of ours in diplomacy and trade.

Our FY 1996 request for stabilizing world population growth is designed to complement our efforts to promote economic development. To maintain the momentum of last September's Cairo Conference on Population and Development, we are requesting $635 million for bilateral and multilateral population programs. We also designate $378 million for USAID and multilateral programs to address global environmental problems like air and water pollution, decreased biodiversity, and damage to the ozone layer.

The FY 1996 budget harnesses the will and capacity of our nation to respond to famine, natural disasters, and the displacement of peoples from their homes. The $1.7 billion we request for humanitarian assistance is integral to our overall development strategy because it not only provides relief, but helps victims of violence and disaster return to the path of recovery and sustainable development. Our budget also designates $283 million to support the Peace Corps and two other agencies that work at the grass-roots level: the Inter-American Foundation and the African Development Foundation.

Our nation's ability to achieve success in the five areas of opportunity that I have identified for 1995, as well as the other objectives of our foreign policy, depends on the dedicated men and women who serve our nation's international affairs agencies.

Our diplomatic posts around the world serve as sentries for the American people. They confront short- and long-term threats to the security of our citizens. They protect Americans travelling abroad. And as I pointed out earlier, promoting the interests of American companies and workers is a central element of our foreign policy, and our posts around the world are on the front lines of that effort.

It is essential that we arm our international affairs personnel with the skills and resources they need to do their jobs on behalf of our nation's vital interests. Like our soldiers, they must be equipped to fight for America's interests. They must have access to modern communications technology. They must work in facilities that help, not hinder, their productivity. And they must be trained in the diplomatic disciplines of the future, from commercial promotion to helping fight international crime, terrorism and narcotics. We have requested $2.6 billion to support the operations of the Department of State at home and abroad. And we have requested $1.26 billion to support the U.S. Information Agency.

Clearly, our long-term interests are ill-served by responding only to the crises of the day. The challenge of diplomacy is to anticipate, and to prevent, the crises of the future. If we are successful, we can dedicate greater resources to the urgent challenges of domestic renewal that the American people demand we meet.

Mr. Chairman, I began by noting that the United States enjoys remarkable opportunities in the post-Cold War world. It is important to remember that most of these opportunities are themselves the product of many years of American leadership on behalf of peace and stability, open trade, and political freedom.

Most of our closest allies and friends are nations that we helped rebuild after the second World War. The structures and institutions through which we advance our interests, including NATO, the GATT, the UN, and the Bretton Woods institutions, were created largely by American leadership.

As we consider our most promising export markets, it is useful to remember our role in creating those markets. There is South Korea -- once a recipient of massive U.S. assistance, now an aid donor in its own right. There is the Philippines, long a treaty ally and another recipient of American assistance, now entering the dynamic mainstream of southeast Asian economies. In Poland and South Africa, our support for human rights helped to end dictatorship and where our support for democracy is encouraging remarkable reforms. And then in Mexico, Brazil, and indeed in all these countries, our support for open trade has been an incentive and a catalyst for market opening and economic growth.

In short Mr. Chairman, the United States is one of the few countries on earth with the power to create its own opportunities. With your support, we will continue to use that power to build a world in which America's interests and values will flourish -- a world of open societies and open markets.

Chairman DOMENICI. We are going to proceed on our side with my yielding to Senators in the order that they arrived. Senator Gregg, you were here first. You can proceed.

Senator GREGG. Thank you, Mr. Chairman.

Mr. Secretary, I appreciate the chance to have the opportunity to discuss the State Department's budget with you today. Let me start by asking why the Administration has abandoned the initiative to merge AID, ACTA, and USIA, which it was represented would generate somewhere in the vicinity of $6 billion of savings by CBO. I think Senator Gore and his Reinventing Government felt it would generate maybe $5 billion, at least in authority. It seems to me that these were good ideas that were put forward but ran into a huge amount of resistance from the bureaucracy which would have been affected basically because they wanted to keep their jobs. But I don't think as a policy matter they can defend their position very effectively.

And I would hope that as we are looking at ways to generate foreign aid we would be thinking about ways to save money in other accounts in the State Department that would allow us to assist some of the initiatives which you have just recently outlined and so eloquently defended, and this would be one to do it.

So I would like to get your thoughts on why the Administration has abandoned this effort at what seemed to be a fairly substantive, thoughtful, and effective reorganization.

Secretary CHRISTOPHER. Senator, as you know, the Vice President has been given the responsibility for the National Performance Review, the so-called Reinventing Government initiative, and he has undertaken that with great sincerity and effectiveness.

This December or January, he called upon all agencies to rethink their priorities and to look at all their activities to see whether some could be either abandoned or streamlined or merged. In that context, the Vice President considered the possible consolidation of USIA, AID, ACDA, and the State Department.

After studying it, the Vice President concluded that the consolidation should not go forward at the present time. He stated, I would say, three principal reasons: first, he felt that the costs of consolidation, both financial and otherwise, would be greater than the benefits achieved; second, he indicated that he felt that each of the agencies had a distinct mission that would be best performed as an independent agency; and, third, he indicated that he felt consolidation efforts would interfere or interrupt the reinventing processes already underway in each of the agencies and in the State Department.

On that basis, he concluded not to press ahead with consolidation. We are going ahead with the streamlining efforts under the Vice President's aegis. He has urged us to seek administrative consolidation at all the agencies, and we are doing so. And in the State Department, we are going ahead with our own streamlining efforts.

Senator indeed, when I get free of various other things this afternoon, I am going out to an off-site meeting where our top Assistant Secretaries are working on those very streamlining efforts that we are undertaking within the State Department.

All that having been said, Senator, I certainly am quite prepared to cooperate with the Congress in any efforts that you might make to help us reduce expenses, because we all have the same goal in mind: to make our dollars in the foreign affairs field as effective as possible,—and I think they are relatively few dollars compared to others.

Senator GREGG. I appreciate that answer. It is a very diplomatic answer, as I would expect. I would just say that there are a lot of folks around here who would like to see that reorganization, which I think was essentially initiated by your office, pursued, and that it would save money. In my opinion, all these different agencies should be directly under your leadership, and they shouldn't be functioning independently, anyway.

Can I ask another question on another topic? My time is running out. About 5 to 10 percent, at the most, of the illegal aliens who enter this country come through Canada. In fact, more people come in on airplanes than come in through Canada. And I am just wondering, with this border crossing fee initiative which the Administration has put forward why it shouldn't be applied along the Mexican border where the costs are being generated for immigration. Why is it being applied to the Canadian border where, really, there is no significant problem of illegal immigration? It can be handled by the present structure, and certainly this is going to have a very negative impact on the tourism industry, which is fairly significant along the Canadian border, and the commerce which has been built up over the years with our Canadian neighbors.

There are a lot of towns in New Hampshire and Maine and Vermont, and I am sure across the country, that are on the border where people literally walk across the street to go shopping in their local store and they are going into different countries. And it has been that way for generations. And to put this fee in place, which is a fee that I understand may be needed to support the efforts along our Southern borders for immigration, but to apply it to the Northern borders where the immigration problem is not so acute seems to me to be unfair in asking people to bear the burden here of a problem that they are not creating.

Secretary CHRISTOPHER. Senator, thank you for those comments, and I will certainly keep in mind that eloquent statement. The border fee was proposed with the thought of making more efficient and effective the border entry and to use the funds that would come from these fees for that purpose.

All the funds that are generated will be used to make border crossing more efficient and more effective through automation express lanes, various techniques. It will make crossing the borders more efficient.

I think that the problem of discriminating between one border and the other is one that I think is quite obvious. We would want to think a long time before we had discrimination between our neighbors to the North and our neighbors to the South.

I take into account your comments, and I do want to assure you that the intent was to use the funds to make the border crossings more effective, faster, and just to ease the entry by some modern techniques, such as automation and commuter lanes and so forth.

Thank you very much for your comments.

Senator GREGG. Is it going to apply, for example, to aircraft coming into this country? Will this gross up the fee for people coming in on aircraft? Because, obviously, there is a border entry there, too.

Secretary CHRISTOPHER. As far as I know, it simply is a land border entry, Senator.

Senator GREGG. Well, then, it is already discriminating on the basis of how you arrive. If you get on a plane, you can come in and not pay the fee. But if you come across to go grocery shopping in Sherbrooke, Canada, from Colebrook, New Hampshire, you have to pay this fee. That does seem to be a decision that is already creating a discriminatory event. If that is going to be the occurrence, why shouldn't you go the additional step of at least generating the fee where the cost is occurring? Because basically what you are doing is taking money from people who border cross in Canada and shifting it down to the Mexican border. That is essentially the discrimination that is really occurring here.

Secretary CHRISTOPHER. Senator, I can't agree with that characterization because I think a good deal of funds will be spent to make more effective and efficient the border crossings in Canada. There are many differences, of course, between arrival by air and the easy crossing back and forth that goes on in the border areas, not only in the Northern border area but in the Southern border area. But I appreciate your point, and I will certainly take it into account.

Senator GREGG. Thank you.

Chairman DOMENICI. Thank you very much, Senator Gregg.

Senator Exon, would you yield me 30 seconds?

Senator EXON. Sure.

Chairman DOMENICI. Senator Brown, if you would be so kind to preside in my behalf for about 20 minutes. I need to go over to the Finance Committee. Thank you.

Before I go, however, I just want to make an observation. I don't expect an answer. I go beyond the question Senator Gregg asked, why the reorganization you proposed several months ago didn't occur. I want to tell you, I believe you missed a rare opportunity. Frankly, there is no way that the functions of your Department and foreign aid can go up. They are going to come down. And I believe the best way to have handled it was to say we are going to modernize the foreign aid structure in its totality.

I think that has to be done. I compliment you for whatever efforts you made, and I don't mean to put you on the spot. But I believe we have vestiges of aid programs that clearly don't fit today. They were brought into the world when we had socialism and communism, and I tell you, it is almost impossible to reform AID under its present structure. It ought to be put together with others, and we ought to start over.

I frankly think it is going to happen anyway, and we are going to save maybe $5, $6, $7 billion in budget authority over the next 5 years.

Thank you for yielding, Senator.

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

I have so many areas that I want to cover. Let me start out with one, though, that I think is very, very important. Have you reviewed your decisions with regard to the PL–480 Program? Mr. Secretary, this is one that I think has wide support, both here at home and abroad. Under the projections as I understand them, the PL–480 Program would take a 60-percent cut between 1993 and 1996. It seems to me that if you look at some of the other proposals for increases, I see that multi-development banks get an increase of 23 percent. Aid to Central and Eastern Europe increases 31 percent. Aid to other countries in transition increases by 23 percent, and funding for anti-narcotics programs and crime grows by 45 percent.

While all those might be worthy, I am just wondering if enough attention has been given to what the PL–480 Program has done for America and underprivileged foreign countries over the last 40 years. Has this thing been thought through thoroughly, in your opinion?

Secretary CHRISTOPHER. Well, Senator, whenever we cut the request in a particular budget item, of course, it is the subject of very intense conversations at the State Department, within the Administration, and with OMB. I would say that the two principal reasons why PL–480 was cut were, first, because of the reductions in agricultural subsidies, second, fundamentally, the overall budget stringency, overall budget constraints.

Clearly, these are good programs, but in very tight budget times, we had to find some ways to make reductions, and they were made in the PL–480 Program. As I say, those are good programs, and every one of the cuts that are made are painful in many ways to us because they represent programs that we have had in the past.

Senator EXON. Well, I would simply say that while I agree with your statement, you didn't answer the question, and I won't pressure you on it further now. But for the record, I would simply say that you are adding to several programs that I outlined, and I question whether or not the trade-offs are appropriate. But they may well be.

Let me get into some other matters that I am very much concerned about as my responsibilities on the Armed Services Committee.

First, I would like to have you comment, if you could, briefly, on the Korean agreement, how we are moving on that. I am very much interested in what your views are with regard to the Nuclear Test Ban Treaty that I have been involved in heavily in the Armed Services Committee and on the floor. I think there is nothing more important to the future of mankind in proceeding as best we can with the Nuclear Test Ban Treaty, the Non-Proliferation Treaty, and others that are designed to defuse ours and other nations' dependence upon the ultimate weapon.

Can you just at least touch upon those to give me some feeling, and for the record here, as to what the Administration's thoughts and proposal are on these tremendously important matters?

Secretary CHRISTOPHER. Senator, with respect to the Framework Accord with North Korea, I am glad to say that implementation is proceeding on schedule. Things that they have agreed to do, they are doing at the present time, and the discussions are going forward with respect to such matters as spent fuels in a satisfactory way. So we are, I think, going forward on track there.

We are meeting with the North Koreans to discuss so-called KEDO, which is the Korean Peninsula Energy Development Organization, which will be the organization that oversees the construction of light-water reactors. There are some issues still in negotiation there as to where the light-water reactors shall come from. We think the only feasible place for it to come from is from the Republic of Korea. But everything considered, we feel that that project is going forward on schedule and on track.

Second, with respect to the Comprehensive Test Ban Treaty, as I said in my remarks, Senator, I think this is the most important year in non-proliferation in my memory, and we have an ambitious agenda. One of the items is the Comprehensive Test Ban Treaty. The United States, as you know, has refrained from testing. We are urging others to do so, and we are looking toward an agreement in 1996.

The United States has recently indicated, I think with wide approval in other countries, that it will no longer seek a 10-year opt out from the Comprehensive Test Ban, but we are studying other aspects of that matter. We are determined to try to get a Comprehensive Test Ban Treaty. I think that the indefinite extension of the Nuclear Non-Proliferation Treaty, an extremely important treaty, is at least in part dependent, Senator, on the world seeing that we are pursuing a comprehensive test ban in good faith. And we certainly are doing that.

Even those countries that are continuing to test, such as China, and threatening to test, such as France, have said that they want to put themselves in a position so that they can enter into negotiations for a Comprehensive Test Ban Treaty. So we will be working hard at that, and I am glad you attach priority to it.

Senator EXON. Thank you very much, Mr. Chairman. Thank you, Mr. Secretary.

Senator BROWN [presiding]. Thank you.

Senator Gorton?

Senator GORTON. I understand, Mr Secretary, that you have been asked about the border crossing fee and about its disproportionate impact on the Canadian border where there are few, if any, problems of illegal immigration. But I would like to ask specifically, in a State like Washington or Maine, for example, will the money collected at the border crossings be spent on the borders of those States and Canada? Or will it be primarily spent on the Mexican border?

Secretary CHRISTOPHER. Well, it will be all targeted for improvements in border crossings. There has been such a tremendous increase in border crossing at both borders that we felt the need to have additional funds available.

The funds will be not used by the State Department, of course. They will be used by the Immigration and Naturalization Service. I can't tell you here today, Senator, because I simply don't know, how they will allocate the use of the funds; in other words, whether they will spend funds collected from the State of Washington in the State of Washington. I simply don't have information which is that precise, and I would be surprised if they were able to allocate it precisely back to the State where the funds were collected.

I will get you that information, though, Senator, so that we can both get educated, because I am not sure how the INS plans to do it.

[The following was subsequently supplied for the record by Secretary Christopher:]

Plans on how the proceeds from a border crossing fee would be used are not yet completed. The border crossing fee itself is still under discussion at the White House.

[On February 22, the White House indicated that the Administration would not pursue a mandatory border crossing fee.]

Senator GORTON. Is the proposal, however, one which will make that charge every time an individual crosses the border and, therefore, will include even people who literally commute across the border for jobs or for shopping every day of the week, 52 weeks a year?

Secretary CHRISTOPHER. That is the present proposal.

Senator GORTON. Do you regard that as an appropriate proposal, an appropriate load or sharing of what is, after all, a problem for all Americans? Should a handful of them have to pay the overwhelming share of the cost?

Secretary CHRISTOPHER. Well, the reason for the border crossing fee is the tremendous increase in travel and trade and tourism back and forth across the border, which was creating expenses for the United States of various kinds. And the border fee seemed to be justified in order to smooth that transit, in order to make crossing more effective and more prompt.

Senator GORTON. Oh, really? It doesn't have anything to do with stopping illegal immigration?

Secretary CHRISTOPHER. Well, I am sure——

Senator GORTON. Wasn't that the real purpose.

Secretary CHRISTOPHER. It will be used by the INS in part for those purposes, but it will also be used, in a very substantial part, in order to speed the entries through automation, through the use of commuter lanes, and other traffic devices in order to speed the entry.

Senator GORTON. On another subject, Mr. Secretary, the Vice President's Reinventing Government report determined that, and I quote, "AID does not have a single clearly defined, articulated strategic mission."

Yesterday, Senator Helms had an article in the Washington Post urging the consolidation of a number of departments into the State Department, and identifies you, correctly, I believe, as the primary inspiration behind that proposal.

But in today's Washington Post, you are quoted as saying that merging the departments "would be greater than the benefits that would ensue."

How do you reconcile your two positions, your original position in helping cause this recommendation by the Vice President, with the one you take today that no changes need to be made?

Secretary CHRISTOPHER. Senator, I replied to Senator Gregg to a comparable question, although it wasn't put quite as sharply as yours, and so I feel the need to—— [Laughter.]

I do feel the need to respond again, and I apologize to those who are hearing me twice on this subject.

I have been given somewhat too much credit for the inspiration, but I did say to Senator Gregg that I felt the foreign affairs agencies should not be immune from possible merger or consolidation if it will achieve efficiencies. In that spirit, the Vice President did consider this consolidation.

Now, the quotation in the newspaper is not mine, although it was my voice. I was passing on what the Vice President found after looking at these issues. He concluded that to go forward would have more costs than benefits, both financially and otherwise. He thought that going forward would interfere with the streamlining efforts of the individual agencies, and he also found that each of the agencies had distinct and important missions.

Now, in stating that here today, I am expressing his views, which I tell you, of course, I fully accept.

Senator GORTON. A wonderfully diplomatic answer, Mr. Secretary. Thank you. My time is up.

Senator BROWN. Senator Abraham?

Senator ABRAHAM. Thank you very much.

Mr. Secretary, you, of course, will be pleased to note that virtually everybody over here has a common Canadian–American border, so I feel compelled to make the same point. Senator Gramm, who is not here, would perhaps have a different viewpoint. And Senator Brown, the landlocked Senator Brown here.

But I would point out, without getting into the questioning, which you have now addressed twice, that at least in my State there is a great deal of concern about these fees, both because a lot of remodeling has been going on in the border crossing areas and because of the degree to which tourism in our State from Canadian tourists is a very vital part of our State's economy. And so I would just echo some of the concerns that were raised already.

Secretary CHRISTOPHER. I always learn things when I come up here to Capitol Hill, and I am learning there is great opposition to that particular fee.

Senator ABRAHAM. What I wanted to get at was a little different issue. It kind of touches in a way on what Senator Exon said. I think that as we have moved into the post-cold war era, at least I would be part of a group that clearly the Administration and others up here are part of that believes the United States should not back away from its commitments and its leadership role in the world.

I think part of the problem that Senator Exon encountered, as he described it, with various folks around his State and I encounter in my State, too, is perhaps a more difficult time understanding what constitutes the vital interests of America in that post-cold war era.

I think when there was a looming Soviet threat, it was pretty easy to outline the need for the aid programs and for the various international affairs budget items that we are talking about today.

I am not saying there is less of a need. I think there is a different type of need. But I think one thing that would be helpful—and this is more just an observation—would be for all of us to have on an ongoing basis a clearer sense of what constitutes the strategic interests of this country in that post-cold war era, both its political, its military, and its economic interest.

To that end, you have done some, I think, effort here today—and in the fuller text of your remarks, probably it goes into more detail—to try to establish some of those. One of those was in the area of moving forward the peace process in the Middle East.

I would just like for you perhaps to outline to the committee how support for Israel and Egypt and the maintenance of the support that we had begun in the past, as well as the proposed forgiveness of debt and assistance to Jordan, how that type of support does advance the strategic interests of this country and why it is vital to maintain it.

Secretary CHRISTOPHER. Senator, that is a very, very fair question, and one that I welcome. The United States has had a long strategic interest in the Middle East. It is an interest that goes back at least to the days of President Truman. Every President from there on has evaluated the Middle East as being an area where the United States leadership and the United States interest was very great. It, in part, flows from our dependence upon the oil supplies from that area, but it is a good deal deeper than that. It involves our commitment to the security of Israel, and the importance of Israel, to the United States.

One thing that one needs to do in my job is to look back where the wars have come from, where international peace and security has been destabilized by threats, and the Middle East is certainly a very strong priority because it has been such a seed bed of conflict over the years. Four wars were fought in that area just since World War II. So we must do everything we can to prevent them.

Now, how does our assistance help do that? Well, actually, it can be summed up in a few sentences, and that is, the United States has committed itself to support those who are willing to take risks for peace. The first country that took the risk for peace was Egypt in the late 1970's, 1978 and 1979. And it is interesting that it took a whole decade for the next peace agreements to be made. But Egypt is still out there rather alone in its leadership of having rapprochement with Israel.

Now that other nations in that area have taken risks for peace—and, of course, Israel has taken the greatest risk itself—I think they deserve the support of the United States. And the United States' support for Jordan and our willingness to engage in debt forgiveness was really fundamental to the agreement between Jordan and Israel, which has changed the relationships between those countries so importantly and reduced the risk of conflict in that area.

So I think those funds have been well expended. They are large sums, but when you compare them to the cost the United States would inevitably undertake if war broke out there, if we had to fight as we have had in Kuwait, I think you can see that those are very good investments for American security.

That is sort of the shorthand answer to a fundamental problem, but there is no doubt about the strategic interest we have in the Middle East and the interest we have in encouraging those who pursue the peace process.

Senator ABRAHAM. And would that be a policy you would extend to others who might take similar risks as we move forward in further negotiations?

Secretary CHRISTOPHER. Yes, I think we always must be conscious of assisting those who take risks for peace. Now, it gets more complicated as you get into countries with whom we have less close relations and more reservations. But, nevertheless, in concept, I think we ought to give our support to those countries, one way or the other, who take risks for peace.

I know that you have an interest in Lebanon, Senator, and it would certainly apply to Lebanon. We would like to be in a position to assist that country more than we are. We would hope that we can pursue the peace process there, and it would be a great happiness on the part of many of us if we could have an opportunity to reward them for taking the risk for peace.

Senator ABRAHAM. Thank you.

Chairman DOMENICI [presiding]. Senator Snowe?

Senator SNOWE. Thank you, Mr. Chairman.

Welcome, Mr. Secretary. Good to see you again.

Secretary CHRISTOPHER. Thank you for having to put up with me 2 days in a row.

Senator SNOWE. I think you are spending more time on Capitol Hill than anybody else.

It is nice to have you here today, and it will come as no surprise to you if I reiterate the statements that have been made by Senator Gregg and Senator Gorton and Senator Abraham on cross-border fee. But I will add something to that. We have had a number of problems with the Administration's proposals, one recently in addition to the cross-border fee. The Customs agency unilaterally increased the amount of tax on goods coming in from the United States into Canada. That was done just very recently, in addition to the problems that we are facing in Maine because of the failure of the dispute resolution panel to resolve a problem of increasing the provincial sales tax by New Brunswick on goods coming in from the United States of 11 percent. And that, in and of itself, has been very, very damaging.

So our U.S. Trade Representative Mickey Kantor decided that he would pursue it through the dispute resolution panel under NAFTA. The interesting part about it is that neither Mexico nor Canada has submitted a list of potential panelists to serve on that panel, and, therefore, the panel has not convened to resolve this problem. I see that as a major loophole in addressing this issue and resolving what is clearly a major dispute and has been damaging to hundreds, if not thousands, of small retail businesses along the border between Maine and Canada.

So it is compounding a very serious problem that already exists with these recent efforts. I would hope that this is something the Administration would reconsider in terms of the cross-border fee.

Also, I would ask the Administration and you, Mr. Secretary, to also resolve this pending dispute concerning the 11-percent provincial sales tax. The dispute resolution panel should be made to reconvene on these issues. Obviously, they don't have to, given the fact that there is no requirement within the agreement to meet. So it obviously, I think, renders the agreement rather useless in terms of resolving disputes.

Is there any way we can resolve that particular problem?

Secretary CHRISTOPHER. Senator, you bring me new information. I really didn't realize that that dispute resolution panel had been frustrated because of the failure of the Canadians to name their members, and it is something I will discuss with Ambassador Kantor to see if there isn't some way we can resolve that.

I know a little bit about the United States-Canadian agreement, and I understand those panels. But, really, I am very surprised that they have frustrated it by not naming their members. I will talk to Ambassador Kantor.

Senator SNOWE. It has almost been the better part of a year since this dispute has been pending, and without a panel to consider it.

On the proposed reorganization of the State Department, is it my understanding that you would be willing to work with the committees of jurisdiction on this issue as we begin to consider it? My Subcommittee on International Operations, which I will be chairing, will be holding some hearings on the reorganization plan.

Secretary CHRISTOPHER. Well, of course, I would, Senator. I would always be willing to work with any of the committees of Congress in a conscientious way. You understand that I am bound by and committed to Administration policy, but, nonetheless, you know, the bipartisan spirit that I hope to achieve and invoke here would certainly be defeated if I wouldn't work with the committees on any project that you felt was in the National interest. So I will certainly do that.

Senator SNOWE. Well, I think that it would be important, because I don't think there is probably any doubt that the Department will be reorganized. The question is on some of the specifics and the provisions of that reorganization plan that my subcommittee will be reviewing.

On another note, and I raised the question yesterday before the Foreign Relations Committee, on the issue of increases, but in particular the $69 million increase in assistance to Russia.

I have concerns because of the disturbing developments in Russia and what has happened in Chechnya, and also in the recent reports concerning Boris Yeltsin's health. Could you comment on both of those issues as to why we should have a proposed increase of $69 million to Russia, at this point in time, given the fact that they have made, I think, little effort in terms of reforms.

And then, second, commenting on Boris Yeltsin's health?

Secretary CHRISTOPHER. First, with respect to the increase, it is a relatively small increase. If you look at our overall budget, Senator, you will notice that this year, in contrast to some past years, more than half of the budget goes to new independent states other than Russia.

The increase, basically, goes to the other new independent states, not Russia. My recollection is that the funds for Russia are flat and—I have just gotten a note here—that Russia will be reduced by approximately $100 million this year and the funds flow to other new independent states, such as Ukraine, Kazakhstan, and so forth, which I think deserve and urgently need our assistance.

With respect to Russia, I think it is important not to lose sight of the progress that is being made there, particularly in privatization. Our best information is that more than half of the industry has now been privatized in Russia, more than half of the Russians are now working in private businesses. And as you know, a substantial amount of our aid has gone to the privatization programs and I think that continues to be very important.

Also, the support for the free press and jury trials and so forth is significant despite the tragedies of Chechnya. It was reported by a free press that was unrestrained, giving the Russian people an opportunity, I think for the first time, to see some of the horrors of that war. And no doubt, it is affecting Russian public opinion.

So I don't think this is the time to draw back from our support for Russia. Indeed, nothing about Chechnya makes me feel it is not important to support reform and reformers.

With respect to Mr. Yeltsin, let me simply say that our best information and our judgment is that he is in control, that he is in command. The President talked to him on the telephone on Monday, and we believe that he is in charge of Russia, making the major decisions on a regular basis.

Now you won't be surprised, Senator, but as Secretary of State I do not think it is wise for me to comment on the personal health or personal characteristics of other governmental leaders, and I don't think that this would be a good occasion for me to begin, but I can emphasize to you the fact that our best judgment is that he is in command and control and making the major decisions.

Senator SNOWE. Well, I think you would agree, it is somewhat disturbing to hear some of the more recent reports. In fact, one that I saw on television this morning in talking about his health, his particular health problems, and also with respect to having control of the 7,500 nuclear weapons that are under his authorization.

We are keeping on top of that, I assume.

Secretary CHRISTOPHER. We follow these matters carefully. I was with Secretary Perry yesterday. Of course, he follows the nuclear matters with great care and he said that he felt that their nuclear weapons were under effective and stringent control.

Senator SNOWE. Thank you.

Chairman DOMENICI. Mr. Secretary, I think we have a vote up, but Senator Brown will return to chair the proceedings in my absence. I am going to return to ask you a few more questions.

Secretary CHRISTOPHER. Senator, I will be glad to wait. Don't feel——

Chairman DOMENICI. What does your schedule look like? Can we have you until eleven thirty?

Secretary CHRISTOPHER. Yes, 11:30 is fine.

Chairman DOMENICI. Let me ask you about the recent announcement with reference to Yugoslavia?

As I understand it, the Administration announced yesterday a plan to lift, at least temporarily and partially, the economic sanctions on the remaining elements of Yugoslavia, Serbia and Montenegro, if Belgrade will recognize Bosnia and Croatia, is that correct?

Secretary CHRISTOPHER. Senator, it goes in the right direction, and if you will give me a moment, I will explain it a little bit more fully.

Chairman DOMENICI. I would like you to, but let me finish my thoughts and then you can answer it all in one package.

Secretary CHRISTOPHER. All right, good.

Chairman DOMENICI. Excuse me, Mr. Secretary. It seems we must go to the floor to vote now. I will be back and I will have a few additional questions.

Secretary CHRISTOPHER. Fine.

Chairman DOMENICI. We are in recess until Senator Brown returns. He will call the hearing back into order at that time.

[Recess.]

Senator BROWN [presiding]. Mr. Secretary, we thought we would just go ahead, to optimize the time you have with us, and try and dispose of the balance of the questions that the committee may have.

I will call the committee back into order.

Mr. Secretary, you are so thoughtful and so diplomatic that I think sometimes people don't give you the credit you deserve for the job that you do. I found myself musing that in the 5-minute segment I had to chat with you yesterday, that I had asked only one question and then I wasn't sure I had gotten an answer to it. And it was a very pleasant exchange, besides. [Laughter.]

Let me repeat it, now, I say, because I think clarity would have some value, at least I hope it will.

We have put at risk some $20 billion out of our Exchange Stabilization Fund to assist Mexico. We have been part of an effort through the International Monetary Fund along with other countries to assist Mexico, and obviously that involves considerable United States resources.

The Federal Reserve has committed some of our Nation's funds. The International Bank of Settlements, that involves at least some U.S. funding, has stepped forward with large commitments.

Have we achieved, to this point, any specific reforms of Mexico's monetary and financial system?

Secretary CHRISTOPHER. Well, they have planned to take a number of steps, as you know, and if we do go forward and advance any funds it will be based upon a contractual commitment between the United States and Mexico that they do go forward with those various reforms to their financial system.

Now, we have not yet advanced any funds pursuant to the President's decision to go forward. The IMF, as I said to you yesterday, will also be putting forward a rather stringent program. As you know, the IMF Program always has various elements that relate to the whole range of the government's financial policies, from their inflation estimates to the amount of government spending to cutting the government payrolls to possibly dealing with wage and price issues.

We would be working with the Mexicans to impose tough conditions that protected our funds because the United States does not want to lose the funds. But since the funds have not been advanced and negotiations are going forward, Senator, I am afraid that I may not be any more satisfying today than I was yesterday, because I cannot tell you what specific conditions have been agreed to because the contractual commitment has not been made.

Senator BROWN. I want you to know I feel better about it, even though we are not necessarily clear. But if I understand what you have said, you have indicated, one, while we have talked about a commitment, we haven't actually sent the money out, yet.

Secretary CHRISTOPHER. That is correct.

Senator BROWN. And two, it is your intention that real reforms be part of the package before U.S. funds are——

Secretary CHRISTOPHER. Exactly. Things like control of their money supply and the attitudes of their Central Bank, things that are, frankly, beyond my particular ken, but will be negotiated carefully between our Treasury Department, advised by our Federal Reserve Board.

Senator BROWN. Mr. Secretary, I appreciate that, and I do think it is helpful. I do think my concern is perhaps shared by others.

As we go forward, I want to direct your attention to an item that I don't think has been handled in a very satisfactory manner and it predates your administration and your stewardship.

That is a question of State Department facilities overseas. Of specific interest are countries of Central Europe and, perhaps, the republics of the old Soviet Union, where we have found ourselves expanding diplomatic relations and looking for new facilities or expanded facilities.

My impression is that we expend a significant amount of funds in providing housing for State Department personnel and other personnel associated with the embassies, that much of that money is expended on leasing or renting because of the nature of our budget, and that we have not moved very quickly to acquire adequate facilities either for housing or for embassies in many of the locations.

Moreover, it was my impression, under previous Administrations, we had funds authorized for that purpose or at least for a similar purpose. That is, much of the funding came from providing for secure premises, embassies, and so on.

The fact is, previous Administrations as well as this one, have not moved very quickly to acquire adequate facilities. I see it as a budget issue because, frankly, I think by investing in facilities, particularly at the time those economies are in difficulties, we would do far better financially than we would to continue to pay rent.

I would be interested in your thoughts on the subject and knowing of any action you intend to take in this area.

Secretary CHRISTOPHER. Senator, before I address that question, let me say, so the record will be clear and so you will be clear about it, despite the fact that we intend to impose tough conditions on Mexico to protect our investment, we do anticipate going forward. I don't want to leave any doubt on the record as to what the situation is. We do expect to go forward.

We expect to be able to reach the kind of agreement that I was talking about, but has not yet been reached.

Now on your question, Senator, it is one I am glad to have an opportunity to talk about. I actually have traveled somewhat in the new independent states, and I have seen the condition of some of our embassies and residences there.

Frankly, anyone who thinks that Foreign Service Officers have an easy striped-pants life, really ought to visit some of our embassies and see the construction problems we have there and the way we are working with very, very antiquated structures, to try to provide facilities.

I think we made the right decision, Senator, in deciding that we should have an ambassadorial representative in each of those countries. Each of their independence is very important to us.

I agree with you that it would be wise if we would invest in some of the housing there rather than paying rent or making leases for a long period of time.

Frankly, I regret that we have no money for purchasing houses at the present time in any of those countries. We only have money for purchasing equipment in our embassies and, when I look around the world I see some of the places where we have very good housing that was purchased right after World War II that has increased in value enormously over time. There are some very valuable properties of that kind and sometimes we sell those properties in order to help with our other budgetary needs.

But I do think it is probably penny-wise and pound-foolish for us to go on paying rents or having leases when we could make purchases and save money in the long run, and if we could work with the Congress to, at least, be able to do some of that, I think it would be very welcome to us.

Senator BROWN. My impression is, we put a lot of money into security measures for personnel—of course, that is appropriate in many countries—and that those become part of the lease-hold. The landlord owns them, and it either results in higher rent, if another embassy employee continues there, or that investment is lost when someone moves.

Would authorization to just switch funds between leasing and purchase be of help? Would authorization to do lease-purchases be of help? Are there some things that we can do to be of assistance to you in this area?

Secretary CHRISTOPHER. Yes, Senator. Actually, I would like to have an opportunity to talk with you or your staff about how we might do that.

We feel very constrained at the present time. Sometimes, we pay what looks to me like fairly large lease payments and if we could convert that into a fund to actually buy the property over time, we would end up, after a relatively small number of years, with the property.

Your point about the security is exactly right. Especially for many of the officials, we have to expend substantial amounts of sums for security. Sometimes the lease can be transferred from one person to the next, but sometimes we lose it. And so, I would like very much to see if we can achieve something along those lines.

Frankly, it has been very hard to persuade the Congress to permit us to buy houses for budgetary reasons that you would understand, but I do think it is penny-wise and pound-foolish.

Senator BROWN. I agree, and I appreciate your willingness to work with us on it.

Mr. Secretary, I wanted to assure you and really invite you—I don't expect you to respond off the top of your head, but obviously any words would be helpful—but I do think that it is not altogether likely that the entire Administration request will be honored when the final budget is put together.

And to the extent that you would be willing to set priorities, I think it would be helpful for the Congress I appreciate that that may not be viewed as the kindest invitation you have had, but I assure you, your priorities are important to us.

To the extent you are comfortable in setting priorities, I want you to know we would like to hear them.

Secretary CHRISTOPHER. Senator, I wouldn't have sent the budget up if I thought that it could be cut without taking risks to our ability to do our jobs well. We will certainly work with the committee as you move forward, but I think the priorities that I have outlined in my statement are the priorities that I have for this year and I believe the United States should have for this period of time.

I would not want to point to one item or another item of this budget and say, now we can give up on this, and now we can give up on that.

I don't think you are surprised that I am not going to do that, but I will say to you that, as this goes forward, we will certainly work with you. And if you think that some items are unjustified, we will certainly want to hear from you on that subject.

We think that, as the budget has gone forward, it is a very austere budget and there is a good justification for each of the items. We have been asked to undertake a number of new and heavy responsibilities, and as I say, the budget has gone down in real terms.

I don't know whether you were here, Senator, but I am particularly concerned about the operations budget. For so many years, cuts have been made in our operations budget, and so we are operating with very outmoded, out-dated equipment. Sometime, that will come back to haunt the United States because our computers will break down or our communications systems will be unavailable at a moment when we need them.

So if I have indicated a sense of priority there, I certainly hope that if cuts come, they do not come in the State Department operations funds because I think that would be quite unwise.

Senator BROWN. Thank you. Last year, Congress passed into law a provision that talked about a visit to this country by the President of Taiwan. It specifically required that he be admitted to the United States under certain specific conditions that, frankly, the conditions were laid out as ones that would be advantageous to the United States.

Do you know at this time if the President of Taiwan will be admitted to the United States, if he seeks to come this year?

Secretary CHRISTOPHER. Senator, under present circumstances, that would not happen. I think you understand how difficult an issue this is.

It goes back to the normalization with China. I was in government in the late 1970's. Understandings were reached at that time, and we have committed ourselves to the concept of there being one China. We committed ourselves to having an unofficial relationship with Taiwan.

I made a trip to Taiwan right after the announcement, which was a rather violent trip in many ways because of the concern in Taiwan. But I think we all can recognize that our relationship with Taiwan has gone very well. They have made important steps toward a market democracy. They have made important strides, in many respects, on this non-official relationship with the United States.

But I would not want to say otherwise, Senator, than it is a balancing matter. We are trying to stay within the context of the three communiques in which we agreed to normalize relations with China. We want to conduct unofficial relationships with Taiwan. We want to try to enhance those unofficial relationships.

As you know, we have made some adjustments last year and some of our Cabinet officials have traveled to Taiwan.

If the President wants to transit the United States when he is going someplace else, that would be acceptable under the new arrangements, but it is regarded as being inconsistent with the unofficial character of our relationship with Taiwan for the President to visit here in what would be, in effect, an official capacity.

Now, I understand the difficulty of that and it is really a very close question of balance. We are trying, as I say, to maintain consistency with the three communiques in the normalization procedures that we had with China, but also trying to enhance our unofficial relationship with Taiwan.

I would be glad to hear further from you on that subject, Senator, because it is a very difficult matter of balance that I think any Secretary of State would find himself dealing with because of the tremendous importance of China but also the growing importance of Taiwan.

Senator BROWN. I want you to know, I appreciate very much your thoughtful reply. At least, my own perception is that a willingness to deal with the in-transit question is very important and it would presumably prevent a reoccurrence of the very, I think, unfortunate incident that occurred in Hawaii.

And frankly, the adjustment in policy with regard to Cabinet members visiting is, I consider, a significant modification, as well.

Secretary CHRISTOPHER. Senator, I try not to come here and make hard questions look easy because it is just better to recognize there are difficult questions, and frequently, a person in my position is in a matter of balancing considerations that are important on both sides.

Senator BROWN. I appreciate that we have not given you an easy burden in this regard. I appreciate your thoughtful answer.

Obviously, it is an area of concern I think the Congress has and we will want to be working with you.

My impression is that Senator Grassley and Senator Domenici are in the process of returning from the floor, and Senator Lautenberg has joined us.

Senator Lautenberg, do you have questions for the Secretary?

Senator LAUTENBERG. I do, Mr. Chairman, I just need about 2 seconds to organize, here.

Secretary CHRISTOPHER. Good morning, Senator.

Senator LAUTENBERG. Mr. Secretary, nice to see you. Neither rain nor sleet nor snow would keep the Secretary from an appointment with the Budget Committee, obviously. It's a great moment, and we are pleased to see you.

Secretary CHRISTOPHER. I probably had more help getting in than most people, Senator, so—— [Laughter.]

Senator LAUTENBERG. No shoveling. It is not a good idea.

I wanted to just deal with a question of debt relief from Jordan, with the kinds of pressures that we see here, against expenditures in what I think are lots of required areas.

One of those, I understand, you have already commented on, that obligations, financial obligations in the pursuit of peace, are things that our country ought to honor and ought to pursue.

When the Administration first indicated that it would ask Congress to provide funds to relieve Jordan's debt, we were told that the request would come in three installments or traunches. The Administration is asking now that the remaining two traunches, worth $488 million, and requiring $275 million in outlays this year, be approved as part of a supplemental funding request.

Why did the Administration decide to seek the remaining two installments of the debt relief package at one time and through a supplemental funding request?

Secretary CHRISTOPHER. Senator, when Jordan took a large risk for peace, we wanted to respond in a positive way, and one of the most effective ways we thought we could respond was through debt relief.

There was about $700 million in Jordanian debt and we thought we should not do it all at once so that we could measure the progress of Jordan toward peace.

As you recall, the initial decision was taken at a time when the announcement had just been made.

Now you are quite right, Senator, that we did contemplate doing it in three tranches, rather than two tranches. But the progress that has been made between Jordan and Israel and the fact that they were able so much earlier than anticipated to reach a peace agreement and the steps they are taking to implement the peace agreement, made it seem justified to us to give the debt forgiveness and to do it as quickly as we possibly could.

Jordan is getting relatively little other benefit from us, I think, only some $23 million increase in military assistance.

And quite frankly, we wanted to be responsive to the risks that they have taken for peace and the progress that has gone forward with more speed than anticipated. I think many in Israel were both pleased and surprised by the fact that Prime Minister Rabin and King Hussein could conclude the peace agreement when they did and implement it in the ways that they have.

We sought a 1995 supplemental rather than going the regular budget route, so that the funds would be available more quickly and we hope Congress will act on that rapidly, Senator.

Senator LAUTENBERG. What is Jordan's expectation here, in terms of timing?

Secretary CHRISTOPHER. Well, I think that Jordan hoped that we would do it all at once and we told them that we were going to do it, as you say, in installments or tranches, so that we could measure the progress. And now that progress has been so rapid, I think they are hoping for this forgiveness very quickly because this burden of debt is very difficult for Jordan, at the present time.

We are also seeking some relief for them in the international financial institutions. The burden of debt is very heavy on them and is keeping them from moving forward with the steps they need to take in their economy.

As you probably well know, they have absorbed several hundred thousand refugees from Iraq, which adds to the burden on their society.

Senator LAUTENBERG. I think Jordan is entitled to as much help as we can give them. They have participated fully and quickly in terms of establishing the kinds of relationship that we believe will ultimately bring peace to the area.

Would the implications be for Jordan, if these installments were not made in timely fashion?

Secretary CHRISTOPHER. Senator, I think that it would have a very adverse effect on their economic situation. Frankly, they are struggling with the burden of the refugees from Iraq and trying to get their economy moving forward.

They have also taken some significant steps toward democracy that I think are quite singular among countries in that region, with elections to their parliament. We want to encourage that, as well.

I think it would be unwise for me to signal some dire consequences, but they are expecting early action, and I know from hearing from them, that they are very concerned about their economic situation. They are concerned about their reserves.

And this debt relief will be significant to them, and we also hope it will pull some other countries along to join us in debt relief in the international financial institutions. So, it would be a very severe setback for our program in the Middle East if we cannot honor our commitment to provide debt relief.

Senator LAUTENBERG. Thank you.

Chairman DOMENICI. Senator, would you like to proceed? Five minutes, and then I will ask my questions.

Secretary CHRISTOPHER. Good morning, Senator.

Senator GRASSLEY. Mr. Christopher, good morning. I didn't hear your testimony. I am sorry, but I was in the Finance Committee on capital gains differential.

My questions might appear to be confrontational, but let me assure you that they are an effort just to have some information, and if you can't supply the information—and you might not be able to through your testimony here today—that you could then get us the information.

It is in regard to the fact that our Administration has just given Mr. Arafat $4 million more in aid to help with the peace process.

There are various reports that the PLO might have resources of its own, tens of millions of dollars, stashed away in various accounts and assets around the world.

Has our government determined that Mr. Arafat and his organization, as well as various entities controlled by him, are broke and therefore in need of taxpayers' money?

Secretary CHRISTOPHER. Senator, we have no doubt that the Palestinian Authority and the Palestinians in the Gaza area are in need of support and I think it is very important for the United States to give them that support at this moment when they are being challenged by terrorists within the Palestinian ranks.

The situation in Gaza, if you have been there, is a very dire one with extreme unemployment, with the infrastructure badly decayed and in need of repairs. So it is clear to us that the Palestinian Authority there need support from the international community and that is why we have organized a donors' conference and we are urging those who made pledges there to pay them up.

Senator GRASSLEY. Do they have their own funds though, Mr. Christopher? That is the key point I am trying to get at. Do you know whether they have funds?

Secretary CHRISTOPHER. I do not know whether they have funds. I do not know whether they have personal funds, but I know from a governmental standpoint that they deserve our support because they have taken huge risks.

Senator GRASSLEY. If they might not need the money, you do not know for sure if they need the money. We can give them support in a lot of ways, can we not, other than money?

Secretary CHRISTOPHER. Senator, I am not exactly sure what the suggestion is. Are you talking about individuals or——

Senator GRASSLEY. No, it would be—I assume, if I am going to be responsible, what I must mean is money that Mr. Arafat would have under his control that would be used for the process of carrying out his quasi-governmental responsibilities he has because I assume that this $4 million is given to strengthen him, to further that peace process. But money, being fungible, could be used for other things. And if he has resources of his own, it seems to me like we ought to get those resources. Not our getting those resources, but he does not need our money until his own resources are gone.

I guess the bottom line would be it seems to me that we should know that they do not have the money. I would like to have you think about it rather than answering right in front of me now. If they need the money, legitimate. I do not see anything wrong with the peace process moving forward and our even financially supporting it. But I think that I would want to know that they actually need the money.

So I will ask you to reflect on it and answer in writing, if you would.

There has been a recent study, on another point, by the London School of Economics finding very little connection between the level of foreign aid provided to poor countries and improved standard of living. At the same time, the United States has been a leader in encouraging free trade by pushing for GATT and NAFTA, as a couple of examples.

I am Chairman of the Senate Finance Committee's International Trade Subcommittee so I am familiar with the benefits that trade brings, not only to our country but to poor nations, encouraging the growth of the private sectors and their free markets. My question to you is what are we trying to accomplish with foreign aid?

If it is to improve living standards, it appears from the study that I mentioned that foreign aid is not achieving this purpose. Should we look instead to encouraging free trade or open markets to realize the goal of improved living standards for poor nations in conjunction with our foreign aid, or even in place of our foreign aid?

Secretary CHRISTOPHER. Senator, first to go back to your comment about Mr. Arafat. I welcome the opportunity to think about it. I do want to tell you that I think the money is well spent. The money we have given for the police there and the money we have given to build infrastructure in Gaza is a very good investment by the United States.

Now on the second point that you have made, I think the judgment of the London School of Economics is far too sweeping. As I look around the world and see where our aid money has been effective and see aid programs that have been effective, I am sure that in many instances it is critical.

Take Korea, which was a large donee or a large recipient of our aid for many years. You can see what South Korea has done now, and its economy has risen to the point where it is an aid donor. Take Tunisia, where I was not long ago. You drive through that country and you see the products of our Aid Program over the years. It has been very effective.

I think it is a matter of whether the money is well spent to create economies and thus produce markets for us over the long run. But our aid funds are so restricted at the present time, Senator, I think we need to be very careful as to where we spend them, to make sure we are spending them in the interest of the United States, to create markets for us in the future, and to create countries that will pursue democracy and thus be better partners with us.

I would like to have an opportunity to submit to you some information that I believe runs counter to that study by the London School of Economics whose conclusion seems to be far too sweeping, rather than trying to answer in detail at the moment, Senator.

[The following was subsequently supplied for the record by Secretary Christopher:]

FOREIGN AID AND DEVELOPMENT

We understand the reference is based on an article in *The Economist* entitled "Down the Rathole" with the caption, "Many argue that foreign aid is a waste of money. They may be right". (December 10, 1994). This article reported on two working papers by Peter Boone of the London School of Economics.

First, it is important to note that Boone responded to *The Economist* in a letter to the editor published in the January 21st edition. In this letter he claimed that the article presented an inaccurate picture of his findings and conclusions. His view was not that aid was socially harmful, but rather that we should strive to find ways to make aid programs succeed.

Second, a review of Boone's articles produced by USAID indicates that his stated conclusions overextend the implications of his analysis, which itself is flawed by fundamental misunderstandings regarding the use of foreign aid. Boone's approach is essentially to take a large sample of countries over a time span of several decades, and attempt through econometric methods to find statistically significant relationships between the level of aid received and levels of savings, investment, growth social indicators, and the size of government. Only in the latter case does he find a statistically significant relationship, leading him to conclude that aid does not contribute to development progress, but it does increase the size of government.

This sort of cross-country econometric approach does not do justice to the framework within which donors and recipients interact, and the channels through which foreign aid contributes to development. For starters, a widely accepted principle is that concessional aid should be focused on countries most in need, generally the least developed countries that have the most difficulty making progress. As countries advance and become capable of making progress on their own their dependence on aid should decrease and eventually disappear. Aid plays a much smaller role in Thailand than in Malawi. This by itself tends to produce a weak or negative correlation between aid levels and development performance. This is compounded by the legitimate tendency for aid levels to rise when countries face crises. Second, the allocation of foreign aod among and within countries has been determined by a number of non-developmental criteria on both the donor and recipient sides, e.g. cold war concerns, commercial interests, and other political and historical considerations. As

Boone points out, the effectiveness of aid depends critically on host country policies and self-help efforts. Yet this often has not been a major determining factor.

Senator GRASSLEY. Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Lautenberg?

Senator LAUTENBERG. Just one, if I might.

Mr. Secretary, I am not going to ask any questions at the moment, the Chairman has kindly permitted me to make just the briefest statement. That is regarding child abduction which is a very serious problem worldwide and everyone is very much familiar with the Obikwa case and what happened there with the murder of the children's mother and the father's abduction of the children to Jordan.

I, Mr. Secretary, would ask if your office can be prepared, we will submit some questions to you and would ask for a prompt response. There is an extradition review taking place, I will not say process, by the local prosecutor and by the Justice Department, if it is called that, from Jordan. And they appear to want to be cooperative, but if we could get this resolved through the international treaty at The Hague, why I think that we could avoid a lot of the difficult problems that we have now when a child is abducted.

Thank you.

Secretary CHRISTOPHER. Senator, I remember your leadership on that one case that we worked on together and I know it is of great interest and we will respond promptly.

Senator LAUTENBERG. You were very helpful. Those children were returned against all kinds of sentiments and pressures. We used a lot of phone time but we got those two wonderful kids back. Thank you.

Chairman DOMENICI. Thank you. Mr. Secretary, I want to get back to the Serbia sanctions issue and, if you will permit me, I would like to state the facts as I understand them, and then ask you three questions. I do not intend to take a lot of time on this but I am a little bit confused.

From what I understand, the Administration yesterday announced a new plan to at least temporarily and partially lift the economic sanctions against Yugoslavia.

Reportedly the offer requires that President Milosevic tighten his own embargo against the Bosnian Serbs and stay out of the fight between Krajina Serbs and the Croatian armed forces. Now I understand that the lifting would be for 2 months and that the United States could veto any extension to that period in the Security Council of the United Nations.

Ultimately, I would like to know whether this is going to cost us anything. First, however, I would appreciate you explaining what is the rationale for this shift in policy on the civil war in the former Yugoslavia? Second, how does this initiative square with the Contact Group's plan giving portions of Bosnia to the Muslim-Croat Federation and the remainder to the Bosnian Serb population?

Finally, I understand that Belgrade must recognize Bosnia and Croatia, but it is not clear to me what boundaries we are talking about? Are they the pre-war internal boundaries of former Yugoslavia or are we talking about the Contact Group boundaries?

I will go back through the question if you did not get them, but this permits you to tell us here what this is all about. I think it is very important.

Secretary CHRISTOPHER. Thanks, Senator, I welcome that opportunity.

Of course, the situation in Bosnia is a tragic one and we have been searching for a solution to it with the rest of the world community without success. The fighting has been attenuated. The situation is probably better on the ground in Bosnia right now than it has been at any time since I have been in office, with fighting only going on in the Bihac area.

But there has been a recent development that heightens the anxiety and heightens our concern and that is the announcement of President Tudjman of Croatia that he is going to insist that the UNPROFOR troops no longer be in Croatia, which heightens the risk of war there.

I am glad you told me that I could take a few minutes on this because it is not possible, really, to do this in simplistic terms. We have been trying, through the Contact Group, to persuade all the parties to the conflict in Bosnia, that is the Bosnian government and the Croatians in Bosnia which have united into the Federation as you correctly said on the one hand, and the Bosnian Serbs on the other hand, to agree to the Contact Group plan which is essentially a plan that divides the country on a 51/49 basis, 51 for the Bosnian Federation and 49 for the Pale Serbs.

We have had a good deal of success in getting some of the parties to agree to that plan. The Bosnian government and the Federation have agreed to that plan. The Serbian government, under Milosevic, has endorsed it but we have been unable to find ways to persuade the Bosnian Serbs who are located in Pale and are headed by Dr. Karadzic, to accept that plan. We have been looking for ways to increase the leverage that we have to persuade Dr. Karadzic to accept the plan.

Now the plan is not perfect, Senator. It has a number of problems in it and I think what the Bosnian government would say—and I talk with them frequently—is it is the least worst outcome for them. But they would like to achieve that plan because it would bring peace and would give them a measure of security because we have committed ourselves to help implement that plan. But until we can persuade the Pale Serbs to accept it, obviously there is no settlement.

The current effort that the Contact Group is making is to get additional leverage on Dr. Karadzic and the Bosnian Serbs through these steps with President Milosevic of Serbia. That is a difficult course and one that we did not undertake lightly because his record of compliance and his complicity has been a matter of concern to us.

But he does seem to be supportive of the Contact Group plan, that is the 51/49 plan. And we are trying to enlist his aid in a more effective way to try to put pressure on Dr. Karadzic to accept the Contact Group plan.

Now what is being proposed here, as you correctly say, is a temporary suspension of sanctions for a 2-month period. If he did not carry out his side of the bargain then, of course, we would not go forward with a further suspension in the future. And in return for that we are asking, as you correctly said, a number of things from him.

First, that he will recognize Croatia and Bosnia's borders. And that is their existing borders, their existing international borders. That is not an odds-on proposition for us. If he would do that, it would be a huge step forward and I think it would help to isolate Dr. Karadzic.

We also want to press him to make the border closing between his country and the other two countries more effective than it has been in the past. There have been teams that have certified that the border closing has been generally effective. It certainly has not been completely effective. Certainly no one would say that it is an absolutely airtight border.

The outline of the plan that you described is essentially correct, but I do want to emphasize, Senator, the aim of this is to try to achieve the C Contact Group plan, not to ignore it. The discussions that took place yesterday in Paris were with the members of the Contact Group and our theory has been that we ought to try to get all of the vectors of force that we can bearing in and putting pressure on the Bosnian Serbs located at Pale to accept the plan.

The Contact Group, of course, representing the United States, Germany, France, Great Britain and Russia bring various vectors of force and if we can bring the Serbs into that picture, it may enhance our chances enough that we could achieve a settlement.

Chairman DOMENICI. Mr. Secretary, could you just summarize what are the principal reasons for the shift?

Secretary CHRISTOPHER. The principal reasons for the shift are to get additional pressure on the Bosnian Serbs to accept the Contact Group plan. We think that that can be achieved by Milosevic's recognition of the border, something that he has never done, and by his tightening and closing the border, which we think will add to the pressure on Dr. Karadzic.

First, the isolation from the fact that his prior supporter, President Milosevic, would be recognizing Bosnia and the fact that the border would be more tightly closed. That is the strategy that we are embarked upon. It is a suggestion that has come forward with the concurrence—indeed—part of the initiative came from the French. We would all like to find a way to reach a settlement here before the threat of UNPROFOR withdrawal from both Croatia and Bosnia leads to a renewal of the fighting.

Chairman DOMENICI. Let me proceed on to another topic, although I may ask to have a clarification on that. On peacekeeping costs, you talked to me yesterday for just a moment on the phone and asked some of the issues that would be raised.

I want to ask about peacekeeping costs and how they might affect our supplementals and our budget. Let me make a statement about what I see happening and, if you could, please comment to the committee on it.

The State Department's peacekeeping expenditures for 1994 were $1.071 billion. With the supplemental that accompanies the Administration's 1996 budget, it appears that the total costs for 1995 will again exceed $1 billion. The President's 1996 request, however, asks only for $445 million for fiscal year 1996.

Now if that is the case, then it is precisely the kind of thing that I talked with you about on the phone. We do not want to use supplementals and emergency funding under the Budget Act when we should have known of potential expenditures in advance. They are hardly emergencies if they are known ahead of time.

I am concerned that your 1996 budget request for peacekeeping is setting us up for a large emergency supplemental. I find that troubling, since it allows the Administration and the Congress, as I have indicated, to perhaps avoid the budget caps which are the only approach we have to keeping control of spending.

I think you should know that if this portion of the budget request is approved as presented, I will look very carefully at any request for a peacekeeping supplemental, particularly if it is designated as an emergency. I think I told you this on the phone and I have said it before when the Defense Secretary was here. I think you understand that and the reasoning for it.

According to a briefing provided by your staff to Senate staff, I understand that the new 1995 supplemental is for operations in Somalia, Yugoslavia, Sahara and Iraq-Kuwait. None of these should have been surprises and all of them should have been considered routine budget items, requests made in the normal manner last year. If you disagree with that, you might tell us why, but I think that is how we are going to start looking at this.

The Administration's budget request for peace operations in 1996 acknowledges that it includes $211 million for operations in the former Yugoslavia but only for the first 6 months of the year. This looks to me like a supplemental waiting to happen and I can see little justification for it.

Can you tell us, based on previous expenditures, is the request a realistic sum or should you be asking for more so we do not invite supplementals and breaking the budget?

Secretary CHRISTOPHER. Senator, we face a real dilemma with respect to this issue. We made the most conscientious estimate that we could of the likely expenditures in 1996, under the 1996 budget. I guess that I would say, Senator, that the UNPROFOR—that is the former Yugoslavia amount—is a very good illustration of the problem we face. We put in the budget enough for 6 months, $220 million, as you indicated.

One of the reasons we felt we needed to do that was because of the threats, the statements by our allies, that they would withdraw their troops, UNPROFOR troops, and the recent statement by President Tudjman of Croatia asking them to leave on the March 31. I think if we had come in and asked for a full year of funding for UNPROFOR, someone in Congress might have said "Mr. Secretary, why are you doing that? UNPROFOR is going to be out of the former Yugoslavia. So why are you asking us to appropriate for a full year?"

This is not a satisfactory situation, Senator, and I have long favored some kind of a reserve or contingency fund. We have asked Congress for that in the past. We have never been able to achieve such a reserve fund. I think it would be a sounder thing to do.

One model that might be useful is the emergency refugee migration fund. I believe that is a fund that allows the President to draw down funds on his certification when it becomes necessary. But it would require the Congress to acknowledge the nature of peacekeeping is that sometimes there are unpredictable, unanticipated demands that require funds during the course of the year. We would like to establish this fund. If it is used for good purpose, fine. If it is not used, it goes back into the Treasury. But we have never been able to persuade Congress to do that. And so we find ourselves in this unsatisfactory position of seeking funds on an emergency basis or in a supplemental at the end of the year.

Senator I think that our expenses this year certainly have been higher than anticipated in peacekeeping. Haiti is part of that. Part of the supplemental that we are asking for, indeed the numbers are $127 million, is to replenish other accounts which we had to invade in order to mount the operation in Haiti.

So there are just some unanticipated, unexpected crises that come along for which funds are needed. I think that would be a strong justification for a contingency or a reserve fund. We would certainly like to work with this committee because from a budgeting standpoint it just makes so much sense.

Chairman DOMENICI. Mr. Secretary, I do not know what this committee can do much beyond recommending, but frankly I just want to leave you with two points. Then I will yield to Senator Exon, although I may have a couple of quetions to follow.

First, I do not think there is any chance that you are going to get the funding for the foreign aid budget that you sent to us. Let me tell you why. Not because your little button or pin says, "Just 1 Percent". Mr. Secretary, we may very well be looking at discretionary domestic cuts of 10 percent this year. I do not know that, but obviously you understand it is not possible that we fund your programs with an increase if we are looking at that kind of domestic reduction.

Second, it seems to me that it is going to be very difficult on the State Department if you do not present some plan to increase streamlining and coordinating and perhaps completely restructuring the way we apply aid around the world.

So we are back where we started. I think we in the Congress would be better off, as would the President and you, if all were cooperating and trying to get reform and changes in the Aid Program, and a lot of other ones as well.

The second point is that there is great concern about peacekeeping up here, and especially that Congress comes in after the fact to provide the money. I am not for taking away a lot of power of the Chief Executive, but, frankly, I think this cries out for some kind of reform that sets the money aside and if it is not used it can be spent somewhere else. You then would not have to seek over a half billion dollars which then leads to people raising the whole spectrum of peacekeeping and United Nation. That is what happens each time we get a supplemental up here. We have to figure out where to get the cuts to pay for a supplemental. That just makes it more difficult for Congress to support what you are so interested in us, as a nation, protecting with reference to foreign policy and foreign assistance.

Enough said. I want to just yield to Senator Exon.

Secretary CHRISTOPHER. Senator, I have got lots of sympathy and commiseration for the problem that you mentioned as to the overall budget, but especially as to our budget and the peacekeeping budget. I think we have been consulting with Congress better before we go into peacekeeping endeavors, before we vote in the United Nation. But I think that if we could work together on that in a non-confrontational way, we could find ways to ensure that Congress is fully consulted before we go ahead with peacekeeping.

It is nothing that I like to do, Senator. I do not like to have the United States committed and then we have to go find the money, because frequently that means the money has to be found from other accounts in the State Department and, as I so often say, our operations account often suffers in order to pay for peacekeeping.

So I would very much like to work with the Congress to see if we cannot preserve peacekeeping, but nevertheless ensure that we go into it as full partners because the budget is critical to the peacekeeping endeavor. The United States pays such a large portion of that budget, even if we get it reduced to 25 percent, we need to have full consultation with the Congress as we go into it.

So I appreciate the way you are approaching it, Mr. Chairman, and we would like to work with the Congress and see if we cannot have a better mechanism than we currently have.

Chairman DOMENICI. Senator Exon?

Senator EXON. Mr. Chairman, thank you very much. I am sorry that I had to leave for some other matters. I am delighted to be back here because this is very important testimony that you are giving to us, Mr. Secretary, and I appreciate it. I just want to salute you and the people that work under you around the world in very dangerous places. The State Department people are there and are obviously potential targets. I have known many of them and I think they serve with great distinction.

I would simply echo the Chairman's words that we are going to have to make some reductions and we want to work together with you very closely on these matters. I think the Chairman has quite adequately stated the concerns that we have here and while I agree that the whole State Department's budget is so far less than most people think it is with regard to the percentage of the total expenditures, with the hope of balancing the budget by the year 2002 there is going to be some painful decisions made, some painful cuts, and I have been telling my people in Nebraska that few, if any, of them will escape that.

All too often I think so many people come to the belief that if fraud, waste and abuse were eliminated in total we could balance the budget overnight. I think basically the news media has not worked as closely as it should with the government to explain what this situation is all about.

I think we have to get our fiscal house in order, but at the same time I think that the people should be fully informed as to what is going to have to be done, the cuts that are going to have to be made, and I think you know that your agency, as important as it is, is going to have to make some cuts also.

Let me first ask about something that I am very much concerned about. We have had recent briefings in the Armed Services Committee, we have a scheduled closed briefing on this whole matter of terrorist activity, the nuclear threat and so forth and so on. Without revealing any details, I must tell you that some of the classified and closed briefings that I have attended give me even greater pause for concern than I had previously.

With regard to the threat to the United States of America here at home and abroad of terrorist types of activities, I know that the State Department is obviously very much concerned about this and have been doing some things that I want to applaud.

Could you please explain to me, I do not think you have had an opportunity to talk about the Heroes Program, what that is all about. From what I understand, it is a program to try and encourage people to come forth and be of help to us in capturing terrorists around the world. Can you briefly explain what your efforts have been in that area?

Secretary CHRISTOPHER. I am glad to have an opportunity to do that, Senator. We have established a program in the State Department that provides substantial rewards for individuals who come forward and identify terrorists and enable them to be captured. The funds that we put forward there, I believe, are supplemented by the Air Line Pilots Association and the Air Transport Association, giving some idea of their own concern about terrorism.

The recent situation in Pakistan is a good illustration of that, Senator. One of our diplomatic security agents had the good idea to have printed up these matchbooks which said a reward would be given for the capture of Ramzi Yousef. That is the person who was captured recently and is alleged to have been the mastermind of the World Trade Center bombing.

These matchbooks were printed up not only in English but Arabic as well, as I understand it. We do not know whether there was a causal connection between somebody walking into our embassy and identifying the location of the terrorist. We do not know really what the factual connection was, but it was a good illustration of this program. It says on the back here that a reward of up to $2 million would be available for information leading to the arrest and conviction of Mr. Yousef.

That is the kind of program that is going on around the world. Probably no one——

Senator EXON. Excuse me, Mr. Yousef is the terrorist that was just arrested in Pakistan and returned to United States for trial; is that right?

Secretary CHRISTOPHER. Yes, sir. He is alleged to have been involved in the World Trade Center bombing. I want to be careful and use the word alleged there, but we are very glad to have apprehended him.

Senator EXON. Let me go on to another matter, too, that I do not think has been touched on. If you do not have it on the top of your head, please supply it for the record. What percentage of the total budget of the State Department is expended to American firms and American individuals? You know, we have the perception that all of this money is simply dumped overseas someplace. I have gotten the impression that a considerable amount of that is indeed spent right here in the United States for United States interests and for the profits of American individuals and firms.

Do you have any offhand percentage as to how much of that is consumed in the United States, rather than in some far off land?

Secretary CHRISTOPHER. Senator, I will provide an exact percentage for the record but it is well more than half of the foreign aid expenditures flow to the benefit of the United States companies or citizens.

[The following was subsequently supplied for the record by Secretary Christopher:]

I will respond to your question both as it relates to foreign aid and to other accounts in the International Affairs budget. Well more than half of U.S. foreign aid expenditures flow to the benefit of U.S. companies or citizens. Although it is diffcult to come up with an exact figure, I have seen studies indicating that nearly 80 percent of such expenditures are devoted to procurement of U.S.-origin goods and services, payments to U.S. contractors, and other transactions that benefit directly the American economy. Moreover, as I have testified to the Congress, there are also indirect and longer-term benefits to the American economy from our foreign assistance activities. Promoting market reform in the former Soviet Union and Central Europe, as well as the Administration's sustainable development programs in Latin America, Africa, and Asia and the Near East, strengthen those countries' economies and make them better consumers of American goods and services over time. Previous recipients of U.S. foreign assistance, such as Korea and Brazil, are now increasingly important customers for U.S. products. It is therefore in the long-term interest of the United States to assist developing countries.

In addition to foreign aid expenditures, there are other accounts in the International Affairs budget that benefit American firms and American individuals. For example, each dollar of budgetary authority in the Export-Import Bank Program budget results in an estimated $17 increase in U.S. exports. Funds for market development made available to agenices such as the Overseas Private Investment Corporation, the Department of Agriculture, and the Trade and Development Agency likewise benefit American business. United States contributions to the Multilateral Development Banks, to cite another example, pale in comparison to the procurement contracts these institutions award to American firms. I would also note that the State Department, under my leadership, has become a more active and effective advocate for U.S. business, both in seeking fairer rules of the game for access to foreign markets and in providing specific support and assistance to American companies bidding on foreign projects.

Senator EXON. Let us talk for a moment about the former Soviet Union, Russia in particular, and in some detail perhaps about the Nunn-Lugar funds. Those are under attack clear across the board now, it seems to me. What was the intent of the Nunn-Lugar funds? The intent of the Nunn-Lugar funds clearly, and it basically stemmed out of the Armed Services Committee and with the help and the support certainly of the Foreign Affairs Committee, was to take the fangs out of the Russian nuclear inventory. It was also designed to take certain steps that would not encourage the Russian military to take over.

What Nunn-Lugar funds are all about is not to give away money needlessly to Russia, but to give money to projects that enhance the National security interests of the United States directly but reducing the threat in that area.

If it will work, and so far it has worked quite well, certainly it would save trillions of dollars in the future, if we could make sure as best we can that the threat that once faced the United States does not face it today as far as Russian and the former Soviet Union. That does not mean that there are not problems there, but I think we have made progress in this area.

Could you comment a little bit on Nunn-Lugar?

Secretary CHRISTOPHER. Senator, that is one of the most prudent and wise programs that I think the Congress has ever enacted. It has done a great deal to lift the nuclear threat from the United States and the world. To just speak in broad terms, the Nunn-

Lugar funds were essential to persuading Kazahkstan to give up its Nuclear Program and to agree to commit to the Non-Proliferation Treaty. Nunn-Lugar funds were essential to persuade Ukraine to give up its nuclear program and commit to the Non-Proliferation Treaty.

Both of those countries were able to ratify the START I treaty because they were prepared to give up their Nuclear Program. The Nunn-Lugar funds have been absolutely essential in enabling the Russians to dismantle nuclear missiles, which they would not have been able to do without some funds coming from the United States.

So these funds have been used to make the United States safer than in the past, and as I say it is one of the most prudent, wise, far-sighted programs that I think has been enacted. Part of it is in our budget this year. More of it is properly in the Defense Department budget, but some of it is in our budget this year, and for very good purposes as well.

One other thing I might say is that Nunn-Lugar funds have recently been used to prevent the smuggling or the risks of nuclear materials becoming available on the export market. You perhaps know that we were able to make a purchase of a considerable amount of highly enriched uranium from Kazahkstan and to use Nunn-Lugar funds, and State Department non-proliferation funds for that purpose. So now they have the added purpose of limiting the risk of smuggling, the risk of diversion of these highly enriched uranium or other dangerous materials.

Senator EXON. Mr. Secretary, I just want to briefly buttress your point. About 4 years ago I led a Senate delegation and one of the stops we made was way down to Kazahkstan and Alma-Ata. We met with their leaders and it was a tremendously eye-opening discussion that we had. The discussion finally resulted in our free-wheeling exchange, argument, sometimes quite vehement, between members of their legislative branch as to what should and should not be done with regard to the removal of nuclear devices from Kazahkstan back to Russia.

I was very pleased to see and work with Admiral Childes, our STRATCOM commander, and others to make sure that money did flow. It did flow primarily because of the availability of Nunn-Lugar funds. I simply want to emphasize again and again that we are making some progress in that country over hard-liners that are still quite prominent in most of the former states of the Soviet Union. And they are a potential threat, especially given the economic difficulties that all of the states of the former Soviet Union are experiencing these days, to say nothing about the conflicts that are now ongoing in some parts of that very troubled former land.

I just want to keep emphasizing, if we can, that while there are plenty of talk show hosts that love to rile up the public, to downplay everything that we do, I happen to believe that Nunn-Lugar, as you have so well said, is one of the finest programs that we ever came up with. And when I see people taking the machete to those kinds of programs today in the name of doing the right thing for America, I simply say they are not doing the right thing for America, and to some extent, they know not what they do. I am glad that we have someone like you that speaks out forcefully on this.

I have many other questions that I will submit for the record, and thank you for being here today and I thank you for the able job that you do in your very important position.

Secretary CHRISTOPHER. Thank you, Senator.

If I could just add a postscript to that, as you go about making the budget decisions that I know are difficult for you, I would want you to remember that although foreign aid, as a "kind of a swear word," is quite unpopular, the results that are achieved through foreign aid are absolutely essential to the American people. The American people want us to get rid of nuclear weapons. They want to be free of the nuclear threat. They want not to have a threat from North Korea. They want to have open trading. They want to have better jobs and markets overseas.

Those are the things that are accomplished through the international affairs budget, so I hope we can get beyond the slogans and recognize the significance of the fact that this international affairs budget achieves a lot of things that the American people want and would be very unhappy if they were deprived of.

Chairman DOMENICI. Mr. Secretary, let me just close on two points and submit some written questions. I ask you to turn them around as quickly as possible.

You know whenever we find a pot of money just sitting around for some purpose like the stabilization fund that has been used to stabilize Mexico's currency, it becomes a budgetary problem when that money is used, or lost or otherwise not available. If funds from that stabilization are lost, it leaves a very small amount for other currency stabilization. You can then be certain that somebody will come up here asking us to appropriate more money or find money for the stabilization fund which was normally used to stabilize our own currency. I have about five questions on it. Would you do me a favor, even though a couple of them may not be within your jurisdiction? I do not want to send them to three different secretaries, so would you answer them——

Secretary CHRISTOPHER. We will get answers for you.

Chairman DOMENICI. I have one on the Iran nuclear deal with Russia. It bothers a lot of us and I would like your evaluation for the record on what America can do about that $8 billion proposal.

And Mr. Secretary, I have become very concerned about trying to determine in advance when we are apt to get big hits on the Federal Treasury that we should have known about in advance. I am going to ask you some questions about the multilateral development banks and their lending practices. If you want to refer them to the Secretary of the Treasury or the World Bank, that's fine. But, would you get me the answers?

The World Bank is lending money, billions and billions of dollars, and their credit rating remains AAA. But nobody should believe that that means their loans are AAA. They are AAA because they are backed by the full faith and credit of the United States of America.

At some point in time, the question is how many of these loans are going to go belly up? And when enough of them go, are we not going to have to pay on our full faith and credit guarantee? I think the answer is yes.

I see a sort of S&L crisis sitting out there. It could be very, very large. I think it is time that somebody does an objective evaluation not of how much credit we have left, but how good or bad is the credit we have extended. There are several questions I will submit in writing. If you would answer them for the record, I would appreciate it.

Finally, there is a problem of how peacekeeping collaps may affect the reserve components of the military. I pose these questions to you, but if you cannot respond to them, just send them back to us and we will submit them to the Secretary of Defense.

I have nothing further. Senator Exon?

Senator EXON. Nothing further.

Chairman DOMENICI. We stand in recess until the call of the Chair. Thank you very much.

[Whereupon, at 11:54 a.m., the committee adjourned, subject to the call of the Chair.]

WRITTEN QUESTIONS FROM SENATOR DOMENICI TO SECRETARY CHRISTOPHER AND THE RESPONSES

Question:

Mr. Secretary, you may recall our discussion last spring at the Commerce/Justice/State hearings about the diverse costs -- both direct and indirect -- that significant peacekeeping or peace-enforcing operations might have on our armed forces. At that time we discussed possible contingencies in Somalia, former Yugoslavia, Haiti and the Golan Heights.

I remain deeply concerned that we fully consider the broad range impacts as we assess the appropriate American role in any commitment of our military personnel.

There are many potential direct and indirect impacts on the budget from peacekeeping operations. While we tend to focus on direct incremental operational dollar expenses, other indirect costs will arise from various sources.

Of particular concern is the impact on the reserve components of longer-term (two years or more) operations which rely very heavily on recurring Guard and Reserve call-ups of low density units.

Many believe that repetitive active duty periods will badly stress both family and employer relationships and cause a serious retention recruiting problem. Ultimately, these units could incur substantial recruiting, training and other costs, to say nothing of the disruption of the organizations' tactical fabric.

These types of problems, if they were to become pervasive, could have potential readiness impacts on the total force.

The Administration has talked publicly about scenarios in which over 25,000 American military personnel, heavily reliant on reserve units, would be used for two years to support a peace agreement in Bosnia. Indeed, my staff is told that planning for the first call-up of an entire tactical combat air unit is now well along and could occur as early as May in the far more limited role that we are now undertaking. This represents a crossing of a rather significant firebreak since, as I understand it, only volunteer reserve personnel have served in the region up to now.

Using the projected Bosnia peacekeeping mission of 25,000 American personnel from all services, including a major ground component, as an example for discussion:

- In this scenario, would there be call-ups of the reserve units?

- How long would the commitment last before reserve units would begin to face repeat tours with the deployed peacekeeping force? What types of units would these most likely be?

- What would be the impact on individual reserve unit morale, retention and recruiting of this type of repetitive call-up?

- o What would be the impact on total force readiness and the recruiting, training and retention budgets if this scenario developed?

Answer:

The President is authorized to call up a limited number of Selective Reserve personnel for certain defined periods of time. Contracting with commercial sources for certain services, rather than using the Guard or Reserve, is also an option available to military planners. Current military planning is on a contingency basis only and hence could change. We will, of course, honor our long-standing commitment to consult with Congress concerning any significant deployment of U.S. forces. Since contingency planning involving possible Reserve unit mobilization is within the provenance of the Department of Defense, I suggest you contact the appropriate people in the Office of the Secretary of Defense.

Question:

The World Bank has been criticized because the quality of its loan portfolio has deteriorated significantly and this fact is hidden. It maintains its AAA credit rating because debts are guaranteed by member countries, particularly the U.S. This holds true for a number of international lending agencies financed with U.S. dollars, such as the IMF, the African Development Bank, the Asian Development Bank, and the Inter-American Development Bank.

More generally, it is argued that foreign aid funneled through these banks has covered financial losses, sustained badly working economies, and subsidized poor government policies of developing countries throughout the third world.

- o Are our commitments and guarantees setting us up for a U.S. taxpayer bailout down the road, not unlike the contingent liabilities that came due on U.S. savings and loan losses.

Answer:

We are satisfied that the multilateral development banks (MDB) are stable, sound, and transparent financial institutions, institutions which serve vital U.S. economic and national security interests. As responsible investors, the U.S. and other contributors monitor their investments in and by the MDBs. Treasury maintains constant vigilance over MDB operations, ensuring that MDBs pursue prudent policies regarding loan quality, portfolio stability, and reserve provisions.

The World Bank and the other MDBs have emphasized improving portfolio management, including improving loan quality and closing or restructuring a few uninitiated or under-performing operations, just like commercial banks.

The MDBs follow commercially accepted practices of provisioning and holding sufficient reserves to meet contingencies. The MDBs have a good record of getting payments from borrower nations, and, unlike the largely open-ended savings and loan losses, the U.S. has fixed limits on MDB callable capital, as authorized by Congress and as included in past Foreign Affairs appropriations bills.

Question:

Are foreign loans and guarantees promoting economic change, or just financing losses from the continuation of poor developing country policy decisions?

Answer:

The last decade has seen the dramatic spread of market-oriented economic reforms, supported strongly by the MDBs. These reforms also contributed positively to the health of the MDBs. The World Bank's commitments to India, for example, look even sounder in the context of that country's new reform policies, which the World Bank has strongly advocated and supported.

In addition to promoting market-oriented economic development, the MDBs condition their support on good governance, environmental protection, etc., and non-performing nations or those with inappropriate policies find themselves increasingly cut off from MDB lending.

QUESTION

Recent press reports reveal that Russia has agreed to provide four nuclear power reactors, to Iran, for $8 billion.

- Iran has one of the world's largest repositories of oil reserves and is currently the world's second largest oil exporter. Why does Iran need nuclear power generation?

ANSWER

I cannot confirm the exact specifications of the reactor deal, nor the amount the Iranians would pay Russia. We would agree, however, that there appears to be no compelling energy-based need for Iran to develop a nuclear power infrastructure. Iran has, in its proven reserves, 9 percent and 15 percent respectively, of the world's oil and natural gas reserves.

We remain convinced that Iran would seek to apply to its nuclear weapons program the technology and expertise transferred through construction of civilian nuclear power reactors. For this reason, we oppose all nuclear cooperation with Iran.

RUSSIAN-IRAN NUCLEAR DEAL

QUESTION

Is there a difference between the type of reactor that Russia will sell to Iran and the West will build for Korea? Can the by-products of the Russian reactors be used to build nuclear weapons?

ANSWER

In both cases, the technology is pressurized light water reactors (LWRs). Russia has contracted to sell to Iran one VVER 1000 MW(e) power reactor, and possibly a second 1000 MW and two additional VVER 440 MW(e) reactors. Under the Agreed Framework with North Korea, KEDO would provide North Korea two Korean standard design pressurized LWRs. While the KEDO reactors are better, from a technical and nuclear proliferation perspective the reactors are the same.

Plutonium from LWRs can be used in nuclear explosives, but it is not particularly well suited for that purpose; it would create problems for inexperienced weapons designers. That said, we do not believe there is a significant risk that Iran will divert plutonium produced in light water power reactors for use in nuclear weapons. Reprocessing plutonium from LWR fuel is a significant technical undertaking. Detection of diversions of nuclear material from such reactors by the IAEA is highly probable. Finally, LWRs require enriched uranium fuel which must be obtained from outside suppliers and would be cutoff if the reactors are misused.

The important differences between the Agreed Framework with North Korea and the proposed Russian sale to Iran are that North Korea will receive LWRs in exchange for giving up a program and facilities fully capable of producing plutonium much more readily usable in nuclear weapons. North Korea has also agreed to enhanced non-proliferation conditions including a commitment not to reprocess spent fuel. The transition from North Korea's current technology -- gas/graphite moderated reactors (a type nuclear weapons states have used to build their weapons) is a clear win for us in terms of national security. However, providing any nuclear reactors to Iran would give it capabilities (technology and expertise) it does not currently have which can be applied to use in a nuclear weapons program.

QUESTION

What is the status of the Iranian nuclear weapons program? How long will it be before Iran is able to produce nuclear weapons?

ANSWER

Iran's nuclear weapons program is at an early stage. How long it will take a country to develop a nuclear bomb depends on many factors. In the past, the U.S. Intelligence Community has judged that Iran would need at least eight to ten years to produce nuclear weapons; access to foreign assistance could reduce this time by months or years, depending on the nature of the assistance. The intelligence community is currently updating its assessment to take account of the information received since the last estimate. It is too early in the process to characterize what the conclusions will be.

The power reactors Russia would provide to Iran would not, by themselves, significantly shorten the time Iran needs to develop a nuclear weapons capability. The technology in question is not directly applicable to nuclear weapons development. However, hundreds of Iranian scientists, engineers, and technicians will receive extensive training in nuclear matters and hundreds of Russian experts will go to Iran as part of this deal. This will massively expand Iran's nuclear technology base and overall ability. The Russians will also provide ancillary facilities and technologies (e.g. research reactors) that will increase Iran's capabilities. Iran could also attempt to use the acquisition of these power reactors as cover to obtain sensitive nuclear technologies critical for producing fissile material, such as uranium enrichment and spent fuel reprocessing.

QUESTION

What pressure can the United States bring against the Russian Government to stop this deal? Specifically, should the United States limit its economic assistance to Russia if this deal takes place?

ANSWER

The U.S. strongly opposes all nuclear cooperation with Iran, and we have made this clear to the Russian leadership. We are also making clear to the Russians that the proposed power reactor sale to Iran is contrary to their own security interests.

The U.S. raised this issue at the June 1992 Summit, and it was the subject of extended discussion with President Yeltsin at the April 1993 Vancouver Summit. I expressed my deep concerns on the issue with Foreign Minister Kozyrev in Geneva in January as well as with Deputy Foreign Minister Mamedov when he visited last week. We have told the Russians that their cooperation with Iran endangers our bilateral nuclear cooperation.

We do not believe that it is appropriate to condition aid to Russia, at this time, on this issue because it would undermine the promotion and protection of our fundamental security interests. The bulk of our aid to Russia is targeted at projects that serve America's fundamental security interests, such as building democracy, encouraging market reform, dismantling nuclear weapons formerly targeted at the U.S., preventing nuclear proliferation through halting brain drain and protecting nuclear material from smugglers, and improving power reactor safety. It is essential that as we quite properly seek to condition our assistance on Russia's continued reform, we do nothing to undermine efforts such as these, which promote our deepest national interests.

Question

Has the United States released any Exchange Stabilization Fund assets to Mexico since December?

Answer

The United States released an additional $3 billion in assets from the Exchange Stabilization Fund on April 20. The total released from the ESF is $8 billion; $2 billion in the form of short term swaps, and $6 billion in the form of medium term swaps (up to five years).

Question

Is there an agreement with the Mexicans on fee structure, conditions and collateral? If not, does it concern you that the U.S. is now at a decided negotiating disadvantage having announced a rather large commitment to Mexico before concluding all safeguards?

Answer

The agreements signed February 21 between the Treasury Department and the Mexican Finance Ministry include details on the fee structure, conditions and collateral.

The United States will charge Mexico interest for the medium term swaps, and fees for the securities guarantees. The fee and interest structure has been set to be appropriate cover for all risks the United States will bear. Moreover, fees and interest rates rise the more support Mexico draws upon, in order to encourage Mexico to turn first to market sources of finance.

There are also economic conditions attached to the U.S. package. These include Mexico's commitment to meet targets regarding the pursuit of tight monetary policy with negative real money growth, reduced government spending leading to a surplus of 0.5 percent of GDP in 1995, and further privatization and other structural reforms.

Mexico has put forward an additional economic policy memorandum which underlies these agreements. In it, Mexico affirms the independence of its central bank, and the use of monetary policy to achieve exchange rate stability and resumption of full access to market sources of finance.

The Bank of Mexico and the Ministry of Finance have agreed to make publicly available key fiscal and financial data on money and credit aggregates, international reserves, the evolution of public sector debt, and other measures of economic performance.

In the unlikely event of default, all of Mexico's obligations to the United States under these arrangements will be backed by the proceeds from Mexico's crude oil and oil products exports.

Payments for these exports will pass through an account of Bank of Mexico at the Federal Reserve Bank of New York.

If Mexico fails to repay Treasury under these agreements, Mexico's obligations will be set off against funds passing through the account.

We are satisfied that the agreements with Mexico include sufficiently strong safeguards.

Question

What if any commitments were given by the Clinton Administration to the IMF, Bank for International Settlements or any bilateral partners in order to conclude such unprecedented arrangements? What will the budget impacts be for, for instance, fund replenishments or similar obligations?

Answer

The Administration made no commitments to international financial institutions or other countries in connection with assistance for Mexico.

There was a strong international consensus to take action. The International Monetary Fund, the World Bank, the Inter American Development Bank and the Bank for International Settlements shared our assessment that it was important to assist Mexico in overcoming its financial crisis.

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If left unchecked, the Mexican crisis risked having a negative effect on other emerging markets and on the strong movement among most of those economies to institute far reaching economic reforms in the direction of free trade, privatization and deregulation.

U.S. taxpayers are not at risk through IMF loans to Mexico. Our contribution to the IMF has already been appropriated in full.

We think the IMF has ample resources at this point.We are not prepared at this point to entertain the possibility of another quota increase.

Question:

Last year, the Senate Appropriations Committee gave the State Department its full request for its operational accounts. The Senate cut funding for the U.N. and for peacekeeping in order to do so. Given the choice last year between cutting operational accounts of the Department or appropriations for peacekeeping and international organizations, you chose the U.N. and peacekeeping as a higher priority, which was the House position. If the same choice is presented this year, how will the State Department respond?

Answer:

This is not a question which can be answered in the abstract. A choice between meeting legal obligations of the United States Government, and funding the essential operations of the State Department is not a real choice. Proposing cuts in either account would represent an abdication of responsibility on the part of the Department of State. When and if this choice presents itself, the Department will have to weigh a variety of priorities, depending on the magnitude of the proposed cuts.

PROMOTING INTERNATIONAL COMPETITIVENESS

Questions:

7. Has the Clinton Administration undertaken a systematic review of policy direction and program levels to align spending with the changing global imperatives?

8. Is the President waiting for Congress to take the lead in directing such a process?

Answers:

The Administration has devoted considerable time and energy to restructuring International Affairs programs to meet the new challenges of the post-Cold War environment. In 1993 and 1994, the Administration conducted an ambitious bottom-up review of the International Affairs budget, reorienting significant amounts of resources toward new priorities and programs that yield more tangible benefits to Americans. In addition, it prepared comprehensive, new foreign affairs legislation. In February 1994, I established a Resources, Plans and Policy staff within my office to link priorities and resources more effectively and to improve program coordination.

The painstaking process of modernizing the International Affairs function has not ended. The Administration will continue to work closely with the Congress to further U.S. national security and foreign policy interests and to maximize efficient use of scarce resources.

Question:

Has the Administration established a plan for the agencies--perhaps a system of benchmarks over time--to put the Executive Branch on a path of deficit reduction leading to a balanced budget or does it believe that the deficit is under control?

Answer:

All agencies of the federal government have a responsibility for playing their appropriate role in deficit reduction. In the case of the International Affairs Agencies, together they cost the taxpayer barely one percent of the federal budget, and it will not be possible to address the entire deficit reduction out of this budget.

What we can do, and are doing, is to ensure that all of the International Affairs Agencies carry out their missions at the least expense possible. This involves cost reductions, re-engineering and streamlining where and when feasible. Each of the International Affairs Agencies is involved in a fundamental review of costs toward this end.

A word of caution is in order. The International Affairs budget funds our nation's efforts at global crisis prevention. The costs of dealing with poverty, trade barriers, and instability, for example, are far less than the costs of dealing with the crises which these issues can generate if they are left unattended. In reviewing our costs we must be sure we do not short-change our cost-effective measures for preventing these crises.

THE PRESIDENT'S BUDGET: AGRICULTURE

THURSDAY, FEBRUARY 16, 1995

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 9:35 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Grassley, Brown, Gorton, Abraham, Frist, Exon, Lautenberg, Simon, and Conrad.

Staff present: G. William Hoagland, staff director; and Ricardo Rel, senior analyst for agriculture, natural resources and community development.

William G. Dauster, democratic chief of staff and chief counsel; and Dave Williams, assistant director for revenue and natural resources.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman DOMENICI. Let's have the committee come to order. I want to welcome my colleagues and distinguished witnesses to this hearing. This is one of a series that we have been holding on moving towards a balanced budget and reshaping the Federal Government for the 21st century.

First, let me say that agriculture, food production, and the delivery system is a key component of our economy, and I think everybody knows that. It is the most efficient food production system in the world, and most effective. Nonetheless, the Federal taxpayer also finances some of agriculture, and, therefore, this sector deserves hearings, as we are doing here today.

I think we have said everything except social security is on the table. I think those engaged in farming and ranching in this country understand that.

Traditionally, when we look at agricultural spending for maintaining stable farm incomes, production, and stable food prices, we refer to the Commodity Credit Corporation, or the CCC. It was established in 1933 when the farm production in this country constituted 26 percent of the total population; that is, 26 percent of our people lived on and were involved in the production and/or growing of those commodities which feed our people.

The commodity programs originated as a temporary emergency initiative by Franklin D. Roosevelt to aid victims of the Dust Bowl and help end the Great Depression of the 1930's.

We have seen major changes take place around the world and within the agricultural industry; however, we still have the same basic policies which were created in the early 1930's as part of the New Deal initiatives that I have just briefly alluded to.

The Administration estimates that CCC spending will total $10.6 billion in 1995 and will decrease to $6.4 billion by fiscal year 2000. When you include the Conservation Reserve Program, the Wetlands Reserve Program, the Federal Crop Insurance Program, the total CCC and related mandatory spending increases to $13.2 billion in 1995 and decreases to $10 billion by the year 2000. Spending for these programs totals $56 billion over the next 5-year period.

Further, looking at the Federal farm spending on a per-farm basis, spending has increased from $4,500 to $7,600; that is from 1970 to 1993, Senator Grassley. A very long period of time. This represents an increase of 41 percent in real terms; that is, over and above inflation.

There is more information that I would allude to, but let me put that in the record and say that here, again, obviously, this program and everything related to it must be put on the table; but it also must be kept in perspective. And I am sure that with the attendance of the Senators who 'are here, it will be kept in perspective.

[The prepared statement of Chairman Domenici follows:]

Opening Statement of Chairman Pete V. Domenici

I want to welcome my colleagues and distinguished witnesses to this hearing—one in a series we have been holding on moving towards a balanced budget and reshaping the Federal Government for the 21st century.

First, let me say that the agriculture food, production and delivery system is a key component of our total economy. It is the most efficient food production system in the world.

Nonetheless, the Federal taxpayer also finances some of agriculture and therefore this sector deserves hearings as we are doing today.

Traditionally, when we look at agriculture spending for maintaining stable farm incomes, production and stable food prices we refer to the Commodity Credit Corporation or the CCC. The CCC was established in 1933 when the farm population constituted 26 percent of the total population.

The commodity programs originated as a temporary emergency initiative by President Franklin D. Roosevelt to aid victims of the Dust Bowl and help end the Great Depression of the 1930's.

We have seen major changes take place around the world and within the agriculture industry. However, we still have the same basic policies which were created in the early 1930's as part of the "New Deal Initiative."

The Administration estimates that CCC spending will total $10.6 billion for 1995 and will decrease to $6.4 billion by fiscal year 2000.

When you include the conservation reserve program, the wetlands reserve program, the Federal Crop Insurance Program, total CCC and related mandatory spending increases to $13.2 billion in 1995 and decreases to $10.0 billion in fiscal year 2000. Spending for these programs total $56.0 billion over the next 5 year period

Further looking at Federal farm spending on a per farm basis, spending has increased from $4,500 in 1970 to $7,600 in 1993. This is an increase of 41 percent in real terms.

The Administration proposes to reduce agriculture spending by $500 million per year for the 1998 through 2000 period. While they do propose a reduction they do not specify how to achieve those cuts. I hope to see those proposals before we mark-up our budget resolution.

I would also like my colleagues to pay careful attention to the large differences between the Congressional Budget Office and the Administration's spending projections for the commodity programs.

The Congressional Budget Office projects total spending of $30.3 billion for feed grains, wheat, and upland cotton over the next 5 years while the Administration projects spending of $22.1 billion for the same programs.

This is a difference of $8.2 billion dollars or approximately 21 percent of the Administration's total CCC spending. I would also like to point out that historically, both the CBO and the Administration have underestimated CCC spending.

With the farm bill up for reauthorization this year, we have a real opportunity for a "bottom up review" of our policies and programs.

As I have mentioned before that we have a number of farm State Senators on this committee, so they will understand when I say "its time to plow a new furrow."

Chairman DOMENICI. We happen to have three members of this committee, Mr. Chairman, aside from this chairman, who will be vitally interested, Chairman Lugar, in what you have to say and clearly will be here to make sure we put in perspective what these programs do for our people.

Senator Exon, I yield now to you for an opening statement, and we will soon get to you, Senator Lugar.

OPENING STATEMENT OF SENATOR EXON

Senator EXON. Mr. Chairman, thank you very much. I want to join with you in welcoming our distinguished colleagues for the first panel that we have. I believe that will be Senator Lugar and Senator Conrad. Certainly, following them, as I understand it, will be Acting Secretary Richard Rominger for today's very important hearing on reforming agriculture and agricultural support programs.

I will be listening with a great deal of interest to all of the testimony, and I will have a number of questions.

I want to be clear on one point right from the start: Agriculture bashing seems to be popular in some quarters these days. However, I am not going to let agriculture become the deficit reduction whipping boy. The simple fact is that even if all agricultural entitlement spending was eliminated, we would still have a deficit near $200 billion in fiscal year 1996. As everyone knows, the real deficit is lodged in the Federal health care programs. They are the only programs that will grow at a rate significantly faster than the economy, and we have already scheduled and will see further reductions in the agricultural programs.

So as we look towards a balanced budget amendment by the year 2002, agriculture is willing, able, and anxious to make its fair share of the sacrifices and contributions. But it will not be victimized.

Having said that, I would note that over the next 5 years agricultural spending is projected to decline from $13.3 billion in 1996 to $10.6 billion in the year 2000. In fact, after a peak in 1986, agricultural spending has declined substantially, as the record clearly shows. This is due primarily to the program reforms, including those enacted as part of the 1993 deficit reduction package.

The President's proposed cuts include mandatory reductions totaling $1.5 billion in the Commodity Credit Corporation spending for 3 years, beginning in 1998. The Administration proposes $500 million per year in unspecified Farm Program cuts. The Administration has stated it plans to work with Congress during the drafting of the 1995 Farm Bill to ensure that these savings are realized.

Mr. Chairman, I want to make one final point. The Budget Committee will play an absolutely critical role, more critical than ever before this year on the future of agricultural programs in the rewrite of the 1995 Farm Bill. The savings made in the budget reconciliation will determine the size of the cuts that we will make in agriculture.

We should not enter into this undertaking lightly. It bears repeating that agriculture is willing to be a full partner in the deficit reduction. However, it should not be burdened with an unfair share of the deficit reduction.

Once again, I welcome our witnesses, and I look forward with great interest to their testimony.

I thank you, Mr. Chairman.

Chairman DOMENICI. Thank you very much.

Senator Conrad, do you desire to do your presentation from the witness table or from here?

Senator CONRAD. I would like to do it from there. After Senator Lugar has had a chance to do his presentation, I would have a chance to ask him some questions from here. Then I would move down there.

Chairman DOMENICI. I wonder if we might have you testify right after him, and then let us ask both of you questions.

Senator CONRAD. Sure, I would be glad to do that.

Chairman DOMENICI. Then you can ask him questions. I would like to get the testimony out.

Senator Lugar, would you proceed, please? We will make your testimony, which we have, a part of the record. We would appreciate it if in your good style you would be as brief as possible. But, frankly, this is so important to you and you have done so much work on it that I am not going to try to cut your time short. So go ahead and proceed. We welcome your testimony.

STATEMENT OF HON. RICHARD G. LUGAR, UNITED STATES SENATOR FROM THE STATE OF INDIANA

Senator LUGAR. Thank you very much, Mr. Chairman and distinguished members of the Budget Committee. I accept the point made by the distinguished ranking member of the committee that this committee, the Budget Committee, is crucial in our Farm Bill debates. For this reason, I am honored to be before you.

Mr. Chairman, even as the United States Senate debates a constitutional amendment to bring balance to the Federal budget in 7 years, the Senate Budget Committee has assumed responsibility for producing the 5-year plan which will make budget balancing a credible goal.

You have mentioned potential spending reductions of $450 billion over the next 5 years as the essential down payment which begins to bring potential budget balancing into view. You have challenged committee chairmen to spell out how Federal spending in their areas of responsibility ought to change and, thus, to share the awesome and unpopular duties which the Budget Committee must perform.

I take for granted that the Senate and the Budget Committee are serious. If this is not so, the Agriculture Committee will inevitably produce a Farm Bill in 1995 which spends more money and takes on more opportunities and programs to serve farmers and consumers. If this moment of intense public interest in the economic future of our country passes without a comprehensive plan to obtain budget sanity and security in this country, we will all be condemned by history as unworthy of the public trust we held at a crucial moment.

Agriculture cannot solve the problem alone. Fewer than 2 percent of Americans are farm families. On average, they are not among the most affluent of Americans. But farm producers know what is happening to the future of their children. Of necessity, they must always have optimism and a long-range perspective.

The majority of the United States Department of Agriculture dollars go to the Food Stamp Program, school lunches, and other nutrition programs. These programs are now involved in the welfare reform debate.

Parenthetically, Mr. Chairman, you have mentioned that you would like guidance from several committees with regard to block grants and how these particular programs are to fit, if they are to go into the welfare reform.

But I would say if they remain in the Farm Bill, finally, our committee and the Budget Committee will have to consider them carefully in that form at another time.

Today, I am here to advocate substantial changes in farm income support programs and export subsidies, which will certainly be in the Farm Bill.

To strengthen American agriculture even as we reduce farm subsidies, we should: increase the opportunities for farmers to make planning choices and other land management decisions on the basis of market signals, not government mandates; we should enhance our continued international competitiveness; we should offer program certainty to producers for 5 years; and we should continue a basic safety net for farm income, given wide swings of weather and natural disasters.

For the major supported commodities—the so-called program crops, which include wheat, corn, cotton, and rice—the government's cost exposure is determined by the target price, a congressionally mandated income support level. If market prices fall below this level, the Federal Government makes up the difference in a so-called deficiency payment. Another source of Federal spending is the Export Enhancement Program, which subsidizes export sales by offering large discounts to move selected United States commodities.

Mr. Chairman, we should save almost $15 billion in the next 5 years in two simple steps. First, we should save $11.45 billion by reducing target prices on the major program crops by 3 percent a year, each year, for the next 5 years, with corresponding reductions for those commodities that are subsidized in ways other than direct payments. Second, we should save $3.4 billion by eliminating the Export Enhancement Program.

The EEP is a costly subsidy. It served a purpose, perhaps, when U.S. prices appeared too high to be competitive. Yet U.S. wheat market share in 1994–95 is actually a little less than it was 10 years ago in 1984–85, the year before the program started. We may want to keep standby authority for EEP, but the burden of proof should be on those who advocate dumping grain at "fire sale" prices while claiming that to do otherwise would be unilateral disarmament.

These two steps would leave intact the Federal Crop Insurance System, which was reformed just last year to offer producers some protection against weather disasters and to give taxpayers protection against unfunded, ad hoc disaster payments. Target price cuts would also allow for continuation of the Conservation Reserve Program at a reasonable level. Even after 5 years, target prices would still remain slightly above the 10-year average of actual market prices, thus providing a more modest safety net for later years.

Chairman Domenici. Chairman Lugar, would you explain what Conservation Reserve is?

Senator Lugar. The Conservation Reserve Program was designed to allow farmers who had highly erodible land or land that has problems to take it off the market, out of planting, in return for a Federal payment to do so for a contractual period of time. There was emphasis on planting trees, and that would make the land disappear for much longer. In most cases, it was a 5-year contract. And farmers bid so much to take their land out of production, and the best bids are taken. Essentially, about 36 million acres have now been taken out of production in this manner in the last 5 years.

Chairman Domenici. For which the owner receives payment?

Senator Lugar. Each year.

Chairman Domenici. That is what a conservation reserve payment is, that payment?

Senator Lugar. That is correct.

Chairman Domenici. Thank you.

Senator Lugar. A target price reduction is also a more straightforward and certain means of actually reducing spending. Past hypothetical farm program savings have often failed to materialize. For example, Congress believed in 1990 that cuts we enacted in that farm bill would reduce spending in the next 5 years by nearly 410 billion. Instead, total spending went up, not down. Overall, we spent $15 billion more than anticipated. The steps I have suggested will ensure that, despite market price fluctuations, Federal deficiency payments will be substantially reduced.

Mr. Chairman, I began by saying I am not certain whether Congress is serious about cutting Federal spending. But if we are not serious, then major reform in agriculture will not occur; and the Farm Bill and the overall budget will largely reflect the status quo.

I believe we are serious. I think it is imperative that we act now. It is imperative that we phase in the necessary program reductions—for farmers and recipients of other Federal benefits—instead of waiting 7 years until it is someone else's problem. At that point, the catastrophe will be apparent. The reductions will take place without gradual adjustment. Farmers and other citizens will not thank us for having failed them through lack of foresight or courage.

We should take responsibility and now is the time to act.

Chairman Domenici. Thank you very much, Chairman Lugar.

[The prepared statement of Senator Lugar follows:]

Prepared Statement of Senator Richard G. Lugar

Mr. Chairman, even as the United States Senate debates a Constitutional amendment to bring balance to the Federal budget in 7 years, the Senate Budget Committee has assumed responsibility for producing a 5-year plan which will make budget-balancing a credible goal. You have mentioned potential spending reductions of $450 billion over the next 5 years as the essential "down payment" which begins to bring potential budget balancing into view. You have challenged committee chairmen to spell out how Federal spending in their areas of responsibility ought to change and thus to share the awesome and unpopular duties which the Budget Committee must perform.

I take for granted that the Senate and the Budget Committee are serious. If this is not so, the Agriculture Committee will inevitably produce a farm bill in 1995 which spends more money and takes in more opportunities to serve farmers and consumers. If this moment of intense public interest in the economic future of our country passes without a comprehensive plan to obtain budget sanity and security in this country, we will all be condemned by history as unworthy of the public trust we held at a crucial moment.

Agriculture cannot solve the problem alone. Fewer than 2 percent of Americans are farm families. On average, they are not among the most affluent of Americans. But farm producers know what is happening to the future of their children. Of necessity, they must always have optimism and a long-range perspective.

The majority of United States Department of Agriculture dollars go to the Food Stamp Program, school lunches and other nutrition programs. These programs are now involved in the welfare reform debate. If they remain in the Farm Bill, our committee and the Budget Committee will have to consider them carefully at another time.

Today, I am here to advocate substantial changes in farm income support programs and export subsidies, which will certainly be in the Farm Bill.

To strengthen American agriculture even as we reduce farm subsidies, we should:

- Increase the opportunities for farmers to make planting choices and other land management decisions on the basis of market signals, not government mandates;
- Enhance our continued international competitiveness;
- Offer program certainty to producers for 5 years; and
- Continue a basic safety net for farm income, given wide swings of weather and natural disasters.

For the major supported commodities—the so-called "program crops" which include wheat, corn. cotton and rice—the government's cost exposure is determined by the "target price," a Congressionally-mandated income support level. If market prices fall below this level, the Federal Government makes up the difference in a so-called "deficiency payment." Another source of Federal spending is the Export Enhancement Program, which subsidizes export sales by offering large discounts to move selected U.S. commodities.

Mr. Chairman, we should save almost $15 billion over 5 years in two simple steps. First, we should save $11.45 billion by reducing target prices on the major program crops by 3 percent a year, for 5 years, with corresponding reductions for those commodities that are subsidized in ways other than direct payments. Second, we should save $3.4 billion by eliminating the Export Enhancement Program.

The EEP is a costly subsidy. It served a purpose, perhaps, when U.S. prices appeared too high to be competitive. Yet U.S. wheat market share in 1994–95 is actually a little less than it was 10 years ago in 1984–85, the year before the program started. We may want to keep standby authority for EEP, but the burden of proof should be on those who advocate dumping grain at "fire sale" prices while claiming that to do otherwise would be unilateral disarmament.

These two steps would leave intact the Federal Crop Insurance System, which was reformed just last year to offer producers some protection against weather disasters—and to give taxpayers protection against unfunded, ad hoc disaster payment programs. Target price cuts would also allow for continuation of the Conservation Reserve Program at a reasonable level. Even after 5 years, target prices would still remain slightly above the 10-year average of actual market prices, thus providing a more modest safety net for later years.

A target price reduction is also a more straightforward and certain means of actually reducing spending. Past hypothetical farm program savings have often failed to materialize. For example, Congress believed in 1990 that cuts we enacted in that farm bill would reduce spending in the next 5 years by nearly $10 billion. Instead, total spending went up, not down. Overall, we spent $15 billion more than anticipated. The steps I have suggested will ensure that, despite market price flutuations, Federal deficiency payments will be substantially reduced.

Mr. Chairman, I began by saying I am not certain whether Congress is serious about cutting Federal spending. If we are not serious, then major reform in agriculture will not occur. The 1995 Farm Bill and the overall Federal budget will largely reflect the status quo.

But if we are not serious, it is imperative we act now. It is imperative that we phase in the necessary program reductions—for farmers and recipients of other Federal benefits—instead of waiting 7 years until it is someone else's problem. At that point, the catastrophe will be apparent. The reductions will take place without gradual adjustment. Farmers and other citizens will not thank us for having failed them through lack of foresight or courage.

We should take the responsibility. Now is the time to act.

Chairman DOMENICI. Senator Conrad, a valued member of our committee, we are very pleased that you have taken your time to engage your effort to discuss this issue as a member of the Senate, not as a member of the committee. Please proceed, Senator.

STATEMENT OF HON. KENT CONRAD, UNITED STATES SENATOR FROM THE STATE OF NORTH DAKOTA

Senator CONRAD. I thank the Chairman for those remarks.

Let me begin by saying I welcome this opportunity to visit with this committee on what I think is an important debate with respect to reducing the budget deficit. I am here to tell this committee that I have a different view than Senator Lugar.

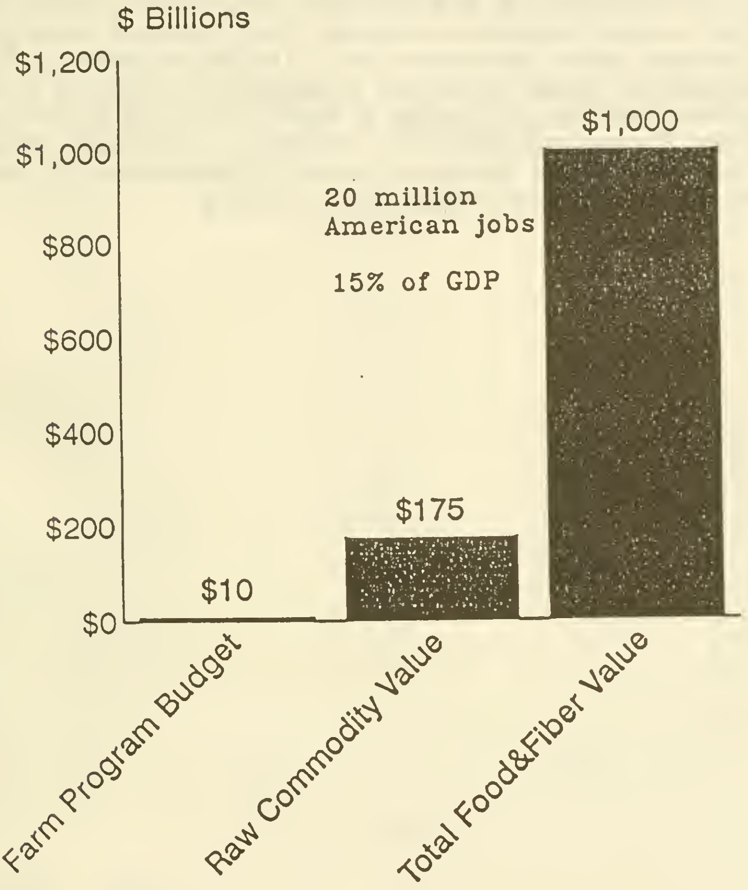
I would remind my colleagues that the United States has a food policy that is the envy of the world. We have a food policy that has produced abundant supplies of the highest quality food and at the lowest cost of any country in the world. That is a remarkable success story. And those who advocate a radical change in the system that has produced that success story and that has produced those results I think have a very heavy burden to bear. They must prove and they must demonstrate that they have a better way. And I don't believe that they can do it.

Mr. Chairman, members of the committee, let me begin by indicating we are in an intense worldwide battle for agricultural markets. That is the circumstance that we face today. Our primary competitor is Europe and, make no mistake, Europe has a plan and they have a strategy. Their plan is to dominate world agricultural trade.

Now, some might ask, if I don't come from a farm State, why should I care very much about farm policy? The reason, Mr. Chairman and members of the committee, is that agriculture is much bigger than farmers. Agriculture is a critical part of this Nation's economy.

I would turn my colleagues' attention to this first chart that shows agriculture in the economy, 1994. You can see the farm program budget is $10 billion. It is that very small bar, the first one on the chart.

Agriculture in the Economy 1994



The farmers that are benefited by that farm program produce $175 billion of raw commodity value. That contributes to the total food and fiber value of $1 trillion in this economy. That produces 20 million jobs in this country beyond the farm gate; 15 percent of the gross domestic product of this country is made up in agriculture.

Let's go to the next chart, if we can.

Chairman DOMENICI. Senator, I interrupted Senator Lugar once, and let me just ask you this. Would you put the chart back? At some point would you tell us why you assume that we will have less than $175 billion if we have a change in——

Senator CONRAD. Yes, I will get to that as I go through the testimony, Mr. Chairman.

Chairman DOMENICI. Thank you very much.

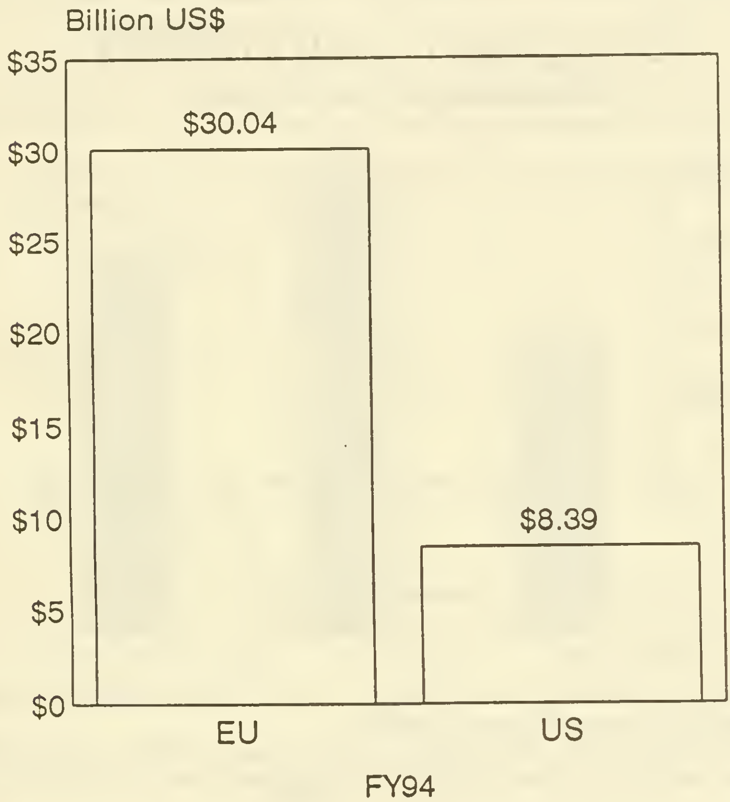
Senator CONRAD. I am glad you raised the point because it is an important point. I think it is really a critical point.

Let's go to the next chart.

As I was indicating, agriculture currently in the world is experiencing fierce competition, and our chief competitor is Europe. Europe has a plan; they have a strategy. As I indicated, their plan is to dominate world agricultural trade. This chart shows the kind of commitment Europe is making to agriculture compared to the commitment that we are making to agriculture. This is for fiscal year 1994: Europe, over $30 billion dedicated to agriculture; we are less than $8.5 billion. Europe is making a commitment to agriculture of from 3 to 4 times what we are making.

E.U. vs. U.S.

Domestic Agriculture Support Spending



Source: USDA

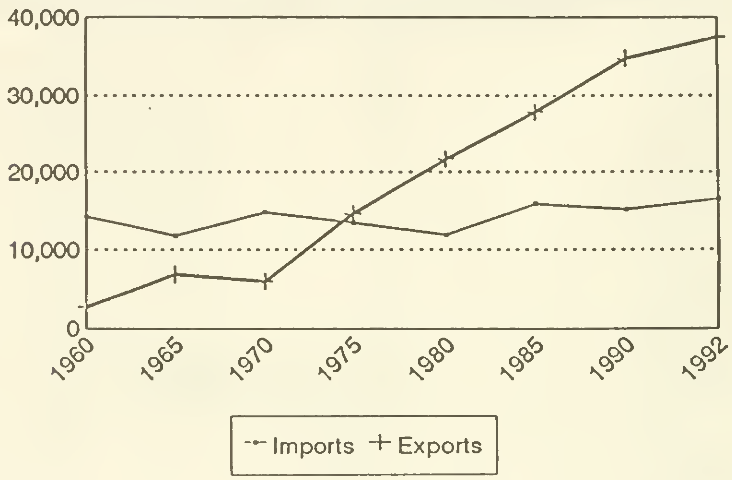
Now, why are they doing that? They are doing it because they understand by having higher supports for their farm producers, they will encourage surplus production. They take that surplus production. They dump it on world markets at fire-sale prices in order to gather world market share.

The reason they are doing that is they understand we are in a trade war. They believe at some point there will be a cease-fire. They believe there will be a cease-fire in place, and they want to occupy the high ground. The high ground is dominating world market share.

Let's go to the next chart because that shows just how well the European strategy is working.

Mr. Chairman, this shows in just one commodity what our competitors have done since 1960. The blue line shows imports of wheat. The red line shows exports. You can see that they have held imports roughly constant over this 35-year period while they have seen a dramatic increase in their exports, precisely the strategy that I have outlined. They have gone from being one of the biggest importers in the world to being one of the biggest exporters.

European Community
Wheat Imports vs. Exports



Source: USDA

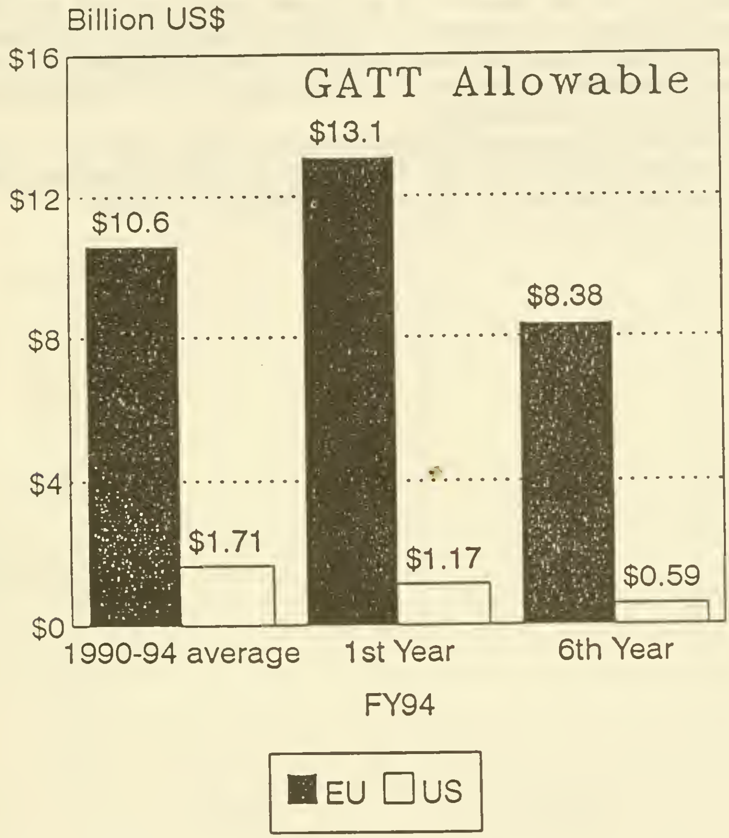
Let's go to the next chart. Let me just continue because I think I will answer some of these questions.

Some people say, well, gee, we just had GATT, and GATT changes the playing field. Well, let's look. Let's see what GATT has done.

This shows export subsidies under GATT, what Europe will be permitted and what the United States will be permitted.

E.U. vs. U.S.

Agricultural Export Subsidies



Source: USDA

First, to put it in some historical perspective, you can see from 1990 to 1994 they were averaging $10.6 billion a year. We were averaging $1.7 billion a year. Look at the first year under GATT, what they will be permitted: $13.1 billion against our $1.2 billion. And look, even in the sixth year they are still going to have an enormous advantage, $8.4 billion against our $600 million.

Now, my colleague, Senator Lugar, says we ought to eliminate our $600 million, or for the first year our $1 billion against their $13 billion. I say that is unilateral disarmament, and I would say to my colleague I don't believe that he would advocate any such thing if this were a military confrontation.

But we are in a confrontation. We are in a battle for world agricultural markets. Our European friends understand it, and they are seeking to win it.

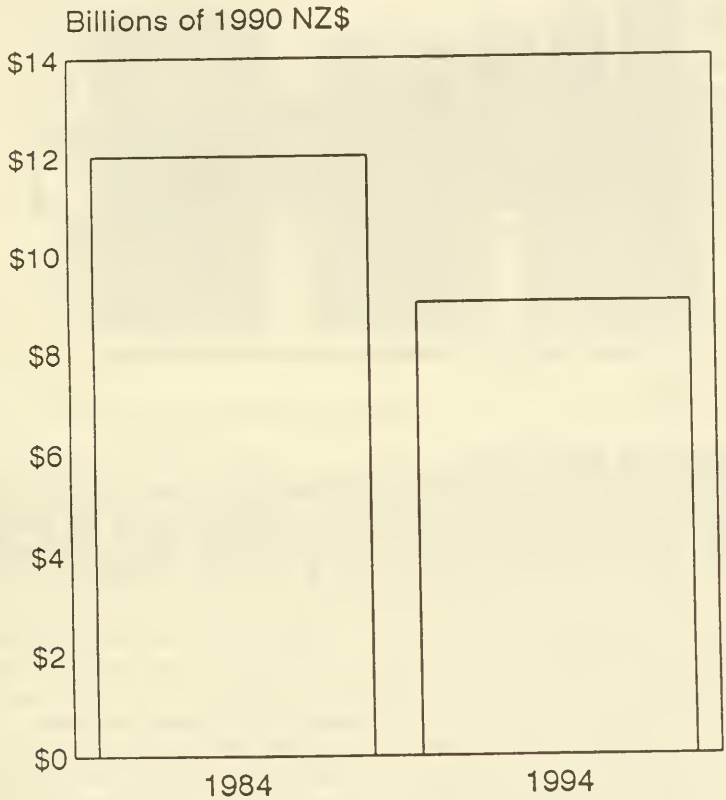
Let's go to the next chart.

You asked the question, Mr. Chairman, What happens if you eliminate farm programs? Well, we don't have to look very far to see what happens. We can look to New Zealand, which tried this experiment, is in the midst of it still now. Let's just look at what happened to them, and remember that New Zealand is far different than the United States because they had a very short period of trying farm programs. They just instituted them for a short period and then did away with them.

Look at what happened to New Zealand. This shows the value of farm output in that country, 1985 with the Farm Program, 1994 without a farm program, a 25-percent reduction in output.

Eliminating Farm Programs

The New Zealand Example
The Value of Farm Output Has Fallen by 1/4



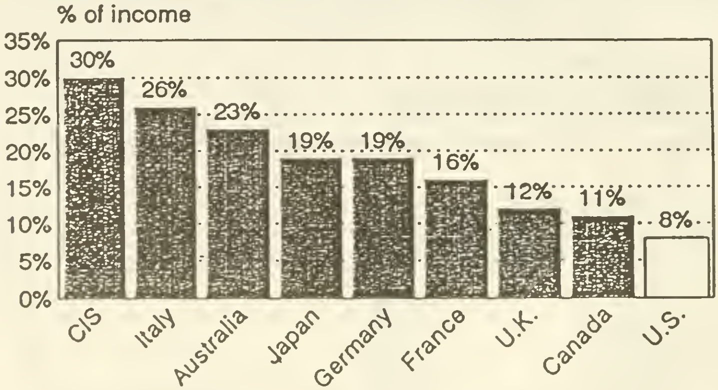
Mr. Chairman, if that rippled its way through the United States economy, it would cost us 5 million jobs. I don't think that is an experiment we want to embark on.

Let's go to the next chart.

Aside from being in the midst of a fierce international battle over world markets, we also have a food policy that has been exceptionally useful for American consumers. This chart shows consumer food expenditures, the United States versus the rest of the world. The first chart there shows as a percentage of income what our friends in Russia are spending for food: 30 percent of their income for food; Italy, 26 percent; Japan, 19 percent; Germany, 19 percent; France, 16 percent; the United States, 8 percent. We have by far the lowest cost food in the world.

Consumer Food Expenditures

U.S. versus the World



Spending on food consumed at home as a percentage of income.

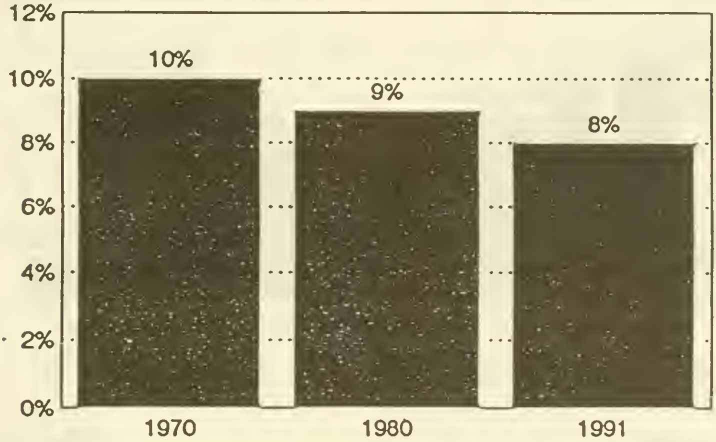
Source: USDA

Let's go to the next chart.

Not only do we have the lowest cost food today, we have an ongoing pattern of a reduction in costs that is the envy of the rest of the world. You can see in 1970 we were spending about 10 percent of our income for food at home; 1980, 9 percent; currently, 8 percent.

Falling Cost of Food

Spending on Food as a Percentage of Income

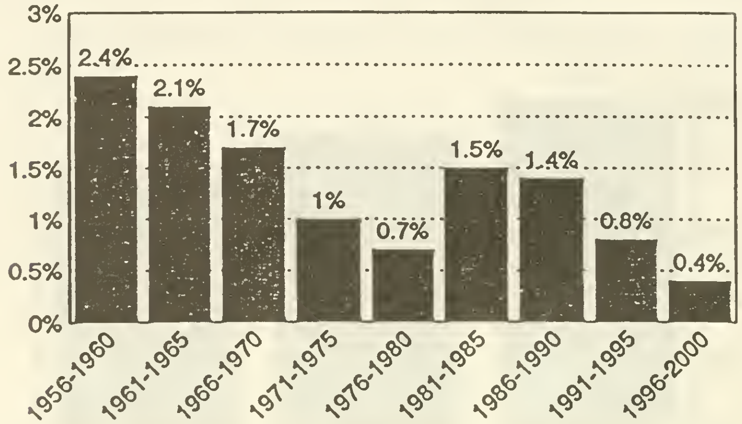


Source: USDA (food consumed at home)

Let's go to the next chart, and take a look at what is happening with respect to the budget for farm programs. Because we have heard a lot of talk about the budget for farm programs. We have heard some assert it is going up. Nothing could be further from the truth.

The contribution that this Federal Government makes to farm programs has been in steady and constant decline. This chart shows agriculture spending as a percent of total Federal outlays. You can see that the high water mark was 1956 to 1960 when we were spending about 2.4 percent of the Federal budget. 1991, 1995, we are down to eight-tenths of 1 percent of the Federal budget. This year we are at six-tenths of 1 percent of the Federal budget. And for the period 1996 through 2000, the estimates are we will be at four-tenths of 1 percent of the Federal budget for agriculture.

Agricultural Spending
CCC Outlays as Percent of Total Federal Spending



Source: USDA
(5-year averages)

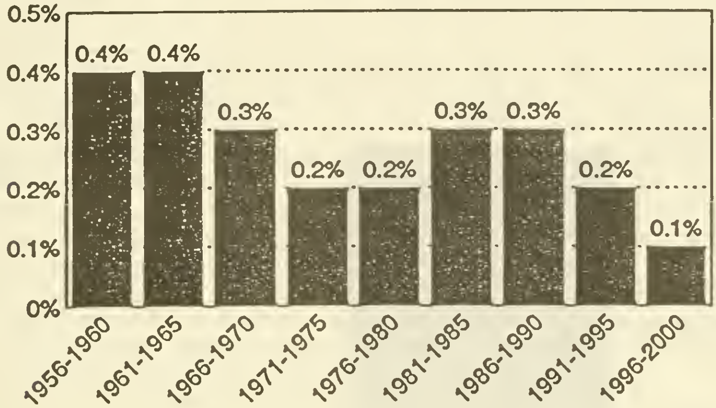
Senator GORTON. Senator Conrad, in 1960, there was no medicare or medicaid, was there?

Senator CONRAD. No, there was no medicare or medicaid. In fact, that is what is contributing to the growth of the deficit now. But if you are looking at agriculture's share of Federal spending, that has been in constant decline. Obviously, medicare was present in 1981 and 1985. It was present 1986 through 1990. Agriculture's share is in decline.

Let's go to the next chart, because it shows it another way as well.

Agricultural spending as a percent of gross domestic product, another way of looking at what kind of commitment this country is making to agricultural spending. Again, you can see that we were at four-tenths of 1 percent back in 1956 and 1960 as a percentage of gross domestic product. In the current period, that has been cut in half, two-tenths of 1 percent of gross domestic product going for agriculture, and the projection is that will be cut in half again for the period from 1996 to the year 2000.

Agricultural Spending
CCC Outlays as Percent of GDP



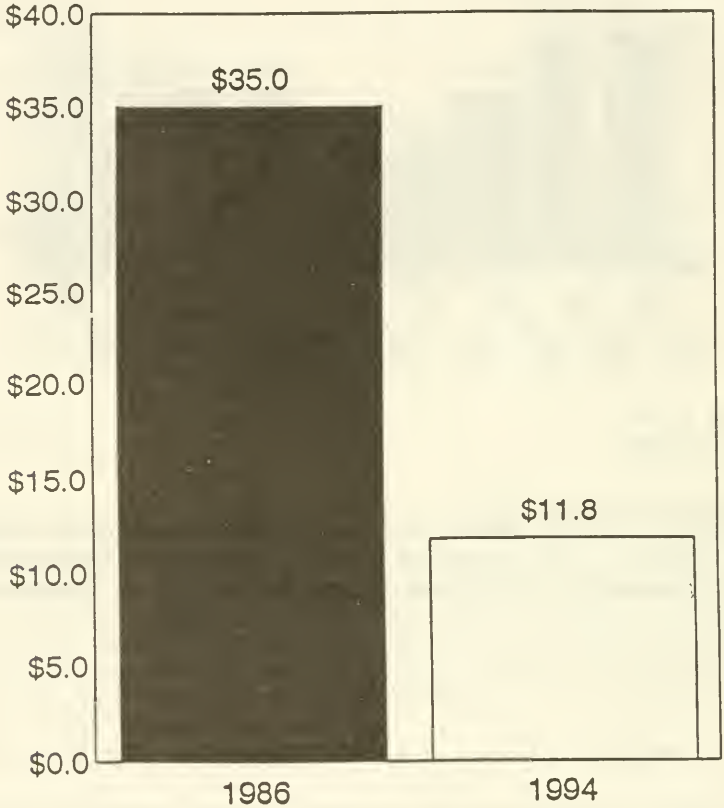
Source: USDA
(5-year averages)

Let's go to the next chart.

For those who say there have been no cuts in agricultural program spending, 1986 expressed in 1994 dollars, $35 billion; 1994, again expressed in 1994 dollars, about $12 billion. A dramatic reduction.

Agriculture Program Spending

(billions of 1994 dollars)



Source: USDA and Dept. of Commerce

Mr. Chairman, one other chart I wanted to put up, because Senator Lugar used a statistic and indicated that in the 1990 to 1994 time period, during that period, that agricultural program spending exceeded the projection. And that is true. That is the only 5-year period in the last 20 years that that has been true.

This chart shows from 1987 to 1991; the projection was we would spend $80 billion. We spent $62 billion, $18 billion less than the projection. For 1988 through 1992, the projection was we would spent $109 billion. We spent $49 billion, $60 billion less than the projection.

For 1989 through 1993, the projection was $79 billion. We spent $52 billion, a $27 billion savings over the projection.

Mr. Chairman, let me just conclude as I began by saying we have the food policy that is the envy of the world. We have a food policy that has produced the lowest cost food and the highest quality, abundant and stable supplies. And those who seek to radically alter that policy, I believe, have a very heavy burden to bear. They must demonstrate, and demonstrate conclusively, that they have a better way.

Mr. Chairman, let me just conclude by saying this is a matter of extraordinary importance to the United States, not just to the farmers of this country but to the $20 million people who live and have jobs as a result of the farm sector. Our friends in Europe understand how important this sector is to the economy. That is why they have a plan and a strategy to dominate world agricultural trade. And we would make a profound mistake to give up in this battle for world agricultural markets.

I think we would rue the day we threw in the towel in this battle. Not only would it adversely affect farmers, but it would have a very deep adverse effect on the 20 million people who have jobs as a result of our agricultural success.

[The prepared statement of Senator Conrad follows:]

STATEMENT OF SENATOR KENT CONRAD

SENATE COMMITTEE ON THE BUDGET

FEBRUARY 16, 1995

Thank you for the opportunity to testify.

We are engaged in an historic budget debate. Every dollar of Federal spending is being examined with a critical eye.

We have heard repeated suggestions that our Federal farm programs are ripe for elimination. We hear that the justification for them is now gone.

I am here to tell this committee the justification for farm programs is not gone. I will explain how our farm programs are essential for international competitiveness. I will explain how our farm programs are crucial for American consumers. I will explain how our farm programs fill an essential role in our economy by creating thousands of American jobs and supporting production of essential human needs: food and fiber.

International Competitiveness

The situation we face in world agricultural trade is a government subsidized, intense worldwide battle for agricultural market dominance. Our primary competitor is Europe. They have a plan. They have a strategy. They want to win the world agricultural trade battle.

Those who are not from farm states like North Dakota might ask why they should care whether our farmers can compete. The answer is simple -- U.S. agriculture is much bigger than just farmers.

Let's take a look at a loaf of bread. The cost of the wheat in a loaf of bread is only 5 cents, while the price of bread is 80 cents. And of that five cents the farmers receives, most goes for inputs, not into his pocket. The 75 cents difference means jobs for the people who load trucks and barges. It means jobs for elevator workers and for the men and women who process and package the food we eat. The list goes on and on. But the bottom line is that these workers' jobs depend on our national food policy.

Our farmers produce $175 billion in raw agricultural commodities that form the basis for our $1 trillion U.S. food and fiber sector, creating 20 million jobs beyond the farm gate. Yet our farm programs cost only $8 to $10 billion per year (Chart 1).

We can see the strategy of the Europeans -- produce it in Europe so that they transport, mill, process, package, wholesale and retail it in Europe.

The Europeans understand how important agriculture is to the overall economy. That's why they provide high levels of support to their producers to encourage surplus production. They dump those surpluses on the world market at fire-sale prices, undercutting our producers and grabbing market share (Chart 2). They expect a cease-fire in this trade war and they want to be on top.

Oh, how well their strategy is working. The Europeans have gone from being the largest net importer of wheat to the number two exporter (Chart 3). Europe is also the number two exporter of beef, the number one exporter of pork, and the number one exporter of value-added food products.

While Europe moves, we sleep. Europe supports its farmers at high levels while we continually slash agricultural spending. *It is unilateral disarmament.* One day we may awake to learn that Europe has done to us in agriculture what Japan has done to us in automobiles and electronics. We're putting our farmers up against not only the German and French farmers, but the German and French governments (Chart 4).

The Europeans know that producing commodities in Europe keeps jobs in Europe. If we dismantle our agriculture policy, we will lose jobs. It's that simple.

Look at New Zealand. They recently dismantled their farm programs. Even though this was much less disruptive than it would be in the U.S., New Zealand's agricultural output is down by one-fourth, according to USDA. In this country that would translate into a loss of 5 million jobs and 4 percent of GDP -- enough to put us into recession (Chart 5).

Consumers

U.S. agriculture is the envy of the world. We enjoy a safe, high-quality, abundant, and stable food supply. This is not an accident, but the result of rationally designed national goals.

Here are the facts: U.S. consumers pay a lower percentage (only 8 percent) of their income for food than the citizens of any other country (Chart 6). Moreover, spending on food is a decreasing percentage of income, dropping from 10 percent of income in 1970 to 8 percent today (Chart 7). And, of that declining percentage, only 22 cents of each dollar goes to the American farmer, according to USDA.

What relationship does this consumer benefit have to farm programs?

This committee will remember the flood of 1993 -- the most recent time we made a claim on our national food insurance policy. Like the drought of 1988-89 when consumers saved $40 billion in higher food costs, consumers again cashed in their food insurance policy.

That is how the farm programs are supposed to work. They assure consumers adequate food at reasonable prices even during weather-related crop disasters. Not only do Americans benefit, but millions of poor people around the world benefit when prices remain reasonable during weather related crop disasters.

If we dismantle U.S. agriculture policy as some suggest, our commodity reserves will be depleted, prices will fluctuate, and consumers will pay more for food.

Those who want to dismantle a food policy that works – a food policy that has created stability and modest prices for consumers -- must explain how they can do better. The burden of proof is on them.

Agriculture is Different

I continually hear people suggest that agriculture is like every other type of business. It is not. Agriculture is unique in supplying a basic necessity of human life under unstable weather conditions.

Unlike other businesses, farmers do not know how much they will produce or at what price when they start the production cycle in the Spring. That violates a fundamental assumption upon which the free-market philosophy is based. This natural flaw in the way agricultural markets works causes a boom-bust cycle in the farm community. The weather should not determine whether or not a rural community has a recession. Economic stability and efficiency require a price and supply stabilization policy under such unstable and unusual market conditions. To do less is to ignore basic economic facts.

Those facts require the maintenance of a commodity reserve for the bad years. That reserve is a national food security system, an insurance policy against production shortfalls.

Because these grain reserves depress prices and reduce farmers' income, we as a nation have maintained a reserve for decades for consumers' benefit. And we have supported producers' income to sustain that supply. That is why we have farm programs.

The Budget

These benefits to the consumer cost very little. Agriculture spending is a tiny portion of federal spending, only 0.6 percent this year. Added to our food bill, we still spend less of our disposable income on food than any other nation.

This chart shows historical agriculture spending as a percentage of total federal outlays (Chart 8). Average agricultural spending for FY91-95 is only 0.8 percent. Current projections show that for FY96-2000, spending drops to 0.4 percent of total federal outlays.

Agriculture spending as a percentage of Gross Domestic Product tells a similar story. We are spending less now on farm programs than we have for decades (Chart 9).

These statistics make three points very clear: First, agriculture spending is an extremely small part of federal spending. Second, agriculture spending has decreased dramatically. Third, agriculture spending is expected to continue its steep decline.

Finally, this chart shows agriculture spending from 1986-1994. In 1986, we spent $35 billion in 1994 dollars but last year we spent only $12 billion (Chart 10).

The Future

I'm not here to suggest that absolutely no changes should be made in our Federal agricultural policy. Surely there should be changes.

First, I believe more progress could be made through international trade agreements. We should urge other nations to level the playing field. My testimony clearly shows the unequal levels of support we now face.

Second, I believe we must work to harmonize our agriculture policies with other nations. For years, the U.S. has carried the burden of maintaining a reserve unilaterally -- other nations should carry their fair share of the burden.

Harmonization should lead to the creation of a multi-national humanitarian food reserve. Decade after decade we see famine in other nations -- famine that must be responded to quickly. Too often, though, food relief is tied up in political battles distant from the needs of the hungry. We should de-politicize food aid. We should stop using food as a weapon.

Through such a system, we can improve our response to these tragedies. In addition, we can spread the burden of commodity reserves that our farmers and taxpayers pay for.

Third, we should promote value-added processing through the formation of cooperatives. North Dakota is a national leader in the cooperative movement. Farmers have joined hands and minds to vertically integrate their operations to produce higher-value products. Producers can gain income while relying less on the Federal government. It works, and others should try it.

Fourth, we must examine targeting farm program benefits to efficient family-size producers. I understand the complexities of this issue but I believe we must -- as part of the budget process -- make difficult choices about Federal farm program payments.

Conclusion

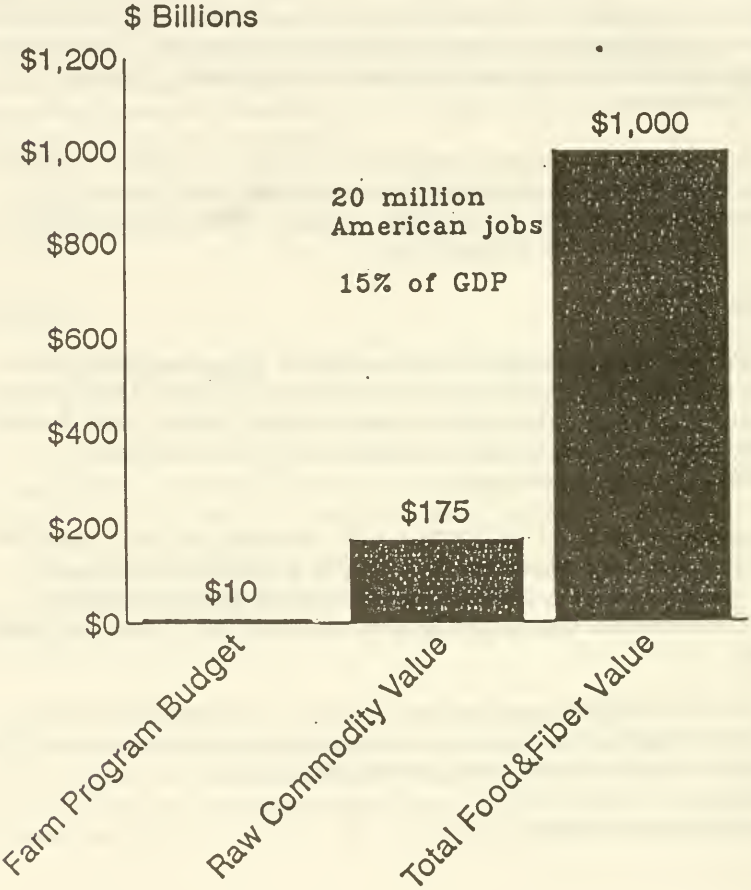
We have a monumental task on our hands. This committee will be making very important decisions about our country's future. Do we want to dismantle the programs that sustain a basic domestic industry, hurt farmers *and* cost hundreds of thousands of American jobs? Do we want to unilaterally disarm? I think not.

Americans of today and tomorrow are depending on us to make the *right* decisions. Our Federal agriculture policy is right for America. It works. History proves it. We have made decisions that have given us enormous abundance in our most basic needs: food and fiber. This was no mistake.

Let us not begin making mistakes. Let us not forget what we have. Let us not forget how we got it. Let us not turn our back on success. This committee -- this Congress -- must continue this success.

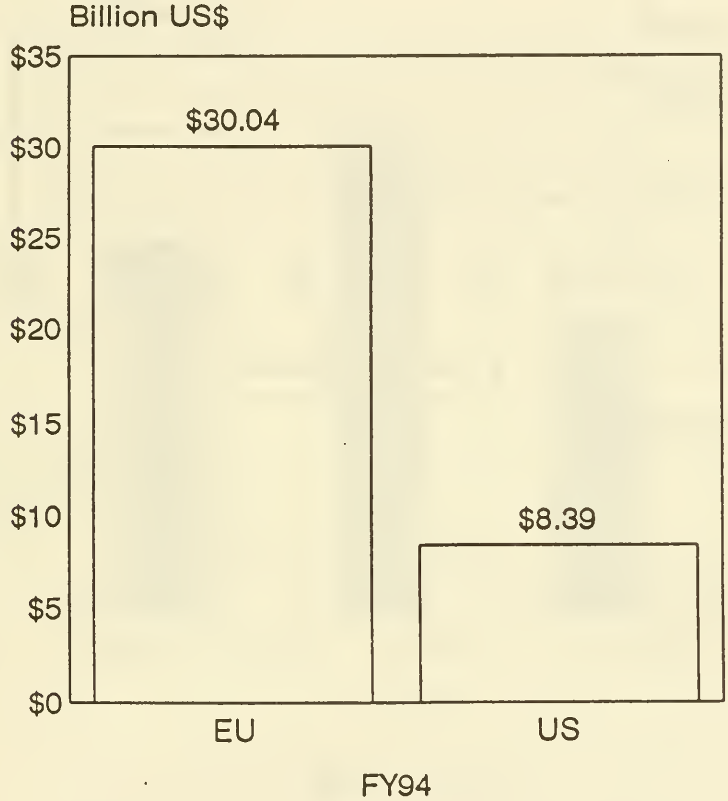
I thank the Chairman.

Agriculture in the Economy 1994



E.U. vs. U.S.

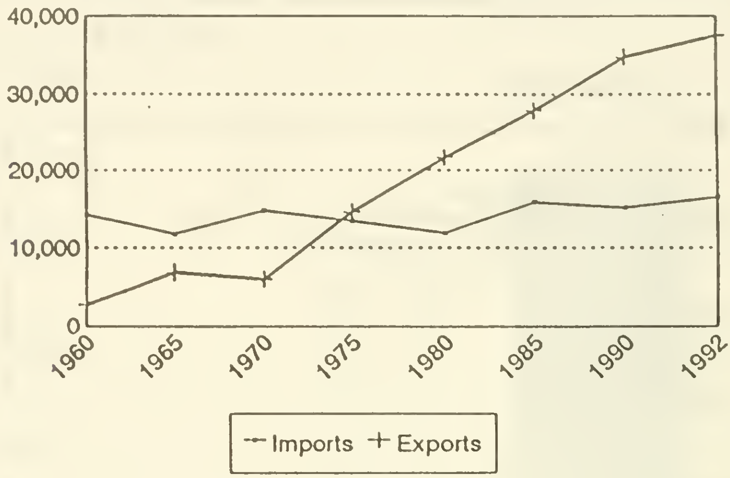
Domestic Agriculture Support Spending



Source: USDA

European Community

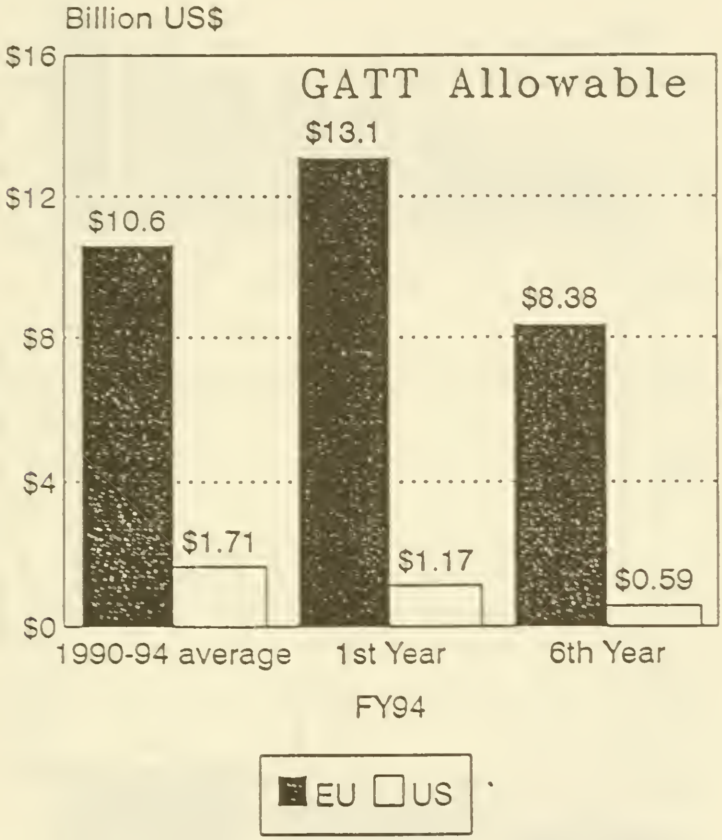
Wheat Imports vs. Exports



Source: USDA

E.U. vs. U.S.

Agricultural Export Subsidies

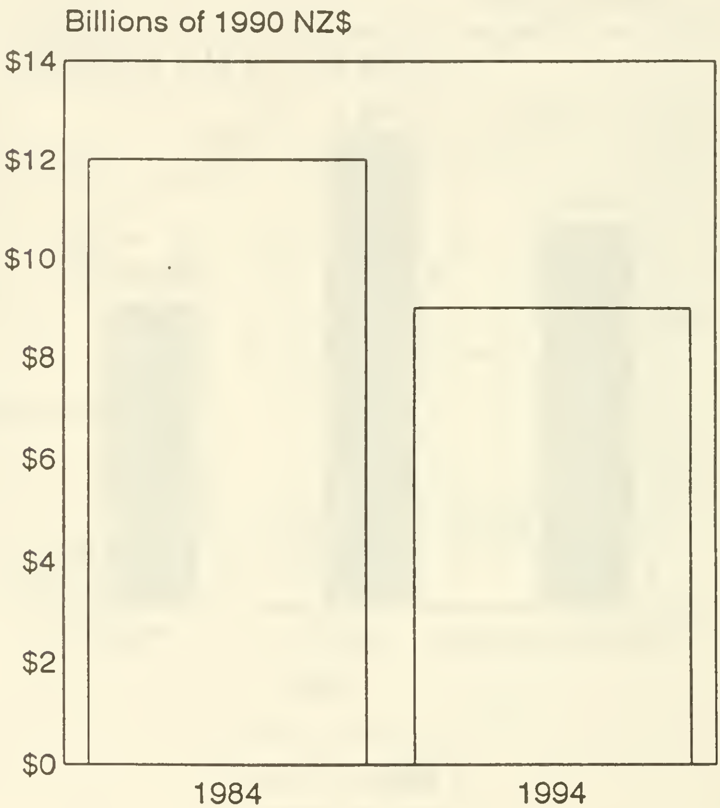


Source: USDA

Eliminating Farm Programs

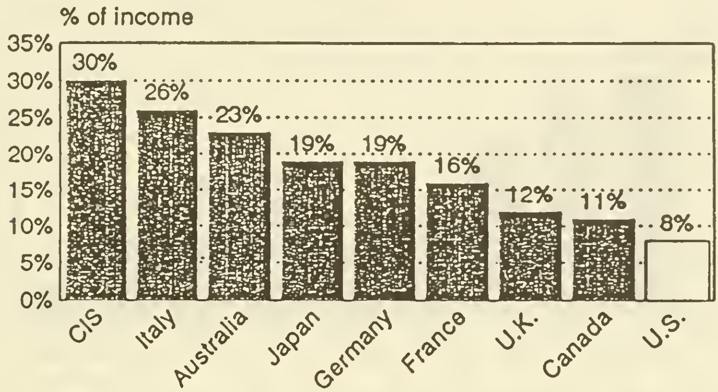
The New Zealand Example

The Value of Farm Output Has Fallen by 1/4



Consumer Food Expenditures

U.S. versus the World

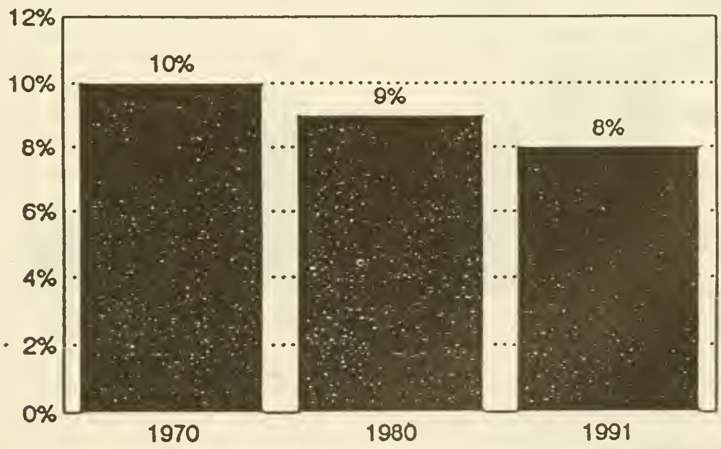


Spending on food consumed at home as a percentage of income.

Source: USDA

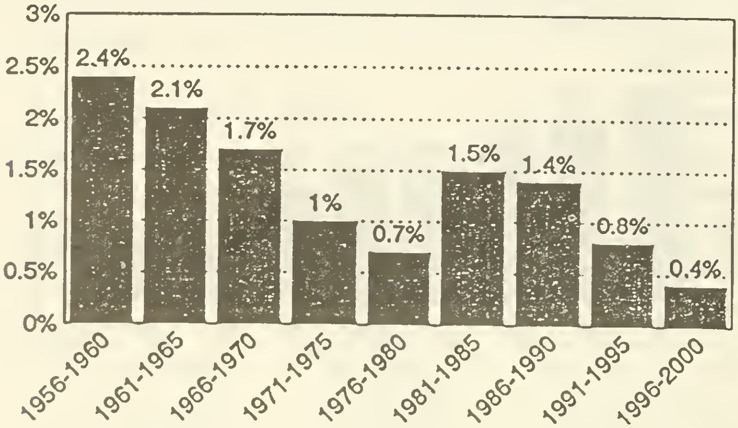
Falling Cost of Food

Spending on Food as a Percentage of Income



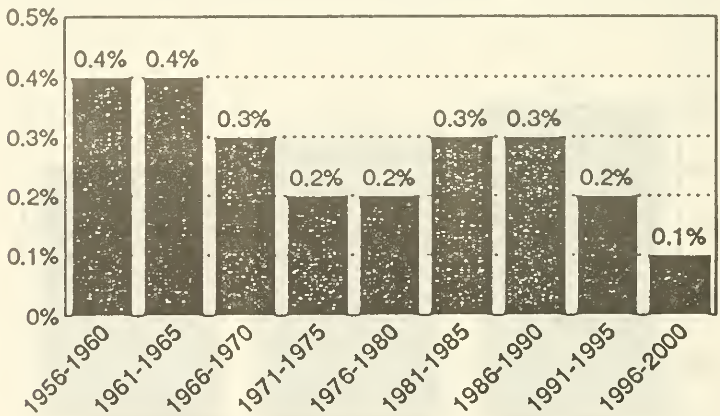
Source: USDA (food consumed at home)

Agricultural Spending
CCC Outlays as Percent of Total Federal Spending



Source: USDA
(5-year averages)

Agricultural Spending
CCC Outlays as Percent of GDP



Source: USDA
(5-year averages)

Chairman DOMENICI. I normally yield on my side, but I am going to ask my first round and keep it to 5 minutes. That is what we agreed to, Senator Exon. Then you will follow me.

Would you put the chart back up that shows the relationship of American farm products, the 175 versus 20 billion or whatever it is? I think it was the first chart up.

Senator Lugar, I would assume that just as a pure statement of facts put on a chart you would essentially agree with that 175 produces a trillion dollars in total food and fiber value.

Senator LUGAR. Yes, that is a fair estimate.

Chairman DOMENICI. I would like to know from you whether your proposal would dramatically reduce that 175, which is the part that we are talking about here today. Or is it your opinion that that would stay the same or increase?

Senator LUGAR. It would increase, Mr. Chairman, as food has increased, roughly 1 to 2 percent in a secular trend for many, many years. That is, the American people have a population growth to consume about as much food of some value. And so these situations have been fairly stable, and there would be, I suspect, a secular change upward.

Chairman DOMENICI. My question more specific if you reduce the subsidies, is it your idea that we would reduce the amount of product that the American farmers produce?

Senator LUGAR. No; I think, Mr. Chairman, the whole quest of ag policy from the 1930's onward has been supply control. The Federal Government has been frightened that too much would be produced and has contrived one scheme after another for 60 years to control what farmers could do.

The possibilities for American agricultural production are unlimited. Unlimited. We could produce a multiple of all we do now, and the problem for us has been we have suppressed our research, we have suppressed most of the good ways in which we would do more, out of fear that somehow or other prices would go down if supply increased. But there is absolutely no possibility of supply decreasing. Quite to the contrary, more abundant supplies, competitive supplies with which to compete abroad would be the consequence of more efficient agriculture.

Senator CONRAD. Might I respond to that question as well?

Chairman DOMENICI. Sure.

Senator CONRAD. Let me just say that in my previous life I was the tax commissioner for the State of North Dakota, one of the most agricultural States in the Nation. I remember very well asking the Wharton Forecasting Service, which was the forecasting service for the State of North Dakota, what would happen if you eliminated Federal farm programs? They told me at the time—I asked them, what would be the equilibrium price of wheat? They told me the equilibrium price of wheat would be $2.25 a bushel. That is when wheat was selling for around $4.

I asked Wharton what that would mean to North Dakota. And I will never forget the chilling response of their chief forecaster. His two-word answer was "mass bankruptcy."

Mr. Chairman, agriculture is different than other industries. It is different because when a producer starts the year, he does not know how much he will produce or at what price. That is a fundamental difference. The result is if you have no policy to create stability, you have wild swings. Just on weather alone, you could have an entire region of the country in recession because you have no program.

That is fundamentally why we have farm programs.

Senator LUGAR. Let me just comment that my colleague from North Dakota makes a very important point about his State. That will be made again and again, the effects upon tax collection of revenue. But what this committee has to consider is whether farm policies, CCC policies, are the appropriate way of keeping North Dakota alive.

In other words, if the real price of wheat is $2.25 and by Federal policy we are making it $4 in order to keep alive North Dakota, that is a very serious problem. But it is well beyond the agriculture budget, and it really comes to a fundamental problem, I suppose, of the entire budget process.

Chairman DOMENICI. Senator Conrad——

Senator CONRAD. Could I just relate to my colleague——

Chairman DOMENICI. My time is going to run out, and I won't even get a second question. You all have a wonderful time discussing this with each other. [Laughter.]

The only thing I might say, from a distance the one thing that looks the same about you, from back here you look like two executives that came to work today with those striped ties and dark suits.

But let me make two points very quickly. First, Senator Conrad, I am a little bit disturbed that you put a chart up that said 10 percent and then went down to 8—if you would put that up real quick. Yes, just put it up there.

Senator it seems to me that your very first chart showing how much the farm product yields in finished product would indicate to me that a substantial portion of that reduction, if not all of it, is attributable not to the farmers but, rather, to the production side of America where we have had great efficiencies in the way food is processed and the way it is kept and the way it is delivered. And I surely don't think you intended to say that that 2 percent was attributable to farmers becoming—the price of farm products going down. You didn't mean that, did you?

Senator CONRAD. Oh, absolutely.

Chairman DOMENICI. But did it contribute 2 percent of the——

Senator CONRAD. No; obviously, you have all of the food chain that is responsible for the final cost to consumers.

Chairman DOMENICI. Right.

Senator CONRAD. But understand, you take—excuse me. Let me answer the question. In an 80-cent loaf of bread, 5 cents of that goes to the farmer. Five cents of an 80-cent loaf of bread goes to the farmer; 75 cents goes to other folks in the food chain, goes to the seed supplier, goes to the person who provides the fertilizer, goes to the trucker, goes to the railroad.

Chairman DOMENICI. But, Senator——

Senator CONRAD. But the fact is we have an entire system here of food policy that gives us that result.

Chairman DOMENICI. Let me just put it another way. You say spending on food as a percentage of income. The variable is income.

Income is dramatically up in 1990 versus 1970. So, obviously, the food proportion would be smaller. I just want——

Senator CONRAD. No, that is not the case at all, Senator. No, the fact is this is a measure of what food costs as a percentage of income. Other costs in our society, you will find, are either stable or have gone up. Go look at health care. What has happened to health care? Income has gone up, but the percentage of our income going for health care has risen dramatically.

The fact is agriculture, food, is one of the few places where we have seen a reduction and, in part, that is attributable to the productivity of the American food production machine. We have a food policy, and that food policy has worked, and worked extremely well.

Chairman DOMENICI. I just want to make one last observation, and perhaps you can come back to it. I don't have time. I have used my time—I didn't use my time. Both of you used my time. [Laughter.]

I asked one question, I got two answers. But, in any event, let me say, Senator, I think we need a better explanation than New Zealand to prove the case of what might happen if the supports are changed dramatically, and I just make that observation. I haven't checked New Zealand, but I will check it only because I don't think that is very much proof that ours will cause the same kind of thing.

Senator Exon, it is your turn.

Senator EXON. Thank you, Mr. Chairman.

Let me just add to that conversation, discussion, argument—call it what you will. We all agree, don't we, that if the Lugar proposals were enacted into law, the income of our food producers out on the farm would go down. Isn't that right?

Senator LUGAR. Not necessarily.

Senator EXON. Do you think they are going to go up?

Senator LUGAR. You are talking about net income, and the point that I am trying to make is that if farmers have the ability to plant and manage their land, it is very possible that taking the shackles of all this off, many will do better. At least 41 percent in my State think they would do better once the government is out of their business altogether.

Senator EXON. Could you comment on that, Senator Conrad? What do you think is going to happen to the income of the farmers in North Dakota?

Senator CONRAD. Well, to me, it is a very simple proposition. Let me just direct your attention to this chart.[1] This is what Europe can do in terms of export support under the GATT: in the first year, $13 billion against our $1.2 billion.

Senator Lugar says, well, let's just kick the skids out from under our producers. Let's not give them any help in this worldwide battle for agricultural markets. Let's send our farmers up not against just the French farmer and the German farmer, but let's put them up against the French government and the German government as well.

I submit to you that is a losing proposition for our producers.

Senator EXON. And the treasuries of the German government and the French government. I think that is important.

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[1] See p. 461.

Senator Lugar, let me ask you a question. As I understand it, you talk about 3 percent a year.

Senator LUGAR. Yes.

Senator EXON. And I was doing some multiplication here with regard to the saving, and I couldn't figure it out. Finally, I discovered or was told by staff that when you talk about 3 percent a year, that is cumulative, isn't it? I mean, isn't it a 3 percent reduction the first year and 6 percent the next year and then 9?

Senator LUGAR. Yes.

Senator EXON. And then 12 and so forth?

Senator LUGAR. Correct.

Senator EXON. Well, 3 percent a year doesn't sound too bad, but when you start accumulating that, it is dramatically different. I am not sure. Is there a better way of stating your proposal than 3 percent a year?

Senator LUGAR. I think that is the simplest, Senator Exon, but I have tables that I would be prepared to give for the record. The wheat target price would decline from $4 to $3.88, $3.76, $3.65, and $3.54, finally $3.43 as the end of this exercise, 3 percent cumulative each year, and that is a certain way of cutting the budget. The point I have made before is that we have all had hypotheticals and thought we were cutting it, but this does it. Very clearly, the target price comes down, and so do the subsidies. But it is clearly just as you stated, 3 percent cumulative each year.

Senator EXON. Did you say that 40 percent of the farmers in your State are supportive of your proposal?

Senator LUGAR. They are supportive of the proposition of ending the subsidies and getting the Federal government out of their farming operation.

Now, some have already voted with their feet by leaving the corn program, and the prediction of CBO is that if my proposal was adopted, a great many more would do so.

Senator EXON. I don't think there is any question that if your program is enacted they are going to be leaving in wholesale lots.

Let me say this about your program. I wonder if you could tell me or if you have any figures on what the impact would be of this cut and how it would be felt among the various producer groups. In other words, is it equal across the board?

Senator LUGAR. It is a fairly equal situation, Senator Exon. At the end of the 5 years, the target price would still be 111 percent of the normal market price for wheat over a 10-year period of time. Now, that means that you still have a target price that is going to give some subsidy in the average year to a wheat farmer. It would be 106 percent of the 10-year average in corn, 107 percent in upland cotton, 134 percent in rice, or at least they come off better at least in this comparison. But everybody comes down fairly close to what the market prices are in a normal 10-year period of time.

Senator EXON. I take it that under this kind of a scenario, the rice farmers might come off a lot better than, say, corn and wheat. Is that true?

Senator LUGAR. They might. That is possible. And over a 10-year period of time that we have here, they would have.

Senator EXON. Well, my time is up, Mr. Chairman. I would simply say that I have some other questions that I would like to go into, and I will try and be here for a second round if you will allow one.

Chairman DOMENICI. Might I ask our witnesses, are you under any time constraints? First, Senator Lugar.

Senator LUGAR. No.

Chairman DOMENICI. You can be here if we stay until 11:30 or 12:00.

Senator CONRAD. Mr. Chairman, might I just respond to the last question that was asked? I think it is an important point.

The Senator from Nebraska asked what is the effect. You, Mr. Chairman, asked, what is the effect on output? Every USDA study that has been done says if you eliminate farm programs, you reduce output. Not just New Zealand. Those are our own USDA studies of what would happen.

But beyond that, in terms of a differential from a geographic standpoint, just looking at the members here, a dramatic difference. In North Dakota, net farm income, 82 percent of farm program payments represent net farm income. In other words, farm program payments make up 82 percent of net farm income. In Iowa, it is 266 percent, farm program payments of net farm income. In Illinois, it is over 60 percent that farm programs represent of net farm income. In Nebraska, it is about 40 percent. In New Mexico, it is about 13 percent.

So you get dramatic regional differences.

Chairman DOMENICI. I think New Mexico is 3 percent of gross cash income for 1992 and 4.4 percent for 1993.

Senator CONRAD. Well, for the year 1993, according to USDA, you would have direct government payments as a percent of net farm income 13.5 percent for the year 1993.

Chairman DOMENICI. In 1992, it was 3, my staff says. Anyway, we don't have to argue over that. We have a lot of other questions around here that people ought to ask.

I think you are next, Senator Grassley.

Senator GRASSLEY. Yes. I am a farmer, and I have defended farm programs, so I suppose everybody expects me to defend the status quo, so to speak, to defend the farm. I can defend the farm. I am not sure that I can defend exactly what we got now considering—and I say considering in emphasizing the total budget problems we have. On the other hand, I think we will all agree that we can eliminate the $11 and $14 billion that Senator Lugar is talking about, and if that is all we accomplish, it is a spit in the ocean compared to what the problem is. So I am actually here to commend my colleague from Indiana for his strong leadership in an area that is his jurisdiction as chairman of the committee, because it is not easy to be so bold with your own committee. It is always kind of easier to be bold with somebody else's program.

First and foremost, I believe that government needs to be smaller and more effective. I think Senator Lugar's position is the same. Senator Lugar, my concern is the process of accomplishing that and all of your excellent work, Senator Lugar, to reform agriculture could be for naught if other committee chairmen fail to follow your lead, because then it becomes a fairness issue. And if there is one thing I am committed to during this debate when it comes to the entire budget process is to make sure doesn't happen to agriculture what happened in 1990 and 1993 when we took unfair, disproportionate cuts, and other programs didn't contribute. And other programs are as much of a problem as agriculture is.

As we all know, if there are sacred cows escaping scrutiny, the path of least resistance is that no cuts are made, no cuts made anywhere. And then it is just business as usual.

I believe that we have to avoid that. To do so, we need leadership from all committee chairmen. Otherwise, Senator Lugar, you will be selling your very fine program and your work to an increasingly skeptical agriculture community.

Having said that, Mr. Chairman, let me say about Senator Lugar that there is no Senator more qualified to chair the Agriculture Committee. I commend him for the analytical and objective approach he has taken in reviewing agriculture programs. But I encourage other committee chairmen to apply such rigorous tests to their programs, and maybe we can make some progress towards really balancing the budget.

I am convinced that we need a farm program of some kind. I might disagree there with you, Senator Lugar. However, people can disagree on details of programs. If someone has an idea for a program that will provide greater benefit to the American farmer and the American consumer at less cost to the Federal Government, we should take a very close look at that program. And I think there are a lot of alternatives to what we have out there, or even things we can do within the existing commodity programs that would be helpful.

However, I want you to know I am skeptical of any spending cuts that will jeopardize the stability of food supply or weaken the U.S. farmers' position vis-a-vis our foreign competitors. That may be a point more towards your export enhancement than it is toward the commodity price support generally.

As I mentioned before, we need to make sure that what we do this year to agriculture—and I hope you will be cognizant of this—is that we don't want the Charge of the Light Brigade but, rather, we want successful reforms.

So the only question I am going to be able to ask you, Senator Lugar, is: You have been a strong advocate of exporting U.S. agricultural goods abroad and maintaining our competitiveness in the world marketplace. And as you know, although the United States has natural advantages in this area, especially due to our natural resources and our own efficiency of our farmers, the governments of the foreign trading partners do, as you have seen on these charts, heavily subsidize. And you know the figures, so I won't repeat those figures.

The bottom line is my question relates to your desire to eliminate EEP and other spending on green box programs, the unilateral disarmament that my good colleague from North Dakota spoke of. How will this affect the U.S. farmers' ability to compete in the world market? And will you propose market development programs as an alternative to EEP?

Senator LUGAR. Senator Grassley, I believe we have to be cognizant of our international competition. I have no quarrel with my colleague from North Dakota, and I certainly agree with you that exporting has always been the up side potential for American agriculture. Each one of us who gives speeches on this always emphasizes that.

I am saying that EEP has outlived its usefulness in large part because most of the sales are now going to Russia, to China, to situations—we are not really competitive with the French. We are always cited as one of the malefactors. Furthermore, in European circles, the farm reductions in terms of both income and employment are going down precipitously. They are not making headway with it even if their treasuries are putting more money into it, and they will be constrained by GATT from doing that from time to time.

But we will have to be thoughtful about a strategy for exports, and I would be in favor of developing programs. And we will look at each one of those, of which there are several that will come into the Farm Bill debate.

I would just finally say that there is no thought, Mr. Chairman and Senator Grassley, that output of food supplies in this country is going to go down. The fact is the American people will get every bit that they want. It is almost like the argument that output in Eastern Germany has been going down recently, because a state produced all sorts of things that people did not want at prices they could not pay.

I don't want to make a precise analogy, but when you get into a Federal Government program and people start planting for the program, planting for the government as opposed to the market, strange things occur. The output of some things will go down because there wasn't demand for them. Farmers just produced them because they knew they would get the money.

Then we think of our own dumping apparatus for China or for Russia to get rid of our own excesses in programs.

Chairman DOMENICI. Your time is up.

Senator Simon?

Senator SIMON. Thank you.

I would join Senator Grassley in commending you for your courage. I have to say philosophically I am more comfortable with Senator Conrad right now in terms of where we are.

Let me give you kind of a big picture thing. We now have on the face of the Earth about 5.8 billion people. By the middle of the next century, we are going to have somewhere around 10.5 billion people. Feeding the world is going to be extremely important to the stability of the world. And there is no question the United States is going to have to play a very critical role in that.

We tend to look short term because farmers have to survive year by year. The family farm, as we have known it—and it gets defined in different ways, but it is the most efficient way of producing. And I am concerned about programs that discourage the family farm.

Now, I do believe, my own feeling is that we have to re-examine target prices as a mechanism for doing that much more than we have, with a cap on what each farm can produce. I think that is a way of encouraging the family farmer, and yet putting a cap on total costs.

Let me just ask the two of you to respond to your feeling about this and the long-term picture. I think in the area of agriculture, as in most areas in Congress, we tend to look very short term. I think we have to look long term more. I would be curious as to the response of both of you.

Senator CONRAD. Well, maybe I could begin by saying what Senator Lugar has proposed is really a dramatic and drastic reduction in farm programs. Three percent sounds insignificant, but you have got to remember you have got inflation occurring during the period. And when you start reducing target prices 3 percent a year, what you wind up with is a final target price that is very close to the market price, and so, in effect, you have wiped out farm programs.

Let's be blunt, let's be direct, in terms of what he is proposing. That would have a devastating effect, certainly in my State, certainly in Senator Grassley's State. I don't have the numbers for everyone here. Certainly in Senator Exon's State, it would have a devastating effect.

We can target, better than we are doing now, farm price supports, and in my testimony I say I certainly support a targeting. Let's limit it to whether it is an earnings test or some other means testing. That makes sense.

Senator SIMON. And I have to say that makes sense to me. Senator Lugar?

Senator LUGAR. Senator Simon, farms with 250,000 in sales or more are only 6 percent of American farms, but they received over a third of all of the subsidies.

Now, your point, of course, is to get to the small family farm the benefit of this safety net. That will require a very, very large change in programs altogether, because essentially the money goes on the basis of bushels produced to whoever does it, whatever size.

Now, most of the attempts to get limits at 50,000—and that has been suggested again and again—run afoul of the fact that people divide their farms into partnerships, separate corporations; so-called Christmas tree scandals abound. Furthermore, it is hard to audit the income tax returns of people, either prospectively or far enough after the fact, to know precisely what their income limits were and how the payments ought to be tailored.

That is why I have approached in, I think, a much cleaner fashion; that is, the target price. The very large farmers in America in many cases will opt out of the program, because, in fact, they could run their corporate farms at a profit, anyway, and are simply using Federal subsidies as additional income.

If there are farmers in America who are very poor and who are marginal, the safety net is still provided by the program that I have suggested. It is still there, something above what is normally the market price.

Senator CONRAD IS CORRECT. My intent is a gradual glide path out of subsidies. And after 5 years, we are pretty close, as he says, to the market price so that finally people are planning for the market. I think that is better than this committee or my committee at some point about 4 years from now coming up with the fact that we have been running along the same as always and suddenly we have got $300 billion deficits. And you say that year this is really serious, and now we are going to whack it all off.

There is no glide path there. It is really a revolution. The changes I am suggesting will change land values, but they will change them gradually. They will change incomes, but in a path that people can count on. And that I think is important to farmers, even the 41 percent who want out in Indiana. Another 30 percent believe we ought to have a glide path out of it, and they would like a phase-out. A majority of American farmers want out of this situation.

Now, many farmers in Senator Conrad's State still want in. I understand that. They have got a situation of high costs. The market situation is not congenial to them. And the predicament for this committee and mine is: What do you do in areas where agriculture really is not an economic procedure? Is this a national welfare dilemma or a national problem of getting people to go out to farms and not depopulate the hinterland? And it is a serious problem.

Now, we have got to look at that in my committee and yours in terms of development of jobs, to make it possible to have income on something other than ag markets.

Chairman DOMENICI. I believe we ought to recess for just a bit, Senators, if it is all right with you, and come back immediately after the vote. There are still three Senators on our side who want to inquire, so would you come back and join us immediately after the vote? We will be in recess for about 10 minutes.

[Recess.]

Chairman DOMENICI. Could we reconvene? I am certain it is all right with Senator Exon. I have to go to a meeting in Senator Dole's office and somebody on my side can preside for me until I get back. Senator Gorton still wants to inquire, but he is not here, so he will have to take his turn. I am going to yield now to you, Senator, for your questions.

I want to make one statement for the record. I failed, in my opening remarks, to adequately, from my standpoint, compliment Senator Lugar as Chairman of the Agriculture Committee for his insights and his knowledge and his efforts. Obviously this committee is not going to agree totally with what you have said. In fact, it may not be what the Agriculture Committee produces, as I understand it. Is that not right, Mr. Chairman?

Senator LUGAR. The Chairman is correct and we could very well try to arrive at the savings in other ways that are substantially different.

Chairman DOMENICI. I want to also echo the remarks of Senator Grassley. I want to make it very clear here today, I do not intend to let the Agricultural Program bear the brunt of entitlement reform. It is on the table with literally hundreds of billions of dollars in entitlements, many of which need reform just as much as this. It may be a different approach. It may not be the market that we are looking at, but clearly we need to reform them.

Senator I asked as the Chairman of this committee, that each authorizing committee help us. I am very appreciative, as Chairman, that you have stepped up to the plate and are trying to be helpful. We will do everything we can to leave enough room for a good farm program as we move through our deliberations, and I will work closely with Senator Exon and other members of the committee.

Senator Gorton, we were going to have Senator Abraham proceed, but you are here and you are next, so would you proceed, please?

Senator GORTON. First, Senator Lugar, just a factual question as to the nature of your proposed cuts. You asked that we save $3.4 billion in this period of time by eliminating the Export Enhancement Program. I have here page 33 of the Department of Agriculture's budget submission, which is Foreign Agricultural Service. And there are apparently export credits under CCC, there is a market promotion program, there is a single line called Export Enhancement Program, and then two others, Dairy Export Incentive Program and Sunflower and Cottonseed Oil Assistance Programs.

Is your recommendation in your $3.4 billion simply the single line Export Enhancement Program or does it include others of those export programs, as well?

Senator LUGAR. It is the single line of Export Enhancement Program. In an earlier answer I pointed out we would examine on the merits each of a number of export programs.

Senator GORTON. But the $3.4 billion is that one standing alone?

Senator LUGAR. Is entirely the CBO estimate for Export Enhancement.

Senator GORTON. One more question of you, just because of you are chairman and have some familiarity with all agricultural programs. With respect to price support programs, the other part, is it your observation as you look at the farm economy of the United States as a whole, that those farmers, those agricultural producers who operate in non-program areas—that is to say those who do not have government price supports—do worse and have lower incomes than those who are in support programs? Or is it your observation that their freedom from any government controls makes them more efficient and productive and often more prosperous?

Senator LUGAR. That issue has been debated by ag economists for a long time. They have cited soybeans as a crop that grew without the government involved and grew very big without those constraints. The suggestion is, as a matter of fact, that programs that have had high government involvement have not grown as much. In the case of peanuts there is a question as to whether demand is growing at all, as opposed to substitutes, given the constraints of the program.

But for individual farmers, it is almost an impossible judgement because the income stream from different types of crops or animal husbandry is mixed together, often with income from off the farm and many other sources.

So the judgements are usually about a single crop as it appears across the spectrum.

Senator GORTON. But there is no clear showing that agricultural incomes are higher simply because you are in a program crop than in a non-program crop?

Senator LUGAR. The income for a farmer in a program crop will often be higher because he or she is receiving money from the Federal Government for the production of that crop. It has no relationship to the market desire for the crop. But if you produce enough of it and you utilize your farm history, you can make money and many people do.

But only about one-fourth, it should be pointed out, of American farmers receive direct Federal CCC payments. The other three-quarters do not, which sort of begs the question, what are these other three-quarters doing? And they are doing things that are not subsidized and apparently doing as well as the one quarter who are.

Senator GORTON. Senator Conrad, I am an agnostic, I guess I would have to say, here today with respect to whether we should make as radical a set of changes as Senator Lugar proposes or pretty much continue what we have been doing. But I must say to you very bluntly, as a friend, that I have not found your charts or your presentation to have enhanced your case.

I have read a little bit about New Zealand, for example, which has operated under a socialist government for most of the years since World War II and which fell from the third highest standard of living in the world to about the 30th or 40th highest standard of living in the world as a result. So I do not find it appealing to be told that New Zealand farm income has declined while New Zealand has reformed and free enterprised its economy.

It is my judgment that New Zealand, as a society, finds itself better off today than it did under a controlled economy. And I do not know from your chart whether it represents a 25-percent decline in product or just a 25 percent decline in what that production was worth on the market. I do not know it.

And I look at the chart that you have sitting up here right now, with a 12-to–1 ratio of European agriculture export subsidies to those of the United States. I reflect on the fact that we have the most competitive agriculture, the most efficient agriculture in the world, which has been one of the points that you have made, and I find it very hard to imagine that if we have the best agriculture in the world at 12-to–1, that it would collapse if we gave up the one.

It seems to me that maybe the Europeans are making one heck of a mistake in so coddling their agriculturalists by this as to constantly decline in their efficiency.

I look at France. We read the newspapers. Every time there is an attempt in France to reform agricultural policy the farmers revolt, they block roads, they burn trucks, they march on parliament and they demand continuing subsidies for what obviously is an agriculture, in wheat production for example, far less efficient than that of the United States. They are still growing wheat the way we did, I suppose, in 1940. And yet the implication of your charts here are that boy, that is the way agriculture ought to be done. That is the way we ought to support our findings.

Why, if we do so well at 12-to–1, why does it suddenly collapse if it is not 12-to–1 anymore, but we just allow free markets to operate? Why is it, in your view, that farming is the only form of economic activity which has got to be coddled and supported by the government where every area of free market competition works?

I have, for example, in addition to farmers in my State, I have people who fish for a living. They do not know how much they are going to catch each year, and they do not know what the price is going to be each year. But they do not demand target prices for salmon.

Senator CONRAD. Let me just say that you have asked a series of questions which I would like a chance to respond to. First, with respect to New Zealand. New Zealand only had a Farm Program from 1978 to 1984. They had a very brief experience with the Farm Program. Then they ended it and you saw a steep reduction in terms of what they produced.

The question was put to me what happens when you eliminate farm programs? Does it have an effect on production? Let me just say, we have got a clear case, New Zealand. And we have got a clear result.

Beyond that, I responded in questioning, USDA has done studies and their conclusion has been repeatedly if you eliminate farm programs you will have a reduction in production. Now why would that be the case? Why would it make sense that that would happen?

If we think a moment about economic theory, if you subsidize something you get more of it. I think we would both agree on that premise. That is precisely what those with whom we compete are doing. That is what the Europeans are doing. They are giving their producers higher levels of support. That encourages surplus production. They take that surplus production, put it on the world market, and reduce prices in order to gain market share.

We have to ask ourselves does it make sense for us to abandon the world market to them? Does it make sense to unilaterally disarm? I submit it does not. I think it would be a mistake.

This chart[1] shows export subsidies. There are other subsidies as well, but in terms of export subsidies it is very clear Europe is making much more of a commitment to agriculture than are we. Can we afford to unilaterally disarm? I do not think it makes sense.

Senator LUGAR. Mr. Chairman, let me just comment for a moment. For the record, I would like to submit pages 28 through 32 of the Agricultural Outlook published in December, 1994 by the USDA. It discusses New Zealand in detail with charts that are, I think, helpful.

[The information follows:]

[1] See p. 461.

New Zealand Embassy

Farming Without Subsidies In New Zealand

In the mid-1980's, New Zealand became one of the first countries to unilaterally deregulate key sectors of its economy and abolish many sector-specific agricultural programs. Total farm assistance, which amounted to 40 percent of gross farm income in 1984, abruptly dropped to nearly zero the following year.

The producer subsidy equivalent in New Zealand—calculated as a ratio of direct and indirect subsidies to the value of production of five major agricultural commodities—fell from 25 percent in the early 1980's to 3 percent in 1993. The comparable level for the U.S. in 1993, calculated for an average of 12 major commodities, was 23 percent.

U.S. policy has addressed a host of farm issues—including price stability, orderly marketing, minimum returns or prices to producers, maintenance of the family farm, resource conservation, and limiting costs to taxpayers and consumers. Debate continues on the appropriate government role in these areas. With increased trade, and pressure to conform to new trade agreements, many countries, including the U.S., must balance internal assistance with external trade considerations.

New Zealand's deregulation experience may offer lessons for the U.S. in terms of the economic and political environment which motivated the deregulation policies and actions, and the resultant short- and longrun adjustment issues. The policy reforms in New Zealand since 1984, for example, have increased productive efficiency in the agricultural sector, but declines in investment have raised questions about longrun productivity.

Divergent Pressures To Deregulate

Nearly a decade has passed since the reform began in New Zealand, and the agricultural sector appears to be moving out of the adjustment period. The value of farm output, which declined initially in real terms, headed back up in the late 1980's, and is estimated at over $8 billion (nearly $10 billion in nominal terms) in 1994. Beef/sheep operations are still the most important type of farm, and meat and wool from these farms are estimated to account for 35 percent of the total value of farm output this year—the same share as in 1983. Dairy products are estimated at 24 percent of the value of farm output in 1994, nearly the same as in 1983, while grain and oilseed share dropped from 5 to 3 percent and horticulture expanded from 11 percent to 13 percent. New Zealand currently has about 80,000 farms, slightly higher than in 1983.

Economists list a number of symptoms that indicate when structural adjustment is needed in a developing country. These include persistent government budget deficits, rising national debt-to-income ratios, and high inflation rates. While policy concerns in developed countries seem more complex and involve many diverse domestic and external pressures, New Zealand and other developed countries might do well to address these symptoms as they occur.

A host of conditions triggered the move to deregulate agriculture and other industries in New Zealand in the mid-1980's, and two issues in particular converged in these years to support change. First, farm leaders recognized that continuation of the subsidies which had been in effect since 1978 would not be viable over the long-term. Farm leaders acknowledged that the subsidies—begun partially in response to lost export sales when the United Kingdom joined the European Union—were overly generous to farmers. New Zealand, a small country, could simply not afford to guarantee against price drops in dairy, lamb, and other exported livestock products. Second, the farm sector saw that subsidies and import protection in other sectors hurt them, and reasoned that deregulation in other sectors would bring relief in the form of lower input prices.

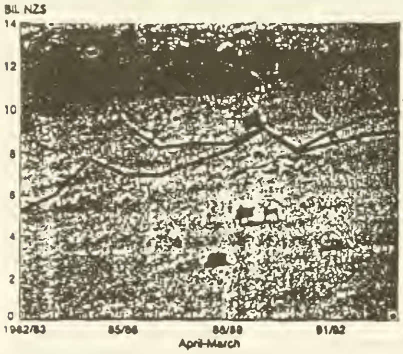
Both issues caused farmers to question whether farm subsidies were in their long-term interest. Many farm leaders also feared that high agricultural subsidy levels would cause the loss of goodwill with the rest of New Zealand's population. In addition, most farmers could readily recall life before subsidies, which had begun in the relatively recent past.

The U.S. currently faces a set of conditions and pressures that are largely different from those brought to bear in New Zealand over a decade ago. But a major issue common to the two countries is the pressure for closer scrutiny on government program outlays, generated by persistent budget deficits. Unlike in New Zealand, however, many farm programs have been in place over a long period of time in the U.S., and have become an important part of farm planning for some producers. And unlike in New Zealand, farm program expenditures make up only a small part of the national budget.

Besides the budgetary pressure, probably the two other major motivations for change in the U.S. are the perceived loss of farmers' political clout, and the maxim to conform to international trade agreements. Neither of these forces was a factor in deregulation in New Zealand. Both are political in nature and emotionally charged.

The political issue involves the perception that the need for government assistance in agriculture has declined, and involves the weakening of past political alliances supporting the status quo in farm programs. The trade issue would alter the form that these programs could take—those that directly affect trade would need to be adjusted. For example, quotas that insulate high domestic price supports would become tariffied, with tariffs slowly lowered over time. The tariffication of past quotas on dairy, sugar, and meat imports is an example.

The Value of New Zealand's Farm Output Climbs Again



NZ$1 = US$0.55 (1994).
'GDP deflator (1990=100).
Sources: Statistics New Zealand; Ministry of Agriculture and Fisheries.

The need for trade agreement conformity, as well as the demands of an increasingly competitive international trade environment, places pressure on many countries to adjust sectoral assistance. For the U.S., the international competitiveness issue involves the pressure to make farm programs more transparent so that trading partners will in turn make theirs more transparent—and should increase their imports from the U.S. In the process. These concerns set present U.S. conditions apart from those in New Zealand in the mid-1980's.

According to recent USDA analysis, deregulation by the U.S. and its trading partners under the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) would result in a substantial increase in U.S. agricultural exports, and raise farm income. The analysis also indicates that lower government program outlays would result from the policy change.

Ag Sector Adjustment Was a Key Concern

More than 30 different production and export subsidy programs were abolished in New Zealand, in tandem with other economy-wide deregulation reforms. Three concerns from the New Zealand experience may be of interest to U.S. policy makers:

- the timing or sequence of economic reforms across sectors;
- initial adjustment problems of farm producers; and
- adjustment problems of downstream participants (marketers and processors) and upstream participants (bankers and input suppliers) in the agricultural sector.

The macroeconomic reforms affecting interest and exchange rates occurred prior to many sector-specific reforms. These economy-wide reforms raised interest rates and appreciated the New Zealand dollar. This had the effect of depressing exports and in turn, lowering domestic prices while raising interest costs on producer loans. Agriculture sustained these impacts simultaneously with the sector-specific reforms, and this raised the question of whether the reforms could have been timed to allow farmers to adjust to one shock at a time. For most U.S. commodities, with their generally heavier domestic market orientation, this probably would be less of a concern.

Concern about shortrun producer adjustment is a major issue regardless of the sequence of policy reform. How were such shortrun adjustment issues addressed in New Zealand? First, the government provided two main safety nets—one to assist farm exits, and one to help farmers weather the storm. The first program provided farmers with a "golden handshake," a one-time payment of $45,000 to exit farming, and was extended to 300 farmers. The other program, the Rural Bank Discount Scheme, suspended or reduced interest payments, capitalized interest into principal, or postponed/wrote off principal in 1986-87. This program was extended to over 4,700 applicants who, on average, had $49,880 in debt written off.

Special Article

Prices Are Rising Slowly in New Zealand

	1990/91	91/92	92/93	93/94	94/95
			Million		
Population	3.35	3.38	3.41	3.44	3.47
			$NZ billion		
Gross Domestic Product (GDP)	73.8	73.4	77.1	81.7	86.0
			Percent		
Agriculture as share of GDP*	4.8	5.7	6.8	5.7	4.8
Inflation rate	5.8	2.8	1.0	1.4	1.3

1994/95 forecast. Year begins April 1.
*Excludes goods and services used in agricultural production and processed agricultural products.
Source: Statistics New Zealand; Ministry of Agriculture and Fisheries; New Zealand Institute of Economic Research.

One lesson of the short-term impacts in New Zealand is that caution is needed to avoid automatically substituting government programs for independent, voluntary arrangements, such as bank-to-farmer agreements, to reduce financial stress. For example, there was evidence that New Zealand banks, working closely with viable producers, were willing to weather the storm of deregulation—without the government's rural bank assistance program—by taking a liberal policy on repayment problems. Other forms of private-sector cooperation occurred on delinquent payments to input suppliers.

Recent examples of similar voluntary efforts in the U.S. involve individual firms responding to fires in Washington State last summer. Seafirst Bank in Chelan and Douglas Counties extended flexible underwriting criteria and low-interest loans to help local small entrepreneurs get re-established after fires destroyed businesses. And free, 24-hour access to fire updates and evacuation information was made possible through cooperation among U.S. West Cellular, the Washington State Department of Natural Resources, and local radio stations. Although government agencies could facilitate these programs, caution should be applied on the extent and duration of government involvement so as not to jeopardize or discourage such voluntary private sector initiatives.

A second lesson in shortrun adjustment to be learned from New Zealand is the value of exploring other, perhaps nongovernmental, means to help producers adjust. For example, futures options could be used to address price instability, and area-wide crop insurance programs could handle production uncertainties. Also, self-help programs, such as marketing boards, could be developed or enhanced. In New Zealand, marketing boards for major commodities probably eased, to some extent, shortrun producer adjustment problems faced with deregulation. In the U.S., recent legislative attempts by dairy groups to allow "self help" programs to market and export products in the post-GATT environment may signal future attempts by other commodity groups to adopt similar tools.

New Zealand's Marketing Boards Take on Commercial Look

New Zealand's producer marketing boards are among the oldest and best known government-sponsored marketing institutions. These marketing boards began forming in the 1920's and were given broad legislative authority by the government to negotiate freight rates and insurance charges, even out seasonal peaks in produce shipping, coordinate export promotion, and conduct other activities to improve grower returns. The economic reforms which began during the last decade have altered the functions of New Zealand's marketing boards somewhat, leaving them more focused on export promotion.

England, Canada, Australia, Israel, and a number of other countries operate marketing boards similar to those in New Zealand. And the U.S. has marketing orders and agreements which perform some of the same functions as marketing boards, but which have weaker legislative authorities.

Today, New Zealand has 11 producer boards covering meat, wool, dairy, apples and pears, fish, kiwifruit, raspberries, game, horticulture, hops, and pork. The functions they assume vary by type of product and extent of statutory powers. These powers fall generally into five possible market interventions: (1) compulsory levies on producers for promotion and other activities; (2) price stabilization, often through the purchase and/or stockpiling of product; (3) licensing of exporters to restrict the number of exporters or access to specific markets; (4) product acquisition for market allocation; and (5) supply control through production quotas.

About a decade ago, the New Zealand government began deregulating the producer marketing boards, treating them more like commercial entities. In general, the deregulation has led to closer scrutiny of producer boards by the public and the government. Four policy changes signal this dual trend:

- In 1986, the stabilization accounts set up by the central Reserve Bank were completely dropped, and boards were allowed to search for funds across commercial channels without government approval or supervision.
- The government ended its role in setting guaranteed or minimal prices for stabilization schemes and monitoring those activities.
- The income tax-exempt status enjoyed by boards was repealed in the late 1980's.
- In 1993, each board was required to conduct a performance and efficiency audit every 5 years.

These deregulation moves, along with the increased awareness that New Zealand could not afford to support prices in many commodity markets, led to changes in the functions assumed by the marketing boards. For example, many marketing boards de-emphasized their price stabilization efforts and dropped many domestic marketing allocation schemes. By the late 1980's, the government removed product acquisition authority for wheat, eggs, and some kinds of milk and other dairy products (for domestic sale), and domestic production controls were dropped for eggs and some kinds of milk.

However, the ability to collect producer levies was essentially unchanged. And export licensing maintained its important elements. For example, product acquisition for dairy products, apples, pears, and kiwifruit *for export* is still compulsory. By acquiring production in order to organize export shipments and pool final producer payments, boards still indirectly control remaining domestic supplies and, in turn, prices, processing decisions, and product development.

And five boards—covering dairy, apples and pears, kiwifruit, raspberries, and hops—still maintain single-seller status for exports in New Zealand.

Although many of the reforms listed above were profound—especially in dropping most domestic marketing arrangements and the easing out of the government's financial exposure—the need for certain board functions, particularly those related to export marketing, has never been questioned. Only minor changes were made to export monopolies or licensing authorities. In fact, kiwifruit producers—even in the midst of the deregulation fervor in 1989—were able to create a new board (the Kiwifruit Marketing Board). Thus, considerable political support for marketing boards apparently remains.

Detractors of boards cite the potential of undue price enhancement, inefficiency brought about by lack of competition, the inherent conflict between the regulatory role and the commercial activities of the board, and the difficulties in assessing board performance. Proponents of boards cite the streamlining of marketing efforts by boards, the ability to capture increased returns in markets when possible, and some ability to counter the actions of market distortions brought about by the actions of governments in other countries.

Past studies generally support the view that boards have not been able to increase market returns for New Zealand. However, marketing boards nonetheless remain popular with many farm groups and policymakers as a way to improve returns to growers. And partly as a result of the reforms, the marketing boards are putting increased emphasis on developing a global corporate strategy to improve international competitiveness. Strategies to increase exports and market share include developing of branded products (such as Anchor milk and the recently introduced ENZA fruit juice), expanding product selection and mix, and selling value-added products.

Special Article

Input suppliers, especially fertilizer distributors and banks, were also impacted in the short run. Fertilizer use and capital expenditures were both pulled back severely—up to 50 percent—while land prices dropped 60 percent. Similar short-run results could apply for the U.S. Lessons could similarly be drawn from the experience of the early 1980's PIK program in the U.S. (and earlier programs) in anticipating response of input suppliers to large shortrun cutbacks in farm input demand.

Output & Resources Are Longrun Issues

The impact of deregulation on output, resource use, and technological innovation and adaption were the three main longer term issues considered by New Zealand policy makers.

Production cutbacks following deregulation were far less than expected. Econometric modeling and expert opinion had suggested far greater production declines than actually occurred following deregulation, and farm numbers declined less than most estimates. For example, initial New Zealand estimates indicated a 10-percent drop in farm numbers, but they actually fell only about 1 percent during the late 1980's.

These findings suggest that deregulation does not necessarily reduce output significantly, but does force some inefficiency out of the system. However, past experience shows that the adjustment period can be long and painful for producers in seeking new, profitable commodity mixes on farms, as well as for farming communities as agricultural activities shift across regions.

As commodity/regional production patterns change, marginal land is expected to leave agriculture. If financial resources are not available to return land to prior habitat, increased soil degradation and pollution could occur. For example, soil erosion increased on marginal land, especially on hilly terrain in New Zealand, as resources were withdrawn due to subsidy removal, according to a recent New Zealand *Federated Farmers* report.

Environmental concerns in the U.S. have laid the foundation for land retirement programs and the Conservation Reserve Program. And environmental impact surveys, particularly impacts of pesticide use on water quality, have been initiated in response to environmental concerns. Additional studies—to monitor the impacts of lower input use—may be important if deregulation is undertaken.

Does some level of price stability/protection encourage or discourage technological innovation and adaption? A number of studies have explored and debated this question. A "happy medium" probably exists between too much profit/price protection and too little—with too little possibly discouraging investment in technological innovation and adaption. The effects of New Zealand's deregulation on production—somewhat dampened output with lower input use—implies greater production efficiency. On New Zealand beef/sheep farms, for example, an increase of 20 to 30 percent in total factor productivity was found to exist almost immediately after deregulation, according to USDA analysis.

Another question is whether such productivity gains are real and sustainable. And do they compromise food security? These are valid concerns which are not readily answered by available evidence from the U.S. or elsewhere.

In New Zealand, the short- and longrun deregulation issues have raised fundamental questions as to the appropriate government response. With increased trade and pressure to conform to new trade agreements, many countries must balance internal assistance with external trade considerations. For example, what nongovernmental means are available and could be fostered? If government programs are called for, how can they be made to be production-neutral or more conservation-based, and foster sound technological innovation and adaption? Policy makers in New Zealand have addressed these issues through a combination of low direct government intervention in production, freedom for producers to actively engage in marketing boards, and more reliance on the world market.
[Felix Spinelli (301) 436-8685] AO

Senator LUGAR. The decline occurred all at once and the mistake the New Zealanders made was there was no glide path, there was no gradualism. Essentially, output has been fairly level since 1986 in New Zealand, just for the record, the last 10 years. And furthermore, New Zealand income has increased. And so the deregulation was a success.

I think that needs to be said for the record, but people can come to their own interpretations, reading from the USDA publication.

Senator GRASSLEY [presiding]. Senator Abraham.

Senator ABRAHAM. Thank you very much, Mr. Chairman. I would just like to begin by echoing the point that Senator Grassley made earlier with respect to Senator Lugar's willingness to come forward here and present us with an obviously very courageous proposal, particularly in light of the economic composition of the State of Indiana.

I would also echo what Senator Grassley said with respect to singling out just one area. I am not, on this committee, planning to just limit the scope of what we might do to one sector of this economy and I hope other committee chairs will come forward. I am not going to limit my scope to just agriculture.

If we are going to, in any sense, reduce programs and entitlement areas and so on, I think it needs to be more comprehensive.

But let me just sort of share what I am picking up in the State of Michigan and admittedly it is a different agricultural State than some of the others that are reflected here. It is certainly different than North Dakota and Iowa in terms of the percentage of our economy that is agricultural. But it is a diverse State agriculturally, as well. I mean, we lead the Nation in six or seven crops, we are in the top 10 in a number of crops. But it is also too cold to produce a lot of the crops which are frequently the beneficiaries of programs.

As I have talked to the people who are in the agribusiness of my State, essentially they say two things. They are willing to see reductions in some programs if they are only doing their fair share. They do not expect or want to bear a disproportionate burden to the rest of the beneficiaries of government supports programs.

But they also say this to me, Senator Lugar, and I would like your comments. They say that what the farm programs do is certainly helpful to them, but that we could be a lot more helpful if we addressed other problems which make it more difficult for them to be successful. This would be in the areas of regulation and tax policy.

I was wondering if you might comment on some of the kinds of things that you think—I mean, this is not a zero sum situation. The question is can we be doing other things, in terms of deregulation or changes in tax policies, that might benefit farm or more significantly the agricultural community of this country, in offsetting what might happen with respect to the reduction in these programs and what might be some of the ideas?

Senator LUGAR. The Senate Agriculture Committee, following your reasoning, Senator, has held two hearings. One on changes in taxation so that the bottom line, the net income for farmers, might increase. And a second hearing, this past Tuesday, on deregulations, specific ways in which if we can make our choice—

and this crosses more than our jurisdiction—we could make a difference in terms of the bottom line again, income for farmers.

There were very good suggestions given, and I will not try to summarize these because they are extensive. But the point that you make is absolutely vital. I have come before this committee because Senator Domenici, the Chairman, has asked all chairman of committees to take part in what is a very tough job. Either we have a $450 billion cut, which your committee is contemplating and a down payment, or there is no hope of balancing the budget, whatever is going on on the floor at present. The whole credibility of the system depends upon this.

The suggestions I made today at least do, I think, an important job with regard to agriculture, but it is a very small part of that. And in the event that the committee is not serious, or the Senate is not serious, I would suggest that probably there is going to be no change in the Ag budget. The Administration essentially proposed that. It just punted ahead, with no change for a year, and nominally a half a billion without specification after that. That is clearly the easy course. And that is what will happen.

Now either we are serious or we are not. If we are serious, then we are going to have to come up, I think, with cuts of about the size I have suggested. I have done so in two ways.

But to answer your question, Senator, in another way, farmers in my State want to know how we can get more net income, not government payments. And the two are not the same. It comes down to changes in taxation, capital gains taxation, inheritance taxation, income averaging, and certainly a deduction for the self-employed.

Most farmers, we found in our hearing, are paying from $4,000 to $8,000 a family for their medical care with no deduction at all, as opposed to a factory worker who gets this as a fringe benefit. That is a big difference, in terms of net income, and dwarfs whatever we are talking, on a per family basis, the direct government payments from these programs.

Senator ABRAHAM. In a similar sense, is it your conclusion that certain reductions in some of the costs of regulatory burdens would likewise have a greater impact on net farm income than the benefit of these programs?

Senator LUGAR. Yes, they will and this is why more farmers are opting out of the programs annually. They have found that planting for themselves rather than for the government, and not having the onerous requirements, is worth a lot of money to them.

Senator ABRAHAM. My time is up.

Senator GRASSLEY. I have no follow up questions and I thank each of you for your participation. I guess if I would make one comment in closing, I would give just a thought to Senator Conrad, and that would be that in regard to the comparison to Europe. In many meetings that I have over the course of a year with people from European parliaments of the various countries, I do not believe I have visited with a one about agriculture where they do not say that they have a tremendous problem. And I think they mean a budget problem.

They have to deal with it, and I think it is their intention to deal with it. When you see the common agricultural program become 70 percent of the European budget—and I do not know whether it is still 70 percent, but I know it got up to 70 percent—you know they have a tremendous problem. Sometime the budget constraints on their economy and their food security, as they get out of the World War II state of thought on food shortages, I think you are going to see some changes in their policies.

Senator CONRAD. Might I just respond by saying, Senator, that this reminds me somewhat of what we faced with the Soviet Union militarily. There we had a confrontation, as well. What did we do? Did we, in anticipation of their cuts, cut back ourselves? No, that is not what we did. We kept the pressure on because we understood that we were in a very serious global competition.

I think the same is true in agricultural. We are in, as you know so well, we are in a fierce battle for agricultural markets and our competition intends to win that battle and they are spending much more than are we, in terms of support for their producers. I think it would be a profound mistake for us to engage in unilateral disarmament with respect to this battle for world agricultural markets.

Senator LUGAR. Senator, let me just comment that the battle will be won by the low cost producer of high quality produce, not by export subsidy. Saudi Arabia once subsidized wheat farmers $14 a bushel to prove that wheat could be produced in the desert, which it could be. And they have cut that out for the reasons the Chairman has suggested. It is a budget buster.

The Europeans paying $9 subsidy for a bushel of wheat and world price at $3 or $4 are running out of money. And they will change. To suggest that we ought to have an SDI with Ag policy to overwhelm our adversary, it seems to me, is not logical and certainly within the purview of this committee as it is trying to cut $450 billion.

Senator GRASSLEY. Thank you, and I will call the next witness. Secretary Rominger, please come to the witness table and please bring any of your staff that you want to and I would receive your testimony. Hopefully, I am not the only one to receive it, because it is very important testimony.

Before you start, Secretary Rominger, there will be permission given by the Chair for witnesses, including yourself—and hopefully the previous witnesses as well—to respond to questions in writing that may be submitted to them and to you. Would you proceed, please?

STATEMENT OF HON. RICHARD E. ROMINGER, ACTING SECRETARY OF AGRICULTURE, U.S. DEPARTMENT OF AGRICULTURE

Acting Secretary ROMINGER. Thank you, Mr. Chairman. As far as other members of my team, I will invite them up if I get some questions that I need more detailed answers on.

I am here to talk about the programs in the budget of the Department of Agriculture, and I will focus on the entitlement programs of the Department and their relation to the budget.

The Department of Agriculture administers two major entitlement programs. One is the Commodity Credit Corporation (CCC) price and income support programs for farmers that you have been talking about this morning. And the second is the nutrition assistance programs which provide the food stamps and school meals.

USDA's budget is dominated by these large entitlement and mandatory spending programs, some of which have grown faster than most of USDA's discretionary programs. Of the roughly $60 billion in outlays for the Department, approximately 70 percent is entitlement spending with the balance for the discretionary programs which include food safety, rural development, soil conservation, forestry, marketing and regulatory services and research.

Efforts to reduce the Federal deficit have cut funding for those discretionary programs and now the attention seems to be on how to control the entitlement spending to help reduce that Federal budget deficit. Currently, the domestic nutrition assistance programs account for 57 percent of USDA's budget and that is 80 percent of the entitlement spending. The other big entitlement area, the farm support programs, account for 15 percent of our total budget and 20 percent of our entitlement spending.

The domestic farm commodity price and income support programs are the oldest of the Department's major entitlement programs. They were established in the 1930's, as we heard this morning, to address farm economic problems, especially severe during those Depression years. The problems included risks of unstable production and market conditions and low prices and incomes.

These same problems, risk and instability in the farm sector, are still with us today. These traditional farm programs are financed through the Commodity Credit Corporation. A majority of the domestic price and income support programs are entitlements in which all producers who meet certain requirements can voluntarily participate and receive benefits, for example, producers who comply with acreage restrictions and conservation compliance requirements.

What makes these programs unique among entitlement programs is the highly uncertain level of the payments that will be received. The extreme variability in CCC outlays reflects the wide fluctuations in global agricultural commodity markets and commodity prices.

CCC outlays during the 1980's reached historically high levels because of the farm policy and changing world economic conditions which led to the worst farm financial crisis since the 1930's. During most of the years from the 1930's until the early 1980's, CCC net outlays ranged from less than $1 billion—or even net receipts for some years—up to $6 billion in nominal terms.

The 1970's saw low CCC outlays as exports grew rapidly and market prices were high. But that situation changed abruptly in the early 1980's as export markets collapsed. CCC outlays then peaked at nearly $26 billion in fiscal year 1996.

So the experience over the past decade-and-a-half should remind both farmers and policymakers that agriculture is a very risky enterprise, difficult to predict and control.

Numerous policy reforms, as well as an improving world economy, have led to the decline in CCC outlays since the mid-1980's. The average annual CCC outlays are currently projected to decline from $16 billion for the period of 1986 to 1990 to $11 billion for the period from 1991 to 1995 and to less than $8 billion for the period of 1996 to 2000 with no change in current law.

The decline in outlays since the mid-1980's reflects the market oriented program reforms that were included in the Food Security Act of 1985, as well as a reduction in payment rates, mandated marketing assessments, land retirement under the CRP, and other provisions of the FACT Act of 1990 and the Omnibus Budget Reconciliation Act of 1990. Additional cost reduction reforms were also enacted in Budget Reconciliation and other legislation of recent years. For example, the Wool and Mohair Program will terminate after 1995.

Budget estimates for the out-years also reflect significant demand for farm products from expanding world income, growth in United States demand for food and industrial products, such as ethanol, and new trade opportunities from NAFTA and GATT.

Also, there will be reduced spending for ad hoc disaster assistance as crop insurance reform is implemented for the 1995 crop. And finally, there will be additional Conservation Reserve Programs sign-ups and extension of existing contracts that will not only benefit the environment but will strengthen crop prices and reduce spending for price and income support programs.

The 1996 budget does not include specific Farm Bill proposals for the commodity price and income support programs. However, the President is recommending a reduction of $1.5 billion in CCC outlays to be taken over the 3-year 1998 to 2000 period. Specific measures to achieve those targeted savings will be proposed later, and we will work with the Congress in the Farm Bill process to identify what those should be.

Some have questioned whether savings have been achieved, since CCC outlays in the 1990's have not declined to the levels estimated at the time the FACT Act of 1990 was enacted. However, the policy reforms in the 1985 and 1990 farm bills, the budget reconciliation acts and other recent legislation have clearly reduced budget exposure. So, reductions must be measured against what outlays would have been without the reforms, not against the projections that were made in 1990. The declines in actual outlays since the early and mid-1980's are clear evidence of reform.

With regard to legislation in 1990, which was a combination of the FACT Act and the Omnibus Budget Reconciliation Act, commodity program outlays were projected to decline by $11 billion over the period from fiscal year 1991 to 1995. Recent analysis has indicated that without the provisions of the 1990 Acts, spending during 1991 to 1995 would have totaled $10 billion more than has been the case.

In other words, savings near the estimated levels were achieved even though actual total net CCC outlays did not decline to the absolute levels expected in mid-1990. I think this is not unexpected, given the role of these programs. Events not projected in the 1990 Farm Bill baseline added to those total outlays in that period. Those events included such things as the collapse of cotton prices in the early 1990's, record crop yields in 1992 and 1994, Iraq's default on export credit, and the appropriation of ad hoc disaster assistance totaling $5.7 billion among other unforseen changes.

Changes in the program since 1981 show dramatic reductions in the government's budget exposure for farm programs. For example, a typical corn producer today receives deficiency payments roughly one-third the level they would be without the reforms, based on changes in program provisions since the 1981 Farm Bill, that include a decline in target prices, reduced payment acres, as well as frozen program yields.

So the declining trend in outlays, the analysis of the potential outlays had policies not been changed, and a review of the changes in the program provisions all show clearly that substantial changes have been made over the past several years to reduce both budget exposure and producer dependence on the programs. So the farm support programs, I believe, are prime examples of real spending reductions in the entitlement area in recent years.

I could talk for a few minutes about the nutrition programs if you would like to, or I could skip over those today. What is your pleasure, Mr. Chairman?

Senator GRASSLEY. Since it will be the only time you will be testifying probably before this specific committee, if you would touch on your key points that you want to make.

Acting Secretary ROMINGER. I have submitted testimony for the record so I could skip it here in my oral comments if you would like.

Senator GRASSLEY. Then I would like to have you skip it there. Is there any other——

Acting Secretary ROMINGER. I did just have a few other comments.

Senator GRASSLEY. Did you have some comments on CRP?

Acting Secretary ROMINGER. I did have some on the discretionary programs. I will cover those and then we can get to questions on CRP and others.

The discretionary programs make up about one-quarter of the Department's budget in terms of outlays but account for the bulk of the Department's staff years. Under our reorganization and streamlining of USDA agencies, we have reduced the number of agencies from 43 to 29. Along with restructuring headquarters and field offices, one stop field service centers will be established as nearly 1,200 field officers are closed or consolidated.

These actions will be a major source of savings for the Department as Federal employment will be reduced by more than 13,200 staff years over the 1993 to 1999 periods. Savings of $2.8 billion in personnel costs and $1.3 billion in other administrative costs by 1999 will bring total savings to $4.1 billion. These are discretionary savings.

In addition to these initiatives, the 1996 budget for discretionary programs reflects the Administration's commitment to fund the Reformed Crop Insurance Program, to invest in the future of rural America, provide for safer food through a pathogen reduction program, to meet our GATT export subsidy reduction commitments, and to invest in new export sales opportunities, and to provide additional funding to support higher participation in the WIC Program.

USDA will also invest in the environment through a modified and extended Conservation Reserve Program and a larger Wetlands Reserve Program. So, the funding priorities in USDA's 1996 budget request promote economic opportunities and preserve our commitment to the Nation's farmers, rural citizens and the needy.

In conclusion, I know that there is going to be intense debate on these entitlement programs in the Farm Bill, as well as in the budget reconciliation process. I think this debate will show how important the agriculture sector is to our globally linked economy. I think that has been demonstrated by the previous witnesses.

While the number of farms is dropping, our food and fiber system generates nearly $1 trillion in economic activity each year, generating 16 percent of our gross domestic product and accounting for one out of every six jobs.

We all know it also makes a very important positive contribution to the Nation's balance of trade, about $17 billion in 1994. For consumers, it provides a steady, abundant, wholesome and low cost food supply unequaled anywhere in the world. Our percentage of income being spent on food is continuing to decline.

Yet in spite of all these positive contributions and even though farm support payments constitute less than 1 percent of the Federal budget, and even though Farm Program spending has dropped dramatically, I think there is still some misunderstanding. Should agriculture assume even more responsibility for deficit reduction? An economically healthy farm sector provides significant benefits to the rest of the economy. Our farm bill and budget decisions will have a significant impact on the economic well-being of our farmers, agricultural output and marketing industries, rural communities and consumers, especially our lower income consumers.

So these broad economic policy implications are crucial as we craft farm and food policy for this country while also dealing with the Federal budget deficit.

That concludes my statement, Mr. Chairman, and I am ready for questions.

Senator GRASSLEY. Thank you very much.

[The prepared statement of Secretary Rominger follows:]

Statement by
Richard Rominger
Acting Secretary of Agriculture
Before the Committee on the Budget
United States Senate
February 16, 1995

Mr. Chairman, Members of the Committee, I am here today to discuss the programs and budget of the Department of Agriculture. I will focus my comments largely on the entitlement programs of the Department and their relation to the budget.

The Department of Agriculture is responsible for administering two major entitlement program areas. These are: (1) the Commodity Credit Corporation (CCC) price and income support programs for farmers, and (2) the nutrition assistance programs which provide food stamps and school meals to the needy. These programs are classified as entitlements because statutory provisions legally obligate the Federal government to make specified payments to any person who meets the eligibility requirements established by the law. The nutrition assistance programs are, however, subject to annual appropriations and the cost of the benefits provided may not exceed the amounts appropriated for the programs.

Before I discuss the specifics of these programs, I would like to make some general comments about the make-up of the Department's budget. USDA's budget is dominated by a small number of large entitlement programs, some of which have grown faster than the majority of USDA's discretionary programs. Of the roughly $60 billion in outlays for the Department, approximately 70 percent is entitlement spending with the balance being devoted largely to a wide range of discretionary programs including food safety, rural development, soil conservation, forestry, marketing and regulatory services and research. Recent efforts to reduce the Federal deficit have sharply constrained the funding for discretionary programs, and now the attention seems to be on how to control entitlement spending in order to reduce the Federal deficit.

Currently, the domestic nutrition assistance programs account for 80 percent of our entitlement spending and 57 percent of USDA's budget. The other big entitlement area -- farm support programs -- accounts for 20 percent of our entitlement spending and 15 percent of the budget.

COMMODITY PRICE AND INCOME SUPPORT PROGRAMS

Background

The domestic farm commodity price and income support programs are the oldest of the Department's major entitlement programs. They were established in the 1930's to address farm economic problems which were especially severe during the depression years. The problems included risks associated with unstable production and market conditions and relatively low prices and incomes.

These traditional farm programs are financed through the Commodity Credit Corporation (CCC), which is a wholly-owned Government corporation first created in 1933 to stabilize, support, and protect farm income and prices. CCC cash outlays are for commodity loans; commodity purchases and storage; direct payments under deficiency and diversion programs; and management of programs and inventories.

CCC's responsibilities also include export activities such as export credit and subsidy programs, as well as direct export sales and disposition of CCC-owned commodities. While the export programs are not entitlement programs in the sense that many of the domestic commodity programs are, they are an integral part of the CCC's activities to stabilize, support and protect farm income and prices. For this reason, it is more useful to discuss net outlays for CCC as a whole rather than just for the domestic component.

The major programs financed by CCC are carried out under the provisions of commodity price and income support or other authorizing legislation. There are a number of primary statutes for these programs such as the Agricultural Adjustment Act of 1938 and the Agricultural Act of 1949 which are amended and supplemented by periodic "farm bills" such as the Food, Agriculture, Conservation, and Trade Act of 1990 (the 1990 Act) and other legislation such as the Omnibus Budget Reconciliation Act of 1993.

The majority of the domestic price and income support programs are entitlements in which all producers who meet certain requirements can voluntarily participate and receive benefits. For example, producers must comply with various acreage restrictions and conservation compliance requirements to receive benefits. What makes these programs unique among entitlement programs is the highly uncertain level of payments received. The largest portion of CCC outlays in recent years has been for deficiency payments which are determined by the difference between statutorily established "target" prices and average market prices or established price support loan rates if the loan rates are lower. Thus, the deficiency payment rate is dependent on market prices which are uncertain at the time the producer signs up to participate in the programs. For example, the corn target price is $2.75 per bushel and if the average market price for the corn crop is expected to be $2.50 at the time of signup, the producer will expect a deficiency payment of $.25 per bushel on eligible production (payment acres times established payment yield). A change of only $.05 per bushel or 2 percent in the actual price of corn could change the deficiency payment rate by $.05 or 20 percent of the expected level -- and change CCC outlays by $250 million. This illustrates why CCC outlays are so difficult to predict.

The extreme variability in CCC outlays reflects the intended role of these programs to buffer farm income from the effects of wide fluctuations in global agricultural commodity markets and commodity prices. The continuing problems of risk and instability are one aspect addressed by these programs which has not changed dramatically since the 1930's. While producers now have other means to reduce risk, such as through the futures markets, these practices are not in widespread use.

It is difficult to predict CCC outlays accurately because they are heavily influenced by weather, pest and disease outbreaks, and other events here in the U.S. or overseas that affect the amount of the commodity available, thereby affecting commodity prices during the

2-year period between preparation of the budget estimates and determination of actual outlays at the end of the fiscal year. The current 1996 budget estimates for CCC, for example, largely reflect supply and demand conditions for the 1995 crop, most of which has not yet been planted. Given the difficulty of predicting actual outlays and appropriating funds in advance in amounts which correspond to actual needs, CCC borrows funds from the U.S. Treasury and repays these borrowings, with interest, from receipts and from annual appropriations provided by Congress to reimburse CCC for any realized losses. The CCC outstanding borrowings from Treasury may not exceed $30 billion at any one time.

Trends in CCC Spending

Because of the year-to-year variability, a review of farm program spending over longer time periods may be more informative than year-to-year comparisons. Changes in economic conditions, legislative or administrative policy, and other events affecting outlays need to be taken into account in any comprehensive review.

CCC outlays during the 1980's reached historically peak levels because of a combination of events in farm policy and changing world economic conditions which led to the worst farm financial crisis since the 1930's. During most of the years from the 1930's until the early 1980's, CCC net outlays ranged from less than $1 billion, or even net receipts for some years, up to $6 billion in nominal terms. Net outlays during the 1950's and 1960's reached then record levels. However, these were exceeded during the mid-1980's when the historical peak of nearly $26 billion was reached in fiscal year 1986.

During the 1950's and early 1960's the farm programs were designed to provide relatively high price support levels which kept domestic market prices high and tended to insulate the farm sector from world markets. During the 1970's, export market opportunities substantially increased and farm programs were adjusted to permit the growth of an export dependent farm sector. The dominant policy concerns in some years were shortages and high consumer prices rather than surpluses and high program costs. During much of this period, CCC outlays were low as increased exports kept market prices high. By the late 1970's inflation was soaring at double digit levels, farm exports were growing as a result of a historically weak dollar, and farm production costs were rising. Real interest rates were low and farmland prices were bid up rapidly.

It was this environment which led to the enactment of the Agriculture and Food Act of 1981 (the 1981 Act) which provided a rising safety net of target prices and price support levels. Unfortunately, as we now know, a major worldwide recession dramatically reduced export demand in the early 1980's. This, along with sharp changes in monetary policy to bring inflation under control, combined with record crop production to precipitate massive economic and financial problems in the farm sector in the 1980's. The rigid high price support levels specified in the 1981 Act prevented prices from adjusting to the new circumstances and encouraged expanded production overseas. The government accumulated large surpluses and CCC costs mushroomed. The farm sector has been gradually recovering from the shocks of the early 1980's ever since. Numerous policy reforms, as well as an improving world economy have led to the decline in CCC outlays since the mid-1980's. But the experience of the past decade and a half should remind both farmers and policymakers that agriculture is a very risky enterprise, subject to many factors difficult to predict and control.

Reduction in Budget Exposure

Average annual CCC outlays are currently projected to decline from $16 billion for the period 1986-1990 to $11 billion for the period 1991-1995, and to less than $8 billion for the period 1996-2000 with no change in current law (See figure 1). The decline in outlays since the mid-1980's reflects the market oriented program reforms included in the Food Security Act of 1985 (the 1985 Act), as well as the reduction in payment acres, increased marketing assessments the addition of the Conservation Reserve Program, and other provisions of the 1990 Act and the Omnibus Budget Reconciliation Act of 1990 (the 1990 Budget Reconciliation Act).

Spending has also been reduced as a result of target price reductions and other adjustments included in budget reconciliation legislation in 1987 and 1989. Legislation in 1993 phased out the wool and mohair program and provisions in the 1993 budget reconciliation legislation reduced payments on idled acreage devoted to conservation uses. Budget estimates for the out-years also reflect significant growth in demand for farm products, expanding world income, growth in U.S. demand for food and industrial products, such as ethanol, and new trade opportunities related to the recent enactment of legislation implementing the North American Free Trade Agreement and the Uruguay Round Agreement on Agriculture negotiated under the auspices of the General Agreement on Tariffs and Trade (GATT). Finally, additional signups and the extension of existing contracts under the Conservation Reserve Program, will benefit the environment, strengthen crop prices and reduce spending for price and income support programs.

While budget and program initiatives have reduced spending for CCC programs, outlays for the programs remain subject to fluctuations that are impossible to predict or control with certainty. However, this does not alter the conclusion that CCC program outlays have been substantially reduced by the reforms mandated by legislation over the past several years. Without doubt, actual and projected CCC outlays are considerably less than what they would have been had the policies of the early and mid-1980's continued without modification.

Some have questioned whether savings have been achieved since CCC outlays in the 1990's have not declined to levels estimated at the time that the 1990 Act was enacted. And others note that CCC net outlays, while lower than during the 1980's, are not substantially below other earlier peak levels of the 1950's and 1960's adjusted for inflation. However, the policy reforms in the 1985 and 1990 Acts, the budget reconciliation acts, and other recent legislation such as lower target prices and payment acre base have unquestionably reduced budget exposure. Reductions must be measured against what outlays would have been without the reforms, not against projections made in 1990. The declines in actual outlays since the early and mid-1980's are also clear evidence of reform.

With regard to the 1990 legislation, the combination of the 1990 Act and the 1990 Budget Reconciliation Act was projected to reduce commodity program outlays by $11 billion over the period FY 1991-1995. Outlays were projected to decline from a 5-year total of $54 billion, based on the 1991 Mid-Session Review (done in June 1990) which assumed extension of the 1985 Act. The 1996 budget baseline projects commodity spending will total $57 billion during FY 1991-1995, $3 billion over the 1991 Mid-Session baseline. However, without the provisions of the 1990 legislation, recent analysis has indicated that spending during FY 1991-1995 would likely have totaled $10 billion higher than has been the case. In other words, savings near the $11 billion level projected in 1990 were achieved even though actual total net outlays did not decline to the absolute levels projected in mid-1990. This is not unexpected given the role of these programs. Events not projected in CBO's baseline (or USDA's baseline for that matter) in 1990 such as a collapse in cotton prices in the early 1990's, yields far above previous record levels for a number of crops in 1992 and 1994, Iraq's default beginning in 1990 with respect to GSM export credit guarantees, and the appropriation of *ad hoc* disaster assistance totalling $5.7 billion, among other changes, added to total outlays in this period.

A look at changes in programs since 1981 clearly shows the dramatic reductions in the Government's budget exposure for farm programs. For example, corn target prices have been reduced from $3.18 per bushel in the 1981 Act to $2.75 per bushel today, while maximum payment acreage has been reduced from 100 percent to 85 percent of eligible base acreage and farm program payment yields have been frozen at the levels of the early 1980's. A typical corn producer today has a payment yield of 105 bushels per acre -- far below the level of about 125 bushels per acre it would be today had payment yields not been frozen. The net effect of these changes made by the 1985 and 1990 legislation is that, given recent price projections and ignoring other effects, corn deficiency payments for a typical producer today are roughly one-third the level they theoretically would be under the provisions of the 1981 Act. These comparisons are even more dramatic if the effects of inflation are accounted for since inflation has reduced the real value of the deficiency payment by nearly 40 percent since 1981. In real terms, today's corn producer receives only about 25 percent of the level of deficiency payments that would have been received under the original terms of the 1981 Act. So clearly substantial changes have been made over the past several years to reduce both budget exposure and producer dependence on the programs.

Farm support program outlays will average about 0.6 percent of total Federal outlays during the 1990's down from 1.5 percent in the decade of the 1980's and the 2.0 percent average of the 1950's and 1960's (See figure 2). The farm support programs stand out as a prime example of where there have been dramatic real spending reductions in the entitlement area in recent years.

1996 Budget

For the near term, CCC net outlays are projected in the 1996 budget to increase slightly from $10.3 billion in 1994 to $10.6 billion in 1995, and to decline to $9.1 billion in 1996. Further reductions are projected in the outyears, to just over $6 billion by the year 2000 (See figure 3). Reductions are projected because of estimated strong demand, and because of the Administration's action to extend and modify CRP contracts. While the CRP will cost roughly $2 billion per year, the resulting reduction in crop acreage in production will raise prices and as a result will reduce estimated CCC payments. In 1995, the higher outlays for feed grains due to the record crop yields in 1994 are largely offset by lower outlays for the cotton program and for disaster assistance. For 1996, the projected decline in outlays reflects lower costs for the feed grain program as yields in 1995 are estimated to return to more normal levels, as well as reduced spending for *ad hoc* disaster assistance as crop insurance reform is implemented effective with the 1995 crop. The Federal Crop Insurance Reform Act of 1994 has made future *ad hoc* crop disaster assistance funded by CCC very unlikely since such assistance would now be subject to PAYGO requirements.

The budget does not include specific Farm Bill proposals for the commodity price and income support programs. However, the President is recommending a reduction of $1.5 billion in CCC outlays to be taken over the 3-year 1998-2000 period. Specific measures to achieve these targeted savings will be proposed at a later date.

Now I would like to address our other important entitlement program areas -- the nutrition assistance programs.

NUTRITION ASSISTANCE PROGRAMS

Background

USDA's nutrition assistance programs serve a dual mission: getting food to people who need it, and strengthening our agricultural economy. Over their fifty year history, the programs have successfully accomplished these missions.

The Nation's food and nutrition programs provide a network of federal nutritional support, built over half a century, including the Child Nutrition Programs, the Special Nutrition Program for Women Infants and Children (WIC), the Food Stamp Program and other smaller programs.

The original mission of USDA's nutrition programs was to achieve specific health outcomes by preventing hunger and promoting good nutrition. It is not often recognized just how successful these programs have been in improving the health of Americans -- particularly low-income Americans. Since the nationwide expansion of the Food Stamp Program and the introduction of WIC, the gap between the diets of low-income and other American households has narrowed. The proportion of low-income households with diets that met 100 percent of the Recommended Dietary Allowances (RDAs) for 7 key nutrients grew at double the rate of the general population over this period.

USDA programs have also improved the health of our nation's children. The incidence of growth stunting has decreased by nearly 65 percent -- falling from 22.8 percent of all preschool children in the period 1974 to 1976, to just 8 percent in 1992. Similarly, the prevalence of low birthweight babies dropped dramatically -- from 8.3 percent of all live births in 1965-66, to 7.0 percent in 1990. The prevalence of anemia in low-income preschool-aged children dropped by 5 percent or more for most age and racial/ethnic groups between 1980 and 1991. We are committed to building on these achievements.

The challenges that both this Administration and this Congress face are to change, improve and reform our nutrition programs, to make them more cost effective and more responsive to the needs of states and recipients alike, while at the same time building on the significant health and nutrition gains they have already achieved. While putting people to work is an appropriate measure of success for most income security programs, improved health and hunger prevention should be the measures of success for nutrition programs. Overall, nutrition assistance program goals are complementary, and related, but different.

Among our nutrition programs, the two that operate like entitlements are the Food Stamp Program and the Child Nutrition Programs.

An important feature about both these programs is that they automatically expand when needed to reflect economic changes. For example, between 1990 and 1994, the number of meals served at the free rate in the school meals program rose by 23 percent, from 9.9 million to 12.2 million, due to the recession and rising rates of childhood poverty. Similarly, between 1990 and 1994, the number of Food Stamp participants rose 37 percent. Because of their funding structure, the programs were able to adjust to meet this growing need, and support consumer demand, important to eventual economic recovery.

Food Stamp Program

The Food Stamp Program is the primary source of nutrition assistance for low-income Americans. The program was initiated in 1961 as an eight-state demonstration. By 1964, it had proven so successful that it was established as a permanent program that any State in the nation could administer. By the mid-1970's, food stamps had supplanted commodity distribution in virtually every state and jurisdiction in the country. It was refined via the in the Food Stamp Act of 1977, the statutory basis of the program today. The program is reauthorized every 5 years as part of the Farm Bill and it is funded by direct appropriation.

The mission of this nutrition security program is to assure access to a nutritious, healthful diet for low-income Americans through food assistance and nutrition education, thereby strengthening the food and agriculture economy. Assistance is provided to eligible households to enable them to obtain a better diet by increasing their food purchasing capability. The program is a federal-state partnership, with the Federal government paying the full cost of food stamp benefits and approximately half the cost of states' administration of the program. States certify eligible households, and issue benefits.

Any household that applies and meets the income and low asset standards is eligible to receive benefits. The income standards are the basic Federal poverty guidelines, which are revised annually to account for inflation. The maximum benefit for a family of 4 was $375 per month in 1994; the average monthly per person benefit was $69.01. Household benefits are based on the number of persons in the household, their available income and the Thrifty Food Plan, a market basket of low-cost food, sufficient to feed the household. While food stamp benefits are adjusted annually to account for inflation, the Thrifty Food Plan needs to be updated to reflect the contemporary nutrition standards of the Dietary Guidelines of Americans. Integrating nutrition into the program is one of the Department's priorities for the coming years.

The Food Stamp Program currently serves approximately 11 million households. More than 80 percent of these households contain children, elderly or disabled; 91 percent are below poverty and 40 percent receive AFDC. About 51 percent of participants are children; 28 percent are women between 18 and 59; 13 percent are men between 18 and 59; and 7 percent are elderly. Data also show that about 20 percent of food stamp households have earnings from work and many more are between jobs; the Food Stamp Program is an important source of nutritional support for our nation's working poor. USDA data suggests that approximately half of those who go on the program in a given month go off within six months; two thirds go off within a year.

Total Federal costs for the Food Stamp Program were just below $600 million in 1970. By 1978, when it was a full nationwide program, costs had grown to $5.5 billion. Weakening economic conditions and implementation of the 1977 Food Stamp Act reforms led to a $9.2

billion program in 1980. By 1990, the Federal share of the program was $16.9 billion and our request for 1996 is $27.3 billion. Program costs were level in the early 1980's after cuts were made in eligibility and benefits in the 1981 Omnibus Budget Reconciliation Act (OBRA). However, in the late 1980's additional changes were made including raising benefit levels by 3 percent in real terms via the enactment of the Hunger Prevention Act of 1988 and the Mickey Leland Acts of 1990 and 1993. In recent years, the President has requested a $2.5 billion reserve, an amount in addition to the program level request. For example, the $27.3 billion in 1996 would be supplemented by such portion of the $2.5 billion reserve as is needed to assure that supplemental funds will not need to be appropriated on an emergency basis late in the year if the cost estimate proves to be too low.

Program participation over the years has varied in concert with persons living in poverty, and is also related to the number of unemployed (See figure 4). We currently see program participation remaining around 27 million persons through the year 2000. Since food cost inflation is projected to be 2 to 3 percent a year, the program is projected at about $30 billion in the year 2000.

While the President's 1996 Budget does not propose major funding changes, USDA will shortly present proposals to improve the Food Stamp Program. These proposals grow out of a year-long, thorough review of the program -- its successes and shortcomings. Our proposal will provide for nutrition security, improve program integrity, modernize benefit delivery, expand State flexibility, ensure economic responsiveness, and promote personal responsibility.

We have already begun to make some of these changes. For example, we are working together with States so that by the end of 1996, nearly all States will be at some stage of development for electronic benefits transfer (EBT), a single card, user friendly, uniform benefit delivery system. Through EBT, a greater emphasis will be put on State/Federal coordination of programs and benefits, with attendant improvements in efficiency. EBT reduces the diversion of food stamp benefits from the purchase of food by eliminating cash change. Moreover, it provides an effective tool for targeting -- and potentially reducing -- Food Stamp trafficking activity. It provides data on transactions that is amenable to analysis to detect trafficking and diversions.

We are also working on changes to ensure that only legitimate food concerns are authorized to redeem food stamps. And we are working to increase penalties for stores and recipients who abuse the program. For example, authority is needed to immediately suspend retailers once illegal food stamp trafficking has occurred, and to impose forfeiture penalties on those who abuse our program.

Further, we have also begun a major integrity initiative to get the states to make more precise benefit determinations and to cut payment error from its current levels. A recent conference "Managing for the Public Trust", sponsored by USDA/FCS, brought together State welfare Commissioners and program administrators to discuss the need to better control payments.

Our reform proposals will change the program for the better; for example, by changing the delivery system and integrating nutrition into the program, we could transform the 30-year old Food Stamp Program into a national nutrition security program that provides administrative flexibility and meets the nutrition needs of the next century.

Child Nutrition Programs

The purpose of the Child Nutrition Programs: the National School Lunch, School Breakfast, Summer Food Service and Child and Adult Care Food Programs; is to assist state and local governments in providing food services that serve healthful, nutritious meals to children and other dependent citizens in public and non-profit private schools, child care institutions, day care centers for impaired adults, and summer recreation programs in low-income areas.

Together, the programs have helped children for nearly half a century. The School Lunch program was established in 1946. The Special Milk Program, initiated in 1955, is available for children who do not have access to another Child Nutrition Program. The School Breakfast Program was authorized as a pilot by the Child Nutrition Act of 1966, and was made permanent in 1975. The Child Care Food Program, initiated in 1968, serves predominantly pre-school children with working parents. In 1969, the Summer Food Service

Program was established to provide poor children access to nutritious meals during the summer when they were not in school.

To operate these programs, FCS provides the States with cash and commodities on a per-meal basis to offset the cost of food service, and with cash to offset a portion of State and sponsor administrative expenses and to provide training and technical assistance and nutrition education. The statute provides that these meal rates be adjusted annually based on inflation figures for food way from home.

Meal reimbursement payments are made to the States based on the number of meals served times the per meal rate. Meals served to low-income children are reimbursed at a substantially higher rate than meals served to other children, so that low income children may receive free or substantially reduced price meals. Food stamp and welfare program recipients are automatically eligible for free meals. Other households file income eligibility applications so that their children may eat free or at the reduced price.

In 1970, total Child Nutrition Program expenditures, at $700 million, exceeded food stamp expenditures. By 1978, the cost of the Child Nutrition programs was $3 billion. Our 1996 budget includes a request of $7.9 billion for 1996 and we project the Child Nutrition Programs at $10.5 billion in the year 2000. The lunch program has provided around 25 million meals every school day, with about 10 million of them being free meals, with relatively modest variation over the years (See figure 5). However, as I mentioned earlier, since 1990, free meals have grown about 23 percent in response to poverty increases. Overall annual increases of about 1 percent in meals served are anticipated in the School Lunch Program, while School Breakfast and Child Care programs are expected to grow at about 6 percent and 8 percent a year respectively through the year 2000 due to outreach and their large growth potential (See figure 6). Food cost inflation of 2 to 3 percent a year is also anticipated on top of increased participation for these programs. Thus, the overall cost of the Child Nutrition Program is expected to increase by about 27 percent over the period 1996-2000.

While meal reimbursements for the School Lunch, Breakfast, Milk and Child Care programs are permanently authorized, including authority to set nutritional standards and administer the programs, authority to operate the Summer Food Service Program, and to pay a portion of State administrative expenses must be reauthorized every 4 years. This reauthorization is typically called "the Child Nutrition Reauthorization" and gives Congress an opportunity to review and revise Child Nutrition Program statutes for all programs, not just those which expire. Congress just completed the reauthorization process for this 4-year cycle with passage of P.L. 103-448, the Healthy Meals for Healthy Americans Act of 1994. Including necessary reauthorizations, this law directs USDA to have schools "improve their meal service by serving meals that meet the Dietary Guidelines for Americans."

Our efforts to make changes in our nutrition programs began with our Child Nutrition Programs. USDA's School Meals Initiative for Healthy Children, proposed last June, represents the first program-wide reform since the National School Lunch Program was established by President Harry Truman almost 50 years ago. Our proposal will assure that children have access to healthy meals at school. It updates standards so that all school meals will meet the Dietary Guidelines for Americans. Administrative red-tape will be cut. We are also improving the nutrition profile of USDA commodities provided to local school districts as well as enhancing their availability.

Our commitment to program integrity is also demonstrated by our activities in our Child Nutrition Programs. For example, when I came to USDA in 1993, the Department had failed to use its powers to suspend and debar unscrupulous processors that fixed prices and rigged milk bids. Over the past two years, the Food and Consumer Service (FCS) has taken an aggressive and proactive stand against these processors. After years of inaction, FCS has initiated 172 bid-rigging cases, and has debarred, suspended or extracted tough settlements from 142 processors that have violated the law.

Mr. Chairman, through our School Meals Initiative, and our proposals for Food Stamp reform, we have demonstrated our commitment to a reform agenda for nutrition assistance programs. Clearly the status quo must be changed, but we believe that block grant proposals, such as those that are currently being discussed, would not achieve the nutrition and health outcomes that our programs have historically achieved, and that are in the national interest. Indeed, a USDA study has shown that block granting nutrition programs as proposed in the House would reduce benefits, eliminate nutrition and other standards, be extremely costly to our farm and food economies, and would result in widely different treatment among States. The Administration opposes block grants for the Nation's nutrition programs.

We believe that food programs can and must adapt to a new vision of food and agriculture policy.

Between block grants and the status quo is a reform agenda for nutrition assistance programs. It is an agenda that meets nutrition objectives, and that measures its success by health and nutrition outcomes. It is an agenda that devolves administrative flexibility to the states. It is an agenda that demands personal responsibility and enforces program integrity.

The Clinton Administration welcomes the opportunity to work with the Members of this Committee to bring about meaningful and lasting change in our federal nutrition programs. We will support changes that preserve those health and nutrition goals that are in the national interest and reform what is out-dated and unnecessary.

DISCRETIONARY PROGRAMS

I would briefly like to make a few comments about the Department's discretionary programs. As mentioned at the outset, these programs make up only about one quarter of the Department's budget in terms of outlays, but they account for the bulk of the Department's staff years. In this regard, I know you are aware of the Department's reorganization and streamlining efforts that we are now undertaking. Under the reorganization, USDA agencies are reduced from 43 to 29. Along with restructuring headquarters, actions are also underway to restructure field offices. USDA one-stop Field Office Service Centers will be established as nearly 1,200 field offices are closed or consolidated. These actions will be a major source of savings for the Department as Federal employment will be reduced by more than 13,200 staff years over the 1993-1999 period. The Department will also achieve a savings of $2.8 billion in personnel costs and $1.3 billion in other administrative costs by 1999 for a total savings of $4.1 billion.

It also should be noted that as part of the President's Reinventing Government Initiative, all Federal agencies are reexamining their mission. This includes: addressing the mission based on "customer" input; asking whether the mission could be accomplished as well or better without Federal involvement; looking for ways to cut costs or improve performance through competition; and ways to put customers first, cut red tape, and empower employees. We are actively participating in this effort and will be keeping the Congress fully apprised of our review.

In addition to these initiatives, the 1996 budget for discretionary programs reflects the Administration's commitment to fully fund the reformed crop insurance program, to invest in strengthening the future of rural America, to provide for safer food through a pathogen reduction program, to meet our GATT trade commitments and invest in new export sales opportunities and provide additional funding to support higher participation in the WIC program. USDA will also invest in the environment through a modified and extended Conservation Reserve Program (CRP) and a larger Wetland Reserve Program. These latter programs are classified as mandatory spending, but appropriations action is required to fund CRP and WRP contracts.

We believe the funding priorities we have identified in USDA's budget request are necessary to promote economic opportunities and to preserve our commitment to the Nation's farmers, rural citizens and the needy.

In conclusion, I know there will be intense debate especially on USDA's entitlement programs in the Farm Bill process as well as in the budget reconciliation process. I believe these debates will show how important the agriculture sector is to our globally linked economy. While the number of farms is declining, our food and fiber system generates nearly $1 trillion in economic activity each year. It generates 16 percent of our gross domestic product and accounts for 1 out of every 6 jobs. It also makes a very important positive contribution to the Nation's trade balance. In fiscal 1994, that contribution reached $17.1 billion and we project a similar level again this year.

Sometimes taken for granted is the contribution it makes to consumers. It provides a steady, abundant, wholesome and low-cost food supply unequalled anywhere in the world. In 1993, as a Nation we spent just over 11 percent of our disposable income on food, down from 13.5 percent in 1980. Of vital importance is the economical food supply, which along with our food assistance programs, helps the well being of our disadvantaged citizens.

Yet, in spite of all of these positive contributions, and even though farm program benefits constitute around one-half of 1 percent of the Federal budget and even though farm program spending has dropped by more than 50 percent since 1986, there is still criticism of these programs. Should agriculture shoulder even more responsibility for deficit reduction? It should be recognized that an economically healthy farm sector provides significant benefits to rural areas and to the rest of the economy. Our Farm Bill and budget decisions this year will have a significant impact on the economic well-being of our farmers, agricultural input and marketing industries, rural communities, and consumers, especially lower income consumers. These broad economic policy implications are crucial as we craft farm and food policy for this country while also dealing with the Federal budget deficit.

That concludes my statement. I would be glad to respond to your questions.

FIGURE 1

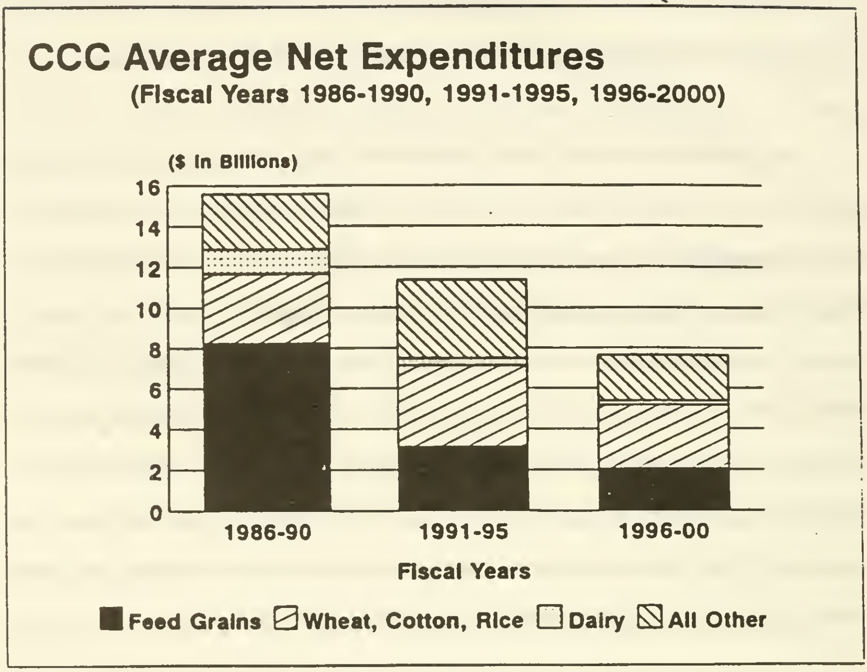


FIGURE 2

CCC Net Outlays as share of Total Federal Outlays
10 Year Averages

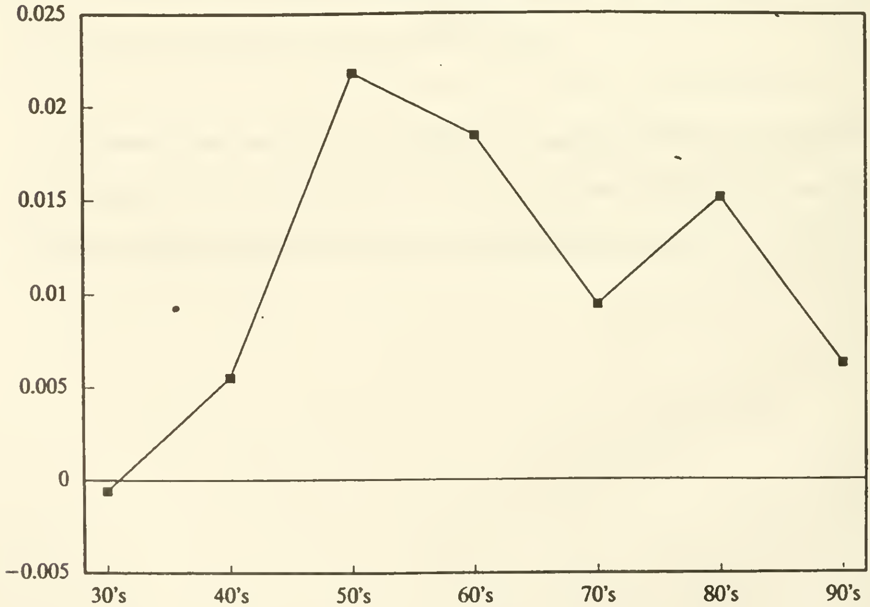


FIGURE 3

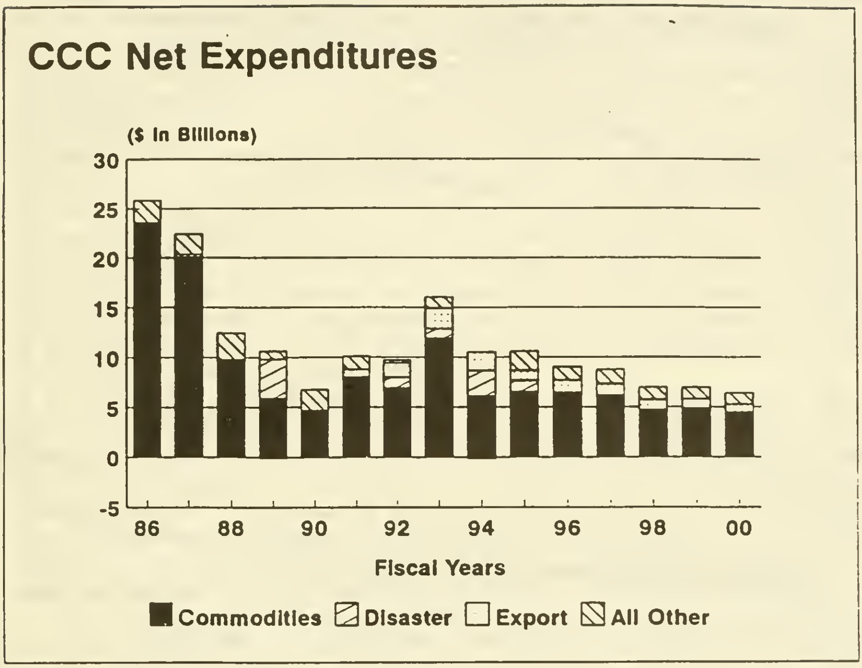


FIGURE 4

FIGURE 5

School Lunch, Breakfast & Child Care Participation

Average Annual, 1970 to 2000

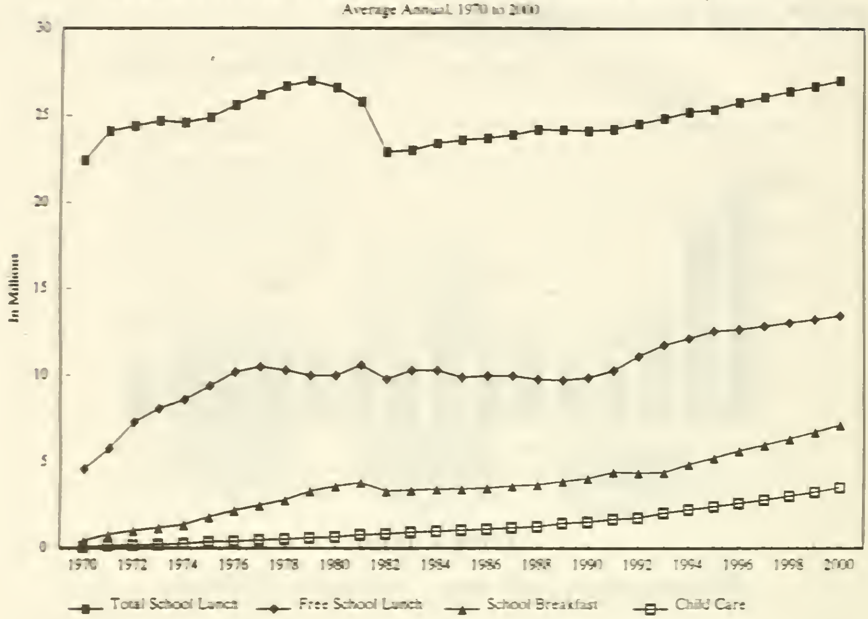
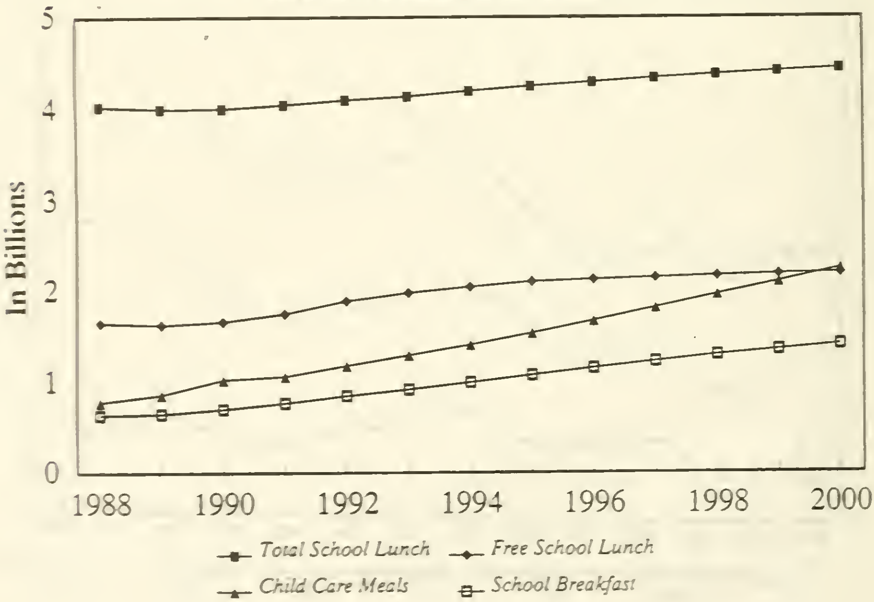


FIGURE 6

Growth of School Lunch, Breakfast and Child Care

Meals Served Annually, 1988 to 2000



Senator GRASSLEY. Before I ask you a few questions, I would highlight something that I agree with you on, and I want to—because I think it gets lost when we talk about agriculture programs costing too much and the reduction of programs. That is the part of your testimony regarding the cuts that agriculture has taken since the mid-1980's. Some argue that the budget cuts made in the 1990 Farm Bill and the budget reconciliation act failed to materialize and I think you have made clear that they have materialized.

Your testimony points out that it is clear that Federal spending on agriculture has decreased significantly due to reforms instituted since 1990. USDA estimates that these reforms have saved the American taxpayers $10 billion in the years 1991 through 1995. No other entitlement program can match that level of savings. Maybe no other entitlement program has saved $1 in that period of time. I do not know that to be fact, but at least proportionately they have not done as well as Agriculture.

Furthermore, since spending on agriculture has declined while the Federal spending as a whole has increased, spending on farm support programs as a percent of the total budget has decreased from what I think is 1.5 percent to, I believe, now .6 percent of the Federal budget. I think this is a very dramatic illustration of how farm programs have been cut disproportionate to other Federal programs, so you are making that very clear, Secretary Rominger. I want to thank you for doing that.

It is my understanding that the projected decrease in spending on feed grains for fiscal year 1996 is due to a return to normal yields and the elimination of ad hoc disaster assistance. Now the President's budget projects spending on these programs to decline by over 25 percent by fiscal year 2002. Since the Administration has not put forth a specific proposal for achieving these cuts, I have three questions I want to ask you all at once.

How much of this decrease do you attribute to the increased demand for feed grains? What is your estimate for the price of corn—I suppose I could ask any commodity, but corn is a big one for my state—by the year fiscal year 2002? And last, how can these prices be realized, given the fact that our foreign trading partners will still be subsidizing exports to a greater degree than we do in the United States?

Acting Secretary Rominger. If I may, Mr. Chairman, I would like to invite Mr. Dewhurst and Mr. Collins to join me here, our budget officer and our chief economist.

It is true that the Administration's budget does show that there will be continuing declines in the spending in the out-years. The first, for 1996, the $1.5 billion reduction that we have anticipated is a result of returning to normal corn crop yields. If we have a normal crop then our expenditures will be down. In addition to that, there are some savings in the Crop Insurance Program. So that is correct.

The reduction in future years is based on the same trends that we talked about before, as a result of the changes that were made in the 1985 Farm Bill, the 1990 Farm Bill, and then as a result of the NAFTA and GATT agreements. We do expect that our exports will increase as a result of these changes, both NAFTA and

GATT. That assumes that we are going to stay in there with the European Community and compete in that export market.

I think we have shown in this year with what we have done with the bonuses, the EEP bonus for wheat in particular, that we're not just dumping wheat on the market. Those EEP bonuses have been coming down dramatically. We are getting down to EEP bonuses of around $10 a ton, where we started out over $40 a ton. So wheat prices have gone up, even though we are using our export subsidy program.

Corn prices, what is the corn price going to be? I guess I had better call on our chief economist to give us his estimation of prices. Keith.

Mr. COLLINS. Thank you. Mr. Grassley, our President's budget baseline projects for the year 2000 a season average corn price of $2.50 a bushel. That compares with $2.30 that we project for 1996.

Senator GRASSLEY. Could I then ask you how you would arrive at a difference, as CBO would project at that year about $2.20, you just said $2.50. What would you see as the difference?

Mr. COLLINS. There are a number of differences between our set of projections and CBO's. First of all, we have a different CRP assumption. We have much more acreage in our CRP by the year 2000 than they do. We have some eastern United States, including corn, base acreage land coming into the CRP, more so than CBO has. So first of all, there is a difference on CRP.

Second, we have a lower stock level to start the the projection period than CBO does. We think that next year, as you indicated, with a return to normal corn yields, that is going to bring corn stocks down by quite a bit. So we think we will have a tight period to begin with, as we look out into the future.

A major difference between our two presentations is in the area of demand for corn for use in ethanol. We believe that with the reformulated gas rule and the 30 percent market share for ethanol in reformulated gas, we see some fairly strong increases in demand for corn grind for ethanol use out over the period. I would say that the difference between what CBO projects and what we project in corn demand for ethanol is roughly 1 billion bushels over the 5-year period. So we have a stronger demand growth, a slightly lower production level than they do, and we have lower stock levels, and so that accounts for the difference in price.

Our average corn price over the 5-year period is about 20 cents a bushel higher than CBO's average price. And as you know, for corn a 10 cent per bushel change in price is equivalent to about $.5 billion in outlays. So it does not take much of a corn price change to get a big outlay difference.

Senator GRASSLEY. My final question, which has not been answered yet, that I gave you is how are you going to do this with the Europeans continuing their subsidy and ours not competing because we have either no subsidy or a very reduced subsidy?

Acting Secretary Rominger. I will start to answer that and then Keith can finish.

We do have, under GATT agreement commitments, a phase-down of subsidies. The Europeans are going to be phasing-down as well. In our budget proposal, the President's proposal, we would keep our Export Enhancement Program to the maximum allowed under

EEP so that we can compete. Even though we had that 12-to–1 differential there, I think we can do a good job of competing in that export market.

Mr. COLLINS. I would only add to that that we are in an advantageous position with respect to the Uruguay Round in feed grains because we do not use the Export Enhancement Program on corn, whereas the European Community will be disciplined, they do not export much corn. They export a lot of barley, and their barley exports will be disciplined. Their export subsidies will be disciplined whereas we are not affected by that discipline because we do not use the Export Enhancement Program on corn. Much of our demand growth is going to come from Asian countries.

Senator GRASSLEY. My last question, though, should not be interpreted just as in regard to corn because they do not—it would be in regard to grains generally. You feel that we can still do that? You were speaking just about corn?

Mr. COLLINS. I was speaking just about corn, yes, sir. I think that we can.

Senator GRASSLEY. But what about what we do compete with them on?

Mr. COLLINS. Take wheat as an example. Over the last couple of years the European Community has exported in excess of 21 million tons of wheat a year. Under the export subsidy disciplines of the Uruguay Round, they will be limited to subsidizing between 13 and 14 million tons a year by the year 2000. The volume constraint is going to bite into their ability to export wheat onto the world market.

As they have to reduce those export subsidies, that is going to provide an excellent opportuity not only for us but for other wheat exporting countries around the world.

Senator GRASSLEY. Senator Brown.

Mr. BROWN. Thank you, Mr. Chairman. I am sorry that our good friend from Washington has left. I know that the Secretary had heard his comments about questioning the farm programs.

I do not want to dwell on it, Mr. Chairman, but I might simply observe this and I hope that the Secretary might comment if he wishes to on it. Part of the reason we need some program here is because of the fact that our competitors in the world have a heavy penalty on American products sold in Europe and other markets around the world.

For most of the last 2 decades the European farmer has gotten more from the sale of wheat than the American farmer has gotten from the sale of their wheat. Let me be specific. The variable import levy levied by the European Common Market takes as much or more than what the American farmer gets for the wheat that is imported. That, at times, has been less but there is a huge tariff that the Europeans levy on American products, corn and wheat, of an astounding portion of the value. And they do that to maintain their artificially high prices.

Japan has likewise levied very huge restrictions on our products. The fact is that we do not have our products sell for good prices. They sell for good prices to the consumer. The fact is the American farmer gets a small portion of it.

At least in my mind, that needs some addressing. Whether you do it through our current programs or not, I think is an open question, and we ought to look for ways to save money. But at least from my point of view, that with the enormous discrimination that takes place against the American farmers in the world markets, we need to be at least thinking about a way to make sure that they are fairly treated.

Mr. Secretary, as we talk about the farm programs and the way to help our farmers, I want to draw your attention to just five things that come to mind and invite you comment on them. Let me introduce this by saying that first, I recognize these problems did not start with this Administration. They have existed with both Republican and Democratic administrations, but I think these are fair.

Number one, the Forest Service is actively involved in a project of stealing Colorado water right now, and that takes place in other places other than Colorado. This is water that is not subsidized by the government. These are water rights that existed before the Forest Service even was in existence. These are efforts that are contrary to the law. These are efforts that are contrary to a direction by Secretary Madigan, when he was Secretary of Agriculture, that has never been repealed.

If the Administration is interested in helping agriculture, stealing Colorado water rights away from farmers who have paid for them and have earned them and pay the full price of operating them, I hope would be looked at.

Second, we now have an active policy of introducing wolves into areas where there is grazing. That makes it difficult to raise lambs and calves, as I know you know. If you are interested in helping agriculture, I would hope you would look at that question of predators that actively harm agriculture.

Third, I do not know if you have had the pleasure of filling out some of those agricultural census reports, but I must tell you I hear from my people all the time. If we are so interested in helping agriculture why do we threaten prison sentences for people who do not fill out the forms?

Fourth, I hear from American producers all the time about strict standards that you insist they comply with in the way crops are grown and treated and the control of chemicals, but that you do not impose, or enforce at least, the same restrictions on imported products. That is, you can use chemicals overseas to produce a product which will reduce the cost of production, but that we do not have an active, thorough program to ensure that the restrictions that exist on American producers are applied to imported products.

Lastly, comments from people who harvest timber in this country, that you have an active policy that discourages production and literally has provided the raw material for forest fires, that you seem in some areas to be following the policy that prefers consumption of those products through fire rather than through an orderly harvesting system.

I understand that covers a lot of area but it outlines a series of policies followed by the Department of Agriculture that are openly hostile to American production, and are harmful to American farmers. I would invite your response, most particularly to the policies that you are following in terms of expropriating water rights.

Acting Secretary Rominger. I will respond to those questions. We are attempting to be a more friendly, farmer friendly department. As you know, I have spent my life as a farmer prior to coming to Washington 2-years ago. I want this to be a farmer friendly Department of Agriculture.

We do have some complicated issues in the area of water rights in the West, not only in Colorado, we certainly have some issues in California, my home State, as well. I will be taking a look at what is happening with the Forest Service there, to see what the situation is, whether it is a different interpretation of the law or exactly what the problem is.

Senator Brown. Mr. Secretary, in that regard—not to interrupt your flow—but let me say, we have asked specifically the regional foresters, the people in charge, for the legal basis on which they are demanding surrender of water rights. They have refused to supply it to us. They will not even supply the basis on which they are basing their decisions.

Acting Secretary Rominger. We should be able to do that. I know we have a lot of laws that we are trying to comply with these days, from the Endangered Species Act, the Clean Water Act, the Clean Air Act, and all of those have impacts on our activities.

Senator Brown. I might say one of the things that came up in that regard was the Endangered Species Act. The Forestry offices specifically told the city of Boulder that the Endangered Species Act did not apply and they should not worry about it, and they did not want to get into it. And that was after the city of Boulder asked them to review it under those circumstances.

Days before they were scheduled to renew these permits, and these are permits that have existed some for more than 100 years, they said oh, yes, we have changed our position. We think the Endangered Species Act should apply. I mention that because the Forestry Service has literally flip-flopped on the issue, and they did it in a way simply to deny the renewal of permits.

Acting Secretary Rominger. We will take another look at that, Senator.

Your second item was the wolves being introduced into the stated there, the mountain States. That is not a project of the Department of Agriculture. I have certainly heard from a number of ranchers in the area, sheep and cattle ranchers, about problems that it does pose for them. We are working to see what we can do to mitigate what is happening.

On the agricultural census, that is the Department of Commerce who does the agricultural census. We will work with them to see if we cannot get some changes in how they go about doing the agricultural census.

Chemicals that are used in other countries on crops that are then imported into this country. We cannot control, of course, as you know, what those farmers use in other countries. I think we have exerted or tried to exert some pressure on them to conform their pesticide regulations more to ours. What we do is, along with the Food and Drug Administration, is sample products coming into the

United States across the borders, to make sure that they have no residue on them that is prohibited in this country.

So even if they did use a chemical in another country that is not allowed to be used by our farmers, there can be no residue of that chemical on that crop when it gets here. Now certainly we do not inspect every truckload that comes across the order. We have to use our resources to the best that we can, and so we do sampling of those food products coming in.

Your last point was on timber issues. We are not attempting to reduce the amount of timber harvested. We are trying to comply with the laws that have been passed, again a number of laws over the last number of years that have been passed by Congress. We are working hard right now on the timber forest health issue, to get in there and salvage timber after burns, to do some thinning in forests to keep the disease problems from increasing, to harvest those diseased areas.

We are working as hard as we can, I think, to comply with the laws, with the National Environmental Policy Act, with the Endangered Species Act, to get some more of that timber out. We are doing our best. We are going to continue to put more effort into that.

Senator BROWN. Mr. Secretary, I appreciate your comments and I know that you are not necessarily the sponsor of all these things that have been put on the books. As a matter of fact, Congress has some involvement in that.

I would just relate to you an event that happened in Southern Colorado. We had a small firm that bid on the opportunity to harvest a particular area that, after all the environmental studies, had been declared appropriate for harvesting. They were put on the new system where they were required to pay in advance and pay for the timber based on the Forest Service's estimate of what it would yield. It was not an estimate they made, it was an estimate the Forest Service made.

They complied with the law. They put their money up in advance. And then the amount of yield that came out of that plot was dramatically less than what the Forest Service had estimated it would be. And of course, as you know, the amount of yield relates to Forest Service activity, in terms of the way they draw up and designate the harvest. The amount of yield was dramatically less from not only what they had estimated for, but what they had paid for. It literally has driven the company into insolvency and has caused the loss of many, many jobs.

In the Forest Service the position at this point is that they are unable to refund the money that the company put up, even though it was the Forest Service's own estimate that was off.

I have got to tell you, in private business, I never dealt with anybody who treated other people that way. I simply never dealt with people who thought that was fair or reasonable. I really, honestly, think you have got a problem with some of those folks. There is such enormous hostility to the private sector that I do not think you are treating people right.

Acting Secretary Rominger. I agree that we should be treating people right. We are going to work to see if we cannot correct that kind of thing. I would like to have specific details on this because it does not sound fair to me either.

Senator BROWN. I would be glad to follow up.

Acting Secretary Rominger. I would like to follow up on that.

Senator BROWN [presiding]. Thank you. Senator Lautenberg.

Senator LAUTENBERG. Thank you very much, Mr. Chairman. I am sorry to walk in so late, but I do have just a few questions I would appreciate hearing from the Secretary on.

I preface my question, Mr. Secretary, with a statement about what has been going on of late here. Lots of talk in the new Congress regarding the elimination of Cabinet level departments. Just this week a group of new members of the House called for the elimination of the Departments of Commerce, Education, Energy and Housing and Urban Development.

While we are talking about reducing the size of government and eliminating departments, I think it proper that the Department of Agriculture be part of these discussions. If we are reviewing the whole of government, then we ought to review it all.

The many functions of this department could be transferred to other agencies or eliminated. For example, the Vice President's Reinventing Government Plan calls for the removal of meat and poultry inspections from USDA to an independent agency. The Food Stamp and Nutrition Programs could be moved to HHS. USDA's Export Promotion Programs could either be eliminated or consolidated into the Department of Commerce. And the commodity income and price support programs also could be eliminated or transferred to Commerce.

Are there any efficiencies, in your judgment, that might be gained by moving some of these programs out of USDA and into other departments or even back to the States? And what kind of an administrative saving might there be?

Acting Secretary Rominger. First of all, I would like to say, Senator, that the Department of Agriculture started on reorganization before the reinventing government was begun here. It started, in fact, in the last Administration. We are streamlining the Department of Agriculture and I think that we are in the lead among departments in the Federal Government.

We will, in these 5 years through 1999, have 13,200 fewer employees and, through administrative——

Senator LAUTENBERG. From what size before the——

Acting Secretary Rominger. From about 114,000 employees. So we are going to be downsizing about 12 percent in employees. That process will save $4.1 billion. We have consolidated a number of programs and we have consolidated agencies so that we have reduced the number of agencies from 43 to 29. We are in the process of closing about 1,200 offices around the country, closing and consolidating, to have a more efficient department. So we have taken seriously the reorganization and streamlining of government.

As far as moving meat and poultry inspection out of the department, we believe that we can do a good job in the department because we have the ability to go back and work with producers so that we begin with healthy products coming off the farm. We have that long-term relationship.

We are re-engineering the meat and poultry inspection program. We have just recently announced our intention to move to a HACCP Program, Hazard Analysis Critical Control Points, in the processing system. We are updating our inspection system from what has been a see, feel, smell inspection system to one that is scientifically based where we will be sampling for bacteria that cannot be seen.

So we are making some dramatic changes in that program and believe that we can do a good job in improving the safety of meat and poultry, even though we have, we believe, the safest food supply of any country.

Food Stamp and Nutrition Programs have certainly been discussed over the years by Congress on whether or not to leave those programs in the Agriculture Department. The decision, at least up to this point, has been to leave those programs with our department.

Those programs are not only for the benefit of low income people, they also work to sell more food. So they are tied to our agricultural economy as well.

Senator LAUTENBERG. But some of these programs, Mr. Secretary, seem like they have a natural fit in other places. Commerce Department and export promotion and things of that nature. I would submit that we have to consider, as we examine all of the departments of government, the possibilities of reducing wherever we can.

Now I commend the Department for taking the steps that it has taken, and they are significant. I would like to hear more about this. I do not want to take any more of the committee's time on that question, and I thank you.

I would like to go to another question. The budget submitted by the Administration contains no reforms of the Commodity Price Program. How, after so much talk about reinventing government, can we allow these outdated and inefficient programs to continue without change? As a result of these programs, Americans continue to pay higher prices for many food products and poor and middle class Americans continue to subsidize the incomes of large corporations and well-to-do farmers.

One study, from 1987, states that 30 percent of commodity subsidies went to 4 percent of farmers with average net cash incomes of more than $100,000 a year, and with average net worth of nearly $850,000. It does not seem fair to me that farming subsidies retain an entitlement classification when the benefits are often directed toward wealthy business people while Federal housing assistance is extended to only one-third of the poor and working that qualify.

So why should we not reduce the price support levels to allow for a more market-driven agricultural sector in the United States or eliminate the commodity price programs all together? It would save a lot of money if we could get on with that kind of a program, I think.

Acting Secretary Rominger. Thank you, Senator.

I would start by saying that I did submit a statement for the record and I think it covers many of the questions that you have asked on why we believe that the programs are operating in the best interest of farmers and consumers.

I would just briefly say that we have had major changes in the commodity programs in the last decade. The changes that were made in the 1985 Farm Bill and the 1990 Farm Bill and several other acts. In fact, Mr. Chairman, I would like to ask that this list of the changes that have been made in the statute in the last decade be included as a part of the record. It indicates all of the changes that have been made in farm programs and as a result of that, Farm Program spending has declined dramatically.

Senator BROWN. Without objection, so ordered.

[The information follows:]

FARM PROGRAM LEGISLATION WITH SIGNIFICANT SAVINGS IMPACT, 1982 TO 1993

Omnibus Budget Reconciliation Act of 1982.

- Froze dairy support prices and authorized marketing assessments. No-net-cost provisions for tobacco program were contained in the 1981 Act.

- A payment-in-kind Land Diversion Program was implemented administratively for 1993 crops.

Food Security Act of 1985.

- Reduced loan rates. Loan rates per bushel for wheat between 1985 and 1990 were reduced from $3.30 to $1.95.

- Froze program yields and reduced target prices in increments. For wheat, target prices per bushel in the same period were reduced from $4.38 to $4.00.

- Further reduced dairy price supports, continued assessments, and began a "whole-herd" buy-out program. No-net-cost basis mandated for sugar program. Authorized an Acreage Conservation Reserve (later known as the Conservation Reserve Program).

Food, Agriculture, Conservation and Trade Act of 1990.
Omnibus Budget Reconciliation Act of 1990.

- Target prices frozen at the 1990 crop levels.

- Under triple-base provisions, payment acres were reduced to 85 percent of base acres. Payment rates reduced by basing payments on the 12-month price rather than the normally lower 5-month price.

- Increased assessments for nonprogram crops.

Omnibus Budget Reconciliation Act of 1993.

- Reduced payments on acreage idled under conserving use programs (0/50/92).

- Increased sugar and peanut marketing assessments, reduced authorized program level for the Market Promotion Program, and tightened stock-to-use targets for the cotton program.

1993 Amendments to the National Wool Act of 1954.

- Amendments reduced subsidies by 25 percent on 1994 production, by 50 percent on 1995 production, and terminated the program effective December 31, 1995.

Senator LAUTENBERG. To what level, Mr. Secretary?

Acting Secretary ROMINGER. The projection for this year on the support programs is $10.3 billion in farm support programs and it is projected as a result of these changes that have been made in prior years. And as a result of the GATT and NAFTA agreements that those declines will continue. The baseline projects that by the year 2000 that program spending will be down to $6 billion per year.

So the changes have taken place and they will continue to result in declining spending for farm programs. What we have is a program that we think has been successful because our spending for food in this country is the lowest in the world and it is continuing to decline. That was pointed out by previous witnesses here, as well.

Senator LAUTENBERG. We will be reviewing the material you submitted, Mr. Secretary.

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

Senator BROWN. Thank you.

Mr. Secretary, I wanted to thank you for your very thoughtful responses and your help this morning. We appreciate your attitude. We know this is not the easiest job in the world.

Senator BROWN. I would like, at this point, to ask unanimous consent to include in the record a variety of pieces of correspondence that have come to Chairman Domenici. Without objection, so ordered.

[The correspondence follows:]

PHEASANTS
forever.

NATIONAL HEADQUARTERS
P.O. Box 75473
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February 14, 1995

The Honorable Pete Domenici
Chairman
Senate Budget Committee
United States Senate
Washington, DC 20510

Dear Chairman Domenici:

Pheasants Forever respectfully requests that the Senate Budget Committee include in the Budget Resolution funds sufficient to maintain, at a minimum, a 36.4 million acre Conservation Reserve Program (CRP). Current Congressional Budget Office baseline projections ultimately end with a 15 million acre program, woefully inadequate to continue CRP's vast benefits. CRP has resulted in tremendous benefits to wildlife and the environment, has been a stabilizing force for agriculture, and has provided returns to taxpayers and society as a whole.

Pheasant numbers have doubled and tripled across most of their range because of CRP. Portions of Iowa now have 13 times more pheasants than prior to the CRP. Other wildlife species have benefited from CRP, including waterfowl, big game, and non-game species. CRP has provided critical habitat for endangered species, substantially reduced soil erosion, and improved water quality.

Rural communities and farmers have benefited from stabilized commodity prices and income from sportsmen and sportswomen utilizing CRP lands for recreation. The American taxpayer has saved from reduced crop subsidies, storage payments, and other commodity program expenditures. According to data from the Food and Agriculture Policy Research Institute, savings to the federal government are approximately $200 million annually as a direct result of CRP.

Previous investments by the Federal government in land retirement programs have come and gone. After investing nearly 19 billion dollars over the last ten years, American taxpayers deserve continuation of CRP at no less than its current level. This vital program should remain as the cornerstone of an agriculture policy that benefits our Nation. Pheasants Forever respectfully urges the Senate Budget Committee to provide funds sufficient to maintain CRP at its current level of 36.4 million acres.

Respectfully yours,

PHEASANTS FOREVER, INC.

Jeffrey S. Finden

Jeffrey S. Finden
Executive Director

JSF:lq

cc: Senate Budget Committee Members

Working for the Nature of Tomorrow.

NATIONAL WILDLIFE FEDERATION, 1400 Sixteenth Street, N.W., Washington, D.C. 20036-2266 (202) 797-6800
Office of the President

January 31, 1995

The Honorable Pete V. Domenici
United States Senate
Washington, D.C. 20510

Dear Pete:

It is my understanding that the Congressional Budget Office (CBO) has included a 21.4 million acre Conservation Reserve Program in the baseline projections included in the January 1995 report, *The Economic and Budget Outlook: Fiscal Years 1996-2000*. CBO projects that the Conservation Reserve Program will ultimately consist of only 16 million acres. If these projections are implemented, a very successful program for farmers and the environment would be reduced by approximately 56%. I urge you to reject such a drastic reduction in the Conservation Reserve Program.

The Conservation Reserve Program (CRP) is an important investment in our Nation's future. It provides unprecedented environmental benefits including protection of fragile topsoil, improvement of underground and surface water quality and increases in wildlife populations. In addition, by providing the opportunity for retirement of marginal crop land, CRP has encouraged active participation by the farming community. The backing of this program is unparalleled; it is supported by both the environmental and farming communities.

Equally important, CRP reduces the levels of federal commodity subsidy payments. By retiring millions of acres of marginal farmland from crop production, USDA estimates that CRP has saved the federal government billions of dollars in commodity subsidy payments. According to a 1990 study, USDA estimated that if CRP consisted of 45 million acres, the program would save between $16.2 and $19.5 billion in price support payments, deficiency payments and other related costs, but with little environmental benefit. The current program costs $19 billion, without figuring in the tremendous long-term savings directly resulting from the environmental benefits of the program.

More recently, a 1994 USDA report stated that if crop production were to occur on the 36.4 million acres currently in CRP, feed grain and wheat prices would decrease by 5% and 9% respectively. Such reductions in commodity prices would require $1.3 billion in

(Over)

January 31, 1995
Page 2

additional deficiency payments.

The economic need for CRP to retire land and thereby reduce federal commodity subsidy payments continues to exist. The 1994 harvest of corn reached a record level of 10 billion bushels. As a result of the record harvest, corn prices fell to less than 2 dollars per bushel. Due to the depressed price of corn and other grains, it is estimated that direct federal subsidy payments to farmers will increase by $2 billion.

The soybean harvest also reached a record level. In 1994, the soybean harvest totaled 2.56 billion bushels, exceeding the 1979 record harvest of 2.26 billion bushels. Soybean prices may also be depressed thereby requiring additional federal commodity subsidy payments.

The record 1994 harvests in corn and soybean suggest that reducing CRP from a 36.4 million acre to a 16 million acre program, thereby allowing crop production on 20.4 million acres of former CRP land, will result in still higher federal expenditures. The environmental benefits such as topsoil protection, water quality improvement and wildlife population growth associated with CRP will be lost. As a result, I strongly urge you to oppose a 56% reduction in the program.

We look forward to working with you on this important issue.

Best personal regards.

Sincerely,

Jay

JAY D. HAIR

JDH:hmw

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February 14, 1995

Dear Senator:

We the undersigned participants in the Campaign for Sustainable Agriculture, urge you, as you begin to set budget and appropriations levels for agriculture, to keep a sharp focus on promoting family farm and rural community economic opportunity and enhancing environmental quality.

We believe the federal government should continue to play an important role in food and agricultural policy. Some current programs, however, are misdirected, not working, or not working nearly as well as they should. **We have developed new proposals and ideas to reform programs and redirect spending. We look forward to participating in a meaningful debate on the Farm Bill, not simply responding to budget and appropriations reductions which could limit farm policy options.**

Over the last five years, the U.S. Department of Agriculture (USDA) budget has been substantially cut. USDA was the first department to go through substantial reorganization and there is a projected staff reduction of 13,000 by 1999. Further reductions in employees and services are not warranted. The solution is a USDA with a change in policy direction that responds to its diverse customers, including those of us involved in this Campaign for change in the Farm Bill.

If additional cuts are made, they should be carefully crafted and targeted. We oppose additional cuts that simply take programs as they are and scale them back. That is not responsible budgeting and would lock in current economic and environmental inequities. We urge you as legislators to seize the opportunity to revise programs that significantly increase economic, social and environmental benefits and to provide budget and appropriations levels to support them.

We will shortly be sending you more detailed proposals and policy options for the Farm Bill reauthorization and for FY 1996 appropriations. However, we briefly want to signal some of our general directions in key areas now as the budget and spending deliberations get underway.

In the **farm commodity program** arena, we urge Congress to close payment limitation loopholes and reduce or eliminate payments to persons with extremely high nonfarm income. Since 1990, small and moderate sized family farms have suffered two rounds of commodity program cuts because all of their production was subject to budget cuts. Meanwhile, the largest producers, with the biggest government payments and production levels, have yet to ante up even a nickel. As a matter of fairness, no other program cuts should be implemented until payment limits are addressed.

We also urge Congress to explore options to raise farm program commodity loan rates and strengthen the farmer-owned reserve to enhance price stability and farm income while reducing budget exposure and budget instability. We support the rights of contract growers to negotiate and bargain for fair contracts. Changes are also proposed in the dairy program. Further, we support cost-effective stewardship option and requirements within the commodity programs to end penalties against sustainable agriculture and enhance conservation benefits.

On the conservation program front, we support the Administration's FY 1996 proposed increase in conservation operations and land retirement options, but strongly oppose any further cuts in conservation cost share and incentive programs. Last year's (FY 1995) draconian cuts, totalling over $350 million went much too far.

The solution is to consolidate and streamline existing conservation programs into a new balanced and cost effective program based on resource planning and a watershed or ecosystem based approach, utilizing a combination of land retirement and management oriented approaches. The new program should involve all stakeholders in setting priorities and should leverage additional state, local, and private funds to the maximum extent possible. We support the continuation of the Conservation Reserve Program funding and improving the environmental benefit from new acreage enrolled. We stress that creative solutions cannot work if the already decimated conservation funding base is not maintained.

To promote rural development and domestic marketing opportunities, there needs to be a strong government role in providing resources such as accessible and affordable direct lending through USDA to help beginning, limited resource, and minority farmers begin and continue their farming operations. Congress should fund programs to ensure that recent legislation enacted in 1990 and 1992 works to address the barriers and crisis affecting minority farmers and beginning farmers.

We support the continuation of much needed federal food assistance programs, a redirection of market promotion program funds and rural development programs to focus on adding value to food and agricultural products on farms and in rural communities, including assistance for the development of marketing cooperatives and other businesses with an emphasis on sustainable agriculture and agricultural diversification. This includes an expansion of direct marketing and a specific commitment to link family farmers with consumers, especially low income consumers.

Valuable food and agriculture research and extension funds should be redirected. We call on you to resist any cuts in these programs but to invest in the future for a productive, environmentally sound and socially responsible agriculture. Research and extension investments and redirection is increasingly important to help farmers cut input costs, diversify their crop and animal production systems, and regain a greater share of the food marketing dollar in ways that are resource-enhancing.

The Campaign for Sustainable Agriculture is a network of diverse interests from all regions of the country working together to change federal policy to foster a sustainable farm and food system. The Campaign, which emerged from a two-year consensus-building effort that encouraged broad popular participation in defining federal policy options, involves over four hundred grassroots and national organizations representing family farmers, consumers, environmentalists, environmental and social justice advocates, fish and wildlife interests, rural and community based organizations, animal protection supporters, farmworkers, religious community, people of color, community food groups, and other concerned citizens. We look forward to working with you and participating in the upcoming debate on the budget process, appropriations and the 1995 Farm Bill.

Sincerely,

American Farmland Trust
Clean Water Action
Community Nutrition Institute
Environmental Energy Study Institute
Humane Society of the USA
Izaak Walton League of America
Mothers and Others for a Livable Planet
National Center for Appropriate Technology
National Contract Poultry Growers Association
National Family Farm Coalition
National Farmers Union
Natural Resources Defense Council
Organic Trade Association of North America
Presbyterian Church, (U.S.A.) Washington Office
Rural Coalition
Sustainable Agriculture Coalition
Union of Concerned Scientists
United Methodist Church, General Board of Church and Society
Wallace Institute for Alternative Agriculture
World Sustainable Agriculture Association

CSPI CENTER FOR SCIENCE IN THE PUBLIC INTEREST
Publisher of *Nutrition Action Healthletter*

February 15, 1995

The Honorable Pete V. Domenici
Chairman
Senate Budget Committee
D-621 Dirksen Senate Office Building
Washington, DC 20510-6100

Dear Mr. Chairman:

We urge the Committee on the Budget to investigate foreign and domestic agricultural marketing programs, including the Market Promotion Program (MPP) and federally authorized research and promotion programs for the beef, pork, dairy, and egg industries. Collectively, these programs have spent over two billion dollars on promoting agricultural products. Yet the programs have not proven effective, have wasted taxpayer dollars, and may have raised costs to consumers.

- **Overseas Program**

The United States Department of Agriculture (USDA) has spent over $1 billion of taxpayer money on the MPP since its inception in 1986 to promote the consumption of agricultural products oversees, purportedly to aid the U.S. economy and the agricultural industry. Millions of these dollars, however, have been received by private companies, such as McDonald's and Campbell Soup, to market brand-name products. American taxpayers should not be paying for the foreign advertising expenses of huge multinational restaurant and processed food corporations.

1875 Connecticut Avenue, N.W., Suite 300, Washington, D.C. 20009-5728 • (202) 332-9110 • FAX (202) 265-4954
Executive Director: *Michael Jacobson, Ph.D.*

- **Domestic Programs**

The USDA also oversees programs to promote consumption of agricultural products within the U.S., and, until 1993, has financed their legal costs. These programs include those sponsored by the Cattlemen's Beef Promotion and Research Board, the National Pork Board, the National Dairy Promotion and Research Board, and the American Egg Board. Since their inception, these programs have spent over $1 billion promoting the consumption of products, many of which contribute to a high-fat, high-cholesterol diet, which increases the risk of heart disease and cancer, the leading causes of death in the U.S. Moreover, it is likely that at least some of the costs of these programs are passed onto consumers in the form of higher prices.

Domestic program funds may be spent on promotional or research efforts. Unfortunately, most of these funds are spent on promotional efforts, some of which are questionable endeavors. For example, a Dairy Board promotional brochure states: "Do not restrict diet to lowfat choices to meet dietary guidelines...Use fats where needed for flavor and enjoyment...," an explicit contradiction of well-accepted nutritional recommendations, including USDA's own *Dietary Guidelines for Americans*. The Pork Board's "Other White Meat" advertising campaign has been investigated by the Federal Trade Commission for false and misleading claims. The FTC referred its concerns to the USDA, which has taken no public action.

Furthermore, many research projects sponsored by these programs are self-serving and attempt to contradict well-accepted nutritional research. For example, the Dairy Board has conducted research to try to conclude that only some people are adversely affected by milk fat and the Egg Board has tried to show that dietary cholesterol does not adversely affect blood lipids.

Finally, these programs are not accomplishing their intended objectives. The authorizing statutes explicitly state that their purpose is to promote higher consumption of the industry's products, but the programs' billion dollar effort has proven futile. For example, the beef program became effective in 1987, when per capita consumption of beef was 74 pounds. Since then, per capita beef consumption has declined steadily to 61.5 pounds in 1993, the last year for which official USDA figures are available. The egg program became effective in 1977, at which time per capita consumption was 267 eggs. In 1993, per capita consumption was 233 eggs.

Regardless of whether taxpayers, consumers of specific agricultural commodities, or the agricultural industry pays for these programs, it is inappropriate to use government resources to favor particular segments of the food industry, especially when no public interest is served.

We would be pleased to assist the Committee in its examination of this issue.

cor

Sincerely,

S. Leila Farzan

S. Leila Farzan
Staff Attorney
Office of Legal Affairs

Senator BROWN. Mr. Secretary, thank you again. If you have any additional thoughts you want to share with the committee, I hope you will feel free to submit them and we would be glad to include them in the record.

Acting Secretary ROMINGER. Thank you.

Senator BROWN. Thank you, we are adjourned.

[Senator Frist submitted an opening statement to be included in the record the statement follows:]

OPENING STATEMENT OF SENATOR BILL FRIST

Thank you, Mr, Chairman, Mr. Secretary, Senator Lugar and Senator Conrad, we certainly appreciate your taking the time to testify before us today. I cannot overstate the importance of the agricultural sector to Tennessee. According to the Tennessee Department of Agriculture, the Tennessee agriculture industry has a $6 billion impact on the State's economy. About 12.4 million acres, or roughly one-half of the State's land area make up some 87,000 farms. Tennessee production ranges from beef cattle, dairy farms, tobacco and vegetables in the eastern part of my home State to soybeans, wheat, corn, cotton, and sorghum in West Tennessee. Some 13 million acres of farm and non-farm forest lands make Tennessee the Nation's leading producer of hardwood lumber.

And so, Mr. Chairman, I am very interested in this issue of reform of Federal agriculture programs. We must continue to promote the U.S. agriculture industry, maintaining safe, reasonable priced food for American families, and enhancing U.S. exports. I look forward to the testimony of our distinguished witnesses, and I appreciate their longstanding interest in this subject. Thank you, Mr. Chairman.

[Whereupon, at 12:00 p.m., the committee was adjourned.]

National Family Farm Coalition

110 Maryland Avenue, NE, Suite 307 • Washington, DC 20002 • (202) 543-5675 • Fax: (202) 543-0978

Statement of the National Family Farm Coalition to the Senate Budget Committee Hearing on Agriculture Reforms for the FY 1996 Budget February 16, 1995

The National Family Farm Coalition (NFFC) represents family farmers in over 30 states through our 39 member organizations. We are extremely concerned about the implications of the current budget debate. Farm programs are not simply a budget item to be slashed but should be designed to meet different needs and goals within our society. The 1995 Farm Bill should focus on the important role of farm and food policy for all members of society: those who produce the food; the rural communities in our nation, and all consumers.

The FY 1996 budget submitted by President Clinton last week recognized the important role of many USDA programs. These programs included increases in direct lending programs in the credit arena to meet increased interest rate levels and unmet needs; funds to provide for the continuation of the Conservation Reserve Program, technical assistance through USDA outreach and education with support for programs directed at minority farmer participation; a federal match for state mediation programs as a more cost-effective method of resolving conflicts, or a USDA national independent appeals division to provide a fair appeal as an integral part of the USDA reorganization plan. NFFC strongly supports the continuation of much needed federal food assistance and nutrition programs that meet the needs of low income consumers.

NFFC supports changes in programs that are part of the 1995 Farm Bill debate. These include changes in the dairy program, the right of contract growers to negotiate and bargain for fair contracts, support for Minority Farmers and Farmworkers, improvements in rural marketing and sustainable development programs, conservation incentive and stewardship programs, and programs to promote community food security.

Our testimony today will focus specifically on the farm commodity programs that are most affected by changes in agricultural support programs. Many existing farm commodity programs are not working for family farmers or their rural communities. We agree that there are more efficient and cost-effective ways to use existing resources. We strongly disagree with further cuts that will directly reduce the net farm income of family farmers in this country. The current "subsidy" debate is misconstruing the role of government farm program payments. The reason why family farmers have become so dependent on a "farm payment or subsidy" is the farm program structure that has kept the price of wheat and feed grains artificially low to provide a low-cost purchase price for grain traders, processors, and exporters.

The target price was established to provide a level that was supposed to meet or come close to the farmers' cost of producing that commodity. This level has not increased since 1986, so in real terms, farmers have been taking a cut in their net farm income every year as their input costs have continued to rise. From 1980-1992, market prices dropped over 25% for wheat and 44% for corn based on a recent National Farmers Union analysis. In 1990, the Omnibus Budget Reconciliation Act (OBRA) put in place two rounds of budget cuts. "Triple base" cut the acreage level by 15% upon which a farmer could receive payments. The other cut changed how the average market price used as the basis for the payment is calculated. This directly cut farm program payments for the small to moderate sized family farmer who is most dependent on the farm program to survive. The farmers who have production that exceeds the $50,000 payment limitation received no cut. This budget process must close loopholes that exist regarding payment limitations.

NFFC agrees that the taxpayer's role in subsidizing agricultural interests through the deficiency payment should be reduced. Our solution is to increase the commodity loan rate and institute a grain reserve and storage program that works alongside conservation, environmental, and supply management programs. For the past five years, farmers have been unable to put their grain under loan since it has been so low that it has been economically unfeasible. Farmers should be able to have more control over the marketing of their grain production. The current system forces farmers to sell their grain at harvest when prices are the lowest. There should be real budget savings in this approach due to increasing the minimum price paid for the wheat and feedgrains by all users through the setting of a fairer level for the non-recourse loan rate. This change would minimize the direct budget cut to the farmers and producers who are struggling to meet their family living and operating expenses. Recent USDA data demonstrates what many farmers have known for years; that they are increasingly being forced to work off-farm to meet their weekly expenses. Working off-farm means displacing other workers; it also means compromising on-farm improvements and investments in the operation.

Senator Lugar's proposal to reduce target prices by 3% a year for the next five years, as quoted in the February 15th Washington Post, would put farmers in the position of receiving less per base acre in direct payments while having less of their acreage covered under the farm program. For corn farmers, this drop would be from $2.75 to $2.38 over five years and for wheat from $4.00 to $3.46 per bushel. These cuts serve as a double negative - forcing farmers to opt out of the farm program which may eliminate "support payments" but also eliminates conservation compliance and other public benefits from the federal role in agriculture. While a 3% cut may sound good on the editorial page of the Washington Post, the reality is that farmers would be further squeezed by an inconsistent national policy. This policy keeps prices low to promote a high volume of exports while ignoring the domestic consequences that destabilize family farmers and their rural communities.

Senator Lugar may be serious about confronting different constituencies in his quest to cut the budget and reduce the deficit --but he has thus far overlooked the primary beneficiaries of these programs - corporate agribusiness and the stockholders of major processing and exporting industries. While farmers had a less than 3% return in 1993, General Mill's stockholders reaped a 35.3% return; Kellogg's a 34.4% return; Quaker Oats at 34.0% and ConAgra at 16.2%.

These industries have been receiving an indirect subsidy through their purchase of low priced grain and record profits during the past decade. This "subsidy" level far exceeds the $9 or $10 billion per year in CCC outlays for 1995 or 1996. These same companies receive an additional subsidy when they export under the Export Enhancement Program (EEP) or the Market Promotion Program (MPP) - both slated for increases in the FY 1996 Clinton budget as part of the "Green Box" GATT agreement.

The "free market" in agriculture is a myth. The public support and desire for a healthy, safe, and sustainable food supply is directly threatened when farmers are forced to compete against unfair labor and unsustainable land and resource-use practices in some other countries. The United States should not further reduce our production standards, labeling, inspection, or other safeguards in response to the anti-regulatory fervor in the Congress or to the lowest common denominator standards of any potential country that wants to export their commodities. NFFC strongly believes in farm programs that are fair to farmers and producers in this country and in other countries. U.S. farm policy directly impacts others in this global economy. The commodity loan rate has set the world market price in almost every year since the early 1960's. The exception was in 1987-88 when devastating drought conditions resulted in high market prices and no deficiency payments - thus making the commodity loan rate irrelevant to the pricing system.

Our farm policy must look at how, who, and where our nation's food supply is produced. We support a farm and food policy that meets the needs of family farmers, consumers, and the environment. We see a direct connection between the need for family farmers to earn a decent living from their farming operation in their efforts to farm sustainably -both economically and environmentally.

NFFC looks forward to working with the Budget Committee as you shape the FY 1996 budget for our nation's overall funding priorities. We recognize the importance of the federal role in developing and delivering important services that work for, not against our nation's family farmers and consumers. Thank you for considering this statement as part of your budget deliberations.

THE PRESIDENT'S HEALTH AND HUMAN SERVICES BUDGET

THURSDAY, FEBRUARY 23, 1995

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:02 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Grassley, Nickles, Gorton, Snowe, Frist, Exon, Lautenberg, Conrad, Dodd, Boxer, and Murray.

Staff present: G. William Hoagland, staff director; and Keith Hennessey, economist for social security and health.

For the majority: William G. Dauster, democratic chief of staff and chief counsel; and Joan Huffer, senior analyst for income security, social security, and medicaid.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman DOMENICI. The hearing will please come to order. I understand Senator Exon will be along shortly, so we are going to get started. Senator Murray is here, and we appreciate your being here this morning. Thank you very much for coming, and coming early.

We know you are very busy, and we want to start on time and get to your testimony as quickly as we can. Are you on any time situation that I should know about?

Secretary SHALALA. No, sir.

Chairman DOMENICI. Thank you very much.

Let me depart from the way we have been doing things and make a brief opening statement. Then if you would like to, Senator, you may on the Democrat side, and then we will proceed to questions.

First, I want to welcome Senators who are here and those who will come shortly, and you, Secretary Shalala, to this hearing on the President's budget request for the Department of Health and Human Services. We do not go into details in terms of your request, but obviously we have to have some kind of overview of it and see where we are going and what we will allow the committees to spend or what we will ask them to reduce.

Before we hear from you, I want to make just a couple of points. First, regarding health care, I must confess, Secretary Shalala, that I am somewhat frustrated by the position of the Administration, and let me explain my frustration. In your remarks, you might answer or answer as if a question had been put to you.

To the best of my knowledge, the President and this Administration agree with me and many others who have looked at the budget for a long period of time and say kind of in harmony that the only way to get the Federal budget under control is to get Federal health care entitlements under control. Now, I believe I have heard that in various iterations from the President on many, many occasions, and perhaps from you.

As we all know, medicare and medicaid continue to be the fastest growing programs in the budget, averaging about 10 percent a year growth each year. If we do nothing, some startling numbers: Medicare and medicaid will grow from $266 billion in 1995 to $694 billion by 2005. That is not a century. That is just 10 years, from $266 billion to $694 billion by 2005.

Moreover, it is now commonly known and accepted that medicare hospital insurance and the trust fund that supports it will go broke very shortly, 2001, according to the last board of trustees' statement.

Senator Exon, we decided to start. Senator Murray was here, and I am in the middle of——

Senator EXON. Please proceed. That is all right. I was at Armed Services. We are all running back and forth. I am glad you went ahead.

Chairman DOMENICI. Thank you very much. So let me continue on.

Every time we bring these issues up, the Administration responds by saying—and I am paraphrasing a bit—we need health care reform, comprehensive health care reform, to solve these problems. And the President tried that last year.

Well, quite frankly, I find these answers to be very inadequate and very irrational, because the President's health care plan did nothing to solve the underlying problem of excessive growth in Federal health care spending. In fact, I think according to the CBO, the President's plan would have increased Federal spending by $428 billion over 10 years, increased taxes by $300 billion over 10 years, and increased the deficit by $128 billion.

Now, I am not saying this is still the plan, but I will get to the point. Furthermore, the President's health care plan did not fix the Medicare HI long-term imbalance and urgent situation with reference to insolvency. So if the Administration answer is we will get health care's 10-percent annual cost increases under control when we have health care reform, I would like to see a plan that cuts overall health care spending and addresses medicare's imminent insolvency.

It seems to me that every time we talk about reducing the extraordinary growth in these health programs, instead of applying that savings to the deficit, somehow or another that savings is going to be spent on something else. And if that is the logic, then I would ask how do we ever get the deficit under control.

Welfare, I would just address it very briefly. Similarly, the Administration has said that it wants to reform our Nation's welfare system, but this section of the 1996 budget is noticeably absent. There is no provision, major provision, for welfare reform in the President's budget.

I am encouraged by the discussions occurring between Congress and the Governors of these sovereign States. We are examining ways to give Governors more flexibility to make resource allocation decisions closer to the people who are affected by them. The Governors are telling us that they can provide better health care and welfare programs for the poor at reduced Federal outlays if we will only cut some of the strings that we have placed upon them. If we are willing to untie the Governors' hands to promote and operate medicaid and low-income programs as they choose under some national goals that are truly what we want them to do, the Federal Government will have a predictable, manageable stream of spending going to them. But we will not tell them precisely what to do, and we will be able to move toward a balanced Federal budget.

I hope that before this year is out the dialogue about these very issues can occur between those of us in the Congress who sincerely want to get health care costs under control and at the same time want to comply with what the President has analyzed, and that is that you won't get the deficit under control until you get those things under control.

I thank you for your attention.

Chairman DOMENICI. Senator Exon, I will yield now to you for an opening statement if you have one.

OPENING STATEMENT OF SENATOR EXON

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

Welcome to you, Madam Secretary. We are awfully glad to have you. I apologize for being late. There is an important meeting going on over at the Armed Services Committee this morning that I have got to be back and forth on. I hope you will understand.

You will certainly have a full plate since you seem to be in the center of many, many very important and long-range issues that are going to be debated and, hopefully, at least begin to be solved this year. Your situation is loaded down with some of the hottest potatoes, I suggest, in Washington: welfare reform, possible medicare and medicaid cuts, and perhaps another run at health care reform.

More often than not, the current welfare system does not work. Once a bridge to span the difficult times, welfare now leads to a dead end, unfortunately, in all too many cases. We should not punish the truly needy, but work opportunity and responsibility should be major components of any reform effort. And I think you agree with that.

I will be most interested to hear your comments on what it will take to break the cycle of dependency. Do you believe that block grants are the solution to our welfare problems? If so, how far do you think we should go in that area?

I have long favored allowing States the flexibility to try innovative approaches, which some of them are now doing and that is somewhat encouraging. But we must ensure that the National concerns are addressed as well. I also look forward to hearing your opinion of the welfare budgetary savings proposed in the so-called Contract With America.

Madam Secretary, I am sure that you are intrigued by the comments made by the distinguished majority leader on the cutbacks in medicare and medicaid needed to balance the budget by the year 2002. Senator Dole has suggested cutting medicare by $146 billion over 5 years and medicaid by $75 billion during the same period. These numbers are not carved in stone, as I understand it, but I want your assessment of the potential impact of such cuts on those two programs.

Any discussion of medicare and medicaid leads back to health care reform. I was extremely disappointed last year during that debate. It produced a lot of heat, but little light. It was full of partisanship and recriminations. As much as I tried, I was never able to work on a bipartisan basis to address that issue, and in the end, as we know, it all collapsed.

However, one thing has not changed in the last 6 months. We cannot allow the status quo to prevail. Health care security is still a nightmare for millions of Americans. Cost shifting is just as bad as it ever was. Federal health care programs take more and more of our national treasury. More than anything else, they contribute to the deficit clouds which we see on the horizon and are certainly looking at very closely these days.

We cannot run away from health care reform. I hope that, for the good of the Nation, we can this year put politics aside and work with all of the Members of the House and Senate to provide adequate health care for all Americans.

Once again, Madam Secretary, I welcome you and I look forward with great interest to your testimony today. Thank you for being here.

Thank you very much, Mr. Chairman.

Chairman DOMENICI. Thank you, Senator Exon.

Please proceed, Madam Secretary. Your in-depth statement will be made a part of the record as if read.

STATEMENT OF HON. DONNA E. SHALALA, SECRETARY, UNITED STATES DEPARTMENT OF HEALTH AND HUMAN SERVICES

Secretary SHALALA. Good morning, Mr. Chairman. Senators and members of the committee, thank you for the opportunity to discuss the President's 1996 budget for the Department of Health and Human Services.

Our budget for fiscal year 1996 protects the taxpayers' dollars, improves the efficiencies of our programs, and invests carefully in the future health and well-being of this country.

Our budget request totals $716 billion. Our budget for entitlements is $676 billion, an 8-percent increase over the 1995 level. Discretionary spending for 1996 will total $37 billion, an increase of 4 percent over 1995.

Mr. Chairman, to be responsive to the legitimate demands of the American taxpayers, we are looking for ways to change the way we do business—all of our business, from medicare and medicaid, to public health programs, to the administration of the Department.

Let's start with medicare and medicaid. Under the Clinton administration, projected medicare and medicaid spending during the period from 1994 to 1998 has dropped by $212 billion. This extraordinary drop in projected spending is due in large part to the President's historic deficit reduction measures, to a strong economy with low inflation, and to the bipartisan legislation on taxes and donations passed by the Congress in 1991. This is a significant contribution to lowering the deficit.

We have also stepped up our efforts against waste, fraud, and abuse in the Medicare and Medicaid Programs. We are doing a better job as watchdogs of the taxpayers' dollars.

Let me illustrate for you. Successful prosecutions and sanctions in 1994 added up to $8 billion in fines, penalties, and savings for the American people—the largest amount in the history of the Department.

In 1996, we intend to intensify our assault on waste, fraud, and abuse. We are examining innovative methods to fund and carry out important program integrity responsibilities, focusing on those parts of the country where we know the problems are the greatest.

Our bottom line is protecting taxpayer dollars while maintaining the quality and availability of services for the elderly, for the disabled, and the disadvantaged.

But as we concentrate on that bottom line, we must continue to find ways to improve efficiency and provide better customer service in Social Security, medicare, and medicaid.

Through a commitment to prudent management and advanced technology, we are making great progress.

The Social Security Administration is completely overhauling the way it does business. It has taken dramatic steps to provide better and faster service to all of its customers.

Our 1996 budget requests an additional $483 million for SSA's disability and automation investments. With these investments, people no longer will have to wait 100 days or more for their disability claim to be processed. By the end of 1996 alone, we will have cut that by a third.

We are also committed to continuing our 5-year investment in automation, which will enhance the productivity and the customer service of Social Security into the next century.

The solvency of the Social Security Trust Funds is a matter of continuing concern to all of us, and that is why we have established a bipartisan advisory council of experts, chaired by Ned Gramlich, of the University of Michigan, to recommend steps that should be taken to protect the future of Social Security. That council has indicated to me that it will deliver its findings in June, which I will share with the committee.

Our improvements in the Medicare and Medicaid Programs are also substantial. We know that States have the ability to develop effective health care solutions to meet their local needs. And that is why this Administration has approved more statewide health care demonstrations than any other Administration in history.

With these demonstration waivers, more and more States are taking advantage of opportunities to expand choice by offering managed care programs under medicaid. Last year, medicaid had a 63-percent increase in the number of people enrolled in managed care plans, from 4.8 million in 1993 to 7.8 million in 1995.

The number of older Americans choosing managed care through the Medicare Program also grew by 16 percent, from 2.7 million people in 1993 to more than 3.1 million in 1994. And we expect another 20 to 25 percent increase this year in the number of elderly moving to managed care.

Of course, our commitment to improved health and security in this Nation extends beyond the Medicare and Medicaid and the Social Security Programs, and that is why the President has asked both parties in Congress to work with him to expand insurance coverage for the American people and to contain health costs for families, businesses, and governments.

That commitment, Mr. Chairman, is the answer to your question, that we are prepared to sit down to design the first steps in a health care reform plan that will help us move towards both cost containment as well as coverage for millions of Americans who have no coverage.

The President is also committed to working with Congress to reform our broken welfare system. He insists that we replace the old system of handouts with a new one that offers a hand up, a new one that requires work and individual responsibility.

We are committed to a bipartisan approach, but we are concerned about legislative proposals that are weak on work and weak on parental responsibility, but tough on children.

We are also concerned about proposals under the guise of welfare reform that simply shift the costs and the responsibility for the problem from the Federal Government to State bureaucracies.

Meaningful reform must be, first and foremost, about moving people from welfare to work. That means providing safe and reliable child care, offering education and training, and putting in place work requirements that have real teeth.

Mr. Chairman, we believe that welfare reform cannot and should not be about punishing poor children for their parents' past mistakes, which is what some would have us do.

We must insist on real work requirements and strong protections for our children while helping their parents to move from welfare to work. The American people will accept nothing less than both.

As we look at ways to reform welfare and improve Social Security, medicare, and medicaid, we must also look at our discretionary programs. In our 1996 budget, we were determined to cut discretionary spending, to consolidate services, and to do more with less.

One way we are doing this is by consolidating activities into performance partnerships. Most notably, in the Public Health Service, we have combined 108 activities. This will give States and grantees greater control and flexibility and accountability in managing these programs.

We have reduced funding for 69 programs, taking them below the levels approved by Congress for 1995. We have frozen an additional 57 activities at their 1995 levels. We are also re-examining the administrative structure of the Department to find more efficient ways of doing business.

Some of our overhead functions will actually be eliminated. And administrative responsibilities will be returned to our agencies, resulting in fewer positions and lower administrative costs.

These savings are real. They represent some of the hard decisions we have made in putting together this budget.

By squeezing down on spending and re-thinking the way we do business, we were able to target increases in a few key investment areas that have shown significant payoffs. I am proud to say that this budget reaffirms the core value of the Administration—putting people first.

One way we do that is by promoting good health and preventing disease. The budget commits an additional $468 million for the brilliant biomedical research at the National Institutes of Health, research that holds the key to conquering such diseases as sickle cell anemia, breast cancer, and AIDS. We know that this investment has made a difference.

Just last month, we announced the NIH-funded discovery of the first drug treatment for severe cases of sickle cell anemia. This was a major breakthrough that gives hope to more than 70,000 Americans who suffer from this disease.

The NIH has also made major breakthroughs in breast cancer, including the discovery of the BRCA–1 gene, which is linked to breast cancer.

From 1989 to 1992, breast cancer mortality rates declined by 5 percent among all women, and by 18 percent since 1987 among women in their thirties.

Mr. Chairman, we are also faced with another tragic health problem that demands national attention—the problem of AIDS. AIDS is now the number one cause of death among Americans between the ages of 25 and 44. And this Administration is continuing to lead the fight against this deadly disease by strengthening our research prevention and treatment efforts.

Our 1996 budget provides an increase of $91 million for Ryan White AIDS Programs. This increase will assure that the 10-to-14 newly-eligible communities will receive vital funding.

We also are strengthening America's efforts to stop crime, violence, and drug use, and we are building on our historic success in immunizing preschool children. Our Childhood Immunization Initiative is another dramatic example of how our investments are making a difference.

Before we began our immunization initiative, only 55 percent of 2-year-olds in this country received basic vaccinations. One year later, 67 percent of those children were immunized. This is now the highest percentage in American history.

With this kind of progress and with this year's budget commitment of $844 million, we will be well on our way to meeting our 1996 goal of immunizing 90 percent of 2-year-olds with the initial and most crucial vaccinations.

This budget also continues the President's commitment to children and families, as reflected in our investments in child care and Head Start. Our 1996 budget provides an overall increase of $100 million to help States provide high-quality, safe, and affordable child care for more working families—goals we all share.

We are also requesting an additional $400 million to improve the quality and capacity of Head Start centers throughout the country.

Some of this increase will help fund our early Head Start initiative, which will serve more than 25,000 children under the age of 3 in 1996.

Mr. Chairman, we believe these are smart investments. They are crucial to the future of the Nation, and they fulfill our Government's commitment to the American people.

What I have just described is more than a budget. It is a new way of honoring our responsibility to work for the public good. It makes very tough choices, and it will produce measurable results.

We look forward to working with this committee, and I greatly appreciate the opportunity to testify before you this morning.

I would be happy to answer any questions.

[The prepared statement of Secretary Shalala follows:]

Good morning, Mr. Chairman and Members of the Committee.

Thank you for the opportunity to discuss President Clinton's 1996 Budget for the Department of Health and Human Services.

Our budget for Fiscal Year 1996 protects taxpayer dollars, improves the efficiency of our programs, and invests carefully in the future health and well-being of this country.

Our budget request totals $716 billion. Our budget for entitlements is $676 billion, an 8 percent increase over the 1995 level. Discretionary spending for 1996 will total $37 billion, an increase of 4 percent over 1995.

Mr. Chairman, to be responsive to the legitimate demands of the American taxpayers, we're looking for ways to change the way we do business -- all of our business, from Medicare and Medicaid, to public health programs, to the administration of the Department.

Let's start with Medicare and Medicaid.

Under the Clinton Administration, projected Medicare and Medicaid spending during the period from 1994 to 1998 has dropped by $212 billion dollars.

Yes, that's "billion" with a "b."

This extraordinary drop in projected spending is due in large part to the President's historic deficit reduction measures, a strong economy with low inflation, and the bipartisan legislation on taxes and donations passed by the Congress in 1991. This is a significant contribution to lowering the deficit.

We have also stepped up our efforts against waste, fraud, and abuse in the Medicare and Medicaid programs. We're doing a better job as watchdogs of the taxpayers' dollars.

Let me illustrate this for you:

Successful prosecutions and sanctions in 1994 added up to $8 billion in fines, penalties and savings for the American people -- the largest amount in HHS history.

In 1996, we'll intensify our assault on waste, fraud, and abuse. We are examining innovative methods to fund and carry out important program integrity responsibilities, focusing on those parts of the country where we know the problems are greatest.

Our bottom line is protecting taxpayer dollars while maintaining the quality and availability of services for the elderly, the disabled, and the disadvantaged.

But as we concentrate on that bottom line, we must continue to find ways to improve efficiency and provide better customer service in Social Security, Medicare and Medicaid.

Through a commitment to prudent management and advanced technology, we are making great progress.

The Social Security Administration is completely overhauling the way it does business. It has taken dramatic steps to provide better and faster service to all of its customers.

Our 1996 budget requests an additional $483 million for SSA's disability and automation investments.

With these investments, people no longer will have to wait 100 days or more for their disability claim to be processed -- by the end of 1996, we will have cut that by a third.

We are also committed to continuing our five-year investment in automation, which will enhance the productivity and customer service of SSA into the next century.

The solvency of the Social Security Trust Funds is a matter of continuing concern to all of us. That is why we have established a bipartisan advisory council of experts, chaired by Edward Gramlich, to recommend steps that should be taken to protect the future of Social Security. That council expects to deliver its findings in June.

Our improvements in the Medicare and Medicaid programs also are substantial.

We know that states have the ability to develop effective health care solutions that meet their local needs.

That's why this Administration has approved more statewide health care demonstrations than any other Administration.

With these demonstration waivers, more and more states are taking advantage of opportunities to expand choice by offering managed care programs under Medicaid.

Last year, Medicaid had a 63 percent increase in the number of people enrolled in managed care plans -- from 4.8 million in 1993 to 7.8 million in 1994.

The number of older Americans choosing managed care through the Medicare program also grew -- by 16 percent -- from 2.7 million people in 1993 to more than 3.1 million in 1994.

And we expect another 20 to 25 percent increase this year.

Of course, our commitment to improve health and security in this nation extends beyond the Medicare, Medicaid and Social Security programs. That's why the President has asked both parties in Congress to work with him to expand insurance coverage for the American people and to contain health costs for families, businesses and governments.

The President also is committed to working with Congress to reform our broken welfare system. He insists that we replace the old system of handouts with a new one that offers a hand up, but requires work and individual responsibility at the same time.

We are committed to a bipartisan approach, but we are concerned about legislative proposals that are weak on work and parental responsibility, but tough on children.

We are also concerned about proposals that--under the guise of welfare reform--simply shift the costs and responsibility for the problem from the federal government to state bureaucracies.

Meaningful reform must be, first and foremost, about moving people from welfare to work.

That means providing safe and reliable child care, offering education and training, and putting in place work requirements that have real teeth.

Mr. Chairman, we believe that welfare reform cannot and should not be about punishing poor children for their parents' past mistakes--which is what some would have us do.

We must insist on real work requirements and strong protections for our children, while helping their parents move from welfare to work. The American people will accept nothing less than both.

As we look at ways to reform welfare and improve Social Security, Medicare, and Medicaid, we must also look at discretionary programs.

In our 1996 budget, we were determined to cut discretionary spending, consolidate services, and do more with less.

One way we're doing this is by consolidating activities into Performance Partnerships. Most notably, in the Public Health Service, we've combined 108 activities.

This will give states and grantees greater control, flexibility, and accountability in managing these programs.

We reduced funding for 69 programs, taking them below the levels approved by Congress for 1995.

We froze an additional 57 activities at their 1995 levels.

We're also reexamining the administrative structure of HHS to find more efficient ways of doing business.

Some of our overhead functions will be eliminated. And administrative responsibilities will be returned to our agencies, resulting in fewer positions and lower administrative costs.

These savings are real -- they represent some of the hard decisions we made in putting together this budget.

By squeezing down spending, and re-thinking the way we do business, we were able to target increases in a few key investment areas that have shown significant payoffs.

I am proud to say that this budget reaffirms the core value of the Administration: putting people first.

One way we do that is by promoting good health and preventing disease.

This budget commits an additional $468 million for the brilliant biomedical research at the National Institutes of Health -- research that holds the key to conquering such diseases as sickle cell anemia, breast cancer, and AIDS. We know this investment has made a difference.

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AIDS is now the number one cause of death for Americans between the ages of 25 and 44.

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What I have just described is more than a budget. It is a new way of honoring our responsibility to work for the "public good." It makes tough choices. And it will produce measurable results.

We look forward to working with this Committee, and I greatly appreciate the opportunity to testify before you this morning. I'd be happy to answer any questions.

Thank you.

Chairman DOMENICI. Senator Grassley?

Senator GRASSLEY. You stated that medicare spending is slowing. Your chart shows that. The Congressional Budget Office, though, is estimating that the Health Insurance Trust Fund will be spending more than it takes in within just a few years, and I believe the Chairman referred to that as 2001.

I can't find any indication in your statement or in the budget summaries of how the Administration thinks that we should deal with the problem at the year 2002, and you can't wait until then to deal with it.

I would like to have you just give us some general view of how you see that problem.

Secretary SHALALA. Well, we see the problem very much the way you do; that is, that we need to deal with the problem of the trust fund. The trustees of the system will meet in April. We will have new calculations as to what the outyears will look like, and we will come back to the Congress for a discussion as to the scope of the problem after we see those new calculations. And we do intend to work in a bipartisan manner to address the issue.

Senator GRASSLEY. That report is in June, so then before the——

Secretary SHALALA. The Social Security Advisory Council group, chaired by Ned Gramlich, will report on recommendations for the Social Security Trust Funds in June. The Trustees will report with their calculations in April, for the Social Security and Medicare Trust Funds.

Senator GRASSLEY. OK. So this spring.

Secretary SHALALA. This spring we will have new calculations, and we will come back and discuss them with Congress.

Senator GRASSLEY. During this year?

Secretary SHALALA. Yes; the trustees, as you know, last year recommended that we look at the issue. We would like to see the new calculations, particularly in light of the decline in the baseline, though our guess at the moment is it may affect it only a year. And we do intend to have discussions with Congress once we see those new calculations and the new trustee recommendation.

Senator GRASSLEY. So at this point, my next question was going to be: Any specific suggestions you might have, they will come after the report in April but——

Secretary SHALALA. After the trustees' report.

Senator GRASSLEY. But not too long afterwards?

Secretary SHALALA. As soon as I have the trustees' report. I am a trustee, along with the Secretary of the Treasury and the Secretary of Labor and two public members. We will come back up and have discussions with Congress.

Senator GRASSLEY. A little more specificmquestion on a different point: Can you explain your proposals for the consolidation or clustering of several of the Department's broad program areas? More specifically, are we talking about actual program consolidation so that there would be an integration at the local level of health services that are now separate and distinct? Or are we talking about changes that will be felt only at the Federal level?

Secretary SHALALA. We are talking about both. Let me give you an example.

The immunization programs now require State governments to fill out these many forms to apply for a number of our immunization programs. We are simplifying the application structure, so this is basically what the States will be filling out. They will be able to integrate a variety of programs that fit into their strategy.

We had taken some of these steps with the AIDS prevention programs last year, so that what the States will be able to do is design their strategies, and we have simplified the application for the moneys.

Let me give you an example from the community health centers. The community health centers now apply for eight major grants in separate applications with separate timing. They will now be able to apply for those grants in one application.

In some cases, we may come back to Congress and ask for the programs actually to be merged together because they are too small as categorical programs. But we are simplifying both the application process as well as the flexibility that the States and local communities have to develop their own strategies.

Senator GRASSLEY. Do you have a dollar savings that might result from these clusterings? Or aren't they being done necessarily for saving money?

Secretary SHALALA. For both. We are eliminating positions and administrative costs at the Federal level, and our major savings are in our administrative costs. What the local governments will get is as many of the dollars for direct spending as opposed to these programs paying for heavy overhead costs.

Senator GRASSLEY. Can you tell me whether the Administration intends to propose only a 1-year extension of this year's Older Americans Act's authorization as contrasted with the usual 3- or 4-year extension we have had?

Secretary SHALALA. We have no plans to shorten the extension. When we come up for reauthorization, we will ask for a normal extension.

Senator GRASSLEY. Mr. Chairman, my light is on.

Chairman DOMENICI. Senator Exon?

Senator EXON. I will yield to Senator Murray.

Chairman DOMENICI. Senator Murray.

Senator MURRAY. Thank you, Mr. Chairman. And welcome, Secretary Shalala. It is good to see you here again today.

I was pleased to see the Administration include in its flexibility and accountability in health care programs, and I was especially pleased to see additional funding for biomedical research at NIH, especially continued funding for AIDS research. As you stated, AIDS is the leading killer of adults between the ages of 25 and 44, and I think we all have to pay attention to that. I also commend you for your focus on child immunizations and Head Start again.

We are debating the balanced budget amendment in Congress, and everybody is asking what is going to happen if that passes and who is going to get hurt. And, frankly, the first indication we got was by watching Washington, DC's budget crisis. The first thing I see that is going to get cut is in education: they are going to shorten the school year and increase class sizes. Kids are the first ones to go. And I guess the second indication came to me last night when I saw the House Labor-HHS panel's rescission package. One hundred-five million dollars cut from Head Start, cutting school lunches, eliminating the drug-free schools program and educational programs.

I believe the adage that we are going to be judged by how we treat our elderly and our children. So I want to give you an opportunity to tell me, again, of your priorities in the President's budget in terms of our children and our elderly.

Secretary SHALALA. Well, I think they are reflected in the President's investments, an investment in the Head Start Program, an investment in the Medicare and the Medicaid Program. Many people think of the Medicaid Program just as a women and children's program, and actually, most of the spending is in long-term care. So the fact that our budget, while we brought down the baseline and tightened up on the programs and reorganized, continues this Nation's commitment to children, to the disabled, and to the elderly is a reflection of where our priorities are.

Senator MURRAY. I appreciate that and look forward to working with you on those programs.

I have another question in another area. A number of my constituents have expressed a great deal of concern about healthcare in our rural areas. I was especially concerned with the 1995 rescission which would eliminate rural health transition grants and essential access community hospital, rural primary care hospital grants.

In view of the recent emphasis on primary care and reaching out to rural areas, can you tell me why those programs were specifically targeted for cuts and what options there are for the future?

Secretary SHALALA. We target them for cuts because we have made systemic changes in the reimbursement in the Medicaid and the Medicare Programs that bring rural hospitals up to what urban hospitals are getting on their reimbursements. So those programs were originally put in place because of the differential and the heavy costs in rural areas. Density and sparsity both produce very high costs. So we made systemic changes in the Government's health programs so we no longer needed targeted categorical programs. And we have started to make changes in trying to get more resources to primary care physicians as opposed to putting the money into just specialists.

So by making those systemic changes, it allowed us to go in and to begin phasing out or eliminating the special targeted programs.

Senator MURRAY. So you don't see a decrease in services?

Secretary SHALALA. No, I do not. In fact, I think that most rural hospitals believe that they are substantially better off with the direct reimbursement activities and being part of the regular programs, as opposed to having targeted categorical programs.

Senator MURRAY. OK. Since we are emphasizing primary and preventive care rather than disease management, a group of physicians that I hear from a lot are osteopathic and naturopathic physicians. Their emphasis is on alternative medicine.

How have you addressed that field of research and treatment, and what is your commitment to this in the President's budget?

Secretary SHALALA. Well, we have done a number of things. In alternative medicine, there is a center at the National Institutes of

Health which explores alternative medical treatments. Therefore, we made a research investment.

As to the array of medical services that we are provided through the Medicaid Program, for example, those decisions are very much local decisions in terms of what they feel is appropriate. And we think that is as it well should be. But we have tried through our investments, particularly through the National Institutes of Health, to avoid prejudice, and I think that our recent experience in the Southwest on the hanta disease, where we worked with the medicine men on the Navajo reservation, the CDC working with them to identify the source of what was a very serious and deadly disease, was an example of the thoughtfulness with which I think this Administration seeks to solve some of our major health problems. They not only identified the deer mice, but gave us great insight and a sense of security to the community itself in that particular instance.

Senator MURRAY. I appreciate that. Bastyr is a really important group in my State. They do a lot of good work, and I care a lot about that.

One other quick question. Actually, it is not quick; it is one I care a lot about. It is Head Start funding. Can you explain what you have done with Head Start in your budget? I am especially concerned because the House last night was asking to cut $105 million. Can you tell me what that means in real terms; how many kids will not be served?

Secretary SHALALA. The House actually restored at the last moment the cut they were going to take in our increase. So we expect the House Appropriations Committee to recommend the full amount, it looks like, from what there was an attempt to do last night. Unfortunately, they also took it out of Chapter 1 to restore that amount.

We have, as you know, been ratcheting up the Head Start Program, but with very serious caveats. First, that the program must use a significant amount of the resources to improve the quality of the program. We would like to extend the program to full day-full year so it is supportive of working families. And, third, a new initiative, a 0-to-3 initiative, that will allow States and communities to fit their earlier childhood programs directly with the Head Start Program so there is a seamless program in place.

So we are very pleased with what we have been able to do, but I can't tell you or repeat enough that the emphasis on Head Start must be on quality. We cannot simply expand the program without substantially improving the quality of the program.

Senator MURRAY. I agree with that. Having been a preschool teacher and having worked with young kids, I know what every budget cut means. It's frustrating to be judged on how well kids are educated and to be accused of not doing a good enough job when the real problem is lack of funding. So I appreciate your comments.

Chairman DOMENICI. Thank you very much, Senator.

I might note that you received 7 minutes instead of 5, which was our understanding for the first round after we made openings. Senator Grassley did not, but he will get his on the second round.

Senator Nickles, you have 7 minutes.

Senator NICKLES. Mr. Chairman, thank you very much. Maybe I won't use the 7 minutes.

Madam Secretary, welcome to our committee.

Secretary SHALALA. Thank you.

Senator NICKLES. In looking at your budget, I am interested in looking at some of the comparisons between OMB and CBO, and maybe if the Chairman and ranking member have already talked about this, I will not go into it. But there are significant differences in the estimates by OMB as compared to CBO, a difference of about $70 billion over the 5 years for medicare and medicaid.

Could you tell us in a minute, very briefly, what the differences are?

Secretary SHALALA. Well, I think my first answer is that the actuaries actually do differ because they are trying to predict the future. The differences are not that significant over that period of time. They are about 4 percent. And they are significant in terms of, obviously, the amount of money, but we are suggesting a 9-percent-plus increase in these programs over that period of time, and CBO is suggesting 10 percent.

If you look over time at the Administration's estimates and CBO's, there have been some differences. I think our actuaries who are civil servants—we haven't redone their numbers—believe they have been very conservative. In fact, they did not start to identify this baseline slowdown until this period. They were very conservative, even though they began to see some indication of it.

Senator NICKLES. Madam Secretary, let me just ask you a couple questions. The OMB growth rate for medicare and medicaid over the 5 years is 9.5 percent, and CBO is 10.5 percent over those 5 years.

Secretary SHALALA. That is right.

Senator NICKLES. And the difference in that 1 percent is a difference of $70 billion.

Secretary SHALALA. That is roughly correct.

Senator NICKLES. Correct me if I am wrong, but this shows medicare in 1995 being $154 billion and in the year 2000 being right at $250 billion. It almost doubles in that 5 years. And medicaid, again, under OMB is $88 billion in 1995, and in 2000, 5 years later, it is $136 billion, not quite doubling in growth.

Secretary SHALALA. Let me explain the medicaid number, for example. What the actuaries are telling us is what they think the behavior of the States is going to be in relationship to the Medicaid Program. Are the States going to begin to slow down their medicaid growth? Are more of them going to come in for waivers and move more of their medicaid population into managed care at some kind of a discounted rate?

So what we are discussing is not something that I have a great deal of—I mean, obviously, these are senior civil servants that make the actuarial estimates. And what the two sets of actuaries are doing is making some assumptions about the behavior of State government over the next few years.

Senator NICKLES. We have a history, though, in medicaid—and I don't have the chart with me, but my memory tells me that medicaid had compounded in the last 5 years, 28, 29, 13, and 10 percent, an explosive growth—a lot of that due to the disproportionate share program, a lot of that due to States exploiting the Medicaid system.

Secretary SHALALA. Right, and we have closed that down.

Senator NICKLES. Well, let me ask you a question. There are some things that are directly under your discretion. You have a lot of States right now that are petitioning you to grant them significant medicaid funding. I guess in waivers—well, not waivers on their programs for new programs, but significant—I don't think you would classify that as waivers. They have petitioned your Department for hundreds of millions, in some cases billions of dollars of medicaid payments. I am not sure how those are classified.

Could you bring us up to date on what you have pending, what is being discussed with what States?

Secretary SHALALA. There are two different things that are going on, Senator. One is the request on waivers, which must be budget neutral, and the other is related to what the Congress did in 1991, and that is to close down the loopholes on the use of—perhaps we should describe it as the creative use of taxes to leverage up their reimbursement under medicaid.

There are some States who did not, I think it is fair to say, move as quickly as they should have to close down some of those provider taxes and other inappropriate taxes now under existing law. Those States are in some fiscal difficulty. They include a State like Louisiana, for example. And they are having trouble slowing down their growth rate and finding local revenues to make up that difference.

They have come and said we are having great difficulty doing that, is there anything you can do for us? I have repeated what the law is and what my authority is; that is, I cannot change the law or give them inappropriate resources.

Senator NICKLES. I am running out of time.

Secretary SHALALA. What we are talking about is two completely different things.

Let me also say regarding the expansion of medicaid over that period that medicaid actually isn't growing at much more than the private sector. It is growing with the private sector, except for the expansion of coverage, and that is, more people are being covered under laws that were put in place in the last few years. So——

Senator NICKLES. Madam Secretary, I am running out of time. Let me just quickly state for the record that in 1990 medicaid grew at 19 percent, in 1991 it grew at 28, in 1992 it grew at 29 percent, in 1993 at 12 percent, and in 1994 at 8 percent. So it has exploded.

Would you please provide the committee a list of—and you may even have it in your submission. I apologize if you do. But State by State, what the State is putting in, what the Federal Government is doing, and the ratio? Because it is supposed to be a 50–50 type share, and I think some States are now 70-some-odd percent Federal?

Secretary SHALALA. Well, it depends on what part of the program they are participating in and—there is a differential.

Senator NICKLES. If you would give us that breakdown, and also give us a breakdown of what is pending in requests from the various States, what they submitted. I know the District of Columbia, you mentioned the State of Louisiana, I believe some other States have multi-billion-dollar requests before your Department. If you would provide those for us, that would be appreciated.

Thank you. Thank you, Mr. Chairman.

[The following was subsequently submitted for the record by Secretary Shalala:]

FEDERAL MEDICAL ASSISTANCE PERCENTAGES

State	FY 1995	FY 1996
Alabama	70.45	69.85
Alaska	50.00	50.00
American Samoa *	50.00	50.00
Arizona	66.40	65.85
Arkansas	73.75	73.61
California	50.00	50.00
Colorado	53.10	52.44
Connecticut	50.00	50.00
Delaware	50.00	50.33
District of Columbia	50.00	50.00
Florida	56.28	55.76
Georgia	62.23	61.90
Guam *	50.00	50.00
Hawaii	50.00	50.00
Idaho	70.14	68.78
Illinois	50.00	50.00
Indiana	63.03	62.57
Iowa	62.62	64.22
Kansas	58.90	59.04
Kentucky	69.58	70.30
Louisiana	72.65	71.89
Maine	63.30	63.32
Maryland	50.00	50.00
Massachusetts	50.00	50.00
Michigan	56.84	56.77
Minnesota	54.27	53.35
Mississippi	78.58	78.07
Missouri	59.85	60.06
Montana	70.81	69.38
Nebraska	60.40	59.49
Nevada	50.00	50.00
New Hampshire	50.00	50.00
New Jersey	50.00	50.00
New Mexico	73.31	72.87
New York	50.00	50.00
North Carolina	64.71	64.59
North Dakota	68.73	69.06
Northern Mariana Islands *	50.00	50.00
Ohio	60.69	60.17
Oklahoma	70.05	69.89
Oregon	63.36	61.01
Pennsylvania	54.27	52.93
Puerto Rico *	50.00	50.00
Rhode Island	55.49	53.84
South Carolina	70.71	70.77
South Dakota	68.06	66.66

Tennessee	66.52	65.64
Texas	63.31	62.30
Utah	73.48	73.21
Vermont	60.82	60.87
Virgin Islands *	50.00	50.00
Virginia	50.00	51.37
Washington	51.97	50.19
West Virginia	74.60	73.26
Wisconsin	59.81	59.67
Wyoming	62.87	59.69

* For purposes of section 1118 of the Social Security Act, the percentage used under titles I, X, XIV, and XVI and Part A of title IV will be 75 per centum.

STATEWIDE HEALTH CARE REFORM DEMONSTRATIONS (3/16/95)

Approved
Oregon
Hawaii
Rhode Island
Tennessee
Kentucky (not implemented)
Florida (not implemented)
Ohio (not implemented)

South Carolina (framework approved)

Under Review
Massachusetts
Delaware
Minnesota
New Hampshire
Missouri
Illinois
Louisiana
Oklahoma
Vermont

Pre-application (Concepts Discussed)
New York
Utah
Kansas
Texas
Washington
Montana (mental health carve-out only)
West Virginia (mental health carve-out only)
Alabama (sub-state expansion for children and pregnant women)

Chairman DOMENICI. Thank you, Senator Nickles.

Senator Exon?

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

Madam Secretary, I want to follow up on a question that my colleague from Washington State, Senator Murray, made reference to with regard to my early days as one of the original founders of the Rural Health Care Caucus. You stated, if I understood you correctly, in answer to a question from Senator Murray, that we should not be concerned about the Administration's proposal to eliminate rural health transition grants. Those of us who represent large rural populations where we have smaller hospitals for example, in Omaha, NE are concerned about rural reimbursement rates.

Because of the unusual mix of the population, we have very heavy participation in the programs because of the elderly. Some of those beds are occupied by, you know, somewhere between 48 percent and 64 percent elderly population. Any change in the reimbursement rates there are particularly devastating.

I understood you to say that that should not be a concern because basically what you have done is recommended that the payment per bed be the same in Omaha, NE, as it would be in a very rural hospital. Are you saying the same amount per day?

Secretary SHALALA. No; let me clarify.

First of all, let me not leave you with the impression that I think that we have solved all the rural health care problems in America by some change in the hospital reimbursement rates. What we have done and what the Congress has basically done over time is we have been phasing in a change in the reimbursement rate for rural hospitals so that we bring them up to similar rates that we have in urban hospitals in this country. That is my understanding.

The transition grants were an attempt to solve that problem, and what the Congress and the previous Administration decided to do is to solve it more systemically. I do not want to suggest in any way that that has solved the problem of rural health care in this country, which includes a very serious problem with getting providers out into rural areas. I was recently——

Senator EXON. Don't broaden it. I want to talk about the cost per hospital bed. Are you telling me that your recommendation would significantly improve the ratio of cost per hospital bed in rural America as opposed to metropolitan America?

Secretary SHALALA. In 1995, rural hospitals are getting paid at the urban rate for reimbursement. And we would be happy to provide you with details on that, Senator.

Senator EXON. That would be very helpful to me because I think that is a very important matter that we should take a look at.

[The following was subsequently submitted for the record by Secretary Shalala:]

DETAILS ON RURAL HOSPITAL PAYMENT

In the Omnibus Budget Reconciliation Act of 1990 (OBRA 90), the Congress established a process whereby rural hospitals would receive, after a phase-in period, the same base payment amount as urban hospitals. This goal has been achieved by applying higher updates to the rural base payment rates until they equalled the urban base payment amounts. This equivalence was achieved on October 1, 1994, the start of fiscal year 1995 as all urban hospitals received an update to their rates of 1.1 percent while all rural hospitals received an update of 8.4 percent.

Large urban hospitals, those in Metropolitan Statistical Areas with more than one million people, continue to receive a slightly higher base payment amount. Prior to fiscal year 1995, there were three base payment rates: large urban, and rural. Now, there are two, large urban and other. Hospitals in large urban areas receive a 1.6 percent higher base payment than those hospitals in all other areas.

Each hospital's final payment amount for each case is derived from the base payment amount plus adjustments made to that rate. The base payment amount is multiplied by the Diagnosis Related Group weight, or DRG weight, which is a measure of how costly a certain procedure is, relative to other procedures. The base payment amount is also adjusted by the wage index, which measures the relative wage levels for each area. The payment amount may be further adjusted for those hospitals that have teaching programs or serve a disproportionate share of low income patients. Finally, while in most cases this adjusted base payment will constitute total payment for a case, in those cases where there are unusually large costs or long stays, outlier payments may be triggered to compensate for those cases.

I would like to get your opinion on some of the things that I covered in my opening statement. You are, I think, aware that some of my colleagues on the other side of the aisle say it is easy to reduce the deficit, just slow the growth in health care and on our mandatory programs. I suggest it is not going to be quite that easy. What would happen in your opinion if we would cap, just cap the rate of growth for medicare and medicaid, which is a tempting proposal, given the facts that have just been addressed about rapid growth in these programs by Senator Grassley and Senator Nickles?

Secretary SHALALA. Let me talk a little bit first about the Medicaid Program if we cap the growth rate in the Medicaid Program or block grant it. There are a number of different proposals out there.

It would have an impact on the number of people that could participate in the program. It would have an impact obviously on the reimbursement rates and the amount of health care that individuals got. The difficulty of capping the Medicaid Program or block granting it would be that the program works in a way that responds to the populations for States, for instance, that had a big increase in population that needed the Medicaid Program. Those States would have a very serious problem as opposed to those States that had a decrease that might get a windfall as part of a block granting approach.

In the Medicare Program, capping the Medicare Program would have an impact on the services that are provided, and we would either have to take the resources out of the providers or increase the amount of money paid by those who participate in the program.

I should point out that more than 80 percent of those who get medicare in this country have incomes under $25,000 a year. There is a good possibility we would cost shift, and our reluctance as an Administration to squeeze down these programs outside of the context of health care reform has been our deep concern that squeezing down on the Government's programs which are a significant part of the health care market in this country would increase the cost to people who are buying—to companies and to people who are buying their health care insurance directly.

So there is no simple solution here, and that is why we have always talked about doing it all together, that we needed something to take the first steps toward something more comprehensive.

Senator EXON. What you are saying is there is no magical solution.

Secretary SHALALA. I wish I knew one, Senator.

Senator EXON. I was hoping you would say there is one, but there is not.

Let me ask you to comment, if you might, on some of the innovative suggestions that have been made. A member of the Budget Committee, Senator Gregg, and others have been talking about and are considering advancing a concept known as medi-check, to reform medicare costs. Under this proposal, beneficiaries would receive a fixed-dollar voucher to purchase private insurance.

What is your opinion of this proposal? It is innovative, and I am wondering if you have given any thought and consideration to such a proposal.

Secretary SHALALA. Since the proposals first came forward, we have begun to think about the proposal, and that is basically a voucher program for health care for the elderly. Let me simply repeat this is a very high-risk group. When the Medicare Program was put in place in 1965, only 50 percent of the elderly in the United States were receiving—had health insurance, and the program was put in place because the market did not respond to high-risk folks.

A rigid voucher program would simply shift costs on to the individuals. It would have the same effect of bringing down the percentages, and that is, do some cost shifting if there wasn't enough money in the program. It would leave the elderly and the disabled population, the two highest-risk groups, at the mercy of a market that has not over the last few years demonstrated that it wants to take in high-risk people. In fact, there has been so much risk selection in the market in terms of pre-existing conditions and other kinds of things—it would be fair to say that most elderly and disabled Americans already have pre-existing conditions—that it is hard to believe that the market would be there to respond to a voucher.

Senator EXON. My final question, Mr. Chairman and Madam Secretary, has to do with the costs. We see these continuing costs of health care delivery in general exceeding, maybe double, the overall cost of inflation that is a part of our economic structure. What do you think is the main cause of the fact that we are talking 9, 10, 11, 12 percent growth in many of these programs? Is it that more people are coming under coverage, coupled with the fact that costs seem to continue to go up faster in the health care field than in other fields of our economy?

It would seem to me if we could get a handle on this of some kind, it might be helpful. There has been some reduction of 11 down to 9, as I understand it, in the projections of what these costs will be in the future. What is the reason for that small reduction of 2 percent? And is there any basic reason why these costs that I think Senator Nickles outlined in the chart that he had, are there one, two, or three reasons that these things are so astronomically high compared with the rest of our economy?

Secretary SHALALA. First, let me make a preliminary statement about this. I don't want to be seen as defending the current structure and organization of the program. I well recognize, as, in particular, does the President, that we cannot tolerate the growth of the Government health care programs at the rates they have been growing and do what we want to do, and that is, bring down the deficit, make the kind of investments in other programs. And so there are some things that we must do.

The reason that no one has done it like that is because it is complex in terms of why health care costs have gone up. The Medicaid Program has picked up a number of the people who have been dropped, whose health insurance has been dropped by their companies. The Medicare Program has responded to technological breakthroughs in the health care business. Technological breakthroughs do not automatically result in reductions in costs of health care, unlike other parts of our society where technological breakthroughs would result in more efficient kinds of cost.

In fact, in health care, better identification of the disease, earlier identification of the disease, more sophisticated identification of the disease has often resulted in more procedures and in more investments to save lives and improve the quality of life.

The Medicare Program, in particular, has been a fee-for-service program with a very high risk group, and I think it is very important to talk about the population that the Government is taking care of, the highest-risk group, the poorest, the most disabled, the most elderly. If they were simply spun into the regular marketplace, there is no question that the private sector would not be able to keep their costs slowing down the way they have been able to because you would be adding to the pool a much higher risk group.

Are there inefficiencies in the system? Absolutely. And we must address those inefficiencies as part of a larger approach—are the programs also absorbing the inefficiencies of the rest of the system in which large numbers of Americans, a million last year, don't have health insurance? The Medicaid Program clearly is doing that for people who don't have health insurance. They are using the most inefficient parts of the system, emergency rooms, critical care, people putting off getting their own health care, and that is being absorbed by both the Government programs and, until recently the private sector programs.

In fact, the private sector programs have gone down so fast in terms of their cost containment, particularly with the large corporations beating on the industry to bring down their costs, that there is some evidence now—and most of it is anecdotal—that we are cost shifting back into the Government programs. That may account for why medicare isn't coming down as fast as we would like it to come down.

Senator EXON. Thank you, Madam——

Secretary SHALALA. The failure until the last couple of years to move heavily into managed care, where we think we can get some savings, but we are not sure because of who has been moving into managed care. So it is all of the above, Senator. I am sorry that, again, I do not have a silver bullet for you.

Senator EXON. Thank you. I will yield. Just let me make a comment if I might, Mr. Chairman. I guess one of the things that we continue to overlook also is the fact that the longevity has increased in the last 20 or 25 years from 65 to 75. We are paying for that now. That we don't often look at. I guess the same thing is true with regard to the future of the Social Security system and its solvency.

You know, it is good that people are living longer and getting better care, but it isn't free.

Thank you.

Chairman DOMENICI. Thank you very much, Senator Exon.

I have not had a round of questions, so I will take my round now.

First, Madam Secretary, I saw a cartoon in the Albuquerque paper today that had to do with DC, I am struck with it about how we treat taxpayers and the budgets that we control. This is two people walking up steps to come before the Congress, and it is DC Government. And it says, one to the other, "You know what really gets me? Having to explain to these guys how we spent more than we had."

Now, you know, we tend to say that about DC, but it seems to me we come before the Congress and we really don't worry about explaining to these guys—and I would add gals—how we spent more than we had.

Essentially, what is happening, Madam Secretary, is that within your budget, within the programs you control, lies the secret to whether or not we will ever have a balanced budget for the United States.

Now, I want to ask you some very specific questions. If the Congress of the United States creates a block grant out of medicaid—and let me tell you, it is going to be in your lap, as I see it, because you are going to answer this today or soon after, because it is going to happen. And the greater growth is not going to be 9.5 percent. It might be as low as a growth of 5 percent or 4 percent, and we will take off all the strings except say you have to treat a certain kind of population. And we will say let's try this for 5 years.

Now, are you suggesting that if we attempt to apply those savings—which I might say to all of you, compared with current baseline expenditures, could be a savings of over $120 billion, and we would still have the programs growing, so everyone will understand—over 7 years, $120 billion, 7 years, in time for the balanced budget if it passes. And it might be more than that if you really went down to 4 and stayed there, but let's just use that number.

I want to know specifically, is it the policy of this Administration that they will not support that, even if we do it, unless we wait for comprehensive health care reform? Just tell me yes or no.

Secretary SHALALA. The answer is that the President has said that he is prepared to discuss the Government's programs in the context of comprehensive health care reform, because we believe that all we will be doing is cost shifting, and we will not be bringing——

Chairman DOMENICI. Right. So the answer is you would not support it.

Secretary SHALALA. We will not support it.

Chairman DOMENICI. Second, Madam Secretary, medicaid for all you talk about in terms of bringing the baseline down and all the other things, the truth of the matter is that the States have pushed the baseline up very high. In many States, they have taken advantage of this program, not only in the extraordinary ways they have used these tax gimmicks, but also funding of programs. They got a very high base.

Now, I cannot imagine why this Administration would be busy about granting waivers, statewide waivers, and lock us into these extremely high numbers rather than come up with some comprehensive policy to reduce the amount of money that States get. We are not talking about cutting programs. We are talking about reducing this enormous, enormous overage that is occurring every year.

Now, Madam Secretary, I remind you that Governor Engler may not be somebody whose philosophy you respect or admire, but I chose to find out how many rules and regulations are attendant medicaid in the State of New Mexico because the Federal Government essentially runs it, whether we want to admit it or not. In my State, there are eight volumes this thick that are New Mexico's rules, regulations, and guidelines for 24 Medicaid Programs, not one. And their costs are skyrocketing.

Now, I spoke to them and, frankly, I suggested that they ought to run the program. And I suggested we ought to throw those eight volumes away and that we ought to give them maybe 3 or 4 or 5 percent less growth than we are now giving them, and let's see if they can't run it better.

Now, I gather that most States are willing to try that. They may argue about, Senator Nickles, whether it is 4 or 5 or 3 percent. But most States are willing to do that.

But I understand you are saying the Administration is not. Is that correct?

Secretary SHALALA. Let me again repeat: We are prepared to talk about the Medicaid Program and the Medicare Program and the growth in both of those programs only in the context of a broader discussion of health care reform so that cost containment and administrative changes and insurance reforms are part of the discussion. And I am not ruling out any of the individual questions you are asking me, but only simply saying that we want to sit down and talk about it within the context of health care reform.

Chairman DOMENICI. Fellow budgeteers, let me suggest to you it is amazing that health care is under control in every segment of the American population except those programs that the Federal Government runs. Now, there is something about that that doesn't strike right. Medicaid is growing under one projection at 9.5, under another at 10.5, while health care in America seems to be coming down. In fact, you admit that it may be growing at 5. There are some saying huge segments are growing at 0, and I cannot understand. And I believe before we are finished Americans are not going to understand why we should not try something different with the Federal Government's portion.

I submit to you waivers to the remaining States who are locked in at extremely high levels and say this is going to be nice reform, we had better send them a signal here today that they may think they are locked in at those levels under waivers. But you are just locking them in at programs that are absolutely wasting our money because we won't let them be efficient. I believe that, and the more I study it, it is the United States Government that won't let them be efficient and gives them these broad opportunities to take advantage of the taxpayers.

But I understand you don't want to do that. You want to wait for more comprehensive health care.

Secretary SHALALA. No, Senator. What I am saying is that this has to be a bipartisan effort and that we have to put a number of things on the table. In the process of bringing down private sector health care costs, another million Americans lost their health insurance. Some were picked up by the Medicaid Program. Many were not.

What is clear here is that coverage is declining for people in the private sector as the costs are coming down. There is no question costs are coming down. We are also slowing down the growth of the Government's own programs. That is also going on. But not one Governor has come in to see me with a waiver request, Republican or Democrat, that wanted to take less money as part of the process.

What we have locked them into is a budget-neutral approach, and that is, they could not get more money out of us in the process of trying to reform their system. And what many of them are trying to do is to expand coverage to working Americans. They have used the waiver process to take the money they currently have and to take the Federal Government's money to get more working Americans insurance coverage. They are responding in their States very much to what is happening, and that is, people are being thrown out of their health insurance systems, working Americans.

Chairman DOMENICI. Madam Secretary, it is absolutely foolhardy and irrational to assume that a Governor will come in for a waiver and say, I will take less than you were giving me. The issue is not that. It is whether they will take less, all of them will take less, and try to do as good a job or better than we are doing. That is the issue. What Governor is going to come up here under a law that says you can get a waiver and say, well, I want a waiver and I want to give the Federal Government back $450 million?

Secretary SHALALA. Well, in fact, they are doing that in a sense.

Chairman DOMENICI. I thought you just said they weren't.

Secretary SHALALA. What they are asking us to do and what they are trying to do is to take existing money and to cover more people. And to be fair to the Governors, what they are trying to do is to deal with an issue that we have not yet dealt with as a country; that is, large numbers of working Americans who have no access to health insurance, to make sure that low- and middle-income and low-income workers have health insurance.

So, Senator, I would argue that the issue of flexibility can be separated from the issue of how many resources we are going to put into the system. You and I will end up agreeing on flexibility as long as there are some standards and some expectations on behalf of the taxpayers, the Federal taxpayers.

But what we may not agree on is how fast we can bring down the system independent of a broader discussion of cost containment and——

Chairman DOMENICI. Well, I don't want to belabor the issue, and I want other Senators to have a chance. I have many questions, but I really think we have today hit on one that will be front and center for the rest of the year. I cannot believe that Congress is going to wait around for some kind of comprehensive health care to save the American public $120 to $130 billion in a Medicaid Program that has gone wild.

Now, if that is what the Administration is going to say, then we will just be there. We will be there, because we will plug in a number in this committee substantially less than now on medicaid, and we will assume some kind of a block grant or getting rid of the cumbersome rules that are there. I don't know whether it will be bipartisan or not. My hunch is before we are through it will be when everybody understands this. We will arrive at something here that we think the American taxpayer needs, must have.

I yield now to Senator Lautenberg. Thank you Madam Secretary.

Secretary SHALALA. You are welcome.

Senator LAUTENBERG. Thank you, Mr. Chairman.

Welcome, Secretary Shalala.

Secretary SHALALA. Thank you.

Senator LAUTENBERG. I was interested in your statement. I am sorry I wasn't here when it was delivered, but I have read it. You close with a comment, describing "more than a budget. It is a new way of honoring our responsibility to work for the public good. It makes very tough choices, and it will produce . . . results."

I think that has to be kept in mind. The fact is that these programs are programs designed for the public good. And while we all—and I say all—want to see the most efficient operation possible, the least cost possible for reasonable health expectations for everyone from childhood through old age, sometimes I think we get lost in the rhetoric of talking about only the budgetary consequences that are immediately felt in the given year. And when we look at 70,000 people less likely to be stricken with a significant result, a damaging result from sickle cell anemia because of discoveries recently made, and all kinds of prevention measures, that will make a huge difference in the way we spend our money in the future.

I noted in your comments also that the number one cause of death of those between ages 25 and 44 is AIDS, and I assume that everybody heard the shocking news this morning about our famous diver, Greg Louganis, who hit his head on the diving board in one of the meets—I think anyone who has ever seen that picture will remember it—and he bled into the swimming pool, and the doctors tried to fix him, and this morning there is an admission that he had HIV-positive infection.

It brings home the fact that this is a problem that is going to overtake us. And if we succeed in eliminating people their coverage, as is the sole interest, apparently, in the budget review, then perhaps we will cast those people out on the street. I doubt that America will turn so coldhearted.

At the same time, I agree that we ought to be saving money. One way, I think, is to look at the consequence of smoking in our society. In 1993, a Center for Disease Control study stated that direct costs associated with smoking was $50 billion a year. Of this $50 billion, about $20 billion paid for by medicare, medicaid, and other Federal health programs. And I understand the figure might grow more in the future as more and more people are eligible for medicare.

Do these expenditures place a significant burden on our Federal health care programs?

Secretary SHALALA. They do, Senator. As you know, there are significant expenditures on upper respiratory diseases and on cancer, and if we could do something about smoking, something significant about smoking, particularly about young children starting to smoke, it would make a difference in Federal health care expenditures.

Senator LAUTENBERG. So we ought to certainly look at ways to recover some of these costs.

As you know, in 1993, EPA reports showed that secondhand smoke was responsible for 3,000 lung cancer deaths per year and thousands of more cases of respiratory illness. In the last Congress, I introduced legislation that would make all Federal buildings smoke-free. It passed the Senate and was dropped in conference.

Now, in addition, some departments of Government, HHS, Department of Defense, EPA, have entirely smoke-free facilities. The bill was endorsed by EPA Administrator Browner, and she also testified that making all Federal buildings smoke-free would save $100 to $300 million a year in reduced maintenance, property damage, and absenteeism.

Now, why hasn't the Administration moved on an Executive order making all Federal buildings smoke-free when we know that secondhand smoke is dangerous and that such an action might save the Federal Government significant money?

Secretary SHALALA. We have, though not with an Executive order. There is a rule out for comment in the Labor Department now which would essentially do that, and that is, end smoking in any Federal buildings. I can get you the name of the part of the act that——

Senator LAUTENBERG. How long a process might——

Secretary SHALALA. It must be out for comment, which means there must be a certain number of days in which we collect comments and then it goes into effect. I can get you the details on it.

Senator LAUTENBERG. Does anybody know how long the comment period is likely to be?

Secretary SHALALA. Normally 45 days, but we will find out where we are.

Senator LAUTENBERG. Yes, I think it would be good if the Federal Government set the example that we talked about.

Secretary SHALALA. Right. But, basically, it is our intention to do that this year.

Senator LAUTENBERG. I would hope so, because the sooner, I think, the better the opportunity to deal with it.

[The following was subsequently submitted for the record by Secretary Shalala:]

STATUS OF PROPOSED STANDARD FOR INDOOR AIR QUALITY

On April 4, 1994 the Department of Labor, Occupational Safety and Health Administration (OSHA), published its proposed standard for indoor air quality.

Following hearings, the Administrative Law Judge, on March 13, 1995, set a bifurcated comment period. The record will remain open until July 3, 1995 for the receipt of written information and additional data. It will then close for receipt of information and data, but will remain open for the receipt of written comments, position statements, or briefs until September 11, 1995.

Senator LAUTENBERG. In 1992, New Jersey put in a welfare reform law that included the so-called family cap. This denies the old $64 increase per child for families on welfare. Have you been evaluating the consequence, the results of this experiment? What do the data show about welfare expenditures in reduced births to welfare recipients in New Jersey? Do you know?

Secretary SHALALA. The data is too preliminary in New Jersey for us to come to a conclusion. We are tracking it, but I have been told by our researchers that it is just too early for us to have an answer to that question.

Senator LAUTENBERG. Would you, therefore, then be unable or unwilling to comment on the type of program? Do you have any view of——

Secretary SHALALA. Not unwilling; unable at this point in time.

Senator LAUTENBERG. Thanks, Mr. Chairman.

Senator GRASSLEY [presiding]. Yes, thank you.

Ms. Snowe?

Senator SNOWE. Thank you, Mr. Chairman, and I want to welcome you, Madam Secretary, to our Budget Committee. Obviously, the discussion is centering around the existing costs and increasing costs of medicaid and medicare, and it is alarming when you see the growth in both the caseload and also the growth in medical service, and at least according to the Congressional Budget Office, both of those elements are what have attributed to the substantial increases in both of these programs.

For example, the growth in caseload by the year 2000 will increase the outlays of the Medicaid Program by 20 percent. I mean, I think that is staggering, as well as alarming. So, obviously, we are going to have to do something dramatically different in delivering some of these programs.

Getting back to the block grant approach, why aren't we encouraging the use, rather than the States having to seek waivers for the use of managed care programs, for example, in the Medicaid Program?

Secretary SHALALA. There has been a rapid increase in the Medicaid Program into managed care, about 25 percent now, and that is increasing rapidly in the States. Let me say something about the caseload in relationship to medicaid because I actually think you were probably a supporter of this.

What you did over the last few years is expand the number of women and children that moved into the Medicaid Program. That is, some States expanded to 200 or 250 percent of poverty, so that caseload increase is directly related. The expenditures in medicaid, though—two-thirds of them are in long-term care and care for the disabled. So most of the heavy expenditures are for a different population than the caseload expansion issue.

It is actually relatively cheap to provide insurance for kids of low-income workers. What is expensive is long-term care; nursing homes, for example, and our ability to get control of those costs. The Medicaid Program—when you remove the growth in the population as a result of Congressional mandates—that is, to expand the program to the kids of working people—is actually not out of control. It is growing at about 5 percent a year, so we have got to be careful when we talk about the Medicaid Program being out of control.

All of you made a very serious decision to expand medicaid to the children and women that are basically low-income in this country. We think it was a good thing to do. The program is also picking up some of those million people that have been thrown out of their insurance program by their employers, but are still employed, and that is they are low-income workers maybe at the minimum wage. So it is a tough decision on medicaid because it really has been expansion, and most of the money is for people we know in long-term care in nursing homes in this country.

Senator SNOWE. Yes, but the States are dealing with the inflexibilities of our mandates, like expanding the caseload, and you are right. I mean, we have expanded it to include the women and children in the low-income definition of the Medicaid Program. But the fact of the matter is, when the States come for those waivers, they don't ask for less money because they are still having to deal with the mandates of providing for a specific population at a certain level.

I guess my concern is that we are not looking creatively at ways in which we can deliver this program differently; i.e., through encouraging the States to use managed care. Second, consider the percentage of costs of health care expenditures in this country due to waste, fraud, and abuse—which you made reference to that in your testimony. I know Senator Cohen has introduced legislation to aggressively expand the law enforcement tools and mechanisms within your department to pursue waste, fraud, and abuse. But if waste, fraud, and abuse amounts to $110 billion a year, by all accounts and estimates, why aren't you and the Administration aggressively pursuing that? I mean, that is a way in which we ought to be able to recover some of our costs—which I consider to be astronomical—in both of those programs.

Secretary SHALALA. Let me give you two answers. First, on the growth in managed care, the States have not had a serious problem getting permission to do managed care or using managed care. There has been a 63-percent increase in the use of managed care in the Medicaid Program.

Second, on the issue of waste, fraud, and abuse, this Administration has had the largest settlements in American history, and my department had the largest amount collected in fines or in settlements in the history of the department. So it is hard to say we haven't been aggressive. We need some other kinds of total, and in REGO–II, in Reinventing Government II, I hope to present the Congress a new strategy for the department.

One of our problems has been that if you look at our budget—and I pointed out we have over a $700 billion budget—$37 million is for discretionary money. Waste, fraud, and abuse enforcement is in that discretionary money. Most of that discretionary money is the Indian Health Service, Head Start, the National Institutes of Health, I mean, if you look at where the money is.

I have to get all of our enforcement out of the discretionary part of the budget, and we will be coming back—and we referenced it in our budget request this year—we will be coming back with a new approach, a new strategy, and I think you will be very pleased with what we think we want to do in the future. But in the past, we have been the most successful people going after this in the history of the department.

Senator SNOWE. Do you need wider discretion or more authority or tougher statutes to pursue those who do defraud our system while participating in that system?

Secretary SHALALA. We will come in and ask for what we think we need, and some of it is a different way of financing the system because we are so restrained, because for every dollar our Office of Inspector General spends we get $80 back, and some of it is some systematic change. But the changes we are making—we, for instance, have closed down some plans this year that weren't delivering in the Medicare Program.

We have consolidated our computer system so we don't have all this differential. So there have been a series of steps, administrative changes in the department, and aggressive—I happen to think we have got the best inspector general in the country in June Brown—aggressive going after fraud in the department. Eight billion dollars is the largest amount ever collected in the history of the Department of Health and Human Services, so you will not find anyone more enthusiastic or firmer, I think, than this crowd at HHS.

Senator SNOWE. I just think that we have to move on that front very, very aggressively and do everything that we can to give you the tools to deal with that because $110 billion is an astronomical sum of money to be lost.

Secretary SHALALA. I can't, Senator, I should say, confirm that number. I can say that there is a lot more to be done, and part of our exercise this year will be to present Congress with a new strategy on behalf of the department because we think with our existing strategies and our existing finance we have reached our limit in terms of what we can do and we would like to do a lot more.

Senator SNOWE. I know GAO had done a report—I think it was within the last couple of years—that indicated that about 10 percent of health care expenditures in the country were due to waste, fraud, and abuse, so it is in that ballpark.

Thank you.

Senator GRASSLEY. Senator Boxer?

Senator BOXER. Thank you.

Welcome, Secretary Shalala. When you collect these funds that Senator Snowe brings up—and I want to associate myself with her remarks; we can't afford to waste a dollar, let alone, hundreds of billions—what happens to the money? Does it go to deficit reduction?

Secretary SHALALA. No; it goes back into the—it depends on what it is, whether it is a settlement or whether what we did was they have to pass back into the fund that it was taken out of. There are different approaches for different——

Senator BOXER. I would like to know; I would like to have some more detail on that.

[The following was subsequently submitted for the record by Secretary Shalala:]

DISPOSITION OF FUNDS COLLECTED FROM FRAUD AND ABUSE ENFORCEMENT

All funds recovered from anti-fraud activities are returned to government entities. Currently, a portion of the Office of Inspector General's (OIG) civil and administrative recoveries goes to reimburse the Medicare Trust Funds for payments erroneously made from those funds. Similarly, States are generally made whole for sums improperly paid due to medicaid fraud. However, the majority of civil and administrative recoveries are returned to the U.S. Treasury.

The following examples demonstrate the disposition of OIG's recoveries:

- For the period 1991–1994, $160 million of OIG's $274 million in non-civil monetary penalty law (CMPL) receivables were creditable to the Medicare Trust Funds.
- During 1994, the State Medicaid Fraud Control Units recovered $36.5 million in fines, restitutions, and overpayments. These funds were returned to State medicaid programs to make both the State and Federal shares of those programs whole, according to the medicaid funding formula used for each State.

OIG is also currently exploring legislative authorization to reinvest certain of its recoveries in enhanced oversight and enforcement efforts in the health care areas.

Senator BOXER. I want to talk a little bit about what the Chairman said, and I think it is fair to characterize him as very angry with the Administration on its view that, absent comprehensive health reform, the President is going to stand up and fight against cuts in the Medicare and Medicaid Programs. I frankly think it is exactly the right position to take because without comprehensive reform, we are going to keep on adding people to the rolls of the uninsured and it is a whole false economy. Eventually they are going to show up somewhere unless we turn into a country that allows people to die on the street, which I never believe we would ever do. We are going to force more people into the emergency rooms.

I want to put a statistic out here so people know what I am talking about. All the talk about how we are ratcheting down in the private sector—this is true and it is to be applauded, but some of it has to do with the fact that people are being pushed out of that private insurance sector.

Let me give you a number. The number of Californians covered by MediCal—that is the Medicaid Program in California—increased by 740,000 between 1989 and 1992 to compensate for decreased access to private insurance. Unless we take all the monies we spend and have a plan, I think we are perpetrating a fraud on the American people to sit here and say we plugged in a lower number for medicaid, therefore those people are going away. They are not going to go away. They are going to pop up somewhere, and unless we allow them to die in the street, they are going to be taken care of.

You can't tell people don't get sick. You can't tell people don't be poor and don't get old. You know, we honor our elderly. I think the fact that we now have a lot of people over the age of 100 in our country—I forget the number, but it is astounding. We are living longer, and it is something that we treasure in this country. We have a doctor now sitting with us on this panel who has been on the cutting edge of a lot of these new surgical procedures that help us live longer and maintain a better quality of life.

So what I want to do is take issue with our Chairman—I am sure he is not at all surprised—that I think the Administration is doing the right thing, and I think the American people will understand that just because you plug in another number doesn't mean the problems disappear, and the fact that we are ratcheting down on the private sector in many ways means that these folks are showing up elsewhere.

In my remaining time I want to ask you some questions about programs that are very important to my State because everything we talk about, times it by 10, and that is how it impacts my State. I want to say that the increases in what I call investments—Head Start, immunizations, biomedical research, the Ryan White Care Act—are very welcome to my State, and to me. Those investments will make us a stronger people.

Certainly, when you ask the person in the street, what are they more afraid of, a missile coming over from Russia or the fact that one of their family members will be struck by cancer, Alzheimer's or AIDS, I think we know the answer, and that speaks to some of the priorities of this Administration. The Ryan White funding—I hope we can fight to keep it in because it does have the element of a block grant in many ways. We let the local people—we have standards, but we let the local people spend it the way they see fit.

I want to say that I am very glad to see that for the first time this Administration is budgeting $150 million to help States pay for the costs of providing emergency medical services to undocumented immigrants, although I must say it is inadequate—underscore "inadequate". We had a GAO report that I requested show that California spends $395 million in medicaid costs for illegal immigrants. So, here, you have $150 million for the entire country and it is costing us $395 million. So it is inadequate, but you are the first Administration that has done anything about it.

I would like to know how you are planning to spend that, and then my last question deals with this issue of the eight volumes of guidelines that the Chairman spoke about. I always find it interesting. If we don't like a program, we say, look, it has eight volumes. You know, if we like a program, we say, look, it has eight volumes. It depends on how we feel about the program.

But the fact of the matter is did we have eight volumes under George Bush? Did we have eight volumes of guidelines under Ronald Reagan? Have you, in fact, cut the guidelines back or have you increased the guidelines? Can you give me a sense of whether or not these eight volumes started with the Clinton administration? So, my two questions: How are you going to spend the undocumented immigrant reimbursement funds? And talk about the eight volumes of guidelines.

Secretary SHALALA. On the reimbursement, we have not worked out the formula yet, and we will be working on how that money is to be distributed. It is targeted for emergency care for illegal aliens to help States like your own offset what are substantial costs in certain parts of California, but also costs for other States, like Illinois and New York and Florida who also have these problems.

Senator BOXER. Will you keep us informed——

Secretary SHALALA. Yes, we will. And we will be in conversation, I think, with appropriate legislators.

On the issue of eight volumes, yes, the eight volumes did exist before. I am not happy about anything that takes eight volumes. We are in the process, through reinventi[illegible]rnment, of looking at all Government regulations to see wha[illegible]solutely necessary under the Vice President's and the President's direction. Medicaid is one of those programs that is going through a thorough review in terms of what regulations we need to get rid of or shorten.

Let me also say that, in saying that, we believe there can be more flexibility in the Medicaid Program. There is no question either in medicare or medicaid or the welfare programs that what we need is better performance measures, outcome measures as opposed to all the kind of detailed inputs that we have been putting in these programs.

We do have different management ideas about how you ought to manage very large, complex programs. The Medicaid Program is essentially managed by the States, as opposed to the Medicare Program that is managed by private contractors that the Government contracts with. So, you will see over the next couple of years substantial reform in the regulation progress from this——

Senator BOXER. If I might say, and I know my time is up, and this is very brief. I would say that the Chairman makes a good point. And I will tell you why I feel that way.

In California, you would not believe what a bad program Medi-Cal is. We have physicians—and I think Senator Frist would be interested in this—who have assisted in complicated births who were reimbursed only $17. Now, better that they would just say I am making a charitable contribution of my time. So something has gone wrong and perhaps somebody has taken a heck of a lot off the top. And by the way, in this case, it may well be that the State is doing it. But I don't really know who is doing it. It could be an underfunded program.

But when I hear those things, it is very, very upsetting, because to pay someone $17, a doctor who assisted in a complicated delivery is just—I think it is a shame on our country. So let's reduce those volumes of guidelines and figure out a way to make it a better program.

Secretary SHALALA. That is a case where the State has made a decision to keep its expenditures in medicaid substantially lower, for instance, than some other States around the country.

But, you are right. I mean, it costs more than $17 to fill out the form probably for most physicians. I recently met with the head of the California Medical Association, and we had a long conversation about what he had to do in his own office and how many people he had to employ. But it wasn't just the Medicaid Program; it was all the different insurance companies that he had to deal with. He had to keep a full-time staff on just because each plan had a different requirement. And he was arguing for a standard plan for everyone that would make it easy for him to determine what he could do with a patient when they came in.

Senator BOXER. Thank you, Mr. Chairman, for your patience.

Chairman DOMENICI [presiding]. Senator Frist.

Senator FRIST. Thank you, Mr. Chairman. Welcome, Secretary Shalala.

Secretary SHALALA. Thank you.

Senator FRIST. I am sorry I missed your opening comments and questioning, so don't repeat anything that you have said.

Let me shift just a little bit away from medicaid and medicare. If I have time, I would like to come back to the Medicare Trust Fund.

For the Food and Drug Administration, right now you are requesting congressional authorization to create two new user fees, $142 million in 1996, I believe, to support FDA activities. And as you know from my previous conversations, I have been very involved from the development of the artificial heart to the use of investigational drugs, and so I speak with some very personal experience with the FDA.

Conceptually, theoretically, this money I would think would be able to or is aimed at accelerating the FDA approval process. Many would argue, as you well know, that just the money alone will not fix the process. Is it your feeling or comment upon whether or not there should be some change in the statute, some more oversight of the FDA activities? As a physician, as an investigator, people have begun, especially in my new position here, people have been coming forward giving me more and more information about this.

I would like to get your general comments with regard to the review process.

Secretary SHALALA. Two comments and two strategies in our case. Number one, the user fees were worked out with the industry, for the most part, as a way of getting resources in and cutting down the amount of time. But the amount of time is related to the process it takes. And it has been our view—and I hope you will see some results, and I expect you to see some results this year—that we need to think through the process and whether we need each of those steps for everything, whether it is medical devices or whether it is for drugs.

So not simply adding on personnel to streamline a process that itself may be flawed is very important. So we are proceeding down both tracks, and I fully expect you to see changes recommended by us this year, both in the process as well as some effectiveness in cutting down the number of days.

Senator FRIST. OK. That is helpful. So, I guess, your response, then, would be basically, let's see what we can come up with this year in terms of the process itself?

Secretary SHALALA. What I would urge you to do, Senator, is to take a look at, when we report out as part of our reinventing government process, at how we are conceptualizing and rethinking what the FDA does in relationship to drugs, in relationship to medical devices. And we may not have gone far enough, but I think it is very important that you hear from me that I don't think that we fix some of the deep concerns by simply adding people and resources to cut down the amount of time.

In Social Security, for example, we rethought the entire disability approval process and cut out steps before we added resources.

Senator FRIST. Yes, and I guess that is my point, is that we see the user fees, and I guess I would like to see the process actually changed more so.

How much of a role is there for the private sector? You have responded that internally we will look at it, look at the review process. What role do you see for the private sector in accomplishing this change in the process?

Secretary SHALALA. I think that this is a partnership. I have always believed that. I believe that Dr. Kessler believes that, that the private sector, the business community, the biotechnology industry, the venture capital industry has as much of a stake in high quality reviews. It is as much as a protection for them.

But they also have an expectation, and an increasing expectation, which I think is real and has to be listened to, that the Government ought not to be doing things that are unnecessary, that delay their ability to get a quality product to market, that delay and significantly affect their ability to compete both in this country as well as around the world.

We have to find the balance, and the challenge is in finding the balance. The important thing is you hear from us an attitude that we know it is more than just a resource problem.

Senator FRIST. Right. Let me again shift gears quickly. Again, a program that I have been involved with in medicaid is TennCare.

That was viewed as one of the early 1115 waivers. The process has been difficult, I think, on everybody's part. It started as a concept, implemented very rapidly in a State that was only moderately well prepared in terms of managed care to bring others up to date. Medicaid in Tennessee became TennCare, which is a 100 percent managed care program.

To date, has it been successful from an expenditure—total expenditures in the medicaid population there, the curve is flat. So, clearly, total expenditures have flattened out on the revenue side? Tennessee has had real problems in terms of reaching out to the patients and constituents directly.

If you look at the curves of expenditures in health care and medicaid for the State, it has been $2.9 billion, essentially flat, for the last 2 years. As a policy maker, you look at those numbers and one says it looks pretty attractive when you look at other curves.

How do you view that program so far?

Secretary SHALALA. Well, first, what the State did, as you well know, is put almost 500,000 people under health insurance. And Tennessee actually is one of those States that has had a very high percentage of its population covered. This covered a very substantial part of those who were uninsured. So success number one is moving large numbers of working Tennesseans into health insurance.

It was a major change, and we expected problems, and we tried to mitigate them in our negotiations with the State. Certainly, we did negotiate an increase as part of that—a flatter increase than I think the State would have wanted, and that is, we tried to control the growth to make it budget neutral. Part of the slowdown, the State believes, is because we negotiated hard on that.

I have said to the Governor—the new Governor, who raised the issue with me, he said, Is there room for changes? I said I don't think we should ever lock anything in. If you have some improvements you want to come in with, as you talk to the medical community in terms of how they adjust to the system, if there are things that we can do to make the providers and the patients more comfortable as you are moving into the system, we ought not to be rigid.

Was it a rough beginning? You live there. You will tell me that it was not an easy beginning, and I, of course, not only heard but I saw various constituency groups.

I have recently asked my senior policy aide to go down there and take a look herself, Judy Fader, with some people, take a careful look and talk to some people as part of that, though I continue to talk to people in Tennessee about the transition.

I think we need to watch it. Whether it was Oregon or Tennessee, the States that have gone through major changes, some other States are moving ahead, we learned a lot from that experience, but we need to protect the population and the Federal Government's investment. We need to watch it, and we will be interested in your reaction.

But you should know that if there are some things that the State and all of you feel that we ought to be doing as part of this discussion, we want to make it work. And we want to make it work in a way that provides a model for some other places around the country.

Senator FRIST. Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you very much, Senator.

Senator Conrad?

Senator CONRAD. Thank you, Mr. Chairman. Welcome, Secretary Shalala.

Secretary SHALALA. Thank you.

Senator CONRAD. It is good to have you here.

You have been critical of the House Republican plan with respect to welfare reform, saying that their proposal was very weak on work requirements. I would like to hear your analysis of why their plan is weak on work requirements and how the Administration's plan would differ.

Secretary SHALALA. The subcommittee plan in Ways and Means actually has almost no work requirements. The requirements are so weak, they are weaker than the Ronald Reagan requirements that were passed in 1988. They would expect about 4 percent, mandate about 4 percent—the States would only have to have 4 percent of their welfare recipients in work in 1996. Under current law 6–8 percent of recipients are working in some kind of part-time employment. The proposed plan contains almost no work requirement.

Our other criticisms, which have been rather extensive, have to do with holding both parents responsible. The Republican bill has yet to have any child support enforcement. It knocks out from any kind of cash assistance all teenagers and their children. It, in fact, punished children as part of the strategy. It knocks out education and training funds. It doesn't provide the child care funds.

We believe it is not welfare reform, that it is, in fact, simply taking the money, giving it to the States, with no real requirements.

I can't imagine that for all of you here that would meet your test of genuine welfare reform. The President's bill requires work, has substantially higher numbers in terms of the number of people moving into work requirements, has time limits on it, had education and training, has child care built in as part of it. And we believe that is genuine—and it doesn't cut off teenagers and their children from any kind of cash assistance.

So I would describe the Republican plan as not welfare reform at all. I am not quite sure what I would call it, except it is just transferring money. It has none of the work or responsibility requirements that have been in other Republican plans and mainstream plans, in conservative Democratic plans, in middle-of-the-road plans. It simply has no work requirements.

Senator CONRAD. Let me, if I could, turn to the whole concept of block grants. I have always been very skeptical about block grants, and I have been skeptical because it seems to me it divorces the responsibility for raising money from the responsibility for how the money is spent; that is, there is really a disconnect here.

They are saying, well, you at the Federal level raise the money. You go to taxpayers and tell them they have got to pony up in order to pay for a program. But then we don't determine how the money is spent. We just send a check off to somebody, and they decide how the money is spent. They have not gone through the sobering responsibility of actually requiring somebody to pay for it. So it seems to me it gets viewed in many cases as free money.

I would just be interested in your comments on the whole concept of block grants.

Secretary SHALALA. This Government over a long period of time has decided there are certain Government investments, fundamental investments in children, in the disabled, in the elderly, that ought not to be block grants. And, obviously, the block grants that you describe have so much flexibility that there is no way there is any accountability built in for the Federal taxpayers. There is a real question—if you hauled up the Secretary of HHS with the block grant on welfare 3 years from now, I wouldn't have a clue what the States were doing with that block grant and could not be held accountable for the Federal taxpayers' money.

You are absolutely right that what the block grant does is simply give the money to the States without accountability, and we have seen some examples in new legislation that is being proposed up until now.

It does something else. If I was in North Dakota, I would be very wary about a block grant in slow-growth States. In a State like North Dakota, you may get a certain amount of money, but if there is an economic downturn where working people get laid off, you would not have Food Stamps or the Medicaid Program or cash assistance through welfare to help people on a temporary basis. The economic stabilizing effect of entitlements has worked not to help the poorest of the poor, but to help working folks who need temporary help. It has worked in exactly the way that we want welfare to now work, as a temporary transitional program for people to get on their feet.

So there is a substantial problem with using the block grant approach from the point of view of States who may go into a recession, or part of the State that may go into a recession, in terms of pulling themselves out because they would not have an infusion of money from the Federal Government to help in that transition.

The economic recession would go deeper and broader, and the business community could not pull it out. It would hurt the economy of a State not to be able to have that kind of input. So accountability and real economic effects to protect the States are two major reasons why block grants, it seems to me, are really not in the interest of the people of this country.

Senator CONRAD. I would just say that, for me, if the States want to have this responsibility, then I think they should have the responsibility for raising the money to pay for it. If they want to make the decisions, fine. Then they ought to raise the money and pay for it.

I think this idea of separating responsibility for raising money from the responsibility for paying for it, how the money is used, is a very flawed principle, that you always ought to keep together the responsibility for raising money and how it is spent.

I thank the Secretary for your testimony today.

Secretary SHALALA. Thank you very much, Senator.

Senator CONRAD. I look forward to working with you in the year ahead.

Secretary SHALALA. Thank you very much, Senator Conrad.

Chairman DOMENICI. Thank you very much, Senator Conrad.

Could I just ask you a question about Indian health care?

Secretary SHALALA. Sure.

Chairman DOMENICI. It is not a macro issue like these billions of dollars, but it is pretty important.

First, last year your budget submission was very, very bad for Indian health. I don't know wherein the mistake was made, but in short order you acknowledged that it was being cut way too much. And we did succeed in putting in substantial new money. I gather this year you are not cutting Indian health.

Secretary SHALALA. That is right.

Chairman DOMENICI. But I do want to ask you if you could submit for the record—and I know this is very precise, but I would like it—what the staffing effects of your proposal are for facilities like the new $58 million hospital at Ship Rock. Could you do that for the record?

Secretary SHALALA. Yes, sir.

[The following was subsequently supplied for the record by Secretary Shalala:]

NEW IHS HOSPITAL AT SHIPROCK

The fiscal year 1996 President's budget requests additional funds for staffing of the new Shiprock Hospital as did the fiscal year 1995 appropriation. Staffing at the facility will increase from the present 548 full-time equivalents (FTE) to 584 (FTE) in fiscal year 1995, to 628 FTE in fiscal year 1996. IHS intends to increase the number of FTE at Shiprock to 677 in fiscal year 1997. These staff figures represent a combination of Federal employees paid for with appropriated funds, Federal employees paid for with reimbursements from patients' health insurance (including medicare, medicaid and private insurance) and contract staff.

IHS plans to meet the challenge of an increasing service population and the need to staff new facilities by reducing staff at headquarters and the area offices, and by increasing the amount of staff at its hospitals and clinics which are provided by contracts, either with tribes or tribal organizations or with the private sector.

Chairman DOMENICI. I want to try a notion on with you, and if you give me the slightest go-ahead, I would do a little communicating through the Indian Affairs Committee. You probably know that I have a genuine concern about mental illness, severe mental illness, and I work very hard here in the Congress to try to make sure we are not doing things to make the life of those people more difficult.

I note—and I believe you should be very concerned about this—that the suicide rate among Indian people is among the highest—it is the highest in the Nation, and in certain tribes it has skyrocketed. I think you are aware of that.

Secretary SHALALA. I am.

Chairman DOMENICI. Now, frankly, a lot of different reasons are assigned to it, and it gets kind of muddled when you try to get numbers and statistics and reasons why, and it banters around between drugs, alcohol. But I am of the opinion as a layman that a lot of it is attributable to depression, whether it is clinical depression or whether it is depression that is added to by drugs or alcohol.

I am very concerned that Indian health has not had a strong enough program with reference to the diagnosis and clinical treatment of depression and other significant mental diseases like manic depression, schizophrenia, et cetera.

I think we ought to ask you to take a look, ask you to ask the good Dr. Trujillo to take a look at this. I have been very concerned. I have some examples where medicines that were available to non–Indians for schizophrenia were not available to Indians, and on a case-by-case basis I have slugged that out and prevailed. I don't like to do business that way.

But I think good overview of the psychiatric and clinical mental illness component of Indian health, especially in light of the enormous suicide rate, would be in order. And I have gone about asking a couple of people if they would consider helping you do this evaluation. I have spoken to Herb Pardes at Columbia medical institution and to a doctor in Albuquerque who used to be at NIH. You may know him, Dr. Sam Keith.

I wonder if I were to ask you if you would consider asking a group of people such as this who would do this for free, gratis, if they would help Dr. Trujillo evaluate that program and give you and Congress a report on how we might make the program better.

Secretary SHALALA. I would be happy to, Senator.

Chairman DOMENICI. Thank you very much.

Now, let me talk about FDA and the campus that is being provided and prescribed by FDA.

If I am wrong then I stand corrected. We are in the process of trying to help them streamline and do a better job of helping doctors and others get their medicines out quicker. We understand that in many areas it is very slow, and we understand particularly in the area of medicines for children that we really have some very significant hiatuses.

But I am kind of worried about how much money we are going to spend for a new campus. So I would like to just tick off a few numbers and see if you, Madame Secretary, might share some concerns about this.

First of all, we have already appropriated $316 million for this new campus that is going to be in suburban Maryland. I have heard estimates that the total cost of this 539 acre campus will be $690 million. In addition, the FDA is also building two other office complexes for another $200 million. One of these is a $40 million center for veterinary medicine. I do not pick on any, I just state some facts.

As I understand it, FDA will come back to us between now and 1999 and ask for another $572 million in program and budget authority for this new construction. Now if I add all this up, I guess I wonder why we are trying, in this episode of balancing budgets, why do we need to spend $890 million on new FDA campuses?

Secretary SHALALA. This has gone through a lot of hearings and oversight. I think that all of this is part of a long term plan to streamline and consolidate the facilities of the FDA. I am happy to provide for the record the details on those expenditure numbers, which I really do not want to confirm since I have only part of them now. But we came in 2 years ago on the tail end of some of these decisions with the GSA. I did review them. I will take responsibility for them. I do not want to back out of what is an appropriate responsibility.

But the attempt here was to really consolidate the facilities of the FDA. They have been all over the place. In the process, not put the old FDA inside the new buildings, but hopefully have a new streamlined FDA as part of the process. But let me provide an answer for you in the record.

Chairman DOMENICI. I want to state for the record that I think our national government has a tendency, when there is a problem with reference to rules and regulations and extremely difficult management schemes, I think we have a tendency to think of a new building. But I am not at all concerned about whether they should have new buildings.

I am very concerned about whether the regulatory process is working right. And I do not think that they are synonymous. That if we spend $900 million for a new building we will straighten out the problems with FDA processes. Some of them we have to change; some of the rigidities have to be changed. And some of them you have to help us change. I mean, some of the requirements are absurd in terms of the risks that have to be met in experimental drugs and the like. I think everybody knows that. But maybe with the new Congress we will change some of them. Hopefully, we will do them consistent with good common sense and perhaps you will be sharing those with us.

[The following was subsequently submitted for the record by Secretary Shalala.]

FDA HEADQUARTERS CONSOLIDATION

Consolidation of the Food and Drug Administration's facilities was authorized by the FDA Revitalization Act (P.L. 101-635) of 1990. At present, FDA is scattered in 48 buildings--many with outdated and unacceptable laboratories--in 20 different locations. Through this law we will be able to improve our laboratories and consolidate in two locations in the Washington area. The Revitalization Act authorized the Administrator of the General Services Administration (GSA) and the Secretary of Health and Human Services (HHS) to work toward that end.

On March 15, 1994, the Office of Management and Budget approved a consolidation plan for the headquarters programs of the FDA, now estimated to cost $810 million, which will provide the agency with a total of 3.6 million gross square feet of laboratory, office, and support space. This plan calls for the Center for Biologics Evaluation and Research, the Center for Drug Evaluation and Research, the Center for Devices and Radiological Health and Office of the Commissioner staffs to be located in Montgomery County, MD, while the Center for Food Safety and Applied Nutrition and the Center for Veterinary Medicine staffs would be located in Prince George's County, MD. Congress has already appropriated nearly $319 million for the project and the GSA has augmented these funds by internally reprogramming about $6 million, creating a total of $325 million in available project funds.

We think this project deserves your continued support because it will make the FDA more efficient and effective. Moreover, according to current projections, it will save U.S. taxpayers a very significant amount of money over the next 30 years.

<u>Expected Benefits</u>

- Consolidation will allow FDA scientists to engage in collaborative efforts that are critical both to the advancement of knowledge and to the coordination of research and review functions performed by the agency.

- Operational efficiency, managerial efficiency and productivity will increase. When our scientists can work in close proximity to each other, they can increase the speed of our product approval decisions--one of FDA's highest priorities. Additionally, working together makes it easier for scientists to share their expertise and bring the best possible scientific intelligence to bear on critical product approval and public health decisions.

- Replacement of antiquated laboratories with "state-of-the-art" facilities will enable FDA to handle today's advanced laboratory functions and meet accepted industry standards for safe research operations. In order for FDA to make its important product approval and other regulatory decisions we need sound science and qualified scientists. The scientific work done in our laboratories provides critical support for our regulatory missions across the entire range of FDA program activities. But our ability to do this job is being threatened by our outdated, inefficient facilities. FDA's leased laboratory buildings were never designed to handle today's advanced laboratory functions, nor do they meet accepted industry standards for safe research operations. The condition of the laboratories makes it difficult to retain highly qualified scientists.

- The agency's ability to recruit and retain the best scientific talent will be greatly enhanced as we replace antiquated laboratories with improved facilities. For example, some employees in the Center for Veterinary Medicine continue to work in laboratory space constructed in a facility that previously was used as a chicken coop. The current overcrowding of laboratories and offices will be relieved and existing unsafe working conditions will be eliminated once the consolidation project is completed.

Cost Savings

- The FDA consolidation project makes good economic sense. In addition to helping us help the public, it will give American taxpayers a solid return on their investment. Not only will FDA's operational capability be greatly enhanced, its operating expenses will also be reduced. Consolidation of FDA facilities will cut travel costs, provide for the better utilization of existing laboratory equipment, reduce the need for duplicating equipment needs and improve the time frames for product approval decisions--thus reducing costs.

- Over a 20-year period, commencing in 2003, the consolidation of FDA programs is expected to save in excess of $1 billion over currently-projected leasing costs, according to the General Services Administration.

- The thrust of this entire project is in keeping with the initiatives of the National Performance Review and the streamlining and reinvention goals of the Department and the Food and Drug Administration.

Current Status

- GSA and FDA are committed to completing the headquarters consolidation project with a cost-effective, functional and flexible design that will serve the mission of the agency far into the next century. The proposed sites will house a combination of general office, storage, and special-purpose space, including a significant amount of laboratory space. The projected space for the buildings is 3.4 million gross square feet. The Montgomery County site will occupy 2.4 million gross square feet. The Prince George's County site will occupy approximately 1 million gross square feet.

- GSA advertised for 350-to-400 buildable acres in Montgomery County, MD, on March 21, 1994. On December 9, 1994, at the property known as the Clarksburg Triangle at the southwest quadrant of MD route 121 and I-270 in Montgomery County, MD, was announced as the preferred site. A public hearing was held on February 9, 1995 to receive comments on the draft environmental impact statement. of the 27 citizens who testified at the public hearing, 22 provided strongly supportive responses. The majority of citizens, county representatives, and community representatives welcomed FDA as their new neighbor. The Montgomery County site will house the agency's headquarters, the Office of Regulatory Affairs, and the centers for drugs, biologics and medical devices.

- The Prince George's County site will house the centers for food and veterinary medicine. Construction of the Center for Veterinary Medicine research facilities began in September 1994. The decision to put foods and veterinary medicine together is a reflection of their similar food safety mission. The Center for

Veterinary Medicine regulates animal drugs and animal foods which, by their ability to cause residues in animal-derived food, can be a food safety concern.

Chairman DOMENICI. I think one of the problems I have, Madame Secretary, when we talk about the President's approach to reinventing Government and we see proposals to streamline Government and consolidate programs. In my head, when you take a huge number of programs, like I understand in the President's budget he proposes to consolidate over 100 categorical programs, Public Health Service, into 16 "clusters and performance partnerships." I applaud that.

But this debate about how we streamline Government is clearly going to go beyond that. Obviously, one approach is to give more flexibility and responsibility to State governments and grantees.

Now having said that, maybe I am wrong, but it appears to me that after all of this clustering and performance partnershiping, that the savings are $15 million in 1996 from overhead, but the budgets for each of these agencies affected, the Health Resource and Service Administration, Substance Abuse Administration, and Centers for Disease Control, go up, not down. As a matter of fact, they go up $220 million in budget authority in 1996 as compared with 1995.

I know there is apparently some great accomplishment in creating these clusters and performing partnerships, but I wonder if it is not sometime possible that when we do it we would spend less.

Secretary SHALALA. Senator, that is a fair comment. If you look over all of the reinventing Government that the President has done, in some cases we actually substantially cut back and restructured agencies as we did with HUD and with the Department of Energy. In some cases, what we were after was to save the number of drug treatment slots that went out to local communities, but we wanted to make the programs more flexible and reduce our administrative costs here in Washington. That is what you see in some of the clustering.

Or we felt that we needed to increase our prevention commitment in some areas like women's health. But what we did was we reduced our administrative cost by consolidating some smaller programs, but either increased the direct money to the community slightly or kept it about the same.

So I am not pretending that every time we consolidate lots of small programs we will save more than administrative costs. Sometimes we will recommend eliminating or straight lining the program. There are different ways of doing this as you well know. I think that in our reinventing Government process you will see a little more in the next couple of months in terms of the kinds of tough decisions we are making. But if you look across the Government, we have done one, two, and three depending on the agency and the priority that the President placed on it.

Chairman DOMENICI. One last question. First, let me just suggest, I know there are some ups and downs as you consolidate. Some go up, some go down. But I think it is pretty obvious that on the appropriated side of this budget, which these programs are, there is not going to be much room for anything to go up. Any proposals I have seen over the next 5 years, appropriated accounts for discretionary spending are going to be reduced off a stagnant baseline in numbers in excess of $100 billion. So we are looking for consolidation like you have done or more major—but we are looking for savings at the end of that consolidation.

Secretary SHALALA. Senator, I took 69 programs down below the 1995 appropriations, and the President made the decision to increase a number of programs. I just think that in this public life that we have to have some investments, a handful. It could be that in our case the major investments are in Head Start and in the National Institutes of Health.

What I think that you should see from us is we are willing to hold down some parts of the budget. But we are not willing to say that there are not some things in which the future of this country is so important, like the basic biomedical research, where we are not prepared to make the sacrifice in some programs to increase those. So that is all you see revealed in our budget.

Chairman DOMENICI. I have one last one that I just want you to think out loud with me and see if I'm on the right track. This has to do with kind of a general question. Can a fee-for-service system control costs without cost-sharing? I think there is some evidence around that it cannot. It cannot control it without some cost-sharing. Medicare operates largely as a fee-for-service system. Both Part A and Part B of medicare attempt to control costs by requiring that a beneficiary share part of the cost of the benefits that they receive.

But there are two services that have no cost-sharing provisions. They are relatively new, but nonetheless, have been around for a while. They are home health care and clinical laboratory services. I note with interest that while hospital payments have risen 6.8 percent, that part of medicare; Part A benefits, 9.8; physician's payments, 11.8; home health care, 21.6; clinical laboratories, 13. I note, Madame Secretary, that the latter two have not cost-sharing. I wonder if you would share with me, do you really think we can control fee-for-service systems if they are going to exist—and they are, I assume, for a while. Can you do that without cost-sharing?

Secretary SHALALA. Senator, let me share that the literature is mixed on this. Common sense would seem to dictate that if someone had to share some of the cost they would be more conscious about what they were asking for. But it depends on what population you are talking about. For a population whose incomes are under $25,000, which is basically the medicare population, would cost-sharing change their behavior? And what kind of behavioral change are we after?

What we are obviously after is to make sure that we are not doing excess things, as opposed to having people put off a stomach ache because they had to pay something up front, where that stomach ache may lead to something much more serious.

So what all of us are trying to find in what is a complicated business is what is the mix between cost-sharing and keeping the kinds of quality health care that we want. Let me point out that at the same time we are also trying to preserve choice and do some other things in health care.

Home health care is an example. The private managed care business has been as unsuccessful as the Government has been in its ability to manage home health care. Everybody is struggling with how you do oversight and manage home health care in this country. So whether or not you have some cost-sharing in home health care does not necessarily dictate our ability to control the cost. The problem is, if you put someone into someone's house, it is much more complicated to try to manage that from an HMO's point of view than if someone is in an institution, in terms of controlling cost.

So it is tremendously complicated. I do not think the literature is clear. All of us believe, in terms of common sense on this, that we ought to find the mix. Congress has struggled with this, obviously, in Part B of medicare.

But again, it is one of those issues that ought to be part of our ongoing discussion about health care. It is clearly something that everybody will want to discuss. We simply want to discuss insurance reforms, and what we do with existing programs, and cost containment at the same table. That is the only point I have been making about the President's willingness and his understanding of how the health care system works.

I was at Jackson Hole this weekend and had long discussions with the industry about how you contain private sector costs and not cost-shift now back to the public sector, and vice versa. I think that we would be happy to provide you with what studies are available on this issue, and come in and have a longer discussion. Perhaps a panel discussion by experts who have tried different kinds of approaches.

Chairman DOMENICI. Let me just ask on home health care, since I have a very strong bias in favor of it. I do not intend to prejudice it by my statement here today. It is just a number. Perhaps you could just take it specifically and answer in the record——

Secretary SHALALA. I would be happy to do that.

Chairman DOMENICI. There may be some other reasons for it. It is now filling a lot of vacuums that wereotherwise——

Secretary SHALALA. It is new. Some of it is, it is new and we haven't built the management systems to figure out what we do about it. But I share your view that the quality of life is much enhanced by our ability to be able to keep our loved ones in our own home. But simultaneously, we cannot have a program that has costs that we do not understand and cannot control.

[The following was subsequently submitted for the record by Secretary Shalala:]

HOME HEALTH CARE COST-SHARING

Last year the Administration did include a home health coinsurance proposal as part of the Health Security Act. Our proposal would have required a 10 percent coinsurance on home health visits occurring 30 days after a hospital discharge. We would be willing to discuss developing a home health coinsurance proposal this year if it is done in the context of comprehensive health reform.

Chairman DOMENICI. I want to just close the hearing now unless, Doctor, you want another round.

Senator FRIST. No, I have no further questions. But the things we touched upon in the last 20 minutes or so, the Food and Drug

Administration is something that I will be very interested in working with you and really getting more input from the outside and not just internal sort of reorganization. I am not sure exactly, and beyond this hearing we can talk, to how best I can participate in that process.

The Medicare Trust Fund issue is one that I know was touched upon before I came in. The 6-year projections, and I know we are looking for new numbers and you look at new numbers. There is a lot of information out there. The numbers are out there, and I really want to be able to address that very directly. I am not sure how much that was addressed earlier.

Secretary SHALALA. A little bit. What I indicated was in April we would have new numbers from the trustees of the system, and that I would be back up to talk to Congress about those estimates, to begin the discussion on behalf of the Administration with the Secretary of the Treasury.

Senator FRIST. My only comment is that we have last year's numbers and the year before, and I know your response is that they are going to be different.

Secretary SHALALA. In part because of the impact of the baseline.

Senator FRIST. And in the whole medicare-medicaid reform issues, we touched upon a lot of things almost superficially today, but I very much look forward to working with you and the Administration in addressing these.

Thank you, Mr. Chairman.

Chairman DOMENICI. I would just comment, a lot of discussion took place here about categorical grants versus block grants—at least some. I would not want to leave the impression with anyone who was paying attention or listening to this and this discussion, that the United States Federal Government set about in a methodical way to establish the categorical situation which permeates the Government today.

It is pretty obvious that it is a willy-nilly, patchwork of some Senator or Representative who got an idea we ought to be involved in this and we passed a bill and we are involved in this. And next year somebody got an idea we should be involved in that, and now we have 2,600 programs and we do not even, in many instances—you all do it because you have got to go through budgets, but in many instances Congress does not even know they are out there. And we keep funding them because it is sort of status quo, keep it going.

I think that happened, and it just had to happen as the Supreme Court made its interpretations during the Great Depression. They made interpretations then that the Federal Government under the Tenth Amendment had a lot more latitude to get involved than anybody thought before that. Since then it has been a wide open door.

If anything is going on now it probably is taking another look at how many of those areas should we really be in. It is not just block grants, which concern us all. But we may have no alternative other than to do some major block grants.

But some of the other is, should we just stop doing some things we are doing. It is kind of funny that we keep telling our States how proud we are of them for having balanced budgets and we end up the spender of last resort. No wonder they can have balanced budgets. I mean, we are going to spend $350, $400 billion. Where do you think it goes? It does to people in their States. It is not going into outer space except the little NASA Program. But even there, the people get paid.

In any event, I think that is what we have to start looking at. I do not know how we get a handle on it. But I might say, this Administration has not been too interested in getting a handle on that aspect of it either. Not that it should have been your responsibility, but I do not think there is much. Reinventing Government has not really taken on the issue of how many programs should we not have because we cannot afford them any more and we just got into them by some process of, let us do something neat. So we did it.

I might add, Madame Secretary, I cannot leave you with a stronger admonition from one who is very, very concerned that you streamline the strings and regulations that attach to the programs you administer. I know that it is hard for some to believe this, but the American people are angry. And it is not just because we spend too much. They are angry because our rules and regulations are frustrating to the point of people just absolutely giving up, whether it is in medicaid, whether it is in medicare, whether it is whatever.

I am talking to small business people and—I had a woman who is the personnel director for a company with 90 workers testify for 8 minutes off a prepared text, and if I can remember, I will send it to you. You will be very interested. She went through a list of alphabet soup that applies to her job that is beyond average Americans even understanding in terms of having 90 workers, men and women work in a company in Albuquerque. Incredible what they go through. Same as everywhere.

If you wonder what the last election was about, it might have not been for all these things people are saying, but I think it was. People are very concerned that their Government is too pervasive, it is too big, and its regulations and rules just do not make sense. I think that is kind of it.

Thank you, Madame Secretary. It is a pleasure to have you up here.

Secretary SHALALA. Thank you, Senator.

Chairman DOMENICI. We stand adjourned.

[Whereupon, at 12:14 p.m., the committee was adjourned.]

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