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Testimony by

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before the

Committee on Ways and Means

U.S. House of Representatives

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Mr. Chairman, members of the Committee, I appreciate the invitation to participate in these important hearings on tax policy. In your announcement, you made it clear that you intended to engage in a comprehensive review of the economic issues surrounding fiscal policy today, involving not only short-run, cyclical considerations, but also the implications of taxation for the longer-range growth of the economy. I applaud this broad scope; I believe that it is essential if we are to have the assurance that any action taken will truly serve the interests of the nation.

If I may, Mr. Chairman, I'd like to devote a few minutes to an assessment of the current economic situation. Obviously, we must know the nature of the problems we confront before we formulate a solution.

The upturn in business activity that began earlier this year clearly has faltered. It is apparent that the economy is struggling and that there have been some strong forces working against moderate cyclical revival. Now that we are well past the period of gyrations associated with the crisis in the Persian Gulf, we can better gauge the strength of the underlying disinflationary forces that were active well before the economy tilted into recession in the autumn of 1990.

During the 1980s, large stocks of physical assets were amassed in a number of sectors, largely financed by

huge increases in indebtedness. In the business sector, the most obvious example is that of commercial real estate, with the accumulation of vast amounts of office and other commercial space--space that goes well beyond the plausible needs in most locales well into the future. Our financial intermediaries, not just depository institutions but other lenders as well, lavished credit upon developers, and they are paying the price today in the form of loan losses and impaired capital positions. The 1980s were also characterized by a wave of mergers and buyouts--purchases of corporate assets, often involving substitution of debt for equity and anticipating the sale of assets at higher prices. I needn't recount for you the subsequent disappointments, and the fall-out for holders of "below investment grade" bonds and related loans.

In the household sector, purchases of motor vehicles and other consumer durables ran for a number of years at remarkably high levels, and were often paid for with installment or other debt that carried extended maturities. In some parts of the country, the household spending boom reached to the purchase of homes, not simply for essential shelter, but as speculative investments--and often involving borrowing that constituted a heavy call on current and expected family incomes. The aftermath of all this is a considerable degree of financial stress in the household sector.

The bottom line of this brief account is that the national balance sheet has been severely stretched. While most analysts, of course, were aware of the increasingly disturbing trends of rising debt and elevated corporate leverage, it was not clear that these burdens had as yet reached a magnitude that would restrain the American economy from a moderate cyclical recovery in 1991.

Indeed, as inventory liquidation abated at mid-year, output moved up and closed the gap with the consumption of goods and services in much the same manner evident in the early stages of other recent business cycle recoveries. A range of leading indicators still were flashing positive signals on the economy's prospects.

By late summer, however, with half the recession losses recovered, it became clear that the cumulative upward momentum that characterized previous recoveries was absent. The growing propensity of households to pare debt and businesses to reduce leverage was a signal that the balance sheet restraints, feared by many for a long time, had indeed taken hold, working against the normal forces of economic growth.

These events do not necessarily mean that a prolonged period of economic weakness is inevitable, but they do mean that policymakers must consider these unusual forces when shaping their response in the current situation. It is essential that the direction of public policy be well

targeted to the nature of the problem it is seeking to ameliorate.

For example, lower interest rates can reduce debt service burdens and their claim on current spendable incomes. Moreover, severely stretched private sector balance sheets must be reliquified if the economy is to return to normal growth. But only in the context of prudent, noninflationary expansion of money and credit are such improvements likely to be lasting.

In concept, private balance sheet liquification also could be facilitated by tax cuts for individuals or corporations if they are largely saved by the recipients. In effect, public debt would displace private debt on our nation's balance sheet. But if the markets were to perceive such policy initiatives as undermining long-term fiscal discipline, long-term interest rates would rise and debt service burdens again would mount. The heavy demand the government is already placing on the credit markets is a significant factor in the persistence of historically high real bond yields and mortgage rates, which is making the private balance sheet adjustment process all the more difficult.

The inference I draw from this is that the Congress should approach with great caution any proposal that would expand the structural budget deficit. At a minimum, care should be taken to ensure that any short-run stimulative

action does not imply a widening of the deficit over the longer term.

Obviously, any policy that bolstered the asset side of the nation's private balance sheet or eased debt pressures without violating the goals of long-term federal budget balance or involving imprudent money creation could be of significant assistance in our current difficulties.

But there appears to be more that is required. It is certainly the case that stretched balance sheets are restraining expansion, and some relief is necessary to foster a resumption of sustained growth. But I have a suspicion that there is more to the story than that. Consumer confidence, which rebounded in a normal fashion as the cyclical recovery began in the spring, fell back as the recovery stalled, exacerbating the problems.

Consumers appear to be more apprehensive than one might expect, given the broad macroeconomic circumstances. For example, the level of unemployment and particularly the layoff rate are well below those experienced in periods of economic weakness; this would not seem to square with the deep concerns expressed in surveys about perceived labor market conditions.

It is true that homeowners sense some contraction, however small, in the market value of their most important asset, the equity in their homes. But it surely is no worse

a concern today than it was in the spring. If anything, the data on home prices suggest it should be less so.

I suspect that what concerns consumers, and indeed everyone, is that the current pause may be underscoring a retardation in long-term growth and living standards. So long as the recovery proceeded, this latent concern did not surface, but as balance sheet constraints held the recovery in check, earlier worries about whether the current generation will live as well as previous ones resurfaced.

Such anticipations certainly need not be realized if we follow appropriate policies, and this suggests strongly that any current policy initiatives should focus on some key fundamentals. Indeed, firm reliance on policies directed toward longer-term stability and incentives are likely to do as much, or more, for short-term economic expansion as a "quick fix."

What are the current restraints on growth and how can they be addressed? I, and others, have long argued before this Committee that the essential shortcoming of this economy is the lack of saving and investment. It's here that our major policy focus should rest. Investment is the key to enhanced productivity and higher living standards. While we have seen some improvement in productivity trends in the past decade, our performance leaves much to be desired--a fact reflected in our loss of international

competitiveness in many industries and in the disappointing real incomes of too many American families.

Bolstering the supply of saving available to support productive private investment must be a priority for fiscal policy, and in that regard, reducing the call of the federal government on the nation's pool of saving is essential. Federal expenditure restraint is, in turn, crucial to this goal.

We also must recognize that private decisions about saving and investing can be powerfully affected by how various economic and financial transactions are taxed. Establishing the optimal structure of taxation is no simple matter, and there are inevitable conflicts among goals.

I would hope that any changes in taxation passed by the Congress in the coming months would give a heavy weight to promoting the capital formation process. In general, special attention should be given to the issue of the taxation of capital income. Our current system already does provide some incentives for saving in certain forms, such as retirement accounts or home equity, through favorable treatment of capital income. But in other areas the incentives are nonexistent or, worse, negative. As a more general matter, the structure of corporate taxation has long been recognized as distortive, and as an ingredient in the movement toward excessive leverage that we witnessed in the past decade.

As I have argued previously before this Committee, a reduction in the capital gains tax would be quite helpful. It is especially important considering our current difficulties with weak real estate property values. A capital gains tax cut would buoy property values, which would alleviate in part the collateral shortfalls that plague our financial institutions. This could induce greater financial intermediation and balance sheet liquification.

How far, and how fast, we can move toward a tax structure more conducive to capital formation is ultimately a political decision. My purpose this morning is not to advocate a particular agenda, but rather to suggest some principles that I think relevant to your deliberations. While I believe those principles--which relate basically to how fiscal policy can best contribute to the achievement of productivity, growth and higher living standards--are germane at all times, they may be of particular importance in today's economic circumstances. Traditional fiscal stimuli might provide a temporary boost to aggregate demand. But, if you accept the view that it is the concern of the American people for our long-term future that is at the root of our problem, then other instruments of policy might well be more effective.

Market forces are already addressing our stretched balance sheets. Record issuance of equity in our capital

markets recently is contributing to deleveraging. And large bond issues are funding short-term debt and removing some of that strain. Finally, lower interest rates, as I indicated earlier, are lowering the debt service burden.

We have made a good deal of progress in the balance sheet adjustment process, and the payoff in the form of an easing of unusual restraint should begin to become evident in the reasonably near future. American industry is striving to enhance efficiency and competitiveness. The resulting increases in productivity, more than anything else, should dissipate the concerns of the American people about our economic future. Tax policy, in my judgment, should endeavor to reinforce these underlying trends.

In summary, then, an analysis of both the special factors affecting the economy at present and of the requirements for healthy growth of productivity and for international competitiveness over the longer run suggests that any changes made to the tax code should give considerable emphasis to the encouragement of long-term economic growth through incentives for saving and investment. Above all, we must not lose sight of the crucial need to eliminate the structural deficit in the federal budget over the coming years.

Thank you, Mr.Chairman.