THE PRESIDENT'S ECONOMIC PACKAGE

HEARING

BEFORE THE

COMMITTEE ON SMALL BUSINESS
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRD CONGRESS

FIRST SESSION

WASHINGTON, DC, MARCH 25 AND MAY 11, 1993

Printed for the use of the Committee on Small Business

Serial No. 103-7

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THE PRESIDENT'S ECONOMIC PACKAGE

TUESDAY, MARCH 25, 1993

HOUSE OF REPRESENTATIVES
COMMITTEE ON SMALL BUSINESS
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room 2359–A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the committee) presiding.

Chairman LAFALCE. The Small Business Committee will come to order.

I am very pleased to welcome to the committee Dr. Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve. Mr. Chairman, the members of the Small Business Committee and I personally deeply appreciate your taking time from your busy schedule to be with us today.

I know that you are asked by virtually every committee in Congress to come up, and you could have a full-time job just testifying before the Congress, and that is why I do view your appearance this morning as a very special event for us. We are very grateful. Thank you.

Dr. GREENSPAN. Thank you very much, Mr. Chairman.

Chairman LAFALCE. We look forward to your testimony regarding the outlook for our small business economy and the impact of the President's economic plan and credit crunch initiative on the economic future of our small business sector.

Also, pursuant to our conversations and your staff's conversation with my staff, we understand that you only want to speak about the budget plan in the aggregate, that you don't want to get into any specific details of it, but just look at the aggregate picture. We will respect that.

In recent weeks, this committee and the small business community have witnessed a very significant turnaround. I have been fortunate to have been chairman of this committee since 1987. Since then, there have been times when months, even years have gone by in the economic policy debate with nary a mention of the small business sector. Now, in the first few weeks of this administration, small business has a front row seat on the economic policy stage.

This is as it should be. For it is the potential of the small business sector—the jobs it creates, the new businesses it develops, the innovation it fosters, and the communities it helps to build—that holds the key to our economic growth. It is the unique problems that smaller firms encounter—costly regulatory requirements, limited access to capital, and stepchild status in too many economic policy discussions—that can impede that growth.

The President's economic plan incorporates a serious effort at deficit reduction, coupled with a modest stimulus package that will ensure we do not forestall the economic recovery we are beginning to see. This reorientation of our economy away from deficit spending and toward productive investment will help all of this Nation's businesses.

But President Clinton is not relying passively on general economic trends to give our small businesses renewed strength. He has chosen to recognize both the enormous economic potential inherent in our smaller enterprises and the formidable difficulties they face, and to respond. Already, the President has proposed key initiatives which will maximize the small business sector's potential and address its problems.

The President's economic plan includes a permanent investment tax credit for small businesses, along with a targeted capital gains tax cut for long-term investments in small entrepreneurial endeavors. These, along with tax credit proposals for research and development and jobs creation, should provide a significant boost to the small business sector of our economy, which historically produces the large majority of new jobs.

In addition, and in my opinion more importantly, President Clinton has only recently announced a package of credit crunch initiatives that will go a long way toward removing the stranglehold that excessive regulation has placed on the flow of credit to small businesses.

Since our consideration of the S&L bailout legislation in 1989, I have consistently argued that the thrift crisis engendered a regulatory overreaction. Excessive restrictions placed on our financial institutions have inhibited banks and thrifts from lending and helped create the severe credit crunch our smaller enterprises have confronted for so long.

As small businesses have been denied badly needed credit, the job creation and economic expansion that smaller firms have contributed to our economy have also disappeared. As the President pointed out, "If you had to put in a sentence why this has been a jobless recovery, it is because small business job creation hasn't offset big business job losses. That is the central challenge we face."

Out of concern for the fate of our small business sector, I had written and spoken to the President on the regulatory relief issue, urging precisely the kinds of changes we are now seeing. I am gratified that the administration is moving in this important new direction and offer my full support.

The regulatory changes the President has already endorsed will help restore banks to the business of lending and small businesses to their essential role in our economy. But I believe there may well remain statutory inhibitions to removing the burden of excessive regulation.

I know the regulators are reviewing current statutory guidelines in the area of bank and thrift regulation, and I hope they will move quickly to recommend any necessary legislative changes.

I would also urge the administration to look closely at innovative proposals to enhance small business lending. I made proposals for the development of a secondary market in small business loans that I would hope could be considered seriously by the administration and by the regulators.

Mr. Chairman, I again extend the committee's thanks and a warm welcome. We look forward to hearing your testimony shortly.

[Chairman LaFalce's statement may be found in the appendix.]

Chairman LAFALCE. Mrs. Meyers.

Mrs. MEYERS. Mr. Chairman, I will be brief because we will probably be interrupted by a vote or two, and I think we all want to hear what Dr. Greenspan has to say. I do thank you for this opportunity to explore the effects of the President's budget package on the success of our Nation's small businesses and their employees. I certainly look forward to continuing our probe in the months ahead as the consequences of the President's plan take root.

My thanks as well to you, Dr. Greenspan, for taking time out from your duties to help our committee grasp the concepts and realities of President Clinton's approach to managing our country's vast and divergent economy, and I fear he is indeed returning to the tried and failed theory that Washington can manage the economy better than the free markets can.

That said, I still think almost all of us agree on the crippling effects of deficit spending and the Government's need to cure its addiction to it. I don't want to belabor the point, but if we are to kick the habit and drop the deficit, we must first understand that the Government has a spending problem and not a revenue problem.

I am concerned that the Clinton budget may have missed the point by relying on rather small spending cuts and very hearty tax increases to address the deficit. While small businessmen and women are honest, hard working people who want to do their part to reduce the deficit, they harbor a really deep anxiety over whether the spending cuts and deficit reduction overall will materialize.

Tax-for-cuts deals in 1982, 1984, 1987, and 1990 levied new taxes on small enterprises and the economy to be sure, but the promised spending cuts faded quickly into memory, if anyone remembered agreeing to the cuts at all. In short, small businesses have learned this lesson well. Taxes materialize, cuts dematerialize, and spending keeps rolling along. Why, then, should small enterprises buy into this charade again?

Mr. Chairman and Dr. Greenspan, these are just a few of my very serious concerns about the ramifications of the Clinton budget: The return to an economy micromanaged through the tax code, the reliance on new taxes rather than real spending cuts to reduce the deficit, and the effect of those new taxes on job creation and real economic growth and prosperity.

It seems to me that the better approach is to produce real upfront spending cuts, demonstrate real deficit reduction, and offer assurances to small businesses, indeed all Americans, that they won't bear the costs without getting the benefits of a strong and vital economy in return. Then, and only maybe then, should we consider modest new taxes to protect future generations from the debilitating burden of deficit spending.

I look forward to your views on these comments and thank you again for joining us today, Dr. Greenspan. I heard what the chairman said about not wanting to get into specifics, but I will say in my defense that this was the first time I had heard this this morning.

I don't want to get into an argument over the Clinton budget, but I do think that the specifics of the Clinton budget will have a tremendous impact on small business over the future years, so any enlightenment that you can shed we would welcome.

Thank you very much for being here.

[Mrs. Meyers' statement may be found in the appendix.]

Chairman LAFALCE. There is a vote taking place, and if it were questions and answers, I would just go ahead with it. Since we want to hear from you, I will recess, and catch the vote, and go over and come right back.

We will stand in recess for about 10 minutes.

[Recess.]

Chairman LAFALCE. The Small Business Committee will resume session.

When we recessed for the vote, the distinguished ranking minority member had concluded her remarks, and we were about to hear from the Chairman of the Federal Reserve Board, Dr. Greenspan.

Dr. Greenspan, the floor is yours.

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

Dr. GREENSPAN. Thank you very much, Mr. Chairman. I am delighted to be here before this committee to discuss the availability of bank credit to small businesses.

Given the importance of small businesses to the economy and the clear dependence of such firms on banks, the decline in overall business loans in the 1990's underlines the importance of understanding the difficulties of bank credit availability. Even more importantly, it emphasizes the need to continue to do whatever is possible to remove those sources of restriction that do not imperil the safety and soundness of the banking system.

The 1990's have witnessed a substantial tightening of lending terms and standards that have affected small businesses. The sources of tighter credit availability are not too hard to find. A significant part of our current problems reflects the lax underwriting standards that characterized the 1980's.

The resulting acceleration of nonperforming loans, and associated reserving and write-offs, not only cut sharply into capital—causing many banks to fail and others to be greatly weakened—it also shook the confidence of lending officers and management. The almost inevitable result of these traumatic experiences has been that bank lending policies have gone through a period of exaggeratedly high underwriting standards, the same error as in the 1980's, but in the opposite direction.

Commercial real estate prices have not stabilized enough to allow most banks to feel confident that they know what collateral is really worth. A significant portion of loans to small businesses involves some real estate collateral, and even though banks often do not look to that real estate as the intended source of repayment, I am still concerned that a real estate market that has not found its feet is retarding the availability of small business credit. This impact is both direct—in evaluating both the bank's own capital as well as particular loans—and indirect—by coloring bankers' sense of general confidence.

Banks' own desire to rebuild a strong capital base has also played an important role in constraining the supply of bank loans. I do not mean to imply that either the Basle or the prompt corrective action capital rules are unimportant. They reinforce the importance of capital at both banks and in the market, but Basle and other capital standards imposed on a less traumatized banking system would have been viewed by few observers as a major constraint on banks' ability to make loans.

Two external forces beyond Basle, other capital rules, and banks' own desire to build capital also played an important role in reducing credit availability to small business. Examiners have been widely and severely criticized for permitting banks to have made such bad credit decisions. That many examiners would respond by becoming unusually sensitive to credit granting procedures and—as professionals—reluctant to respond to pleas for more flexibility cannot come as a surprise. At last reading, the laws of human nature have not been repealed.

The other critical external force contributing to reduced credit availability to small businesses is recent banking legislation—FIRREA and FDICIA. In understandable reaction to the huge taxpayer costs of the failure of the S&L's and the need to establish a taxpayer's backup to the FDIC, the Congress felt it necessary to place severe restrictions on insured depository institutions. But the scale and sheer detail of the noncapital portions of recent legislation have, I believe, played an important role in constraining small business credit flows.

The scale has resulted in a drum beat of mandated regulatory announcements and, perhaps worse, anticipated actions that have created uncertainties that could only make bankers more reluctant to take risks. In addition to cost and burden, the micromanagement required by FDICIA has had a chilling effect on bank lending attitudes.

Aside from the general impacts on the bankers' attitudes and risk taking, two regulatory factors have particularly constrained small business credit availability at banks. The first, I am sure, was unintended: The real estate appraisal requirements of FIRREA were designed mainly to eliminate excesses in development and commercial real estate loans. However, most small business loans involve some real estate collateral, even if the purpose of the loan is not to purchase or refinance real estate, and the bank does not look to real estate as the source of repayment. Nonetheless, FIRREA requires banks either to increase their risk by foregoing real estate collateral on such loans or to impose significant costs and delays on the credit granting process by requiring certified appraisals on the real estate collateral. Either way the willingness and ability of banks to make such loans is reduced and in some cases may have been eliminated.

The second regulatory development that has affected small business credit availability at banks is the huge increase in the amount of paperwork resulting from heightened risk aversion by examiners and the attitudes induced by the banking legislation. Many bankers now perceive that full documentation and collateral on such loans are necessary in order to minimize the possibility that examiners will classify them. As a result, the cost of lower risk loans to small business has risen by the imposition of documentation and collateral requirements, or if the necessary documentation and collateral are not available, such loans are not being made. In either event, the economy suffers.

Nonetheless, as I review the current banking situation, I find reasons for optimism, but not complacency. While not yet totally stabilized, some degree of firmness is occurring in some commercial real estate markets. Our surveys and other information indicate that banks' attitudes toward loans and risk taking are improving. While a segment of the industry still is under stress, the banking industry as a whole has made remarkable progress in working through severe portfolio problems during a difficult economic cycle.

With an improving economy, I am hopeful that the signs of some business loan growth this winter will become more evident this spring. Banks are patently in a strong position to meet such demand. But the issues are too important to leave to chance. There are steps we can and should take. As the President announced on March 10th, the banking agencies are working on ways, within the parameters of FDICIA and FIRREA, to modify their policies and regulations in order to encourage more small business credit availability. The primary objective of this program is to restore banks' ability to use their special expertise to make loans based mainly on judgment to small businesses and to reduce—where possible—regulatory burdens.

These regulatory actions will be, I hope, quite helpful, but legislative action is still required. The Federal Financial Institutions Examination Council will be making legislative proposals this spring, and I urge the Congress to consider them seriously. But perhaps most important is to learn from the experience of the 1990's. One key lesson, surely, is that each new proposed piece of detailed banking legislation has to be evaluated in advance to determine what the impacts are likely to be on the health, vigor, and competitiveness of the banking system. It is even more important to consider the potential implications for the vitality and growth of the economy, especially those sectors that create so much of our employment and innovation. These sectors often have few credit alternatives beyond their local banks.

Thank you, Mr. Chairman. I request that the full text of my remarks be included for the record.

[Mr. Greenspan's statement may be found in the appendix.]

Chairman LaFalce. Without objection, so ordered. We will attempt to confine all the Members and responses to no more than 5 minutes so that all those might get an opportunity to dialog with the chairman.

Dr. Greenspan, some individuals have expressed concern that an attempt to reduce the deficit while we are in the embryonic stages of economic recovery could have a stifling impact on the economy, whether done through reductions in spending or increases in taxation, and that the only way that we can counter what could be a dampening effect on economic recovery would be through monetary policy or possibly additionally loosening up the flow of credit from financial institutions to our business sector as the President attempted to on March 10th.

What is the appropriate interplay between fiscal policy and monetary policy and credit policy?

Dr. GREENSPAN. Mr. Chairman, let me add an additional element to this issue which is really quite important in the context of the most recent weeks, and that is the response of the bond market and long-term interest rates to the prospect that the President and the Congress have come to grips with the budget deficit question and that some success is seemingly evident from the processes that are going on.

As a consequence of that, although there are clearly other reasons why long-term interest rates have fallen, in my judgment, a substantial part of the decline is attributable to that expectation, and that means——

Chairman LAFALCE. How much have they fallen since the expectation was created?

Dr. GREENSPAN. I would say approximately a full percentage point, perhaps a little less than that, but it depends on where you start. That is a very material change. It has dramatic effects in the mortgage market, Mr. Chairman, and it has created a very major refinancing, not only of mortgages and other forms of credits, but it has had a similar impact in the corporate sector and small business sector as well.

With respect to the more general question that you raise, first of all, the issue of addressing the credit crunch as a structural question is, in one part, independent of both fiscal policy and monetary policy, and effectively stands on its own as an endeavor to improve the liquidity of the system and credit availability.

Obviously, to the extent that lower interest rates engendered through monetary policy do not loosen up the credit availability, then clearly structural changes of the types that we have been discussing before the Banking Committee and others clearly supplement this, and that is precisely the purpose of the President's initiative of March 10th.

With respect to the more general question of how the interface of monetary and fiscal policy functions, we at the Central Bank look at a wide variety of elements within the economy to make judgments as to how we implement policy in a manner which contributes to what we perceive to be the long-term goal of policy, namely to maximize the sustainable long-term economic growth of this country.

We view a necessary condition of that to be a noninflationary environment. A crucial factor of how the economy functions will be what the stance of fiscal policy is. So, without saying that there is a simple relationship between the two—because I know that a number of academics and, indeed, some of the models which we use ourselves have got simple trade-offs—in the real world, regrettably, it is a lot more complex than that, and we tend to try to integrate all of the elements that are occurring in the economy when we initiate policy. Therefore, if there is a certain particular fiscal policy stance which has an impact on the economy, that is one of the many elements which we respond to.

Chairman LAFALCE. Good. I just have a follow-up question. You indicated there has been a decline in long-term bond rates of approximately 100 basis points.

Dr. GREENSPAN. It is a little less than that, but, yes.

Chairman LAFALCE. Since the President presented, as you have posed it, a serious, credible——

Dr. GREENSPAN. This goes back to the late weeks of 1992 actually.

Chairman LAFALCE. What is your estimate of the decline in interest payments that we would have to make over, say, a 1-year period as a result of this decline? What is your estimate, if you have any, of the level of private sector investment that would be stimulated over, say, the next year by such lower long-term rates on corporate debt securities?

Dr. GREENSPAN. Well, the calculations are not too easy. We do know that we are likely to have to refinance maybe $75 to $80 billion of notes and bonds over the year, and if you think that the 1 percentage point is what the replacement cost is from what it otherwise would have been, what we are talking about is something, in that case for total interest costs, under $1 billion.

But obviously, if you extend the decline through the full maturities of those particular instruments, it is a number that is significantly more than that. It would depend on the maturities of what those notes and long-term instruments would be. But it is fairly clear that, over a long period of time, if interest rates in the long end of the market stay down, there is an appreciable savings through the full life of the debts that are being replaced.

Chairman LAFALCE. Does the Federal Reserve have any projection of the increased economic investment that might be brought about through the private sector on account of that?

Dr. GREENSPAN. You mean on account of decline in the long-term rates?

Chairman LAFALCE. Yes.

Dr. GREENSPAN. We have not made a specific estimate, but clearly that is not an unimportant element in the cost of capital. Overall, in the very broadest sense through our various calculations we estimate that for every 1 percent increment, you have a fairly substantial increase in economic activity, so that over the longer run the effect of a full percentage point decline is a very large increase in the $50 to $100 billion area if you take all aspects of the economy into account.

Chairman LAFALCE. That is quite considerable.

Mrs. Meyers.

Mrs. MEYERS. Dr. Greenspan, to comment just a minute on what you have just said, are the lowered interest rates just an unmitigated blessing? I think most of us tend to think, most of us with children who are trying to buy a house, tend to think that they are.

On the other hand, for those who have savings or for those who might save, lowered interest rates may not be such a blessing. What kind of a tradeoff is that and how long do you expect the lowered interest rates to last?

Dr. GREENSPAN. Mrs. Meyers, clearly there are a large number of holders of debt instruments, to a substantial extent shorter-term debt instruments, many of whom are retired, who have had not insignificant reductions in their incomes as a consequence of the decline in interest rates, and I think I have heard from most of them.

Mrs. MEYERS. I have heard from the ones you haven't.

Dr. GREENSPAN. However, if you look at the impact of the economy overall, there is no question that the net effect of lower interest rates on the levels of economic activity is really quite significantly positive, so if one thinks in terms of job growth, economic activity, productivity, standards of living, all the broad elements which make an economy function, it is evident that the effect of what economists like to call real interest rate declines, meaning adjusted for the rate of inflation, has a significant impact in a positive direction.

So, while there is no doubt that it is not universally positive, it is clearly, on a net basis, unequivocally so.

Mrs. MEYERS. I am sure that you saw Tuesday's Wall Street Journal that featured the comments of several Nobel laureates on the effect of the Clinton budget. Four American laureates—Dr's. Friedman, Miller, Buchanan, and Becker—all derided fairly strongly the Clinton budget plan and the way it would impact on the total economy. In other words, the large tax increases and the way that those tax increases would impact not only on large business, but small business, and the relatively unbeneficial effect of his spending plan, the nonstimulus effect of his spending plan was commented on.

I wonder if you would react to that.

Dr. GREENSPAN. Mrs. Meyers, in response to similar questions, to a number of questions of the Congress in recent weeks, I have indicated that we at the Central Bank, while we may have our individual views as citizens as to what particular elements of programs we might or might not like, as Central Bank professionals, our interest is essentially in getting the budget deficit down because that is fundamentally where we see the major problems in the financial system are coming from.

Hence, in our judgment, it is essentially that reduction that we wish to focus on and should focus on, and we have eschewed getting involved in commenting on the specific aspects of the President's program or indeed of any of the programs that have been offered from the Congress.

In my judgment, what is involved here, and I look at this quite positively, is that we are currently engaged in what the democratic process is all about in that we are looking at the fundamentally political decisions in the best sense of that term.

All I can say is that as I have said before other committees, there are certain technical questions with respect to the longer term which require, as a necessary condition to restore budget balance, that the rate of current services outlays be cut, because that is an arithmetical truism. I have not and do not intend to focus or comment on any of the specific aspects of any of the programs which are before us.

Mrs. MEYERS. Well, a final comment, Mr. Chairman. A number of people agree, and I think you would probably agree from what you just said, that the best tool that we have for getting the deficit down is an improved economy. In other words, if our economy were growing at a rate of 3 to 4 percent, our deficit would be infinitely lower than if it is growing at the rate of 1 to 2 percent.

Dr. GREENSPAN. That is without question.

Mrs. MEYERS. That is without question. That is why I think a number of us are very concerned about the impact of the Clinton budget on the economy because our ultimate concern also is the deficit. I think that is the major issue in my district, and it certainly, therefore, is the major issue with me.

But I do appreciate the constraints that you are under, and I appreciate very much your being here today.

Dr. GREENSPAN. Thank you very much.

Chairman LAFALCE. Mr. Bilbray.

Mr. BILBRAY. Thank you, Mr. Chairman.

Dr. Greenspan, you mentioned the credit crunch down to the banks and lending. My bankers, my home builders, my real estate people, and my commercial developers all say that it is the regulators who are really squeezing the problem.

The bankers say we are not that apprehensive, we have good customers of our bank who have had long-term histories, who have never defaulted and have never been late on a payment, but yet the regulators come in and say, well, there is not enough security there; we are going to make you reserve for this particular account or do something with this account.

Major borrowers who have tremendous track records in our community in Southern Nevada have been told that they are just cut off at this point, even though they certainly are not, to anybody's estimation, a credit risk.

I try to assure them that the President is sending down messages to work this problem out, but they say basically it is not getting down there. It is not getting to the banks. If the regulators are hearing it, they are not passing that on to the banks.

I think one of the reasons, of course, is that many of these regulators don't want to come back before a congressional committee in 4 or 5 years and say why did you let this happen at this bank or this other bank and not going to be able to say, well, the Clinton administration or Congress told us to lighten up somewhere down the line, and so, therefore, we lightened up.

How do you foresee us getting the message down and getting this thing worked out? The banks, I don't think, are the problem. There are certainly people out there who are creditworthy and aren't getting loans.

Dr. GREENSPAN. Congressman, obviously I have been exposed to very much the same type of notions that you have, and I agree it is partly correct but not fully. The trauma that occurred as a consequence of the nonperforming loans that emerged the latter part of the 1980's very clearly had a major impact on the attitudes of individual bankers, and it is exhibited in a tightening of lending standards that they clearly moved toward.

That is perfectly understandable because their concern is the franchise value of their institutions, and if they see a very large number of nonperforming loans, the value of which they are not really certain, they are terribly uncomfortable about their real capital position because their capital position is only as good as the adequacy on which they can make judgments about what their loan loss provisions should be.

In my judgment, the evidence clearly indicates that they have pulled back, although less so recently, and that for exactly the reasons you suggest, the examiners have as well.

The major reason that we are confronted with this problem, as I indicated in my prepared remarks, is that we are dealing with human nature; that is, as one of my colleagues said, the cat which sits on a hot stove is not going to sit on a stove again whether its hot or cold.

When you run into a situation such as the S&L's, and in many instances some of the commercial banks, what you get is a very significant concern on the part of a number of examiners whose job is to make sure that the safety and soundness of that institution is not impaired. There will be a tendency to overdo it. It is not all that easy, as much as we try, to fully get them to take a more sensible and balanced attitude.

We are starting to succeed in that area, but I would be naive to believe that it is very easy to merely stipulate to a certain examiner, don't be scrupulous in looking at this particular institution, and don't be as forthcoming in trying to classify everything to be exceptionally conservative, because, by doing that, you are undercutting the viability of the institution.

Clearly, in many instances, they have, and in recent periods, there is general awareness as the banks' balance sheets have improved something is apparently beginning to gel, but you cannot ask somebody to do a job less than they think is appropriate, and this is where our problems lie.

Mr. BILBRAY. I agree with you. I think the problem is what is less than appropriate is a very difficult term to define. As of 2 weeks ago, I can guarantee the bankers in my district don't feel that trickle down, that whatever guidance is coming from above, is reaching the regulators.

In fact, in some cases, some of the bankers have told me that they have been required to reserve against SBA guaranteed loans, not only for the percentage that is not guaranteed, but for the entire loan, which is crazy.

Dr. GREENSPAN. It is. That obviously is silly.

Mr. BILBRAY. Thank you.

Chairman LAFALCE. I am going to try to recognize the Members on the basis of seniority.

Mr. RAMSTAD. Mr. Chairman, may I speak out of order and ask unanimous consent to include my statement in the record in that I have an 11 a.m. markup.

Chairman LAFALCE. Without objection, so ordered.

[Mr. Ramstad's statement may be found in the appendix.]

Mr. BAKER. Thank you, Mr. Chairman. I always enjoy hearing your comments, particularly with regard to the impact of future congressional plans on economic recovery.

Mine is, in a generic sense, not specific to any particular proposal, but frankly whether it is classical or Keynesian or supply side or Marxist or any economic theory one wishes to call up in defense of a particular plan, there really are no economic theories that would hold out the belief that increasing rates of taxation would lead to economic stimulus, but, in fact, that increases in Government revenues are inherently going to chill economic activity for some period of time.

I won't ask you to respond to that at the moment, but if you would maybe address that general view or policy not with regard to any specific plan in front of the Congress.

Second, although I am not exactly in concurrence with your views as to the effects of the Basle requirements on the extension of credit, because I think in a stand-alone environment they perhaps would not have a chilling effect, but when coupled with other regulatory enhancements, capital fanaticism, enhanced audit requirements, that the Basle effect, coupled with those in a low-demand loan market, is certainly of some consequence.

I would suggest that there are really greater effects on one of two types of lenders, and this is very simplistic, and I know it. There are those lenders who are basically portfolio lenders and those who sell to the secondary market. The portfolio lender tends to be those who serve rural community lenders, inner-city lenders, and because they are nonconforming borrowers, they can't meet the cookie cutter requirement of the secondary market.

The farmer with the septic tank on the property line—great guy, good farm, makes money, but it doesn't meet the secondary market requirements because of the septic tank. The small bank will make that credit extension. They are going to keep the loan in their portfolio and service it for the life of the loan.

Those regulatory requirements greatly affect that lender because he has to have higher capital reserves to secure against that risk. He has to deal with those appraisal requirements because it is secured by real estate. Why fight that battle? Why extend that credit? Why not buy treasuries, zero percent capital risk requirement, and not worry about making the borrower mad with all the regulatory hype he must comply with?

I think we must do something about that. Regulatory relief is essential, but the Federal Home Loan Bank system is of great concern to me because, generally speaking, that is the window of credit opportunity and liquidity for the smaller institutions, banks, savings and loans, and I think the Federal Home Loan Bank system is under some duress because of regulatory requirements the Congress has placed upon them. That is legislation for another day.

The second part of the market is the secondary market requirement. If you make that small business credit extension, and you can't sell it to the secondary market, and you have to have the 8-percent capital reserves, and it is secured by real estate, you are not having a good day, so you have to get rid of that obligation somehow and service, make your money off origination and perhaps some servicing fees.

Under current rule, whether it be securities law or banking law, it is very difficult, if not outright illegal, to sell a small business loan in the secondary market. I have, along with Mr. D'Amato, proposed a new avenue which would not create a GSE, would not create specific Government liability nor taxpayer responsibility, that would allow the bundling and sale of small business obligations into the secondary market.

From my limited view of it, that would do more to enhance the flow of small business credits to small businessmen, farmers, and others than perhaps anything else we could do in the current environment.

Could you share your views on each of those questions. In less than 5 minutes, of course.

Chairman LaFalce. It was a 5-minute question.

Dr. Greenspan. Let me just say very quickly, I am familiar with the legislation that you and the Senator have put forward, and I agree with you that it is clearly a positive contribution to the creation of a secondary market in small business loans. I trust that you will make progress in that direction.

On the first question that you asked with respect to taxes, as I said before the Senate Finance Committee yesterday, it is sort of an economic principle that all taxes, no matter what their nature, repress business activity.

The question essentially, however, gets to the notion as to whether, in the combination of reducing the deficit, the end result is a more positive result than the sum of the parts, and that is basically a political judgment, and I am just not going to get involved in it.

But your initial principle is, I think, something which everyone would agree with. That is fact.

Mr. Baker. Thank you. I am not sure everyone does, but I appreciate your comment.

Dr. Greenspan. No; it is an economic fact. The reason people won't agree with you as a broader question is that, in combination with other things, you have goods and bads, and there is a balancing issue that is involved.

Mr. Baker. Thank you very much.

I yield back, Mr. Chairman.

Chairman LaFalce. Thank you. The subject of the secondary market, of course, is something that I have had an interest in for 10 years. One of my concerns is that we do not develop a market that would encourage cherry picking on the part of our financial institutions so that in order to get a loan which could be sold off, especially if it were sold off without recourse, you would really only be able to provide loans to the best of the best, and you could wind up with a worse situation than you started with. That is something we have to at least consider.

Dr. Greenspan. I agree with that as a concern because we are not dealing with 1 to 4 family mortgages which have a somewhat different characteristic than small business loan portfolios.

Chairman LaFalce. Mr. Flake.

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

We are happy to welcome you, Dr. Greenspan. As you have cited in your testimony, one of the problems relating to credit availability is the passage of the FIRREA legislation and the continued weakness in the real estate market. Part of the FIRREA legislation, of course, created the Resolution Trust Corporation.

Can you comment on the impact of the Resolution Trust Corporation as it relates to the administration's request for full funding that will allow us to be able to move toward what the FIRREA mandated, and if we do not fully fund RTC, what will be its impact on credit availability?

Dr. GREENSPAN. The reason that it is important to fund the final tranche, as we like to say, of the RTC is that, at the moment, we have Government guarantees of a significant amount of deposits because they are insured under the FDIC.

Effectively, they are Government obligations, but we are paying interest rates to finance those liabilities in these conservatorships that are in excess of the interest that we would pay if we were to substitute Government debt for these deposits. In effect, the $45 billion which is being requested as a pool, to the extent that it is used—and we hope that not all of it will be—is replacing high-interest debt with low-interest debt.

The estimates that are currently being made are that difference, among a number of other things, is costing $3 million a day to the Government, to the taxpayer, and so the longer we hold off funding that institution and allow it to liquidate, the more it is going to cost the taxpayer.

The trouble is that the legal obligation is already there. In other words, we insured the deposits under the Federal Deposit Insurance Act. People expect that their deposits are safe, and indeed they are because the Government stands behind them. So, it is not an issue where we have the option.

It is not as though we have the option of considering the necessity of financing these deposits or not. We have already committed. It is only a question of how we finance it. The advantage of resolving this through the RTC is that it will cost the taxpayer a good deal less; we are saving $1 billion a year by allowing RTC to liquidate and shut down rather than keep it in place.

Mr. FLAKE. Dr. Greenspan——

Chairman LAFALCE. If I could just interrupt you for a second, Mr. Flake. Those bells indicate that there is an extremely important vote on a motion to adjourn that is taking place, and for the knowledge and information of the Members, it is the intention of the Chair to personally miss this vote so that we can continue this dialog with Dr. Greenspan. But I would expect most Members would want to, sometime during the course of the questioning, go cast their vote and then return. I will leave it up to you.

Mr. Flake.

Mr. FLAKE. Thank you, Mr. Chairman.

This is my 7th year on the committee and my very first year, in 1987, the question of S&L's was the first item of business, and each subsequent year it continued to be the first item. Here we are again in 1993, and once again it is one of the first items.

As you know, in each of those instances, we were given an amount of money that would be necessary to resolve the S&L crisis, and each time the Congress voted less than one was required or did not vote out any moneys at all.

Is it your opinion at this time that if we authorize the $45 billion we will, in fact, have this matter behind us and the Congress would not have to face this issue again?

Dr. GREENSPAN. You are quite correct, Congressman, that, in fact, the actual estimated cost of the completion of this job hasn't changed for quite a while, and it is just that it has been underfunded. I haven't done the specific calculations myself, but the people who have done it in some detail feel reasonably confident, in the context obviously of making economic forecasts, that will be more than adequate to resolve the question.

Indeed, the actual estimated cost of the total bailout has gone down, not up, in the last year. I don't want to say to you I know for certain because this is not a legal question, but we have a number of documents. There is an element of economic forecast in this, and it is subject to error, but I would say it is a conservative estimate, and it is the best estimate that can be made, and let's say I will be quite surprised that if the Congress moves on the Treasury's request for these moneys that this issue will not be behind us effectively and fully within a reasonable period of time.

Mr. FLAKE. May I ask unanimous consent for an additional 30 seconds. The President made an announcement relating to his overall approach of trying to deal with the regulatory burden. I would assume that this approach would be sufficient to mitigate the need for legislation. However, your testimony says that it will be necessary.

Might we expect any specific proposals that will be necessary to legislate this spring.

Dr. GREENSPAN. Congressman, it is too soon. I don't think that the Examination Council has coalesced around specific requests. They are all supportive of the President's initiative on March 10, but there are a number of other technical issues which, in their judgment, should be appropriately addressed by the Congress for statutory change.

So, I don't want to prejudge what they will conclude because I don't think they have made their final judgments as yet, but they will within the next few weeks.

Mr. FLAKE. Could part of the answer be in looking at FIRREA? For instance, in areas of real estate appraisals and so forth?

Dr. GREENSPAN. I would think they would be looking at all aspects of those elements which they perceive to be elements constraining the amount of credit availability.

Mr. FLAKE. Thank you very much. I yield back the balance of my time, Mr. Chairman.

Chairman LAFALCE. Mr. Zeliff.

Mr. ZELIFF. Dr. Greenspan, I am from New Hampshire. I am a small businessman. As you know, our State has been devastated. Five out of our top seven banks have changed hands and many others have failed.

We had a hearing 3 weeks ago, when seven of my colleagues, and I took extensive testimony over 5 hours from people who are having trouble getting loans. The interest rates are down, the banks seem to have the money, but they just can't seem to process loans, and we really are trying to do everything we can.

We are meeting with the FDIC this afternoon and some folks from New Hampshire, and the problem that we hear is that this is a just lack of flexibility in terms of character lending, in terms of any risk taking at all. I don't think banking was meant to be a risk-free process.

In an interesting hearing a couple of days ago in the Government Operations Committee, a banker from Arkansas showed an example of how 20 years ago a 2-inch thick folder comprised all the banking regulations in terms of how they dealt with regulators versus the 2½ foot pile of some 15 to 16 different books that they now have.

President Clinton will—and I appreciate his taking the initiative—introduce character lending, and we are going to talk about it this afternoon. How do you put character lending back in when we are dealing strictly with the implementation of the law?

Aren't we opening up a whole new gray area here—as much as I would encourage them to do it—and don't we really have to go back and revisit FDICIA totally?

Dr. GREENSPAN. The issues that are being raised with respect to opening up character lending are not statutory. In other words, the President will be forthcoming with some detail, or I should say more exactly in conjunction with the President's announcement the regulators will be specifying some significant detail which, in our judgment, will open up the window for at least some character lending which used to be a very significant part of small bank lending, and, quite regrettably, it has gone by the wayside in the avalanche of those 2½ feet of regulations which require excessive documentation when those documents are not really the basis on which those loans are made.

Mr. ZELIFF. I guess one other thing is that the cost of processing small business loans both on the bank and also the small business person has gotten so big that it is obvious that it is not a very profitable part of the bank's business.

We were able to bring the New England Lending and Recovery Act up to New Hampshire and ultimately to New England. Also, the SBA Guaranteed Loan Program helped a little bit. But how do we get back? How do we create incentive or force banks to start lending to the small business segment, which, frankly, we are depending on to be able to provide some 80 percent of the jobs in New Hampshire and get our economy turned around? But if banks won't lend to them, and it becomes an unprofitable part of the banking business, what do we have to do to open that process up?

Dr. GREENSPAN. I think that is what the President's initiative is focused on, and that is what the Examination Council evaluations will be focused on, and my impression basically is that it is a very high priority among all of the supervisory and regulatory operations within this Government. I can only tell you that we are going to keep pushing until we get progress that is meaningful here. There has been some, but not enough in my judgment.

Mr. ZELIFF. One last question, Mr. Chairman. I had an example from a New Jersey banker who I talked to on Monday. He apparently had a visit from the Currency, and then from FDIC. He commented on the duplication of the examinations, one being 1 week and the other one being 3 weeks within the same. Please comment on what direction you see this taking.

Dr. GREENSPAN. That is one of the elements which is on our agenda to address because there has been significant criticism, a goodly part of it valid, that the timing of examinations, and the overlapping of examinations, and some of the duplications that are involved are not very helpful, either to the process of supervision or to the process of lending.

Mr. ZELIFF. That is for sure. Thank you. Mr. Chairman, I ask unanimous consent that my opening statement be included in the record.

Chairman LAFALCE. Without objection, so ordered.

[Mr. Zeliff's statement may be found in the appendix.]

Chairman LAFALCE. Mr. Poshard of Illinois.

Mr. POSHARD. Thank you, Mr. Chairman. Mr. Chairman, I would like to ask unanimous consent to submit an opening statement for the record.

Chairman LAFALCE. Without objection, so ordered.

Mr. POSHARD. Thank you.

[Mr. Poshard's statement may be found in the appendix.]

Mr. POSHARD. Dr. Greenspan, just a couple of quick things. You have already answered for the most part my questions on character lending. I represent a large rural area in Illinois where agricultural lending is of the utmost importance to us.

I just had several meetings with bankers in our area, and the issue of character lending is a huge issue with those folks. I would hope that we could promulgate whatever legislation necessary to open that up again within respectable boundaries at least.

Especially in the rural areas where we have smaller banks, there is a need for venture capital and a need for being able to finance a medium-sized industry that might locate in one of our communities. But small banks don't have enough money alone to do that.

Are there any incentives that we can offer at the Federal level for a group of banks to go together and pool their resources so that we might have that kind of capital available where we are to help an industry locate in the rural cities of this country? Is there anything we can do to promote that?

Dr. GREENSPAN. Are you referring to debt capital or equity capital?

Mr. POSHARD. Equity capital.

Dr. GREENSPAN. I don't think we want, obviously, the banks to be terribly involved in this, but, clearly, I think if you look at the whole small business area, this is where all the risk taking, the innovation, all of the really major elements of growth which occur in our system, where it all begins.

It is almost by definition that when you get exceptionally large, your rate of growth can't be very large because you can't continually take an increasing share of the GDP. But when you are small- and medium-sized, there is really no limit to how fast and how much you can grow.

That is really a risk taking, incentive-based question, so we are more involved not in banking as we are in areas of incentives for risk taking. I have argued before many committees of the Congress that, in my judgment, we should be looking more toward the capital gains tax as a potential creator of incentives rather than capital gains tax cut or some form of indexing retrospectively which would have a major impact on incentives to put capital in small venture areas.

Clearly, the issue of aggregative regulation is also not an irrelevant consideration because all you have to do is ask yourself what is it that inhibits people from wanting to risk moneys on what cannot be a sure thing. If the odds are loaded against you, you are going to be less than interested in doing so.

We have to bring down some of those barriers which, in my judgment, have been major factors inhibiting the movement of equity into small business.

Mr. POSHARD. Thank you, sir. I appreciate your consideration of that.

Thank you, Mr. Chairman.

Chairman LAFALCE. Thank you.

Dr. Greenspan, I have welcomed what I deem this administration's new and much greater emphasis on the role and the import of the small business community. President Clinton has said one of the reasons this has been a jobless recovery is that we have not witnessed the historic increase in jobs through the small business sector to offset the loss of jobs in the big business sector.

Now, assuming the validity of that statement—I think you would—what has been the historic role of the Federal Reserve Board with respect to the small business community? How do the activities of the Federal Reserve Board take special cognizance of the small business community historically, and is anything going on at the Federal Reserve today to give increased attention, increased emphasis to all those responsibilities of the Federal Reserve Board and how they do or might impact the small business community in particular?

Dr. GREENSPAN. There is no question that we agree with the general concept that the dynamics of the American economy are in the small- and medium-sized business area. It is in the nature of the way any economy of our type functions, so we take that as a given and that as a consequence. We look fairly closely at what is going on in the small business area and in some considerable detail.

The data in this area are not as good as we would like, and, indeed, we have pending this year a significant survey of small business finance which we hope will give us an update from our now somewhat obsolescent last reading on this, but we have——

Chairman LAFALCE. Have statutory provisions calling for this type of study been helpful? Do they need changes?

Dr. GREENSPAN. I don't think so. We feel pretty comfortable at this stage in the direction which we are going. As I am sure you know, Mr. Chairman, we have advisory committees of small business and farmers who meet with each of the Federal Reserve Banks and with the Board periodically so that we have very significant continuing input, even though we don't have a good data system of small business problems and trends in small business.

While we don't have as much data as I would like, and as accurate as I would like, we have a vast amount of anecdotal evidence which actually serves quite well for us to get some judgment of what is going on.

Chairman LAFALCE. I frequently have bankers tell me, this is not the case, there is a credit crunch. When I receive so much anecdotal evidence over the years—not just a handful or dozens or hundreds, but thousands—then you must give some credibility to that volume, the quantity and quality of that anecdotal data.

Dr. GREENSPAN. Exactly. So, I would just say that we are highly sensitive to the nature of small business, and as you pointed out especially so when something clearly is broken down. We obviously were aware of what was happening 5 or 10 years ago in some detail, and what was happening was pretty good, so when things are working, you tend to forget it.

But that has not been the case of late. Since we know the importance of the dynamics of the small business community on the aggregate level of economic activity, we don't have the luxury not to be watching fairly closely what is going on.

Chairman LaFalce. Let me ask one more question before I go to the other Members who are returning. I recall working on legislation circa 1986, 1988 dealing with exchange rates, working with the Federal Reserve Board, and we included some language dealing with competitive exchange rates in the Omnibus Trade Act.

I was firmly convinced that we needed, within the administration, within the regulators, and within the Congress, to give much more attention to this, given the fact that we do not have fixed exchange rates today. I recall, as you will undoubtedly also, when there were 260 yen to the dollar in February 1985.

What is it today, about 115? That does have some impact on trading patterns, doesn't it?

Well, the fact of the matter is we do have these floating exchange rates. What I am concerned about now is the imminent approval of NAFTA with or without side agreements, probably only with side agreements pertaining to the environment, labor provisions, import surges, et cetera, when I think there might well be, in fact probably will be, almost certainly will be, a considerable devaluation of the Mexican peso, which then could completely obliterate all the econometric studies that have been made with respect to trade patterns between our countries and to investment patterns between our countries.

What are your thoughts about the present value of the peso? Do you think it probably should have been devalued within the past year or two? Do you anticipate that it will be devalued and maybe is not being devalued now in anticipation of consideration and approval of NAFTA? Do you anticipate that it will be devalued subsequent to congressional approval of NAFTA, and if so, what would the consequences be on trading and investment patterns?

Dr. Greenspan. Mr. Chairman, as a central banker, you know I am not going to respond in any detail to the question that you asked, but let me take the spirit of your question as distinct from the specifics.

I don't believe that the patterns of trade will be significantly altered by exchange rates, and the reason basically is that we have a wide variety of other things, including inflation, nominal exchange rates, and a variety of other effects going on.

While you unquestionably get some response, in my judgment, our overall evaluation of what will occur if hopefully the Congress passes NAFTA, is a significant improvement over the long run in generalized trade between our two countries to the benefit of both.

One of the most extraordinary things of the post-World War II period has been the emergence of trade throughout the world as a very dynamic force, and, in my judgment, it is a major factor contributing to the standards of living that have been engendered throughout the world really with very little retrenchment in the post-World War II period.

I attribute that, to a substantial extent, to opening up markets, and we have another opportunity here to enhance standards of living in the North American continent because, if NAFTA moves forward successfully as I certainly trust it will, we will be looking at other relationships within the hemisphere which will be of a positive nature.

I must say to you that it is very difficult not to conclude that having NAFTA go forward is of major importance to this country, obviously of major importance to Mexico. But the most crucial thing is it is jointly important because it is not a zero sum game by any means. We both benefit measurably, and, indeed, since it is a North American Free Trade Agreement, I ought to add Canada who too often, regrettably, is not recognized as a member of this tripartite agreement.

Chairman LaFalce. I find quite surprising your comment that the exchange rates have little to do with trading patterns.

Dr. Greenspan. That is not basically what I said. I was very specific. I said I do not expect exchange rate changes to impact significantly on the United States-Mexican trade relationships in the period ahead. That is not the same statement as saying I believe exchange rates have no effect. I have said just about as much as I can say on that question.

Chairman LaFalce. Well, we are going to be exploring that issue in the future because I think it is extremely important, and we will be talking to you privately on that. We will be having some good economists come in and discuss what they see as probable with respect to the devaluation of the Mexican peso and what impact it might have on trading patterns.

Let me turn now to the other Members.

Mr. Dickey.

Mr. Dickey. Dr. Greenspan, I don't know if this has been asked before, but in my district, we have some difficulties with everybody getting loans, but particularly with minorities.

Can you tell me what ideas there might be to ease restrictions in a responsible way, in a fiscally responsible way? Do you have any ideas as to how we can handle that problem?

Dr. Greenspan. The best way of defining the problem to get it resolved is to recognize that what is happening is that banks are foregoing profitable opportunities by not probing for profitable loans in a number of the minority areas.

We, for example, as I am sure you know, Mr. Dickey, in an examination by the Federal Reserve Bank of Boston, concluded that the nature of the discrimination on mortgage loans up there was not the way one would expect it to have occurred. In other words, what was concluded, as I recall, was that all of the creditworthy borrowers, whatever their color, had no trouble getting loans.

The problem existed in the fairly substantially large number of potential borrowers whose applications were deficient in some respect, but curable. In other words, if they did a few things, they could find that the loan applications would be enhanced. It turns out that that is where the discrimination appears to show up, namely that white borrowers would have a far greater probability of having their deficient applications repaired by a bank telling them if you can do this, we will make the loan, whereas that was lacking in a number of minority loans.

Now what that strikes me as is basically banks foregoing profitable opportunities, and we are endeavoring to find ways in which, in this particular area, we can make them increasingly cognizant of the fact that good business would suggest that they try to repair all of the applications which are creditworthy. My judgment is that we may be able to make some progress in that regard.

Mr. DICKEY. So, perseverance might help, just keep going on?

Dr. GREENSPAN. I would say perseverance is necessary.

Mr. DICKEY. This leads to my next question. I am a small business person, and I have been turned down for loans over and over, and I finally had to evaluate how much time it is going to take, and sometimes it is just a matter of confidence.

I feel like now, in talking to the bankers and being where I am, that the regulations are the things that were hampering our local banks, at least in Arkansas. I have been asking this question, and I bet you can tell me: Who turns the regulators on and who turns them off? Who really does sick them on the banks or sick them on us, and who can turn them off?

Dr. GREENSPAN. Well, to a large extent, it is the Congress.

Mr. DICKEY. I didn't want to hear that. I want the world to know I don't have anything to do with it. Well, how can we help?

Dr. GREENSPAN. Basically, what we are functioning under is a series of statutes which determine what the nature of our regulatory and supervisory processes are. Within a statutory structure, we do have rulemaking authorities, and we do have certain discretions. But with respect to the general structure of how the system functions, that is statute.

Mr. DICKEY. As you know, I have a lot of respect for you, and I really don't want to interrupt you, but there is not any way that I can believe that Congress has brought some of these regulations and the way that they have been imposed on our banks in the detail and the minute degree that it has been done.

Dr. GREENSPAN. No; I agree with that, and indeed I did in response to an earlier question when I believe you were out voting, Congressman, acknowledge that fact.

Mr. DICKEY. You can call me Jay, by the way, if you like; go ahead.

Dr. GREENSPAN. OK, Jay. There is no question that we do have something of a problem in the question of trying to remove some of the elements of considerable concern that occurred among examiners as a result of the S&L problems and a lot of the other commercial banking problems that existed in the latter part of the 1980's, and their function individually is to protect the safety and soundness of the banks which they are supposed to examine.

Some of them very clearly have become extraordinarily assiduous in trying to find every little point and adjust every little element of documentation to be sure that they essentially have covered all the bases, and regrettably there is a cost to that, a significant cost, and——

Mr. DICKEY. It may be a cost of confidence?

Dr. GREENSPAN. You are quite correct, there is a cost of confidence, and there is a dollar and cents cost which is not insignificant.

Mr. DICKEY. Can I ask one more question?

Chairman LAFALCE. You have had 6 minutes. I really do want to go on, Mr. Dickey.

Mr. DICKEY. Just remember me next time.

Chairman LAFALCE. I will remember you.

Mr. Fields.

Mr. FIELDS. Thank you, Mr. Chairman.

Mr. Chairman, I would like for unanimous consent to introduce my statement into the record, followed by a few questions.

Chairman LAFALCE. Without objection, so ordered.

[Mr. Field's statement may be found in the appendix.]

Mr. FIELDS. First of all, welcome, Dr. Greenspan. I apologize for being a little tardy because of floor action. I want to touch on the North American Free Trade Agreement that you alluded to earlier. Many economists predict that this will cost the American economy some 20,000 jobs.

Do you agree with that assertion?

Dr. GREENSPAN. No; I do not.

Mr. FIELDS. Do you agree that it will cost some number of jobs to the American economy?

Dr. GREENSPAN. Not on balance. It is certainly the case that when you, in effect, increase the degree of trade, you will of necessity, expand some industries, and contract certain other industries because that is what trade is all about.

If that did not happen, there wouldn't be any purpose of it. I mean, the basic purpose is to create improvements in where production occurs so as to maximize the wealth of everybody. But I see no evidence which convinces me that on balance there is a net loss of jobs in the United States.

My impression, basically on the basis of past history, is that it is not a zero sum game, as I indicated before, and I think both Mexico and the United States as well as Canada would benefit from this.

Mr. FIELDS. But if we operate from the premise that business is in business to make money and operate from the premise that businesses will be under a lower environmental standard as well as cheaper wages, would you not have to reasonably assume that businesses would find it would be more productive from a profit perspective to operate there versus here?

Dr. GREENSPAN. Well, if that were truly the case, Mr. Fields, I would suspect that even now, without the NAFTA agreement, you would expect that there would be a huge flood of capital into Mexico, more than we have seen, but, more importantly, if it was so profitable, we would see that profit margins within Mexico would be abnormally high, and we don't see that. In other words, it is not all that profitable generally to do that.

If, in fact, it really were all that profitable, what we would observe is first the profit margins would open up, and then, if there is competition going on in that economy, which there is and increasingly so, real wages would begin to move up because you couldn't maintain that balance between profits and wages, and standards of living would rise very significantly in Mexico, as indeed we have seen that process occur in Korea, Taiwan, and elsewhere.

So, I have a very major problem with the notion that, because wages are so much lower in Mexico than they are here, as indeed they are, why are we not seeing this huge movement of activity, more than we have seen.

The answer is basically that the bottom line is while it is true that the wage rates are much lower, so is productivity, and profitability, while in some areas is above average, and indeed that is what causes some assets to move, overall, there is no evidence that is, in fact, the case.

Whatever anyone may say about the NAFTA agreement, it doesn't change that structure all that much. It is not as though Mexico is now closed and that NAFTA opens up the whole thing. It is incremental; it is a very positive change, but it is not something which really upsets, in my judgment, either economy. In fact, it works beneficially, and I certainly look at it as positive for the American economy as a whole.

I do not deny, Mr. Fields, that there are certain industries which would probably be under more competitive pressure with NAFTA than without it, but that goes for both sides of the fence, and net, on balance, what we have learned over the years is that competition is an extraordinarily powerful force for increasing standards of living.

Mr. FIELDS. Since I don't want to exceed my time, I close on this note. I don't think the American workers or the American business person for that matter, but particularly the American worker, fear any competition. I think it is a question of unfair competition when you can have a business operating in one country under no environmental regulations or very little, with no minimum wage criteria, when you have to be under so much pressure here to make sure that the environmental requirements as well as minimum wage laws must be adhered to. I think that is the big discussion, and that is the big question.

Dr. GREENSPAN. That is the reason why these supplemental issues are being raised and discussed; appropriately so.

Mr. FIELDS. Exactly. So my final question, Dr. Greenspan is what safety nets would you suggest that we put into the North American Free Trade Agreement so that it would not have a devastating effect on the American economy, particularly the American worker?

Dr. GREENSPAN. Well, first of all, I don't think, even without these supplemental agreements, that there would be a devastating effect. There are problems that obviously are associated with certain areas, significant benefits in others. But the presumption that this is a major disruptive effect on the American economy, just makes no sense to me.

Mr. FIELDS. If there is a loss of 20,000 jobs, I consider that a major effect.

Dr. GREENSPAN. I am not willing to acknowledge that is, in fact, the case because I don't believe that, on balance, we are seeing anything of that nature at all. So, it is a question of who is forecasting what is involved here, and my main concern is that we will lose the benefits of this agreement by a view that its impact will not be beneficial to all which is where frankly the evidence in my judgment largely lies.

Mr. FIELDS. Thank you, Mr. Chairman.

Mrs. MEYERS. Mr. Chairman, would the gentleman yield for a related question?

Chairman LAFALCE. Well, I really want to call on——

Mrs. MEYERS. OK, we will get back to it.

Chairman LAFALCE. Mr. Tucker.

Mr. TUCKER. Getting down to the row that we never get to. Thank you very much, Mr. Chairman, and thank you for not yielding.

Dr. Greenspan, thank you very much for coming here and sharing a lot of information with us. Mr. Chairman, first of all, may I ask unanimous consent that I introduce my opening statement to the record.

Chairman LAFALCE. Without objection, so ordered.

[Mr. Tucker's statement may be found in the appendix.]

Mr. TUCKER. Thank you very much.

Dr. Greenspan, I would like to just follow up a little bit on the dialog you were having about minority lending and, in essence, you intimated that the discrimination was occurring not so much on the basis of the qualifications, but rather where there were one or two things that were short on the loan application, and at that point either advice could be given or could not be given as to how the application could be successfully completed.

Obviously, as a practical matter, let's say to nonminority borrowers, certain advice or certain help was given, and to minorities, they did not receive that information, the net effect of which, though, is still some kind of discrimination or discriminatory impact.

My question is: Do you think, in light of that kind of a scenario, that an expansion of minority lenders and minority banks and/or community development banks could be a solution to that predicament? That is the first part of the question.

The second part of the question is: If you find any validity in the concept of community development banks, could you shed some light or some insight as to how those community development banks could be effective and efficacious?

Dr. GREENSPAN. I haven't given up yet on the fact that we have got a long way to go in the existing banking system in resolving some of these problems, and that, for the first time, having struggled with this issue for quite a while and being unable to get our hands on it because, as you probably are aware, it is very difficult to pin down discrimination, we finally, with the Boston study, got our hands on it. We finally found out how it works because it didn't make sense that there was no discrimination going on, yet what you ran into was the obvious evidence that creditworthy minority borrowers were getting credit.

The problem wasn't those who had ideal credit ratings, it was the ones who didn't. So, if you had, for example, a fault in your application, and you are a potential minority borrower, and you get turned down, and the banker says the reason we turned you down is A, B, and C, it sounds perfectly rational, so your reaction is I am just not a creditworthy borrower and that wasn't a discrimination issue.

Mr. TUCKER. Which, by the way, I am sorry to interrupt you, but the many minority borrowers do not have ideal credit ratings.

Dr. GREENSPAN. I understand that. That is not the question. The question really is of those who can be and those who should be given access to our existing banking system, frankly, because as we like to say in the business, bankers are leaving money on the table here, not making these types of loans.

Whether or not there are community development banks or whatever else is done, I do not think it gives us a reason not to pursue this issue in the existing banking structure because, if we can resolve it here, that is far more of a permanent solution than to have special selective type of institutions which are there basically because they are out of the mainstream of the system.

We had Joe Kennedy up at the Federal Reserve for dinner last night at one of our community activity committees, and he raised a very interesting question, namely, unless we get assets in the hands of the minority community, we are not going to get our society integrated in the proper manner.

I must say to you that I would much prefer to see this issue resolved in the existing structure and the existing institutions than to get heavily involved in secondary institutions which are a certain special status. I am not saying they may not do some good, but I am saying that is a secondary question. The primary question is to get the issue resolved in the existing system.

Mr. TUCKER. Two quick questions. How is my time, Mr. Chairman?

Chairman LAFALCE. You have about 30 seconds.

Mr. TUCKER. OK, very quickly. Do you believe that if you go through the primary channels of primary institutions, that an approach would be either punitive or more incentive related? Which approach do you think would be——

Dr. GREENSPAN. I prefer incentive, because I think punitive only really works for a short period of time and doesn't thereafter. One of the things we are trying to focus on is how we can take what we have learned in the last year or so in Boston, and get it functioning for the rest of the country.

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

Thank you very much, Dr. Greenspan.

Chairman LAFALCE. Next, Mr. Klink of Pennsylvania.

Mr. KLINK. Thank you very much.

Dr. Greenspan, it is a pleasure to hear you again. There is so much of what you have talked on, I want to get to much of it so you will excuse me if I do jump from subject to subject.

First of all, you mention there is a lot of refinancing that is going on. Of course, we have seen this. Do you see this as being good or bad for the economy, the fact that so much refinancing is going on, both commercial and home mortgages?

Dr. GREENSPAN. It is very good. What it is doing is taking a lot of high-cost debt out of the system, whether it is mortgages or in the corporate or the business area generally, and replacing it with low-interest-cost debt, and that to me is an unqualified good. In fact, if

I were to say what is the major force which is moving the economy these days in a buoyant manner, it is this process.

Mr. KLINK. You mention also under FIRREA that the banks are left to decide whether or not they are going to forego real estate collateral or to impose the costs of certifying the appraisals. Being a businessman, too, like Mr. Dickey, and having seen all that you have to do sometimes for a loan, and then just saying, as I have said it myself, I have got to walk away, it is just not worth it.

How much of that do you think goes on, taking it not from the bank's side but from the consumer's side, look, it is not worth it for me to go through all the paperwork and go through the cost of an appraisal to get a loan to do whatever I have got to do?

Dr. GREENSPAN. Obviously, we don't have any explicit data because people who don't show up to make a loan application——

Mr. KLINK. I am sure. But do you hear that from people?

Dr. GREENSPAN. My suspicion is it is not an insignificant issue.

Mr. KLINK. One final question. You talk about FIRREA and FDICIA. Then you say, as I indicated a moment ago, the Board supports the capital and prompt corrective action provisions of FDICIA. As a reporter,—in my other life I was a reporter—I often look not at what is said, but what is not said.

Is FIRREA bad legislation?

Dr. GREENSPAN. No; I wouldn't argue that. I would say that it has some very good elements in it, and it has some elements that we would question. I would say we at the Federal Reserve were a major participant in formulating the legislation. We got a lot of what we thought was right, and we got somewhat less in areas where we would have preferred that we got more.

Chairman LAFALCE. A lot more in areas where you would have preferred to have gotten a lot less.

Dr. GREENSPAN. I think that is well stated, Mr. Chairman.

Mr. KLINK. We hear so often from the bankers that it is not necessarily any particular bill but the layering on of——

Dr. GREENSPAN. I was about to say, Mr. Klink, that is the best way to look at it, not as to whether or not FIRREA or FDICIA or any of the other collateral pieces of legislation are even of themselves a real problem, but it is the cumulative layering effect that generates cost on cost on cost to a point where the profitability and, therefore, the incentives involved in small business lending have been very materially reduced.

Mr. KLINK. OK, getting on to NAFTA, I am afraid we disagree greatly on this. Coming from the Pittsburgh area, we have lost significant amounts of industry and significant jobs to Mexico—an automobile plant, Volkswagen who was very big and at one time employed 5,000 people very near my district. They have taken everything as far as North America to Mexico. They are no longer operating in this country.

We have lost Westinghouse plants, we have lost Union Switch and Signal, we have lost Glass Works. Truly, in my district and in the area around my district, the losses are significant. We fear that when you get beyond the 100 kilometer Maquiladora area and you open up the entire country, that it will be significantly more.

How can you assure me and the people I represent that we won't have one big Maquiladora once this NAFTA pact is passed, if and when it is passed?

Dr. GREENSPAN. Mr. Klink, all I can say to you is that all of those of us who have looked at the nature of what trade agreements do and do not do and what economic forces are involved, pretty much concluded that this is a beneficial deal for the United States as a whole.

The question you have to ask yourself when you see a lot of these changes occurring is what is causing it and whether or not the types of changes that are occurring in the economy are long-term types of changes which have to be addressed in other ways.

It is one of the strengths of the United States that there is a tremendous amount of churning going on. If you look at the number of businesses which move, go out of business, and come into business, if you look at the turnover in jobs, and remember that we have a turnover in jobs of about 400,000 a week in this country, this is an extraordinarily mobile, viable economy, and it is the reason why we have been so successful.

What concerns me is that, if we think in terms of shutting our borders or in any way restricting the competitive pressures we get from abroad, we are going to find ourselves a lesser Nation, not the head as we are now of all the world's nations.

Chairman LAFALCE. The time of the gentleman has expired. I would just comment, though, Dr. Greenspan,that nobody in the world is talking about shutting our borders, being more restrictive. Unfortunately, people put in juxtaposition, either you are for the free trade agreement or you are for shutting the borders. That is a false dichotomy.

Dr. GREENSPAN. I grant you that.

Chairman LAFALCE. We may have a 400,000 job turnover. The question is what percentage of the jobs lost in that turnover are good jobs, what percentage of the jobs lost are not quite as good?

The fact of the matter is the real purchasing power of the American worker has declined considerably over the past several decades. It has really only been compensated for by the entry of women into the work force in increasing percentages. We have almost reached the saturation point, and we are going to have to come up with other ways to increase our standard of living.

The Federal Reserve Board historically has been, as I understand it, exclusively macroeconomic in its approach. Does the Federal Reserve Board have any microeconomists on board or are all your economists macroeconomists?

Dr. GREENSPAN. We have a vast entourage of microeconomists.

Chairman LAFALCE. Mr. Hilliard.

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

Dr. Greenspan, I have two related questions. The first one: Do you think there will be any effect on our economy if Government would remove its guarantees from S&L and bank deposits?

Dr. GREENSPAN. Would have an effect? Pretty appreciably, I would say, immediately.

Mr. HILLIARD. Short term or long term or both?

Dr. GREENSPAN. Well, I think you are raising a really interesting question because——

Mr. HILLIARD. Isn't it about time, though?

Dr. GREENSPAN. Well, I don't disagree with you on that. We tend to have notions about how our system works which we don't revisit periodically and we should. I would say to you this, that we do have a number of financial institutions without deposit insurance which work rather well.

I mean, finance companies, for example, being the obvious case, and I am sure that we could construct a total system that would function without the deposit insurance but you would need very significantly higher capital in our depository institutions.

Having said that, it is my impression that deposit insurance is something which in principle is very strongly accepted by the American people, and it is a major element in our financial system. I would suspect that if we went through a whole series of hearings, say, on an issue in which we would expose the Federal Deposit Insurance Act to sunshine legislation, my own impression is that it would repass overwhelmingly in the Congress, reflecting the fact that it is an accepted element in our financial system.

If you were asking me as an economist, in principle, do we need deposit insurance for the safety and soundness and insurance, actually say the safety of deposits, in theory, the answer is that if we have adequate capital, capital can offset the necessity for insurance, but it would probably be a fairly significant increase in capital requirements on the part of the commercial banks.

But I do think that there is very little support in this Congress as I judge for any really significant change in deposit insurance, as I think the chairman can readily attest, having sat through probably many, many hearings in the Banking Committee on this question.

Mr. HILLIARD. Doctor, that might be true of all new ideas, relatively. When concepts are first introduced, they are new, they have not been tested, and there is always skepticism.

However, the second question: Do you think that it would help our deficit if we made loans to resolution trust through FDIC rather than continuing to put money down a rat hole?

Dr. GREENSPAN. The commitment has already been made, Congressman, in the sense that whether you think it was a good idea or a bad idea, it is done, and the question really is do we honor our debt or do we not.

I don't think we have got that choice because the only alternative of avoiding the amounts of money is to say to a large number of depositors who are currently insured in conservatorships of the RTC, that they will not get their money back 100 cents on the dollar. That is the choice we have got. In other words, do we renege on our guarantee which we have put in place?

You may argue, and I think you will probably find a lot of people might agree with you, that it may not have been wise to do it the way we did, but it was done, and the question essentially is not whether we can avoid this. The only alternative to not funding the RTC and basically allowing it to liquidate the whole system is to renege on the significant amount of deposits.

Mr. HILLIARD. OK. We want to keep our commitments and our promises and guarantees, I am sure, so for the short term, I guess we will increase the deficit and let them have the additional billions they need, but long range, from a policy matter—and I don't think it would compromise your position any—but as an economist, do you think that our system could ever be as strong as Germany or Japan if we remove the guarantees?

Dr. GREENSPAN. You mean the Federal Deposit Insurance?

Mr. HILLIARD. Yes.

Dr. GREENSPAN. I would say that if we had adequate capital in our financial institutions, it has been demonstrated in the past that one can go without deposit insurance.

That has not been the trend in the post-World War II period. Indeed, a number of European countries, including Germany, incidentally, who did not have significant deposit insurance, have gradually increased coverage, and, as a consequence of that, the case is mixed.

But if you are asking me in theory as an economist can you run a banking system without deposit insurance, in theory, the answer is yes; you can.

Chairman LAFALCE. Thank you very much, Dr. Greenspan. I regret the fact that we again have another vote, so we will have to interrupt this.

Chairman LAFALCE. I also realize you have a luncheon engagement, and so rather than just recess, the Small Business Committee thanks you for your testimony before us today. We appreciate it very, very much, and we adjourn.

Thank you.

Dr. GREENSPAN. Thank you very much, Mr. Chairman.

[Whereupon, at 12:08 p.m., the committee was adjourned, subject to the call of the Chair.]

THE PRESIDENT'S ECONOMIC PACKAGE

TUESDAY, MAY 11, 1993

HOUSE OF REPRESENTATIVES,
COMMITTEE ON SMALL BUSINESS,
Washington, DC.

The committee met, pursuant to notice, at 10:13 a.m., in room 2359–A, Rayburn House Office Building, Hon. John J. LaFalce (chairman of the committee) presiding.

Chairman LAFALCE. The Small Business Committee will come to order.

We welcome to the Committee on Small Business this morning Dr. Laura D'Andrea Tyson, the chairperson of President Clinton's Council of Economic Advisers.

I am particularly delighted to have Dr. Tyson appear before us this morning. I recall her testimony 10 years ago at a hearing that I chaired in California in 1983. At that time, we were discussing the subject of industrial competitiveness.

Dr. Tyson pointed out that there is a certain hierarchy in addressing those issues. First, at the top, you get your macroeconomic policy right, to ensure that interest rates and inflation, for example, are in order.

Next she said that you focus on market promotion policies, policies that do not override the market, but help it work more efficiently in moving resources from declining sectors to advancing sectors. Finally, if necessary and if cost beneficial, consider sector specific policies.

That was the first occasion that I had to be acquainted with Dr. Tyson's work, and I was greatly impressed. Most recently, she published a book, *Who's Bashing Whom.* I would recommend it to all interested in the subject of trade, because, in my judgment, it may well serve as the bible for President Clinton's trade policy. It was done under the auspices of the Institute for International Economics headed by Dr. Fred Bergsten, who this committee has heard from quite frequently.

I just want to quote a few of the passages in the preface written by Dr. Bergsten.

> For over a decade, the U.S. scholarly and policy communities have debated the merits of freer trade versus managed trade. For the most part, this debate has been astonishingly sterile.

Chairman LAFALCE. Dr. Bergsten and the Institute decided to have Dr. Tyson undertake this study and this work. I now return to the preface.

The study written by Dr. Laura Tyson of the Berkeley Round Table on the International Economy. Dr. Tyson is a superbly trained neoclassical economist, who understands both modern trade theory and the revisionist critique that free trade is irrelevant in a world of imperfect competition and Government support for certain industries.

She is admirably qualified to move this debate forward. She excels at using case studies to understand how markets and Government policy affect economic outcomes, a crucial tool for addressing problems in this area in the real world. We hope that her volume will help bridge the gap between the competing schools of thought, and start developing a consensus on the proper course for policy in the future.

Chairman LAFALCE. Being aware of Dr. Tyson's work, I could not agree with Dr. Bergsten more. I think that her brief tenure as Chair of the Council has proven that she might well be able to bridge that gap.

I have reviewed this not so much to extol Dr. Tyson, but to indicate that we finally have a Chair at the head of CEA who has been thinking, researching, and writing about U.S. competitiveness for many, many years. It is reassuring to have you as a personal adviser to the president.

The problems that we must overcome today were years in the making. You talked frequently about the hierarchy, and the importance of macroeconomic problems. But we have known for years that the U.S. debt build-up was occurring before we crossed the line to become a net debtor in 1985. During the early 1980's until it hit its peak in February 1985, the overvalued dollar wreaked havoc on most U.S. businesses, particularly those that exported. It was perhaps the chief push that moved many U.S. factories and jobs overseas.

We lost export markets permanently, in considerable part because of the overvalued dollar. The problem was, unlike our currency whose value could move up and down, it is nearly impossible to move factories and markets back and forth. Once lost, they are often gone forever.

When the dollar sank, though, the United States then became, to a certain extent, a shopping mall for foreign buyers on a spree, snapping up U.S. assets, further enmeshing us in debt, and, in some cases, leaving us vulnerable and dependent on foreign-owned products.

We had our so-called trophy purchases, Rockefeller Center, Columbia Pictures, Pebble Beach Golf Course, et cetera. There are also hundreds of manufacturing and high-technology companies that were cash-starved that were also on the block.

During the decade of the 1980's, not only did we have those macroeconomic problems, but, in my judgment, we completely neglected microeconomic policies. Indeed, there seems to be a concentrated effort by macroeconomists, both from the left and the right, to minimize the import of microeconomic policies, in my judgment, again, to our great neglect.

I review this, because I think that it is important to understand the dimensions of the task of economic rebuilding. I believe, Dr. Tyson, that the president understands that immediate action is critical, and that the economic challenges, both domestic and international, both macroeconomic and microeconomic, are enormous.

While these economic problems affect all U.S. businesses, the impacts can be especially profound for small business. Small businesses have fewer resources, less recourse to solutions, and a narrower range of options. That is why I am particularly pleased that the Clinton administration has especially recognized the plight and the potential of the small business community in our economy.

They have done this in many ways: By highlighting small business in their technology policy announced in February and by focusing in March on needed bank credit. This month, they have proposed a program to revitalize poor communities in which small business owners can hold the key to economic turn-around.

I also think that in selecting Erskine Bowles as the head of SBA, they have picked an individual who promises to be the best SBA administrator, at least in my history.

We have many unanswered questions. One of them, of course, is going to be the health-care package recommended by this administration. It is so important to the future of our economy in addition to the health of our people. But it is also important to the future of small business. It can be a double-edged sword. We have to explore both sides of that sword quite carefully.

In exploring health care and remembering the small business community and the economy, we also have to understand that we are cutting jobs in the defense sector. In order to control costs within the health care sector, we probably will have to make significant reductions in jobs there, too, especially involving administrative burdens.

That is a concern of mine. It must be done, but what impact will that have? There are so many questions. We raise these questions at a time when first quarter GDP growth fell by more than half to an annual 1.8 percent, at a time when in the first quarter growth in consumer spending fell a meager 1.2 percent. Defense spending dropped 25.5 percent.

Let me just go on. I am trying to raise a lot of different issues, Dr. Tyson. I am interested in all of those issues: I am interested in the results-oriented trade policy that we seem to be pursuing, and the efforts that we have undertaken with Japan and the European Community to implement that. Whether it will budge Japan, and whether it will help open certain markets in the EC, such as telecommunications. The prospects for a successful completion of the Uruguay Round. A discussion, if you will, of the yen, where it has been, and where it is going, and what its ramifications are. Whether U.S. companies are appropriately taking advantage of the changes in the yen to expand market share, or are they using it, as the Japanese say, simply for their profits.

There are countless other issues. All of these profoundly impact the small business community. The public does not realize that, and sometimes the small business community does not realize that. But they do. Large businesses can very often accommodate this. Large businesses do business around the world. They hedge their currencies. Small businesses are often the chief or primary victims or beneficiaries, as the case may be, of these economic phenomena that are taking place.

I have brought you here, Dr. Tyson, not to just read your prepared script. So, I almost hope you will not. We will put the entirety of that in the record, as if it has been read. But I would hope that this committee can just engage in a good dialog with you on whatever you think is important, and, hopefully, some of the things that I think are important, too.

Most of the Members of my side have said that in order to listen to you to the maximum extent possible and to get into dialog with you, that they will forego their opening statements.

But I do want to call on the ranking minority member of the committee, Mrs. Meyers, for any statement that she might wish to make.

Mrs. MEYERS. I will forego my opening statement.

I would like to say congratulations to you, Dr. Tyson. Also, one quick comment: That is that already this year, there have been 27,000 pages of regulations published. Some of those are necessary, and some of them may not be. We are very concerned about the BTU tax, and the fact that the income tax increase will be paid very heavily by small business; 16 million out of the 20 million small businesses pay their income tax as individuals, and many of them will be thrust over that threshold, so that it will impact on businesses, not just wealthy individuals.

We think, many of us think, that a business-friendly climate is probably the best thing that we could do to assist with unemployment. With that, I would very much like to hear what you have to say.

I do think that my colleague, Mr. Zeliff, has an introduction to make.

Chairman LAFALCE. Mr. Zeliff from the Great State of New Hampshire.

Mr. ZELIFF. Thank you, Mr. Chairman.

I would just like to mention that present at today's hearing in the front row are some very special people. Andy Cochran and his wife Charlotte, and his consultant Steve Woods. Andy is the guy with the red ribbon. He is a resident of my district in New Hampshire, and is the New England business person of the year.

I am very excited about his success. Certainly, many of the things that you, Dr. Tyson, are going to talk about today will be affecting people like Andy and me. I am also a small business person.

If I could just add one more sentence. We are looking forward to your testimony, particularly the president's plan relative to the ability of turning our economy around and have a sustained rate of growth to provide jobs. I think it is absolutely critical.

I, too, have some questions about the BTU tax, and some of those things that I think may not put people back to work. So, I look forward to your testimony.

Thank you, Mr. Chairman.

[Mr. Zeliff's statement may be found in the appendix.]

Chairman LAFALCE. We will put the statements of Mr. Mfume, Mr. Tucker, and Mr. Ramstad into the record.

[Messrs. Mfume's, Tucker's, and Ramstad's statements may be found in the appendix.]

Chairman LAFALCE. If there are no other opening statements, then we will turn to Dr. Tyson. Dr. Tyson.

TESTIMONY OF LAURA D'ANDREA TYSON, CHAIR, COUNCIL OF ECONOMIC ADVISERS

Dr. TYSON. Thank you very much.

First of all, I want to say, Congressman LaFalce, that it is an honor to be back testifying before you. I think that the Congressman neglected to mention that was the first time that I ever testified. I had such a good time at it, as it was such a nice committee, that I continued to testify thereafter.

Chairman LAFALCE. I might say that Dr. Tyson so impressed me 10 years ago, that I tried to hire her immediately thereafter, but to no avail. Then some fellow from Arkansas was able to hire her.

Dr. TYSON. The next thing that I want to say is that it is an honor to address this particular committee this week, which is a week honoring the small business community and its manifest contributions to the U.S. economy.

I think that because you raised such a large number of issues in your introductory comments that I will be brief. If you want to talk about trade policy or technology policy, I am perfectly willing to talk about any aspect of the program.

My prepared remarks really were primarily to just give the basic logic of the budget package that is now being discussed under reconciliation, and to highlight some of the areas where I think we are trying to do things which would specifically benefit the small business community. So, why don't I limit my prepared comments to that, and then we can have a more wide-ranging discussion?

From my point of view as an economist, the important thing about the package, the budget proposal, that is now under negotiation is its emphasis on investment. The emphasis on investment is motivated by the simple fact that over long periods of time any country's standard of living, rate of growth, and well-being for citizens depends on its investment rate in plant and equipment, in human skills, and in technology.

The investment rates that are of concern here are a private investment rate, what the private community or business community both large and small do, in terms of investing in knowledge, workers, plant, and equipment; and also investment by the Government in training, in civilian research and development programs, in infrastructure programs, and in a variety of other programs which help the private sector or provide public support for private economic activity.

So, the notion is that investment is key. If you look at international comparisons or if you look at comparisons of the United States relative to its own history, you see that the U.S. investment performance has been relatively weak. Compared to other advanced industrial countries, we invest less relative to the size of our economy than do our competitors—one third as much as Japan does, one half as much as the other OECD countries do.

We also under-invest publicly in things like training for noncollege bound workers once they have left high school. We have very little in the way of apprenticeships, or training programs, or retraining programs. We only invest about one-fifth as much relative to our GDP as our competitor nations.

In civilian technology programs, we are under-investing relative to our major competitors, particularly Japan and Germany. If you look at any measure of investment in public infrastructure over the past three decades, you see that it has been falling decade by decade relative to the size of our economy. So, I think that we can say that we suffer from an investment problem—an under-investment problem.

We also suffer from a deficit problem. These are not unrelated problems. The primary problem created in the economy as a result of the deficit is essentially a drain on funds which could otherwise be used for investment purposes. If the Government borrows $300 billion from the economy, that is $300 billion that is not available for other uses. This borrowing primarily takes money away from businesses and households that they would otherwise use to invest.

Now because investment is key, when you reduce the deficit, it is very important, it seems to me, to make sure that you do not reduce it at the expense of public investment programs. That is, we face a challenge which is a two-part challenge: Reducing the claim of the Government on the economy—and reducing the rate of growth of Government spending in the economy—while at the same time shifting the composition of Government spending toward public investment spending that can really help the private sector become more productive.

That is what our proposal attempts to do, and we can talk about any aspect of it.

Let me say right at the beginning, since a couple of people have already raised questions about the revenue components of our deficit reduction package, that they are there because of the need to have a credible deficit reduction effort. They are there because of a need to have a balanced and a credible approach, and a nongimmick approach, if you will, to getting the deficit down.

A BTU tax and the higher income tax rates—the motivations for those are not to spend more. The motivations for those are to reduce the deficit and change the composition of private spending. But if you look at the actual proposals we have made, you will see that, in fact, except for interest payments on the debt and health care, which we can talk about as a separate reform, the rate of growth of all other items of Government spending in real terms will go down over the period 1994 to 1998. We are slowing down these rates of growth.

I think that it is really important to emphasize that the revenue part of this is for deficit reduction.

Now, having given that general introduction let me just talk a little bit about some of the areas where we have tried to fashion the package we have proposed in such a way as to really deal with some concerns of the small business community: Some of those have already been mentioned by Congressman LaFalce, but let me emphasize them.

First of all, we have included some targeted tax relief for small business. In particular, we have made a proposal for the small business capital gains exclusion, which is designed to encourage the formation of new small businesses held for 5 years through a generous tax relief on capital gains realized through investment in such new business activities. That is the first thing we have done.

Second, we originally proposed a small business investment tax credit. The small business investment tax credit, like much of our proposals on the credit side or on the incentive side, needs to be understood as being limited by our overall need for deficit reduction. We could not go for an extremely generous proposal, because that would undermine the deficit reduction effort.

As a matter of fact, we have now been working with the Congress, the relevant committees of the Congress, to substitute for the small business investment tax credit an expensing option. Remember, our motivation here is to try to have a targeted approach to stimulating the small business community. Given the size of the small business investment tax credit we felt we could offer, we have been considering whether it would be a more effective route to actually go through an enhanced expensing proposal, and that is really where we are right now, to raise expensing from the $10,000 limit a year to a $25,000 limit a year. So, that is another area where we are trying to do something directly to encourage capital formation investment by the small business community.

Other areas where we have tried to emphasize the small business community would be, again, in the proposal on enterprise or empowerment zones where a number of the kinds of credits that we are proposing on the wage side and on the investment side we assume would go to small and microbusinesses, which are going to have to be the core of the rebuilding of these urban areas. We see that as an important urban or a rural development effort, but it is also important as a small business effort.

We also have proposed, as Congressman LaFalce indicated, a technology program which, by design, will allow the small business community to take advantage of many of the programs as effectively as possible through the SBIR Program, but also by making the programs quite flexible so that the small business community, particularly the high-technology part of the small business community, can be very actively involved.

Chairman LaFalce. We will be hearing from Dr. Gibbons on Thursday of this week.

Dr. Tyson. Wonderful.

We will be coming forward with a proposal on community development banks which are designed to provide seed capital and technical assistance grants to targeted communities, and this would, we think, go to local entrepreneurs. This is to go to underserved areas, really to underserved groups of borrowers. While it is not unique to the United States, we recognize very clearly that the small business community is always relatively disadvantaged in the acquisition of or access to capital markets. There are a variety of things one can do on the tax side. We are proposing some. But also on the community development banking side we are proposing some. That is to really improve the ability of the small business community to gain access to funding.

Along those lines, as Congressman LaFalce mentioned, the Treasury has already come forward with a series of proposals, which they are now in the process of enacting, to deal with the credit crunch issue.

Let me just say in passing that one of the most effective things for dealing with the credit crunch issue may, in fact, be the decline in long-term real interest rates, which we have seen in the past several months. When Government securities and other financial assets become less attractive as investment opportunities for the banking community, they may indeed be encouraged to look more actively at lending opportunities in the business community, including the small banking community.

So, the interest rate change may have a beneficial effect in this regard. But we have also introduced some particular proposals and, in particular, the Treasury has proposed reducing the paperwork burden, encouraging more character lending by sound banks, and raising the appraisal limit to make it less expensive for individuals to borrow using real estate as collateral. So, those are some examples of efforts——

Chairman LAFALCE. Last week we heard from the regulators, Gene Ludwig.

Dr. TYSON. Let me just say that one other area which we are now working on, of course, is to try to find a way, either through reconciliation or through a supplemental, to get the funding for the Small Business Administration loan guarantee program. We are very committed to doing this.

I remember being committed to this early on when I first started to work for the economic transition, before I was named to be Chair of the council. I was assigned to the issue of small business, manufacturing and technology. Right at the top of the list of important topics was the SBA loan program, and I think it has remained at the top of the list. So, we will find a way to have an appropriation so that we can continue lending through that very important program.

I guess I will end saying that it is traditionally the role of the Council of Economic Advisers, contrary to anything you might read about me as Chair of Council of Economic Advisers, to look at regulatory issues. We are already deeply involved in the regulatory review process. We will be looking always at the issue of the cost burden of regulation, as we know that the cost burden can be particularly heavy on small business. That is something on which I would very much want to work with members of this committee. If you have particular regulatory issues that you think are particularly burdensome, remember that these are areas where the council is always actively involved, providing input to the administration and to Congress as to the costs and benefits of regulation.

Finally, let me end on trade, which I was not going to talk about at all, but which is my area. The most important thing I think we can do for the small business community regarding trade is to work as hard as possible to get a successful conclusion to the Uruguay Round and also to the North American Free Trade Agreement.

I say that because big businesses can fight trade barriers by hiring lawyers, by hiring a local staff to figure out ways to get around the trade barriers, and through a variety of very expensive and costly mechanisms. One of my cases in that book is Motorola's 12-year efforts to sell cellular telephones in Japan, and it was a successful effort. But Motorola had to spend a vast amount of money and resources in people. They have had people dedicated for a decade to breaking into the Japanese market.

Well, a small business cannot do that. It simply cannot do that. So, this is really where the national trade policy becomes critically important. If we can, more effectively, say, open the Japanese procurement process to telecommunications purchases from the United States, or get a Uruguay Round decision which improves market access and services, or get a NAFTA agreement which reduces the rate of tariff protection against U.S. producers in Mexico, then the small business community, I would argue, might be the disproportionate beneficiary because they will not have had to fight those battles themselves. I think in that sense our trade policy, while it is meant to benefit everyone, is a very important effort for the small business community in particular.

Why do I not stop with that, because I know you want to get to questions, and I am happy to address whatever area you would like.

[Dr. Tyson's statement may be found in the appendix.]

Chairman LaFalce. Terrific. Thank you very, very much.

Dr. Tyson, it is correct that you are the first woman Chair of the Council of Economic Advisers?

Dr. Tyson. Yes.

Chairman LaFalce. Well, I should have mentioned that.

Dr. Tyson. Thank you.

Chairman LaFalce. Another reason we are honored.

I have a million questions, and, therefore, I will defer them until after all the other Members have asked their questions.

Dr. Tyson. OK.

Chairman LaFalce. Mrs. Meyers.

Mrs. Meyers. Thank you, Mr. Chairman.

I was very pleased to hear you say that you will be focusing and looking at regulatory issues, because I do think that is tremendously important.

The issue of community development banks I think has been of interest to a number of people, and, in one respect, I think I understand how this might be of some assistance to small business. I think it might be, in some ways, destructive to small community banks.

Why do you think that setting up a system of community banks is going to be more beneficial than trying to assist with maybe getting the regulatory burden off of banks so that they are a little more comfortable with making loans, and some of the other things that the Government could do—like the 7(a) Loan Program which you have mentioned and that you support of course? What other things could we do to make money available for small business rather than starting a whole new structure of community banks?

Dr. Tyson. I think that I do not see these as substitutes for each other. What I think is that we recognize, or must recognize, that a perennial problem for the small business community is to realize equal access, if you will, to credit markets. I think what we have laid out is a kind of multitrack approach. I think beside supporting the SBA loan program we are working with the Treasury on looking at ways to ease the regulatory burden.

There is a debate, which is an ongoing debate, and which I have heard experts from both sides make their case. One view is that, in fact, it is not the regulatory burden so much as the way bank regulators are interpreting the regulations. The other view is that it is some of the regulations themselves. We are starting with a series of proposals to see if we can get any improvement by working on an easing of the regulatory burden, but also by putting a lot of pressure on the regulators to ease up in their interpretation of the regulations. If that does not work, we will have to assess our efforts, and then see if further regulatory adjustments may not be in order.

At the same time, I think the community-based development banks really are to deal with financial services to underserved urban and rural communities.

Chairman LaFalce. Dr. Tyson, have they submitted their community development bank proposals yet?

Dr. Tyson. No.

Chairman LaFalce. So, it is still not necessarily the creation of new entities?

Dr. Tyson. No; that is exactly right.

Chairman LaFalce. It could well be working through existing institutions in some new ways.

Dr. Tyson. That is exactly right. In fact, it is meant to be very flexible in terms of institutional form. The notion here is how to figure out a mechanism, either through creation of new institutions or through the development of organizational changes within existing institutions, to serve underserved communities. It will be critical for small and microbusinesses in distressed areas. It might be quite well linked with the enterprise or empowerment zone initiatives.

But you are correct to say that we have not yet come forward with a formal proposal, but I can assure you that the objective is to have as much institutional flexibility as possible.

Mrs. Meyers. If I could make one more comment maybe and ask for your reaction to it.

I think many of us on both sides of the aisle have been concerned because, as you say, the deficit is of real importance to small business. It means that if there is an enormous deficit and debt the Government is taking so much of the money out of the economy that it makes it more difficult for small business to get loans.

But I think the concern, and it is on both sides of the aisle, is that with the enormous number of new taxes, according to the figures that I have, it is about $4.70 in new taxes to every $1 in spending cuts; about $365 to $375 billion. Even after having that kind of an increased tax record over 4 to 5 years, there is still only about $14 billion in deficit reduction, and that is by your figures. I am greatly concerned with that.

Chairman LaFalce. You are not talking about percentage of GNP or budget, are you?

Mrs. Meyers. No.

Chairman LaFalce. Oh.

Mrs. Meyers. I am talking about the reduction in deficit, the amount of tax increases if you count the Social Security as a tax increase, which most of us do, and I think CBO said that is the way it should be scored also, then it comes out so many dollars of tax increases compared with very little in spending cuts. I would like to hear your reaction to how this is going to be helpful in any way to small business, to have relatively small amounts of deficit reduction with such an enormous heavy tax burden.

Dr. TYSON. First of all, I think there is a lot of debate about how you account a tax increase and how you account a spending cut. The Social Security one, which is actually a very small part of the overall deficit reduction number, whether you count it——

Mrs. MEYERS. That is $23 billion.

Dr. TYSON. Yes; but $23 billion out of a package of more than $500 billion is a small amount, and we are looking over the total period of time.

We can debate about the composition of this. By our numbers we counted the Social Security adjustment as a spending—not as a tax, but as a spending cut. Now, we can debate that. All I would say is that——

Chairman LAFALCE. Is it true that you did that because that is the way it had been historically treated?

Dr. TYSON. Yes; all that I was going to say is that was the proposal under the Reagan administration. It was the proposal under the Bush administration. It was a standard way of handling this. You can debate the merits of it, but it was a standard way of handing it. We did not create it. We did not invent it. We inherited it.

On the issue of interest payments on the debt, there is a debate about whether those should be counted totally as a spending reduction. There is no historical tradition. There, I just think, is intuition. That is, if you went out to the average person on the street and said this Government has to spend one less dollar in interest payment, what is that? They would say that it is a spending cut. The Government is spending one less dollar.

But I think that our numbers are over the course of its lifetime. Although it starts out heavily in the first year as basically a revenue increase, if you look at 1994 to 1998, over the entire period, it is 52 percent on the spending side and 48 percent on the revenue side because the spending increases build up over time. The revenue increases do not build—they start at the beginning and then do not build up.

Now, the thing that is important for all of us to do, and we are working on this right now, is to make sure that, in the budget enforcement initiatives we set in place, the American people understand this balance, and so that when we raise the additional revenue, in fact, it does go for deficit reduction. So, I think it is incumbent upon all of us to have a budget enforcement agreement with punch and teeth which grades this process. That is what I would say.

The second thing I want to say——

Chairman LAFALCE. Can we just lock in the dates that you said? Over what period was that 52 to 48?

Dr. TYSON. That is 1994 to 1998.

Chairman LAFALCE. Thank you.

Mrs. MEYERS. That is basically Social Security and those fee increases——

Dr. TYSON. Absolutely.

Mrs. MEYERS [continuing]. Are spending cuts.

Dr. TYSON. But, again, even the fee increases for the spending cuts is something that the CBO does propose. CBO does propose that fee increases are spending cuts. Again, it is tradition. That is inherited. The debatable one, in terms of tradition, is actually how you treat interest payments on the debt.

In that area you could say, well, you might want to take half of that and score it on the revenue side, and take half of it and score it on the spending side. Again, intuitively it seems like that it would be more compelling to the public as a spending cut, but that is the only place where I think we were not relying on what was the sort of standard practice.

As far as how much are we reducing the deficit, again, this is a game—this analysis depends upon what you think would have happened to the deficit in the absence of our program. Our numbers, which we took from the CBO, were that in 1997 the deficit would have been $347 billion. Our proposal is to get it down to $214 billion.

If the economy does even slightly better than what we assumed in the model, we could get the budget deficit down to below $200 billion. In fact, by our CEA estimates, we might get it down as low as $186 billion.

So, again, when you are saying it is only $14 billion dollars, you are not taking into account the fact that the economy was on a trajectory of growing deficits, not declining deficits. You cannot take this year's deficit or next year's deficit. You have to go out and see where the structure of our spending and revenues was going to take us. It was going to take us to $347 or thereabouts.

So, I think in that case it is a serious deficit reduction effort, and I think that if you look at the deficit relative to the size of the economy, it was on a growing course, and we have set about reducing it.

Another thing I want to emphasize, because I do not think it is emphasized quite as much, is if you look at Government spending compared to the size of the economy, Government spending relative to GDP, which is how an economist would tend to look at it, that number was on an increasing trend between 1980 and 1992. It was not going down. It was going up.

If you look at what this plan does, it takes Government spending over GDP and it brings it down. Now, people will say, but you have not actually cut the absolute level. Well, the problem is we were all on a growing trajectory. The first thing we do is get the trajectory going in a different direction. I think that is what we have done.

Chairman LAFALCE. Dr. Tyson, could you be a little more helpful by giving us a ballpark figure of what percentage of GDP—Government spending was circa early 1980's? What it is now, and what it is projected to be without the changes, and what it is projected to be with the changes?

Dr. TYSON. The easiest way to say this is that it went up by about 1 percentage point of GDP between 1980 and 1992. It is going to go down by——

Chairman LAFALCE. From 22 to 23?

Dr. TYSON. Yes; 22 to 23, right, and it is going to go down by more than 1 or approximately 1½ between 1992 and 1998 under our proposal.

Chairman LAFALCE. Where is it at right now?

Dr. TYSON. I do not have the exact number right now as a percentage. It must be in the range of 23 to 23½, something like that. So, we are getting it down by a percentage and a half, and I think you have to say that this is in a much shorter period of time. We have a 12-year upward trajectory, and we have a downward trajectory that is even more dramatic.

The other thing to say is that if you look at the numbers, if you do inflation adjustment, that real Government spending, the growth rate of real Government spending over the 1994 to 1998 period in our plan is negative except for interest payments on the debt, which frankly is a problem of the debt we inherited. We cannot do anything about that. We are not going to default on our debt. I think we should discuss Medicare and Medicaid in terms of health care reform.

Chairman LAFALCE. We will do that. We are going to try to confine everybody to roughly 5 minutes so that we can make sure all the Members have an opportunity to dialog with you.

Mr. Andrews.

Mr. ANDREWS. Thank you, Mr. Chairman. Dr. Tyson, welcome.

Dr. TYSON. Thank you.

Mr. ANDREWS. I would like to ask you about two basic areas that I would like you to expand on a bit. First of all, in the area of public investment. I agree with your basic assumptions, and, in fact, a main economist from Bates College by the name of David Aschauer did an exhaustive study of the relationship between public investment and private investment. He said that if we had maintained our level of public investment since the 1950's constant as a percentage of our Gross Domestic Product, then productivity growth would be 50 percent higher than it is today. Private investment would be 22 percent higher. Business profits would be 20 percent higher than they are today. So, there is a direct relationship. Intuitively, as you were saying earlier, it makes sense.

I mean, if you have better quality employees coming through the door because they are trained well, you are going to get better productivity. If you can get your goods and services to market more efficiently because there are roads, bridges, and rail systems that work, it is going to help your productivity.

The problem that we have here is a political problem, because you have people who like to demagogue this to death; who say, OK, investment is just another code word for tax and spend, and actually making a credible argument to the public in this political atmosphere that these are real investments that are going to generate real productivity, that are going to generate a real return, and then to say that the best way to get this budget deficit in line is economic growth; it is a very difficult proposition in this climate, and I think the defeat of the stimulus package is a very good illustration of the political problems that we are facing.

My first question is, how do we deal with that? How do we make this credible to the American people?

Would, for example, a division of our budget, as I have been suggesting, between capital investment on the one hand and operating expenses on the other hand, with an investment strategy to go with one, and you cannot spend any more than you take in for the operating side, would that be a step in the right direction?

The second general area I would like you to comment on, and I will be quiet and listen, has to do with conversion from the dependency on defense spending. In the State of Maine, 53,000 people are dependent, directly or indirectly, on defense spending. Last year and the year before I asked questions of the administration about industrial policy, and whether or not we should be helping to create new markets to replace the Government being the market for so many industries across the board.

Could you please comment on that? How we can better link the technology development that we are talking about and the skills of our work force working in defense and the defense industrial base so that we might have a better chance at helping those regions of the country that are hurting right now because of defense cuts.

Dr. TYSON. OK. Well, on your first question about convincing the American people that not every dollar of Government spending has the same effect on the economy. That is how I would put it. There are different kinds of Government spending, and that some kinds of Government spending, we know from our own history, we know from the examples of other countries, are really very important for the viability and prosperity of the private economy.

Now, I believe that one can make that case, but I think it is important politically, given the debt and debit situation that we have all inherited, that we must first and foremost pass a credible deficit reduction package; that we must convince the American people who we, in fact, are using their additional revenues, and the spending cuts that we have proposed, primarily for reducing the deficit; we must convince them that it is a very big effort.

We are asking that some of the package be devoted to investment. I think the next thing we have to do is be very careful to define investment rather precisely and to try to set up by legislation a very efficient mechanism to guarantee that public moneys used in the training area, or in the research and development area, be used effectively.

Now, an area where I have worked a lot is technology policy. We have a number of institutional mechanisms already in place for guaranteeing that additional civilian technology money is well spent. We have the advanced technology program of NIST in the Department of Commerce, which is widely recognized by scientific, business, and international experts to be a successful program. We know if we put additional money in ATP, it is going to be well used. We have some examples of the national labs doing research agreements with local businesses. Again, these are competitive. The business community puts in some of its own money. It is a cooperative effort between business and Government. Those have good track records so far.

We know if we put some additional money there that we are going to actually get a return. We actually know from study after study that the rate of return on a dollar of Government money in technology is very high. I mean some estimates suggest that it is as high as 60-percent return.

We also know about infrastructure. Study after study really show that you get a positive return on infrastructure projects.

So, I think we can, by targeting rather specific investment efforts, by making sure we have programmatic forms which guarantee efficiency, that we can make the case for investment. But we cannot do it without this major deficit reduction effort side by side, because we would have no credibility, because it is very important at this point to get the deficit under control in a way which the American public believe in. So, that is my answer to your first question.

The issue of conversion: Let me start by showing how important defense conversion is just by talking about the last quarter's GDP numbers, which, as Congressman LaFalce mentioned, were somewhat disappointing.

If you go back and you try to explain why did we grow so slowly in the first quarter, you could say that we had bad weather which was clearly a factor, particularly in the East and southern parts of the United States, and that we had the change in withholding which may have affected the refunds that people got and their consumption spending in March and April. But we also had a very big decline in Federal spending, mainly because of defense procurement adjustments.

Now, defense procurement is very lumpy. It is not even. We had a particularly big decline in the first quarter. What that demonstrates, very clearly, is when the Government cuts its spending, when it contracts and contracts sharply, that is good for deficit reduction in the long run—we need defense conversion, we need to reduce the deficit—but that it can hurt the economy in the short run. The Government is a consumer. It buys things. It buys services. It buys equipment from the private sector. When Government spending contracts, which we want it to do for deficit reduction, it can hurt the economy in the short run.

So, all of us are in a balancing act. We want deficit reduction. We want to cut defense. But we do not want to do it so brutally or so suddenly that we actually cause the entire economy to contract, and that is the challenge that we face. We saw it very clearly in this first quarter.

That being said, I get to the issue of conversion. I think that it is incredibly important, if we are going to keep the process of deficit reduction moving forward and keep the change in our spending priorities, which are away from our Cold War priorities—after all, we won the Cold War—we can afford to have some reductions. But if we want to keep on track, we are going to have to support the process by a conversion effort. Otherwise, I think that the communities, the workers, and the companies who are adversely affected by the Government pulling back will really mobilize an effort to slow down the process, which is a necessary transition.

So, defense conversion is essential for the transition, and what we have tried to come up with is a bold policy which incorporates a number of items: Technology policy, training policy, and infrastructure policy, and allows for a lot of input from the local community. Also, incidentally, it has ways of allowing the private small business community to be involved.

For example, some of the programs that ARPA is putting into place and that Commerce would put into place with the defense conversion money would very much help small- and medium-sized manufacturers who are specializing in selling to the military find alternative sources of demands for their products.

Chairman LaFalce. Thank you very much.

Mr. Zeliff.

Mr. Zeliff. Thank you, Mr. Chairman.

Dr. Tyson, on the one side, we are talking about major cutbacks in defense, $127 billion, I believe, and on the other side we are talking about sending troops into Bosnia. We are just pulling some troops out of Somalia.

Does it make sense for us to be cutting the defense budget back to 1948 levels, in terms of Gross Domestic Product. Should that be reevaluated?

Dr. Tyson. I think that decision, the size of the military relative to our geopolitical or military commitments, is something that I would defer to the national security and defense officials of the administration who feel that they can meet the objectives that they must meet in the context of the budget proposal we have made.

Mr. Zeliff. I think that is going to be a debate for another day. But certainly, what we expect from our military, and what we are willing to give them in terms of support, seems to be going on different tracks.

Another question on defense conversion. I think the President is on the right track in terms of enterprise zones. I have a bill to create a defense conversion policy. We are one of the first bases—I believe the first base was Rease AFB—to close under the defense conversion policy. I think we should put an enterprise zone at a base closure, and let the private sector forces come in by providing Government through taxation policies, incentives to take risk, and let the private sector come in and do the risk-taking. I want to throw that out as a suggestion. We have very limited resources and the President is looking for creative, innovative schemes to get the private sector moving. I think this would be a good place to expand the enterprise zone concept.

As a small businessman from New Hampshire, I know that we have an economy that is pretty well devastated. I look at it from a New England perspective as well, and I see the same difficulty. I have talked to many companies in New Hampshire and in New England, and I have talked to large companies like the duPont Co., MCI, and others. If you combine the BTU tax with a change in the corporate income tax rate, and the personal tax rate, it will certainly affect 1.6 million small businesses, 3.2 million individuals. Will the combination of increased taxation, both the BTU tax and the corporate tax increase, as well as the individual rates, be a drag on the economy and hurt the President's initiative in terms of job creation? It would actually go the opposite way it is intended.

Dr. Tyson. Well, I think you have to take it in the context of the entire package. A BTU tax by itself, if we did nothing else but have a BTU tax, is a drag on the economy. It is an excise tax equivalent. I mean, in a macromodel you would model this as an excise tax, which has an effect of increasing price and reducing output, yes.

On the other hand, if you put into the model the overall deficit reduction, and you put into the model the interest rate benefits, which you anticipate from deficit reduction, they more than offset the contractionary effect of the tax. I think it is important to emphasize that really when we talk about taxes the debate needs to be not "is the tax a drag on the economy?" but "is there, in fact, any other mechanism that has been proposed to achieve deficit reduction of this amount over this time?"

It is my view that, in fact, although our proposal has been criticized on various sides for various reasons, there has been no alternative that I would say is credible, because to sort of cut various programs like Social Security, Medicare, or Medicaid by a third is not something which I see ultimately being passable, or being enacted, or being accepted by the American people.

So, in point of fact, if you accept the goal of deficit reduction, the BTU tax becomes a mechanism to achieve that goal. The macromodels show that the beneficial effects to the economy offset—more than offset—the contractionary effects from the tax by itself.

Mr. ZELIFF. Just a comment. At the rate that we are now going, neither the Republican or the Democratic plans will balance the budget or give a sight-specific date.

In your opinion, with your expertise, at what point, assuming the plan that the President is proposing is implemented, will we have the lines cross and be able to balance the budget?

Dr. TYSON. Well, I think the appropriate way to think about this is basically more or less a decade-long effort where you first reduce the deficit to GDP in half, get it down to around a 2-percent range, and then you reduce through health care, because, again, if you go into those out years, the causes of the growth in the deficit are just two. They are interest, which if we actually get the first round enacted and we keep interest rates down, will be less of a problem; and Medicare and Medicaid. It seems to me that's why you have to couple the first deficit reduction package with a health care reform. Otherwise you do not get to close to a balance.

Let me also emphasize that I do not think a decade is such a bad amount of time for the reasons that I mentioned before. If we do this too fast, if we decide we are going to try to do this in 4 years, I can almost guarantee you, given the size of the deficit we are currently operating with, that we will have 4 years of very sluggish and perhaps negative growth. That is just taking too much out of the economy in a too Draconian fashion. So, we want to do it slow, but not too slow.

Mr. ZELIFF. May I just make a point?

Chairman LAFALCE. Make a point.

Mr. ZELIFF. I think in New Hampshire, particularly, and I do not know about the rest of the country, the numbers do not add up. To help you sell the Presidents plan, maybe all these tax enhancements and revenue producers should be put in a separate trust fund to make sure that they go to balancing the budget. I do not think anybody believes that the plan itself is going to do that.

Dr. TYSON. Right.

Mr. ZELIFF. I think the problem that you have is convincing people this is not a spending plan. If you do that, then maybe you can sell it to the American people and they will start to support it. But, right now I think there is a lot of concern that the numbers just do not add up. Is this the time to be spending money on new programs, and will the money really go to deficit reduction?

I certainly hope that the plan works. I do not see it adding up, and any help that you can give me to do that, it would be great.

Dr. TYSON. I agree with the point that we need to do something through the budget enforcement mechanisms and that we work through with Congress to convince the American people on the credibility issue. That is right.

Chairman LAFALCE. I think the tax component of the overall economic package in order to bring about budget deficit reduction not only helps lower the interest rates, which saves considerable expense, but permits the Federal Reserve Board to effect a more accommodating monetary policy, I would think and hope, which can help grow the economy, reducing the deficit as a percentage of GNP.

Dr. TYSON. Right. I think just to elaborate on that, since I emphasized investment very much, the main thing we can do for investment is to sort of change the composition of macroeconomic policy by reducing the fiscal role in moving the economy forward and increasing the monetary role and getting a lower, long-term environment of interest rates.

Chairman LAFALCE. That is why it was so important to have Dr. Greenspan indicate that the economic package is a serious, credible package, because that not only sends a message to the markets, it sends a message to the members of the Federal Reserve Board that they cannot entertain activities that they previously were unable to entertain.

Mr. Sarpalius.

Mr. SARPALIUS. Thank you, Mr. Chairman.

Dr. Tyson, I certainly am honored to have you here before our committee today. I would like to express a concern that I have. I have always believed that in order to be a strong country it takes two things. First, you have to have a strong defense in order to protect yourself. Second, you have to be able to produce enough food and fiber for your people. Those two things happen to be the two areas that took the highest percentage of cuts in the budget that Congress recently approved.

My concern is that for many years now we have followed the trickle down theory. We now have an opportunity to change those directions. When you look at small businesses in rural America, many of those businesses are very dependent on the economy, on agriculture as well as oil, gas, and energy in my part of Texas. Unfortunately, agriculture took a big cut.

Now we turn around and look at a BTU tax placed on farmers which will be detrimental to them. In the central part of the United States, which is where the Oglala aquifer is, which encompasses Texas, Oklahoma, Kansas, Nebraska, North Dakota, and South Dakota, where a high percentage of your grain crops are produced, they have to pump water out of the ground to irrigate their crops. In California, a lot of their water is subsidized. The Eastern part of the country, they have a high percentage of rainfall. A BTU tax really hurts agriculture a great deal in the southern part of the United States.

In my district, 28 percent of the cost of producing a crop is energy, and my farmers do not know what they are going to do if a BTU tax is implemented. It seems to me that if farmers were making money, then those small businesses in those rural towns would be making money. If those small businesses are making money, big businesses would make money. If big business is making money, industry makes money. It is an opportunity to have a trickle up theory.

I would like to get your response to that.

Dr. TYSON. Well, I guess I would say that I would have two reactions. One, on the budgetary cuts.

I think it is important to note that relative to its size in the economy fraction and relative to the size of the employment, U.S. employment in agriculture versus other economic activities, that the amount of the Federal spending that goes to agriculture is really quite high to begin with. So, we are starting off with a situation in which the Government support for agriculture as an activity compared say to Government support for manufacturing as an activity, or services as an activity is very high. It is high for historic reasons. It is high because we started out as an agricultural economy. It is high because other countries around the world are engaged in promoting their own agricultural base.

But I think that the only way to judge the significance of those cuts is to note that the two areas where we have made the biggest cuts—defense and agriculture by your calculations—were areas which had very significant claims on the budget to begin with.

If you look at agriculture after the cuts compared to manufacturing and services, the two other major parts of the U.S. economy, it is still the case that, with the cuts, agriculture is more benefited by Government programs than the other areas of economic activity. So, that is the first thing I would say.

The second thing I would say about the BTU tax is that basically we tried very hard—there is no perfect way to do this—to come up with a tax which was relatively even across regions, and across activities. For example, other issues which we discussed included a gasoline tax, which has very uneven income effects by income class and uneven effects by region because of different driving patterns and distances. We looked at a carbon tax which, of course, has very differential effects on coal using versus coal producing States. The BTU tax was meant to be a tax which, relative to the alternatives, was quite broadly based and had the least adverse distributional consequences, but it is not perfect. In that sense, I understand some of your concerns.

Mr. SARPALIUS. Well, let me respond by saying that as far as the cuts in agriculture, less than one-half of 1 percent of the total budget for this country goes in farm supports for farmers. Yet for that less than one-half of 1 percent you can go into any grocery store and you will find the widest variety, the safest food of anywhere in the world. It is one of the best buys I think going for the American taxpayer.

In regard to the BTU tax, my only concern about it is that in the past agriculture has been exempt from paying any type of energy tax. A BTU tax will really damage agriculture in those areas where farmers have to irrigate their crops.

My second question is relating to trade. This country is so far behind other countries as far as our willingness to go out and identify markets where we could export based on supply and demand. I chair one of the subcommittees on this committee, and we have identified between 10 and 19 different agencies that have export programs, over 122 programs. The Federal Government is looking at exports with a shotgun approach without focusing on the opportunity. For every $1 billion we increase in exports, that adds 20,000 jobs. I would like to get your response on that.

Dr. TYSON. Well, first of all, I would say that I would like to work with you on this issue, because we have put together an interagency group to look exactly at the issue of trying to do better at coordinating the export programs we have. So, your studies and your knowledge about where these are, and how they are working, would be very helpful to us.

I think it is going to be a very important part of our strategy. Again, we are all faced with trying to do things better, because we cannot spend more. We have to spend less and do things better.

In the area of export promotion, we are not spending a lot relative to our competitors—I agree with you—to begin with. We are not going to be able to spend a lot more. That is not possible in a deficit situation we find ourselves. So, the only thing we can do is to try to figure out how to get these 122 programs, or however many there are, and to make them work more efficiently, and we are very committed to that.

Incidentally, it also gives us real bargaining power with our trading partners. If we go to our trading partners and say, look, our problems in trade are because of your barriers, they can turn around and say, well, our barriers may be a problem, but what are you doing internally to improve your efforts at organizing to sell products in our markets. So, we have to have an initiative at home to complement our trading negotiations abroad. It is a very important area.

Mr. SARPALIUS. One final question. In today's Washington Post, there was an article in there which you might have seen, where the U.S. Chamber of Commerce intends to oppose the President's budget plan, and I would like to get your response to that. What can we do to try to, I guess you could say, stimulate the President's stimulus package?

Dr. TYSON. I did not see the article. Is the U.S. Chamber of Commerce opposing the budget plan or the stimulus or any additional——

Mr. SARPALIUS. It is basically opposing the President's budget plan, and it mentioned some concerns about the stimulus package.

Dr. TYSON. Well, of course, I think that the issue now really is the stimulus package, as we proposed it, and as I would continue to defend it. As an economist, I had absolutely no problem defending the stimulus package. I think that, again, to go back to the notion of if you have an economy with a lot of unutilized resources and you have an infrastructure program which you know can improve the economy's productivity in the long run, it can also employ people in the short run. There is a very powerful argument for spending some money on it. So, I felt economically the case was very compelling.

It lost for political reasons, not for economic reasons.

At this point, I think the issue is to come back with a supplemental request, no longer as sort of a stimulus package, which is paid for and which would address some important specific needs like the Small Business Administration loan guarantee refunding issue, like some specific jobs programs, job training programs for the summer. We will be working on that, but it is a very different package, because the original idea was a large stimulus effort that was designed to create jobs and move the economy more rapidly forward right now. It is not the same as the small package which you pay for, which is where we are now.

As far as the budget program, since I think there is a tremendous agreement among the American public that we need a deficit reduction package that is real and serious, and since there are no serious contending programs out there, I would hope that people will say this is an important initiative that we should support. It is critical to reverse directions. I may have problems with this or that item in this package, but I would take the position which I think Chairman Greenspan has taken before many committees, which is that the most important task is deficit reduction. It matters a little less how you do it. It matters that you do it, first and foremost.

Chairman LaFalce. Thank you.

Mr. Johnson.

Mr. Johnson. Thank you, Mr. Chairman.

I would like to follow up on Bill Sarpalius' questions because I too am from Texas, and I think we are missing the whole impact of this tax on agriculture. What he is talking about, and I think what Bill tried to say, was our agriculture guys are going to go broke with that tax laid on them. It is that simple. So, you are going to lose the whole economy, as far as agriculture is concerned, notwithstanding your comment that, well, we are supporting them in other ways so they can get through it. I think you did make the comment earlier that big business can support some of these added impacts in taxes, but small business flat cannot do it.

I was in Dallas this weekend, and they were telling me if this goes through they are going out of business. It is that simple. We are to the point where you cannot make gross and net meet, and it is Government regulation, which you spoke to, and it is Government taxation, and Government spending. All of those things you are trying to address, but I think we are doing it in the wrong way.

We need to stimulate business, and I really do not know how to help you do that. I mean, reducing the military, which was spoken to earlier in questions, where you lose the vast number of jobs—I have heard 2.7 million over the 4-year term—has not even talked to, and it did in some newspapers over the weekend, the related business impact, small business that suffers with those job losses in the military areas that are cut. I know you know the impact of those things, and just putting enterprise zones in to try to restimulate those bases, I am not sure restructures the business impact that much.

Let me ask you a question. I am told that S corporations, partnerships, and sole proprietorships are taxed on undistributed profits, and under the Clinton proposal their tax rates could increase as much as 44 percent while regular corporations with gross sales less than $10 million will have no effective tax increase. I would like to know what your opinion is on why smaller businesses are being asked to pay more taxes just because of their legal form.

Dr. Tyson. I do not think the proposal was to ask small businesses to pay more taxes because of their legal form. The way that works out is primarily because we have proposed two major mechanisms for raising revenue. One is the BTU tax, the other is an increase in personal income tax rates at the upper end.

The way subchapter S corporations and individuals meld in terms of paying taxes, it is the second tax, it is the increase in the income tax rate, which adversely affects the subchapter S community. It was not designed to be an effect on small business. It was designed to raise revenues in a way which restored some of the progressivity in the income tax system, not all of it. That is, we did not go back to degrees of progressivity that were with us in the late 1970's or early 1980's, before tax reform in the 1980's, but to restore some.

So, basically, you have to see the motivation, which is what I just told you. It has the effect that you suggest, but that is the reason for the proposal.

Chairman LAFALCE. If I could just interrupt. In the practical business world, I think you have most every attorney for every subchapter S corporation considering whether to establish a new entity, whether——

Dr. TYSON. New entity.

Chairman LAFALCE [continuing]. The basic charter, and that is a real problem out there, and I suppose any time you float or introduce a proposal you are going to have real problems, but this one is really disturbing virtually every subchapter S corporation in America, and that is an awful lot of them.

Dr. TYSON. Yes; I understand that. There have been some attempts, in terms of measuring or estimating the revenue from this tax rate proposal, to take into account some efforts to reorganize or to change entity form to avoid the tax. So, some of that has been taken into account. But I do agree with you that it will have the effect of encouraging people to look at other forms of organization.

Chairman LAFALCE. Mr. Johnson made a point about closing defense installations. Of course, the surrounding small business community will be adversely impacted. Some countries do have plant closing legislation that gives tremendous assistance to the neighboring business, factory small business community. In a sense the closing of an installation is somewhat similar to a plant closing, only very often much larger in scope.

When we talk about conversion, it ought to be conversion, not simply of a base, a physical facility, but conversion of an economy that has grown up around the physical facility.

Dr. TYSON. I agree. Look, I would say on the defense conversion issue that the truth is that we were already on the road to real declines in defense spending before the Clinton administration took over. This started really in the late 1980's.

What is different about this administration is we are proposing to have a plan and some funds to help us get through this transition. I do not think that we as a nation want to miss the opportunity created for us by world events, by our victory in the Cold War, to really change our priorities, to put a little bit more into our long-term economic well being, and a little less into our military commitment. I think we can afford to do it without jeopardizing our defense. I believe that the Defense Department believes that, and the National Security Council believes that, and the State Department believes that.

But I think, by the same token, defense conversion does cause economic dislocation. So, what we are proposing is to have an effort largely organized at the local level, but financed through some Federal programs for helping communities and workers get through the process.

So, I agree with you. I think we need to think about it as a community issue, not just as a particular displaced worker issue.

Mr. JOHNSON. Thanks for your comments. I appreciate them.

Dr. TYSON. Thank you.

Chairman LAFALCE. Yes, Mr. Tucker.

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

First of all, may I have my opening statement be accepted into the record?

Chairman LAFALCE. Without objection we will put it in.

Mr. TUCKER. Thank you.

Dr. Tyson, thank you for coming and sharing information with us. I have a couple of questions that are specifically geared toward and attendant to the areas of the intercity and minority businesses.

I represent a district in Southern California that was heavily affected by the riots of a year ago. President Clinton has been out there, and we are really trying to find out what tangibly is going to be done.

My first question deals with something that I think is rather fundamental as it relates to SBA. I heard what you said about deregulation. I have heard your comments about trying to do something in the way of community development banks, and I think Mrs. Meyers and your colloquy was rather interesting in terms of whether or not you would use existing banks or whether or not some new institutions would be created.

But as it relates to the SBA, the Small Business Administration, in particular, my information is that there is an abysmal record as it relates to minority loans within loan guarantee programs. Now, I am much in favor of refunding $140 million, whatever the operative number may be, in terms of getting some more small business loans out there. But the record, as it relates to and reflects the amount of participation or reception of loans by minorities, in particular, African Americans, Asian, and Latino Americans, as I have read it is very, very dismal.

Can you respond—this is the first question—can you respond to that, and what is the administration doing about that? What recommendations are being made about that? Some people have suggested that perhaps SBA as an entity is an inappropriate entity that is too independent. Has there been any suggestions that maybe it should come under the Department of Commerce or something where the administration, this administration or any administration could make it more accountable to promulgating access to capital and credit by minority businesses?

Second, I read an article recently about a suggestion on enterprise zones vis-a-vis something called enterprise boards and how that might work in terms of coordinating interagency efforts in particularly disadvantaged areas.

Can you give me a little more information on that and tell me how that may work and in what areas that may work in?

Dr. TYSON. Well, on the SBA, I have not been involved in any discussions to date on issues that might involve reorganization or a change in where the SBA is. But I would say, however, that I think that what is important is a commitment to elevate the significance of the SBA in terms of the leadership and in terms of bringing the SBA into more of the conversations that involve Commerce, and Labor, and Defense, where SBA might be a complement to programs coming through other agencies, and to really elevate its role in those kind of discussions.

But as far as organizational issues, so far I have not been involved in discussions precisely on that. I can check into it for you. If I find out anything, I will let you know.

Mr. TUCKER. I appreciate it, and I will contact you on it.

Dr. TYSON. On the issue of enterprise corps, enterprise zones, and empowerment zones, I think that our proposal is to have really some major effort targeted in 10 areas of the country, and almost certainly the area that you represent would likely be a contender.

In these major areas, there would be a board that would have as its primary goal coordinating Federal programs as they reach into the community. I was very struck by a presentation that former President Carter made to a number of White House officials in February. I think that it really influenced, to some extent, the way that our enterprise empowerment zone proposal came forward. He came with a number of community leaders from Atlanta. There were also leaders from Baltimore. There were also leaders from Los Angeles.

They made a very compelling case that money was important, but organization was also important. It was also important to better coordinate Federal programs. It was also important that the local community come forward with a plan of how to use the money in a coordinated fashion. You have coordination both of the Federal programs, so there is not conflicting bureaucracies, and also the private community, the local community, public and private, organized to efficiently use the money.

We have put into this proposal the requirement that there would be competition to get the funds, and the funds would be substantial. But the competition would depend upon the board—a local board of community leaders, public and private—coming up with a plan and making a proposal to the Federal Government. The Federal Government would evaluate the proposal, and then agree to work with the community in a coordinated way.

That is really, I think, the most important new part of our proposal. The second new part, unlike enterprise zone proposals in the past, is a significant amount of the support would go for wage credits to encourage employment creation, rather than simply the creation of capital without employment.

I think that those are the major ways that we have tried to respond to what we heard from the communities in a new proposal.

Mr. TUCKER. A real quick followup.

Chairman LAFALCE. Very quick.

Mr. TUCKER. Very quickly, Mr. Chairman.

Do you have any projection on the turn-around time of implementing these kinds of enterprise zones?

Dr. TYSON. I think that we would like to move as quickly as possible. We first have to get the legislation passed through the Congress. But we are committed. The lead agencies HUD and the Department of Agriculture, because there would be a few rural zones, are ready to go. They have thought very hard about this. We have been working inside the Government to think about better ways to coordinate the delivery, so there is work going on. I think that, once the proposals are passed, we will be ready to move fairly quickly.

Mr. TUCKER. Thank you very much, Doctor.

Thank you very much, Mr. Chairman.

Chairman LAFALCE. That is a subject that I wish to discuss with you at some other time. Indeed, I am fearful of raising undue expectations with respect to those proposals. I hope that they will not be marketed too aggressively. Because the more aggressively that they are marketed, the more likely they are to create frustration and disappointment. Because of necessity, they can be so limited.

Of your 10, you have divided the 10 into urban, suburban, and rural?

Dr. TYSON. Mainly urban and rural.

Chairman LAFALCE. Just urban and rural?

Dr. TYSON. Yes.

Chairman LAFALCE. But are there not three?

Dr. TYSON. There is urban, rural, and Indian.

Chairman LAFALCE. Oh, OK. Is it three urban areas?

Dr. TYSON. No; it is three rural. There are 10.

Chairman LAFALCE. Three rural and how many Indian?

Dr. TYSON. I cannot remember the exact number. Do you remember the exact number? Six, three, or one. Yes.

Chairman LAFALCE. Six, three, one. One Indian, three rural, and six communities. I can think of at least 100 urban areas.

Dr. TYSON. Of course, it is a two-part proposal. They get the lion's share of the money. But there is a proposal for various forms of credits that would go for the smaller areas.

Chairman LAFALCE. OK.

Dr. TYSON. In all of these things, I think, and I really feel this as an administration official, that we have to constantly recognize that we have to do our initiatives within the context of overall budgetary restraint.

Chairman LAFALCE. Sure.

Dr. TYSON. If these 10 are well designed and are effective, then they can become models for doing more. But we have to demonstrate credibility to the American people. We are reducing the deficit. If we have 10 successful programs, then we can go forward at a later date, and say let us build on these.

Chairman LAFALCE. If we have the likelihood of resources existing that will enable us to go forward. There is a question as to whether or not we can answer that in the affirmative. I would distinguish between marshaling the resources of the Federal Government in a targeted way with respect to spending and regulatory programs, and then trying to use targeted incentives in the tax code.

I am concerned about the use of the tax code doing violence to tax policy. Also, if you look at the efficiency of dollars spent, direct spending, as opposed to indirect through the tax code, you get much greater efficiency in every study that I have seen through direct expenditures, much more targeted to your socioeconomic goals, too. I am more concerned about the tax incentives of the proposal.

Mr. Knollenberg.

Mr. KNOLLENBERG. Thank you, Mr. Chairman.

Dr. Tyson, good morning. It is still morning.

A couple of things. I want to ask you first about a comment that was attributed to you that you made some 2 or 3 years ago, and I am sure you are familiar with this. I would just like for you to have an opportunity to expand on it, defend it, or in fact change it to your liking.

It goes as follows. "There is no relationship between the level of taxes that a nation pays and its economic performance." Now the sheer impact of that bothers me a great deal. Because it suggests that we can continue to tax, and tax, and tax, and that it really does not make any difference, because maybe Government can do it better than we can do it ourselves. I would just like your response.

Dr. TYSON. There are two responses, and then there is an observation about what it means about my position. If you look at any ranking of advanced industrial countries, whether small or large, whether you include 10, 20, 25, or 30, the United States is at the bottom in terms of taxes relative to GDP.

The United States is not at the top in terms of lots of other indicators. The United States does not, relatively, have a high tax rate. It is in the lower end overall taxes relative to GDP.

This was motivated by a graph, a series of numbers, in the Economist, where you can see every year where the United States stands in the ranking, and the United States stands at the bottom in taxes relative to GDP.

Now the fact that the United States stands at the bottom, you might say well, maybe that means that the United States has the highest investment rate, or the highest growth rate, or the highest income per capita, or the highest level of educational excellence. None of those things are true. Actually, the ones that I mentioned, other countries with slightly higher or much higher tax rates do better than us on a number of indicators.

So, the conclusion is that there is no simple relationship between overall taxation rates and how an economy performs. That is all.

Let me just say what my policy position is on this. My policy position is not to suggest that we should increase taxes to match the top. The article did not say that. It simply made the observation, which I think is defensible, that there is no simple relationship; that we cannot worry. That people who want to discuss public policy solely in terms of the level of taxation are overlooking how a whole variety of public policy issues affect the economic performance of a nation. There are many other indicators and things that Government does.

Mr. KNOLLENBERG. Let me just respond in this way. In 1986, Congress passed an increase in the capital gains tax from 20 to 28.

Since that time, new business starts, and that is what we are talking about this morning, the improvement of new business, new business startups have dropped substantially.

As you know, and I do not have to tell you, the real job creator of this country of ours is small business. So, if we want to help small business, maybe we should do something about those kinds of things.

In that regard, I think that there is a relationship between taxes and growth. But I do not suggest that you are saying, I would hope you are not saying, that we want to turn toward a centralized economy.

Dr. TYSON. No.

Mr. KNOLLENBERG. Let me dwell on one more thing. I appreciate your response on that. But let me also hit on something. I believe you said that you were in favor of NAFTA or at least agreeably on most points. What concerns me about NAFTA—and by the way I am in favor of it, too, and I come from an area of Michigan that surrounds the Detroit area, which is the auto center, as you well know—there is some movement among the various elements that would want to challenge NAFTA, and perhaps even scuttle it. I know that there are these side agreements that we hear about, that have been talked about, and will be continued to be talked about.

Do you think that those are going to have a negative impact on NAFTA? Do you think that the final package, the final package as it rolls out, is going to be potentially scuttled by some of those side agreements?

Because it looks to me like the work that went into that agreement was a tremendous effort on the part of a whole lot of people. Nothing is perfect, but it is as close, I think, to being perfect. It will help this country. It will help my State. It will help, I think, the entire country.

I just wondered what your views were about that aspect of it?

Dr. TYSON. Well, I think that the whole intent of the side agreement, and this is certainly not in any way meant to undermine what we have gained from the agreement that we have already initialed and has been finalized, it is simply to address some issues, particularly in the workers area, which I think were simply not well represented in the first round of negotiation.

But I do not think that anything under discussion so far would in any way undermine the benefits to the American business community in terms of much better access to the Mexican market, both in investment terms and selling product terms. I think that nothing that we are considering would undermine any of the agreement, as it is currently written.

It is meant to be complementary. To address issues that were not fully addressed, but not to address them in such a way as to undermine what is already there. We are working very hard to resolving the debate, because we are committed to realizing the benefits for the American economy from having freer trade with Mexico.

Mr. KNOLLENBERG. Thank you, Doctor.

Thank you, Mr. Chairman.

Chairman LAFALCE. Mr. Collins, do you have any questions?

Mr. COLLINS. Thank you, Mr. Chairman.

Dr. Tyson, the president's tax proposal both gives incentives for small business, and it also has increasing tax rates, as well as the BTU tax, and then some other fees that kind of offset one another.

In your opinion, what will actually be the bottom line impact for small business?

Dr. TYSON. Well, the objective of this whole exercise is to allow the economy to get on a sounder fiscal footing. I think that when you ask that question, that you have to ask where you think that we were going.

There were many people who felt that if we stayed on the course that we were on that there was a real possibility of considerable financial market instability, maybe a real spike in interest rates, a turning upward of long-term rates once again as the Government started on this trajectory of increasing structural deficits.

So, you have to say where do you think that the economy was going. We think that it was headed into trouble in terms of the increasing claim of the Government on society's investable resources.

With that interpretation, of course, this deficit reduction package, if it works, if we put in the enforcement mechanisms, if we really make sure that these additional revenues and spending cuts go primarily to reduce the deficit in the order of magnitude that we have proposed, then I think that we are trying to get the economy on a sounder growth path with lower long-term interest rates. An economy which, because of lower long-term interest rates, offers better growth prospects and better investment prospects for the private community, including the small business community.

Now that being said, as I emphasized in my remarks, small business always has a problem, even in an improved interest rate environment, of access to capital. That is why it is important to have the small business SBA loan guarantee program. That is why it is important to have the tax exclusion targeted for capital gains from the formation of new small businesses. That is why it is going to be important to make sure that we deal with the credit crunch in other ways if we need to.

I do not think that we can count on an improved interest rate environment as the only solution for the small business community. But I think that it is an important part.

So, I would look forward to working with the committee as we move forward to see how much benefit is realized by the small business community through this package, and whether additional initiatives are required.

Mr. COLLINS. Can you discuss the potential additional initiatives now?

Dr. TYSON. At this point, I would rather get proposals from you as to what kind of things you would like us to think about.

Mr. COLLINS. That was very well put. But your objectives seem to be filled with many ifs, ands, and buts, and speculative opinions.

What will be the reality of the impact of raising taxes on one hand, and, on the other hand, trying to give an incentive for small business?

Dr. TYSON. What economists can do is take macromodels and other models and run them with the assumptions of policy. What we did in our budget proposal was, in the Vision of Change document, and it is in the budget document as well, we asked ourselves the question: If we had the administration's policy put into place—and that includes the tax increases, it includes the spending cuts, includes the overall deficit reduction of the magnitude that we have requested, and it also incidentally would include the stimulus package which is now gone—what would happen to the economy?

Our numbers suggest—and incidentally, the DRI, WEFA, and a number of other forecasters came up with similar conclusions—that the economy would actually grow through the process. That we would get growth rates this year on the order of 3.1 percent.

Now I think that might be revised downward somewhat as a result of the loss of the stimulus. For example, the Blue Chip Forecasters just came out with their most recent forecast, and, since the failure of the stimulus to pass, they have revised down for this year from 3.2 to 3.0, shaving off a percentage point because we are not going to stimulate the economy up front.

On the other hand, the forecast over the period 1994, 1995, 1996, 1997, and 1998—and those out-year forecasts, I admit you should take with a grain of salt—suggests that the economy could grow in the range of three for a couple of years, and then maybe going down to its long-term growth rate estimated at about 2.5.

If those projections hold true, then the economy gets a lower deficit, and it is on a long-run path which is a more sustainable and which benefits both large and small business communities.

Again, small business needs special programs precisely because it has special problems. But in terms of the macrocontext, this program should help the small business community as it helps the large one.

Mr. COLLINS. What about the small business person who does not have a need for a great deal of investment in equipment, but will still pay the higher tax rate because of the BTU tax?

Dr. TYSON. I think the answer there is that the small business individual who does not and will have to pay those higher rates would also benefit, it seems to me, from having buyers, consumers, and purchasers of its services and goods be in an improved financial situation because of the improved economy which the package creates.

So, I may not help a particular business directly, but I can help the particular business indirectly, if I provide a sounder economic climate for the purchasers and consumers of that business' output.

Chairman LAFALCE. We are going to have to move on.

Mr. COLLINS. What did you mean exactly when you made the comment earlier that the tax increases are mainly to restore productivity of income taxes? I think tax increases will reduce productivity in small businesses throughout all industries.

Dr. TYSON. I only have one sort of editorial adjustment to that, which is that I would never say, and I am sure that I did not say, that they were mainly to restore progressivity.

The reason that we asked for tax increases at all—and I call them tax increases, I am not calling them contributions or anything else—the reason that they are there is for deficit reduction.

Let me emphasize again that we have gone through 12 years of programs which have increased the deficit and increased the debt. This is a credible program for reversing that trend. We have not seen, and I do not think that it is really out there, a serious alternative proposal. This is not about raising taxes. This is about reducing the deficit.

Chairman LaFalce. Mr. Huffington.

Mr. Huffington. Dr. Tyson, many of us are small business people, or at least we started that way. There is no question that small business men and women today cannot afford any more taxes or any more regulations. It is clear. There are many of them who will go out of business. They hire people who make anywhere from $10,000, $15,000, or $20,000 a year. Those people will be unemployed. Our welfare rolls will go up. That is not helpful to anybody.

It seems to me that raising taxes, if it is really for deficit reduction, ought to go for a 100-percent deficit reduction. That is not what is happening. There are a lot of new spending programs. So, if we really say that it is going for deficit reduction, I think that you would see American people willing to sacrifice, and those are the words that are used, and make contributions, if, in fact, that they thought that it was going to a 100-percent deficit reduction. But they know that is not the case, and that is why they are dissatisfied, and that is why the polls show it.

But on a more positive note, you said that you were willing to work with us to reduce regulations, if we could give you suggestions. I would ask the chairman that we have committee meetings on that topic, because it is clearly complicated. There are specific issues to each business. It is not something that you can universally say if you do this it will improve things. There are so many businesses in this country that have different types of regulations. I think that it would be good for all of us to meet and have those sessions that might not be exciting, but they are certainly going to be helpful.

Chairman LaFalce. We had a very important hearing last week with the bank regulators on the regulatory relief proposals of the Clinton administration to stimulate the flow of credit to the private sector.

Mr. Huffington. Which is a good start.

Chairman LaFalce. We have a subcommittee chaired by Congressman Wyden of Oregon that is specifically concerned with regulation as it impacts the small business community.

Mr. Huffington. Once again, there are many businesses in this country, and I would like to hear from as many as possible. I certainly would encourage Congress to work with the administration for the benefit of American businesses, no matter what their political ideology. We want this country to succeed.

So, I thank you for your openness. We will certainly try and come up with some specific suggestions that we will pass on to you. Hopefully, you will pass them on to those who can use them.

But the regulations are not written by Congress. They are written by the bureaucracy that reports to the administration, Republican or Democratic. I think that is a frustrating thing for both groups, and we need to do something about it.

Chairman LaFalce. Thank you.

Mr. Dickey.

Mr. Dickey. Hi, Laura.

Dr. Tyson. Hello.

Mr. Dickey. How are you doing?

Dr. TYSON. I am fine.

Mr. DICKEY. I need to know something about the stimulus package.

If you take it away from the President's plan, where does that leave us as far as being any different than just say the Kasich plan? Are you familiar with the Kasich proposal?

Dr. TYSON. No.

Mr. DICKEY. It was just deficit reduction.

Chairman LAFALCE. It was the Republican alternative.

Dr. TYSON. OK. There is the stimulus, and then there is the budget package. I think that we were different on both counts, because in the stimulus package we were really asking for some up-front spending. Again, the logic as an economist was that there is a lot of unutilized resources in the economy right now. That the private sector, although we are growing, is doing so at a fairly modest rate.

We could both encourage some short-term job formation and get some things done that we should get done, some infrastructure projects, some environmental wastewater projects, and benefit both the long run by getting important things done, and the short run by generating some jobs and incomes for unemployed Americans; that was the notion.

But the budget package is also different in the sense that we are asking in our budget package to do two things. One is to bring the deficit down, and the other to change the composition of Government spending.

It is true that for some programs we are proposing spending increases. However, I do want to emphasize again that the overall rate of growth of Government spending, with the exception of interest and health care spending, short of health care reform, is actually declining in real terms in our budget proposal.

Mr. DICKEY. Well, let us talk about that for a second. You made the statement that, other than health care reform, the deficit is going to be reduced.

What is the health care reform going to do to the deficit reduction?

Dr. TYSON. The reason that I wanted to make that distinction is because if you look at our graphs or anybody else's graphs, what you see is that the deficit as a percentage of GDP was on an upward trend through the end of the decade. Our program brings it down. But then when you go into the out-years, depending on what growth assumptions you make, it is either flat or it starts up again.

When you ask yourself why do we not get any more deficit reduction, it is because of projections about health care spending, Medicare and Medicaid, and what will happen to them in the second part of this decade.

So, that is the primary reason for trying to introduce health care reform. Which, if we can make our health care reform more efficient over the next 4 or 5 years, by the time that we get to 1997 and 1998, we will have slowed down the rate of increase of Medicare and Medicaid spending.

It is not to say that our health care reform will make the deficit worse. It is to say that one of the primary reasons for needing health care reform, and there are several, is that you look out, and you see those growth rates, and you know you have to do something about it now, and the process has to be a slow one. We have to do things now which will get those costs under control in the latter part of the decade.

Mr. DICKEY. Another subject. I hear a lot of proposals. When they do mention something about small business, a lot of proposals will have the statement that this is not hurting small business, or this is not going to affect small business.

Is there a way for us in any conceived idea to start talking about how we can help small business, not just not hurt them?

Dr. TYSON. The primary way that I think about this problem is the one that I have emphasized, which is that I think there is a recognition that small business does have a problem in accessing capital.

Chairman LAFALCE. If I could interrupt, Dr. Tyson. I think that the principal problems of small business right now are number one, money; number two, health care costs; three, Workmen's Compensation costs.

Mr. DICKEY. Regulation.

Dr. TYSON. All right. Capital is what I was emphasizing.

Mr. COLLINS. Mr. Chairman, I think that one of the primary problems of small business with capital is that they can borrow all they want, but paying it back is rough. Because of business, because of the economy, because of taxation, because of regulations, and because of constant intervention and interruption by Government in small business operations.

Mr. DICKEY. But when are we going to start saying this is what we are going to do to help small business? I am a small business person. I get back on my heels, and I think what have I done wrong, why am I a target. You could just put a big target up there, and you have the yellow circles, and the white circles, and everything else, and then the red circles. I have felt at times that the Government was aiming right at me with these regulations and these restrictions, and all of these things that are suspicious of our motives.

Can you get an idea in your own mind that can help us with that?

Dr. TYSON. I guess that I would pose it a little differently. It is not that small business is targeted in particular.

Big companies can just afford to handle the regulatory burden better, and they can afford to get around the trade barrier. They are big enough that they can absorb that cost and continue to function. So, it is not that the regulation or the barrier is targeted at small business, but it does have a disproportionate impact. That is how I would say it.

That is why I say that even if we had a growing economy—growing robustly—and we had no fiscal deficit problem to speak of, it is still the case that even in that situation that small businesses would suffer some disadvantages simply on the basis of size. That is why I was getting at the lending issue.

It does not matter where you are in the economy cycle. Small businesses do have a problem of access to capital. The same thing is true in a system in which we do not have a mechanism for providing health care coverage. Small businesses have an unattractive choice. The choice is to either provide coverage at exorbitantly high rates, because they do not have any of the ability to purchase insurance at an attractive rate which size would bring. Or they have the alternative of not providing it at all.

For many small business lenders, that is not the place where they want to be. They would like to provide insurance, but the system does not give them the option of doing it in a cost-attractive way.

So, I want to emphasize that I think that one of the many reasons for doing health care reform is to ultimately provide a system in which the small business community has a more attractive alternative posed to it than the system in which we are currently functioning.

Mr. DICKEY. Thank you.

Chairman LAFALCE. Mr. Talent, do you have any questions?

Mr. TALENT. Thank you, Mr. Chairman.

Dr. Tyson, I appreciate you taking the time to come here today. I know that you have a lot of things to do, but it is important to all of us to hear your views on these things.

I apologize for coming in late, Mr. Chairman. I am discovering the number of subcommittees that there are in the Congress, and they often meet at the same time.

I wanted to make a point in connection with regulations. I think that we tend to emphasize so much the areas where the major parties differ in their thinking, and we do not emphasize the areas where basically they are the same.

For example, regulatory reform has been a mainstream article of faith of both parties. I think that President Carter initiated it in the late 1970's. You asked for specific things. I can tell you what my constituents are telling me. Just as an example, wetland regulations. There are three to four different Federal agencies that regulate wetlands. EPA, the Corps of Engineers, the Federal Emergency Management Agency. They all have different definitions of a wetland.

It is impossible. People talk to me, and they say look, we can comply with about anything, if we know what it is. As a general point, it seems like our regulations do not take into account transaction costs. Obviously, something that, as an economist, you are very familiar with. Normally, I do not suggest that economists or lawyers get more involved in processes.

But we have got to get across the idea that if businesses are spending a lot of money for lawyers and accountants to try to figure out what the law is, they are not putting the money into production, and they are not putting it into actual compliance in achieving some social welfare objective. They are spending the money trying to identify what the law is.

I defy anybody to tell me what the regulations of the Occupational, Safety, and Health Administration are. You cannot comply with them. The example I use is when the Emperor Caligula wrote the laws in small letters at the top of the high monuments, so nobody knew what they were.

It demoralizes people. I could go on and on. This is an area that I congratulate the chairman and the administration for their initiatives in the investment area. Because I think that this is an area where we could really make some headway. As you lighten up in regulatory costs, then the business community will produce more for everybody.

Now let me just ask you about another area. With regard to your statement, you talked about the need to increase labor productivity, and that increasing public capital was part of that. This, it seems to me, is an area of basic disagreement.

I am skeptical of the idea that Government spending produces more goods and services, or jobs, or wealth for the economy as a whole. It may produce social justice, environmental gains, and health care for people. But the idea that it produces wealth seems to me to be contradicted by the experience of the last 20 years.

It seems to me that it is the market that will produce wealth. It may not distribute it the way that we want. It may not spend it on exactly what we want to spend it on. But it will produce wealth.

Can you give me examples where you think spending on public capital, and I do not mean the Corps of Engineers model where a dam has produced it, but in countries where it has increased productivity as a policy where it has achieved that, and on what you base your underlying thinking.

Dr. TYSON. I think that it is important, and I do think that we need a pretty tough notion of what kind of spending that I have in mind. The example that I know best where I think that there is a very compelling case is support for science research and development. Look at what you consider to be high-technology success stories of the United States: Computers, semiconductors, aircraft, and now biotechnology.

These are not areas where the Government has played no role. These are areas where the Government has made substantial investments. Now in the area of aircraft, computers, and semiconductors, it was primarily under the rubric of DOD. But nonetheless, it was a lot of money up front.

The reason that there was any demand at all for semiconductors in the United States was because DOD wanted semiconductors. That is where the demand came from.

The reason that you got a number of new innovative firms being created was because DOD was willing to pay premium prices to startups if they offered a particularly attractive new technology in the semiconductor area. So, we got a very competitive industry precisely because DOD was willing to be the procurer of high-priced products. DOD also put tremendous R&D money in.

Now biotechnology is another one. Biotechnology is a private/public success story. If you go into the history of where most biotechnology ideas came from, you will find NIH supported scientists in major American universities, who worked on genetic problems, for example, came up with an idea, moved the idea out of the university into the private sector, and went with the idea to form a product. That is a private/public partnership.

So, I think that there are examples. On infrastructure, you sort of talked about the dam but did not want to talk about it. But I think that if you define this right, then infrastructure projects like dams, roads, railroads, air traffic control systems, and all of the rest are precisely things that you would not expect the private economy to provide. But you would expect the private economy to need to use. They need it.

Let me just give you another definition, and this is a very different kind. But it is the Head Start Program. We do know from many studies that those programs are successful at improving the performance of children through education. Now those can be short-lived. Meaning that if these children fall off another cliff later on in seventh and eighth grade, they may disappear. But we do know that the program more than pays for itself. We know that about immunization programs as well. So, I think that we have to sort of define this on a case-by-case basis.

Mr. TALENT. I appreciate that, and I think that narrowly defined, we are beginning to reach an area of possible consensus.

One comment about biotech. Let me state right up front that the Monsanto Chemical Co. is headquartered in my legislative district. This is an area that you might want to look into. What they tell is the difficulties they have dealing with the FDA. Obviously, we need to make sure that we have safe procedures here. They are threatening to snuff out all of those developments, which you recognize also are very, very important. You might want to have somebody on your staff talk with them about this.

The idea of a regulatory budget. The idea of the Government on a regular basis taking into account the costs imposed by regulations, not necessarily to say that we do not want to impose the regulations, but we are going to recognize that this is a cost that the economy has to bear as well. That is an idea that you might want to look at.

Thank you, Mr. Chairman.

Chairman LAFALCE. Thank you very much.

Dr. Tyson, so many issues have been raised that impact the small business community. I know that you are very concerned about the small business community, but I hope your appearance today will reinforce that concern and reinforce throughout the Council of Economic Advisers and the administration the realization that everything they talk about has a special impact on the small business community. Let us take some of those major issues. Let us take health care, for example. I feel passionately about the need to reform our health care system. Indeed, the possibility of doing this is one of the reasons that I decided to run for reelection again. I feel so strongly about it. I am delighted that Ira Magaziner is working on this. Ira, too, testified before me 10 years ago. He and I were supposed to get together last week. We had to cancel it.

I am enamored of the single payer system for a great many reasons, but primarily because that is the only proposal, to my judgment, that would sever the link between health care and jobs, and right now there is an umbilical cord between health care and jobs. Health care is pretty much a privilege of employment now. There are those who are advocating that we make it a right of employment with a fail-safe mechanism for the unemployed. There are others such as myself who would advocate we make it a right of citizenship.

I do not know that we are going to go as far as I want to go. There are substantive reasons that are advanced against, and then primarily political reasons. I do hope, though, that we can devise a plan that would permit States that desire to, the option of going that route so that we can look to some pilot programs in the States.

But assuming that is not the route we will take, we have had a number of—I will not call them trial balloons, but we have had a number of financing mechanisms floated. What I am most concerned about now is that we seem to be fixating on a premium or some percentage of payroll where there is only a metaphysical distinction between a premium and a payroll tax. This is something that I thought President Clinton, during the course of the campaign, had ruled off the table, the payroll tax as a means of financing it. I would hate to think we would resort to something that is only a metaphysical distinction away from a payroll tax.

I wonder if you have any thoughts on this, and if you should concur with me within the administration, I could use all the support to see to it that the financing mechanism for substantive reasons, the potential impact on the small business community, and for political reasons, because that, in my judgment, will incite the most opposition from the small business community, be the last of all policy optional alternatives.

Dr. TYSON. Well, I guess what I would say is that there are various things being looked at in health care reform, and that they are interrelated. It is not just the financing, but it is also what would be in the benefits package, how quickly the benefits package could be phased in, how quickly the formation of health alliances would occur, which, to a certain extent, is going to be a State decision. They are interactive, and we have to assess the economic effects of each possible constellation of choices; that is where we are right now.

Chairman LAFALCE. Yes.

Dr. TYSON. So, we are really looking at a variety of options on a variety of different questions about the benefits package, the phase-in, State flexibility, how much there should be or can be, and financing mechanisms.

As far as financing mechanisms are concerned, I do not think you should assume that any particular one has gained ascendance. There are various ways being discussed, but it is really too early at this point to say that there has been a decision on any one or the other. I think we have to look at a variety of alternatives, and looking at those alternatives the employment effects are very important to us, as are the effects on the small business community.

Whatever one is ultimately chosen——

Chairman LAFALCE. On March 10, the President said the reason this has been a jobless recovery is because the small business jobs have not increased to compensate for the contraction in jobs and the big business.

Dr. TYSON. Yes.

Chairman LAFALCE. Therefore, we are going to have a problem with the reduction in health-care personnel. We ought not to exacerbate that by coming up with a financing mechanism that is going to have a depressive impact on the ability of the small business community to generate the new jobs necessary to compensate not just big business contraction as it presently exists, but contraction in the health care industry.

Dr. TYSON. Right, which we really cannot, although I think it is important to emphasize, even in the health-care industry, we are really talking about a reform which slows down the rate of growth.

Chairman LAFALCE. Yes.

Dr. TYSON. It does not cause the rate of growth to go negative. There will be some dislocation presumably in parts of the industry, because even if we did nothing else with health care reform, we need insurance reform, and insurance reform by itself, if done seriously, will have some dislocation in the health insurance industry. But I think overall we are slowing down the rate of growth. There is going to be growth in the health industry.

Chairman LAFALCE. I am just looking to you to be an ally, to make sure that this perspective is considered at the table.

Dr. TYSON. It is being considered at the table. You can rest assured of that.

Chairman LAFALCE. All right, good.

Let us go now into money. As you know, I have long suggested that the development of a secondary market for a small business, commercial and industrial loans, are often potential to the small business community especially for giving them long-term financing that they cannot now avail themselves of, and very possibly to fixed-rate financing. President Clinton spoke fondly of this idea during the course of his campaign. You said yourself that it should be explored in your confirmation hearings before the Senate. I have had communications with you and Mr. Stiglitz on this. I know the Council is looking at it. I talked last week with Roger Altman. Treasury is looking at it.

How have you evolved from January 20 on this issue? Do you have any new conclusions or are you still at a tentative stage on this?

Dr. TYSON. I think that I would have to say we have not really reached any conclusions. It is a process which we are fitting in with a number of other activities. Particularly the CEA has been very involved in the health-care issue and in the overall budget issue. One of the main issues, of course, is to ascertain the extent to which a new institution would be needed, or the extent to which there might be some reduction of existing impediments to lending through private channels. This is an issue that we are looking at carefully.

Chairman LAFALCE. Yes; you have a point person on that. Is it Mr. Stiglitz?

Dr. TYSON. Yes.

Chairman LAFALCE. I wrote to him, too, as I did to you, and he and I really should get together at some time.

Dr. TYSON. Yes; he has actually thought about this issue quite a lot both in terms our own market and international comparisons.

Chairman LAFALCE. All right, good.

Now, you may or may not know that I was one of the strongest proponents in Congress of the Canadian-American FTA. There were imperfections in it, of course, but I thought it would be a great benefit to both our countries and a model that could be used elsewhere. One of the defects was we did not deal with the subsidy question. We put that off hoping that the Uruguay Round would deal with it. I will not get into that now.

In my judgment, another defect was, and I tried to get a provision in the Canadian FTA to explicitly call for coordination between our Governments with respect to monetary policy, and to establish some type of a band, if you will, for the value of our currencies. Should we get beyond this band, to consider some type of corrective mechanism, perhaps a duty.

Nobody took that seriously, and there was relative stability in the Canadian-American dollar. Although in the past year there has been about a 15-percent change in value, which has had a considerable impact, for example, on cross-border shopping. Even so, 15 percent as some currencies change is absolutely considerable relatively, perhaps not all that great.

Now, my point. I am infinitely more concerned about that problem with respect to the Mexican-American agreement or the NAFTA, and everybody is talking about side agreements. I think we should be talking about the side agreements, and the President is. I think they are extremely important in ameliorating any potential down-side impact of that agreement.

But we should be talking about the swing in the value of the peso, and I am very concerned about that. I think in the beginning of the 1980's, there were 25 pesos per dollar, and today there are over 3,000 pesos per dollar.

Is that roughly accurate?

Dr. TYSON. Yes.

Chairman LAFALCE. That's enormous, gargantuan. Some people are very concerned that there could well be a precipitous devaluation of the peso. There is no way of knowing this until we know what the new Mexican Government is going to be. You cannot lock it in. At the very least, it seems to me, we should be considering an additional side agreement to be included, a provision to be included calling for economic coordination, particularly monetary coordination, amongst our three countries, particularly the United States and Mexico, because of the tremendous amount of trade that we have, and possibly calling specifically for a certain band to exist in the relative value of our currencies beyond which some remedial measures could be implemented on a unilateral basis.

What think you?

Dr. TYSON. I think that we should start with Mexico in the trade area. I think that the experience of the Europeans in this regard is to think of the free trade area, or creating a freer trade area with Mexico, is logically the first step in a long-term process of greater integration of the North American market.

If that occurs, I would imagine that the first thing that would happen would be that we would see increased trade and investment flows, and then, at a later date, we might see an attempt to harmonize or coordinate other policies. But I think it is too early to do that, and I also think that——

Chairman LAFALCE. What I am afraid of is that we are going to integrate our economies to a certain extent without harmonizing our policies first.

Dr. TYSON. Again, from the European experience, you can have a tremendous amount of integration over a 20-year period that comes through trade and investment flows without the effort of coordinating broader policies.

Now, if that integration process really takes hold, as it has in Europe, then, at a later date, you begin to coordinate or harmonize other parts of the policy process. I think that it is simply not at a point where we need to do that, nor could do that. I do not see it as a possibility.

Chairman LAFALCE. Well, let me read to you from—do you know Dick Rothstein of VPI?

Dr. TYSON. Yes.

Chairman LAFALCE. All right. Last night I was reading "The American Prospect," and I have been on this kick for awhile. In fact, we have a hearing scheduled next week. We are having six economists, top notch economists.

> The NAFTA establishes no currency nor even coordinated monetary policy between the United States and Mexico. So, the treaty itself will not protect the dollar value of peso investments, * * *. U.S. investors' lack of concern about future peso devaluation and their failure to press for monetary coordination in NAFTA is perhaps the best evidence that, contrary to public propaganda, these firms have little interest in selling to the Mexican market. They do not care about the possible low value of sales in pesos, only sales in dollars matter, and a cheap peso helps that.

Dr. TYSON. Well, I think we have to think about it from the point of view of the NAFTA. I do not know what the interest of any particular business operation is in terms of whether they want to sell from here or sell in Mexico, whether they want to invest in Mexico or do cross-border trade. I mean, this free trade area, or freer trade area, opens up for American companies choices as to where they locate production for Mexico—whether they locate it here and export to Mexico, whether they locate it in Mexico and sell in Mexico, whether they hold their profits in pesos or in dollars. Those are all choices for the business community.

I think the issue at a national level, I think we are very far from the need and ability to coordinate macropolicy. Exchange rates, as you well know, all ultimately reflect macroeconomic policy decisions. So, to say that you are going to set a band on exchange rates is to say that you are going to effectively set up a mechanism whereby the decisions of Mexico and the United States on fiscal policy and monetary policy are going to be coordinated.

Groups of countries that are very highly integrated in Europe—extremely highly integrated—and very similar in development levels, have found European unity a particularly vexing task, and a task which, indeed it is argued by many, is almost derailing at this point because they set up an ambitious effort at coordination that was simply not realizable.

Here we have two very different economies, very different size, very different levels of development, very different institutions.

Chairman LAFALCE. Yes.

Dr. TYSON. I do not see the mechanism.

Chairman LAFALCE. In the European Community, they harmonized their economies first, and, therefore, they could then look forward to the harmonization of the monetary policies.

Here within the United States and Mexico you have such disparate economies that it seems to me that it cries out for some greater harmonization of monetary policy, or at least for the establishment of some coordinating mechanism. It is an idea. I toss it out. I really think it is important.

Jeff Garten wrote recently in the International Economy, speaking of coordination,

> The current G7 mechanism is in bad shape. We saw the beginnings of rigor mortis at the Houston summit in 1990; by London the next year gangrene had set in; at Munich last July the group was headed for the intensive care unit; and the meeting of G7 finance ministers at the end of February was a cordial get together but changed nothing. Now major surgery is called for.

Chairman LaFalce. What think you?

Dr. Tyson. He is a good writer. I like to read Jeff Garten. He has good analogies.

I think that actually if he were asked today, I will not put words into his mouth, but you can ask him, that he would have a slightly different assessment. That in fact the G7——

Chairman LaFalce. This is the April 1993——

Dr. Tyson. Yes; but still he was talking about past meetings.

Chairman LaFalce. OK.

Dr. Tyson. I think that the G7 meeting that we just had of the finance ministers actually had some good things. We have had a situation in which the United States needed in some sense to take a critical action. Deficit reduction was important to the G7 process. Our G7 partners have been telling us for years that the first step to our credibility in influencing G7 outcomes was to have deficit reduction at the top of our agenda.

Now when you talk to the Europeans and the Japanese they will agree that, in fact, we have delivered on that request. At the same time Japan has moved in the direction of economic stimulus, even assuming that not every yen in that package is actually stimulus. It is still the case that a conservative assessment is that their stimulus package amounts to something like 1½ percent of their GDP, which is a big economic stimulus package. In Germany, we have seen some interest rate reductions because the Germans are looking in the face of a recession which is really undermining European growth—not just German growth—and they are willing to take some measures to try to turn the economy around. That is very important coordination. I think there actually is some coordination. There has also been coordination on the Russia aid question, which has been very dramatic this year, and I am optimistic that those two forms of coordination we have seen, macro and Russian aid, will feed into coordination on the Uruguay Round in the July meeting in Tokyo. So, I think this year looks good for the G7 coordination process.

Chairman LaFalce. Good. I have some time constraints so I am going to try to wrap it up with one or two quick questions, but not simple.

We spend so much time talking about the deficit, and then to try to make it meaningful rather than just talk about numbers. Because if the deficit is going up, it is not necessarily going up as a percentage. But we spend little time talking about the fact that whereas every State in the union which achieves a balanced budget has a capital construction component. The Federal budget does not.

President Clinton understands the profound ramifications of switching our present budgetary structure to a different budgetary structure, one that would have some capital construction component.

If we did have a capital construction budget—query, what would be capital—but assuming that we came to closure on that, would we still have a deficit, and would it be much of a deficit, and is anybody in the Council of Economic Advisers trying to sit back and say should we adopt this approach? How helpful would this be for us in order to not only get our economic house in order, but to rearrange our priorities, so that we can be putting more into long-term investment rather than short-term consumption.

Dr. TYSON. Well, I think that it is a very important issue, and I think that we will be working on it. But I want to say that it is very important. If we were to attack the deficit problem right now, given the public's perception of Governmental credibility on this issue, by saying,

Look, the deficit situation is not as nearly as bad as you thought. We have the investment budget, and once you put it by itself you can have this operating budget. We still have a deficit; we do still have a deficit, but it is much smaller as a percent of GDP, and that is not a serious problem.

Dr. TYSON. I believe that would strain the credibility of the American people to the breaking point.

Oh, they are trying to do some fancy accounting here to tell us that there is no problem.

Chairman LAFALCE. The irony is that we would be attempting to foist truth on the public, and they would not be ready for it.

Dr. TYSON. I think you do two things. You first commit to deficit reduction of a serious nature. Then you try to adjust the accounts, and engage in the public dialog that needs to be engaged in—that not all Government spending is the same, that some of it is in the form of investment, that here is an investment budget, and here is what is happening over time, and here is the other budget.

I think that we should do that, but we cannot do that as a first step. That would not have been a wise first step.

Chairman LAFALCE. Absolutely. One of the things that we can do as a first step, however. The administration may have done this implicitly, but not explicitly enough. Someone who is near and dear to both you and me, Les Thurow, has said that one of the most important things that they can do is call for bench marks.

As a public educator, the President should flag the basic factors that determine economic success. Investment in plant and equipment, research and development, infrastructure and skills; the willingness to shift to more productive forms of organization; the need to have a well-thought-out international economic strategy. Then seek to compare the United States in the performance of the country in a world that does each of these things best, et cetera.

But he called for clarity of specific bench marks, measurable bench marks, in each of these things. Then seeking to be the best, and showing how we are moving toward that.

I know that we are trying to shift to a greater investment, but are we establishing bench marks in x number of areas? What are those areas? Are we articulating who is the best right now and where we want to be 4 years from now, and are we developing this?

Dr. TYSON. Yes; that is something that we actually are working on. There is an interagency group that will be working on that. The CEA will be the lead organization. As you can tell from some of my comments before, I am very interested in international comparisons and bench marks of taxation rates, investment rates, R&D spending, all of the things that I think that Professor Thurow would suggest. Perhaps it is because he was my adviser, that he and I think about this in a similar way.

We are definitely working on that. That part of the education process, it seems to me, is also to try to explain to the American people why certain kinds of things are important to follow, even if that means interchanging what the Government does, so that it does less of certain kinds of spending and more of other kinds while bringing the overall level down.

Chairman LaFalce. I think that with you, President Clinton, and Bob Reich, that we have the ability to educate the American public. The sooner we realize that this very important—establishing bench marks and educating the public on why we want to move toward these bench marks, how we establish these bench marks, what our goals are, and how we are going to reach them—the better. It would help us politically, too, if we could fit our political actions into the achievement of these bench marks.

This committee has been concerned about many things, and it has been concerned about those who have had special problems within the small business community, minorities, and women. Indeed, we held a series of, I think, landmark hearings on the special problems and potential of women in business.

We issued reports, and we offered legislation. One of the things that I did in 1988, when I passed the Women's Business Ownership Act, was create a Women's Business Council. I am not sure that is the best approach, but it was the best approach that I could take at the time under the circumstances. At one time, there was an interagency task force on women's issues, particularly economic business issues.

Is anyone discussing this within the administration right now? I ask you, because of your position as the first woman Chair of the Council of Economic Advisers. I think that you are especially qualified to give guidance in this area within the administration deliberations.

Dr. Tyson. So far, we have not set up an interagency group on that issue. On the other hand, I think that we in the council have talked a little bit about, and are thinking about, what issues would be worth exploring in that area. So, I think that there will be an initiative. We have not set it up yet, but I think that it is most likely and logical to come out of the council, for obvious reasons.

Chairman LaFalce. Congratulations.

Dr. Tyson. Thank you.

Chairman LaFalce. I am reminded by the staff director that Congressman Poshard of Illinois has come in. There are no questions. All right, good.

Mr. Poshard. I do have a couple of questions, Mr. Chairman, when you are finished.

Chairman LaFalce. Fine. Mr. Poshard.

Mr. Poshard. Thank you, Mr. Chairman. I apologize for being late. It may be that you have covered these before.

But Dr. Tyson, I was interested in your comments about international comparisons with these bench marks. I recently read the so-called economic stimulus package that the Japanese Government has put forward to try to bring them out of the recession that they have gone into; some of the things that the German Government has proposed, and so on.

It seems that with the exception of varying levels in each of the different areas, these are almost the same things that President Clinton has advocated in his stimulus package.

Now there is no magic to this, is there? There are certain things in every economy that need stimulating, if we are to come out of a recession.

Why are we having such a difficult time here then in dealing with a $16-billion stimulus package that every other country in the world is putting forth in the very same way, although to some differing degrees within the package itself of particulars?

Why is this so troublesome for us? Infrastructure investment. Every community in my district and in this country is having trouble right now with sewer systems, water systems, and basic roads and bridges, and these kinds of things.

The training of workers. It is a given with the amount of jobs that we have lost in the industrial sector of this country over the past decade. Head Start, WIC, these are so basic to getting our children off to a decent start, and not having to spend billions of dollars on remediation 3 to 4 years into the school system.

Why is this so difficult when every nation of the world basically has put forth the very same thing?

Dr. TYSON. I emphasized in my discussion about deficit reduction that the benefit to the economy would be that we would get long-term interest rates down. There is another benefit, and we have allowed public discourse about it to be strangled by the deficit. The fact that we have a big deficit means that every sensible spending program that we might want to introduce is strangled by the deficit. Basically, you will say we cannot afford it.

Japan has a surplus. They have a situation where their Government accounts allow them to, without any real controversy, to say we need to spend more money on infrastructure. They are not going to have to go out and borrow that money. They have a surplus.

So, we need to get rid of the deficit simply so we can have more intelligent conversations about what the Government should and should not spend its money on. That is a very important issue.

The second issue, just to emphasize, is that I think that the defeat of the stimulus was entirely a political act. It had to do with a voting rule in the Senate, and a decision to have a majority opposition given the voting rule.

If you looked at polls at the time that it was defeated, there was public support for the stimulus package. It was a supported program. The American public was willing and is willing to spend money on those kinds of things. But for reasons of the rules in the Senate and that decision, which was really a political decision and not an economic decision, the package did not go forward.

So, I can give you both a kind of long-term answer that we have to get rid of the deficit to get public discourse correct, and a short-run answer which is we had a voting problem in the Senate.

Chairman LAFALCE. Back home, I try to distinguish between gridlock which I think because of the Democratic President and a Democratic Congress in great part we have eliminated, and obstructionism which we can never eliminate as long as there is a rule that enshrines it within the Senate, so the minority can virtually always obstruct.

Mr. Poshard, if you do not mind, I am going to have to bring this hearing to a close. I am a half an hour late for an appointment.

Mr. POSHARD. Thank you, Mr. Chairman.

Chairman LAFALCE. Dr. Tyson, you have educated and informed us. You have also graced us with your presence. I thank you very much.

Dr. TYSON. Thank you very much.

[Whereupon, at 12:43 p.m., the committee was adjourned, subject to the call of the Chair.]

APPENDIX

OPENING STATEMENT OF THE HONORABLE JOHN J. LaFALCE
CHAIRMAN, HOUSE COMMITTEE ON SMALL BUSINESS

Hearing on the Clinton Economic Plan and Credit Crunch Initiative and the Impact on Small Business
March 25, 1993

I am very pleased to welcome to the Committee Dr. Alan Greenspan, Chairman of the Board of Governors of the Federal Reserve. Mr. Chairman, the Members of the Committee, and I personally, deeply appreciate your taking time from your busy schedule to be with us today. We look forward to your testimony regarding the outlook for our small business economy, and the impact of the President's economic plan and credit crunch initiative on the economic future of our small business sector.

In recent weeks, this Committee and the small business community have witnessed a very significant turnaround. I have been Chairman of this Committee since 1987. Since then, there have been times when months, even years, have gone by in the economic policy debate with nary a mention of the small business sector. Now, in the first few weeks of this Administration, small business has a front row seat on the economic policy stage.

That is as it should be. For it is the potential of the small business sector -- the jobs it creates, the new businesses it develops, the innovation it fosters, and the communities it helps to build -- that holds the key to our economic growth. And it is the unique problems that smaller firms encounter -- costly regulatory requirements, limited access to capital, and step-child status in too many economic policy discussions -- that can impede that growth.

The President's economic plan incorporates a serious effort at deficit reduction, coupled with a modest stimulus package that will ensure we do not forestall the economic recovery we are beginning to see. This re-orientation of our economy away from deficit spending and toward productive investment will help all of this Nation's businesses.

But President Clinton is not relying passively on general economic trends to give our small businesses renewed strength. He has chosen to recognize both the enormous economic potential inherent in our smaller enterprises, and the formidable difficulties they face, and to respond. Already, the President has proposed key initiatives which will maximize the small business sector's potential, and address its problems.

The President's economic plan includes a permanent investment tax credit for small businesses, along with a targeted capital gains tax cut for long-term investments in small entrepreneurial endeavors. These, along with tax credit proposals for research and development and jobs creation, should provide a significant boost to the small business sector of our economy, which historically produces the large majority of new jobs.

In addition, President Clinton has only recently announced a package of credit crunch initiatives that will go a long way toward removing the stranglehold that excessive regulation has placed on the flow of credit to small businesses. Since our consideration of the S&L bail-out legislation in 1989, I have consistently argued that the thrift crisis engendered a regulatory over-reaction. Excessive restrictions placed on our financial institutions have inhibited banks and thrifts from lending and helped create the severe credit crunch our smaller enterprises have confronted for so long.

As small businesses have been denied badly-needed credit, the job creation and economic expansion that smaller firms have contributed to our economy have also disappeared. As the President pointed out, "if you had to put in a sentence why this has been a jobless recovery it's because small business job creation hasn't offset big business job losses. And that is the central challenge we face...."

Out of concern for the fate of our small business sector, I had written and spoken to the President on the regulatory relief issue, urging precisely the kinds of changes we are now seeing. I am gratified that the Administration is moving in this important new direction, and offer my full support.

The regulatory changes the President has already endorsed will help restore banks to the business of lending and small businesses to their essential role in our economy. But I believe there may well remain statutory inhibitions to removing the burden of excessive regulation. I know the regulators are reviewing current statutory guidelines in the area of bank and thrift regulation and I hope they will move quickly to recommend any necessary legislative changes.

I would also urge the Administration to look closely at innovative proposals to enhance small business lending. For a decade I have proposed legislation -- now embodied in H.R. 660 -- that would facilitate the development of a secondary market in small business loans that would link small businesses, with their long-term credit needs, to institutional investors who are capable of meeting them. The proposal is not perfect -- it is intended to generate discussion, and I am anxious to have the Administration's input, and the input of the regulators as the proposal moves forward. But I do strongly believe that such innovative approaches are essential if we are to spur real growth in this key sector of our economy.

Mr. Chairman, I again extend the Committee's thanks and a warm welcome. We look forward to hearing your testimony.

Opening Statement
U.S. Rep. Jan Meyers (R-KS)
House Committee on Small Business
Dr. Alan Greenspan and the President's Economic Package
March 25, 1993

Thank you, Mr. Chairman, for this opportunity to explore the effects of the President's budget package on the success of our nation's small businesses and their employees. I certainly look forward to continuing our probe in the months ahead as the consequences of the President's plan take root.

My thanks, as well, to you, Dr. Greenspan, for taking time out from your important duties to help our committee grasp the concepts and realities of President Clinton's approach to managing our country's vast and divergent economy -- and I fear he is indeed returning to the tried-and-failed theory that Washington can manage the economy better than free markets can.

That said, I still think almost all of us agree on the crippling effects of deficit spending and the government's need to cure its addiction to it. I don't want to belabor the point, but if we are to kick the habit and drop the deficit, we must first understand that the government has a spending problem, not a revenue problem. Let me quickly reinforce that assertion with a few numbers.

From 1980 to 1993, all receipts to the federal government rose from $571 billion to over $1 trillion -- an increase in revenues of $630 billion. On-budget receipts doubled, from $404 billion to $828 billion.

Yet during that same period, all federal spending soared from $590 billion to $1.5 trillion, an increase of $884 billion. On-budget spending rocketed from $477 billion to over $1 trillion. And for those who are quick to blame defense spending, let me note that only $173 billion of the $530 billion increase went to bring down the Berlin Wall.

In short, over the past decade, the government has blown about $300 billion in new on-budget revenues, much of it raised on the backs of small enterprises; and it has depleted the capital markets by borrowing yet another $200 billion. Now the President and Congress are calling for still more tax increases to bridge the gap that spending caused.

We ought to be clear on that last point, too. By most calculations, the plan calls for only $1 in real spending cuts to every $5 in new taxes. Indeed, in the first year of Clintonomics, that ratio may be as high as $18 in taxes to $1 in cuts.

Mrs. Meyers
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So where are these new taxes coming from? Well, the largest chunk, over $125 billion, is a tax hike on personal income. This is crucial because over 16 million of the country's 20 million small enterprises are organized as sole-proprietorships, partnerships, and Subchapter S corporations, which means they file individual, not corporate, tax returns: They pay personal taxes on any income earned by the business.

Unlike large corporations, these businesses must rely heavily on any profits they earn as a source of capital for job creation and reinvestment in the firm. As such, any increase in personal taxes depletes these reserves and suffocates investment, expansion, and job creation.

Compounding this drain on private capital are the other new taxes on small businesses: The BTU tax, the extension of the gas tax, and the estate tax hike, to name just a few.

Let me grant that there are some good tax incentives for small firms in the package, like the reduction in the capital gains tax and the new Investment Tax Credit -- although the ITC won't help the vast majority of small enterprises that are labor, rather than capital-equipment, intensive.

Still, every little bit helps. But what concerns me is that there seems to be something of a Ponzi scheme developing here: In order to provide limited tax help for a few small businesses, the President plans to pay for them by taking a whole bunch of money from the many.

Quite frankly, I think there is something dishonest in proclaiming the great benefits the plan offers small businesses when, in fact, small businesses are paying for those benefits themselves -- and more. What's worse is that we aren't, in fact, talking about taxing the faceless rich, we're talking about taxing job creation, production, innovation, and competitiveness -- the forces that drive our economy.

I think Clintonomics has hit the point of diminishing returns by relying on such anemic spending cuts and such hearty tax increases. While small business men and women are honest, hard-working people who want to do their part to reduce the deficit, they harbor a deep anxiety over whether the spending cuts -- and deficit reduction overall -- will materialize.

Tax-for-cuts deals in 1982, 1984, 1987, and 1990 levied new taxes on small enterprises and the economy, to be sure, but the promised spending cuts faded quickly into memory, if anyone remembered agreeing to the cuts at all.

Mrs. Meyers
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In short, small businesses have learned this lesson well: Taxes materialize, cuts de-materialize, and spending keeps rolling along. Why, then, should small enterprises passively hold on to their profits and take yet another tax hit? Why buy into the charade again?

Mr. Chairman, Dr. Greenspan, these are just a few of my very serious concerns about the ramifications of Clintonomics: The return to an economy micro-managed through the tax code; the reliance on new taxes rather than real spending cuts to reduce the deficit; and the effects of those new taxes on job creation and real economic growth and prosperity.

It seems to me that the better approach is to produce real, up-front spending cuts, demonstrate real deficit reduction, and offer assurances to small businesses -- indeed all Americans -- that they won't bear the costs without getting the benefits of a strong and vital economy in return. Then, and only <u>maybe</u> then, should we consider modest new taxes to protect future generations from the debilitating burden of deficit spending.

I look forward to your views on these comments, and thank you, again, for joining us today.

STATEMENT BY CONGRESSMAN JIM RAMSTAD
BEFORE THE HOUSE SMALL BUSINESS COMMITTEE
March 25, 1993

ALAN GREENSPAN AND CREDIT AVAILABILITY FOR SMALL BUSINESSES

Mr. Chairman, I welcome Dr. Greenspan to the Small Business Committee this morning to discuss the critical issue of credit availability for small businesses.

As a member of both the Small Business and Joint Economic Committees, I am keenly aware of the importance of the role of small businesses in our economy -- and the problems they have faced in recent years in gaining access to credit.

I have two informal advisory groups back in my district -- a banking advisory group and a small business advisory group. In recent months, I could have combined the two meetings as both the small business owners and the bankers are concerned almost exclusively about the lack of credit.

Now that President Clinton has announced his proposal to impose the largest tax increase in history, the availability of credit for small businesses will be an even more urgent concern. As most economists agree, President Clinton's proposal to transfer $328 billion from the productive, private sector to the federal government will certainly constrict economic growth and reduce the availability of capital.

I very much appreciate that Dr. Greenspan will provide us with a comprehensive analysis of the source of the "credit crunch." My personal experience leads me to believe that a very significant contributor to the lending problem is excessive bank regulations.

I recently visited a bank in my district and reviewed the administrative procedures required by banking regulatory agencies. I was truly stunned by the excessive paperwork -- which translates into added costs for consumers -- necessary for approval of just a simple loan.

And as Chairman Greenspan is well aware, a recent study commissioned by the banking oversight agencies estimates that regulatory costs to the banking industry in 1991 were between $7.5 and $17 billion.

According to one industry analyst, in 1980, there was one regulator for every three banks -- by the end of this decade there will be more than three regulators for each bank. And for the first time in 27 years, banks now hold more government securities than business loans.

Clearly, excessive regulations combined with the regulatory bias that encourages banks to hold government bonds rather than commercial loans has contributed to the sluggishness of our economic recovery.

The effect of tight credit is particularly hard on small businesses, which, unlike larger companies, do not have easy access to the debt and equity markets. Because they have no alternative financing avenue, when small businesses face tight credit, the result is devastating to the entire economy.

(OVER)

Small businesses, as we all know, are the real engine of job growth in our country. In recent years, 85% of all new jobs were created by small businesses, and in fact between 1988 and 1990, small businesses created all of the net new jobs in this country.

I also read with great interest a story in the March 18 Wall Street Journal about the skepticism with which most community banks -- which make the majority of loans to small businesses -- greeted President Clinton's plan to spur lending. According to a survey by the Western Independent Bankers group, three out of four bankers from nine Western states said they had "little or no confidence" the president's plan would lead to more lending.

Mr. Chairman, I am extremely concerned. Later in the article, William Isaac, former head of the Federal Deposit Insurance Corp., said "I don't think the Administration has a prayer of changing it" -- referring to the regulatory environment caused by the 1989 and 1991 banking bills.

As the article continues, "President Clinton hasn't proposed legislation to do away with or change many of the rules that bankers say have multiplied the documentation required for a bank to make loans."

In this truly chilling atmosphere for our economy -- and particularly for the credit-starved sector of our economy -- I trust that Dr. Greenspan will provide substantive insights into the necessary steps to be taken to alleviate the regulatory burden on our banks and small businesses and the resulting credit crunch.

I look forward to his learned testimony.

OPENING STATEMENT OF
CONGRESSMAN BILL ZELIFF (R-NH)

Small Business Committee
March 25, 1993

Mr. Chairman, thank you for calling today's hearing about the availability of bank credit to small businesses. It is always a pleasure to discuss this important issue with someone as distinguished as Mr. Greenspan.

Without a doubt, the credit crunch and banking regulations are a major concern for small business these days. Being a small businessman myself, I have personally experienced the credit crunch and have seen many of my colleagues suffer extremely hard times as a result.

New Hampshire is still suffering from the effects of a Very difficult economic environment. Although interest rates are low, small businesses are still experiencing problems obtaining a loan. Small businesses are drowning in a quagmire of federal regulation. Our small businesses need help. What we need to do is create jobs and stimulate economic growth, starting by getting the government off the backs of American businesses.

One of the major reasons for the problem in New England was that federal regulations came at the worst possible time. For instance, simultaneous to the passage of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) and the increased capital levels it requires, the New England economy went through not just a cyclical decline, but a structural collapse.

Enormous hits were suffered by high-tech companies and defense contractors, two of the regions most important economic engines. In light of spreading economic decline, the Northeast was over-invested in real estate.

Once FIRREA was implemented in 1989, New Hampshire was already deep in a recession. Unlike other regions of the country, New Hampshire banks were caught holding non-performing loans as a result of the overextension of the real estate market.

While NH banks should have been using capital to absorb their losses, they were required to build capital under FDICIA in 1991, and this of course caused a structural collapse of the banking system in NH and New England. I submit, Mr. Chairman, that we had more of a credit drought than a credit crunch.

I have been battling for reform since my first days here in Congress. In September of 1991, I held a hearing in Manchester, New Hampshire to hear testimony about the credit crunch problem in New Hampshire and about the need for a pro-growth agenda.

As a result of the FDIC's takeover of 5 of the 7 largest state banks and FDIC holding 30% of New Hampshire's total banking assets, New Hampshire was burdened with an obvious problem.

Working with the FDIC and the SBA, we seemed to address this problem with the New England Lending and Recovery program and the credit crunch continues.

The program has been more successful then we anticipated, but some banks still lack the confidence to issue small business loans. Combined with the regulatory problems we will discuss today this has slowed the recovery.

Of course, there is now some recovery in sight, and there are loans now being slowly reinstituted, but the traditional post-deficit increase in bank credit is not happening this time.

Mr. Chairman, we have an important duty here today. This country was built on the small business, and now we are faced with a problem that is jeopardizing our small businesses. I hope we can go beyond the excessive regulations and get down into the detail of the causes of the credit crunch. From there we can begin rebuilding what has been severely damaged. A remedy has to be found, and this hearing is an excellent start.

Finally, I just want to point out that serving as Chairman of the Republican Task Force on Tax Policy and Job creation, I held a hearing three weeks ago in New Hampshire on this very subject. Seven of my colleagues and I heard testimony from several participants from the banking and business community, as well as from the public.

Thank you Mr. Chairman.

OPENING REMARKS OF HON. GLENN POSHARD
COMMITTEE ON SMALL BUSINESS
March 25, 1993
10:00 a.m.

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, I AM PLEASED TO BE HERE THIS MORNING TO HEAR THE TESTIMONY OF DR. ALAN GREENSPAN, CHAIRMAN OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

I SUPPORT THE PRESIDENT'S BUDGET PACKAGE BECAUSE IT IS THE MOST REALISTIC APPROACH TO RESOLVING THE DEFICIT CRISIS FACING OUR COUNTRY. ALMOST EVERY AMERICAN WILL BE CALLED UPON TO HELP. THE ADMINISTRATION'S PLAN DOES NOT OFFER ANY EASY COURSE BUT IT DOES CHALLENGE US TO WORK TOGETHER TO INSURE A MORE SECURE ECONOMIC FUTURE FOR OUR GREAT COUNTRY.

THE DEBATE IS ABOUT ESTABLISHING ACCOUNTABILITY BY BEING HONEST WITH THE PEOPLE. WE MUST ACKNOWLEDGE THAT SOME THINGS HAVE TO BE PAID FOR KNOW AND SOME NONPRIORITY THINGS WILL HAVE TO BE ELIMINATED FROM THE BUDGET.

MR. CHAIRMAN, THANK YOU FOR SCHEDULING THIS HEARING. I LOOK FORWARD TO HEARING THE VIEWS OF DR. GREENSPAN ON THE ECONOMIC PACKAGE.

Opening Statement

of the

Hon. Cleo Fields

before the

Committee on Small Business

Mr. Chairman, I too like many of my colleagues have some very high expectations with respect to the President's economic package, and its effect on the small business sector.

I readily admit, as a supporter of the President's economic package, which has provisions for a stimulus package, deficit reduction, and long term growth, is glaring to some and not so attractive to others. It is my opinion that the changes this administration have made will help to strengthen our tax base, and subsequently lead to a much healthier economy in the not to distant future.

Mr. Greenspan, as Chairman of the Federal Reserve Board, it is my

wish that your testimony can give us as members of Congress some insight as to what effect positive or negative, this package will have on the small business sector.

Mr. Greenspan welcome to the Committee on Small Business and I look forward to hearing your testimony.

Statement of Congressman Walter R. Tucker, III
Hearing with Alan Greenspan, March 25, 1993:

I thank you for coming to testify before the Committee this morning, it is quite an honor to have such a key player in the president's economic plan here with us today. I often hear it said that small business will be the engine of our economic recovery. While I myself believe that small business will in fact be the driving force behind any economic recovery, every "engine" needs fuel to operate. In economic terms, that fuel is credit, small businesses need credit to operate. I will be very interested to hear your views on how we can make credit more accessible to the small businesses that need it so desperately. Time is of the essence because small businesses are currently running on fumes.

OPENING STATEMENT, SMALL BUSINESS COMMITTEE
CONGRESSWOMAN NYDIA VELAZQUEZ
MARCH 25, 1993

Thank you Mr. Chairman. I would like to welcome Dr. Greenspan to the Small Business hearing on the Clinton Economic Plan and Credit Crunch Initiative and the Impact on Small Business. We are honored that you can be here with us today.

As the Chairman stated, I am delighted at the emphasis that President Clinton has placed on small business as a means to economic recovery. He recognizes the potential of small business to generate jobs, particularly in some of our most starved urban communities. The President has already eased bank regulations in order to provide small businesses with the capital necessary to strengthen their economic base. This action, in conjunction with the stimulus package passed by the House last week, will surely strengthen the country's economy.

I look forward to your testimony Dr. Greenspan. Thank you.

OPENING STATEMENT OF RONALD K. MACHTLEY
COMMITTEE ON SMALL BUSINESS
HEARING ON THE PRESIDENT'S ECONOMIC PACKAGE
MARCH 25, 1993

Thank you Mr. Chairman. And thank you Dr. Greenspan, for agreeing to come here today to testify on the effects the President's economic package will have on small businesses.

In his plan, Mr. Clinton has outlined a number of initiatives that are intended to help small businesses. Indeed, with 88 percent of all registered companies classified as small businesses, it is clear that we must focus on helping them stay competitive in an ever changing market. Although I commend the Clinton Administration for it's good intentions and hard work in this area, I do not feel that the administration has done all it can to help struggling businesses in need of assistance.

In my state of Rhode Island, a state heavily reliant on the defense industry, I do not feel as though the administration has fully considered the ramifications an accelerated build-down would have on the economy. When most people think of the defense industry, they envision large firms swooping in like greedy hawks for the fresh government contracts. Although there are a number of large companies that will feel substantial losses from a reduction in the defense budget, there are even more small businesses that will be severely affected. According to a report performed by the Rhode Island Defense Economic Adjustment Project, "over one tenth of the state's employers do business directly with the Department of Defense, it's contractors and subcontractors or their employees. Together, these employees account for roughly one third of the state's workforce." Although most of these people do not work on defense products, a considerable portion of their income is defense-related.

Here are some jarring statistics: In Rhode Island almost one quarter of defense-related employers are involved in the services industry, including health and education, and over one fifth are involved in manufacturing. Other effected businesses are construction (14.1%), retail trade (14.3%), and wholesale trade (12%). These are private companies - small businesses - which will be seriously affected by defense drawdown. I am sure that small businesses in other parts of the nation are also significantly impacted.

Although President Clinton has made some progress in identifying problems that small businesses are having in our economy, he has not fully considered the implications of his economic package which contains $127 billion in defense cuts over the next four years.

It is clear, that we will have to cut the defense budget, and other government expenditures, in order to control our spiralling federal deficit. As a member of the House Armed Services Committee, I am fully aware of the need to trim the defense budget and emphasize the importance of defense conversion. However, while trying to tackle our monstrous debt, and make our government more competitive in today's global economy, we must also create an environment which gives the private sector an opportunity to do the same. Defense-related businesses must convert to become competitive. But one major obstacle these businesses face - in Rhode Island in particular - is the lack of working capital and reluctance of banks to make credit available to these businesses.

In talking with small business owners across the state, I have found that, in many cases, small firms interested in expansion or in need of working capital have been turned down by the banks. When asked why lending is so tight to small businesses, banks indicate that laws and regulations prevent them from providing small businesses with long-term capital.

What kind of message are we sending our nation's small businesses when they read in the newspapers that many big banks loan hundreds of millions of dollars to countries in South America -- loans that are not even repaid. What kind of message are we sending when these same banks lend large sums of money to foreign countries simply to help them repay the interest on their previous loans? How can my colleagues and I go back to our districts and explain to small business owners that big banks perform all sorts of foreign lending but can't give a local small business a loan?

One idea, which is gaining steam in Congress and in the private sector, is the creation of a secondary market for small business loans. The sale of securities by the private sector, which are backed by small business loans, would create a strong secondary market benefitting bankers, small businesses and investors alike. In 1984 regulatory impediments to selling securities were removed from the housing industry through the formation of a secondary market which pooled residential mortgages. Creating such a market for small business loans would encourage capital market investment rather than discouraging it under current regulations.

I was pleased to hear, Dr. Greenspan, that, during your testimony at the House Banking Committee, you supported the idea of creating a secondary market for small business loans. I would appreciate hearing more about the feasibility of this idea and how it can fit into a Clinton plan to help small businesses.

In closing, I believe that it would be penny wise and pound foolish to neglect the financing needs of our small businesses at a time when Rhode Island, as well as the rest of the nation, desperately needs the jobs and economic development small businesses generate. Thank you, again, Dr. Greenspan, for coming before us today to address the effects of future government policies on small businesses. I look forward to hearing your testimony.

OPENING REMARKS FOR REP. SAM JOHNSON
MARCH 25, 1993
COMMITTEE ON SMALL BUSINESS

MR. CHAIRMAN:

I WANT TO THANK YOU FOR HOLDING THIS HEARING TODAY TO EXPLORE HOW THE PRESIDENT'S ECONOMIC PACKAGE WILL AFFECT THE ECONOMY AND IF IT WILL START THE FLOW OF CREDIT AND LOAN AVAILABILITY TO SMALL BUSINESSES. I ALSO WANT TO THANK MR. GREENSPAN FOR AGREEING TO TESTIFY HERE TODAY.

SMALL BUSINESSES HAVE CREATED MORE THAT 77% OF THE NEW JOBS IN THIS COUNTRY SINCE 1983. EVEN THOUGH SMALL BUSINESSES ARE GROWING AT A STEADY RATE, SOMETHING MUST BE DONE TO ENSURE THAT CREDIT AND LOANS

ARE AVAILABLE TO THESE BUSINESSES, AND RISK CAPITAL IS AVAILABLE TO BUDDING ENTREPRENEURS.

AS YOU KNOW, MR. GREENSPAN, THE BANKING COMMITTEE WHICH I ALSO SERVE ON, HAS TIGHTENED THE REGULATIONS AND SCRUTINY OF BANK LENDING IN ORDER TO AVOID ANOTHER SAVINGS AND LOAN BAILOUT.

I BELIEVE THESE NEW REGULATIONS "SWING THE PENDULUM" A LITTLE TOO FAR IN THE OTHER DIRECTION. WE ARE CHOKING THE INDUSTRY THAT SMALL BUSINESSES RELY ON TO SPUR EXPANSION AND CREATE NEW JOBS.

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WE MUST ALLOW THE BANKS OF AMERICA TO WORK FOR AMERICA. THEY MUST BE ABLE TO TAKE RISKS AND MAKE LOANS.

MR. GREENSPAN, I HOPE TODAY, YOU WILL ADDRESS THESE REGULATORY EFFECTS ON LENDING TO SMALL BUSINESSES AND THEIR OVERALL EFFECT ON THE ECONOMY IN ADDITION TO THE EFFECTS OF THE PRESIDENT'S ECONOMIC GROWTH PACKAGE..

THANK YOU MR. CHAIRMAN

ORsmallbus

SMALL BUSINESS COMMITTEE HEARING
CLINTON ECONOMICS AND SMALL BUSINESS
COMMENTS BY MAC COLLINS
MARCH 25, 1993

MR CHAIRMAN, I appreciate this opportunity to discuss economic impacts on small business this morning. Over the last few weeks our attention has been tightly focused on budget issues and I think this will be a good opportunity to take a look at how the President's proposals will affect small businesses.

As you mentioned in your testimony Chairman Greenspan, there are problems in the small business/bank lending arena. I have a small business background and can tell you from 1st hand experience -- through good relationships with community bankers -- that the regulatory burden placed on banks plays the major role in restricting small business access to bank loans.

The last few years have indeed been very tough on small businesses looking to invest and grow. But now I am worried about the next few years ahead of us. The President has proposed a few small business incentives that at first glance indicated we may be moving in the right direction -- a temporary investment tax credit and a capital gains break on C corporation stock investments.

But unfortunately, the good that these offer are outweighed by the increased tax burden the President's plan will strap onto businesses: individuals who are self employed will see their tax rate climb to 36%; corporate taxes will go up; higher energy and gas taxes that will affect the cost of transporting goods and maintaining facilities; the 10% surtax on more successful businessmen; elimination of the wage cap on the Hospital Insurance portion of FICA; limitations on itemized deductions, etc., all add up to limiting the investment potential for our nations top investors and employers: small businesses.

I am interested in hearing your opinion on the impact of the President's proposals, as well as any economic theory you may have that indeed supports his claim that raising taxes as opposed to making major spending cuts, will help the economy.

Thanks you for appearing before this Committee and I look forward to discussing these issues.

OPENING STATEMENT

for

SMALL BUSINESS HEARING

with

DR. ALAN GREENSPAN

Mr. Chairman, thank you for holding this hearing today to discuss some very important issues with Chairman Greenspan. I hope to attend several more of these committee hearings in the near future.

Welcome Chairman Greenspan. I look forward to your testimony because it is important for members of this committee to learn first-hand how the Federal Reserve Board will respond to Clinton's tax and spend proposal and its impact on the nation's small businesses.

As you may know, Chairman Greenspan, from 1988 to

1990, small businesses in America created 4.1 million new jobs while corporations employing more than 500 employees had a net loss of 500,000 jobs. Despite these impressive figures, the federal government has increased taxes on small business a staggering 34 percent since 1989.

As we have witnessed in the last few years, small businesses appear to be the shinning star in this spotty economic recovery. Taxing these businesses at this point in our nation's economic cycle just might put us back in the same ditch we've been trying to get out of. I'm afraid we're getting into the mind-set again that increasing taxes is synonymous with reducing the federal deficit.

The government's budget deficit is not caused by taxpayers and small businesses paying too little in taxes, but by government's excessive spending. In fact, the government received a relatively steady 19 percent of GNP in revenues since 1977. During the same period, however, government spending increased from 21 percent to 24 percent. Small businesses should not continue to be the dumping ground for the federal government's tax increases.

We owe it to the small businesses and every taxpayer across this country to take a long, hard look at the Clinton tax package. I think you, Chairman Greenspan, can help us more accurately critique the President's plan. Thank you again for being here and for giving us your honest views of the President's plan.

STATEMENT OF CONGRESSMAN JAMES M. TALENT, 2ND DISTRICT, MISSOURI
BEFORE THE SMALL BUSINESS COMMITTEE, MARCH 25, 1993
TESTIMONY OF DR. ALAN GREENSPAN, RE: CLINTON ECONOMIC PLAN

Dr. Greenspan, I want to thank you for taking the time to appear before the Small Business Committee to discuss President Clinton's economic plan.

President Clinton pledged in the fall campaign to cut the federal deficit in half over the next four years. He has since submitted a draft plan that, in extremely optimistic terms, will hopefully cut the deficit from $350 billion to $200 billion. You are on record as supporting the President's plan as a way to meaningfully reduce the deficit.

Dr. Greenspan, I think we agree that one of the biggest problems facing our economy is the federal deficit and debt. We must do something soon or our country is going to go bankrupt. Deficit reduction should be our number one priority.

I do not want to focus today on HOW to reduce the deficit. My personal beliefs are different from President Clinton. I believe that we should significiantly cut government spending to reduce the deficit rather than the President's proposed 70:30 taxes to spending cuts ratio.

What I do want to focus on today is the seriousness, or lack thereof, of the deficit plan itself. First, I want to revisit Congress' past track record on deficit reduction. The Gramm-Rudman-Hollings law which was in effect from 1986 to 1990 had helped Congress reduce its deficit to $152 billion, and, under that law, we would have a balanced budget today. But in 1990, when the automatic budget cuts under Gramm-Rudman-Hollings would have really taken effect--causing Congress to make cut across the board or make tough choices--Congress predictably gutted Gramm-Rudman-Hollings in favor of the 1990 Budget Summit Agreement. That deal promised us a "serious" $500 billion deficit reduction package over 5 years in exchange for $165 billion in taxes--the largest tax increase ever. Congress happily delivered on the taxes, yet again reneged on the deficit reduction. It is now 1993 and we have no balanced budget; in fact, our budget deficit for FY 1993 will be $350 billion.

I have analyzed the Clinton Economic Plan, and discovered that there are no net spending cuts for three years, and then only in defense. This demonstrates that Congress and the President are unwilling, as usual, to make any tough choices. This is the same song-and-dance as the 1990 Budget Deal: If you let us increase taxes today, we'll cut spending in three years.

Thank you Dr. Greenspan for taking the time to appear before the Small Business Committee. I appreciate your attention in this matter.

For release on delivery
10:00 a.m., E.S.T.
March 25, 1993

Testimony by

Alan Greenspan

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Small Business
U.S. House of Representatives

March 25, 1993

I am pleased to appear before this Committee to discuss the availability of bank credit to small businesses. It is clear that any assessment of the outlook for the economy as a whole--especially employment--has to focus on the health of our small business sector--including its ability to obtain finance. Indeed, the importance of bank credit flows to small business was highlighted by the President's recent announcement of joint actions by all the banking agencies to facilitate such lending.

Given the importance of small businesses to the economy and the clear dependence of such firms on banks, the decline in overall business loans in the 1990s underlines the importance of understanding the difficulties of bank credit availability. Even more importantly, it emphasizes the need to continue to do whatever is possible to remove those sources of restriction that do not imperil the safety and soundness of the banking system.

Assessing the true nature of small business bank credit availability is especially complicated, in part because it seems clear that a substantial share of the decline in the 1990s of *total* business loans at banks reflects significant balance sheet restructuring by large firms. Many larger businesses have taken advantage of the decline in interest rates and the increase in stock prices to refinance their bank loans.

The declines in business loans associated with balance sheet restructuring by the larger firms were superimposed on a secular downtrend in business credit flows by banks to large firms that have been increasingly relying on nonbank finance. And overlaying the interest rate and stock market induced repayment of bank loans by large firms, and their secular shift to nonbank credit, has been a normal cyclical decline in the demand for credit during the recession and modest recovery.

However, I do not believe that cycles, trends, and refinancing are the sole explanations for the decline in business loans. There *has* been a substantial tightening of lending terms and standards and it *has* affected small businesses. This tightening of terms and standards has been clear in our periodic surveys of senior loan officers at large banks since the start of the decade, although this aspect of loan pricing seems to have stabilized in 1992. Evidence from the National Federation of Independent Business is also suggestive. For example, owners of the larger small businesses report greater difficulty obtaining credit than three years ago. The period of credit stringency appears to have lasted longer than in other recent downturns. And, small business credit problems have been very intense in some regions of the United States. Clearly, New England has borne a disproportionately large burden.

The sources of tighter credit availability are not hard to find. A significant part of our current problems reflects a too expansive credit policy throughout most of the 1980s. Large numbers of lenders mistakenly perceived that financing real estate was very profitable, and virtually risk-free because of the near certainty of continued real estate inflation. But inflation in real estate not only ended, it was in many cases reversed, exposing the lax underwriting standards that had evolved.

The resulting acceleration of nonperforming loans, and associated reserving and write-offs, not only cut sharply into capital--causing many banks to fail and others to be greatly weakened--it also shook the confidence of lending officers and management. Indeed, despite the low rate of depository institution failures so far in 1993 we should not forget that the past several years have seen many more depository institution failures than all the other years since World War II combined. The almost inevitable result of these traumatic experiences has been that bank lending policies have gone through a period of exaggeratedly high underwriting standards--the same error as in the 1980s, but in the opposite direction. While there appears to have been no further tightening in recent months, the effect on banks of excess optimism in real estate in the 1980s is not, I am afraid, as yet behind us.

Commercial real estate prices have not stabilized enough to allow most banks to feel confident that they know what collateral is really worth. Thus, a kind of traditional bank liquidity--a sense that real estate collateral could be liquidated expeditiously within a known price range--has not yet returned to bank balance sheets. While improving significantly from the dark period of 1989-91, we do not yet have the turnover and transactions required to instill adequate confidence in most bankers about either their existing or new loans secured by commercial property.

The real estate market plays an important role in small business credit, since a significant portion of loans to small businesses involves some real estate collateral. And, even though banks often do not look to that real estate as the intended source of repayment, I am still concerned that a real estate market that has not found its feet is retarding the availability of small business credit. This impact is both direct--in evaluating both the bank's own capital, as well as particular loans--and indirect--by coloring bankers' sense of general confidence.

As significant as the real estate contraction has been on bankers' attitudes, it is clearly not the sole source of trauma. The lax underwriting standards adopted by many banks in the 1980s contributed to large losses and write-offs--write-offs of almost $125 billion since 1988.

Surviving banks have not only covered such losses by earnings and capital issues, but have increased their own minimum capital standards. This increase in internal standards has resulted in part from their own review of "policy," but in many cases it is the direct result of market demands. Both capital-issuing banks and those without ready access to capital markets also improved capital ratios by growing less rapidly or even shrinking. All of this, I suggest, is not an unexpected reaction to difficult problems. Indeed, I would argue that it is not surprising that underwriting standards have been reviewed and tightened.

Banks' own desire to rebuild a strong capital base has played an important role in constraining the supply of bank loans. Research at the Fed appears to have begun to pick up the importance of internal capital targets. In saying this, I do not mean to imply that either Basle or the prompt corrective action capital rules are unimportant. They reinforced the importance of capital at both banks and in the market. But, Basle and other capital standards imposed on a less traumatized banking system would have been viewed by few observers as a major constraint on banks' ability to make loans.

Indeed, the Federal Reserve Board supports both the Basle standards and the prompt corrective action zones of FDICIA. The behavior of the 1980s--and the associated losses--would surely not have occurred to the same extent without a deposit insurance system that permitted banks and thrifts to take major risks on a slender capital base with only minimal market response. Political concerns apparently made it impossible to lower directly the per account level of deposit insurance. Hence, making the moral hazard of deposit insurance moot through higher capital standards was the most attractive option available. With larger amounts of stockholders' capital at risk, banks will be encouraged to adopt more careful and efficient loan policies. Moreover, simulating market responses, as is intended in the progressively restrictive prompt corrective action zones, is helpful. In the absence of deposit insurance, markets would impose reduced dividends, a lower pace of expansion, and other increasingly severe actions on firms becoming financially distressed.

Parenthetically, so far as we can tell, the risk weights in the Basle standards have not played a significant role in disrupting credit flows generally, or to small businesses in particular. To be sure, the intention of the risk weights was to make the capital charge reflect differences in credit risk, and to induce banks at the margin to hold more liquidity in their portfolios. Thus, if the weighting system had not caused banks to lean somewhat more toward securities, it would have had to be counted as a failure. Nonetheless, the weights were not designed to cause a large shift from loans to securities. And there is simply no real evidence that the weights have been a significant factor causing the observed substantial shift in bank credit from loans to government or mortgage-backed securities. In addition, the banks that have accounted for most of the increased holdings of Treasury securities are those with the *highest* capital ratios, where the zero weight could not have been particularly relevant to their decision. Indeed, financial institutions not subject to risk-based capital or FDICIA, such as credit unions, have also shifted strongly away from loans and toward securities in the 1990s. In short, other factors--lower credit demands, balance sheet restructuring, and tightened loan standards--are better explanations of portfolio shifts than the Basle risk weights.

But Basle and prompt corrective action were not the only external forces supplementing banks and the markets' responses to the residue of the 1980s. Examiners have been widely and severely criticized for permitting banks to have made such bad credit decisions. That many examiners would respond by becoming unusually sensitive to credit granting procedures and--as professionals--reluctant to respond to pleas for more flexibility cannot come as a surprise. At last reading, the laws of human nature have not been repealed. This tendency to respond in an overly cautious way is doubly unfortunate, because if there were ever a time that bankers would be careful *without* examiner oversight it has been the early 1990s.

The other critical external force contributing to reduced credit availability at small businesses is recent banking legislation--FIRREA and FDICIA. In understandable reaction to the huge taxpayer costs of the failure of S&Ls and the need to establish a taxpayer's backup to the FDIC--a backup, I note, which has not been used--the Congress felt it necessary to place severe restrictions on insured depository institutions. As I indicated a moment ago, the Board supports the capital and prompt corrective action provisions of FDICIA. But, the scale and sheer detail of other portions of recent legislation have, I believe, played an important role in constraining small business credit flows.

The scale has resulted in a drum beat of mandated regulatory announcements and--perhaps worse--anticipated actions. All have diverted management resources, increased burdens and costs, and created uncertainties that could only make bankers more reluctant to take risks. As I have indicated over the past year, I have been particularly concerned about provisions that require regulations to specify operational, managerial, asset, and earnings standards and minimums, as well as detailed auditing requirements--especially management reports and certification by auditors. In addition to cost and burden, such micromanagement has a chilling effect on bank lending attitudes, imparting a high degree of management uncertainty while the implementing rules are developed, debated, and adopted. It is not unreasonable that banks expect the worst in rule changes before they are promulgated.

Aside from the general impacts on bankers' attitudes and risk-taking, two regulatory factors have particularly constrained small business credit availability at banks. The first, I am sure, was unintended: the real estate appraisal requirements of FIRREA were designed mainly to eliminate excesses in development and commercial real estate loans. However, most small business loans involve some real estate collateral, even if the purpose of the loan is not to purchase or refinance real estate, and the bank does not look to the real estate as the source of the repayment. Nonetheless, FIRREA requires banks either to increase their risk by foregoing real estate collateral on such loans, or to impose significant costs and delays on the credit granting process by requiring certified appraisals on the real estate collateral. Either way the willingness and ability of banks to make such loans is reduced, and in some cases may have been eliminated.

The second regulatory development that has affected small business credit availability at banks is the huge increase in the amount of paperwork resulting from heightened risk aversion by examiners and the attitudes induced by the banking legislation. Our research, and the conventional wisdom in banking, support the view that the least risky small business loans of the 1980s often had no collateral at all. Despite this evidence to the contrary, many bankers now perceive that full documentation and collateral on such loans are necessary in order to minimize the possibility that examiners will classify them. As a result, the cost of lower risk loans to small business has risen by the imposition of documentation and collateral requirements or--if the necessary documentation and collateral are not available--such loans are not being made. In either event, the economy suffers.

Nonetheless, as I review the current banking situation, I find reasons for optimism, but not complacency. While not yet totally stabilized, some degree of firmness is occurring in some commercial real estate markets. Our surveys and other information indicate that banks' attitudes toward loans and risk-taking are improving. Notwithstanding the almost $125 billion of loans that have been charged off over the last five years, loan loss reserves are $5 billion higher. Earnings were at record levels in 1992, and banks have been extremely successful in raising new equity. Indeed, equity capital in the industry has risen by almost $80 billion over the last five years; the resulting bank capital ratios are at their highest levels in a quarter of a century. On balance, while a segment of the industry still is under stress, the banking industry as a whole has made remarkable progress in working through severe portfolio problems during a difficult economic cycle. With an improving economy, I am hopeful that the signs of some business loan growth this winter will become more evident this spring. Banks are patently in a strong position to meet such demand.

But the issues are too important to leave to chance. There are steps we can and should take. As the President announced on March 10, the banking agencies are working on ways--within the parameters of FDICIA and FIRREA--to modify their policies and regulations in order to encourage more small business credit availability. I anticipate that the agencies will shortly promulgate policies that will significantly ease documentation requirements for a portion of loans to small- and medium-sized businesses and farmers by stronger banks and thrifts. While research suggests that loans that likely will be made under this policy will be low risk, the banks that will be permitted to extend such credits are those most able to absorb some additional risk without threat to their safety and soundness and, by the record, are adept at credit underwriting. Loans with limited documentation--often called "character" loans--require the special expertise that is the hallmark of the bank lending process and, I believe, is one of the special ingredients that fuels small business--and hence economic--expansion.

Consideration is also being given to easing formal real estate appraisals for transactions that do not present unusual risk to banks, and for increasing the current $100,000 exemption level for all loans. In addition, the agencies have a long list of technical modifications in process, including revisions to other real estate owned, in substance foreclosures, and partially charged-off accounting and reporting rules, as well as efforts to attempt to reduce examination duplication by function and agency. Finally, each agency will attempt--where necessary--to streamline its examiner appeal and complaint process.

These regulatory actions will be, I hope, quite helpful, but legislative action is still required. The Federal Financial Institutions Examination Council will be making legislative proposals this spring, and I urge the Congress to consider them seriously. But perhaps most important is to learn from the experience of the 1990s. One key lesson surely is that each new, proposed piece of detailed banking legislation has to be evaluated *in advance* to determine what the impacts are likely to be on the health, vigor, and competitiveness of the banking system. It is even more important to consider the potential implications for the vitality and growth of the economy, especially those sectors that create so much of our employment and innovation. These sectors often have few credit alternatives beyond their local banks.

* * * * *

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

ALAN GREENSPAN
CHAIRMAN

June 9, 1993

The Honorable John J. LaFalce
Chairman
Committee on Small Business
House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I am pleased to respond to your questions submitted after my testimony on March 25, 1993, before your Committee. The enclosure sets forth the answers to your questions.

Sincerely,

Enclosure

Answers to Questions on Risk-Based Capital Standards

Requested by

Chairman John J. LaFalce

Committee on Small Business

U.S. House of Representatives

June 3, 1993

Q. 1. **The Basle risk-based capital standards are now supposed to be fully phased in. Frankly, I am concerned when I read stories about massive loan problems in Japanese banks. Perhaps our competitors are not fully implementing these standards and permitting much looser loss-reserving and other practices that mask the true condition of these institutions. If the standards are not phased in uniformly, with comparable enforcement, won't this place U.S. banks at a competitive disadvantage vis-a-vis their G-7 colleagues, particularly in competing for U.S. commercial loan business? I would appreciate it if you would furnish the Committee with a report on the current status of the implementation of the Basle standards for the G-7 countries.**

A. 1. The Basle Accord provides a framework for setting minimum levels of capital that takes into account differences in asset profiles among internationally active banks. The Accord focuses principally on the risk inherent in various broad categories of credit: it does not explicitly cover other factors, such as asset quality, which also bear on whether a bank's capital is adequate or is realistically stated.

The Japanese financial authorities have met their commitment to implement the final Basle rules by the end of their 1992 fiscal year, March 1993. It has always been appreciated that we must rely on the commitment of each cooperating country's financial authorities to exercise supervisory oversight over their banks under the Basle rules. We regard this as reasonable since it is in the supervisor's own interest to act in such a way that internal problems are not permitted to grow more serious over time which could have serious consequences for global markets.

In other countries, as in the U.S., loan loss reserving is affected importantly by tax considerations. In Japan, reserves typically reflect permission by the authorities to allow tax-deductible reserves against loans that have already gone bad. The past reluctance of the Japanese tax authorities to grant such permission has led to lower reserves than otherwise would have prevailed. In recent months, a number of regulatory changes have been implemented making it easier to make tax-deductible write-offs against loan losses.

Since 1990, Japanese banks' commercial and industrial lending in the United States is estimated to have declined 14 percent. This decline may be explained by the need of Japanese banks to respond to market signals of the decline in their own credit standings. Anecdotal evidence suggests that Japanese banks have been tightening their terms of lending in the U.S. as a result of their weakened financial condition. This tightening is due in part to the Japanese banks' efforts to meet the Basle standard by reducing risk-weighted assets.

Some European banks have maintained higher credit ratings than U.S. and Japanese banks and, by virtue of those ratings, have a competitive advantage in certain markets. Banks have an incentive, on competitive grounds, to improve their capital position and, more generally, their financial health.

The "Capital Equivalency Report" submitted to Congress by the Federal Reserve Board and Department of the Treasury in June 1992 provides information on the current status of the Basle standards for the G-7 countries. This report to Congress is to be updated on June 19, 1993.

Q.2 **The small business lending initiative announced by President Clinton on March 10 will make it easier for banks to lend to small and mid-sized businesses by permitting strongly capitalized banks to make and carry a "basket" of loans with considerably less documentation required for these loans. The Committee would be interested in your comments on concerns still being expressed that qualifications for loans to be placed in the "basket" are too severe. Also, how will examiners be guided in evaluating the adequacy of loss reserves for the loans in the "basket"? This is particularly important since the purpose of the "basket" is to rely more on bankers' judgments and less on examiner fiat.**

A.2. The Federal Reserve recognizes that creditworthy small- and medium-sized businesses and farms have had problems obtaining loans from banks in the recent past. The interagency policy statement on credit availability, issued on March 10, 1993 (copy attached), makes clear the agencies' position that loans to creditworthy borrowers should be made whenever possible, as long as they are fully consistent with safe and sound banking practices. The statement goes on to state that the agencies will attempt to relieve regulatory burden where risk is low, especially for strong, well-managed banks and thrifts. In this regard, the new program announced by the agencies includes a policy permitting the reduction of documentation by strong and well-managed banks for a "basket" of loans. An interagency policy statement outlining the important points of the program was issued on March 30, 1993 (copy attached). It is the intention of this program to insure that documentation of such loans does not obstruct the granting of credit.

At the same time, however, the supervisory bodies must ensure that prudent banking practices are followed: it is because of this concern that the agencies will place a ceiling on the size of such loans and limits on the aggregate amount of such loans a bank may make.

It is a long-standing policy of the supervisory agencies that an adequate allowance for loan and lease losses be maintained by banking organizations. This policy should not be disregarded in analyzing a "basket" of loans that does not fulfill certain documentation requirements. As you know, the purpose of the allowance is to absorb all estimated credit losses associated with a bank's loan and lease portfolio, including its small business loan portfolio.

Q.3. **In terms of credit availability, would deposit insurance reform have been a better public policy response to the problems of our financial institutions than a focus on capital regulation?**

A.3. It is not clear that existing capital standards have had an effect on the availability of credit that would have been substantially different had other strategies been employed to resolve the industry's recent problems. First, what has been referred to as the credit crunch was brought about in part by perceptions that bank underwriting standards had declined too far and that the condition of the banking system needed generally to improve. This view was widely held by bankers and bank supervisors alike. The spate of costly commercial bank failures throughout the 1980s and early 1990s has made that point clear. Many weak banks simply needed additional capital to absorb problem loans, rebuild their strength, and regain the confidence of the general public. Even sound banks that avoided excessive risk learned quickly from the experiences of others and took steps to review their credit and pricing standards.

Second, our analysis and industry surveys do not support views that regulatory capital standards have caused the credit crunch. As a whole, the banking system's capital ratios are well above minimum standards with an average risk-based capital ratio of 12.3 percent at year-end 1992, compared with the regulatory minimum of 8.0 percent. Indeed, more than 9,000 banks (out of approximately 11,500 banks) had ratios above 12.0 percent. Moreover, staff analysis has indicated that well capitalized banks increased loans quite modestly suggesting that capital was not a significant factor in the slow aggregate loan growth.

Surveys of senior lending officers have consistently indicated that weak loan demand from creditworthy borrowers, rather than supervisory pressures, have had the greatest effect on the pace of loan growth. Certainly tighter lending standards -- whether dictated by management, examiners, or declining economic conditions -- have also had an important effect, but that situation probably would not have been helped by deposit insurance reform. Indeed, by increasing risks to depositors at such a particularly stressful time, deposit insurance reforms could have caused banks to retrench further in efforts to avoid making weak loans and to strengthen their image of being safe.

Finally, deposit insurance is a practice that is well established in this country. The existence of insurance enables depositors to be less concerned about their banks because they are protected by the insurance guarantee. Reducing or eliminating that insurance would likely lead depositors to insist on more capital in banks because, without insurance, their funds would be placed at greater risk. Since depositors would also be more attentive to developments at their banks, they would be more inclined to exert market discipline on management practices at their bank. There is much to be said for that. However, should a bank experience significant problems, depositors would also be more inclined to withdraw their deposits than they have been in the past. This action would tend to decrease the stability of the banking system and probably cause more banks to fail. One of the fundamental purposes of deposit insurance when it was originally put into place in 1933 was to prevent a swelling of bank failures.

Q.4. **You note that the Federal Reserve supports the prompt corrective action provisions. Is there not an argument to be made for greater regulatory flexibility that would allow an institution-specific response within the various capital categories?**

A.4. While it is our belief that the specific tools used by bank regulators should not be legislated, the prompt corrective action provisions of FDICIA, which established a capital-based supervisory framework, do indeed allow a certain amount of regulatory flexibility in dealing with troubled institutions. For example, the regulatory agencies were allowed to establish the threshold levels of capital for the different categories of supervision. Although we believe that these threshold levels place a heavy emphasis on capital as the major factor in determining the future health of an institution, this emphasis on capital is somewhat tempered because the statute affords regulators the flexibility to downgrade an institution into a lower category based on certain non-capital factors.

Flexibility for regulators also surfaces with regard to the timing of supervisory actions. For example, the prompt corrective action statute allows the regulator to delay appointment of a receiver to an institution whose capital falls below the critically undercapitalized level if, for instance, the institution is profitable or is demonstrating an upward trend in earnings that the regulator projects as sustainable. However, any deviations from the requirements of prompt corrective action cannot indefinitely defer the winding-up of a bank's affairs.

Moreover, supervisors have long had the authority to take any of the actions specified by the legislation. One advantage of the prompt corrective action framework is that it clearly states options available to supervisors in dealing with troubled depository institutions.

Q.5. Is there anything inherent in the Basle capital standards that <u>requires</u> their application to community-based, purely domestic institutions? Do other countries apply the standards this way?

A.5. The Basle Accord, as adopted by the central bank governors of the G-10 countries, recommended that the risk-based capital measurement system be applied to internationally-active banks, but each national supervisory authority may decide to apply the framework to a broader class of commercial banking organizations. Since the condition or stability of any banking organization is affected by its level of off-balance sheet exposures and the risk composition of its asset portfolio, the risk-based capital system provides an analytical framework that is equally relevant for large and small institutions. For this reason, the Federal

Reserve applies the risk-based capital measure, including the minimum supervisory ratio guidelines, to all state member banks and bank holding companies.

The Federal Reserve and the other federal banking and thrift agencies have, for some time, employed capital adequacy systems to measure capital at all banking organizations in the examination and supervisory process, as well as in the analysis of applications acted upon by the agencies. Prior to implementation of the risk-based capital framework, the agencies employed for these purposes the primary capital measure which was a simple ratio of a banking organization's capital to total assets.

The majority of the G-10 nations apply the Basle standards to all of their respective banks. A small number of nations apply the standards to all internationally-active banks, as required under the principles of the Accord, and other banks are generally obliged to meet capital adequacy standards which may incorporate some type of Basle standards. In addition, many nations that are not signatories to the Basle Accord apply the Basle standards to all of their banks.

Joint Release

Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision

Interagency Policy Statement on Documentation of Loans

March 30, 1993

The four federal regulators of banks and thrifts — the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision — today announced further details on the implementation of their March 10 program to increase credit availability. Today's policy statement outlines changes in the area of loan documentation.

The strongest banks and thrifts, those with regulatory ratings of 1 or 2 and with adequate capital, will now be able to make and carry some loans to small- and medium-sized businesses and farms with only minimal documentation. The total of such loans at an institution will be limited to an amount equal to 20 percent of its total capital. Eligible banks and thrifts will be encouraged to make these based on their own best judgment as to the creditworthiness of the loans and the necessary documentation. These loans will be evaluated solely on the basis of performance and will be exempt from examiner criticism of documentation.

Each minimal documentation loan is subject to a maximum loan size of $900,000 or 3 percent of the lending institution's total capital, whichever is less. If a borrower has multiple loans in the exempt portion of the portfolio, those loans must be aggregated before the maximum is applied. Loans to institution insiders — executive officers, directors, and principal shareholders — are ineligible for inclusion, as are loans that are already delinquent.

The package also offers some relief for banks that do not qualify for the program, and for loans that are not in the exempt portion of a bank's portfolio. The policy statement also includes guidelines which provide institutions some additional flexibility in applying their documentation policies for small- and medium-sized business and farm loans without examiner criticism.

Today's initiatives are directed at eliminating unnecessary documentation and reducing costs to lending institutions and the time it takes to respond to credit applications. OTS will soon issue a regulation to amend its current loan documentation requirements to comply with the statement. For banks, the program requires no change in existing regulations and is effective with today's release.

The complete program is being mailed to all regulated institutions and all examiners, and additional copies are available from the agencies.

Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision

Interagency Policy Statement on Documentation for Loans to Small- and Medium-sized Businesses and Farms

March 30, 1993

Introduction

Problems with the availability of credit over the last few years have been especially significant in the area of small- and medium-sized business and farm lending. This reluctance to lend may be attributed to many factors, including general trends in the economy; a desire by both borrowing and lending institutions to improve their balance sheets; the adoption of more rigorous underwriting standards after the losses associated with some laxities in the 1980s; the relative attractiveness of other types of investments; the impact of higher capital requirements, supervisory policies, and examination practices; and the increase in regulation mandated by recent legislation — specifically, the Financial Institutions Reform, Recovery, and Enforcement Act and the Federal Deposit Insurance Corporation Improvement Act.

The four federal banking agencies — the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision — expect small- and medium-sized business and farm loans, like all credits, to be made consistent with sound underwriting policies and loan administration procedures. The agencies are concerned, however, that institutions may perceive that the agencies are requiring a level of documentation to support sound small- and medium-sized business and farm loans that is in excess of what is necessary to making a sound credit decision. Unnecessary documentation raises the cost of lending to small- and medium-sized businesses and farms, results in delays in bank lending decisions, and may discourage good borrowers from applying. The agencies believe that the elimination of unnecessary documentation for loans to small- and medium-sized businesses and farms will reduce costs to the institution and the time it takes to respond to credit applications from small- and medium-sized businesses and farms without adversely affecting the institution's safety and soundness.

The federal banking agencies expect financial institutions to maintain documentation standards that are consistent with prudent banking policies. However, the maintenance of documentation beyond that necessary for a credit officer to make a sound credit decision and to justify that decision to the institution's management adds to loan administration costs without improving the credit quality of the institution. Unnecessary documentation impedes the institution from responding in a timely and prudent manner to the legitimate credit needs of small- and medium-sized businesses and farms in its community. Accordingly, the agencies are taking steps to correct any misunderstanding of regulatory requirements and to reduce regulatory impediments to lending to creditworthy small- and medium-sized businesses and farms.

Documentation Exemption for Small- and Medium-sized Business and Farm Loans

Well- or adequately capitalized institutions with a satisfactory supervisory rating will be permitted to identify a portion of their portfolio of small- and medium-sized business and farm loans that will be evaluated solely on performance and will be exempt from examiner criticism of documentation. While bank and thrift management will retain responsibility for the credit quality assessment and loan loss allowance for these loans, the lending institution will not be subject to criticism for the documentation of these loans.

This exemption will be available only to institutions that are well- or adequately capitalized institutions under each agency's regulations implementing section 38 of the Federal Deposit Insurance Act and that are rated CAMEL or MACRO 1 or 2. These institutions are by definition those that have demonstrated sound judgment and good underwriting skills; moreover, their strong capital position insulates the deposit insurance funds from potential losses that may be incurred through small- and medium-sized business and farm lending.

To qualify for the exemption, each loan may not exceed the lesser of $900,000 or three percent of the institution's total capital, and the aggregate value of the loans may not exceed 20 percent of its total capital. In addition, loans selected for this exemption by an institution must not be delinquent as of the selection date, and each institution must comply with applicable lending limits and other laws and regulations in making these loans. Furthermore, such loans may not be made to an insider.

Small- and medium-sized business and farm loans that do not meet the criteria for exemption set forth in this policy statement would continue to be reviewed and classified in accordance with the agencies' existing policies.

The details of the exemption are as follows:

- **Documentation exemption.** Each institution eligible for the exemption provided in this policy statement may assign eligible loans, subject to the aggregate limit on such eligible loans, to an exempt portion of the portfolio. Loans assigned to this exempt portion will not be reviewed for the completeness of their documentation during the examination of the institution. Assignments of loans to the exempt portion shall be made in writing, and an aggregate list or accounting segregation of the assigned loans shall be maintained, including the performance status of each loan.

- **Restrictions on loans in the exempted portion of the portfolio.** The institution must fully evaluate the collectibility of these loans in determining the adequacy of its allowance for loan and lease losses (ALLL) or general valuation allowance (GVA) attributable to such loans and include this evaluation in its internal records of its assessment of the adequacy of its ALLL or GVA. Once a loan in the exempt portion of the portfolio becomes more than 60 days past due, the loan may be reviewed and classified by an examiner; however, any decision to classify would be based on credit quality and not on the level of documentation.

- **Eligible institutions.** An institution is eligible for the documentation exemption if (1) pursuant to the regulations adopted by the appropriate federal banking agency under section 38 of the FDI Act, the institution qualifies as well- or adequately capitalized, and (2) during its most recent report of examination, the institution was assigned a composite CAMEL or MACRO rating of 1 or 2.

- **Ineligible loans.** Loans to any executive officer, director, or principal shareholder of the institution, or any related interest of that person, may not be included in the basket of loans.

- **Aggregate limit on loans.** The aggregate value of all loans assigned to the basket of loans provided for in the exemption may not exceed 20 percent of the institution's total capital (as defined in the capital adequacy standards of the appropriate agency).

- **Limit on value of individual loan.** A loan, or group of loans to one borrower, assigned to the basket of loans provided for in the exemption may not exceed $900,000 or 3 percent of the institution's total capital (as defined in the capital adequacy standards of the appropriate agency), whichever is the smaller amount.

- **Transition from eligibility to ineligibility.** An institution that has properly assigned loans to the exempt portion of its portfolio pursuant to this statement but subsequently fails to qualify as an eligible institution may not add new loans (including renewals) to this category.

Treatment of Small- and Medium-sized Business and Farm Loans Not Qualifying for Exemption

The agencies will continue current examination practices with regard to documentation of small- and medium-sized business and farm loans at institutions not qualifying for the exemption and loans at qualifying institutions that are not assigned to the exempt basket. The guiding principle of agency review will continue to be that each insured depository institution should maintain documentation that provides its management with the ability to:

(a) make an informed lending decision and to assess risk as necessary on an ongoing basis;

(b) identify the purpose of the loan and the source of repayment;

(c) assess the ability of the borrower to repay the indebtedness in a timely manner;

(d) ensure that a claim against the borrower is legally enforceable; and

(e) demonstrate appropriate administration and monitoring of a loan.

In prescribing the documentation necessary to support a loan, an institution's policies should take into account the size and complexity of the loan, legal requirements, and the needs of management and other relevant parties (such as loan guarantors).

In applying these standards, the agencies will continue to recognize the difficulty and cost of obtaining some documents from small- and medium-sized businesses and farms. These difficulties and costs could result in some deviations from an institution's own loan documentation policy for small- and medium-sized business and farm lending. Such deviations are frequently based on past experience with the customer. In such cases, the loan will not be criticized if the examiner concurs that sufficient information exists to serve as a basis for an informed credit decision.

Implementation

This policy statement will take effect immediately upon issuance. However, the agencies will monitor how qualifying institutions implement its provisions and how those institutions and the loans they designate for inclusion in the exempt basket perform. Changes to this policy statement may be made based on the agencies' experience.

Joint Release

Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision

Interagency Policy Statement on Credit Availability

March 10, 1993

The four federal regulators of banks and thrifts — the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision — today announced a program directed at dealing with problems of credit availability, especially for small and medium-sized businesses.

The program will focus on the five areas.in which the agencies will take action designed to alleviate the apparent reluctance by banks and thrifts to lend. Those areas are:

- Lending to Small- and Medium-sized Businesses
- Real Estate Lending and Appraisals
- Appeals of Examination Decisions and Complaint Handling
- Examination Processes and Procedures
- Paperwork and Regulatory Burden.

The agencies intend to complete virtually all of the changes proposed in the program within the next few months. As the specifics of any change are finalized, that change will be made and published while details of other changes are in the process of being finalized.

A complete statement about the actions the agencies have planned is attached. The statement reaffirms the agencies' belief that it is in the interest of lenders, borrowers and the general public that creditworthy borrowers have access to credit.

This policy statement will be distributed to all federally examined banks and thrifts and to all regulatory agency offices and examiners.

Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision

Interagency Policy Statement on Credit Availability

March 10, 1993

Problems with the availability of credit over the last few years have been especially significant for small- and medium-sized businesses and farms. This reluctance to lend may be attributed to many factors, including general trends in the economy; a desire by both borrowing and lending institutions to improve their balance sheets; the adoption of more rigorous underwriting standards after the losses associated with some laxities in the 1980s; the relative attractiveness of other types of investments; the impact of higher capital requirements, supervisory policies, and examination practices; and the increase in regulation mandated by recent legislation — specifically, the Financial Institutions Reform Recovery and Enforcement Act (FIRREA) and the Federal Deposit Insurance Corporation Improvement Act (FDICIA).

The four federal regulators of banks and thrifts — the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Office of Thrift Supervision — recognize that in the last several years the buildup of certain regulations and practices has become overly burdensome. Indeed, those regulations and practices may have, in some cases, stifled lending, particularly to small- and medium-sized businesses that met prudent underwriting standards.

It is in the interest of lenders, borrowers, and the general public that creditworthy loans be made. Since economic growth, especially job growth, is fueled primarily by small- and medium-sized businesses, credit availability to those borrowers is especially important. Accordingly, the agencies are working on the details of a new program to help ensure that regulatory policies and practices do not needlessly stand in the way of lending. Loans to creditworthy borrowers should be made whenever possible, as long as they are fully consistent with safe and sound banking practices.

Background

The new program is one aspect of an overall effort by the agencies to evaluate carefully and react appropriately to risk in the United States financial services industry. That overall effort envisions substantial oversight, in some cases more than we have now, in areas that pose greater risk to the system. By the same token, regulatory burden will be reduced where risk is low, especially for strong, well-managed banks and thrifts. This program is also part of a broader effort to ensure equal credit opportunity for all Americans and to make credit and other financial services available to low- and moderate-income neighborhoods and disadvantaged rural areas.

The Program

The new program involves a variety of regulatory and other administrative changes which have been agreed to in principle by the agencies. These changes fall into five categories, each of which is discussed below.

Timing. The agencies will work to complete virtually all of the changes outlined below within the next three months. Once the specifics of any of the changes are agreed upon, that change will be made and published, while distribution of other changes remains to be made.

1. Eliminating Impediments to Loans to Small- and Medium-Sized Businesses

Reducing Documentation. Strong and well-managed banks and thrifts will be permitted to make and carry a basket of loans with minimal documentation requirements, consistent with applicable law. To ensure that these loans are made to small- and medium-sized businesses, there will be a ceiling on the size of such loans and limits on the aggregate of such loans a bank may make.

Encouraging Use of Judgment\Borrower's Reputation. The agencies will issue guidance to make it clear that banks and thrifts are encouraged to make loans to small- and medium-sized businesses, particularly loans in the basket discussed above, and to use their judgment in broadly assessing the creditworthy nature of the borrower — general reputation and good character as well as financial condition may be elements in making these judgments. Reliance on a broad range of factors when making a credit determination is especially important.

Other Assets Especially Mentioned. Improper use of the category of Other Assets Especially Mentioned (OAEM) may inhibit lending to small- and medium-sized businesses. Accordingly, the agencies will clarify that examination and rating procedures do not group OAEM loans with classified loans.

2. Reducing Appraisal Burden and Improving the Climate for Real Estate

The experience of the last decade has underscored the importance of sound underwriting standards and effective supervision for commercial real estate loans. Nonetheless, in certain instances regulatory burdens may be adversely affecting loans to sound borrowers. This may be particularly so in the case of loans secured by real estate that are primarily used for non-real estate business purposes. Real estate collateral is often pledged for loans to small- and medium-sized companies that have few other tangible assets.

Using Real Estate Appraisals Prudently. In some cases currently required real estate appraisals may not add to the safety and soundness of the credit decision. Indeed, in some cases, appraisals may prove so expensive that they make a sound small- or medium-sized business loan uneconomical. Accordingly, the agencies will make changes to their rules relating to real estate appraisals along the following lines:

- **Accept Additional Collateral**
  When real estate is offered as additional collateral for a business loan, both the time and expense involved in obtaining an appraisal from a certified or licensed real estate appraiser may discourage a bank or thrift from taking the collateral, may increase the cost of credit significantly, or even may cause the loan not to be made. In some such cases, the real estate appraisal requirement is counterproductive from a safety and soundness perspective. Moreover, the constraint on credit flows to sound businesses may be substantial. Accordingly, the agencies will alter their real estate appraisal rules so as not to require an appraisal by a licensed or certified appraiser for such loans.

- **Reexamine Appraisal Thresholds**
  Appraisals conducted by licensed and certified real estate appraisers, even on real estate of modest value can be quite costly. In the case of a smaller loan, the requirement of an appraisal by a licensed or certified real estate appraiser may make a sound loan uneconomical. Accordingly, the agencies will reexamine their existing rules to make certain that thresholds below which formal appraisals are not needed are reasonable.

- **Limit Periodic Appraisals**
  In some cases real estate appraisals have been required after a loan has been made, and in circumstances where the appraisal did not add to the safety and soundness of the loan. Accordingly, the agencies will work to make certain that real estate appraisals are required after a loan is made only when clearly needed for safety and soundness purposes, provided of course, that all requirements under law have been met.

Changing Rules on Financing of Other Real Estate Owned. Currently, accounting and other rules may discourage banks and thrifts from providing financing to borrowers who wish to purchase real estate classified as Other Real Estate Owned. The agencies will review rules relating to the reporting treatment and classification of such loans and make appropriate changes to facilitate financing to creditworthy borrowers, consistent with safe and sound banking and accounting practices.

Reviewing In Substance Foreclosure Rules. The inappropriate use of in substance foreclosure rules have required foreclosure valuation treatment of loans when borrowers were current on principal and interest payments and could reasonably be expected to repay the loan in a timely fashion. The agencies will work with the appropriate authorities to alter that treatment and to coordinate a change in accounting principles and reporting standards.

Avoiding Liquidation Values on Real Estate Loans. Loans secured by real estate should be evaluated based on the borrower's ability to pay over time, rather than a presumption of immediate liquidation. The agencies will work with their examination staffs to ensure that real estate loans are evaluated in accordance with agency policy.

3. Enhancing and Streamlining Appeals and Complaint Processes

Appeals. It is important for bankers to have an avenue by which they can obtain a review of an examiner's decision when they wish. For that reason, each of the agencies has established an appeals process. To ensure the effectiveness of those processes, each agency will take appropriate steps to ensure that its appeals process is fair and effective.

In particular, each agency will ensure that its process provides a fair and speedy review of examination complaints and that there is no retribution against either the bank or the examiner as the result of an appeal.

Complaints. Each of the agencies has a process to handle more general complaints from the institutions they regulate and from the general public. Although the volume of such complaints can be high, each agency recognizes that reviewing and responding to these complaints is an important element of proper supervision. The agencies are particularly concerned that complaints of discriminatory lending practices be handled with the utmost seriousness and on an expedited basis.

Accordingly, the agencies will review their complaint processes to improve both the care with which complaints are scrutinized and the timeliness of responses.

4. Improving Examination Process and Procedures

Reducing the Burden of the Examination Process. A proper examination of a bank or thrift by its very nature involves some disruption to the examined institution. Such disruptions, however, are costly to the institution and can interfere with its credit functions. It is highly desirable that examination disruptions be minimized.

Accordingly, the agencies have agreed to intensify efforts to minimize such disruptions and, in particular, to take the following steps: (i) eliminate duplication in examinations by multiple agencies, unless clearly required by law, (ii) increase coordination of examinations among the agencies when duplication is required, and (iii) establish procedures to centralize and streamline examination in multibank organizations.

Refocusing the Examination Process. If examinations are to fulfill their functions in the areas of safety and soundness, fair lending, and consumer protection compliance, it is important constantly to reexamine the elements of the examination to determine whether the process is effective. Similarly, regulations and interpretations must continually be assessed to determine whether they are fulfilling these functions.

To improve the regulatory process, the agencies have agreed to heighten their emphasis in examinations on risk to the institution and to issues involving fair lending in place of areas that have become less productive over time. Agency policies and procedures will be reviewed with this focus in mind.

Reducing Regulatory Uncertainty. Uncertainty is part of the regulatory burden that banks and thrifts face and that contributes to their reluctance to make some credits available. This uncertainty can stem from ambiguous language in regulations and interpretations, from delays in publishing regulations and interpretations, and from failures to follow uniform examination standards that clearly reflect agency policies.

Accordingly, the agencies will review their regulations and interpretations to minimize ambiguity wherever possible and will step up efforts to publish regulations and interpretations required by law or sound regulatory practice. In addition, the agencies will reemphasize to their examiners to follow agency policies and guidelines carefully and accurately in carrying out examinations and reviewing applications. The agencies will make every effort to ensure that examination and application processing is performed uniformly across the country.

5. Continuing Further Efforts and Reducing Burden

Further Efforts. Additional items will be reviewed for possible change. One item that will be reviewed relates to the treatment of partially charged-off loans. Under current practice delinquent loans that have been partially charged off cannot be returned to performing status even when the borrower is able to, and fully intends to, pay the remaining interest and principal to the bank in a timely fashion. The agencies will work to develop common standards for determining when a loan may be returned to accrual status.

Paperwork Burden. No good is served by forcing banks to bear an excessive regulatory paperwork burden. Accordingly, the agencies have begun and will continue to review *all* paperwork requirements to eliminate duplication and other excesses that do not contribute substantially to safety and soundness.

Regulatory Burden. It is not paperwork alone that unnecessarily burdens banks and thrifts. Regulations and interpretations also may be unnecessarily burdensome. In some cases the passage of time has made regulations outmoded. In other cases the regulations may not have fulfilled their goals.

Accordingly, the agencies also have begun and will continue to review *all* regulations and interpretations to minimize burden while maintaining safety and soundness standards.

OPENING STATEMENT OF CONGRESSMAN BILL ZELIFF (R-NH)

Small Business Committee

May 11, 1993

Mr. Chairman, thank you for calling today's hearing about this important issue.

I would first like to mention that present at this hearing is Andy Cochran, his wife Charlotte and his consultant Steve Woods. Andy is a resident of my district who is the New Hampshire and New England Business Person of the Year. It is his success that demonstrates why we need to solve this credit crunch and help our small businesses, not hurt them with more and more regulation.

I have been to numerous hearings on the many problems our small businesses are experiencing in today's difficult economic environment.

The lack of credit availability and government over-regulation continue to be major concerns for small businesses.

We are here today to discuss the Presidents economic program and its impact on the small business community. I have many concerns about the BTU tax, the increase in the corporate tax, and the lowering of the tax deductible share of business meals and entertainment from 80% to 50%.

None of these proposals will stimulate the economy and create jobs. In fact, they are likely to have the opposite effect-- they will take jobs away from the economy. I hope today's testimony will provide some insight on how the President will address the issue of job creation.

Thank you.

THE HONORABLE KWEISI MFUME

OPENING STATEMENT

BEFORE THE COMMITTEE ON SMALL BUSINESS

MAY 11, 1993

PRESIDENT CLINTON'S ECONOMIC PROGRAM

GOOD MORNING MR. CHAIRMAN, MEMBERS OF THE COMMITTEE, AND DR. TYSON. THIS MORNING'S HEARING PROMISES TO BE AN IMPORTANT ONE ON AN TOPIC THAT IS OF CONCERN TO EVERYONE IN THE NATION. SURELY, THE PRESIDENT'S ECONOMIC PROGRAM WILL HAVE AN IMPACT ON THE FUTURE OF OUR ECONOMY. AS MEMBERS OF THE COMMITTEE ON SMALL BUSINESS WE ARE ALL CONCERNED WITH HOW THE PROGRAM WILL IMPACT SMALL BUSINESS, THE LINCHPIN OF OUR ECONOMY.

AS WE ALL KNOW, THE FEDERAL DEBT IS A MAJOR CONCERN OF AMERICANS TODAY. THE EFFECTS OF OUR MASSIVE DEBT REVERBERATE THROUGHOUT OUR ECONOMY. IF WE WISH TO CONTINUE AS A ECONOMIC POWER WE MUST DO SOMETHING TO REDUCE THIS BURDENSOME PROBLEM.

WHILE REDUCING THE GROWTH OF THE DEBT IS OF CRITICAL IMPORTANCE, WE MUST NOT ATTACK IT BLINDLY. IT IS ESSENTIAL THAT WE CAREFULLY EXAMINE THE PROPOSED PLANS IN ORDER TO DETERMINE WHAT THE POTENTIAL EFFECTS ARE. THIS IS NOT AN ATTEMPT TO DERAIL PRESIDENTIAL INITIATIVE BUT MERELY AN ATTEMPT TO ADEQUATELY ENSURE FUTURE GROWTH FOR THE ECONOMY.

THE PROGRAM THE PRESIDENT HAS PRESENTED IS AN AMBITIOUS ONE.

THE PLAN CALLS FOR A CREDIBLE REDUCTION IN THE FEDERAL DEFICIT AND, AT THE SAME TIME, SEEKS TO FUND PROGRAMS THAT ARE NECESSARY TO THE CONTINUED STRENGTH OF OUR NATION. IN THE CONGRESS, WE MUST LIVE UP TO OUR RESPONSIBILITY BY CUTTING SPENDING. BY WORKING TOGETHER WITH THE PRESIDENT, WE CAN BEGIN TO ADDRESS THE PROBLEM OF OUR DEBT.

EVERY MEMBER OF CONGRESS WILL AGREE THAT DEFICIT REDUCTION IS A NOBLE GOAL. BUT NOW IS THE TIME TO EXAMINE THE DETAILS OF THE PROGRAM AT HAND. IN THIS HEARING, AND IN FUTURE HEARINGS, WE MUST DETERMINE THE EFFECT THAT OUR ACTIONS WILL HAVE ON SMALL AND MINORITY BUSINESSES AROUND THE COUNTRY. IF WE ACT IN HASTE IN AN ATTEMPT TO REDUCE THE DEFICIT, WE COULD END UP DOING MORE HARM THAN GOOD.

I DO NOT WISH TO GIVE THE IMPRESSION THAT I AM SKEPTICAL OF THE PRESIDENT'S PLAN. IN REALITY, I SEE THIS AS A GOLDEN OPPORTUNITY FOR THE PRESIDENT AND THE CONGRESS TO WORK TOGETHER TO MAKE FAR REACHING IMPROVEMENTS TO THE STATE OF OUR ECONOMY.

I WOULD LIKE TO THANK CHAIRMAN LAFALCE FOR HOLDING THIS HEARING AND DR. TYSON FOR HER APPEARANCE TO GIVE US MORE INSIGHT INTO PRESIDENT CLINTON'S VITALLY IMPORTANT ECONOMIC PROGRAM. I LOOK FORWARD TO THE TESTIMONY.

STATEMENT OF HON. WALTER R. TUCKER III
Small Business Hearing with Dr. Laura D'Andrea Tyson

IT IS A PLEASURE FOR ME TO BE HERE TODAY TO LISTEN TO THE TESTIMONY OF DR. TYSON. I WAS ONE OF THE MANY SUPPORTERS OF THE PRESIDENT'S STIMULUS PACKAGE YET WE ALL KNOW WHAT HAPPENED TO THAT. TODAY THE SMALL BUSINESS COMMUNITY IS FINDING IT MORE AND MORE DIFFICULT TO GET THE CAPITAL IT NEEDS TO OPERATE AND EXPAND. I WILL BE LISTENING INTENTLY TO WHAT YOU HAVE TO TELL US REGARDING THE PRESIDENT'S ECONOMIC PROGRAM, THE INITIATIVES CONTAINED THEREIN, AND THE ANTICIPATED IMPACT THE PROGRAM WILL HAVE ON SMALL BUSINESS. THANK YOU FOR COMING HERE TODAY AND THANK YOU MR. CHAIRMAN.

What role do you see community based banks and local redevelopment agencies playing in the increase of available credit in urban and inner city communities?

How will streamlining the credit procedures for small business lending be made simpler without risking the regulatory debacle of the 1980's?

Statement of Congressman Jim Ramstad
Before the House Small Business Committee
On
The President's Economic Plan
Dr. Laura Tyson, Chair, Council of Economic Advisors
May 11, 1993

Mr. Chairman, I am particularly pleased to have Dr. Tyson with us this morning to discuss President Clinton's economic plan. As a member of the Joint Economic Committee, I was disappointed that last week's hearing with Dr. Tyson on the same topic was cancelled by the Chairman of the JEC.

It is certainly appropriate for Dr. Tyson to appear before the Small Business Committee, since we all know small businesses are the engine of jobs growth in our economy. Without a thriving small business sector, our economy will never experience the long-term, sustainable economic growth we need to shake off the lethargy in our economy.

Unfortunately, while I applaud the rhetorical emphasis the President has placed on reducing the massive budget deficit, the details of his budget proposal -- and the reaction of the economy since its release -- concern me greatly.

While the ratio of tax hikes to spending cuts varies according to which analysis you read, the plan clearly does not meet the President's campaign promise of two dollars in spending cuts for every dollar in new taxes. With all respect, I believe we must reduce the suffocating deficit primarily by cutting spending.

I had been hopeful the President's plan would recognize that the private sector -- not the government -- creates jobs. Instead, his plan is a government growth plan, not an economic growth plan.

The President's economic proposal and the testimony of his advisors before various congressional committees indicate he believes raising taxes will damage the economy less than reducing spending. Asked why the five-year plan does not include significant spending cuts in the early years, OMB Director Panetta responded that spending cuts would "cause even greater consternation with regards to the economy."

I do not believe Congress has a right to ask the American people -- particularly middle-income taxpayers -- who have seen congressionally-mandated spending programs consume larger and larger portions of their "contribution" to the federal government every April 15 -- to give even more to a wasteful and profligate bureaucracy.

I would submit that taking funds out of the pockets of the productive, small business sector of our economy through the largest tax increase in American history -- which Clinton has proposed -- will be far more harmful to the economy than forcing a bloated, $1.5 trillion government bureaucracy to tighten its belt. Businesses need capital, not higher taxes. Raising taxes and increasing regulations on our small businesses will stifle growth -- not result in increased economic growth or new jobs.

Mr. Chairman and Dr. Tyson, it flies in the face of precedent to believe tax increases will reduce the deficit or increase economic growth. History shows every time taxes are raised, Congress spends an additional $1.59 -- hardly a recipe for real deficit reduction.

The small business men and women in my district ask me repeatedly why Congress won't relieve the credit crunch, reduce taxes and alleviate the crushing burden of government regulations. President Clinton's proposal to increase taxes and grow the government -- even under the euphemistic guise of "investment" -- moves in the exact opposite direction our small businesses want and need.

The threat of President Clinton's higher taxes has also severely dampened consumer confidence, which has fallen for the third straight month since the President outlined his plan in his State of the Union Address. The Chamber of Commerce Business Confidence Index, released yesterday, shows business confidence has plunged to its lowest level since October. As you know, the Chamber's index is based on three separate surveys of expectations of the economy, employment growth and sales.

The New York Times last Sunday ran an article entitled "Confidence in Clinton is Slipping Among Many Business Leaders," which was based on interviews with key business leaders. The Times noted, "That these executives are far more worried than they were a couple of months ago is not just a political problem. Confidence is a necessary ingredient in business decisions to invest in technology, hire workers or start new ventures, so the bleaker mood is bad for an economy that is already on a slow-growth path."

I certainly agree with this analysis -- low confidence will perpetuate economic sluggishness. However, despite my strong concerns about the economy, I don't believe the answer is to enact a deficit-financed "stimulus package." There is talk now of scaling back and reintroducing the President's defeated $16 billion plan, which nearly all economists -- except Dr. Tyson -- agreed would have had little effect on our $6 trillion economy.

As you probably know, a similar "stimulus package" was enacted in 1983, but a 1986 GAO report concluded that "implementation of the act was not effective and timely in relieving the high unemployment caused by the recession." Further studies concluded that anti-recession plans only work when implemented soon after an economic downturn begins.

Having said all that, it is clear there are systemic problems in our economy. What should be done to achieve long-term economic growth and job creation?

Primarily, we must reduce the cost of capital to our small businesses. This can be done through lowering the capital gains tax -- which would unleash a flood of venture capital funds in our economy -- and relieving the private sector of the excessive regulations that shackle entrepreneurship. Creating a low tax, limited government and lower regulation environment for our small businesses will allow them to do what they do best -- create jobs.

Most economists agree: the last thing we ought to do is impose President Clinton's $328 billion tax package on the productive private sector. Doing so will only stifle growth and dampen our economy.

Thanks again for coming this morning. I look forward to this exchange, during which I hope we can focus on the anticipated economic effects of the plan and the President's decision to rely more on tax increases than spending cuts to attack the budget deficit.

Remarks by Dr. Laura D'Andrea Tyson
Chair of the Council of Economic Advisers
before the
Committee on Small Business
U.S. House of Representatives

Tuesday, May 11, 1993

Thank you, Mr. Chairman, for the opportunity to come before the Small Business Committee to discuss the President's economic package and, in the process, highlight a few of the initiatives that are designed to benefit the small businesses of the United States.

It goes without saying that any economic plan which does not directly address the interests of small business is insufficient. Small businesses employ nearly 60 percent of the private work force and contribute over half of all sales in our country. They provide the innovations and flexibility essential to a healthy and vibrant economy. Additionally, small businesses are an important mechanism for economic advancement--women and minorities comprise a rapidly increasing fraction of all small business owners. For all of these reasons, the Administration has kept and will continue to keep small business owners in mind when formulating its economic policy proposals.

The economic policies supported by the Administration attempt to counteract a number of disturbing economic trends which have developed in recent years. Let me name just a few of them: median family real income has been stagnant--its 1991 level was actually below the level reached in 1979--despite more two-earner families; the poverty rate in 1991 was higher than in any year during the 1970s; and the Federal Government is borrowing to pay almost a quarter of its current bills. Clearly, the mandate that voters demanded in 1992 was one for economic change.

Underlying these disturbing trends are three fundamental problems in the American economy: an erosion in the growth rate of productivity over the past twenty years; a anemic recovery which, after twenty-five months, has barely begun to show signs of substantial employment growth; and an increase in inequality that has undermined the sense of fairness in our economic system.

The President's economic initiatives, including those specifically oriented towards small business, are designed to correct each of these fundamental problems. The investment and deficit reduction components of the package are directed toward boosting productivity growth and living standards over the long-term. Furthermore, all of the elements of the package are designed with an eye toward restoring basic fairness to the system. Let me elaborate on the President's plan in the context of the Nation's fundamental problems.

The Nation's Long-Term Problems

Sustainable increases in the Nation's standard of living can only be attained through rising levels of labor productivity. As the amount of output per worker increases over time so do the wage rate and potential consumption per worker. Because of this linkage, the rate of productivity growth is a crucial indicator of how living standards will change over time.

From the end of World War II until 1973, productivity grew at an annual rate of about 2.5%, which implies a doubling in the standard of living in just under 30 years. The notion that each successive generation would have a significantly higher living standard was virtually taken for granted. Not any more. Since 1973, the average annual rate of productivity growth has fallen to about 0.8 percent, which implies that living standards will double every 90 years. The slowdown may be exaggerated to some extent by our inability to measure productivity growth in the rapidly growing service sector of the economy, as some observers claim, but a substantial portion of this slowdown is a consequence of adverse economic events and policy choices that have promoted consumption rather than investment.

Intuitively, our workforce's productivity increases with its skill level, with improvements in technology, or with increases in the amount of plant, equipment, and infrastructure our workers use in the production process. All of these driving forces of productivity growth require that we make investments--investments in health, education, and training to improve workers skills; investments in research and development to improve technology; and investments in buildings, machines, roads, bridges, railways, airports and the like to increase our Nation's capital stock. These investments will allow businesses of all sizes to operate more efficiently and become more competitive.

The amount of investment that the Nation achieves depends directly and indirectly on government actions. Many government programs contribute directly to the stock of public capital--health care, education, training, and infrastructure spending, for example. Other government policies, especially tax policies, indirectly influence the amount of spending on private capital--research and development, plant, and equipment--that firms choose to undertake.

Policies of the last twelve years were not successful in reversing this erosion of productivity. Conventional measures of public investment as a share of GDP have fallen each decade since the 1960s. Furthermore, the large budget deficits required to finance growth in defense and other non-investment government spending programs during the 1980s have reduced the pool of resources available for private investments in human and physical capital. We must reverse the fiscal policies of the last twelve years in order to increase capital formation and the rate of growth in our living standards. The investment program and the deficit reduction plan are intended to accomplish these objectives.

The Investment Program

The Administration's investment program includes a wide range of projects whose benefits will be felt over long periods of time, and thus, fit the conceptual definition of investment. The Clinton investment package delivers on all of the major public investment initiatives promised by the President during his campaign--initiatives to put people back to work; initiatives to facilitate lifelong learning from childhood through retirement; initiatives to reward work for those who work hard and play by the rules; initiatives to address urgent public health problems; and initiatives to encourage private-sector investments that provide technological gains and improved productivity.

While many aspects of the investment program are aimed more generally at the entire economy, the Administration's plan calls for many programs which are oriented specifically towards small business.

- The Administration supports capital gains relief for small start-up companies. Young companies have historically been a primary source of innovative ideas and products. By providing greater financial incentives to those Americans who wish to develop and produce their great ideas for new businesses, the Federal Government can help ensure the future vitality of the American economy.

- Many initiatives within the investment program are designed to encourage economic development in troubled urban areas. The creation of empowerment zones will provide inducements for the creation of new business and the expansion of existing ones in neighborhoods in need of a stable local economy. The expansion of the earned income tax credit and increased funding of Head Start will encourage workers in these areas to join the workforce and make them less expensive for business owners to employ. Through these initiatives, the Administration hopes to foster an investment in the small businesses which make up the economic backbone of urban neighborhoods.

- Similarly, the Administration wants to ensure the economic health of non-urban areas by providing an increased amount of grant and loan money to rural communities.

- The Federal Government plans to invest in science, engineering, and technology, and small businesses will share in these opportunities. Small businesses will continue to expand their role as providers of services or research and development to the Federal Government, either as direct contractors or as subcontractors.

- The Administration realizes that small businesses are heavily dependent on banks for their financing. However, many areas, both rural and urban, are underserved by the banking industry. The President's Community Development Banking initiative will provide seed capital and technical assistance grants to create a network of 100 community development banks. These institutions will provide credit, technical assistance, and basic banking services to local entrepreneurs and their communities.

- Under present law (section 179 of the Internal Revenue Code), a small business may expense up to $10,000 of investment per year. Property qualifying for expensing is generally comprised of equipment. The amount of investment that may be expensed is reduced (dollar-for-dollar) for qualifying investment in excess of $200,000. (As a result, firms with investment in excess of $210,000 receive no benefit from expensing.)

- The Administration is considering options that would increase the amount of investment that may be expensed by small business, for example, by increasing the limitation on the amount of property that may be expensed to $25,000 from $10,000. This would more than double the benefit of the present law provision to small businesses, increasing the cash flow of small business to permit them to investment and employ more people.

These programs, and the Administration's overall investment program, will stimulate private and public investment. This investment will increase our rate of productivity growth, resulting ultimately in higher living standards.

The Deficit Reduction Plan

In order to reduce the government's claims on credit markets, the President's economic package includes a credible deficit-reduction plan which will be phased in gradually over four years. Deficit reduction is not an end in itself, but a means to greater capital formation, faster productivity growth and higher living standards. Deficits require government borrowing--either from the private sector, which reduces funds available to private investors and consumers and raises their cost of borrowing, or from the rest of the world, which forces a growing share of our future tax dollars to be used to pay off foreign lenders.

The President's proposed multi-year budget has no plugs, caps, gimmicks, or magic asterisks. All cuts are identified in the OMB document "A Vision of Change for America" and in the Budget released by the Administration last month.

There is no denying that some of the deficit reduction will be accomplished by raising some additional taxes. Businesses will be asked to pay a share. However, the Administration encourages all business owners to remember the benefits that they will receive from the Administration's economic policies. For their contribution, small business owners will receive tax breaks for capital formation, a better educated workforce, and improved access to credit. In addition to these and other benefits, many analysts expect that a credible deficit reduction plan will result in even further declines in long-term interest rates, which are already near or at historic low. This will significantly lower the cost of financing on-going business operations and corporate expansion.

Economic Stimulus

The United States economy has experienced a protracted period of weak performance. Since 1989, the average annual rate of real GDP growth has barely exceeded one percent--inadequate to even keep up with population growth. This period was marked first by sluggish growth in 1989 and early 1990, then by a recession which lasted from July of 1990 until March of 1991, and, finally, by a very slow recovery since March of 1991. The recovery has been so slow that most Americans have barely noticed it is underway. In the third quarter of the recovery, the economy showed serious signs of falling back into recession--real GDP grew by only 0.6 percent and real gross domestic purchases actually declined. And, despite relatively robust growth numbers for the second half of 1992, the preliminary measure of GDP for the first quarter of 1993 is a disappointing 1.8 percent.

Many of the factors that contributed to the recession or to sluggish growth over the past four years are still acting to slow the economy.

- o Many U.S. companies are in the midst of a painful restructuring process that will ultimately make them more competitive, but currently generates large and permanent layoffs. This restructuring is manifest by the fact that the fraction of unemployed workers that have permanently lost their previous jobs reached an all-time high of over 45 percent in October of 1992.

- The ongoing and future reductions in defense spending will require a significant reallocation of resources that and will continue to act as a drag on the economy. This process actually began in the late 1980s, and before it is completed may well involve a shift of over 3 percent of our GDP from military to civilian purposes.

- In several parts of the country the commercial real estate market remains considerably depressed, a consequence of overbuilding that occurred in the 1980s. There is little hope that commercial real estate construction will return to 1980s levels anytime soon.

- A number of our trading partners have experienced much slower growth in recent months and that has reduced the growth of our exports. Real GDP in both Germany and Japan, for example, declined in recent quarters.

- Reduced withholding of taxes last year reduced tax refunds and consumer spending this Spring.

For all of these reasons, President Clinton's economic plan originally included a stimulus package of spending increases and targeted tax cuts to spur investment and job growth in the near term. The Administration viewed a short-term stimulus package as an insurance policy designed to make sure that the recovery did not falter again, and as a downpayment on the investment plan that will largely occur in subsequent fiscal years. Unfortunately, the spending increases contained in the stimulus package have not been enacted because of Republican resistance.

The spending side of the package included about $16 billion in increased funding for the following programs: extended unemployment benefits, highway construction, a summer jobs and training program for underprivileged youth, community development block grants, education programs, wastewater cleanup, and important environmental and technology programs. Three criteria guided the design of this package: the potential for rapid spend-out rates; consistency with the investment program; and modest size. All of the items included in the package were fast-acting and job-creating; each were worthwhile on their own merits and were consistent with the basic long-run goal of shifting public expenditure toward investment.

The Republican opposition to these spending measures dealt a particularly hard blow to the small business community. When the stimulus bill was defeated, so were funds to be used to for the popular and important 7(a) Small Business Administration loan program. Without additional money, the SBA will not be able to make any additional future loans. The Administration is committed to this loan program and encourages future authorization of funds.

<u>Additional Small Business Initiatives</u>

In addition to the broader economic plan outlined above, the Administration supports other proposals which would directly benefit small business.

The past few years have witnessed a significant decline in the amount of commercial lending done by banks. Some analysts have described the conditions as indicative of a "credit crunch" and have pointed to a stricter bank regulatory environment (which evolved in the wake of the savings and loan crisis) as the impetus for the decrease in lending. In order to improve the flow of credit in the economy, particularly to small- and medium-sized businesses, the Administration announced a program of regulatory and administrative changes to ensure that the Federal Government does not impose unnecessary impediments to bank lending. These changes include:

- A reduction in the amount of documentation required for loans made to small businesses by strong and well-managed banks. Banks will be allowed to take into account a borrower's reputation and character in making credit decisions, as well as his or her financial condition and the value of collateral.

- Alteration of appraisal requirements for real estate securing small business loans. This will decrease the costs associated with lending to businesses which secure their loans with mortgages on property (as do many small businesses).

- A general reduction in regulatory burden. The Federal banking regulators will taking steps to minimize the costs to banks of regulatory examinations, of appealing examination complaints, and of paperwork requirements. These changes are intended to encourage lending by banks without interfering with their ability to operate in a safe and sound manner.

Financial markets have experienced a revolution in the last two decades. While these innovations have been to the advantage of many American companies, the benefits have not always extended to small businesses. The Administration is dedicated to promoting continued innovation in financial markets that will increase the flow of capital to small businesses.

Mr. Chairman, this concludes my testimony, but I wanted to take a moment to thank you and your committee for your invitation and for your welcome. I look forward to working with you during my tenure at the Council of Economic Advisers. I know by working together we can all share in the effort to strengthen our economy by ensuring a stronger recovery, higher rates of public and private investment, and reduced Federal budget deficits.

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