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THE 1991 ECONOMIC REPORT OF THE PRESIDENT

FRIDAY, JANUARY 4, 1991

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 10:45 a.m., in room SD-628, Dirksen Senate Office Building, Hon. Paul S. Sarbanes (chairman of the committee) presiding.

Present: Senators Sarbanes and Symms.

Also present: Stephen A. Quick, executive director; William Buechner, Steve Baldwin, Lee Price, Joe Cobb, and Chris Frenze, professional staff members.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

Senator SARBANES. The committee will come to order. Our second hearing this morning will examine the health of the unemployment insurance system.

If the current recession, which we are now experiencing, is no worse than the postwar average, employment will fall by almost 2.5 million before the economy begins to recover. That is assuming it is no worse than the average. During that time, millions of workers will lose their jobs and experience at least some period of unemployment. It is clear that for the first time in a major turndown since probably the Great Depression the job losers will include not only blue-collar, production-line workers and construction workers, but a large number of white collar and service workers whose jobs, generally speaking, were relatively secure in previous recessions.

For all of these workers and their families, blue- and white-collar workers alike, the social safety net consists almost exclusively of the unemployment insurance system. We want to look today at the question of whether the unemployment insurance system is ready for this recession. For workers, the key question is whether the system will provide benefits adequate to keep them and their families out of poverty and to carry them over into new jobs. During the 1970's, almost all job losers were helped by unemployment insurance benefits. Today it is barely two-thirds. These are job losers. In the 1970's, two-thirds of all unemployed workers were covered by unemployment insurance. Today, it is barely one-third.

A second question, in addition to the people covered by the unemployment insurance system, concerns the duration and the adequacy of benefits. In the last two recessions, regular unemployment benefits were supplemented by both an extended benefits program

and a program of Federal supplemental benefits. Today the trigger rate for the extended benefits program is set so high that not a single State qualifies currently under this program. And, the supplemental benefits program was eliminated during the 1980's. The question then is without the support of these additional programs whether benefits will be adequate to workers' needs.

Finally, there is the question about the health of the unemployment insurance system as a whole. Unemployment insurance benefits are paid out of trust funds which build up reserves during periods of expansion. The question is, Are the current reserve levels adequate to fund benefits during the coming recession, or would a long recession force the States either to cut benefits or raise payroll taxes or borrow from the Federal Government in order to fund their unemployment insurance systems?

We are very pleased this morning to have three expert and qualified witnesses to discuss this matter: Mr. Gary Burtless who is a senior fellow at the Brookings Institution; Mr. Michael Deisz who is president of the Interstate Conference of Employment Security Agencies and is himself the executive director of the Jobs Service for the State of North Dakota; and Mr. Wayne Vroman who is a senior research associate at the Urban Institute.

At this point, I will recognize my colleague, Senator Symms, for his opening statement.

OPENING STATEMENT OF SENATOR SYMMS

Senator SYMMS. Mr. Chairman, I will be very brief. I am looking forward to hearing the witnesses. However, I did want to make just a comment or two, because I have another meeting. I may have to leave before the question period comes.

I want to first welcome all three of you here to the committee. I hope that you will address this question: Would it not be good for our economy at this point in time to reduce the payroll tax and the rate of taxation on capital assets or the capital gains tax simultaneously, taking the added boost of the new generation of revenue from the capital gains tax to pay for the reduction in the payroll tax so we would encourage more growth in jobs and get back on a program of encouraging growth and productivity in this country rather than discouraging it?

I hope you can address that in your statements. Thank you, Mr. Chairman.

Senator SARBANES. Mr. Burtless, we will hear from you and then we will go to Mr. Deisz and then Mr. Vroman. We are pleased to have all of our witnesses with us this morning.

STATEMENT OF GARY BURTLESS, SENIOR FELLOW, THE BROOKINGS INSTITUTION, WASHINGTON, DC

Mr. BURTLESS. Thank you, Mr. Chairman, for the invitation to appear this morning.

Senator SARBANES. If you would please pull that microphone closer to you, I think it would be helpful.

Mr. BURTLESS. OK. I prepared a longer statement giving my views on the questions raised in your letter of invitation, but I only want to give a brief summary of those views right now.

Senator SARBANES. The prepared statement will be included in the record.

Mr. BURTLESS. The economy now appears to be entering a recession, but its unemployment insurance system, the main program protecting jobless workers against the effects of recession, has emerged from the 1980's battered and worse for wear. The percentage of unemployed workers collecting unemployment benefits is lower than it has ever been at the outset of a recession.

The fraction of long-term unemployed who can expect to collect benefits is far below the fraction which received benefits in recessions over the past two decades.

Senator SARBANES. I think you need to pull that microphone even closer.

Mr. BURTLESS. Finally, the aftertax value of an unemployment check is sharply lower than its value in any of the past four recessions.

In the remainder of my remarks, I would like to briefly comment on these developments and to suggest some possible congressional responses to them. Let me begin by reminding you of the unemployment system's two main functions.

First, it offers essential income protection to those who temporarily lose their jobs. For many low-wage workers, the program provides an important buffer between their families and poverty. And, this is particularly true in the case of workers suffering from long-term unemployment.

Second, by helping to sustain the consumption of unemployed workers, the program gives a needed boost to consumer expenditures in the midst of a downturn. Unemployment insurance is one of the economy's most important automatic stabilizers. Spending climbs rapidly when the economy falls out of bed, and it shrinks almost as fast when the economy recovers.

Adverse trends during the 1980's eroded the value of unemployment insurance, both as income protection for the unemployed and as an automatic stabilizer. Let me discuss four of these adverse trends.

First, roughly one-fifth fewer unemployed job losers are collecting regular unemployment insurance benefits than we would expect based on the historical experience before 1980. The impact on the percentage of all unemployed collecting some type of benefits is shown in figure 1, which I included in my prepared statement.

The lower broken line in the diagram shows the percentage of unemployed collecting benefits under regular State programs. As you can see, this percentage drifted downward between 1950 and 1980 primarily because of the changing composition of employment and unemployment in this country.

Compared to jobless workers in the 1950's, the unemployed in the 1970's were more likely to be young, to be new labor market entrants or reentrants or to be employed in industries where it's tougher to get an unemployment check.

All of these factors contributed to a decline in unemployment insurance coverage that was not particularly worrisome. When workers who were supposed to be covered by unemployment insurance lost their jobs, they generally got a check. To show this, I have pre-

pared a graph, figure 2 in my prepared statement, giving the percentage of job losers who receive unemployment insurance benefits.

In particular, the graph shows the number of unemployment insurance claimants under the basic 26-week program for every 100 job losers who have been unemployed for 26 or fewer weeks. Job losers are the main group the program is supposed to insure, and it turns out that the relationship between this job loser rate and the number of people collecting regular unemployment insurance benefits is very strong.

Between 1967 and 1980, there were roughly 108 regular unemployment insurance claimants for every 100 people who had lost their jobs within the last 26 weeks and remained unemployed. The percentage moved a bit over the business cycle, rising at the start of a recession. But, the relationship was otherwise very stable.

Beginning in late 1980, as you can see in the graph, the pattern changed. The number of unemployment insurance claimants plunged compared with the number of job losers. It reached an all time low in the third quarter of 1984 when there were only 71 unemployment insurance claimants per 100 short-term job losers.

Since 1984, this ratio has improved a bit and it now stands at about 85 claimants for every 100 people who lost their jobs in the last 26 weeks and remain unemployed. This is well below the ratio that we saw before 1980.

So, why did the fraction of collecting benefits tumble? There is no single reason that explains everything. But, I think the biggest reason is that both the State and the Federal Government raised eligibility standards for benefits or otherwise cut benefits so that they would seem less attractive to the unemployed.

Most of these changes occurred at the State level when many States found themselves struggling to restore the solvency of their systems when they ran into funding problems in the 1980's.

A second worrisome trend is related to the first one. As a result of the drop in the fraction of job losers collecting unemployment benefits, there has been a corresponding drop in the insured unemployment rate, the IUR, relative to the civilian unemployment rate. The relationship between these two measures of unemployment is shown in figure 3 of my prepared statement.

As you can see, the two indexes drifted apart for a long time before 1980, though this drift can easily be explained given the changing composition of employment and unemployment in the country. After 1980, however, the growing gap between the IUR and the TUR, the total unemployment rate, was entirely attributable to the rapid decline in the number of jobless workers collecting benefits.

The relative drop in the IUR would be of only academic interest except for one thing. It is the index used to trigger extended unemployment benefits in a recession. Extended benefits provide the long-term unemployed with an extra 13 weeks' benefits when high unemployment in a State makes it very hard to find a job.

As a result of the growing gap between the IUR and the TUR, the extended benefit program seldom triggers on except when State labor markets enter almost depression conditions. Unlike the big insurance company that claims "we will be there," it is probable in

the next recession that the extended benefit program will not be there.

The situation can be compared to that of a faulty thermostat on your air conditioner, one that is off by about 20 degrees. The radio says it's in the upper 90's. Outside, your flowers are wilting and the grass is turning brown. Your children are laying down in heat prostration. But, when you check your thermostat, it says it's a comfortable 70 degrees. That's why the air conditioner doesn't click on.

The broken thermostat will certainly save you a lot of money over the course of a hot summer, but it will not keep the house very comfortable. The IUR is like the broken thermostat; it takes a lot of unemployment before this particular thermostat registers recession.

Your typical homeowner might either junk the thermostat or at least change the setting where the air conditioner clicks on. But, we have done neither with the extended benefit trigger.

In fact, in the early 1980's the administration and Congress reformed the trigger so that it takes a higher insured unemployment rate to turn on the extended benefit program. In my prepared statement, I suggest some alternative triggers to restore the extended benefit program to better health.

A third trend worth mentioning is the transformation of unemployment benefits from a completely tax-free form of income to one that is completely taxed. From 1935 to 1978, your unemployment check was an untaxed form of income like many other kinds of transfer benefits. Beginning in 1979, some or all benefits for high-income families were subject to taxation.

In 1983, the tax thresholds were lowered in the midst of a recession, so more families paid taxes on their benefits. And, the Tax Reform Act of 1986 subjected all compensation in income tax starting in 1987.

I should say right off that I entirely approve of this treatment of unemployment compensation in the Tax Code. Since workers pay no taxes on contributions to the unemployment insurance trust fund, it seems equitable to charge them taxes when they receive benefits from the fund.

On the other hand, taxing benefits is equivalent to reducing their value by 15 to 20 percent, depending on the recipient's tax bracket. Since States did not raise benefit levels when we imposed these taxes, workers in the next recession will essentially receive weekly benefits that are 15 to 20 percent smaller than workers received in the 1974–76 recession and perhaps 8 or 12 percent smaller than net benefits paid out in the 1980–82 recession.

A fourth and final development worth noting is the trend in Federal budget control. The Budget Enforcement Act, passed last October, has made it significantly harder to fund the administrative costs of unemployment insurance during a recession.

If unemployment should shoot up in the current fiscal year, the Department of Labor will have to ask for a supplemental appropriation to pay for the administration of the extra benefit checks. Unlike previous recessions, however, the Appropriations Committees will have to find the extra funds by cutting spending somewhere else in the domestic discretionary accounts.

For some odd reason, unemployment insurance benefit payments are considered an entitlement, but the administration of the payments is considered a discretionary domestic account.

While I certainly hope that Congress and the President will eventually come up with the extra money if it should be needed, the new budget rules will make it more difficult because you will have to identify programs that you want to cut at the same time you increase this administrative funding. Let me close with an overall assessment.

The situation is certainly not all bad. I even see hopeful signs. State unemployment insurance trust funds are healthier than they were at the beginning of the last recession.

The fraction of unemployed job losers collecting benefits is up in the past 2 or 3 years compared with the abysmal levels reached in the mid-1980's. The administration of the program appears to me to be more efficient than ever.

But, as a result of the ominous developments I mentioned earlier, the unemployment insurance system enters this recession a 97-pound weakling. The combined effects of the lower coverage rate, the taxation of benefits, and the virtual elimination of the extended benefit program can be stated fairly simply.

Compared with recessions in the 1970's and 1960's and 1950's, unemployment insurance now provides about one-third less income protection and countercyclical stimulus. At a minimum, Congress should reverse one of these trends by improving the trigger mechanism for extended benefits.

Whatever improvements it chooses, Congress should turn its attention to this problem soon. They system badly needs a boost if its economic usefulness is to be restored.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Burtless follows:]

PREPARED STATEMENT OF GARY BURTLESS[1]

THE ADEQUACY OF UNEMPLOYMENT INSURANCE FOR THE COMING RECESSION

Overview

The nation's unemployment insurance system serves two essential functions. It offers workers critical income protection during temporary spells of unemployment. And by helping to sustain the consumption of jobless workers, it gives the economy a needed counter-cyclical boost during periods of high national unemployment. Changes in the system over the past decade have reduced the adequacy of unemployment benefits and diminished the effectiveness of the program as an automatic stabilizer. The percentage of unemployed now collecting insurance benefits is one-fifth to one-quarter below levels that were typical before the 1980s. Moreover, the value of unemployment insurance shrank in the 1980s as a result of the decision to make benefits taxable. In the short run, Congress and the President should shore up the system by reforming the way we provide extra benefits to the unemployed in slack labor markets. Over the longer term, the program should be strengthened by reform of its financial structure and greater equalization across states of eligibility and benefit formulas.

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[1] Senior Fellow, The Brookings Institution, Washington, D.C. I am grateful to Suzanne Smith of Brookings for providing exceptional help in preparing this testimony. The views expressed are solely my own and should not be ascribed to the staff or trustees of the Brookings Institution.

Declining UI Coverage

In the 1980s unemployment rose to new post-war highs, but the share of unemployed workers drawing unemployment benefits fell to new lows. The percentage of jobless workers collecting benefits has risen modestly in the past two years, but still remains well below the level prevailing before the mid-1980s (see Figure 1).

The proportion of unemployed collecting benefits has declined for several reasons. First and most important, fewer unemployed workers now apply for benefits when they lose their jobs. In part the drop in applications is due to a change in unemployment insurance eligibility requirements, which are established both at the state and national levels. In addition, some unemployed workers may have decided against applying for benefits as the after-tax value of these benefits fell. Finally, the nature of unemployment has changed over time.

The unemployed are now drawn from different industries, geographical areas, and demographic groups than was the case through much of the post-war period. For example, as the nation's population has moved toward the south and west and out of the northeast and midwest, a shrinking fraction of the unemployed have held jobs in states with liberal eligibility requirements. Workers losing their jobs in many southern and western states are less likely to collect benefits than jobless workers in the northeast and upper midwest. (The recent jump in the fraction of jobless collecting benefits is partly due to the sharp increase of unemployment in New England and the mid-Atlantic states, where liberal eligibility requirements are common.) However, careful analysis of the regional distribution of unemployment has shown that this factor can explain only a small part of the decline in insurance coverage over

the past decade. The percentage of jobless workers collecting unemployment insurance payments has dropped in every region and nearly every state in the union.[2]

A much more important reason for the drop in the percentage of unemployed collecting benefits is the change in UI law and regulation that has occurred since 1976. Some important legal changes occurred at the federal level, but many changes were instituted at the state level as state governments responded to shortfalls in their unemployment insurance trust funds by scaling back on benefits. Many of these changes affected the eligibility of unemployed workers to receive insurance benefits. For example, several states have increased their base period earnings requirements, reducing the chances that part-time or intermittently employed workers will become insured. Workers receiving pensions or severance pay are also more likely to be denied insurance benefits or to receive smaller benefits when they qualify.

State UI Reserves

Why did so many states take the unprecedented step of tightening eligibility requirements in the midst of a severe recession? One reason is that most states entered the 1980-82 recession with relatively small trust fund reserves. As the trust funds were exhausted, state legislatures were forced to raise payroll taxes or slash benefits in order to restore their programs to solvency. In the previous recession of 1974-76, many states had freely borrowed from the federal Treasury to keep benefit payments flowing.

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[2] Gary Burtless and Daniel Saks, The Decline in Insured Unemployment During the 1980s, Brookings Economic Discussion Paper (Washington, DC: The Brookings Institution, 1984). For an analysis of the effects of industrial and economic shifts, see Walter Corson and Walter Nicholson, "An Examination of Declining UI Claims During the 1980s," Unemployment Insurance Occasional Paper 88-3 (Washington, DC: U.S. Department of Labor, 1988).

But under legislation passed in 1981, the Treasury began imposing interest charges of up to 10 percent a year on new borrowing. The interest charge placed greater pressure on states to take immediate steps during a recession to ensure that their trust funds did not fall far out of balance.

States were not obligated to restrict eligibility or slash benefits, of course. They might have raised the payroll taxes imposed on employers. In fact, many states did so. But in the anti-tax climate of the last decade, it became difficult for legislators to raise taxes enough to keep their systems financially healthy. Moreover, as labor unions have weakened, the voice of ordinary working people has become much fainter in most state capitols. The views of business lobbying groups remain very influential. The net result is a bias against raising taxes and in favor of restricting benefits.

One hopeful aspect of the current situation is the relatively strong condition of most state UI trust funds. This is primarily the result of the very long economic recovery over the second half of the 1980s rather than a carefully considered policy on the part of state governments. An analysis by the Department of Labor's Unemployment Insurance Service shows that most states are entering 1991 with healthier reserves than was the case in 1980. Thus, state legislators will not find themselves pressed to trim benefits quite so early in the next recession. Nonetheless, reserves are lower than they were at the start of the 1970 and 1974-76 recessions, and the anti-tax climate is even stronger at the state level today than it was in the early 1980s. If state trust funds face insolvency during the next couple of years, I expect that many state governments will turn to the same remedy they used in the 1980s: restrictions on UI eligibility.

Whether states decide to raise taxes or reduce benefits, however, the

macroeconomic consequences will be the same. If legislatures act to shore up UI reserves in the middle of a recession, the counter-cyclical stimulus provided by the program will be reduced. The appropriate time to boost reserves is during an economic expansion, not a contraction, but the anti-tax climate of the 1980s worked against the accumulation of adequate reserves.

Taxation of Benefits

In addition to legal changes that directly affected workers' eligibility, several other changes reduced the value of benefits and hence the attractiveness of applying for compensation during very short spells of joblessness. An analysis by the House Ways and Means Committee, for example, suggests that federal taxation of UI benefits reduced their value to unemployed workers by 16 percent.[3] Because most states with an income tax system use the same tax base defined in the federal system, many UI claimants now pay state as well as federal taxes on their benefits. Thus, the combined income tax rate on unemployment insurance benefits probably ranges between 18 and 20 percent.

Although it is certainly equitable to include UI benefits in the tax base, until 1979 unemployment compensation was exempt from all income taxes, and between 1979 and 1986 benefits were taxable only for taxpayers with incomes above certain thresholds.[4] Since states did not raise benefit levels when UI was made taxable, the taxation of benefits is equivalent to a benefit cut of at least 16 percent and possibly as much as 20 percent. The benefit cut not

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[3] Committee on Ways and Means, U.S. House of Representatives, 1990 Green Book (Washington, DC: U.S. Government Printing Office, 1990), pp. 467-68.

[4] The Revenue Act of 1978 taxed UI benefits received by some middle-income and all high-income taxpayers, while the Tax Act of 1982 (TEFRA) reduced the income thresholds for taxation of benefits to $12,000 for single filers and $18,000 for married couples filing jointly. The 1986 Tax Reform Act made all unemployment compensation subject to taxation under the personal income tax.

only reduces income protection offered to jobless workers, it also diminishes the effectiveness of unemployment insurance as a counter-cyclical stabilizer. I suspect that it also deters some unemployed workers from applying for benefits.

Trends in Coverage under State UI programs

The percentage of jobless workers collecting *regular* UI benefits has dropped by roughly 20 percent compared with the level that prevailed before 1980. This estimate is based on analysis of trends in the percentage of unemployed workers who are most likely to be eligible for benefits under the rules in effect before the 1980s. In the U.S. system of unemployment insurance, benefits are not provided to all jobless workers. New labor market entrants and most reentrants into the job market are not eligible to receive benefits, because the program insures only those workers with recent employment in a covered job. In addition, workers who voluntarily leave their jobs may not be eligible for benefits or may be eligible only after a specified waiting period, such as 6 or 10 weeks. This means that the overwhelming majority of workers eligible for benefits will be those who are unemployed because they are on temporary layoff or because they involuntarily lost their last jobs. Under the main state unemployment insurance programs, jobless benefits are limited to the first 26 weeks of a spell of unemployment. Thus, the group of unemployed most likely to be insured are involuntary job losers who have been unemployed for fewer than 27 weeks.

Figure 2 shows the number of regular unemployment insurance claimants measured as a percentage of the number of involuntary job losers unemployed fewer than 27 weeks. In previous research, I found that this coverage ratio

remained quite stable over the thirteen years from 1967 through 1979.[5] Over that span of years, there were about 108 recipients of regular state UI for every 100 job losers unemployed less than 27 weeks. This ratio fluctuated somewhat over the business cycle, as can be seen in the figure, but it was otherwise quite stable. (In fact, the ratio was probably stable even before 1967, although this cannot be known with certainty because the BLS did not collect information on the number of job losers before that year.)

Beginning in 1980 the ratio of regular UI recipients to short-term job losers fell very sharply. This coverage ratio reached an all-time low in the third quarter of 1984, when it fell to just 71 insurance recipients for every 100 job losers. Since 1984 the coverage ratio has recovered somewhat, until now there are about 85 regular UI claimants for every 100 short-term job losers. In spite of its recent recovery, however, the ratio remains well below its level before 1980 and even below its level during the 1980 recession. If we are now entering a recession, it is one in which the unemployment insurance system could provide benefits to a historically low percentage of job losers.

Extended UI Benefits

The extended benefit UI program offers additional insurance protection beyond 26 weeks of unemployment for workers who have exhausted regular benefits and who live in states with high unemployment. The drop in the percentage of unemployed job losers collecting regular benefits has directly affected the insured unemployment rate (IUR), which serves as the basis for triggering extended UI benefits. If I am correct in estimating that the number of regular

[5] Gary Burtless, "Why Is Insured Unemployment So Low?" Brookings Papers on Economic Activity, 1983:1; and Gary Burtless and Wayne Vroman, "The Performance of Unemployment Insurance Since 1979," Proceedings, Industrial Relations Research Association, 1985.

UI claimants has fallen by one-fifth, then the IUR is also about one-fifth too low relative to the civilian or total unemployment rate (TUR), which provides a more accurate gauge of current labor market conditions.

The relationship between the insured and total unemployment rates is shown in Figure 3. Although the two rates tend to move in parallel fashion over the business cycle, they have drifted apart since 1955. Before 1980, this drift could be easily explained by the changing composition of the civilian unemployed -- who were younger, less likely to be job losers, and increasingly drawn from industries with low levels of insurance coverage -- and by changing regulations about the insurance coverage of employed workers.[6] After 1980, however, the sharp decline in the IUR relative to the TUR has been almost entirely due to the sharp drop in the fraction of new job losers collecting benefits.

As a result of the drop in the IUR, the extended benefit program has shrunk into insignificance. When the employment situation in a state deteriorates, its total unemployment rate rises, but its insured unemployment rate often does not rise by enough to trigger extended benefits. The result is that the extended benefit program either fails to trigger on or triggers on late in an economic downturn. Moreover, even where extended benefits are available, the IUR can be expected to fall below the critical threshold relatively early in an economic recovery. Many beneficiaries are thus dropped from the insurance rolls even though the job market remains very weak.

The extended benefit program also contracted over the past decade because of significant changes in federal law passed in 1981. Before 1982 the extended benefit trigger rate was computed by including recipients of both regular and

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[6] See Burtless, "Why Is Insured Unemployment So Low?", pp. 233-34.

extended benefits in the count of insured unemployed. (Thus, the trigger rate used before 1982 was not identical to the IUR, which excludes recipients of extended benefits from the numerator.) Since extended benefit recipients are now excluded, the level of insured unemployment needed to trigger the extended benefit program has effectively been raised. Also, before 1981 the extended benefit program could be triggered in all states if the national insured unemployment trigger rate exceeded 4.5 percent. The national trigger rate was eliminated by the 1981 legislation. Beginning in October 1982, extended benefits have been available only in states in which the IUR exceeds 5 percent and is at least 120 percent of the rate over the previous two years. Some states also provide benefits when the IUR reaches 6 percent, regardless of the rate in previous years. These trigger rates are one percentage point higher than the comparable rates in effect before 1982.

The legislative reforms of 1981, along with the sharp drop in the number of regular UI claimants, had a calamitous effect on the extended benefit program. At the end of 1982, when the civilian unemployment rate reached a post-war high, only fourteen states with particularly high insured unemployment rates offered extended benefits. By October 1983, with unemployment still hovering above 9 percent, only two states and Puerto Rico offered extended benefits. In contrast, during the 1974-76 recession, when unemployment was lower, all 50 states offered extended benefits for prolonged periods. As a practical matter, the extended benefit program no longer operates as an effective counter-cyclical stabilizer. Except in extraordinarily severe recessions, the program is unlikely to offer benefits to a sizable number of workers.

Administration of UI

The nation's UI system will enter the next recession under budgetary rules that can impede needed spending on routine program administration. The Budget Enforcement Act passed last October fundamentally altered the enforcement of spending limitations, first enacted as part of the Gramm-Rudman-Hollings legislation. The new enforcement mechanism affects unemployment insurance administration in two ways. First, it changes the way budget targets for UI spending will be made for future fiscal years. And second, it reduces the flexibility of Congress to respond to a surge in UI applications after the fiscal year has begun. In my view, the second effect is more serious, and I will devote a little time to discussing it here.

UI administrative costs are classified as "discretionary domestic spending" in the new budget scheme adopted by the last Congress. (Benefit payments are counted as entitlements; they are permitted to climb if the economic situation deteriorates.) If the nation's employment situation turns out worse than forecast when the current budget was adopted, the amount of money needed to pay for program administration will almost certainly have to climb. The Department of Labor would be required to request a supplemental appropriation for UI administration, as it has been forced to do in 10 of the last 18 years.

Under the new enforcement mechanism, however, the Appropriation Committees are forced to find the additional funds by reducing appropriations under other accounts in the domestic discretionary budget. Of course, this will make the extra funds much harder to obtain than was the case under the Gramm-Rudman-Hollings Act, where no budget cuts were required within the current fiscal year. The President can designate a supplemental request an "emergency

requirement," thus exempting it from the spending cap. But I have no reason to believe this would be likely. As a practical matter, the current legal environment makes it more difficult for the federal government to appropriate extra money for UI administration if rising insurance rolls should make that necessary.

Policy implications

An important implication of these developments is that the unemployment insurance system has become a much weaker source of counter-cyclical stimulus during economic downturns. The effectiveness of the extended benefit program has been cut at least in half as a combined result of the legislative changes passed in 1981 and the continued weakness of the IUR as a measure of the labor market situation. The stimulus provided by the regular 26-week program has dropped by one-fifth because of the decline in the number of claimants relative to the number of unemployed job losers. And the stimulus provided under both the regular and EB programs has dropped by an additional 15-20 percent since 1978 as a result of the taxation of benefits. ***In comparison with the level of counter-cyclical stimulus available during the 1960s and 1970s, the stimulus provided by the current system has dropped by at least a third.*** The income protection available to jobless workers has dropped by a similar amount.

Reform of extended benefit trigger. Because the IUR is a poor indicator of the condition of the job market, it is a faulty instrument for triggering state-level extended benefit programs. Any substitute for the IUR in triggering extended benefits must meet three criteria. It must specifically reflect the labor market situation of workers insured by the program. It must be available in a timely manner, either weekly or monthly. And it must be available on a state-by-state basis. The total unemployment rate and the job

loser rate (the number of job losers as a percentage of the civilian labor force) meet the first two of these criteria much better than the IUR. Unfortunately, neither index meets the third criterion. Except in the eleven largest states, the BLS does not produce accurate estimates of state-level unemployment or job loser rates. (The Current Population Survey, which is used to obtain the main unemployment statistics, is simply too small to permit accurate estimation of unemployment in the 39 smallest states.)

Given present limitations in state-level unemployment data, the best trigger mechanism must depend on a combination of information about overall unemployment, as reflected on the Current Population Survey, and state-level insured unemployment, as indicated by the IUR or some other statistical series maintained by state UI systems. One possibility is the Bureau of Labor Statistics' estimate of monthly or bi-monthly state-level unemployment rates. This estimate is available on a timely basis, although it suffers from somewhat questionable reliability. As a practical matter, I would suggest that we rely on the BLS estimate of the *national* unemployment rate to determine the *national average* duration of extended benefits. When the national total unemployment rate rises above, say 6.5 or 7 percent, states could be required to offer at least four weeks of extended benefits. States with BLS-estimated unemployment rates above, say, 7.5 percent would be obligated to offer two weeks extended benefits in addition to the minimum of four. States with BLS-estimated rates above 8 percent would be obligated to offer an additional two weeks, and so on.

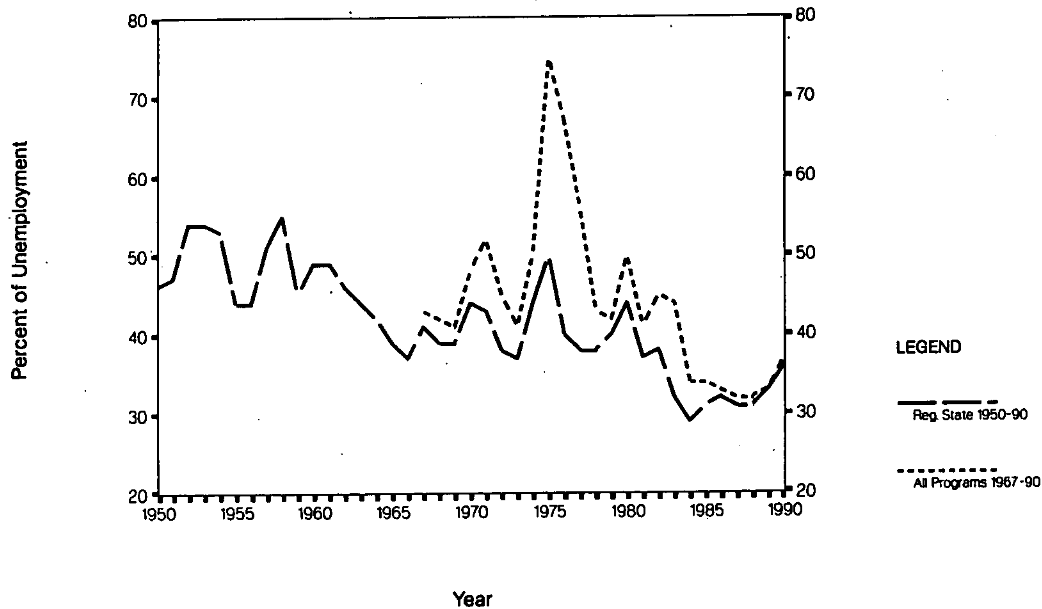
As an alternative to this rather complicated system, the extended benefit program could be triggered by the percentage of regular UI claimants in state who exhaust benefits. When the percentage of exhaustees rises, there is good

evidence that the state suffers from a weak job market. Either of these alternatives would represent an improvement over the current trigger mechanism. Their main advantage is that they would prevent a recurrence of the experience of the early 1980s, when the extended benefit program shrank even as unemployment -- especially long-term unemployment -- rose to new post-war highs.

Long range reform. In the long run it would be worthwhile to consider alternatives to the current method of financing unemployment insurance and of setting eligibility requirements and benefit levels. Experience over the past 15 years suggests that state legislatures are reluctant to build up their UI reserves during economic expansions by enough to weather deep recessions. When a severe recession occurs, state governments often resort to immediate payroll tax hikes or benefit cuts to keep their programs solvent. Either action reduces the effectiveness of unemployment insurance as an automatic stabilizer. A benefit cut also adds unnecessary hardship to the plight of the unemployed. The long-term remedy to this problem is to give states substantial incentives to build up their trust fund reserves during good times, for example, by penalizing states with low reserve ratios if their unemployment rates have remained low over several years.

A vital task for policymaking in the coming year is to restore the ability of the nation's unemployment insurance programs to deal with severe recession. A worthwhile beginning to this task would be a thorough overhaul of the triggering mechanism for extended unemployment benefits.

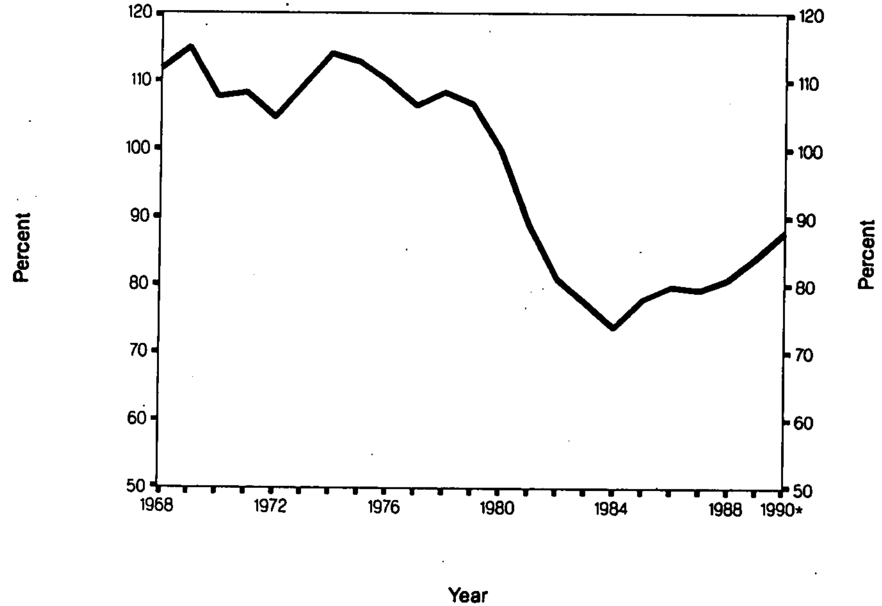
Figure 1. Unemployment Compensation Weeks Claimed as a Percent of Total Unemployment for Regular State Programs and All Programs



"All programs" include state UI, UCFE, UCX, RR, EB, FSB, SUA, and FSC.
Source: DoL/ETA/UIS

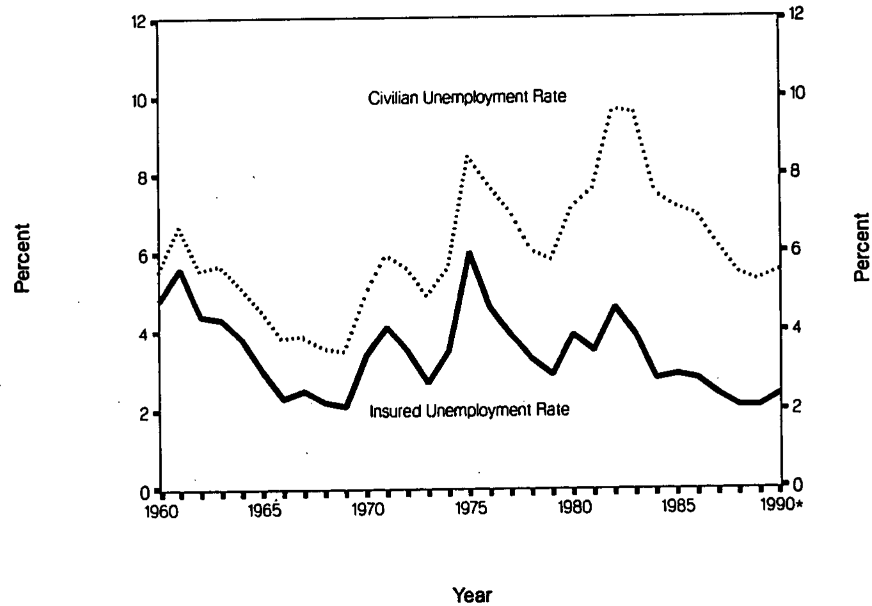
Figure 2. Unemployment Insurance Coverage Ratio

Covered by Regular Benefits / # of Short-term job losers



*Through September 1990

Figure 3. Insured Unemployment Rate Versus Civilian Unemployment Rate



*Through September 1990

Senator SARBANES. Thank you very much. Mr. Deisz, please proceed.

STATEMENT OF MICHEAL V. DEISZ, EXECUTIVE DIRECTOR, JOB SERVICE, STATE OF NORTH DAKOTA, AND PRESIDENT, INTERSTATE CONFERENCE OF EMPLOYMENT SECURITY AGENCIES

Mr. DEISZ. Thank you, Mr. Chairman. My comments are going to be a summary also of my prepared statement.

Senator SARBANES. Well, the prepared statements of all of the panelists will be included in the record.

Mr. DEISZ. Thank you. And, I will be focusing, Mr. Chairman, on the administrative end of the unemployment insurance program.

And as we begin to see the increases in unemployment that Mrs. Norwood and others referred to earlier, it is our position that the Federal State unemployment compensation system is not prepared to deal with the substantial increases in claims filing that we are already seeing and the additional significant increases that we anticipate in the near future.

We are probably looking right now at a shortfall somewhere in the neighborhood of $150 to $180 million if the basic projections hold up. During the month of October, the Department of Labor notified the individual States that the estimate of the average number of weeks claimed, which drives the budgeting process, had increased from 2.54 million per week, resulting in a shortfall at that time of about $84 million. That estimate didn't include the anticipated $10 million increase in postage nor the $49 million across-the-board reduction that that program took along with the rest of the Labor, Health and Human Services, and Education budgets.

As I mentioned before, we anticipate that shortfall will increase into the neighborhood of $150 to $180 million dollars.

The whole problem, as we see it, has to do with the funding process itself. State agencies are funded based on projected workload. If that workload, the actual workload, exceeds expectations, there is provision for some contingency funding. However, that amount for additional claims is limited by the budget process.

And, once the collective increases of the States pass that ceiling, there are only two options left. One is a supplemental appropriation and the other is to reduce the payoff rate to the State agencies.

I would like to, Mr. Chairman, just review very quickly what happened in the fiscal year we just completed and what is occurring right now. In December 1990, the Department of Labor, in response to the revised economic projections which showed a significant workload increase, reduced the base allocations of the individual States by 6.7 percent to free up money to deal with the increased claims loads.

As workloads were increasing, some States were actually reducing staff. This resulted in a deterioration of service, both in terms of quality and timeliness.

The administration took the position that there would be no supplemental request. The Interstate Conference, along with representatives of business, labor and other organizations, worked with

the Congress, and the Congress did provide $100 million in supplemental funds during the month of May.

However, that was really about 6 months after the crisis had occurred. In the interim, for that 6-month period, people had to stand in long lines, experienced delays in claim filing. In addition, error rates that drive up the employer's cost increased in some States.

As we go into the current fiscal year, which started on October 1, as the budgeting process was taking place, the workloads were increasing. However, with the rules in the budget as they were, any increase in the unemployment insurance budget would have resulted in a decrease elsewhere.

Some increase was provided. However, because of the current shortfall, States that experience larger than anticipated workloads, those workloads are only going to be funded at the 75 percent level and even that is not guaranteed. There is a possibility it will be lower.

The State of Michigan, as an example, for the week ending December 22, recorded about 75,000 initial claims and the record for any week in that State's history is 81,000. So, we are experiencing some very high levels right now.

Most unemployed workers in Michigan are not receiving their first check until 4 weeks after filing their initial claim. And, that experience, I am sure, is not unique. And, that experience I think will get worse as we get further into this situation.

The situation is getting worse. The resources we have to deal with the increase in the claims filing is fixed. And, as we had indicated earlier, is already short.

Our Conference, in our formal testimony, Mr. Chairman, is recommending four actions. One, an emergency supplemental to avoid what we see as an unconscionable hardship for the unemployed. And two, that supplemental language should be included to provide such sums as necessary to process that workload.

I am sure the chairman and members of the committee are well aware that supplementals take a long time under ideal conditions to accomplish. The workload is increasing quickly and could increase beyond projections at the time that process is started.

We are recommending also that there be language provided which would include the amounts necessary to fund the workload that does occur.

Our third recommendation, Mr. Chairman, is that the costs for administering the unemployment insurance program be switched from the discretionary category to the mandatory category. And, our fourth recommendation in the longer term, from both an administrative funding standpoint and also from the standpoint of coverage of workers, that the Federal unemployment trust fund, both the accounts that house and maintain the State unemployment compensation trust funds as well as the administrative accounts, be removed from the Federal budget deficit calculations.

The reason for that is that, No. 1, the program is funded by a dedicated tax. The collections are currently more than adequate to meet the needs that are there.

However, in the process that it has gone through right now, those taxes are income on the one side. They can be used for unemployment insurance purposes only. However, the collections do pro-

vide budgetary authority elsewhere if they are not used for that purpose.

So, we feel that the budgeting process, the deficit calculation process, drives the administrative policy and keeps the funding at a level that is below what is necessary to maintain an effective program. We also maintain that the budgeting process drives the coverage issue on the unemployment compensation program itself.

An example of this is that one of the considerations during the last budgeting process that was not adopted was the consideration to have a mandatory 2-week waiting period for each individual who filed for unemployment insurance benefits. Right now, most States have 1 week. Some do not have a waiting period at all.

The madatory 2-week waiting period, which would have been established at the Federal level, would have been imposed on the States, would have resulted in a reduction in unemployment insurance payments greater than any of the other actions that we have talked about. And, the only reason for it would have been it would have resulted in about a $1.5 billion reduction in the Federal deficit.

And, again, we feel that that process is really driving the administrative system and the quality of the program itself.

Senator SARBANES. I'm not clear on that point.

Mr. DEISZ. Yes, sir.

Senator SARBANES. Are you saying that there is a trust fund into which the unemployment tax is paid and that the money in that fund is not being used to cover these administrative costs but is being held in the fund simply to offset the deficit?

Mr. DEISZ. That's correct, Mr. Chairman. There are two taxes that employers pay for the unemployment insurance program—the Federal tax, which has a basic tax of six-tenths of 1 percent on the first $7,000 plus a temporary add on of two-tenths which has been in place for about 15 years now.

But, that money is all deposited in the Federal unemployment trust fund in three accounts: The employment security administrative account, which is available for administration but must be appropriated by the Congress before it can be used; the extended unemployment compensation account, which is used to pay the cost of extended benefits when they are triggered on and other extended programs that the Congress may adopt; and, third, an account called the Federal unemployment account, which is used to make loans to States who run short of money.

The Federal tax goes into those accounts. The administrative account itself, I believe this year, the year that we just ended, collections into that account were approximately $450 to $480 million more than was made available for administration.

And, again, we feel that is more than adequate. That is, again, if, as an example, the $1 billion that will be collected because of the two-tenths of 1 percent add-on tax, that creates budgetary authority whether it's spent directly for that program or somewhere else. So, we feel that the resources are there. The employers are paying more than enough to adequately finance the program, but the money is not being appropriated because it's part of the total deficit package.

The individual State accounts are also held in that trust fund. They also become part of the Federal deficit calculation.

And, that is why the Congress over the years has taken certain actions such as reducing the extended benefit triggers, and considered the proposal for the 2-week waiting period. Again, while it impacts the State program directly and the benefit recipients very directly, it also has a positive or negative effect on the deficit.

And, so that's a driving force. And, that's why we feel very strongly that for the program to be effective it needs to come out of that calculation process and go on its merits and the needs at the time.

As we indicated, Mr. Chairman, the system is entering the recession in trouble from an administrative standpoint. We feel we are short about $150 million right now. The unemployed workers, the employers who paid a tax and ultimately the general public will bear the impact of the fact that these resources are not provided.

I do want to make a partial response to the question that Senator Symms raised. I am not going to get into the capital gains tax issue, because I don't understand that well enough to comment on it effectively.

But, on the payroll tax, I think getting back to the point I made about the unified budget or the deficit calculation, the extension, the two-tenths of 1 percent extension, which was put in place for a 5-year period, again amounts to about $14 per worker. The fact that it's being collected and not used to administer the program that it's being collected for would certainly appear to us to be counterproductive.

I don't know how much $14 per worker means in terms of job creation, but in our State through the North Dakota Job Service Advisory Council which deals with these issues, we look at it as part of the total package, not that the one thing will turn things around but a collection of those items will. So, we would certainly advocate that collections in excess of what is needed to administer the program certainly do not create jobs and would be a positive factor if that additional tax were eliminated.

So, that brings me to my final point, Mr. Chairman. I think the real missing ingredient we've had here in this whole program is not the absence of but the inactive Federal Advisory Council on Unemployment Insurance. Somebody needs to be looking at this program ongoing, looking at changing conditions, looking at what is working and what is not. And, the tendency, absent that commitment, has been just to look at it in crisis situations as we are approaching now.

Thank you for the opportunity to speak.

[The prepared statement of Mr. Deisz follows:]

PREPARED STATEMENT OF MICHEAL V. DEISZ

Mr. Chairman and members of the Committee, my name is Mike Deisz. I am Executive Director of the Job Service North Dakota and President of the Interstate Conference of Employment Security Agencies (ICESA). ICESA is the organization of state administrators of unemployment insurance laws and public employment offices throughout the country. My colleagues and I appreciate your interest in the impact of higher unemployment on the state-federal unemployment insurance system.

ADMINISTRATIVE IMPACT

As we face a deteriorating economy, most states are not as well prepared as they need to be to serve a growing number of jobless workers. Cutbacks in federal appropriations for administration of unemployment insurance and employment services during the 1980's have left most states with fewer staff and local offices than they need. In addition, the Budget Enforcement Act has made the prospects for obtaining additional funds uncertain.

One of the great strengths of the unemployment insurance system over the years has been its ability to expand and contract in direct response to economic conditions. This flexibility has been due in great measure to reliable federal funding based on workload--the number of unemployed workers filing claims for benefits. In recent years federal funds have been greatly restricted. Since 1983, state unemployment insurance staff levels have dropped from about 57,000 to about 43,000 in the current fiscal year. Although this drop in staff has been due in part to lower unemployment, funds to maintain an infrastructure of offices and computer systems have also been reduced. Thus the unemployment insurance system enters this recession at a minimal level of staff and offices from which to expand.

The system was able to expand expeditiously in the past because federal administrative funds increased concurrently with increases in unemployment. Before Fiscal Year 1990, when claims for unemployment benefits exceeded the level on which the appropriation was based, the Department of Labor requested supplemental funds to pay for services to the additional unemployed workers. However, our experience in FY 1990 and the changes to the budget process enacted last year suggest that we can no longer rely on additional federal resources when unemployment increases, creating uncertainty in state planning and service delivery.

Let me outline our experience last year. In December of 1989, the Department of Labor notified states that although unemployment projections were higher, the Administration would make no supplemental funding request. Instead, the Department of Labor reduced the amount of basic grant funds previously allocated to states by an average of 6.7% and implemented plans to reimburse states at a reduced rate each quarter for additional workload. As a result, many local unemployment offices were closed. For example, 17 full-time offices and 45 part-time offices were closed in Indiana. There were long lines in many offices; unemployed workers waited four to five hours to file claims in Michigan, for example. Due to these obvious hardships, Congress took the initiative and provided $100 million in supplemental funds in May, 1990. These additional resources shored up the system for the remainder of FY 1990; however, the delay of almost six months meant that from January to May many unemployed workers were subjected to overcrowded offices and delays in claim filing and payments. Our own employees in these offices were pushed further than good management dictates. They put in long hours and were blamed for the overcrowded conditions by understandably frustrated unemployed workers.

We are again faced with a substantial shortfall in the current fiscal year. The current funding level for unemployment insurance is based on an estimate of 2.54 million claims per week for FY 1991. The Department of Labor notified states in October that the estimate had increased to 2.84 million claims per week, resulting in a shortfall of about $84 million. The Department's shortfall estimate does not include an estimated $10 million needed for the increase in the postage rate or the $49 million reduction resulting from an across-the-board cut in the Labor, Health and Human Services, and Education appropriation for FY 1991. As a result of the shortfall, the Department of Labor has reduced reimbursements to states for additional workload each quarter by 25%. If unemployment reaches the 6.5-6.6% levels now predicted by some private economic forecasters, claims will likely increase to 3.0-3.1 million claims per week, pushing the shortfall to $150-180 million and reducing the reimbursement rate still further.

Unless additional funds are provided, the impact of this shortfall in administrative funding for unemployment insurance in FY 1991 is likely to be similar to the impact felt in FY 1990: long lines and hours of waiting to file claims; offices closed and unemployed workers forced to drive long distances to file claims; and, most important, significant delays getting checks to unemployed workers.

ICESA has several recommendations for addressing the current shortfall which have also been supported by governors, state legislatures, organized labor, and members of the business community:

First, an emergency supplemental appropriation is needed quickly to avoid unconscionable hardship on unemployed workers. The amount of this supplemental should be determined by the most current unemployment estimates. The supplemental must be designated an emergency in order to avoid triggering a sequester on other domestic discretionary programs.

Second, language should be included in the supplemental which would provide such sums as may be necessary to process claims for unemployment which are not anticipated at the time the supplemental is adopted. This would ensure that funds would be available if unemployment should rise even higher, without the necessity of a second supplemental. Similar "contingency" appropriations language already exists for administrative costs of other benefit entitlement programs.

Third, administrative costs of unemployment insurance should be switched from the discretionary to the mandatory category. Administrative costs of the program are directly related to the economy--the level of unemployment. If unemployment insurance remains in the discretionary category, increases in the cost of unemployment insurance administration due to economic changes will either be ignored to the detriment of unemployed workers or funded at the expense of other domestic discretionary programs. By switching unemployment insurance administration to the mandatory category, these changes in cost due to economic changes and technical reestimates could be accommodated.

The current situation illustrates that the existing administrative funding arrangements for unemployment insurance are in need of an overhaul. The scarcity of funds for unemployment insurance is particularly difficult for employers, workers, and state officials to understand because a federal payroll tax, the Federal Unemployment Tax, produces revenue which is dedicated to providing administrative funds for unemployment insurance, employment services and certain veterans employment programs. These funds are held in the Employment Security Administration Account in the Federal Unemployment Trust Fund, from which appropriations for these programs are made. The Employment Security Administration Account was projected to have a balance at the end of FY 1990 of $1.64 billion, $480 million above its statutory ceiling. More than sufficient federal unemployment tax revenues are collected for unemployment insurance and employment services; however, they are held hostage like many other trust funds to the federal budget deficit. ICESA believes that a first step in reform of administrative funding for unemployment insurance and employment services is to exclude federal unemployment trust funds from federal budget deficit calculations.

STATE TRUST FUND IMPACT

During the past seven years states have repaid about $14 billion in federal loans and built up total state trust fund reserves of about $40 billion. Studies by the General Accounting Office project that in a severe recession beginning in 1991, 22 states would borrow $17.4 billion over a five year period from the Federal Unemployment Account (loan fund) in the Federal Unemployment Trust Fund.

ICESA has no independent projections of state borrowing; however, we believe that the federal policy decisions in the 1980's related to unemployment trust fund loans will tend to limit borrowing and encourage quicker repayment. The interest charging provisions which went into effect in 1982 have eliminated any incentives for states to build large debts.

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While adequate reserves are always a goal, there are tradeoffs between higher reserves which require higher taxes and lower reserves which may require occasional borrowing. Each state has determined the risk it is willing to take. There have been suggestions by Mr. Vroman and others for federal incentives for higher trust fund reserves. For example, the federal government could pay a higher rate of interest on state trust fund reserves that exceed a certain level of solvency, or discount the rate of interest charged on loans if the state met a certain level of solvency in the year prior to borrowing. We think that these are interesting ideas which should be explored further.

Thank you for your attention to this important matter. I would be pleased to answer any questions you may have.

Senator SARBANES. Thank you, sir, very much. Mr. Vroman, please proceed.

STATEMENT OF WAYNE VROMAN, SENIOR RESEARCH ASSOCIATE, THE URBAN INSTITUTE, WASHINGTON, DC

Mr. VROMAN. I would like to thank the committee for the opportunity to be here. I will touch on each of the four areas covered in my prepared statement briefly, Senator.

The first thing I want to discuss is the situation of the unemployment insurance trust funds at present, restricting my attention to the State funds. Since the recession of the early 1980's, individual States and the program as a whole have been engaged in large-scale accumulations of unemployment insurance trust fund reserves.

The situation as of the end of September last year was that the aggregate across the 53 State accounts was just over $39 billion. That is up from about $8.6 billion in 1979. And, I make the 1979 comparison simply to have a number that preceded the recessions starting the decade of the 1980's.

Relative to the scale of the economies, trust funds are about twice as adequate now as they were at the end of 1979. That is, the reserve ratio, the technical term, was about 0.9 in 1979 and it has moved to 1.9. The reserve ratio measures reserves as a percent of payrolls.

Another technical term that actuaries in this area use is a reserve-ratio multiple. I won't do very much in describing that, simply to say that it considers three factors in assessing adequacy—the size of the State's reserve fund balance, the scale of the State economy as reflected in its total wages and salaries and then the annual cost rate that the State experienced in its most serious previous recession.

The rule of thumb that many people in this area use is that the State, to go through a recession without needing to borrow, should have a multiple of about 1½. The aggregate multiple for the economy as a whole is just a little bit more than half of that, 0.85, as of last September.

However, it is distributed quite widely at high and low rates when you look at individual States. As of last September, there were eight States where the reserve ratio multiple was less than a half. That means the States basically had less than 6 months' worth of benefits sitting in a trust fund that they could pay out without some kind of either tax increase or benefit reduction.

And, the States are—I think it's fun to name names: Connecticut, Massachusetts, Ohio, Michigan, West Virginia, the District of Columbia, Missouri, and Arkansas. Additionally, there were four other States whose reserve multiples were just slightly higher. Specifically, Pennsylvania, Illinois, Minnesota, and Louisiana.

Now, if you review that list, 5 of our 11 largest States are on the list and face the risk of insolvency should they enter a serious period of prolonged increase in unemployment insurance claims. I mention this, because the reaction to the prospect of debt and the fact of indebtedness in the early 1980's was for unemployment in-

surance programs to both cut back on their benefits and raise taxes on employers while they were still in the recession.

Neither of those can be viewed as good or positive developments. I should conclude this, however, by saying that the unemployment insurance system is better financed now than it was at the start of the 1980's. So, the need for some of these cutbacks will be smaller when compared to 10 and 11 years ago.

I am here mainly to talk about the receipt of unemployment insurance benefits. Gary Burtless has been very helpful to me in terms of defining insured unemployment, which is the measure of the number of claimants; total unemployment, the number which comes out of the monthly labor force survey conducted by the Census Bureau for the Labor Department.

The ratio in the regular unemployment insurance programs of insured to total unemployment dropped in the early 1980's by some 20 to 25 percent and then remained low throughout the remainder of the decade. The explanation for the decline is something which reasonable people can disagree about; however, they can point to at least five or six different things that all have contributed.

The regional mix of unemployment in our economy has been moving toward those areas which compensate a lower share of their workers. And, I will return to this point in just a minute.

The mix of industries in the economy has seen a decline in areas like mining, manufacturing, and construction which typically compensate more of their workers. And, in particular in the 1980's, the manufacturing sector never really recovered. It sat on a plateau of about 19 million jobs for most of the decade and is now falling below that level.

Another factor related to claims activity is union status. People who are members of labor unions are much more likely to claim unemployment insurance benefits. With the decline of union presence in the economy that has been a factor contributing to this decline.

Unemployment insurance laws and administration are certainly important. And, many of the laws that were enacted at the State level were done because the States had unemployment insurance trust fund debts. Their response to the situation of indebtedness in the period of time from 1981 to 1983 was to engineer a State legislative package that combined both tax increases and benefit reductions. And, in the States that had the biggest debts, States like Michigan, Ohio, Illinois, and Pennsylvania, the scale of these cutbacks was quite large.

In table 2 of my prepared statement, I bring out some measures of how many of the unemployed collect unemployment insurance benefits or are actively participating in the unemployment insurance system on a State-by-State basis. Table 2 is arranged by regions so that the Northeast, the Midwest, the South, and the West, each of those areas are individually distinguished.

The numerator in the IU–TU ratio is just the number of unemployment insurance claimants. The original conception of the unemployment insurance program is to pay benefits to people who lost jobs through no fault of their own.

One way to talk about that in operational terms is to say the unemployment insurance should primarily compensate job losers.

And, in normal times, job losers in our economy constitute about half of all of the experienced unemployed.

Now, not all job losers even collect, because some people delay in filing for benefits, some people haven't worked enough in a base period to be eligible for benefits. And, a technical quirk in this measurement of unemployment insurance claimants is that people, once they exhaust, no longer enter into insured unemployment calculations.

So, I have devised the benefit availability measure, suggesting that a good comparison of how easily people can collect benefits in a State is in the numerator to look at the number of insured unemployment, that's people actively seeking benefits, and then the denominator measures 70 percent of your job losers so that you don't say every job loser should collect, but you distinguish job losers from the other categories.

When you look at table 2 in my prepared statement, there are several States for which this ratio falls way below 1 percent. And, 1 percent would be the index if 70 percent of the people were claiming benefits.

You can see, in fact, that there are nine States where this index falls below 0.7 percent. In other words, less than half of the job losers are getting unemployment insurance benefits.

And, again I think it's interesting to name names: New Hampshire, Indiana, Florida, West Virginia, Alabama, Kentucky, Louisiana, Oklahoma, and Texas. For an additional six States, this calculation produced a ratio between 0.7 and 0.799 percent. And, those six States were South Dakota, Virginia, Colorado, Nevada, New Mexico, and Utah.

Now, I've calculated the ratio based on 3-year averages so that problems of statistical variability in the measure of TU and the measure of job loser unemployment get averaged out largely in a 3-year averaging period.

Twelve of the fifteen States that I've just identified are either in the South or in the Rocky Mountain regions. Senator Symms, I'm relieved to note that the one State for which this index is above 1 percent in the Rocky Mountain region is Idaho. And, I want to return to that in one of my comments toward the end of my remarks.

The question of why so few people are claiming unemployment insurance benefits is something which has puzzled economists, it has puzzled the Unemployment Insurance Service of the U.S. Department of Labor and it has puzzled UAW and employer representatives for several years now. I have had the opportunity to examine recent data from current population surveys where supplemental questions were administered to people who were unemployed in the monthly labor force survey.

One of the things that the new survey data show fits quite well with what we would expect. Job losers are the group who are most likely to apply for and receive unemployment insurance benefits.

In these data, which mainly pertain to 1989, the application rate among job losers was about 53 percent compared to 11 percent for job leavers and 14 percent for reentrants. Overall in these data, about 34 percent of all the unemployed, when they were asked,

"Did you apply for unemployment insurance benefits," responded in the affirmative.

An interesting thing about the new data is that followup questions inquired why people didn't apply if they answered no to the question on applications. Half the people said they didn't think they were eligible. Another 15 percent said they had another job. They felt that they were transiting from the job they had just left, either through employer action or through their own quitting, to another job, that they would be in that transit period for such a short period of time they wouldn't bother to try to get into the unemployment insurance system.

The next two most common responses were "other" and "don't know." And, you can make as much of those as I can. We don't really know what these responses mean.

However, the survey data were very instructive in suggesting some certain reasons which occasionally have been suggested, and these reasons being very rare occurrences. Namely, "I don't know about unemployment insurance." Hardly anyone gave that explanation. "It's too much hassle to apply for the program"; and, "It's too much like charity." Very few respondents fell into those three categories.

So, it appears on surface that the people who don't apply for the unemployment insurance program are aware of its existence and don't think it demeaning to actually go into the unemployment insurance offices to try to collect benefits.

For those who were ineligible, there were other questions probing as to why people thought they were ineligible. Half of the ineligibles said that they didn't think they worked enough in their base period. Another one-third said they had quit their last job.

If those perceptions are completely accurate, then I think many people would say there is less cause for concern about the unemployment insurance program not compensating people if you thought that the reason, "I quit my last job," is a valid reason for not paying benefits and if you thought that the monetary eligibility and other eligibility requirements were sufficiently lax that any normal person should be able to meet them. I think there are questions both about how well people understand their eligibility and certainly some States have cut back on the number of claimants by raising eligibility standards, and that's something which could be looked into by a followup in a similar type of data by going back to the States, taking the same people and seeing what their actual eligibility was, looking at the information that is inside the unemployment insurance systems themselves.

OK. I'm going long, so let me stop there and move on to the final point.

Currently, we "trigger on" extended benefits if the IUR, the insured unemployment rate, is 5 percent for a 13-week period and it's 20 percent higher than it was in the same 13-week period over the previous 2 years. Let me give the example of Texas as to why an IUR trigger has certain very serious problems.

When the energy industry turned down in the mid-1980's, here is the following sequence of unemployment rates in the State of Texas. In 1984, 5.9 percent; in 1985, 7 percent; and 1986, 8.9 per-

cent. So, the State's total unemployment rate got almost up to 9 percent in the worst year of their energy downturn, 1986.

What were the IUR's for those 3 same years? One and a half percent, one and a half percent and 2.6 percent, respectively.

So, with the total unemployment rate up close to 9 percent, the State's average IUR got halfway up to the threshold needed to trigger extended benefits for the year. I think it would require a TUR of something like 15 percent in the State of Texas to turn on the extended benefits program if you continue to use the current triggers.

I should point out to Senator Symms that the one State in the Rocky Mountain region that turned on to the extended benefit programs in the mid-1980's was your State. Your State is the most generous in terms of providing benefits for the regular program.

Your State has a higher IUR than almost all the other Rocky Moutain States on a consistent basis for a given TUR. Therefore, long-term unemployed workers in your State have a much better chance of collecting unemployment insurance benefits than people in Arizona, Colorado, Utah, and the other States adjacent to you. Montana is probably second to Idaho in terms of the availability and the likelihood of EB.

But, your State does stand out in the Rocky Mountain region as having enough compensation of its regular program to satisfy the trigger for the EB program, and historic evidence showing that it did activate EB.

Suggesting using a TUR trigger for unemployment insurance extended benefits seems to be an obvious thing. The TUR comes out of a sample survey. It has a certain amount of noise attached to it.

I think the noise problem could be addressed quite easily. You could average the TUR for a longer period of time than the 3 months which goes into the IUR calcuations, and you could set the TUR to trigger at a high level so it was a conservative number that didn't cause too many false positive signals, so that it wouldn't just be temporarily up there and then jump back down due to statistical noise.

I think technicians at the Bureau of Labor Statistics could come up with a number that would satisfy these kinds of criteria and allow use of a TUR as well as an IUR to trigger on the program.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Vroman follows:]

PREPARED STATEMENT OF WAYNE VROMAN*

Unemployment Trust Funds and
Benefit Availability in 1990

I would like to thank the Joint Economic Committee for the opportunity to appear today and offer some observations about unemployment and unemployment insurance (UI). My remarks will address four topics:1) the adequacy of state trust fund reserves, 2) the availability of benefits in the regular State UI programs, 3) why so few unemployed workers claim and collect UI program benefits and 4) the current triggers in the Federal-State Extended Benefits (EB) program.

I. The Adequacy of State Trust Fund Reserves

At present the state and federal trust fund accounts in the unemployment insurance system have total net reserves of more than $50 billion. My remarks today will focus on the state accounts which had about $39 billion in net reserves (total reserves less outstanding loans from the U.S. Treasury) at the end of September 1990. Only one state, Michigan, had any outstanding loans while 12 states have reserves of at least $1 billion on that date. The present situation presents a vivid contrast with the situation in the state accounts at the end of 1983 when net reserves totaled -$5.8 billion and 23 of 53 state programs (the 50 states plus the District of Columbia, Puerto Rico, and the Virgin Islands) had outstanding loans from the U.S. Treasury.

With the economic recovery since 1983, the states made sustained and large scale additions to net reserves. For the seven years 1984 through 1990 net reserves increased by nearly $45 billion to reach a net balance of $39.1 billion at the end of September 1990. The September 1990 balance represented about 1.90 percent of total payrolls.

Although the recent years have seen major increases in the fund balances of the states, a reasonable question to pose is: how adequate would reserves be if there were to be a serious recession? The information contained in Table 1 is intended to address this question. The answer to the question suggested by a review of

*The views expressed in this statement are those of the author and do not necessarily represent the views of The Urban Institute or its sponsors.

historical evidence is twofold. (1) A serious recession would cause several states to need loans, although the number of states and volume of borrowing is difficult to forecast with any degree of precision. (2) Under current borrowing provisions the response of states to the prospect of potential borrowing would cause them to restrict benefit availability while still in recession. This would be the wrong time to restrict benefits both from the standpoint of maintaining the incomes of unemployed workers and their families and from the standpoint of providing countercyclical stimulus to the economy.

As a guideline for assessing the adequacy of trust fund reserves, UI policymakers and practitioners frequently measure their fund balance in terms of a "reserve ratio multiple" also termed a high cost multiple or simply a reserve multiple. This measure provides an indicator for gauging the size of reserves relative to the potential demand for benefits that could arise in a recession. The multiple is a quotient that is computed from two ratios. The denominator is UI benefit payments as a percentage of total covered payrolls in the highest cost twelve month period from the past (not necessarily a calendar year). The numerator is total net reserves at the end of the current year expressed as a percentage of total covered payrolls for the year. If, for example, a hypothetical state's highest cost year had benefit outlays equal to 2 percent of total payrolls and if current payrolls were $30 billion, it could expect to pay as much as $600 million in annual benefits should the current year have a recession as serious as that of the high cost year.

A rule of thumb that has arisen is that states should have enough reserves to produce a reserve ratio multiple of 1.5 or larger. This means there should be 18 months worth of benefits in the trust fund in order for a state to go through a recession without needing loans. The state in the previous hypothetical example would need a trust fund balance of $900 million to satisfy the 1.5 reserve ratio multiple guideline.

Expressing the September 30, 1990 net reserves as reserve ratio multiples helps to place the states' present positions into a broader context. Despite the reserve accumulations of 1984-1990 more than half the programs (29 of 53) have multiples that fall below 1.0 and 8 have multiples smaller than .50. Note that only two states (Connecticut and Michigan) have multiples below .25. From Table 1 the 8 states with reserve multiples below .50 and most at risk of insolvency are Connecticut, Massachusetts, Ohio, Michigan, Missouri, the District of Columbia, West Virginia, and Arkansas. However, four additional states with reserve ratio multiples of from .50 to .59 are also seriously exposed: Pennsylvania, Illinois, Minnesota, and Louisiana.

A point to emphasize regarding the September 1990 distribution of reserve ratio multiples is that several states fall into ranges where the probability of borrowing during the early 1980s was quite high. Thus, the reserve accumulations since 1983 have not been so large as to remove nearly all states from the risk of insolvency if there were to be a serious recession in the near future.

On the other hand, if the economy were to experience a serious recession in 1991 the number of states needing loans and the amount of borrowing could be less than suggested by earlier experiences. Three factors could operate to reduce the volume of future borrowing. First, the back-to-back recessions of 1980 and 1981-1982 were unusually severe and unlikely to be repeated. Second, access to benefits from the regular UI and the EB programs was restricted in the early 1980s so that a future recession would probably generate fewer UI claims than an earlier recession of comparable severity. Third, many states reluctant to incur substantial interest bearing debt would probably enact solvency legislation quickly in a future recession (reducing benefits and raising taxes) as a debt-avoidance strategy. Despite these three considerations it is clear from Table 1 that several states remain exposed to the threat of insolvency even after the large trust fund accumulations of the past seven years.

II. Receipt of UI Benefits by the Unemployed

During the early 1980s the proportion of unemployed workers claiming and receiving UI benefits declined and remained low for the remainder of the decade. The reduced rates of application and receipt occurred in both the regular State UI programs (which can typically compensate workers for up to a maximum duration of 26 weeks) and in the Federal-State Extended Benefits program (which can compensate the long term unemployed for up to an additional 13 weeks). In the regular State UI programs the decline in the proportion of the unemployed claiming benefits was roughly 20 to 25 percent, from about .40 at the start of the 1980s to the .30-.32 range from 1983 through 1989. With the increase in the unemployment rate of 1990, the ratio (based just on the regular State UI programs) rose to about .35, a pattern typical at the start of a downturn when job losers become a larger component of the unemployment pool. The decline in benefit recipiency of the 1980s adversely affects the performance of UI both as an income maintenance program for unemployed workers and their families and as an automatic stabilizer of aggregate economic activity.

The decline in UI claims activity of the early 1980s is not fully understood, but several contributing factors have been identified by earlier research undertaken at the Brookings Institution, Mathematica Policy Research, Inc., the Urban Institute and by some academics.[1] This previous research has not reached a consensus, but certain conclusions about the decline can be

[1] Four papers of note are: Gary Burtless and Daniel Sax, "The Decline in Insured Unemployment During the 1980s," (Washington, D.C.: The Brookings Institution, March 1984); Walter Corson and Walter Nicholson, An Examination of Declining UI Claims Activity During the 1980s, Unemployment Insurance Occasional Paper 88-3, (Washington, D.C.: U.S. Department of Labor - ETA, 1988); Wayne Vroman, "The Decline in Unemployment Insurance Claims Activity in the 1980s," (Washington, D.C.: The Urban Institute, December 1990); and Rebecca Blank and David Card, "Recent Trends in Insured and Uninsured Unemployment: Is There an Explanation?" Quarterly Journal of Economics, (1991) forthcoming.

offered. Three contributing factors have been a change in the regional distribution of unemployment, a decline in the share of overall employment accounted for by the mining, construction and manufacturing industries and a decline in unionization. For all three of these factors evolutionary changes in the labor market have been away from areas and groups of workers with above-average participation in unemployment insurance.

Declining claims activity has also been associated with changes in federal and state laws and state administrative practices. Disqualification penalties have been increased, maximum benefit durations have been shortened and base period earnings requirements have been raised. These types of state-level changes were most noticeable in the states that had large UI trust fund debts early in the decade of the 1980s. States such as Illinois, Michigan, Ohio and Pennsylvania enacted large scale benefit reductions and tax increases to improve the solvency of their programs in these years. Strong financial inducements to make solvency improvements were provided by changes in federal debt repayment policies of 1980 and 1981 and by the Social Security legislation of 1983.

One aspect of UI claims activity that may deserve special emphasis is the variation across states and regions. Table 2 provides background data to support some of the following observations. The proportion of the unemployed who apply for and receive benefits varies considerably from one state to the next. As a rule, states in the North East and along the Pacific coast have the highest application rates while southern and Rocky Mountain states have the lowest application rates.

Table 2 shows three common unemployment measures by state for calendar year 1989. Insured unemployment (IU) is a measure of persons actively claiming benefits from the regular UI programs. It measures the average weekly number of beneficiaries plus persons serving their waiting period and certain persons serving disqualifications. It does not count persons who have exhausted their benefit eligibility. The estimates of total unemployment

(TU) are derived from the monthly labor force survey of 55,000 households (the Current Population Survey or CPS). This survey provides annual estimates of TU by state and monthly estimates for 11 of the largest states.

The CPS also determines each worker's reason for unemployment, distinguishing among job losers, job leavers, reentrants into the labor force and new entrants into the labor force. The former three groups are frequently referred to as the experienced unemployed. Job losers are persons who lose jobs through employer actions, mainly layoffs, and are the group most likely to receive UI benefits because they became unemployed for reasons largely beyond their control. Table 2 displays each of the three unemployment measures (IU, TU and job loser unemployment or JLU) for 1989.

The UI program was established to pay benefits to unemployed workers who lost their jobs through no fault of their own. Benefits are intended to go to eligible persons among the unemployed. Suppose a state does not compensate a substantial share of its job losers, the group of experienced unemployed most likely to collect benefits? This would constitute de facto denial for many eligible persons, denials arising partly from explicit administrative determinations and partly from the associated deterrence of eligible applicants who would otherwise collect benefits. The latter group would not be present in any UI program data (hence not counted in insured unemployment) because they have no direct contact with the program subsequent to their job losses. They are referred to as nonfilers and their situation as counter denials.

As an example of a possible implication of this idea, use 70 percent as a measure of the share of job losers that would be expected to collect UI benefits. The percentage, 70 percent of job losers, was selected partly because a national calculation for 1989 shows insured unemployment to be about 70 percent of job loser unemployment. The 70 percent figure also acknowledges such factors as application delays, monetary and nonmonetary disqualifications

and exhaustions.[2] The ratio of IU to 70 percent of JLU can be termed a UI benefit availability index. This calculation of a benefit availability index is conservative in that it implicitly assigns all IU to the job loser category and assumes no job leavers or reentrants are eligible to claim benefits. A more refined measure could be constructed if we had better data on the personal characteristics of UI claimants, including both earnings histories and indications of their reasons for leaving employment.

In calendar year 1989 there were 25 states where the number of insured unemployed (IU) from UI program data was less than 70 percent of the number of job losers (JLU) as estimated in the monthly household labor force survey (CPS). The 25 states were distributed as follows: 1 in the North East (New Hampshire), 5 in the Midwest (Illinois, Indiana, Ohio, Iowa and South Dakota), 13 in the South (all but Delaware, Maryland, D.C. and North Carolina) and 6 in the West (Arizona, Colorado, Nevada, New Mexico, Utah and Wyoming).

Several states fall considerably below this "70 percent of job losers" standard. The 1989 ratios were below .70, ie. (IU/(.7*JLU)) < .70 or (IU/JLU) < .49, in Indiana, Florida, West Virginia, Alabama, Oklahoma, and Texas. Ratios between .700 and .799 were present in New Hampshire, South Dakota, Louisiana, Colorado, New Mexico, and Utah. The regional implications of this calculation are striking. Almost all of the states where the benefit availability index falls below .800 are located in the South or the Rocky Mountains.

The preceding calculation is crude, and because the monthly household survey is based on a sample, it has a certain amount of statistical "noise" for any given year. The noise problem could be addressed by averaging over a longer period such as three years. In

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[2] It should be noted that some unemployed leavers and reentrants are eligible for and collect UI benefits. For reentrants those who were job losers prior leaving the labor force and who remained out of the labor force for less than a year could easily be eligible for UI benefits.

fact, the group of low performing states is quite stable from one year to the next. When identical calculations of an availability index were performed for 1988 and 1987 the results were quite similar to the results for 1989 . The final column of Table 2 shows three year averages of this benefit availability index.

The three year (1987-1989) averages of IU/(.7*JLU) ratios were below .700 in nine states: New Hampshire, Indiana, Florida, West Virginia, Alabama, Kentucky, Louisiana, Oklahoma, and Texas. Ratios between .700 and .799 were present in six states: South Dakota, Virginia, Colorado, Nevada, New Mexico, and Utah. Of the fifteen states where these three year averages fell below .800, twelve were in the southern and mountain states.

We cannot determine from readily available data on IU and JLU what the monetary and nonmonetary eligibility status of nonfilers really is. New data from some 1989-1990 supplements to the CPS suggest about half of job losers who do not apply for UI think they are not eligible (due to inadequate prior earnings or the circumstances of leaving their last job).[3] We do not know how well these workers understand UI monetary eligibility criteria and other eligibility conditions. This is an area where our knowledge needs to be improved. The regional patterns identified in Table 2 seems to suggest that UI is less hospitable to potential applicants in the South and Mountain areas than elsewhere.

III. Reasons for Not Applying for UI Benefits

Over the past six months I have been analyzing the responses to a set of supplemental questions about unemployment insurance asked of unemployed workers in the CPS. Supplemental questions were asked in the surveys of May, August and November of 1989 and February 1990. Usable responses were received for about 2850 persons who were job losers, job leavers or reentrants. Job losers

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[3] We return to this question in the next part of this testimony.

made up about half of the total in the special sample.[4]

Several aspects of the new survey data are noteworthy. Job losers are much more likely to apply for UI benefits than are leavers and reentrants. The average application proportions (people who applied sometime during their current spell of unemployment) across all demographic groups were .532 for job losers, .112 for job leavers and .137 for reentrants yielding an overall average of .339 across all groups of experienced unemployed. Application rates rise with age and unemployment duration for workers in all three reason-for-unemployment groups.

When nonapplicants were asked why they did not apply, the most frequent response (accounting for about half of nonapplicants) was that they did not think they were eligible. The second most common reason (roughly 15 percent) was that workers thought they had another job. The other most common reasons given for not applying, unfortunately, were "other" (a mix of many possible reasons) and "don't know." These latter responses illustrate the perils of conducting interview surveys.

Other possible reasons for not applying were quite infrequent. Very few workers responded "Didn't know about UI," "Too much hassle," and "Too much like charity." Thus workers appear to be informed as to the program's existence and give plausible reasons for not applying. One can question how well workers understand the monetary and nonmonetary eligibility criteria in the states, but in the absence of some matching of worker survey responses with program data, this speculation cannot be tested.

For workers who indicated they were not eligible for UI, a follow-up question probed the reason for ineligibility. About half said they did not work enough and about one-third said they quit their last job, both plausible reasons for ineligibility. Again, it would be most interesting to check these responses against eligibility determinations made by the UI agencies themselves.

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[4] Analysis of these data is summarized in my report cited in footnote 1.

The new survey data were also subjected to multiple regression analysis. This investigation revealed the importance of other factors in application and receipt of benefits. Married persons were more likely to participate in UI than others. Higher application and recipiency rates were found for workers formally employed in the mining, construction and manufacturing industries. Union members were much more likely to participate than others. Lower application and recipiency rates were found in the South.

These new data have not yet been thoroughly analyzed. They contain a wealth of new information that should help us to understand the UI application-receipt process better in the future. They point to changes in the regional distribution of unemployment, declining employment and unemployment in the mining, construction and manufacturing industries and declining unionization as factors contributing to declining UI application and recipiency rates among the unemployed.

IV. Extended Benefit Triggers

Most states activate the Extended Benefits program when the insured unemployment rate or IUR (UI claimants as a percent of employment covered by the program) averages 5 or more percent for 13 consecutive weeks and is at least 20 percent higher than the average for the same period over the prior two years. An additional point suggested by the data in Table 2 is that reaching the 5 percent IUR threshold would be difficult in several states. If a state compensates a low share of its unemployed it would require a very high total level of unemployment to cause UI claims to reach 5 percent of covered employment.

Note in Table 2 that the IU/TU ratio fell below .250 in 15 states in 1989. In South Dakota, Florida, Virginia and Texas the IU/TU ratio did not even reach .200. As long as the EB program is activated with an IUR trigger, EB would very rarely, if ever, be turned on in such states.

A good example of this situation is provided by the

experiences of Texas during the energy crisis of the mid 1980s. The state's total unemployment rate (TUR) increased from 5.9 percent in 1984 to 7.0 percent in 1985 and then to 8.9 percent in 1986. The Texas IURs for the same three years were 1.5 percent, 1.5 percent and 2.6 percent respectively, far below the threshold needed to activate EB. Because Texas compensates so few workers in its UI program, it would need an annual TUR in the neighborhood of 15 percent to trigger on EB. A similar situation applies in Florida, South Dakota and Virginia.

The use of an IUR trigger for the EB program in states that compensate a small share of the unemployed practically ensures that the program will not be activated. To provide a better likelihood of EB benefits in such states, an alternative trigger based on a TUR calculation from the CPS would seem a logical alternative.

Because the TUR is calculated from a sample, there are questions as to the reliability of monthly total unemployment estimates by state. To guard against the real problems posed false positive signals from the TUR, some combination of a longer averaging period (longer than three months) and/or a conservative (high) TUR trigger threshold could suggested. Specialists at the Bureau of Labor Statistics should be able to derive an acceptable alternative trigger based on monthly TURs.

Table 1. Summary of State UI Trust Funds in 1990

	Net Reserves (millions)		Reserve Ratio (percent)		High Cost Rate (pct.)	Reserve Ratio Mult. 1990
	Dec. 1979	Sept. 1990	Dec. 1979	Sept. 1990		
UNITED STATES	8582	39077	0.91	1.90	2.24	0.85
NORTH EAST						
CONNECTICUT	-267	127	-	0.32	3.29	0.10
MAINE	0	194	0.00	2.34	2.84	0.83
MASSACHUSETTS	132	549	0.51	0.81	3.22	0.25
NEW HAMPSHIRE	82	187	2.42	1.91	2.51	0.76
RHODE ISLAND	-96	276	-	3.44	4.37	0.79
VERMONT	-21	211	-	5.17	3.25	1.59
NEW JERSEY	-507	2921	-	3.45	3.33	1.04
NEW YORK	403	2808	0.51	1.56	2.50	0.62
PENNSYLVANIA	-1091	1802	-	1.94	3.37	0.58
PUERTO RICO	-33	666	-	8.86	4.21	2.11
VIRGIN ISLANDS	-7	35	-	6.99	2.28	3.07
MIDWEST						
ILLINIOS	-460	1510	-	1.39	2.67	0.52
INDIANA	418	870	1.69	1.97	1.79	1.10
MICHIGAN	112	430	0.25	0.52	3.69	0.14
OHIO	513	921	1.02	1.04	3.09	0.34
WISCONSIN	465	1186	2.37	3.20	2.57	1.25
IOWA	155	567	1.45	3.22	2.62	1.23
KANSAS	238	539	2.75	2.83	1.97	1.44
MINNESOTA	70	401	0.41	1.06	1.96	0.54
MISSOURI	296	338	1.47	0.84	1.98	0.43
NEBRASKA	81	142	1.58	1.45	1.50	0.97
NORTH DAKOTA	21	51	1.13	1.70	2.34	0.73
SOUTH DAKOTA	16	48	0.95	1.51	1.04	1.46
SOUTH						
DELAWARE	-30	231	-	3.34	2.70	1.24
DIST. OF COL	-44	78	-	0.71	1.84	0.39
FLORIDA	665	2066	2.13	2.27	1.84	1.23
GEORGIA	447	1093	2.28	2.06	2.13	0.97
MARYLAND	273	563	1.83	1.44	2.19	0.66
NORTH CAROLINA	564	1530	2.71	3.01	2.58	1.17
SOUTH CAROLINA	195	494	1.96	2.11	2.89	0.73
VIRGINIA	103	747	0.56	1.48	1.31	1.13
WEST VIRGINIA	39	160	0.56	1.67	4.00	0.42
ALABAMA	118	648	0.98	2.55	2.17	1.18
KENTUCKY	159	427	1.36	1.94	2.77	0.70
MISSISSIPPI	231	391	3.47	3.10	1.97	1.57
TENNESSEE	264	696	1.63	1.94	2.18	0.89
ARKANSAS	24	141	0.37	1.09	2.69	0.40
LOUISIANA	238	435	1.51	1.76	3.08	0.57
OKLAHOMA	177	391	1.56	2.08	1.37	1.52
TEXAS	396	1303	0.65	1.02	1.14	0.90
WEST						
ARIZONA	226	507	2.36	1.99	2.48	0.80
COLORADO	137	295	1.11	1.09	1.26	0.87
IDAHO	93	243	3.20	4.48	3.17	1.41
MONTANA	16	89	0.64	1.99	3.03	0.66
NEVADA	95	352	2.31	3.15	2.75	1.15
NEW MEXICO	80	198	2.14	2.58	1.64	1.57
UTAH	67	280	1.43	2.77	2.02	1.37
WYOMING	69	76	3.15	2.82	3.03	0.93
ALASKA	65	217	2.78	4.55	4.33	1.05
CALIFORNIA	2738	5716	2.51	2.05	2.34	0.88
HAWAII	79	393	2.24	4.00	2.65	1.51
OREGON	320	959	3.00	4.82	3.21	1.50
WASHINGTON	297	1579	1.66	4.44	4.21	1.05

Source: Trust fund data taken from US Department of Labor, Handbook of UI Statistics(1983) and later Handbook supplements. Calculations of reserve ratio multiples done at the Urban Institute.

Table 2. Summary of State UI Benefit Availability for 1987-1989

	Unemployment Measures for 1989: IU, Insured Unemp.	TU, Total Unemp.	JLU, Job Loser Unemp.	IU/TU Ratio	UI Benefit Availability Index: Ratio of Ins. Unemployment to 70 Percent of Job Loser Unemployment - 1987-1989: 1987	1988	1989	Avg.
UNITED STATES	2113.7	6529	2983.7	0.324	0.908	0.946	1.012	0.955
NORTH EAST								
CONNECTICUT	28.6	64	25.9	0.447	1.291	1.459	1.576	1.442
MAINE	11.5	25	11.8	0.459	1.048	1.305	1.388	1.247
MASSACHUSETTS	84.4	127	62.2	0.664	1.628	1.851	1.937	1.805
NEW HAMPSHIRE	5.3	21	10.4	0.253	0.642	0.708	0.728	0.693
RHODE ISLAND	14.2	21	10.6	0.674	1.597	2.165	1.908	1.890
VERMONT	5.0	11	5.7	0.456	1.193	1.759	1.260	1.404
NEW JERSEY	81.4	163	92.1	0.500	1.268	1.313	1.263	1.281
NEW YORK	180.1	442	222.3	0.408	1.161	1.318	1.157	1.212
PENNSYLVANIA	126.9	264	139.9	0.481	1.084	1.092	1.296	1.157
MIDWEST								
ILLINIOS	104.6	359	164.8	0.291	0.777	0.767	0.907	0.817
INDIANA	29.3	136	69.0	0.215	0.602	0.580	0.607	0.596
MICHIGAN	109.4	326	145.1	0.336	0.982	1.007	1.078	1.022
OHIO	86.0	300	144.6	0.287	0.762	0.818	0.850	0.810
WISCONSIN	46.1	114	56.2	0.404	0.994	1.030	1.172	1.065
IOWA	17.8	65	27.9	0.274	0.940	0.871	0.914	0.908
KANSAS	19.8	52	25.5	0.381	1.250	1.110	1.108	1.156
MINNESOTA	37.2	102	40.6	0.365	0.823	1.263	1.310	1.132
MISSOURI	46.1	143	62.2	0.322	0.898	0.954	1.059	0.970
NEBRASKA	7.5	25	9.2	0.299	0.861	1.106	1.159	1.042
NORTH DAKOTA	4.5	14	5.7	0.321	1.043	1.048	1.134	1.075
SOUTH DAKOTA	2.7	15	5.0	0.179	0.771	0.814	0.766	0.784
SOUTH								
DELAWARE	4.0	13	5.2	0.311	1.078	1.309	1.104	1.164
DIST. OF COL	7.4	16	6.4	0.464	1.150	1.496	1.645	1.430
FLORIDA	58.1	348	133.6	0.167	0.606	0.640	0.621	0.622
GEORGIA	39.4	177	72.0	0.223	1.064	0.772	0.782	0.873
MARYLAND	28.9	93	36.7	0.311	1.128	0.955	1.125	1.069
NORTH CAROLINA	41.2	119	45.8	0.346	0.939	1.094	1.283	1.105
SOUTH CAROLINA	22.9	80	40.5	0.287	0.794	0.898	0.809	0.834
VIRGINIA	21.7	123	36.5	0.176	0.728	0.799	0.848	0.792
WEST VIRGINIA	16.1	66	34.8	0.244	0.624	0.617	0.662	0.634
ALABAMA	32.2	134	71.6	0.240	0.707	0.598	0.643	0.649
KENTUCKY	27.5	108	48.8	0.254	0.604	0.667	0.804	0.692
MISSISSIPPI	21.9	91	35.5	0.240	0.714	0.805	0.880	0.800
TENNESSEE	41.5	121	64.0	0.343	0.868	0.919	0.925	0.904
ARKANSAS	24.7	82	38.0	0.301	1.062	1.029	0.929	1.007
LOUISIANA	36.3	151	72.0	0.240	0.681	0.582	0.720	0.661
OKLAHOMA	17.0	85	38.1	0.200	0.629	0.596	0.638	0.621
TEXAS	107.1	567	236.4	0.189	0.598	0.588	0.647	0.611
WEST								
ARIZONA	22.9	89	39.4	0.257	0.839	0.741	0.830	0.803
COLORADO	22.9	98	46.4	0.234	0.722	0.677	0.707	0.702
IDAHO	10.8	25	11.8	0.432	0.886	1.126	1.309	1.107
MONTANA	7.1	24	9.1	0.296	0.870	0.863	1.119	0.951
NEVADA	9.2	30	16.3	0.308	0.777	0.762	0.810	0.783
NEW MEXICO	10.9	46	22.1	0.237	0.696	0.733	0.704	0.711
UTAH	8.2	37	15.7	0.222	0.810	0.829	0.748	0.796
WYOMING	3.5	15	6.1	0.233	0.818	0.799	0.819	0.812
ALASKA	9.1	17	7.9	0.533	1.236	1.298	1.633	1.389
CALIFORNIA	321.1	737	356.7	0.436	1.219	1.224	1.285	1.243
HAWAII	5.1	13	3.7	0.389	1.395	1.483	1.957	1.612
OREGON	31.9	84	38.1	0.379	1.113	1.387	1.197	1.232
WASHINGTON	54.7	151	57.7	0.362	1.128	1.362	1.355	1.282

Source: Data on insured unemployment from UI program statistics. Data on total unemployment and job loser unemployment from the monthly labor force survey. All data are annual and measured in 000s.

Senator SARBANES. Thank you all very much. Senator Symms has another engagement, and I am going to yield to him to do his questioning so he can get a chance to get it in.

Senator SYMMS. I will be very brief, Mr. Chairman. Thank you very much for your courtesy.

I don't think Mr. Burtless or Mr. Vroman really addressed the question of the payroll tax, so I might get to that. But, first, I guess the question is—Mr. Vroman, I might ask you first and then, Mr. Deisz, you may want to comment also.

During the period of the 1980's when there were a lot of new jobs created and so forth, how is it that these funds were depleted at the end of that period? You mentioned in my State that the funds were in good condition. Usually when I talk to people in my State, they have told me, "We think we are doing pretty well. We are in pretty good shape. We are keeping it solvent."

But, what has happened in these States that are in trouble?

Mr. VROMAN. Well, you have to compare the growth in the State's economy with the rate at which they are building up the trust funds. And, because of experience rating in unemployment insurance, several of the States have cut their unemployment insurance taxes as they have followed along in the economic recovery from 1983 through, say, the midpart of this present year.

I was, I thought, reasonably careful to say that the States are in much better shape now——

Senator SYMMS. Yes, you did. Overall they are in better shape.

Mr. VROMAN [continuing]. And many of the individual States, in fact, could handle a recession without having to engage in the kinds of benefit reductions and tax increases that they had to in the mid-1980's

I'm not trying to duck your question, but experience rating does ensure that in unemployment insurance, if you have low claims for a long period of time and as you start to build up trust funds, that buildup feeds back and lowers your tax rates.

Senator SYMMS. Do you want to comment on that, Mr. Deisz?

Mr. DEISZ. Mr. Chairman and Senator Symms, thank you. I think there are several reasons why we have the situation that we do.

First of all, I think we went into the 1980's in relatively good shape and came out of the 1980's in relatively good shape in most States. But, in between we had some very devastating impacts.

I believe at one time more than half of the States were in a borrowing situation. There were a variety of reasons why the funds have not been built back up to where they were and why the benefit levels were addressed.

One of them is that at one point in time, the States could have an impact on the interest that they paid on their loans if they showed that in the last year they had taken certain actions which would increase taxes and reduce benefit payments. So, there is some Federal policy pressure there.

But, I think really on a State level the State legislators are looking for opportunities to lower taxes when they can. I think it is a constant debate between business and labor communities.

The tax rates were very high in most States during the middle 1980's. Some State were able to resist the pressure to reduce those rates prematurely and other States, for a variety of reasons, eco-

nomic conditions and others, perhaps were not able to build up the reserves that they needed to.

But, I agree with Mr. Vroman that, generally speaking, I think the States are in better shape. Ultimately, those who are not, I'm not quite sure what the answer is there.

One argument that is made sometimes is that the loan fund is put in place through the law to avoid having to raise an unreasonably high reserve to cover any foreseeable contingency. But, I think the ability is there to raise the reserves that are necessary and perhaps just some continued—I don't know what the right term is, but I think we are looking for standards, some jaw boning, and bringing attention to it will help those others come around.

Senator SYMMS. When you were asking earlier for Congress to fund the administrative costs, are you thinking that there are some States that also will actually need supplemental funds for the actual moneys that are distributed?

Mr. DEISZ. For the benefits——

Senator SYMMS. For the benefits.

Mr. DEISZ. Yes. Our conference has had a position for some time that we should be looking at some form of reinsurance. In other words, an assessment that all States would pay into, so that if any State's cost rate as a percent of wages exceeded a certain level they could draw from that pool.

So, there has been some indication for that. Now, at least our Conference or myself would never suggest that this come out of general revenues but rather through a reinsurance proposal that all of the States would contribute to.

There is a feeling among many of our States, and I happen to be one who shares that, that in some cases, given a particular economic circumstance, that for a State or region probably it would be very detrimental to their economic recovery to individually fund an adequate unemployment program, which is also much needed. So, the suggestion there is that a reinsurance program might addresss that.

Mr. VROMAN. Having had a chance to think a little bit more about your question, I think one thing that has helped several States in the 1980's is if they have an index taxable wage base in their unemployment insurance program. And, you may know that Idaho has the second highest of any of the States. And, Idaho's tax base goes up automatically each year as the wages in the State rise.

Several of the States that are in financial trouble right now, like Massachusetts and Connecticut that come quickly to mind, have sat on a $7,000 tax base throughout the decade of the 1980's and have seen the share of their wages that is taxable decline to less than 30 percent. And, when you are trying to finance a program on such a small share of the total that is out there potentially to tax, that is almost inviting trouble.

Senator SYMMS. I guess that Senator Sarbanes and I will probably be faced here with some of those States coming in and asking for Congress to bail out their funds. Then, a logical response would be to raise the wage base of which you tax people first. Is that correct?

Mr. VROMAN. I don't believe any State now thinks that coming to Congress and getting bailed out is a realistic option. Every State is proceeding as if they know they are completely on their own. If they get into debt they are going to have to pay off the debt themselves.

That is, I think, a major reason why the unemployment insurance program has shrunk in the last 8 to 9 years, that there was serious financial problems in a lot of States like Illinois, Ohio, and Michigan, those States engaged in large-scale tax increases and benefit reductions which they haven't fully turned around in the ensuring recovery.

So, I don't think any State really thinks that the Feds are going to—given the Federal budget deficit—going to come in here and say, "Forgive us our debts."

Senator SYMMS. Are there enough statistics? Have you ever had any statistics or analyses on the relationship of productivity and unemployment insurance? In other words, if it is harder to get unemployment insurance then productivity might be higher because people are more motivated to continue to work even though it is a job they might not have chosen but will take it anyway.

Mr. VROMAN. I think I will pass.

Senator SYMMS. Mr. Deisz.

Mr. DEISZ. I would like to respond to that, Senator, not in terms of a study but in terms of what is happening now as we begin to see a decline in the rate of growth of the labor force. I think one of the things we see is that in that situation we see a lot of the value of the unemployment insurance program, because States are seeing those people who are in industries that are affected by cyclical layoffs or periodic layoffs, those people, the better workers there will tend to go to the State where they can get better protection for periods of involuntary unemployment.

I think the program that we have now was shaped in a time when we had labor surpluses, where we could say, "Well, if you don't like the job and the conditions, I will go to the next person waiting out the door." And, that's no longer there.

And, I think now we have an opportunity and perhaps a need to look at the unemployment insurance program as a human investment program. It may require a different strategy and different formats, but I do believe it is geared really in the philosophy that there is an unlimited supply of workers out there and we, you know, in effect, can give them what we want to and that perhaps some perception that people prefer to be on unemployment.

I don't know of a productivity study that has been done. But, I also am not aware of anybody who has demonstrated that the availability of benefits linked and created unemployment.

Senator SYMMS. Do you want to comment on that, Mr. Burtless?

Mr. BURTLESS. Yes, I think that in the short run, the link between productivity and unemployment insurance, the ease of getting unemployment insurance, might work in the direction that you suggest, over a 1-year period, say.

But, if you take a longrun perspective, it probably works in the opposite way, in that often high-productivity jobs are those that are subject to lots of unemployment risk. By offering insurance protection on fairly reliable terms to people when they become temporar-

ily jobless, you actually attract workers into those fields that are high productivity but have lots of unemployment risks. The risks arise because of the specialization that people have to enter into and the special kinds of skills that they have to acquire and the lack of lots of other employment opportunities requring those specific skills.

So, the umemployment insurance system and the availability of benefits during temporary unemployment actually encourages people, I think to get into these lines of work. And, for the greater good of the economy it is good that they get into them, but they are lines of work where there is lots of temporary unemployment.

Senator SYMMS. Thank you very much. Do either one of you two choose to comment on that first question I asked?

Mr. BURTLESS. Well, if you are specifically talking about the payroll tax rate used to fund unemployment insurance, I don't think it makes a great deal of difference in the——

Senator SYMMS. No. I was talking about the payroll tax——

Mr. BURTLESS. For Social Security?

Senator SYMMS [continuing]. For Social Security, just as an economic drag on employment.

Mr. BURTLESS. Well, on the other hand, we do want to pay for retirement benefits. And, we do want to pay for medical insurance benefits in the next century.

So for that reason I think it's advisable to build up sufficient reserves so that when the large generation that reaches retirement age in the next century is there there is going to be enough reserves to pay for the——

Senator SYMMS. If they were actually built up, I think I would agree with you.

Mr. BURTLESS. That's a big problem. I agree.

Senator SYMMS. But, did you want to comment on it, Mr. Vroman?

Mr. VROMAN. I don't think I am qualified to comment.

Senator SYMMS. OK. Mr. Chairman, thank you. I have gone past my time. I appreciate all of your efforts to testify this morning. Thank you again, Mr. Chairman. Congratulations again on your new appointment.

Senator SARBANES. Thank you very much, Senator Symms. Mr. Vroman, I wanted to ask on the taxable wage base, how many States have gone above this extraordinary low base of $7,000?

Mr. VROMAN. I haven't looked at the data recently, but a rough order of magnitude would be that about two-thirds of the States have a base that exceeds $7,000. That is almost equally split between States that have indexed their tax base and States that have engaged in some kind of legislative action to go from $7,000 to $9,000 or $7,000 to $9,500, something of that order of magnitude.

The number of States with a wage base above $15,000, however, once you get to that range you are in a very rarified atmosphere for the unemployment insurance program. It's about three States or four States.

So, the States that have a base above $7,000 typically have taken a ministep, not a giant step, when you think about the Social Security tax base in comparison.

Senator SARBANES. Is the raising of the wage base a more desirable way to address a revenue need for these funds than raising the rate? I ask this of all the members of the panel.

Mr. VROMAN. I don't think there is any necessary superiority of one over the other, but there may be more informed speculation from the other panelists.

Mr. DEISZ. It's a philosophical issue. I guess the impact of raising the base verus raising the rate is that raising the base tends to spread the costs or tends to have a more equal effect on large and small employers.

Small employers generally pay lower wages. Therefore, if you raise the rate on the low base, it tends to affect small employers more adversely.

Mr. BURTLESS. I think that generally it would be desirable to raise the base rather than the rate. And, the explanation that an economist would give for that is fairly straightforward.

In the long run, we think that these payroll taxes are eventually paid in the form of lower compensation to workers. They are not borne by the employers that nominally are writing out the checks and sending them into the State funds. We think that they are borne by the workers.

Currently, with a very low tax base, what you have is low-wage workers essentially bearing a very big chunk of the burden of paying for unemployment insurance, probably a disproportionate burden. I mean, the $7,000 wage base for unemployment insurance should be compared to $55,000 for the Social Security system.

Many people consider even the Social Security tax system to be regressive. The unemployment insurance payroll tax is far more regressive even than the Social Security tax.

Senator SARBANES. I want to go back to this question, because I would like to get from each of you as succinctly as possible why you heard the Commissioner say that we have gone from a situation where two-thirds of the unemployed were covered by insurance and we are now down to one-third covered by insurance. Why is that?

Mr. VROMAN. First of all, your two-thirds figure has several different programs combined into it. In 1975, the year for which the two-thirds applies, extended benefits were paid in all the States.

The Federal Supplemental Benefit Program or FSB was active. And, yet a third special program called Special Unemployment Assistance or SUA also existed.

A more appropriate comparison of how much the regular State programs have declined is that in 1975, the ratio of insured unemployment to total unemployment was about 50 percent. So, you have gone from 50 percent in 1975 in the regular program down to a situation now which I understand in this year will be about 35 percent. So, it's still a substantial shrinkage.

But, the way you get to the two-thirds is by adding in a whole lot of special programs that were in the nature of one-time recession related or programs which expanded very sharply in the recessions. Of course, for the affected workers, particularly the long-term unemployed who are the most at risk of being in poverty, my statements do not change the fact that in 1975 they had a much better

shot at getting benefits and escaping poverty as a result of regular and long-term benefits being available.

Mr. DEISZ. The point that Mr. Vroman makes about the Federal add-on programs that were in effect when the 65 percent or 75 percent figure came out, I think is true. If you use that as your reference point, then I would say that the largest share of the reduction is due to the fact that we don't have those programs now and that the regular extended benefits program is more difficult to access. It requires a higher rate of unemployment.

The other two factors, which I think are significant, and one is obviously the States have passed some more restrictive legislation which is not insignificant, but I think the makeup of the unemployed is also a key factor, particularly the duration of unemployment.

The peak periods of coverage we had was when during the period that Mr. Vroman mentioned it was possible for an individual to draw up to 65 weeks of benefits during that time. And, that's when we had the highest degree of coverage. And, I would argue that a large share of the people who are not covered are those who have already exhausted their entitlement.

Then, the other part has to do I think with the people coming into the system and the emphasis on part time that people coming in for the first time, the new entrants, to the extent that they make up a higher proportion of the total, you are going to have less drawing benefits. And, then with the emphasis we have on part-time employment as part of our economy, those people are also less likely to qualify or if they qualify most likely will qualify for just a smaller number of weeks.

Mr. BURTLESS. And, I would repeat the things that they have said, maybe in this order: First, there are fewer programs in effect. The EB program is comatose. Second, State tightening of eligibility requirements for the regular 26-week program has made a difference. Third, the lower aftertax value of the benefits probably on the margin persuades some people that it is not worth the bother to go through the process of filing a claim, especially if they are only going to be unemployed very briefly and they know that.

And, finally an emphasis in Wayne Vroman's formal statement on the changing industrial and regional composition of employment and unemployment in this country. Those two factors combined have had an effect on what share of people we can expect will receive benefits.

Senator SARBANES. Is there a very large population that is entitled to benefits that doesn't claim them and draw them? Or is that a fairly small group?

Mr. VROMAN. One of the surprises I had when I was analyzing these recent CPS supplemental data sets was that the number of people who said, "I am eligible and I did not bother to apply," or gave that impression was quite limited.

I came away from that study still skeptical, wondering if people understand their eligibility as well as they should. But, for the vast bulk of the people who didn't apply, the most common reason they gave was they said, "I am not eligible."

So, I think there are some people in particularly short-duration situations who may never explore their eligibility, because they

don't expect to be unemployed for very long. But, your question I think is probing in an area where I would say even with the new survey data, we don't have the information we need to really put the question to rest or to say that we have the answer to it.

Senator SARBANES. Have we ascertained whether people who say they are not eligible, in fact, are not eligible? Suppose someone says. "I'm not eligible," and they don't understand what it means to be eligible and, in fact, they are eligible? Have we done any kind of check to give you any sense as to how accurate their judgment that they are not eligible is, in fact?

Mr. VROMAN. My prepared statement emphasized the State differences in the share of the job losers who are in the program. To me that's instructive, suggesting that in States like Texas and Florida there are several eligible workers who are job losers who are not trying to participate in the unemployment insurance system.

But, let me emphasize that I am speculating on that point, Senator. We don't really have a source of information where we get the individual's perceived eligibility matched up with what the unemployment insurance program could tell the person if they went in the door, applied and went through the monetary and nonmonetary eligibility criteria that exists in that State for that person.

Senator SARBANES. Let me ask this question: Of course, one issue is not only how many of the unemployed are covered but how much of their income is replaced by the unemployment insurance. I am now talking about people actually who are qualified and draw it. What has happened in that regard in terms of the level of the average weekly unemployment insurance that is paid? We have been focusing mainly thus far on whether a worker is covered or not covered. I now want to look at the workers that are covered, but to what extent are they covered in terms of having their income that they were receiving from the job replaced by the unemployment insurance; what impact that has, one, on their ability to stay out of poverty and support their family; and, two, the obviously important antirecessionary impact, too, in terms of the stabilizing factors you were talking about.

Mr. BURTLESS. Well, the most common benchmark used is to compare the average weekly check in unemployment insurance to the average weekly earnings of workers. And, you can find those series in the Economic Report of the President or many other places.

My recollection is that it's about 34-36 percent or so and has fallen within a fairly narrow bound over quite a number of years now. It has remained fairly stable.

So, the weekly benefit checks have kept up with wages. Now, wages, of course, have grown very slowly, measured in inflation adjusted dollars, in recent years. But, the gross benefit check has kept up with the rise in earnings.

Now, one point of my testimony is that the aftertax value of those benefits has declined, because now they are entirely taxed, so that according to an analysis of the Committee on Ways and Means over in the House about 15 to 16 percent of the value of those benefits is taken away just by Federal taxation. And, I would suspect that maybe on average 2 or 3 percent more is taken away by State income taxes on these benefits.

So, for that reason, after subtracting out the taxes, benefits have probably fallen somewhere between 15 and 20 percent relative to the average weekly paycheck.

Senator SARBANES. When you make that analysis, the benefits are included in taxable income, but depending on how much they amount to and what the income is would affect how much of it is, in fact, taxed; is that correct?

Mr. BURTLESS. Yes. The analysis that I am referring to, I think it was the Congressional Budget Office probably did the analysis, and they just saw what parts of the income distribution were receiving the benefits and they tried to calculate what the Federal tax and liability on the compensation would be.

And, that's the basis of the 15 to 16 percent estimate of how much was taxed away. Clearly, now after——

Senator SARBANES. Well, are they assuming that it was all taxed?

Mr. BURTLESS. Well, it's all taxed unless you can evade the taxes on it, I suppose, because that——

Senator SARBANES. Well, no, but you get a certain number of deductions from exclusions and so forth and so on, and if you give me a 15-percent rate that's your initial tax bracket, isn't it?

Mr. BURTLESS. I suspect that a big majority of recipients of unemployment benefits do not itemize on their taxes, so they probably just get whatever the marginal tax rate is. And, I suspect that was the CBO assumption. But, I don't know for sure.

I should emphasize that under the 1986 Tax Reform Act, I think you now have to have income about 15 or 16 percent above the poverty threshold before you are liable to pay positive taxes. So, if you are poor and get unemployment compensation, those benefits are not taxed. It is only at a level, 20 percent or so above the poverty line that people start to pay income taxes on these benefits.

Senator SARBANES. I had a question on what is the theory on whether States should build up a reserve sufficient to weather a recession or should go into the borrowing part of the program in order to cover part of the costs of meeting a recession?

Mr. DEISZ. I would like to attempt to respond to that, Senator. First of all, the most commonly accepted standard as to what the reserves should be is 1½ times the high cost year multiple. And, the assumption there is that's going to get you through most recessions.

But, I think the theory that I am familiar with on the borrowing is that the borrowing should be there for unusual circumstances. State should not need to have the large reserve that will cover you in the once in a lifetime situations, but to take care of those ordinary ongoing circumstances.

I think one of the reasons though why the borrowing provisions were tightened up is that for a while the States were, in effect, using that for cash-flow purposes. The borrowing capability was there. There was no interest charged, so there was virtually no incentive at all to maintain much of a reserve.

So, I think there was some tightening up for that reason. But, I think generally the idea is that the borrowing should be for unusual circumstances, but that it is there for that purpose.

Mr. VROMAN. If I might offer one short point. If you think about the way the Federal Reserve's interest rate policy of the 1980's and

up through the present has been conducted, a State that had a decent unemployment insurance trust fund would, in fact, accumulate a lot of reserves simply through the interest earnings on their trust fund. With interest rates in the 8, 9, and 10 percent range, there would be no need to levy additional taxes on employers and you would have a source of revenue coming from the fund that you already had.

Mr. BURTLESS. I think it's generally thought to be a bad idea to make a fast response in the midst of a recession. And, that has been an old criticism of funding of unemployment insurance.

Even before the difficulties people ran into in the 1980's, a number of academic analysts as far back as the 1960's pointed out that the experience rating built into most State programs' tax system for unemployment insurance would automatically kick up the unemployment insurance payroll tax on those employers experiencing above average unemployment.

Now, if those extra taxes kicked in in the midst of a recession, General Motors and Ford, after a severe recession, as they are trying to recover would find that they are paying higher payroll taxes. And, a lot of people thought that that was a bad idea.

But, the situation in the 1980's has compounded this problem, because States now feel that they cannot borrow either. As Wayne Vroman says, States are behaving as though there is no borrowing available. And, so they try to build up these large reserves.

But, even worse is that those States that don't build up large reserves, as soon as they enter a recession, begin to think about taking actions which will keep the solvency of their system in good shape. But these actions will hurt the economic climate of the State, because tax rates are raised, benefits are cut right in the midst of a recession. And, that's generally thought to be a bad idea.

We would like the reserves to be large enough so that they can sustain a system through a long recession. And, if that isn't possible, we would like the Federal Government, I think, to be able to make loans so that States don't have to take these economically counterproductive steps in the midst of a downturn.

Mr. VROMAN. Illustrative of the situation in the States, Senator, when they started to pay interest on the debts, if you followed each individual State's borrowing and what they did with their interest bearing debt, they tried to pay off those debts as quickly as possible. Several States had both interest bearing and interest free debt in the early 1980's, and the rate of repayment of the interest bearing debts was extremely rapid.

It would be very likely, since there are still interest charges on the debts, that any State that gets into debt now would again try to repay very rapidly, partly through the mechanisms that Gary Burtless just mentioned. I mean, they would raise taxes and cut benefits even while still in recession.

Senator SARBANES. How quickly are claims generally paid?

Mr. DEISZ. Mr. Chairman, the standard is that—I hope I'm right on the percentage—I believe it's 87 percent have to be paid within 14 days after the week ending date for the week in which they were claimed. That's a standard that States must maintain.

And, there is some potential action that can result if they don't meet it. So, it's within basically 2 weeks after the filing is the standard.

Senator SARBANES. But, as I understand your prepared statement—you don't actually read that part of it although you referenced it as you went through your oral statement—you are giving a situation now because of the difficulty on the administrative side of sufficient moneys to carry out the administration, you have these long lines that you were talking about. You say many local unemployment offices were closed, long lines, workers had to wait most of the day to file claims, overcrowded offices, delays in claim filing and payments and "our own employees in these offices were pushed further than good management dictates," et cetera.

Mr. DEISZ. I think the point, Mr. Chairman, there really is a two-edged sword. No. 1, we do have a standard timeframe in which payments are to be made which subjects the agency who is not complying with that standard to legal action if they don't meet that criteria. The other part of it then is how do you get payments out quicker.

Well, one of the responsibilities we are charged with also is to ensure prompt payment of benefits to eligible individuals. So, it's a matter of—you know, the things that tend to suffer are the eligibility reviews and the help that is provided to the individual in terms of finding employment.

So, you really have the dilemma of either just running people through the system without doing the things that, you know, support accurate claims payments in the first place which results in increased costs and, second, which helps the person get back to work sooner.

So, the standard that is there and the fact that resources are, in effect, fixed but as workload increases the quality of the program and the timeliness both suffer.

Senator SARBANES. Let me ask you all a very general question. What is your view of the adequacy of the unemployment insurance system?

Mr. BURTLESS. I think that if our system suffers a very severe problem, it is in the duration of benefits. A couple of years ago, I did an analysis of unemployment insurance systems around the world.

And, the United States stood out in two dimensions. One is how low benefits are as a percentage of average earnings of the laid off worker. But, that wasn't as big as the difference between the U.S. system and other systems in terms of the duration of benefits.

In Germany, which——

Senator SARBANES. We are noticeably low on both measures compared with other systems?

Mr. BURTLESS. Yes. We are not exceptionally low, I don't think, for the first 26 weeks. There are other countries that are nearly as low as we are or have benefits that are only slightly below ours.

But, in terms of the duration of benefits, we are exceptionally cheap, I would say. We give benefits for 6 months in typical times. And, a much more normal benefit duration is 1 year. Germany, which hardly had until the 1980's any severe unemployment prob-

lems to mention, has had a year's worth of regular benefits for most of the century.

I think that this short duration of benefits primarily affects our system in the midst of a severe recession. One characteristic of unemployment in our country compared to other countries is that we have exceptionally short spells of unemployment. So the fact that people can exhaust benefits at the end of 26 weeks is not a hardship probably to 75 to 80 percent of people who lose their job. But, in a recession it becomes a hardship to a much higher percentage of unemployed workers, because they are more likely to exhaust their benefits.

That is the reason that I would emphasize extending the duration of benefits, particularly when unemployment rises.

Mr DEISZ. Mr. Chairman, my comments I think are very similar to Mr. Burtless'. The problem, as I see it, is that our policy, the framework around which our unemployment insurance system is built really is geared toward short-term temporary unemployment.

I think the system probably does reasonably well to address short-term temporary unemployment. It does not do nearly as well when you get into the heavier cyclical unemployment or the longer term structural unemployment.

I think that's a real shortcoming we have, not just for the unemployment insurance system but for an employment and training policy in general. We have covered the short-term temporary layoffs I think reasonably well through unemployment insurance, but we really have nothing beyond that.

Mr. VROMAN. The only thing I would add is that in the area of compensating the short-term unemployed, the geographic differences going from, say, the New England, Middle Atlantic, and west coast States were if you become unemployed you have a very high probability of collecting benefits to States in the South and the Rocky Mountains where you have a much lower probability. I think that's a defect of our system.

You know, we have this unique Federal-State system. Unemployment insurance has several different provisions that vary from one State to the next.

But, as a rule, States in the South and States in the Rocky Mountains don't compensate nearly as many of their unemployed as States in other areas.

Senator SARBANES. That leads me to my next question, and that is: To what extent is the unemployment insurance burden used as a competitive device among the States? Is the burden significant enough that it counts in that regard? And, if it is, to what extent do you have, in effect, States doing less than they should by any reasonable judgment to gain a competitive advantage as against other States for the purpose of attracting industry or industrial development?

Mr. DEISZ. My response to that, Mr. Chairman, is that I've heard the saying that perception is reality. And, I would say that there is a strong perception out there that a low employment insurance tax rate gives you a significant advantage.

And, it is one that is used. Where that condition is present, it is used very extensively in trying to recruit and encourage business.

I am not so sure whether the impact is real. But, I think the perception is there that it's important and that consequently that does affect things like benefit levels. It affects things like building up a reserve.

My sense is that some time in the future, we are going to look at that differently. And, I think we have tended to treat the work force more as a—I don't know if expendable commodity is the right term, but really in terms of unlimited replacements.

I think as we have become more aware of the fact that that is not going to be a reality in the future, as we begin to look more at that work force as an asset that we want to protect, there may be a reversal, where rather than talking about how low our tax rates are we may be talking instead about what an effective program we have to meet the needs of employers of workers and emphasize that point.

But, right now I think the low tax rate is one that is striven for, because it is perceived as a competitive advantage.

Senator SARBANES. Of course, that attitude about your workers I think is a marked contrast between the attitude that prevails at least in some circles in this country compared with other industrialized nations, which may tie in with Mr. Burtless' point about the contrast between the coverage under our system with other countries who seem to see this human resource as something that needs to be sustained.

They have a heavier component of training programs, don't they, as well, or not?

Mr. BURTLESS. Well, that largely depends on the country. Some countries do emphasize retraining of their workers and providing excellent employment services with lots of access to knowledge about where new jobs are being created and so forth. But, not all countries follow that.

We are fairly unique I think in believing that if you provide a limited amount of income maintenance to people during spells of temporary unemployment that is enough to take care of unemployed workers. Other countries have much greater emphasis on trying to create the jobs through some governmental structure or have a governmental structure that tries to link the workers with the jobs.

The employment service in this country is very weak in comparison to similar services in other industrialized countries. And, as you suggest, the employment and training efforts are weak compared to some other countries as well.

Mr. VROMAN. Back to your original question, the unemployment insurance taxes are a very small part of payroll. But, it seems to me many people try to make a connection between the level of unemployment insurance taxes and business climate.

And, unemployment insurance taxes are something that potentially a State can control similarly to its workers' compensation costs and having a right to work law. You can think of several kinds of actions that States can do which may affect the perception of businesses as to how friendly an environment the State is offering to locate new plants and to expand existing establishments.

So, my first comment about perception being more important than the reality, I agree with. But, it may be, if you accumulate

several things, that the business climate or perceived business climate may, in fact, differ by State and the unemployment insurance tax may be an important component of that.

Senator SARBANES. Do you think there should be enhanced Federal standards that preclude some of this interstate competition on this issue, for instance, the wage base?

Mr. VROMAN. At a de minimus level, we have that right now. That is, there is a minimum that each State has to have. The $7,000 is a Federal standard.

Last year, the Congress had the opportunity to enact a change that I thought went in a modest direction and in a constructive direction by going 8, 9, 10 and then indexing it from that point forward. It chose not to do that.

It seems to me that that would be the kind of thing that is feasible and that would help.

Senator SARBANES. It would help in terms of diminishing the range within which States——

Mr. VROMAN. Yes.

Senator SARBANES [continuing]. Then seek to compete with one another and gain an advantage?

Mr. VROMAN. Yes. A State could then offset the effect of the higher base by restructuring its whole set of tax rates in the unemployment insurance system, but that would require some extra legislative action at the State level.

By raising the tax base, that would be—I'm sorry for the phrase—leveling the field some.

Senator SARBANES. Do you want to comment on that, Mr. Deisz?

Mr. DEISZ. Just briefly, Senator. My comment would be I think not necessarily in terms of standards, because standards become fixed and conditions change.

I think there is a need to have an active Federal advisory council reviewing these issues on an ongoing basis and making appropriate recommendations to the Congress and to the individual States. The system has not changed a great deal in its philosophical orientation really in the 50-some years.

And, I think the world in which that system works has changed considerably. So, I think that an ongoing review to test relevance and current and future needs is an element that has been missing and perhaps tends to accentuate problems such as interstate competition that can result.

Mr. BURTLESS. But, there is one other thing, too, I think in the climate in the last few years that may have changed, at least at the State level and probably also even at the Federal level. That is that while there is this competition between States to offer a good business climate, which might be indicated by having a low payroll tax rate for unemployment insurance, historically there was a countervailing voice within governments and that was the voice of ordinary working people who, of course, wanted to have decent protection if they should be laid off.

And, I think a prominent exponent of that view has been labor unions within States. They would often take an adversarial role with the business community in the State in determining what exact arrangements are going to be made, not only in unemployment insurance but also in workmen's compensation and so on.

These kinds of discussions take place largely out of the view of most of the public. These are the interested parties. They understand what is going on. They understand the technicalities of unemployment insurance.

But, as the voice of labor unions has weakened I think around the country, there is one voice that gets a little bit fainter year after year in the discussion of how the State unemployment insurance system should move. And, that's just a practical assessment of the situation, I think.

The voice of labor unions representing the viewpoint that says, "No, there should be good protection during spells of unemployment," is weaker I think in many places around the country. And, the business community voice remains just as strong as ever. And, businesses do see differences between States and the attractiveness of the business climate.

Senator SARBANES. You all have either worked in the system or studied it very closely. There are a lot of ad hoc stories about abuses in the system. You are constantly encountering those on the street, that people abuse the unemployment insurance program, they are drawing it when they shouldn't and so forth and so on.

What is your view of how widespread that is? Or, how effective is the system in monitoring itself and providing the benefits where they are supposed to be provided and in precluding benefits where they are not supposed to be provided?

Mr. VROMAN. Certainly,the perception is quite widespread. When the Labor Department instituted a quality control program about a decade ago, they did find several people who collect benefits who are not eligible.

The predominant reason that people collect who are not eligible is that they are not continuing to search actively for work. It's not like they got in the door illegally, claimed the wrong amount of base period earnings or anything like that, but they haven't gone out and contacted the three employers this week for the 5th or 7th or the 15th week that they have been unemployed.

Now, if you view that as a major abuse, then there is a measurable amount. But, the quality control data do not come up with large estimates of outright fraud in terms of having earnings at the same time, which I think is the more common perception.

Mr. DEISZ. Mr. Chairman, I believe any program that involves payment to a large number of people has some fraud in it. And, if it's a publicly funded program, of course, I think the instances of fraud will be widely discussed and often perhaps exaggerated.

I think the system does a reasonably good job of protecting against fraud. I think there is a point where the efforts become not cost effective, where the cost of eliminating one additional case becomes prohibitive.

Under normal conditions, I think our record is quite good. I think where we run into problems is where we have the crunch of massive increases in claims without people to deal with them effectively and sometimes that creates not only an opportunity for improper payment, in individual cases, but for somebody who has large scale plans in mind to work the system.

But, I would say on the whole I think the record is reasonably good.

Mr. BURTLESS. I think that the level of fraud is closely tied to the fact that in our system it is very difficult to monitor how effectively people are seeking jobs. And, that is what Wayne Vroman also emphasized.

We don't know how actively people are out there searching for work. And, so what we do is create a number of bureaucratic hurdles for people to jump over to prove that they are making a good faith effort to seek jobs.

Sometimes that involves filling out cards. And, those cards might not be filled out.

But, the question is: Does the filling out of those cards actually imply that there is active job seeking going on? And, the evidence suggests, no, that's not what it indicates at all. It's just a form that has to be filled out at some cost to the applicant in order to receive benefits.

In some other systems, they don't have to do this extensive monitoring. And, the reason is that the employment service in the country has a very good knowledge of all the vacancies that are available in the local job market. It knows what job openings there are. And, the Government also creates some jobs for the long-term unemployed.

And, so they don't have to worry as much about this kind of fraud or whatever you want to call it.

In our system, I think our response to this problem is that we limit benefits. Since we don't know where the jobs are and we don't know how to help workers find those jobs, to limit the overall amount of fraud, limit benefits to 26 weeks.

I think these two things are linked in our system: the lack of a government service that is really effective in helping people find work and also the short limitation on how long people can draw unemployment benefits.

Senator SARBANES. Do you think significant resources should be put in to trying to make the employment service more effective in helping to fit together the unemployed with job opportunities?

Mr. BURTLESS. I think so, although whether under the current administrative setup of the employment service that would be money well spent is a question I really can't answer, because I don't know whether they would be equipped to spend an additional 30 percent or 50 percent or 100 percent in funds very effectively.

Senator SARBANES. What do you think about that, Mr. Deisz?

Mr. DEISZ. Well, I——

Senator SARBANES. You are right on the firing line, so to speak.

Mr. DEISZ. I think, No. 1, we tend to paint a lot of things with a broad brush, often without some firsthand knowledge. We have a saying back home in North Dakota that everybody who has never farmed knows how.

I think the employment service does a reasonably good job. If you look at the record in the funding area, the staffing for the public employment service from 1980 to 1990 decreased from about 30,000 to 17,000. That will give you an idea of what has happened to the effectiveness of the short term.

That same decade was one of vast technological change, increased computer capability, et cetera, which can be used to gather information about the job market to bring those services to people.

However, the funding situation where the actual dollars available to the system stayed pretty much the same while the cost of doing business went up, made it impossible to take advantage of new technology.

So, the last decade has been an extremely dificult one for the public employment service. And, I think the record has shown that for the money that is put into it, I think we are doing pretty well.

I think we could effectively use a great deal more resources. I think last year may have been the first year in some time that we had an increase in funding that exceeded the cost of living.

But, it's a very critical element that is part of the whole unemployment insurance issue. As I had mentioned earlier, we talk about temporary income maintenance and that's it. We have a very strong need for a coherent employment and training policy and a strong, reasonably funded employment service is part of that need.

And, I think it's a system that is doing well, given the circumstances.

Senator SARBANES. Well, gentlemen, you have been a very helpful panel. We appreciate very much the obvious effort that was given to preparing for this appearance. We are very grateful to you.

The committee stands adjourned.

[Whereupon, at 12:25 p.m., the committee adjourned, subject to the call of the Chair.]

THE 1991 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, FEBRUARY 12, 1991

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 11:08 a.m., in room SD-138, Dirksen Senate Office Building, Hon. Paul S. Sarbanes (chairman of the committee) presiding.

Present: Senator Sarbanes and Representative Hamilton.

Also present: Stephen A. Quick, executive director; William Buechner and Chris Frenze, professional staff members.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

Senator SARBANES. The committee will come to order.

The Joint Economic Committee is pleased to welcome the Council of Economic Advisers here this morning, its Chairman, Michael Boskin, and his colleagues on the Council, Messrs. John Taylor and Richard Schmalensee.

They are here this morning pursuant to time-honored tradition, to present to Congress the 1991 Economic Report of the President, which was released just a short while ago, and to testify on the President's economic program.

Today's hearing will focus on both the short-term prospects for the American economy, and what must be done to ensure steady growth of the economy for the longer term.

With respect to the short term, we are obviously, as I think all Americans are, concerned about the severity of the current recession. It has now been recognized as a recession. Alfred Kahn, a few weeks ago, perhaps more than a few weeks ago, when people were refusing to recognize it as a recession, said, "Well, let's call it a banana." But I see that you have decided that that is not the better course, and we now perceive it as a recession. And we are concerned about what plans the administration has to help move the economy out of its current decline.

Over the longer term, we hope to focus on the kinds of investments which our economy ought to undertake, the Government and the private sector working together to create a healthy and dynamic economic system.

During the past decade, in the 1980's, many in the Congress were concerned that the administration was pursuing economic policies that had the potential to harm the longrun growth prospects of the U.S. economy. We seem to have been focusing on the short term,

tax cuts, cuts in spending on education, housing, community development, capital grants for the development of infrastructure, all of which, of course, are important investments—and spending on research and development—all of which are important to the future strength of the economy. And in fact, I think it's fair to say that budgets submitted during the 1980's were not what one would call investment budgets.

I must say that this year's budget and the Economic Report of the President seem to me at least to recognize this problem or difficulty. I think they reflect a growing recognition among economists, businessmen, labor people, and people generally that economic growth requires government investments in certain important parts of the infrastructure, that the private economy upon which we place our prime reliance cannot grow without adequate physical infrastructure, without well-educated and well-trained workers, or without a safe and healthy financial system. This is an important change and welcome change in emphasis, but serious questions remain about whether there is a willingness to put adequate resources into these investment commitments.

We hope to explore that matter as well as we hear from Chairman Boskin and his colleagues this morning.

Mr. Boskin, let me just finally say to you in closing that I, for one, having spent in my youth a year at the Council of Economic Advisers as an assistant to the Chairman, do want to commend you on your efforts to bring professionalism into the processes of the Council. You have addressed, I think, a number of issues. Albeit a small, but important one of this committee is your efforts to improve the statistical infrastructure. I think you've brought the Council back into the economic policymaking circles of an administration where it was designed to be by the Employment Act of 1946, and I may question you a bit about that in the course of the morning's hearing. While I may disagree with the substance of some of your policies and we may argue about direction, I do want to say that I think the Council has shown professionalism under your tenure as the Chairman and we welcome that and commend you for that.

Mr. BOSKIN. Thank you very much, Mr. Chairman. We're trying very hard in that regard.

Senator SARBANES. I yield to Congressman Hamilton.

Representative HAMILTON. Well, thank you, Mr. Chairman. I have no statement, just a word of welcome to Mr. Boskin and his colleagues.

We look forward to your testimony.

Senator SARBANES. We'll be ready to hear from you, Mr. Chairman.

STATEMENT OF HON. MICHAEL J. BOSKIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, ACCOMPANIED BY RICHARD L. SCHMALENSEE AND JOHN B. TAYLOR, MEMBERS

Mr. BOSKIN. Thank you. We have a prepared statement that we'd ask to be entered into the record.

Senator SARBANES. The full statement will be included in the record.

Mr. BOSKIN. And I will make some introductory remarks and then Mr. Taylor and Mr. Schmalensee will amplify briefly, and then we'd be pleased to take questions.

In particular, I want to thank you, Mr. Chairman, and also Congressman Hamilton, who have long been supporters of the professional activities the Council of Economic Advisers.

I would point out that the Joint Economic Committee and the Council of Economic Advisers, created simultaneously by the Employment Act of 1946, are somewhat brother or sister organizations. We very much appreciate the focus that the committee has had over the years on longer term developments in the economy and trying to bring research and analysis to bear on some of the problems of the economy.

I also would like to commend you simultaneously, Senator Sarbanes, and also you, Congressman Hamilton, for the support you have given to the initiative you mentioned, the attempt to improve the quality of the Government's economic statistics. With all the other things going on at the moment, or even in more normal times, it is not the sexiest topic in town. But it is, we believe, an important part of our infrastructure—the informational infrastructure that forms the basis upon which our citizens are able to draw their interpretations of what is actually going on in our society.

And so I commend the Joint Economic Committee and your efforts and I note the desire and willingness of the administration, especially the Council of Economic Advisers, to cooperate with you in the future on that subject.

As I indicated, I just want to give a brief overview of the Economic Report of the President and then highlight some issues discussed in it. The 1991 report is the second of the Bush administration.

Last year's report dealt heavily with policy principles. This year's report emphasizes several themes and then goes on to discuss recent economic developments in the outlook; the oil shock and how it compares to those of the 1970's; the dynamic changes occurring in many sectors of the economy and how economists tend to think about the benefits and costs of those; the economies in transition in Eastern Europe and other parts of the world, including Latin America; and the important trade situation involving the Uruguay Round and in our own hemisphere.

I'm going to focus my remarks on the themes and then on recent developments and the outlook. Mr. Taylor will speak on some macroeconomic issues and trade, and then Mr. Schmalensee on microeconomic issues, regulation, market flexibility, and associated topics.

The four main themes of the report are, as you noted in your opening remarks, first, the importance of economic growth as the foundation for providing the resources necessary for much of what we hope to do in our society, which includes not only providing higher standards of living to our citizens, but also enabling us to meet a variety of other important public and private goals.

The second theme concerns macroeconomic policy, credibility, and making macroeconomic policy—both monetary and fiscal policy—more systematic.

A third theme, and Mr. Taylor and I will both speak about that with respect to monetary and fiscal policy, is that a major asset of our economy stems from the flexibility that results from a heavy reliance on markets for decisionmaking.

And the fourth theme is how that flexibility can be enhanced and encouraged in various ways through a variety of initiatives and changes.

Those four themes are reflected throughout the report. They are broad, important themes. They are general enough that I think almost all economists would agree on the importance of these general themes, whatever their political persuasion or economic school of thought.

Obviously, how people feel the policies suggested by these themes ought to be implemented, and how they are indeed implemented in the political process, engenders some disagreement.

Let me spend a moment or two talking about the recent developments in the economy, Mr. Chairman.

After the longest peacetime expansion in American history, the economy has entered its ninth postwar recession and that expansion has been interrupted.

The economy was already growing slowly. For several quarters, real GNP had been growing at an annualized rate of a little over 1 percent prior to entering the recession.

The reasons the economy was growing slowly were many, and among them were the increase in worldwide interest rates, in part due to, in our view heavily due to, the changes in the demand for capital—for example, to finance German unification and the internal needs of Japan. Unexpectedly tight credit conditions also played a role. The so-called credit crunch had several sources, among them the slowing economy, regional real estate problems, and perhaps some overly zealous bank examiners that swung from being too lax to being too stringent, rather than being in the middle in terms of prudent oversight of our financial institutions.

Also, some bank capital requirements pursuant to the Basel accords caused some changes in lending behavior.

And finally, we had the lingering effects of the monetary tightening that began in early 1988 through the middle of 1989, which successfully prevented an acceleration of inflation, but, as usual, caused a subsequent slowdown in real output and employment.

So the economy was already growing very, very slowly, and then the oil shock hit following the Iraqi invasion of Kuwait, and that shoved the economy over the edge.

There was the direct effect of the transfer of resources abroad because of higher oil prices, and the fact that we are an oil-importing nation. And there was the indirect effect engendered by the uncertainty that was created by the situation in the Gulf that led to a decline in consumer confidence. Because of that uncertainty much big-ticket consumer spending and some business spending was frozen.

Despite these conditions, I might say there were some areas of the economy, some sectors and some regions, that continued to do well.

As always, even when the economy is doing well, some regions and sectors lag behind, and when it does poorly, some regions and sectors still do reasonably well, in general.

There are some areas and regions of the country that have been hurting longer and are in worse shape than the national average, and others that are doing better.

New England and New York have experienced problems longer. The Mountain States, the industrial Midwest, except for the auto industry, the farm community, on average, and the oil patch, even before the Iraqi invasion, were rebounding and doing better than average.

Automobiles and construction in particular have been hit very hard, and the regions associated with their slowdown have been hit hard as well. To a large extent, that is where the increases in unemployment have been concentrated.

Before turning to the outlook, I might say that it's important to remember that the U.S. economy is still the largest, most productive—in terms of its absolute level of productivity—in the world.

With less than 5 percent of the world's population, we produce over a quarter of the world's GNP. We're more than twice as large as the second largest economy, which is Japan. The waxing and waning of particular industries within manufacturing causes much consternation in various quarters, but, indeed, the U.S. economy is not deindustrializing.

If you look at manufacturing's share of real GNP in the late 1980's, it's quite similar to, as a matter of fact, slightly higher than it was in the mid-1970's.

So, in any event, we start from a base of a wealthy, strong economy. We have entered a recession. Our expectation is, as is that of most private economists, that it will be relatively brief and relatively mild.

I'll come back in a second to why I think that's to be the case.

Our forecast for real GNP growth for the year is 0.9 percent. That includes a continued decline in the early part of the year, a leveling off, and then an improvement in the second half of the year.

By way of comparison, the February 1991 average of the Blue Chip 52 forecasters is also 0.9 percent. The Congressional Budget Office forecasts a somewhat shallower recession with, in the short term, a somewhat faster rebound.

Before saying why I believe it's likely to be short, I should say that economic forecasting, as I know both of you know, is a very imprecise science. We may all be wrong about this. The economy could do better or worse than these forecasts, which all tend to be pretty close together for the short term.

Senator SARBANES. John Galbraith, testifying before one of the congressional committees about economists making forecasts, said there are two kinds of such economists—those who don't know and those who don't know that they don't know. [Laughter.]

Mr. BOSKIN. Well, I'm trying to indicate the degree of imprecision, sir.

We, in the report—and this is something that we have instituted in the report and in the budget—it's an innovation—have tried to indicate the different paths the economy might follow which are

better or worse than the baseline projections. We have also tried to indicate what might cause them and what the implications might be for things like the budget deficit and so on.

Some of the areas of uncertainty include, obviously, the Gulf and oil situation and the availability of credit.

With that in mind, I won't go into detail on the short-term outlook. We see unemployment rising about another half percentage point before declining starting next year. We see interest rates about a percentage point lower this year than they were last year, with inflation coming down from the temporarily elevated levels of last year, which were caused by the oil price increase.

I would indicate that even though it's a very imperfect forecaster itself, the stock market also seems to be predicting a relatively short, mild recession and a decent recovery. But I guess I ought to also say that the stock market predicted nine of the last five recessions.

I would add something about the intermediate term projections that go through the end of the forecast period, the fourth quarter of 1996. If we take the third quarter of 1990 as the business cycle peak, our average growth over that period is 2.6 percent. The Congressional Budget Office, which is a little more pessimistic about the economy's growth potential, projects 2.4 percent.

The average growth rate over 25 quarters—which is the length of period I've just described following the business cycle peak—has been a little over 3 percent.

There are some demographic factors. The labor force is growing a little less robustly for example, but I think the basic outlook over this period is relatively similar to CBO's. Indeed, our real GNP level is below that of the Congressional Budget Office through 1993. It's slightly above in 1994. And in 1996, it's about 1 percent above the level of the CBO.

So, as I said, we may all be wrong. We certainly hope the economy does better. But these forecasts are generally roughly in the same ballpark.

I'd like to add a word about the oil shock. It's been a proximate cause of the recession and a source of much concern.

I would like to highlight a couple of differences between the recent oil shock and those of the 1970's, the one that hit in 1973 and the one that hit in 1979.

First, the economy uses about 30 percent less energy per dollar of GNP produced than it did in the 1970's. Some of the deregulation of energy markets has improved the resource allocation in the energy sector, and fortunately, we have not suffered this time around from things like the long gasoline lines that our citizens had to bear with in the 1970's.

Importantly, macroeconomic policy has been in a vastly different position—in particular, monetary policy—to respond to the current situation for some very important reasons.

If one looks at the period right before the last two oil shocks, right before the 1973 shock hit and the 1979 shock hit, inflation was much higher than today and was already accelerating.

Then came the oil shock that worsened inflation, and put the Federal Reserve in an untenable situation—having to deal with a

high and rising inflation prior to the oil shock and then the worsening with the oil shock.

Monetary policy tightened. Other things happened—the large transfer of resources to the oil-producing countries, for example. We had the two worst recessions in the postwar history of the United States, with unemployment reaching 9 percent in 1975 and 10.8 percent in 1982.

We expect that to be far less of a problem this time around for some of the reasons I mentioned. The size of the oil price increase and its duration is somewhat less. Fortunately, we're already beginning to see the reduction of that direct big drag with the fall in oil prices down into the low $20 range.

But also, monetary policy is very differently situated. Inflation has been much lower and relatively stable in this expansion. Certainly it is different relative to the situation the Federal Reserve found itself in prior to the two oil shocks in the 1970's.

That has earned the Fed the credibility of being able to help cushion the downturn, without generating great fears of increased inflationary expectations, and has put monetary policy in a better position.

And certainly money and credit growth has been at the lower end of the Fed's target range for the last few years. I think that has created a situation where the Fed has been in much better shape to deal with the current downturn without increasing fears of future inflation increases.

And indeed, the Fed has begun to do so more aggressively in the last couple of months.

A couple of other points.

Inventories remain quite lean by historical standards. Many of the previous postwar recessions were aggravated substantially when production cuts had to occur to work off excess inventory.

In most industries, and in the economy as a whole, that is not the case now. As I said, we've also had the oil price declines. Interest rates have come down and that traditionally has led, after a lag of two or three quarters, to a revival of activity.

So we believe all these factors put the economy in the position to recover by the middle of the year. But, again, as I indicated, there's a variance around that forecast and I appreciate the tenor of your comments about the difficulty of forecasting.

I'd like to say just one or two more words, then ask Mr. Taylor and Mr. Schmalensee to say a word or two.

We have the shortrun problem of cushioning the impact of the downturn on the economy, and on American families. We also have some longrun problems which you alluded to in your opening remarks, Mr. Chairman—public and private investment, including our public infrastructure. Last year's budget proposed some major expansions. For example, our aviation infrastructure—Secretary Skinner will unveil tomorrow some detailed plans for expansion in our surface infrastructure investment. We likewise have similar situations with respect to public and private research and development. We want to make sure that when we generate new technologies, as we often do in the United States, that we rapidly make it commercially available.

Investment in our human capital is also important. It's easy to forget in talking about all these other kinds of investment that three-quarters of the income received in the United States, including fringe benefits and three-quarters of business costs, accrues to labor, our human capital, our workers. And this is vitally important not only to our current workers, but also to our workers of the future. It is important that our citizens are increasingly productive and develop the skills in their elementary and secondary education, in their postsecondary education, and in their work careers, to compete in an increasingly skill-dominated marketplace.

In the Council's view, problems in, and the relatively poor performance of, elementary and secondary education in the United States, which undoubtedly has many causes, is a major, longrun economic problem for our country. If our children don't learn as much or more as their peers abroad, they're not going to earn as much or more in the future.

We highlight this issue in the report as a serious long-term problem. And if I was asked, what would be my major concern about the American economy 25 years from now, it would be to make sure that our labor force was in good shape, and I'd put heavy emphasis, as the President has with the Nation's Governors, on education.

Also in the report, we lay out the economic background and some intellectual justification and background for various administration initiatives. These include trade initiatives, such as those in this hemisphere, for example the potentially historic Enterprise for the Americas Initiative, as well as the Uruguay Round of the GATT. We also analyze the certainly historic proposals for banking reform, which Secretary Brady unveiled last Tuesday and I know you, Mr. Chairman, will play a major role in discussing and debating as legislation proceeds. There are discussions of a variety of other areas, including those that try to give low-income individuals more of a stake in their communities in home ownership.

The major achievements made in the budget legislation last year, including the expansion of the earned income tax credit that targets resources to families rather than to institutions, and a variety of other such initiatives, are also discussed in the report. Some that were discussed in more detail in last year's report are not in this year's.

If I may, Mr. Chairman, I'd like to ask Mr. Taylor to amplify for a couple of minutes, and the same to Mr. Schmalensee.

Senator SARBANES. Thank you very much. Mr. Taylor, we would be happy to hear from you.

Mr. TAYLOR. Thank you, Mr. Chairman. I will focus my remarks on issues related to macroeconomic developments and international trade developments that are touched on in the Economic Report.

The report tries to provide an economic analysis of how the Administration's policies are designed to both mitigate the current recession and to provide a foundation for a solid and strong recovery.

One of the features of those policies, which we highlight in the report, is that the macroeconomic policies are both credible and systematic and they should remain so.

Mr. Boskin indicated with reference to monetary policy how the advantages of a credible and systematic monetary policy allow for

the Fed to provide for an adjustment to help mitigate the downturn without at the same time raising expectations of inflation.

In the 1970's, with inflation already high and rising before the oil price shocks took place, that latitude did not exist.

The same principles apply to fiscal policy. I'd like to elaborate on those for a moment.

The new budget law enacted last year allows opportunity for short-term increases in the budget deficit, if such increases are brought about because of a weakening economy, and for continued declines in the structural budget deficit over the longer haul.

As you know, the so-called automatic stabilizers, whereby tax receipts decline relative to what they otherwise would be as the economy weakens, and transfer payments for such things as unemployment compensation increase as the economy weakens, have long been thought by economists to be an important stabilizing feature of fiscal policy that should be maintained.

The new budget law, in allowing the budget deficit targets to be adjusted for changes in the economic assumptions, allow these automatic stabilizers to work more efficiently than the previous budget laws permitted.

In particular, by allowing the budget deficit to increase in the shorter term, while at the same time maintaining the caps on spending and the pay-as-you-go rules with respect to entitlement legislation, the structural deficit declines gradually over time, and is expected to do so.

We have some charts and illustrations of that phenomenon in the report using calculations from the Department of Commerce which are based on the national income and product accounts, and therefore, related to the impact on the overall economy.

According to the Department of Commerce, in the short term, while the actual budget deficit, of course, will increase, the structural budget deficit will actually decline in this current fiscal year. And that's because the slowdown in the economy temporarily raises the measured deficit.

While credible and systematic policies will provide the stimulus to keep the recession short and mild, in our view, these policies will also provide the foundation for a recovery. We think that additional policies are needed to provide for longer term growth in the U.S. economy, which so much depends on increases in productivity in the long haul.

And for that reason, the President has proposed a whole host of initiatives which are designed to increase saving, reduce the cost of capital, and to provide for this increase in productivity in the longer term.

I would just mention the things that have been proposed already and are discussed very briefly in the report—family savings accounts, enhanced individual retirement accounts, extended tax credits for R&D, a reduction in the capital gains tax, the Treasury's proposals to modernize the financial system, and the proposals in education that Mr. Boskin briefly referred to.

To get our long-term growth rate up, so that we can remain competitive and provide for increased standards of living, policies like that are needed.

Moving on to trade policy briefly, one of our chapters in the report is dedicated entirely to international trade. It has two features which I'd like to emphasize.

One, it tries to explain the gains from trade and the losses from protectionism or from managed trade in the context of as modern a view of international trade as we can provide.

This analysis doesn't rely solely on standard comparative advantage arguments originally developed at the beginning of the last century by David Ricardo, but it tries to explain why growth could actually increase because of the induced innovation that can occur as markets grow. Larger markets provide greater incentive for innovation and for technological progress and increased growth.

We try to elaborate on that in the report and try to consider how important it might be in quantitative terms.

The second point which I would mention about the discussion of international trade is that we go through, in summary in certain areas and in detail in others, all of the protrade initiatives which the administration is working on and has put forth.

This includes the GATT Round, which, of course, remains the No. 1 trade priority. We have an extensive discussion of the gains that can come from the completion of that round, not only in agriculture, but in a whole wide range of areas, including manufacturing.

But we also mention how this initiative and these negotiations are complementary to protrade initiatives such as the Mexican-American free trade area negotiations, which would combine with U.S.-Canada free trade area to provide a free trade area for the North American continent.

We discuss how this initiative interacts with the Enterprise for the Americas Initiative, a proposal which not only would provide official debt relief, and thereby complement the Brady initiatives in the commercial debt area in Latin America, but would also set the foundations for free trade areas in many of these countries in the future.

We also discuss our initatives with Japan, the structural impediments initiative, which aims to reduce trade barriers and to open markets, and even the Andean initiative, which reduces some of the trade barriers in countries that are making progress in restricting drugs.

So, viewed together, all these policies I think indicate the very protrade orientation of the administration's policies which are aimed to exploit the gains from trade and open markets around the world. Thank you, Mr. Chairman.

Senator SARBANES. Mr. Schmalensee, we would be happy to hear from you.

Mr. SCHMALENSEE. Thank you, Mr. Chairman.

If I may, I would just take a few minutes to embroider a bit upon a theme that Chairman Boskin mentioned and indicate how it runs through the report. That theme is the flexibility of market processes.

In the abstract, the argument is a familiar one: the use of market processes and market forces to allocate resources, rather than the use of administrative or political processes, tends to increase an economy's flexibility. That increase in flexibility has the

effect of reducing the costs of adverse shocks, such as oil-price shocks. The obvious example is a comparison of buying gasoline last fall versus buying gasoline when the shocks of the 1970's hit. The absence of lines last fall is a consequence of market forces. The presence of lines and shortages in the 1970's was a consequence of an administrative process, that raised the cost of the oil shock, an unfavorable development.

The other advantages of flexibility are linked to favorable developments. A flexible economy is able to adapt quickly to new opportunities and new innovations.

The example that strikes me most clearly in this environment is the fax machine, how rapidly it has diffused in this city, and how it has changed working styles in rather short order. This city isn't always a great example of market processes, but in this case, it is. That very adaptability to innovation increases the rewards to innovators, and thus, provides stronger incentives for, and encouragement for, innovation.

On the negative side, it follows that, to the extent that flexibility promotes innovation and progress, growth is slowed by unnecessary regulation, by replacement of market forces with administrative decision processes. It's slowed by attempts to resist the economy's natural evolution in order to protect special interest groups. And it is generally enhanced by expanding the scope of market forces.

Now, this theme, the value of flexibility, the sources of flexibility, appears by design most clearly, and most directly, in chapter 4 of the report, which describes in rather general terms the process of economic growth and the importance of flexibility in that process.

The point made there is that if you look behind the macroeconomic aggregates, you see that the process of growth always involves the waxing of some industries, the waning of others, and technology creating new industries, eliminating others. And resisting that process inevitably slows growth.

We also discuss there the critical role of education, both in terms of added skill and also in terms of added flexibility. And we touch on policy problems that relate to flexibility in telecommunications, agriculture, health care, and in the defense production sector.

As we wrote the report, we found this theme creeping into a variety of other discussions—indeed, permeating several of them. Let me just mention those other contexts briefly, if I may.

The discussion of oil price shocks in chapter 3 deals with energy policy in the short run and the long run. The discussions of response to shocks in the short run and of response to longrun price uncertainty makes quite clear the importance of placing primary reliance on market forces to preserve the economy's flexibility and ability to grow.

In chapter 5, which deals with banking reforms, the historic proposal that Chairman Boskin referred to, at the heart of that reform is a rejection of the approach of the 1930's, which sought safety in a diminution of competition rather than in an increase in competitiveness and an increase in the scope of market forces properly supervised. Chapter 5 also discusses the evolution of the financial services sector, making clear that change, waxing and waning, has indeed been the historic norm.

In chapter 6 we discuss economies in transition, focusing on Latin America and Eastern Europe, particularly Eastern Europe. Those economies have not done very well at, if you will, going straight ahead and expanding. They have been particularly badly suited to reacting to change, to reacting to price changes, which they are now experiencing in international markets, and to innovation, which they've been particularly slow to adopt. So when one thinks about what is needed in those areas to create healthy market economies, one of the first things that is striking is the absence of the flexibility that we take for granted in our system.

And finally, in chapter 7, we discuss, as Mr. Taylor indicated, the impact on growth of trade, the reduction of trade barriers and thus, an enhancement of the scope of market forces. We also talk about the benefits of an important evolutionary development, a qualitative change in the world economy, the globalization of firms.

We thus have, particularly in chapter 4, but also throughout the Report, an emphasis on the dynamics of market processes and on the dynamic benefits that flow from well-functioning competitive markets.

As an historic footnote, I would offer the observation that Joseph Schumpeter, the great Austrian economist, would, I hope, have approved of this report.

Thank you, Mr. Chairman.

[The prepared statement of Messrs. Boskin, Schmalensee, and Taylor follows:]

PREPARED STATEMENT OF

MICHAEL J. BOSKIN, CHAIRMAN;

RICHARD L. SCHMALENSEE

JOHN B. TAYLOR

Members
of the

PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS

Before the

JOINT ECONOMIC COMMITTEE

February 12, 1991
11:00 a.m.

Mr. Chairman and other distinguished Members of this Committee, we appreciate this opportunity to appear before you today to discuss the 1991 Economic Report of the President. The Report's analysis of economic events, the economic outlook and economic policies reflects the Council's best attempt to incorporate available economic research as well as historical experience.

We will present an overview of the main body of the Report, which consists of the President's message followed by the seven chapter report of the Council of Economic Advisers. As you requested, our testimony will, in the context of discussing the Report, focus on how the President's economic program will affect both the short- and long-term outlook for the American economy, our competitiveness in the world economy, and the well-being of American workers and families. We will also highlight the main themes of the Report:

- To improve living standards and increase job opportunities, economic policy must create an environment conducive to strong long-term economic growth.

- To mitigate the current recession while building the foundations for a strong and long expansion in the 1990s, economic policy must be credible and systematic.

- A key source of the U.S. economy's dynamism and resiliency is the flexibility it derives from reliance on markets.

- To maintain the economy's flexibility, government policy should seek to provide choice and opportunity, and regulation should be limited in scope and cost-effective.

The President's Message

The Report begins with the President's message--a brief discussion of basic principles, important developments, and key initiatives. The President begins by noting that the current recession interrupts the longest peace-time expansion in U.S. history. This expansion created over 20 million new jobs, took unemployment rates to the lowest levels since the early 1970s, and was accompanied by a lower and more stable rate of inflation. He states that the current recession does not signal a lack of fundamental health in the U.S. economy and that the Administration's policies are designed both to mitigate the current downturn and to provide a foundation for solid long-term growth.

The President also emphasizes that long-run prosperity is enhanced by strengthening and extending the scope of market forces, not by substituting government dictates for the free choices of workers, consumers and businesses. The Administration is committed to limiting the role of government regulation and will oppose protectionism in all nations, including our own. The President concludes by expressing continued confidence that, with the maintenance of sound economic policy principles, "we have reason for both hope and optimism in full measure as the nation approaches the next American century."

Chapter 1: Foundations for Economic Growth

This chapter provides a thematic overview of the Report, highlighting key principles, policies, and analyses developed in the following six chapters. The chapter's basic theme is that the Administration's policies are designed both to mitigate the current recession and to strengthen the foundation for a solid recovery and a return to sustained economic growth. Particular attention is paid to the importance of credible and systematic macroeconomic policies, relying on market

forces in enhancing the economy's flexibility, supporting long-term growth, and opening markets and supporting market-oriented reform.

Chapter 1 stresses that the Administration's fiscal, monetary, trade and regulatory policy goals are designed to achieve the maximum sustainable rate of economic growth, by both enhancing the Nation's potential output and ensuring the economy generally operates at its potential. The goals are as follows:

1) Raise national saving to stimulate investment and future economic growth by reducing the Federal structural budget deficit;

2) Support a credible monetary policy program that mitigates the current recession and then sustains economic growth while controlling underlying inflationary pressures;

3) Support policies that increase the role of market forces and decrease the role of regulation, and improve regulation in those areas where regulation is necessary;

4) Support policies that encourage investment, entrepreneurship, work effort, and research and development, that improve the educational system, and that provide increased opportunities for the disadvantaged; and

5) Lead the world to expanded trade and more open markets.

The Nation has already taken an important step to raising national saving and investment by enacting the Omnibus Budget Reconciliation Act of 1990, which contains the largest and most comprehensive deficit reduction package in U.S. history. It is designed to reduce the Federal deficit by a total of nearly a half-trillion dollars over the next five years, relative to what it would otherwise be. The law contains credible enforcement mechanisms, using caps on discretionary spending, pay-as-you-go rules on mandatory spending, and several types of sequesters to prevent new legislation from increasing the budget deficit.

The Administration remains committed to a tax system with low marginal tax rates and the lowest possible barriers to saving, entrepreneurship, and productive investment. The Administration has proposed a reduction in the tax rate on long-term capital gains. A capital gains tax cut would reduce the existing bias against equity financing, lower the cost of capital, and increase investment and GNP. Lower capital gains tax rates would also encourage entrepreneurial activity, a sparkplug of economic growth. To further stimulate private saving and investment, the Administration has proposed to make the research and experimentation (R & E) tax credit permanent, to establish Family Savings Accounts, and to ease requirements for withdrawals from Individual Retirement Accounts for people purchasing a home

for the first time. All of these proposals will raise national saving and capital formation.

The chapter also emphasizes that, although economic growth is needed to reduce poverty in America, growth alone is not enough. Policies designed to give power and opportunity to individuals and families are also needed. Several accomplishments during 1990 are highlighted, including:

- The Americans with Disabilities Act, the most significant extension of civil rights legislation in two decades, which will enable more of our citizens with disabilities to enter the economic mainstream and thus better their own lives while contributing to the economy;

- The expansion of the Earned Income Tax Credit and other child care provisions in last year's budget legislation, which will put billions of dollars for child care directly in the hands of parents; and

- The Homeownership and Opportunity for People Everywhere (HOPE) initiative, which will expand homeownership and give more families a stake in their neighborhoods.

Chapter 2: Economic Developments and Prospects

This chapter provides a review of significant economic developments during 1990, as well as the prospects for monetary and fiscal policy and for the economy in 1991 and later years.

After almost 8 years of expansion, the economy entered a recession during the latter part of 1990. In the fourth quarter of the year, real GNP registered its largest decline since 1982, and industrial production fell sharply. The downturn was caused in large part by the economic effects of Iraq's invasion of Kuwait. That caused a jump in oil prices and directly reduced business and consumer confidence. Those factors, coupled with continuing uncertainty about the timing of the resolution of the crisis, dealt a substantial blow to an economy already sluggish from other factors. These included worldwide increases in interest rates, unexpectedly tight credit conditions, and the lingering effects of a tightening of monetary policy from early 1988 through mid-1989 that was undertaken in a successful attempt to prevent an increase in inflation.

Real GNP growth for 1990 on a fourth-quarter-over-fourth-quarter basis was only 0.3 percent, with a 2.1 percent decline at an annual rate in the fourth quarter. The decline in the fourth quarter was expected, although it was somewhat smaller than many analysts, including the Administration, had predicted. It may be that

some of the decline we anticipated in the fourth quarter of 1990 will spread into the first quarter of 1991.

Chapter 2 discusses our projection that a recovery is likely to begin toward the middle of 1991. For 1991 as a whole, we project real GNP to expand 0.9 percent on a fourth-quarter-to-fourth-quarter basis. Consistent with the sluggish production performance expected in 1991, we project the unemployment rate to average 6.7 percent. We project CPI inflation will be 4.3 percent during 1991, compared with the 6.3 percent rate of 1990, and that in 1991 interest rates will average about one percent below their 1990 level.

The slack economy, falling inflation, and, perhaps most important, the demonstrated willingness on the part of the Federal Reserve to mitigate the current downturn by reducing the Federal funds rate and the discount rate are projected to allow interest rates to average about a full percentage point below their 1990 levels in 1991.

This projection corresponds to a recession that will be mild and brief by historical standards. Compared with the 2.6 percent average real GNP decline associated with the 8 other postwar recessions, the Administration projection contains a 1.2 percent decline. There are several reasons why this recession is likely to be relatively short:

- o Crude oil prices have fallen substantially from their October peak, especially after the successful start of Operation Desert Storm. The decline has already begun to remove a large drag on consumer income.

- o Inventories are low relative to sales, suggesting that the sharp inventory liquidation that has accompanied and worsened most previous recessions is unlikely to occur.

- o Because underlying, or core, inflation was much lower and relatively stable going into the recession than at the onset of the three previous recessions (1974-75, 1980 and 1981-82), the Federal Reserve has had the latitude to begin to take steps to mitigate the downturn without causing an increase in inflationary expectations; the Federal Reserve has gained credibility by keeping inflation relatively contained during eight years of expansion.

- o Interest rates have come down substantially since the beginning of the fourth quarter of 1990 and are likely to decline further. Although it can take several quarters for the full effect of declining interest rates to benefit the economy, by mid-year interest-sensitive sectors such as big ticket consumer durable purchases should improve.

- The automatic stabilizers in the budget--both the natural decrease in tax receipts and the increase in benefit payments accompanying an economic downturn--quickly and automatically cushion the decline in household income and spending.

- The prospects for export growth remain good; exports have been at record levels and are one of the bright spots in the economy, cushioning the effects of the recession.

While these factors lead the Administration and most private forecasters to expect a relatively short and mild recession, there are downside risks as well. For example, there is still uncertainty regarding the future path of oil prices. It is also important that the Federal Reserve maintain strong money and credit growth, recognizing that a decline in interest rates during a recession does not necessarily indicate an easing of monetary policy. Even though interest rates are coming down, if credit is not forthcoming at these rates the recovery may be stalled. Bank regulators must avoid being so stringent that sound banks cannot make sound loans to sound borrowers. The Fed's job should be made somewhat easier as the new budget law reduces the deficit significantly in coming years, in part because of the important budget process reforms it put in place.

Chapter 2 of the Report also presents longer-run economic projections for the years 1992 and beyond. The Administration's real GNP growth projections, which extend from the third quarter of 1990--probably the business cycle peak--through the fourth quarter of 1996 (25 quarters), average 2.6 percent at an annual rate. By way of comparison, for the same period the Congressional Budget Office's projections average 2.4 percent at an annual rate. There have been 8 previous business cycle peaks in the post World War II era. In the 25 quarters following those peaks, real GNP has grown at slightly over 3 percent on average at an annual rate.

The Administration's projections reflect our view that the United States economy is fundamentally healthy. They also reflect our view that the Administration's approach to policy--emphasizing the power of private markets to generate growth and jobs, pursuing deregulation where desirable and more sensible regulation when regulation is necessary, increasing national saving, and developing and adhering to policies that take the long view--best promotes sustained economic growth.

Chapter 3: Oil Price Shocks and Economic Policy

This chapter focuses on the implications of large, unanticipated increases in oil prices for the economy and for both macroeconomic policy -- monetary and fiscal policy -- and policies concerned with energy and other markets.

The circumstances surrounding the recent oil price shock differ significantly from what we experienced in the 1970s. The Nation entered the 1970s' shocks already plagued by very high and accelerating inflation, while we enjoyed relatively low and stable inflation throughout the expansion. The economy last summer was already soft, not operating near capacity as in 1973 and 1979. The economy today is also more energy-efficient; in particular, compared to the 1970s the economy now uses roughly 30% less oil per dollar of GNP produced. Deregulation of energy prices in the 1980s has permitted markets to respond flexibly to the shock and avoid the gas lines and other disturbances that worsened the direct effects of the oil shocks of the 1970s.

Although the recent oil price shock has reduced GNP and raised inflation, the proper design of macroeconomic policies can ensure that these effects will be temporary and that the economy will soon return to solid growth with lower inflation. The key is to adhere to well-designed systematic policies. The increased power given to automatic stabilizers by the new budget deficit reduction law allows fiscal policy to mitigate the current downturn; and the credibility built by the Federal Reserve's containment of inflation gives monetary policy the ability to cushion the effects of the recession without causing long-run inflationary expectations to rise.

The principle of providing for flexible responses to changing short-run conditions while maintaining a clear and consistent focus on long-term objectives should also guide energy policy. Reregulating energy markets would only raise the costs of price shocks, while making oil from strategic reserves available to the market can sometimes reduce these costs. A continuation of reliance on market forces is essential.

Energy markets have brought about impressive improvements in efficiency, and the United States is not a profligate user of energy when appropriately compared to other countries. Energy prices are determined in world markets, and U.S. vulnerability to oil price shocks in an increasingly integrated world economy is not determined primarily by U.S. oil imports. The Nation can reduce its vulnerability to shocks emanating from insecure oil supplies by cost-effective domestic conservation and production, removal of barriers to market flexibility, development of new world oil supplies outside the Persian Gulf, and continuing international policy coordination.

Chapter 4: Flexibility and Change in the Economy

This chapter focuses on a central theme of the Report: Economic flexibility, which stems from reliance on market forces, reduces the costs of adverse

disturbances, enhances opportunities to exploit new ideas, and encourages innovation.

The chapter begins with a general discussion of the process of dynamic change in the U.S. economy. Changes in technology create entirely new products and eliminate the demand for others. Changes in tastes, the demographic makeup of the population, and international markets similarly cause some sectors to grow and others to decline. The dramatic decline in agricultural employment over the last century and a half and the rise in the manufacturing and service sectors of the economy reflect these forces. Since growth requires change, and change requires flexibility, the long-run growth rate of the U.S. economy is dependent on avoiding unnecessary regulation, on forgoing attempts to stymie the inevitable rise and fall of particular industries, and on removing barriers to innovation.

Educational excellence is necessary both to raise the skills of the labor force and to enable workers to adapt to the changing demands of a dynamic economy. Unfortunately, primary and secondary education in the United States too often fails to perform well. Fundamental reform is necessary if the National Education Goals developed by the President and the Nation's governors are to be achieved. This reform must increase the ability of parents and children to choose among schools and removing unnecessary barriers to talented individuals who wish to become teachers.

The remainder of the chapter discusses the role and importance of flexibility in four important sectors. In agriculture, the full potential benefits of extraordinary technical progress are not being realized because of inflexible and protectionist policies. The demand for and costs of health care have been increased both by the aging of the U.S. population and rapid technological advance, augmented by increased government financing and incentive problems related to insurance. Health policy reform must deal with both cost inflation and the problems of the uninsured; doing so will require improving the system's incentives to balance costs and benefits in making treatment decisions. Technological change has also been rapid in telecommunications; the challenge is to re-shape the boundaries and methods of regulation to maximize the benefits of progress. Finally, although the projected reductions in defense spending as a share of GNP are small by historical standards, defense conversion offers both potential benefits and transitory costs.

Chapter 5: Innovation and Reform in the Financial Sector

This chapter highlights the critical role played by the institutions and markets of the U.S. financial center in ensuring a growing, healthy, and flexible economy.

A discussion of the development of financial institutions in the United States highlights the historical importance of innovation and change. The origins of the

current system of regulating depository institutions, with its stress on reducing competition, in the traumatic events of the Great Depression is described.

The chapter then analyzes the growing strains on this system in the late 1960s and 1970s, with increases in the level and volatility of the rate of inflation, the advent of the electronic age and new competition, and the increasing internationalization of the world's economies. The roots of the S&L crisis are shown to lie in these institutions' vulnerability to the interest rate increases of the period. The crisis then deepened as economically insolvent institutions were permitted to invest in high-risk ventures in frequently vain attempts to regain solvency.

The chapter stresses the use of market forces to enhance flexibility, innovation, and safety in the financial sector. Key features of the Administration's recent regulatory reform proposals are discussed in historical and theoretical context. These proposals are designed to permit banks to exploit available economies of scale and scope by, among other things, removing outdated and uneconomic restrictions on interstate branching, the activities of sound banks, and affiliations betwen commercial firms and banks.

The recent reform of the budgetary treatment of federal credit programs is explained, as are important issues raised by the credit activities of government-sponsored enterprises.

Chapter 6: Economies in Transition Around the World

This chapter is concerned with the remarkable worldwide movement toward reliance on competitive market forces, which continued during 1990. It focuses on the transformation process as it is unfolding in Eastern Europe, in the aftermath of the economic collapse of communism, and in Latin America.

The chapter begins with a discussion of the forces for change in these regions. The most important of these is surely the undying and universal desire for political freedom. But another fundamental motivation for change in Eastern Europe and Latin America was the failure of these economies to produce adequate living standards -- reflecting their basic failure to provide adequate incentives for producers to supply efficiently the goods and services that consumers wanted to buy. Early attempts at reform in both regions were unable to correct this basic failure.

The principles necessary for successful reform are discussed in some detail. These include both macroeconomic reforms -- adopting sound monetary and fiscal policies, removing domestic price controls, opening the economy to international market forces -- and structural reforms -- establishing private property rights and

ensuring their protection, creating competition, and reforming and limiting the role of government. Latin American nations began their transitions with more of the elements of healthy market economies in place than countries of Eastern Europe.

The discussion of reform principles highlights the complexity and difficulty of the economic transition and makes clear the importance of realistic expectations. The importance of comprehensive reform is discussed and illustrated by an examination of problems arising in Polish agriculture. Recent economic developments in Eastern Europe and the Soviet Union and in Latin America are discussed in some detail.

The chapter concludes with a discussion of the role the United States can best play in supporting transitions to democratic societies and free-market economies: how we can best help these countries help themselves. In both regions this role involves technical and financial support aimed at assisting reform, not providing an excuse to delay it, and reduction of barriers to trade and investment. In addition, the United States has encouraged and will continue to encourage multilateral institutions and other governments to support the transformation process. In the last analysis, however, the private sector must be the main source of investment capital and an important source of know-how.

Chapter 7: Trade Liberalization and Economic Growth

This chapter describes the gains from trade liberalization and the costs of protectionism, U.S. pro-trade initiatives, and the linkage of trade and investment flows in global markets.

World trade has grown more than one and a half times as fast as world income since 1960, and the fraction of U.S. production sold abroad has more than doubled. Free trade raises incomes in all nations by allowing a more efficient allocation of resources and by stimulating flexibility, competition, innovation, and growth. In contrast, protectionist policies that close markets or manage trade generally lower living standards.

Past rounds of multilateral tariff reductions under the auspices of the General Agreement on Tariffs and Trade (GATT) have contributed importantly to the growth of trade in the post-war period. The current round of GATT negotiations, the Uruguay Round, is aimed at further reducing trade barriers and at modernizing GATT rules and extending their coverage. Unfortunately, these negotiations were suspended in December 1990 due to an impasse in the key part of the talks dealing with agriculture. Successful completion of the Uruguay Round, which remains the Administration's top trade policy priority, could greatly increase U.S. and world GNP. But a breakdown of the multilateral trading system could bring on the sort of

cycle of economic distress fuelling and being fueled by protectionist measures last seen in the Great Depression of the 1930s.

The benefits of the proposed U.S.-Mexico free-trade agreement are discussed, along with those of the President's Enterprise for the Americas initiative. The initiatives, along with the U.S.-Canada free-trade agreement, pave the way toward the world's first hemispheric free-trade area. The U.S.-Japan Structural Impediments Initiative is also briefly discussed.

The chapter concludes with a discussion of multinational corporations and the increasingly important links between trade and investment flows. The globalization of companies increases the importance of intra-company trade flows and foreign direct investment. It also provides for more rapid diffusion of new technologies, lower production costs, and greater product choice for consumers, which engender significant benefits in all nations. Attempts to manage investment flows could lower those benefits substantially.

Mr. Chairman, we would now be happy to answer any questions you or other Members of the Committee may have.

Senator SARBANES. Gentlemen, thank you very much. When discussing the unemployed, someone was talking about some policies for the long run. And Harry Hopkins said, people don't eat in the long run; they eat in the short run. I want to start off by addressing the short run.

The difficulty I'm having is with the almost sanguine attitude in this report about the unemployment situation. Take just this morning's paper, and go to the business section of the New York Times: "Chapter 11 for Carter Hawley, West Coast Retailer Struggling With Big Debt, Slow Sales. Largest department store chain on the west coast sought protection from its competitors under Federal bankruptcy law today in an effort to shore up its deteriorating finances. It became the latest retailer to fall victim to the combination of a weak economy and a crippling debt burden."

Then on the same page: "Sears To Cut More Jobs—Profits Fall. U.S. Air To Lay Off 3,585. I mean, almost this whole front page of the business section is dominated by these kinds of stories about further layoffs, cutbacks. Now you're projecting an unemployment rate for this year of 6.7 percent average. Is that correct?

Mr. BOSKIN. That's correct.

Senator SARBANES. And it is at 6.2 percent for January. How high do you see it going?

Mr. BOSKIN. Well, it may well go a little bit above 6.7 percent, maybe up to 6.9 percent or so. We think the worst of it will occur in the coming months. There will be a continued increase for some manner of months. Then it will level off and start to decline slightly the early part of next year, and as the economy continues to get better from there.

Usually, the slowdown in output is succeeded by a rise in unemployment. The fall in output leads the rise in unemployment. That's the same pattern of this projection. That rise in unemployment is relatively similar to that projected by the average of private forecasters and the CBO.

Senator SARBANES. If it is going to average 6.7 percent for the year, it is going to have to get up above 7 percent at some point during the year, isn't it, to bring out that average?

Mr. BOSKIN. It depends on how rapidly it gets up to 6.7 percent.

Senator SARBANES. How rapidly do you expect that to happen?

Mr. BOSKIN. Well, that is difficult to judge. We do expect that to happen in the next few months. So it may get up there on a monthly basis. We don't usually predict monthly data, but it may get up to 6.9 percent or something of that sort.

It's hard to tell. It could either get up to 6.7 percent rapidly, or 6.8 percent briefly and then 6.7 percent for many months throughout the year, or it could go higher and come back down again.

It's hard to say.

Senator SARBANES. What do you expect?

Mr. BOSKIN. My best judgment is that it will——

Senator SARBANES. Go to 6.7 percent very quickly.

Mr. BOSKIN [continuing]. Go to 6.7 percent in the next few months, perhaps get a little bit above that for a few months, and average 6.7 percent for the year and then start down from a little bit above 6.7 percent in 1992.

Senator SARBANES. And what are you projecting unemployment to be next year?

Mr. BOSKIN. About 6.6 or 6.5. percent; 6.6 percent on average for the year starting maybe from 6.9 percent and then declining to the low 6's.

Senator SARBANES. So you expect another 700,000 or 800,000 people to be thrown out of work, at least; is that right?

Mr. BOSKIN. We expect the unemployment rate on average to be a half a percentage point higher than it is now for the year, and that would be about 600,000.

Senator SARBANES. I want to ask about the stabilization measures. What is the administration doing to address this situation?

Mr. BOSKIN. There are a variety of things. Mr. Taylor mentioned the automatic stabilizers. They will provide some $40 to $50 billion dollars in the aftertax incomes of families and businesses, which will help cushion the decline in spending, particularly of household spending.

I'll ask him to reply in a second.

Also, we've seen monetary policy begin to make some much more aggressive moves. We've seen a decline in interest rates that usually has been succeeded a couple of quarters later by a rebound in the economy.

So that's one of the bases through which we expect the economy to begin to rebound by the middle of the year.

Also, I think it's clear that much of the direct drag of the higher oil prices has been removed because of the decline in oil prices. So while we expect some continued deterioration for a few months, we do expect to be turning around by midyear.

We have forecasted a rather modest, not a tremendously robust, recovery. That is because, in contrast, say, to the period in 1982, we don't expect the unemployment situation and the degree of unutilized human and physical resources, capital and labor, to be nearly as bad. So you don't have that huge pool of unutilized resources to put back to work quickly.

Hence, we don't see rapid growth rates because we don't get that extra kick, say out of reducing unemployment from 10.8 percent down into the 6's and 5's, as we did coming out of the last recession.

Senator SARBANES. Mr. Taylor, both you and Chairman Boskin have alluded to the automatic stabilizers in the budget, the decline in tax receipts and the increase in income payments, and you specifically mentioned unemployment insurance. You labeled those a stimulus to keep the recession short and mild. Is that correct?

Mr. TAYLOR. Yes, Mr. Chairman.

Senator SARBANES. Under the budget agreement, the unemployment insurance, the increase in unemployment insurance claims was excluded from the caps. Is that correct?

Mr. BOSKIN. The administrative costs.

Mr. TAYLOR. Mr. Chairman, the administrative costs are included in the discretionary spending and therefore, in the cap.

The increase in transfer payments that occurs as the economy has weakened is not. That's basically the effect of the economic changes on the budget, and that doesn't require new legislation. It's an automatic increase in the amount of compensation that

takes place. And it's not just unemployment insurance. Welfare payments can increase, retirement payments can increase.

Studies have shown that there's a tendency for all those payments to increase as the economy weakens. Also, I think it's important to emphasize the changes in tax receipts, too. With weaker incomes, tax receipt will not come in as rapidly and that will leave more purchasing power at the household level.

But it's important to emphasize as well, I think, that this is actually already taking place. In fact, it took place last year as the economy weakened.

We have a calculation in our report which shows that part of the budget deficit increase last year was due to the weakening of the economy. So it's already put in place some of the stimulus which is needed, even as we speak, and even last year.

Senator SARBANES. I take it it is your view that it was a positive and good feature of the budget agreement that it excluded from the caps—let's take unemployment insurance—the additional claims filed for unemployment insurance as a consequence of the worsening of the economy, which means that people have been thrown out of work and more people are going to file claims, that it was a positive feature of the budget agreement that it was not under the caps. Is that right? So you get an automatic response to this weakening economy.

Mr. TAYLOR. It's a positive feature because of that, and also because the caps can focus on the declines in spending as a share of GNP on a more permanent basis, which focuses on more secular changes rather than the temporary changes in the economy.

Senator SARBANES. Before this meeting I spoke to the Interstate Conference of Employment Security Agencies. I want to hear from you the rationale as to why the administrative costs of the agencies running the program, which increase with the increase in claims in order to respond to this flood of increased claims and to make the payments, have gone up.

Why shouldn't those costs be out from under the caps in order to respond to the situation, particularly when you have situations where in some States, unemployed workers are lining up outside the unemployment security offices before the break of dawn. They have hundreds of people standing in line waiting to file their claims. In some States, it's now taking 4, 5, 6 weeks or more to receive a claim.

We considered as part of the budget discussions last year a proposal, I think by the administration, to put a 2-week delay on the payment of claims as a standard policy. That was rejected. But an even worse result is being achieved on the ground simply because of the inability to respond to the tremendous additional demand for unemployment insurance coming in these high unemployment States. Why shouldn't those administrative costs associated with those increased claims also be automatic? Otherwise, the automatic aspect of the benefits is undercut de facto by the inability to process them administratively?

Mr. BOSKIN. Well, there is this anomaly that the administrative costs are under the discretionary cap.

Senator SARBANES. Let me just interject for a second.

Those administrative costs are paid——

Mr. BOSKIN. Out of FUTF.

Senator SARBANES [continuing]. Out of a trust fund at the Federal level. That trust fund, the employment security administration account of the Federal unemployment trust fund, had a balance at the end of fiscal 1990 of $1,640 million which is $480 million above its statutory ceiling.

The participants in the program have paid into the fund more than an adequate amount to cover these administrative costs. And yet, the money is not being made available to properly administer this program. There are these incredible delays in the payment of claims for families who literally live from paycheck to paycheck. When a paycheck stops, if they don't get some boosting of their purchasing power, they're in dire difficulty almost immediately, and certainly, in a matter of a few weeks' time.

Mr. BOSKIN. We certainly share your concern, Senator, for those who have become unemployed.

This is not my area of primary responsibility. But as I understand the situation, $100 million of supplemental funds has been made available. I think the Department of Labor has been trying to estimate how much additional funds might be required.

That is under study by DOL and OMB. I'm sure they will be coming out with whatever they think is the appropriate action to make sure that, indeed, the program runs as intended.

You're quite correct in saying that, if the administrative side is not functioning, then that part of the automatic stabilizers would be weakened.

Senator SARBANES. Do you think that ought to be declared an emergency by the President, to provide the administrative money in order to pay the claims? Since the claims themselves have been treated under the budget agreement as, in effect, an emergency or outside the caps, shouldn't the administrative money be declared an emergency in order to move this thing forward? It's not right, is it, that there literally should be hundreds of people in line unable to even file their claims and that once they file them, they should wait weeks before they get their payments?

Mr. BOSKIN. Well, I'm concerned for the well-being of those people. I would make two points.

One is that I would reserve judgment until I see what OMB and the Labor Department have to say about this request for additional funds from States for administrative purposes.

I take the point under advisement. It is something that the administration is looking at carefully and hopefully, we'll have something to do quickly.

But I'd also indicate that much of the administration of these programs is based on State requirements and State laws. I think that there is some virtue in allowing that to occur.

On the other hand, different States have different standards regarding exactly how long you'd have to wait and so on. I would indicate that the percentage of the unemployed who are covered by unemployment compensation has risen abruptly by about 50 percent in the last year. And so I think it's this increase relative to what the States were planning for, that has caused, some, especially for some States, their facilities to become overwhelmed.

But I will take the point back and redouble my efforts to deal with the Labor Department and OMB and get an administration decision soon.

Senator SARBANES. I am going to yield to Congressman Hamilton for his round, but let me just make this final observation.

This problem of not providing the money needed to handle the administrative side of the unemployment insurance program is a very serious one, because even if you exclude the claims so they have an automatic element to them, so if the economy worsens by another 500,000 people unemployed, they're going to be able to file their claims and get their benefits, but they're in effect delayed from getting their benefits by the administrative breakdown because there aren't the resources.

Now the resources are there. They are in the trust fund. More than adequate resources are in the trust fund. They have been paid into it by employers who pay the unemployment tax. That is the purpose of it, one of the purposes of the payment of that tax, is to fund these administrative costs.

Last year when this recession got underway, there was an increase. The administration request was about $130 million short. The administration did not seek a supplemental. The Congress provided $96 million fortunately to help address a large part of that need.

This year, the States are estimating $150 to $200 million additional. The administration asked in the supplemental for $100 million, but they didn't declare it an emergency, and they did not put it outside of the caps, and have created the problem of where the money is to be found and the breakdown between automatically providing for the claims, but not automatically providing the money to process the claims.

The unemployed person faces an incredibly difficult time filing the claim, and then he has to wait extra weeks before he gets the benefit.

First of all, that puts an enormous pressure on the family. I think one of the difficulties is that policymakers in Washington by and large are not, at least a lot of them are not, dependent on the next paycheck in order to meet the next set of bills. They can miss a paycheck and still function until it comes along. For many working people in the country, that is not the case. If they don't get the paycheck, all of a sudden, they have big problems on their hands. Their creditors are knocking at the door. And they really cannot make it.

If they go down to get on unemployment, I understand the unemployment insurance payment is only on the average about 50 percent of what people were earning before they lost their jobs. They have taken a 50-percent cut right there. And if they have to go weeks before they get the payment, you can imagine what kind of chaos it creates in their personal finances.

Second, the automatic stabilization that you were making reference to is undercut because it comes in much later and you get an even sharper drop in purchasing power than if you were making these payments on a more proper basis.

It is my own view that the amount is not enough for the administrative costs in order to clear up this problem and that it ought to

be declared an emergency, since the benefits are outside the caps and taken outside of the caps.

You have a placeholder in the budget of $30 billion—$30 billion—for the Operation Desert Storm, as I recall. Is that correct?

Mr. BOSKIN. In budget authority, $15 billion in outlays.

Senator SARBANES. And you're just asking for another $30 billion from the Congress for the resolution of the S&L problem, an additional $30 billion authority. Is that correct?

Mr. BOSKIN. Yes.

Senator SARBANES. If you can find that kind of money all outside of these budget caps, it seems to me you can find $180 million—not billion—$180 million compared to $30 billion and $15 billion, $180 million to make this unemployment insurance program work properly.

Mr. BOSKIN. I appreciate your concern and your remarks and I'll relay them and work with Secretary Martin and Director Darman on this problem.

Senator SARBANES. Thank you very much. Congressman Hamilton.

Representative HAMILTON. Thank you very much, Mr. Boskin.

Mr. Boskin, just let me confirm what Senator Sarbanes was talking about.

I've just spent a few days in Indiana. This unemployment problem is formidable. There is a lot of hardship out there at these unemployment offices today. I think almost all of us who are in our constituencies are hit with that immediately.

So I appreciate the fact that you're receptive to the Senator's suggestions and that you'll look into it.

I know we're usually supposed to look forward in these hearings, and yet, I want to begin with a historical question. And that is, what caused this recession?

Mr. BOSKIN. Well, Mr. Vice Chairman, I think a variety of things caused it. The most important factor was the oil shock and the resulting temporary transfer of income to oil-producing countries, the resulting decline in consumer confidence, and the reduction in big ticket consumer spending.

But that would be only a partial picture because the oil shock hit an economy that was already growing very sluggishly for several reasons, averaging a little over 1 percent at an annual rate for several quarters.

Representative HAMILTON. Would you have had a recession if you had not had the oil shock?

Mr. BOSKIN. I think that is difficult to say. We unfortunately don't have a counterfactual experiment to run. We may have, we may not have.

Representative HAMILTON. What's that word? Counterfactual?

Mr. BOSKIN. We can't go back and redo it again.

Representative HAMILTON. That's a good one. I'm going to have to mark that down.

Mr. BOSKIN. It's a common academic phrase; I slipped into the jargon.

Representative HAMILTON. Well, you had references to Mr. Ricardo—I thought it was pretty well done, actually.

Mr. BOSKIN. Thank you very much.

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Representative HAMILTON. Who was the other one? Schumpeter? That impressed me a great deal.

Mr. SCHMALENSEE. We have more. [Laughter.]

Mr. BOSKIN. The point I would make, however, is that there were many factors causing the economy to slow. When the oil shock hit, the economy was growing sufficiently slowly to be pushed into a recession by the shock. Part of the slowing was due to the lingering effect, as I indicated earlier, of the monetary tightening from early 1988 to mid-1989 to ward off an increase in inflation.

Representative HAMILTON. Was there a mistake in monetary policy that caused this recession or contributed to it?

Mr. BOSKIN. Well, I don't know if I would describe it as a mistake. I would say that the Fed was successful in warding off an increase, an incipient increase in inflation. It has moved aggressively now to begin to deal with the downturn, perhaps with the benefit of hindsight, particularly about the credit crunch, which was a second problem.

Perhaps they might have done things slightly differently, but it's difficult to judge.

Representative HAMILTON. If you look at the budget document here, this modest book here.

Mr. BOSKIN. All 2,000 pages, yes.

Representative HAMILTON. It's interesting to me to see the statement there, and I'm quoting now, "Among the principal causes of the weaker economy are a combination of the following," first off, "monetary policy, which for an extended period, roughly 2 years, remained on the tighter side of its target range not seeking to halt real growth, but slowing growth out of concern for inflation and dollar weakness."

In other words, the budget director apparently, as I read that, monetary policy is one of the principal causes of this recession. Do you disagree with that?

Mr. BOSKIN. Well, I would say it was one of the principal reasons the economy was growing slowly in 1990 when the oil shock hit. So it's one of the causes, in addition to the credit crunch and worldwide increases in interest rates, as I referred to earlier, and the oil shock. Certainly, it contributed.

Representative HAMILTON. Were there any policies that could have prevented the recession, in your view, fiscal or monetary, as you exercise hindsight here?

Mr. BOSKIN. With hindsight, the types of things that are now being done to try to deal with credit conditions and the types of actions the Federal Reserve has taken, certainly would have provided more of a cushion. Whether a recession per se—that is, avoiding growth moving below zero—could have been avoided given the nature of the oil shock, I think is probably a 50–50 proposition.

Certainly, the economy could have been a little stronger prior to the oil shock and it would have given it a better chance to avoid a recession. But I don't think you can make a definitive statement on that subject.

Representative HAMILTON. I get the impression, and I may not be accurate, but I get the impression from you that, in your mind, this recession was caused basically by the oil shock, by the Gulf crisis.

Mr. BOSKIN. Superimposed on a weak economy, caused by the lingering effects of the monetary policy, the credit crunch, and so on. Had we not had an oil shock, the probability that these effects would have caused a recession themselves is probably 50-50. And had action been taken earlier, whether the oil shock would have prevented us from tipping into recession is probably also 50-50.

Representative HAMILTON. What about fiscal and trade and regulatory policy and all of these things?

Were there anything there we could have done to have avoided this recession?

Mr. BOSKIN. Well, let me give you my view, and I'll ask Messrs. Taylor and Schmalensee to comment on trade and regulatory policy and fiscal policy as well. The trade policies we've been pursuing create the prospect for an expansion of longer term growth. But these policies are less tied to the quarter-to-quarter, or very short-term movements, of the economy, unless you get into a kind of retaliatory trade war situation such as occurred in the early 1930's and deepened the Great Depression.

And with respect to regulatory policies. Let's leave the credit crunch and financial credit situation aside which I'll come back to in a second.

The general set of regulatory policies are, I think, a longer term growth issue, as Mr. Schmalensee said. With respect to the credit crunch, it's one of the contributing factors.

With hindsight, had it been perceived more broadly earlier, perhaps some of the things that Treasury is now trying to do in working with the regulators could have been put into place earlier and perhaps this would have eased it some.

Representative HAMILTON. Let me ask Messrs. Taylor and Schmalensee how they react to this.

As you look back over the causes of this recession, how could it have been avoided?

Mr. TAYLOR. I think the reasons why we had the slowdown that Mr. Boskin summarized are quite accurate.

I think, given the fact that we had this increase in the price of oil, which reminded many people of the 1970's—for example, the high unemployment and high inflation that accompanied that period—I don't think there was much of a way to avoid the drop in consumer confidence that we saw at that point in time.

Representative HAMILTON. Well, look, we're all policymakers here. You're a policymaker on the executive side; we're policymakers on the congressional side.

Do we go into this recession saying to our constituents out here that we performed flawlessly. We were pristine pure here. We didn't make any mistakes at all. The recession came just because of an external shock out here.

Mr. TAYLOR. I think the economic policies could always be improved. We have, as you know——

Representative HAMILTON. That's what I want to drive at. How should we have improved them to avoid this recession?

Mr. TAYLOR. I don't think there's any one thing that we could have done to avoid this recession.

Representative HAMILTON. Just give me a few. [Laughter.]

Mr. TAYLOR. There's a whole wide range of things that we should be doing now, and we could have done them earlier, which would have reduced the probabilities of recessions like this. We should continue with a trade policy which tries to expand markets and increase market flexibility. We should continue with efforts to prevent more regulation and try to reduce regulation in energy markets which would lessen the impact of oil shocks on the economy.

Those policies would have made a difference. And I think that we should continue to pursue those policies. Policies which raise our productivity growth, and therefore, our long-term growth rate, could have turned a decline in economic growth into a slowdown of economic growth if our long-term growth path had been higher.

Those are all things which I think we could have done earlier. If it's not too late, we should start to pursue them now.

Representative HAMILTON. Mr. Schmalensee, do you have any comments here?

Mr. SCHMALENSEE. Well, I would make two general remarks and one specific remark. The general remark is that we are talking here now about the benefit of hindsight.

Representative HAMILTON. Sure.

Mr. SCHMALENSEE. And it's important to understand that hindsight is very powerful. I'm reminded of that particularly as I think about the one area in which I think we learned a great deal as the year wore on, and that is the area of the credit crunch.

The question of whether there was a problem there, what its nature was, what its extent was, was an issue on which, as I try to replay the year in my mind, information kept coming in in bits and pieces—sometimes anecdotally and sometimes in other ways.

With the benefit of hindsight, we know that it was an important issue. There might have been regulatory action that could have been taken earlier. But at the time, it was not quite so clear.

Representative HAMILTON. How about that budget agreement we had last year, the contractionary impact, I guess, from that agreement?

Was that involved in any way in bringing about the recession or contributing to it?

Mr. BOSKIN. Well, let me just make two points. But first, I'd just add to Mr. Schmalensee's comment about the credit crunch. The benefit of hindsight—as we learned more throughout the year—helped put into sharper focus what the effects of monetary policy and the slow money growth were. And indeed, the Fed has itself said that.

But with respect to the budget agreement, as Mr. Taylor indicated, and as the charts in the report indicated, the change in the budget law from the previous Gramm-Rudman-Hollings budget law allowed, subject to the important caveat Chairman Sarbanes mentioned, the deficits temporarily to rise rather than forcing an override of the deficits' natural tendency to increase in a recession as receipts come down and some social spending rises. This feature, whereby we do not have to override that temporary stimulus, the cushioning of aftertax incomes that automatic stabilizers provide, is indeed, I think, a major improvement.

So I do not view the budget agreement as having been particularly contractionary.

I also think that the enforceable mechanisms, the spending caps, the pay-as-you-go rules, et cetera, have a favorable impact on longer term expectations about fiscal imbalances and the need for large government borrowing as we move down the road. The beneficial effects of that on interest rates will offset some of the contractionary impacts—the direct contractionary impacts of the higher revenues and the decrease in spending.

Representative HAMILTON. Has the monetary policy been appropriate since that deficit reduction agreement, in your view?

Mr. BOSKIN. I think that, especially recently, it has.

Representative HAMILTON. Are you satisfied with monetary policy at this point?

Mr. BOSKIN. I think it has begun to move aggressively to deal with the problem and has certainly been moving in the right direction.

Senator SARBANES. Is the President satisfied with it?

Mr. BOSKIN. I think the President, in the State of the Union, said that interest rates should be lower and, for whatever reason, interest rates came down in the market and the Fed also lowered interest rates.

Representative HAMILTON. The Fed apparently pays attention to the President, right?

Mr. BOSKIN. I do not know if that had anything to do with it or not. I think the President was referring to the availability of credit and interest rates that consumers and borrowers are facing, which is primarily determined in the market.

Sometimes, of course, market rates can be coming down and the Fed could be lagging behind the market. Other times, it leads the market.

So I wouldn't just associate statements about interest rates, whether in the report or in the President's remarks, as a direct discussion of the interest rate that the Fed has the most direct control over, the Federal funds rate.

Senator SARBANES. Is the President more unhappy with the policy of the Fed than you are?

Mr. BOSKIN. I wouldn't say there's an unhappiness. I would just say that we've been pleased with the recent steps and——

Senator SARBANES. Well, the President hit them, both in the State of the Union message and in his speech to the Economic Club up in New York, a lot harder than you're doing right here at the table.

Mr. BOSKIN. Well, as the President's economic adviser, as someone who speaks with the President often, and I think knows what the President thinks, I think that his view and mine are virtually identical on this. That monetary policy——

Senator SARBANES. Is his your view or is your view his? [Laughter.]

Mr. BOSKIN. I suspect, in a very close working relationship, it's hard to separate that out. But he's the President of the United States and I work for him.

He's a delight to work for and does listen and take advice from a variety of sources, myself included.

My point is simply, though, that we've been pleased with the recent actions of the Fed. We were obviously less pleased earlier with their reluctance to ease.

Representative HAMILTON. I must say that sentence in the State of the Union address—interest rates should be lower now—was the most extraordinary statement I have ever seen a President make with regard to monetary policy.

It has to reflect at that point in time a very deep dissatisfaction.

For a President of the United States to direct a comment as sharp and targeted and specific as that on monetary policy must have reflected in the President's view a very deep dissatisfaction with monetary policy at that point. Is that fair?

Mr. BOSKIN. Well, I wouldn't quite use your adjectives. I think the President was very much, and his advisers, myself included, very much thought there was ample room for monetary easing—that it could have happened more rapidly.

We're pleased with the subsequent steps. But clearly, there was a concern that, with the state of the economy and its likely evolution, as we saw it, interest rates needed to come down further. Both market rates and monetary policy needed to become more aggressive.

Representative HAMILTON. Now, within 2 days after that statement, the Fed cut not one interest rate, but two interest rates. The discount rate, and what was the other? The Federal funds rate?

Mr. BOSKIN. Federal funds.

Representative HAMILTON. We hear a lot about the independence of the Fed. Here, it seems to me, the Fed is almost taking instruction from the President of the United States.

Mr. BOSKIN. I wouldn't give it that interpretation. I think that, to the extent that I know about it, and to the extent that there's been some discussion in the media about it, it appears the Fed had been considering this action for sometime prior to the President's remarks.

But the President is very knowledgeable about the economy.

Representative HAMILTON. Very persuasive.

Mr. BOSKIN. And I think he gave the right advice.

Representative HAMILTON. We've had testimony in the past from members of the Federal Reserve Board in which they advise that it is not advisable for the President or economic advisers of the President to give advice to the Fed because it would be counterproductive.

But that didn't seem to work out that way this time.

In any event, at this point in time, you're satisfied, is that correct, with monetary policy, or pleased with it?

How would you describe that?

Mr. BOSKIN. I would say that I'm pleased with the more aggressive steps that the Fed has begun to take to try to mitigate the downturn.

Representative HAMILTON. Do you think that interest rates should go lower now?

Mr. BOSKIN. I think that they probably will go somewhat lower, especially——

Representative HAMILTON. Should go lower. You believe that interest rates should go lower now?

Mr. BOSKIN. I think that there is some room for interest rates to decline further and that reflects the state of the economy. I'm sure the Fed will act accordingly. I hope no one was trampled to death. [Laughter.]

Representative HAMILTON. Is that really your hope? [Laughter.]

Mr. BOSKIN. No, I just wanted to get rid of some reporters. [Laughter.]

Representative HAMILTON. You believe that this recession is shallow, mild—I guess mild was your word. And if I have the figures correctly here, you're predicting a 1.2 percent drop in the GNP. That's compared to an average of recent recessions of about 2.6 percent, I think.

So you're really looking, in your view, to quite a shallow recession. Is that correct?

Mr. BOSKIN. Yes, in our baseline case. However, in the report, we do point out some possibilities of it being either better or worse than our baseline.

Senator SARBANES. You think the weakness of the financial system, which is a significant difference, as I understand it, going into this recession than in previous recessions, in fact, since the 1930's, is going to become a contributing dynamic to the recession?

Mr. BOSKIN. Well, I think that certain concerns in the financial system were part of the reason for the credit crunch, and are part of the reason for some of the problems we've seen. And they are part of the reason why the Fed has had problems getting money growth up to where they'd like it to be, for example.

The availability of credit and the concerns about the financial system are one of the downside risks and one of the concerns. I think that's going to begin to turn around. I think some of what went on is related to the international accord reached a couple of years ago called the Basel accords on capital ratios, which requires banks to have higher required ratios of equity to assets.

In the second half of 1990—the first deadline approached at the end of 1990—there was not the kind of a market where banks could easily attract equity. So some of them shrank their lending or they changed the composition of their lending away from commercial and industrial loans into the Government paper market, because the weighting of risk in these accords put a heavy weight on commercial and industrial loans.

Representative HAMILTON. I'll return, Mr. Chairman. I'll yield my time in just a minute.

If you look at the various sectors of the economy, which sectors do you think will pull us out of this recession? People mention exports a lot, for example. If you look at business investment and consumer spending and all the other sectors. Where do you think you'll get the drive here?

Mr. BOSKIN. Well, I think that some of it will come from exports. The relatively stronger growth expected abroad and the lower dollar in 1990 probably positioned exports well at 1991.

There are several other sectors. The farm sector has been doing well with record planting now reported for most crops. I think today or yesterday, the Agriculture Department sent me a notice saying——

Representative HAMILTON. Do you think that government spending will be a factor in bringing us out of this recession?

Mr. BOSKIN. The direct government purchases of goods and services I think will rise only very slightly. There is, as Senator Sarbanes put it, a placeholder in the budget for Operation Desert Storm of $15 billion of outlays. The bulk of the costs are being defrayed by our allies, the coalition partners, in this regard.

So I do not think government spending, either at the State and local level or the Federal level, will be a major cause, except for the kind of automatic responses that Mr. Taylor spoke about earlier.

Representative HAMILTON. Thank you, Mr. Chairman. I have additional questions.

Senator SARBANES. I'll come right back to you.

Let me just pursue this very important area that Congressman Hamilton has just raised.

My concern is I see factors present in this recession, factors of weakness, that were not present in previous recessions in the postwar period, not going back now to the 1930's, which, after all, was a depression and not a recession. First of all, the condition of the financial system that we've just made reference to, so that you run the risk that weakening economic condition will cause financial institutions to fail, the failure of the financial institutions will lead to further weakening of economic conditions. That is a danger, I would assume. Is that correct?

Mr. BOSKIN. That is one of the downside risks we point to and I think you're quite right. That is a major difference between the current situation and other postwar recessions.

Senator SARBANES. Now what about the exceptionally high level of both consumer and business debt? Isn't it at a level in this recession that's unprecedented in the postwar period?

Mr. BOSKIN. Both consumer and business debt has, as you know and as you stated, grown substantially and is at high levels. The decline in interest rates recently alleviate part of that problem because the cost of servicing debt is the interest rate times the amount of borrowing.

So that is a concern. I don't mean to mitigate that. And in some particular industries, very highly leveraged firms, weak demand and declining revenues running up against the need to make fixed, nominal interest payments have caused problems.

You indicated one particular firm when you read from the business page earlier in the hearing.

So in those particular instances, there will be some problems. But I think the flip side, which is not stressed enough—not that this eliminates the problem—is that asset values have increased for the business sector. The stock market is more than three times as high as it was in 1982, for example.

Now asset values can swing a lot, as we saw in the 1987 stock market crash where you still had the fixed nominal interest payments.

For households, asset values have generally tended to go up, although regional real estate problems have created a substantial problem. And I believe one of the concerns of consumers has been their inability to count on rapid increases in the value of their

home, which is after all the largest asset for the typical American household. And they're concerned about their liquidity, as they see that it's taking longer to sell homes in the current depressed real estate market.

So I view those as concerns. I share those concerns. And they are a bigger concern in this recession than they have been in previous ones.

But always, as we get into recessions, firms have similar problems. I think you're probably right.

Senator SARBANES. But you don't have the extent of weakness that's present this time.

What about the unprecedented Federal deficit, which seems to have hamstrung the ability of the Government to react? There was a story in yesterday's New York Times, and I quote:

> Many analysts fear that a legacy of chronic budget deficits, insolvent banks, and dependence on foreign capital has undermined Washington's ability to keep economic growth on track. We're in a recession with no tools to get out.

So said Fred Bergsten, director for the Institute for International Economics.

It then goes on to say, in this same article, about the inability of government to do anything because it's in a sense gotten itself in a position where it doesn't have tools to work with.

> This new-found humility is reflected in President Bush's 1992 budget, which offers no policy initiatives for fighting the recession.

What do you say to that?

Mr. BOSKIN. Well, first of all, as you know from our previous interaction and both reports, we have been quite critical of large continuing budget deficits, especially as they developed as the economy moved out of the 1982 recession and stayed large.

We believe it's very, very important for those deficits to be brought under control.

I should make two points. One is we do not believe that the traditional government spending kind of Keynesian pump priming is a likely, or very sensible, policy response were it available in the current situation. The relatively short period of the recession is one reason. The average recession is 11 months. If we entered the recession in September or October and this was an average recession—we think it will be slightly shorter, as do most forecasters, but even if it were average—it would be over by the summer.

Because of the time it takes Congress to legislate new spending and so on, the response would be late. The recovery would have begun. And in the past, it has proved difficult to curtail some of those programs. Those spending programs have developed lives of their own at times.

So the Keynesian kind of pump priming is not something that we believe is appropriate. Also, I think the bulk of academic economists, regardless of their political stripe or school of thought, believe it is not a terribly effective way to deal with temporary downturns in the economy.

I'd contrast that, of course, with something as severe as the Great Depression, expected to last for years, rather than months.

Senator SARBANES. Suppose this recession is deeper than you're forecasting. What will you do?

Nothing?

Mr. BOSKIN. Well, we will take under advisement a variety of options. There will obviously be——

Senator SARBANES. Have you done that yet? Are you doing it now?

Mr. BOSKIN. Well, the President's advisers, including the Council and others, continually analyze this and continually discuss various options. Certainly.

Senator SARBANES. Well, apparently, Mr. Darman indicated to the Senate Budget Committee that he was doing contingency planning for the possibility of a deeper economic downturn. Is that correct?

Mr. BOSKIN. Well, we do discuss almost on a daily basis various options should various things occur. That's just the normal course of doing our job.

Senator SARBANES. Well, are you involved in this contingency planning?

Mr. BOSKIN. Yes.

Senator SARBANES. So you at least see some significant risk of a longer and deeper recession, a sufficient risk that at least you have to try to address it.

Mr. BOSKIN. Well, I think in the normal course of doing my job and Director Darman doing his, and Secretary Brady doing his, and so on, that Troika agencies naturally are always continuously, as you may recall from your days at the Council, analyzing various potential paths the economy may follow and what might be the appropriate response.

So I would not say that this is unusual. It's the normal course of things we do. Because the economy is now in a recession, it is more of a live subject than it would have been had the economy been booming.

Senator SARBANES. What are some of the appropriate responses that you think would need to be made if in fact the recession proved to be deeper and longer than you are now predicting?

Mr. BOSKIN. That would depend a lot on the causes. We see that the Treasury Department has taken the lead, for example, in trying to deal with some of the credit crunch issues with the regulators. Deputy Secretary Robson is now working with them to try to make sure that, within the grounds of safe and prudent and responsible oversight, they're not inadvertently restricting credit to creditworthy borrowers through various types of liquidating accounting on everything. And things of that sort.

So there are a variety of things that are discussed at various points in time. But there is no specific here that has been decided upon by the President, or anything of that sort.

It's all in the nature of understanding that there are risks. The economy could perform somewhat differently than we forecast and we would have to consider various types of options in that circumstance.

Senator SARBANES. Are there any programs that you might recommend if the recession proved not to be short and shallow as you're anticipating, that would involve some leadtime and that Congress ought to consider now rather than waiting until the recession gets much worse?

Mr. BOSKIN. Well, I would have to explore that in more detail with my colleagues. But, yes, as a general principle, to the extent anything would be done that would involve legislation, obviously, that involves time.

Senator SARBANES. I want this question on the record and I want it to come home in a very pointed way because you said on August 2 when you testified before the committee that the Persian Gulf crisis would not cause a recession, "by itself unless it was compounded by policy mistakes or some other weakening that for some other reason also occurred."

I don't want a hearing 6 months from now with having experienced a deeper downturn than you are now anticipating and have Congressman Hamilton say, well, now, I want you to look back about mistakes that were made, and then be told, well, you know, we really should have put into place A, B, and C, because that would be useful if we had it right now or it has been slow getting into place, and if we had simply anticipated it then and had it on a standby basis or ready to go, it would have served a purpose in helping to ameliorate this downturn.

Mr. BOSKIN. I appreciate that concern and will carry it with me.

I did try to indicate in my remarks that our analysis of what happened was that the oil shock came on top of worsening credit conditions and more sluggish growth in money and credit than had been anticipated.

But I certainly take your concern and will share it with my colleagues involved in the setting of economic——

Senator SARBANES. I don't think you can at the end of all of this simply look back and say, well, you know, there was really nothing we could have done. It was all foretold in the stars. That's not your view, I take it, is it?

Mr. BOSKIN. No. I would like to indicate, for example, that one of the things we put into the Economic Report and therefore, into the budget and the forecasts, is a higher and a lower growth path. In this case, the lower growth path is a deeper recession. We tried to figure out what that might do to the budget and what that might do to the economy and so on.

So we've begun this process and we will, I'm sure, work with the Congress to the extent we come to conclusions that require that.

We have seen thus far, not only in terms of our forecasts, that the major policy levers are, in addition to the automatic stabilizers, in the financial sector.

Senator SARBANES. There are a lot of people who are deeply anxious because the recession is not being responded to at the levels at which we find it. And I disagree with your sense of urgency over that. At least if we can't move you on that front, wouldn't it be helpful and reassuring to the country if the administration were to indicate that if it worsens, they intend to take certain steps and perhaps indicate what some of those steps might be?

Mr. BOSKIN. Well, there may be some value in that. I'd have to think about exactly what those steps would be and I will take that under advisement and share it with my colleagues.

Mr. Taylor might want to make a comment on that.

Mr. TAYLOR. I'd just mention, Mr. Chairman, that if the recession is worse or longer lasting than we're forecasting, there will be some actions taken.

For example, there's no question that a more weak economy will bring forth lower interest rates. Something that we very much stated explicitly in the report is that interest rates need to be situated in such a way that they could decline if the economy weakened.

That would in fact be a stimulus which is not to be ruled out, a very important aspect to our policy.

Senator SARBANES. How low do you think they can go given the international situation in which we find ourselves? The Germans are now raising their interest rates. Is that correct?

Mr. TAYLOR. That's right, yes.

Senator SARBANES. We are dependent upon the flow of foreign capital given our deficit situation. Is that correct?

Mr. TAYLOR. We have a situation now where U.S. interest rates have declined somewhat and interest rates in Germany have increased somewhat. We don't know whether that difference will persist or continue.

But I would say that the most appropriate answer to your question is that what we should do in terms of economic policy in the United States is to provide for a strong, growing, balanced economy.

If that requires a monetary policy in which interest rates decline as the economy weakens, if the economy does weaken more than we forecast, then that's exactly what the appropriate response should be, because that will provide for a stronger, growing U.S. economy and a healthier world economy at the same time.

Senator SARBANES. What problems will that create for us on the international scene, then?

Mr. TAYLOR. It's difficult to say that it would cause any complications.

Senator SARBANES. Will we still get the flow of foreign capital under that scenario?

Mr. TAYLOR. Not necessarily.

Senator SARBANES. Don't we need it in order to address the deficit situation?

Mr. TAYLOR. The main way in which we're affecting the flow of foreign capital is by taking actions to reduce our Federal budget deficit over the longer haul.

Senator SARBANES. Well, I understand that, but you've got a short-term problem here, don't you?

Mr. TAYLOR. Excuse me. For 3 years in a row now, and last year, our trade deficit has declined; 3 years in a row. And part of the reason for that decline has been the continued structural decline in the Federal budget deficit.

We anticipate that we'll be able to continue to reduce our international trade deficit. One of the ways to do that will be to reduce our Federal budget deficit over the longer haul.

But, Mr. Chairman, let me just mention, on the fiscal policy side, if the recession is weaker, we do have the automatic stabilizers in place, which are significant in magnitude. The magnitude of $40

billion is a substantial amount and is the impact on the economy for the changes we've already had.

It is a substantial amount of fast working funds, which provide for economic stability.

Senator SARBANES. Are you in favor of improving the extended employment benefit program and reinstituting the supplemental unemployment benefit program if we have a deeper recession?

Mr. TAYLOR. We have at this point rules in place for extending unemployment compensation, and while we're studying those rules, as we're studying the administrative issues that you raised, we have no proposals at this point to change them.

But we obviously are studying those as well as the administrative costs.

Senator SARBANES. Well, my understanding is that for those rules to apply in most States, they would have to be, for the extended unemployment benefits program, they would have to be in a depression. They would have to have unemployment rates far in excess of where we are now or even where you anticipate being.

Mr. BOSKIN. I would just indicate, I think that two States are now in the situation where they have extended benefits. Most State programs trigger off of the relationship between the State unemployment rate and the national average and there are various other formulas.

Senator SARBANES. We held a hearing on January 4 on this very issue and I commend it to you because the fact is that for most States, the trigger is exceedingly high, I think at levels that you would not accept as being a point that you could wait until. Not only from the point of view of the individuals involved, but from the point of view of economic stabilization.

Senator SARBANES. Congressman Hamilton.

Representative HAMILTON. Thank you, Mr. Chairman.

I want to direct your attention to your long-term growth projections. As I understand that, you think that the economy will grow from 1992 through 1996 at a 3-percent-per-year rate.

Now the labor force is projected to grow only about 1 percent a year. And if I understand the way you economists work on these things, that means that you're looking to see that the output per worker to rise 2 percent a year in order to hit the 3 percent.

Is that basic economics or not?

Mr. BOSKIN. You've done the analysis exactly right, but the numbers are slightly off, though. The projected labor force growth is somewhat higher than that. The projected productivity growth is either 1.8 or 1.9 percent.

Representative HAMILTON. All right. Now, if you look at the productivity record based on output per hour, nonfarm business sector, through the 1980's, the figures are quite low—0.3, 1.0, 0.9 percent, there was a 2.9 percent, there was a 2.1, 1.3, 2.0, 1.0, 2.5, 0.7, and 0.7 percent.

In other words, we're really going to have to get our productivity up sharply from the record of the 1980's in order to hit that 3 percent. That's correct, is it not?

Mr. BOSKIN. That's correct, unless there were substantial other ways to have the labor force grow.

Representative HAMILTON. Assuming that that labor force projection is about right, now how are we going to get that productivity up? How do you foresee getting the kind of a sharp shift in productivity gains back really to the kind of records we had, as I understand, in the 1950's and the 1960's after a decade in which our performance on productivity has been low?

Mr. BOSKIN. Well, let me just try to give some factual data.

The productivity growth in the 1950's and 1960's was somewhat higher than this. The 1.8 percent is about the longrun average for the whole postwar period from 1948 to 1989.

Representative HAMILTON. The 1.8 percent is?

Mr. BOSKIN. The 1.8 or 1.9 percent. I've forgotten exactly.

Representative HAMILTON. All right. We're talking approximations here.

Mr. BOSKIN. Our estimate actually turns out to be 1.85 percent, so it may be 1.9 percent because of rounding.

This is about the long-run historical average productivity growth for the American economy, including, as you recall, the high productivity growth rates in the 1950's and 1960's, the rather poor ones of the 1970's and the partial rebound, but still not high, total for the 1980's.

There are a variety of reasons we expect productivity growth to improve, including some demographic factors such as the fact that our work force will be moving into more productive ages and because of the half trillion dollars that will be freed up because of less government borrowing for expanding investment. We also had an historic immigration law passed last year, which will provide for an influx of skilled workers.

So there are a variety of factors that suggest that there are opportunities for productivity to do better. Not having to absorb the very large amount of very young workers and new entrants and reentrants, for example, second earners and families, as in the 1970's and 1980's, gives the economy a chance for productivity to do a little better.

In periods in the past, when the labor force has grown more slowly, productivity has in fact grown more rapidly. And conversely—when the labor force has grown quite rapidly, it's grown——

Representative HAMILTON. Let me ask you this. In your projections of these factors that you think will increase productivity in the future, 1992 on, are you operating on the basis of hard evidence or are you operating on the basis of assumptions you're making?

Mr. BOSKIN. Well, this is a projection, but it's based on our analysis——

Representative HAMILTON. Of the evidence.

Mr. BOSKIN [continuing]. Of the evidence and of these trends. There's a range of opinion on this.

Representative HAMILTON. As professionals in this field, are you optimistic on this—mean, I haven't really seen that among other economists, projecting that sharp an increase or that steady a growth figure, 3 percent for 4 or 5 years there. Are you optimistic among professionals there?

Mr. BOSKIN. I would say two things to that, chairman—pardon me—former chairman. Congressman Hamilton.

Senator SARBANES. Once a chairman, always a chairman. [Laughter.]

You'll discover that yourself, as a matter of fact. [Laughter.]

Mr. BOSKIN. And I'd also ask Mr. Taylor to comment. Productivity growth estimates are in the range of 1.3 percent or so up to a little over 2 percent.

There are lots of reasons why those numbers change from year to year and among different people. There is also what might be a more plausible comparison or a more sensible comparison. If you look at the period from the business cycle peak through the end of the forecast period, the historical average real growth rate has been 3 percent. Ours is 2.6 percent and CBO has 2.4 percent.

We're somewhat under the historical average for the 25 quarters after a business cycle peak. So I think that this is quite reasonable.

Representative HAMILTON. Well, OK. Let me get an answer——

Mr. BOSKIN. In that range, we'd probably be toward the more optimistic end of the spectrum than in the middle.

Representative HAMILTON. You're on the more optimistic side.

Mr. BOSKIN. Not at the extreme, but toward the more optimistic side.

Representative HAMILTON. I'm talking now about the years 1992 to 1996, basically.

Mr. TAYLOR. Sir, it's important to point out that part of the explanation for the higher growth, especially in 1992 and 1993, even 1994, is that we're coming out of a recession. It's really poor economic forecasting not to recognize that.

Representative HAMILTON. Well, let me just express my general concern here. And what I'm trying to get at is if you look at the CBO figures, not yours, but I gather you're fairly close to them, what happens is that this debt of ours, this deficit of ours just balloons in the short term. And then you look out down the road for 5 years and it's quite under control, if not at zero.

Now I've been seeing those projections for a long time around here.

Mr. BOSKIN. I know that, sir.

Representative HAMILTON. And I have a lot of skepticism about them. We always have the pot of gold 5 years down the road. And the immediate years are always worse.

I don't accuse the Republicans of doing that any more than the Democrats. But I just want to say to you that I have big doubts about your projections down the road. Big doubts. Not just yours, but CBO's as well.

I think you've made quite a bit of progress, frankly, in the short term. I think you deserve credit for your short-term projections. I think they're much better than a year ago, 2 years ago when we first began visiting about these matters. You deserve credit for that.

But this long-term projection still bothers me a great deal. We always seem to rationalize these things and say, well, we'll go ahead and pump up the old deficit and increase the debt here for the short term because everything's going to be great 3, 4, 5 years down the road. Does that bother you?

Mr. BOSKIN. Well, I certainly agree that historically it has. I think that——

Representative HAMILTON. Your case is different.

Mr. BOSKIN. No, no. I was going to say I think the deficit reduction law, the budget law, that was passed last year does offer some hope that in this regard things will be better in the future than they have been in the past.

Representative HAMILTON. Let me tell you—I tried that out on an Indiana audience this weekend. They just about laughed me out of the room. [Laughter.]

I told them about this wonderful debt reduction agreement we got last year that was going to get that debt down. Then they asked me, what's the debt going to be this year and next year? And I was lucky to come out of there with my skin.

Mr. BOSKIN. I understand that and I understand and respect the fact that you face the constituents and I only get it by the transitivity of appearing before you, sir.

But there are some very important special features of the budget law. And I understand there is skepticism. There are always special features. But a very, very large fraction of the entire cost—including the working capital costs—of the S&L's is being borne this year and next. And that really is a very different kind of thing than the normal borrowing the Government does.

The chickens have come home to roost and we're paying those bills. The bills have not been paid on an accrual basis and this problem has developed over many, many years.

No one that I know foresees these kinds of unusual, one-time expenditures—$111 billion this year, and $88 billion, I believe, next year—occurring in the future. And of course, we hope they're right.

Senator SARBANES. How do you get these productivity figures? I have really Congressman Hamilton's skepticism about these productivity figures. My skepticism was intensified when you said the postwar average increase in productivity was 1.9 percent. Is that right?

Mr. BOSKIN. The 1.8 or 1.9 percent, somewhere in there.

Senator SARBANES. Which is exactly the figure you've plugged in for the next 5 years projecting out.

My question is did you build that figure up with building blocks that were the process of analysis that sort of came together and gave you 1.9 percent, or did you just take the postwar average of 1.9 percent and plug that figure in? It's passing strange here that we got 1.9 percent, 1992, 1993, 1994, 1995, and 1996. Doesn't productivity worsen when you go into a downturn?

Mr. BOSKIN. Sure.

Mr. TAYLOR. And it speeds up as you come out of a downturn.

Senator SARBANES. Well, you go from productivity in 1990 of minus 0.1 percent at a 5.4 percent unemployment rate. You then project for the next year a 6.7-percent average unemployment rate, which is a significant worsening of the economy. And you project an increase in productivity from minus 0.1 to 1.6 percent.

Mr. TAYLOR. Well, that's the productivity growth rate during the year. It's from the fourth quarter of 1 year to the fourth quarter of the next year.

So the economy is recovering, as we and others forecast. The unemployment rate has risen and will linger there, then come down with a lag, as it normally does with economic recoveries.

So the projection of high productivity reflects the projected recovery of the economy in that first year.

Senator SARBANES. How about these other years where it stays at 1.9 percent, even though you have the economy improving?

Mr. TAYLOR. Well, the productivity growth will come up, as I said, as the economy rebounds. In the longer term, 1995, 1996, this is our best estimate at this point. It assumes the various economic policies that we think are good for the economy are put in place and the other factors that Mr. Boskin referred to, such as the immigration policies, the changing demographic composition of the work force, all these are features that didn't occur in the 1980's.

If they do in fact take place and do have the effects which most economists predict they would, then we think it's quite reasonable to get productivity growth in the 1.8, 1.9 percent range during that period.

Senator SARBANES. Suppose I put a question to you. Would you expect productivity growth to be the same with a 6.5 or 7 percent unemployment rate as it is for the 5 percent unemployment rate? What would you say to me?

Mr. BOSKIN. It would depend on the time pattern.

Mr. TAYLOR. It's very much a timing pattern, Mr. Chairman. You could have an unemployment rate at, say, 5 percent throughout a whole decade and have productivity growth very low. Or you could have an unemployment rate which is 6 percent through a whole decade while the economy is growing very strongly and have a very high productivity growth rate.

What we do know is that when the economy slows down, productivity growth slows down. When the economy speeds up, productivity growth speeds up. But the average level of unemployment at a particular time is not the factor. It's the change in the unemployment rate or the speed of growth of the economy.

Senator SARBANES. My reaction on these productivity figures is like Congressman Hamilton's on the deficit figures. You are projecting these productivity levels which we've not reached in recent years, haven't even come close to. Of course, productivity is at the center of having a rising standard of living for our people, right at the heart of it. You project this kind of optimistic scenario, then you can sort of say, well, everything is going to work out pretty well. There is nothing we really need to do much about in order to increase or improve productivity.

If you reach these figures, there will be an incredible performance compared with what we've experienced in the recent past.

One has to go back and factor in the whole postwar period to find a 1.8 percent figure, and that included periods in the 1950's and 1960's, when the productivity performance was well above 1.8, 1.9 percent.

Mr. BOSKIN. As well as abysmal productivity performance in the 1970's and the partial rebound, but still lower than the 1950's and 1960's in the 1980's.

Let me try to put this into perspective in a somewhat different way.

If you take our forecasts and you compare it, say, to CBO's—I know, Congressman Hamilton, you're not sanguine about CBO's either—the level of real GNP we forecast is below CBO's until 1994, and then we're almost identical. And even in 1996, our level of GNP is 1 percent above theirs.

So these are not radical. We could both be wrong. We may well both be wrong. We may well both be optimistic or pessimistic and our estimates may be different from what actually occurs. But this is not a large difference.

I would also indicate that you're quite correct that the long-term growth over a period of 5 years has a very pronounced effect on what the budget deficit will be.

I think it is not as widely understood that the amount of savings from the 1990 budget law, relative to the baseline with different economic assumptions, is much less sensitive to what one assumes about the growth rate.

If one had a lower growth rate, you would have larger baseline deficits and the savings would be about the same. And if you had a higher growth rate, you would have smaller baseline deficits in the outyears and surpluses by the mid-1990's to late 1990's. And you would still have about the same kind of savings.

So I'd just make that point. But I really do believe that when you look at what we've done, we've tried to use our best judgment based on all the factors.

But I'd echo one point that Chairman Sarbanes said. We don't want to take long-term economic growth for granted or productivity growth for granted. We want to do everything we can to move the economy to higher productivity growth because, as you say, it's the source of increases in the standard of living for the population.

Representative HAMILTON. Mr. Boskin, I'm very grateful that you've spent so much time with us this morning. I'm running out of time now and I'm going to ask you kind of a broad question that covers a lot of different things and let you make whatever comment you think appropriate.

One of the things I ask myself when I look at a report like this is what you've left out of it. I'm struck by the fact that you leave out of this, or I think you leave out of it, I've not read it all, but I've looked through good portions of it. I think you leave out any real discussion of poverty.

You leave out discussions of income distribution. On the energy section, you leave out conservation. Nothing in there that I can see about conservation. You're going to solve the problem—and maybe if I'm wrong about that, then I'm thinking of the President's proposal.

But it seems to me that the whole emphasis is on producing more energy, and we all recognize that has to be a part of it. But I don't see very much in here about conservation.

And then with regard to education, let me just say that I agree with the comments you made earlier with respect to education. But we're confronted with an administration budget which is cutting outlays for elementary and secondary education, cutting outlays for higher education, cutting outlays for research and general education, cutting outlays for training and employment. All of those are below current service levels.

Higher education and training and employment both get cuts in budget authority relative to current services as well.

So it looks to me like the rhetoric that we're hearing from you and from others on education, when compared with the budget we're getting, don't match. And you're cutting education programs while extolling the values of education.

The final point I want to make, and I know I'm raising a lot of them here.

Mr. BOSKIN. I'm making a list here.

Representative HAMILTON. You'd better make a list. I'm sorry to throw so much at you. I apologize for that.

The other point, I'd like you to comment just briefly on industrial policy. It's probably a bad phrase. I don't know what we call it now. But, anyway, you're asking for funding increases in high performance computer communications, advanced manufacturing and materials R&D, aeronautics R&D, and expanded R&D at the National Institute of Standards and Technology.

It seems to me this administration is moving more and more toward some kind of what we used to call industrial policy. And in those instances, at least, it's moving away from letting the market decide.

Mr. BOSKIN. Well, let me give you a quick response to all of the points, and then ask Mr. Schmalensee to comment on a couple.

First of all, we had an entire chapter on human resources last year where we talked about poverty and income distribution, the widening of the gap with respect to returns to high school and college education, and a variety of things of that sort.

We tend to think of the report as a sequence. And when we have a report with a whole chapter devoted to a topic—except for the outlook and similar chapters—we usually don't repeat it the following year.

That isn't meant to indicate that we're not concerned about it. As a matter of fact—I don't know if this will please or surprise you—there is a statement in the report, which I'm paraphrasing, that economic growth is necessary to prevent poverty from rising, but growth is not enough by itself. That more must be done.

And we do discuss some of the administration's initiatives in this regard.

Representative HAMILTON. That's in the report?

Mr. BOSKIN. That is a paraphrased statement. But it's close to that.

Without a healthy, growing economy, poverty in the United States cannot be reduced. But growth alone is not enough, and it goes on. So I think we try to highlight——

Representative HAMILTON. Does it go on to say what you have got to have in addition to growth?

Mr. BOSKIN. It does get into some of those things, including the administration's emphasis on trying to get people who are disadvantaged, whether with disabilities or for other reasons, into the economic mainstream. Giving them more opportunities and so on.

So that's an answer to the poverty and income distribution parts of your question.

I would say that energy conservation is also addressed. We are concerned that conservation be cost effective. And I'm going to ask

Mr. Schmalensee to comment on that in a second. The full details obviously will be unveiled by Secretary Watkins at the National Energy Strategy next week.

On education, while it is correct that some programs, especially in the Department of Education, are not growing as rapidly as inflation, we take a much broader view of education and we have been advised by education experts to do so.

A very major focus of the budget initiatives that we consider to be in education is to shift resources, and make much more resources available, to prepare disadvantaged kids for effective learning.

We've had major expansions in Head Start. We have an emphasis on health and nutrition and prenatal care and so on in the budget.

So I hope that that is at least a part of an answer. We take that as an indication of our seriousness. You seem to want to respond to that.

Representative HAMILTON. No, no. I appreciate those comments. I don't want to turn it into a debate.

Let me ask you one other figure here. Our budget chairman over in the House, Congressman Panetta, I think is my source for this. It's another item that's missing, it seems to me, from the report.

He used a figure last week, I think I cite it correctly. I don't have it down in front of me, that the Nation's debt 10 years ago was about 25 percent of GNP. And today, it's 50 percent or so of GNP.

In other words, during the decade of the 1980's, we doubled the national debt in relationship to GNP.

Now, if I'm correct in those figures, how serious a matter is that and how do you respond to it and why don't you discuss it in your report?

Mr. BOSKIN. Well, first of all, it is a serious matter. We discussed it in detail in last year's report. The numbers are not quite exactly that. I think you'd have to go back and——

Representative HAMILTON. I have to go back and read that last year's report. That must be one whale of a report. [Laughter.]

Mr. BOSKIN. There is a discussion of the stabilization of the Federal debt as a share of GNP. I think you'd have to go back into the 1970's to get down to 25 percent, and I think we're not quite at 50 percent.

But, in any event, you're correct qualitatively, if not with the precise numbers.

The cost of servicing the debt has become the third largest component of Federal outlays.

Senator SARBANES. There it is [indicating]. There it is. That's the interest, that big one over here. That's the interest.

And 75 percent of the debt on which this interest is paid was run up in the decade of the 1980's.

Mr. BOSKIN. Well, we view this as a major——

Senator SARBANES. In other words, this is the interest charge on the debt and 75 percent of the debt on which this interest is being paid was run up by the Federal Government since 1980.

Mr. BOSKIN. Well, we have both in this report and in others berated large budget deficits. We think it's one of the reasons—along

with expectation of large budget deficits—why interest rates have been high and the economy has had some problems.

We are hopeful that the credibility of the budget accord hopefully, eventually, will spread more broadly, including to your constituents in Indiana. And that this will lead to a decline in that share. And we believe that that is highly desirable.

Let me just answer, if I may, your industrial policy question and try to clarify that. I think you're quite correct. It's an unfortunate phrase because it means different things to different people.

Our position has been that we are trying to do various things to expand the capability of the economy to grow. We have a philosophical our partially based on judgment of aversion, history, to picking winners and losers at the commercial level; to saying that this firm should get a subsidy or this technology should get a heavy subsidy.

We are very strong believers, as I mentioned in my introductory remarks, that the Federal Government has a major role to play in some areas.

For example, the Government has a role in research and development where there are potentially broad social benefits, when no single firm or small consortium of firms would be able to appropriate all the benefits of a discovery if they had to develop it themselves.

This is most obvious at the extreme end of research and development. For example, basic physics is very hard to do in a commercial company because, if the firm comes up with something new, it will have wide application be available to everybody.

So we are pushing forward our view that the Government has a very important role to play and we're trying to expand government's role in broad-based R&D that is likely to have broad social payoffs.

We're also—and Director Darman and Science Advisor Bromley, have taken a lead in this and deserve a great deal of credit, in my opinion—trying to do a better job to make the benefits of research that is done in the public sector more quickly available to private sector.

You asked about energy conservation. I defer that question to Mr. Schmalensee, and he will answer it.

Mr. SCHMALENSEE. Thank you. I had one additional observation. We also didn't discuss the environment this year because we discussed the environment last year. And we didn't focus particularly on saving and investment in the United States, which we consider to be a vitally important issue and which has arisen a number of times, because we focused on that last year.

On the specific issue of energy conservation, our discussion of energy policy was not intended to preview or replace the National Energy Strategy. What we tried to lay out were the basic principles.

There's also not a lot of discussion of production increases in our treatment of energy policy. In fact, my guess is that if you did a line count, there's more discussion of conservation, because we do discuss efficiency standards and we do discuss integrated resource planning.

My guess is, that by chance, there is probably more attention paid to conservation in our document than to production increases. But that's not reflective of policy. These issues were chosen as examples to illustrate principles and that's the approach we took.

Representative HAMILTON. I thank you for your testimony this morning, for your answers to my questions.

Mr. Chairman, I commend you for the hearing. I apologize here for leaving. We've had these gentlemen here quite a while.

Senator SARBANES. I'm going to wind it up shortly.

I wanted to pursue something that Congressman Hamilton put to you about industrial policy. At the end of your first chapter you quote Adam Smith about the cost of misguided interference of market forces. Adam Smith also recognized the strategic nature of certain industries, England's sailcloth and gunpowder industries, for example, and he said, "if any particular manufacture was necessary for national power and for the defense of society, it may not always be prudent to depend on our neighbor for supply." He also went further and favored the notion of gaining monopoly positions for U.K. firms in foreign markets through government policies. He said, "the natural good effects of the colonial trade more than counterbalanced to Great Britain the bad effects of the monopoly."

The question I put to you, is it possible that the United States is pursuing a highly idealized notion of free trade while competitor countries such as Japan are merely following the teachings of Adam Smith?

Mr. TAYLOR. Mr. Chairman, I will briefly discuss this.

Adam Smith has a number of places where he indicates that, for defense reasons, in particular, one needn't follow the completely laissez-faire suggestions that he lays out.

Senator SARBANES. Also, the protectionist policies to lock the colonies into buying U.K.-manufactured goods as well, was it not?

Mr. TAYLOR. In the case of free trade or open economies policies, Adam Smith couldn't be more clear about his principles. And that is allowing competition against domestic monopolies and domestic industries is one of the primary reasons to consider open markets and free trade and fair trade.

Monopoly was something that he was concerned with very much. Mr. Schmalensee will probably comment on that as well.

But the free trade arguments that Adam Smith focused on were by and large focusing on ways to introduce more competition and more flexibility in the economy, not to promote monopolies.

And the national defense arguments he made were very well laid out and very well circumscribed. His deviations from free trade policy, in general were narrow. He talked about retaliation, for example, as something that governments might consider as a way to promote free trade around the world. But he considered it and discussed it in very, very narrow terms and warned against the danger of retaliation as bringing on trade wars.

So I think the particular quotations that you put forth have to be put in context. He had a philosophy which, with very few exceptions, is one of open markets, free markets, and free trade.

Senator SARBANES. It's an interesting response because the thrust of my question is really more directed to Japan than it is to Adam Smith.

Mr. BOSKIN. We were so overwhelmed by the——

Senator SARBANES. You were so overwhelmed by the Adam Smith quote. But it's really directed more toward Japan.

Mr. BOSKIN. We've always been impressed by your economic——

Senator SARBANES. Let me put this question to you.

The Department of Commerce has identified 12 technologies that the Department says will be critical to economic prosperity a decade from now. That list includes superconductors, biotechnology, et cetera, et cetera. Commerce concludes, based on present trends, not current status, but present trends in these 12 technologies, that the United States is losing badly to Japan in 4 of the technologies, losing in 7, holding its own in 2, and leading in none.

Now does that conclusion trouble you? And assuming it does, what steps does the administration think should be taken to reverse these trends?

Mr. BOSKIN. Well, certainly——

Senator SARBANES. Do you quarrel with the underlying statement of the Commerce identification?

Mr. BOSKIN. Well, I wouldn't get into a discussion of whether each and every one of those was essential at the expense of everything else in the economy. Those are all very important industries that have the prospect of providing substantial benefits in the future.

And we have developed a variety of initiatives, from allowing for joint production ventures, the proposal for the advanced R&D tax credit, the attempts to make more capital available to finance investment. And the substantial increase in government R&D and things of that sort.

And if a very large fraction of the additional capital at the commercial level, not at the level where the Government has to be financing or doing a lot of the research and development, was devoted to many or all of those technologies, I think that would be fine.

I think that when you get to commercialization, you start to get to the point where private firms can sufficiently appropriate the benefits. It should be the people whose profits and jobs are on the line that should be making those decisions, not the Federal Government.

But we have a variety of proposals. For example, making the R&E tax credit permanent, and allowing for joint production ventures. There are a variety of others and maybe Mr. Schmalensee might care to mention a couple.

Mr. SCHMALENSEE. I just wanted to add briefly that there is a real difference in mindset, I think, in terms of how different people react to something like the Commerce Department report.

If one believes that the Commerce Department is uniquely able to predict those technologies that will be of particular importance, then one might want to argue for directing resources, for using the power of the Government to direct resources toward those technologies.

I think the alternative approach is to say that the Commerce Department, for all its skills and depth, may not be right; that perhaps a better approach is to rely on pluralism in the market place, and to react to this report by taking steps to increase the base.

Senator SARBANES. It may not be right in saying these are the essential technologies? Is that your point?

Mr. SCHMALENSEE. Yes.

Senator SARBANES. Are they right in saying that, based on present trends, the United States is losing badly to Japan in 4 of the 12, losing in 6, and holding its own in 2, and leading in none? Are they correct in saying that?

Mr. SCHMALENSEE. I defer to their expertise and the expertise of the scientists involved. I have no independent opinion on that.

Senator SARBANES. Well, leaving to one side for the moment whether the technologies listed by Commerce are the 12 technologies of the future, as opposed to there may be some others that ought to be on the list, and maybe some that are on the list ought not to be there, how concerned are you by the relative performance of the United States in these technologies as compared with Japan?

Mr. SCHMALENSEE. I'm concerned generally that——

Senator SARBANES. I keep asking these questions. I get Adam Smith on the one hand, I get the Commerce Department on the other, and I am trying to get at sort of the relative status of the United States and Japan and the Japanese competition.

Mr. SCHMALENSEE. I was going slowly toward a response.

Senator SARBANES. Well, I was just trying to speed you up.

Mr. SCHMALENSEE. I know. That's more than fair, Mr. Chairman. I do believe there's a reason for concern. But the appropriate way to express that concern is to strengthen education in general, to strengthen science and math education in particular—where the Energy Department, among other agencies, has taken the initiative—to try to remove barriers to innovation, and to try to increase support for research with spillovers.

In short, to strengthen the base or to strengthen the pool of research capability and development capability in the U.S. economy. Not to try to channel it, but to try to deepen it.

Senator SARBANES. Meanwhile, the Japanese are——what's our trade deficit with Japan now?

Mr. TAYLOR. It has come down. The year before last, it was close to $50 billion. This past year, it's estimated to be a little less than $40 billion. We don't have the estimates.

Senator SARBANES. $40 billion.

Mr. TAYLOR. Yes.

Senator SARBANES. Is that the biggest we have with any country in the world?

Mr. TAYLOR. Yes.

Senator SARBANES. By what order of magnitude?

Mr. TAYLOR. I'll have to look it up to get the exact details, Senator, but since our overall trade deficit is on the order of magnitude of $100 billion, it's roughly 40 percent. I would say, though——

Senator SARBANES. What would you say is next? How big is our trade deficit with our next largest trade deficit partner?

Mr. TAYLOR. I'll have to look that up, Senator. I don't know who is in second place.

Senator SARBANES. Would it be as much as $10 billion? Probably not, I would think.

Mr. TAYLOR. My guess is, no, Senator.

Senator SARBANES. It would be less than $10 billion.

Mr. TAYLOR. Yes.

Mr. BOSKIN. We'll have the answer for you in just a second.

Senator SARBANES. Mr. Boskin, I have some questions that I want to put to you very quickly.

Last week, Germany raised the two short-term interest rates directly controlled by the central bank to slow the German economy and prevent inflation from rising. A number of other Western European countries in the EMU also raised interest rates to keep their currencies aligned with the deutsche mark since it has that dominant role. One possible effect of a slowdown in the European economies would be a decline in U.S. exports and therefore, a worsening of the recession here.

Did the Bundesbank consult with either the administration or the Federal Reserve before it raised interest rates last week?

Mr. BOSKIN. The Bundesbank certainly did not consult with the administration. I can assure you of that. I do not know of any specific contacts between the Bundesbank and the Federal Reserve, but as you know, the central banks of the G-7 often are in contact with one another, so it would not surprise me if they had. But I do not know for sure.

Senator SARBANES. What are the administration's views on the rise in German interest rates?

Mr. BOSKIN. Well, in general, we believe that the foreign economies should be concerned about growth. We believe the United States, Canada, and Britain, which have all gone into a recession, are a matter of months or quarters ahead of some potential problems in other countries. We believe the rise in inflation in Europe is transitory and due to the oil shock, and that inflation will come back down again.

We would in general like to see growth-promoting policies there.

Giving a personal perspective, you indicated your deep concern with the deficits of the 1980's. I can recall being berated by the Germans for those deficits some years ago, not without cause. They now have moved in 1 year from a slight budget surplus to a deficit on the order of 5 percent of GDP. They're financing unification with deficits and borrowing rather than with taxes.

Senator SARBANES. If two of our major trading partners, Canada and Great Britain, are, as you just said, tipped over into recession, if the Germans are raising interest rates to slow the economy down, and if the other European countries are following along, what prospect does that hold out for the projected growth that you were anticipating coming from exports?

Mr. BOSKIN. Well——

Senator SARBANES. Are some of the markets into which we seek to send our exports going to be contracting?

Mr. BOSKIN. Some will, but some of them will still be growing more rapidly than our own.

The net effect on GNP comes from real net exports, exports minus imports, and that reflects the relative growth.

So even if they're slowing a little, but they—say in Germany and Japan—are still faster than the United States, that should be a net stimulus. Also, the lower dollar in 1990 is likely to lead, as usual with a lag, to an increase in exports.

Senator SARBANES. Is it your counsel that Desert Storm should be financed by borrowing?

Mr. BOSKIN. Given what is anticipated now, and the fact that over 80 percent of the costs appear to be being funded by our coalition partners, and given the likely magnitudes, yes, I do.

Senator SARBANES. At what point do you think it ought to be paid for? This is just another item we are putting on the tab and we are right back into this expanding the deficit, building up the debt, raising the interest charge on the debt, according to that chart I showed to you earlier.

Let me put the question to you in this context. I'm now quoting from a newspaper article about the Japanese regarding the discussion in Japan over approving $9 billion in aid for the war against Iraq:

> On Thursday, Mr. Kaifu, the Prime Minister, and his cabinet agreed to put the entire $9 billion package in one bill that would appropriate the money, authorize taxes on cigarettes, gasoline, and corporations to pay for it, and issue treasury bonds to cover the aid until the government is reimbursed from the new tax revenues.

We are taking just the opposite approach. We are just borrowing it. We are not providing for it. How long do you think we should do that? And in what magnitude?

Mr. BOSKIN. I would draw a distinction. The Japanese economy has been quite robust, and ours is in a recession. I would say that is a major factor. I don't know if Mr. Taylor has anything to add.

Mr. TAYLOR. I'd just say two things, Mr. Chairman. And we have the specific numerical information that you wanted on the trade deficits.

If there was a tax increase to pay for the war expenditures, it would be a temporary tax increase, presumably. It's a temporary war. And there are many economic arguments that suggest that a temporary tax increase would be bad economic policy. It would be bad to change the tax rates more or less on a temporary basis like that.

There's a whole literature in economics that has developed over the years to argue against that kind of change.

What that suggests is that the borrowing route is appropriate. It's a temporary, one-time expenditure from which we benefit from the control of aggression around the world and from which future generations benefit as well. So the economics of the argument is pretty clear.

Senator SARBANES. What would be——

Mr. TAYLOR. Now to the question that you raised about the trade deficit. We have data, as you know, not through the full year 1990, but only through the first 11 months. The trade deficit with Japan is $38 billion out of a total of $96 billion. The second ranking deficit is with Taiwan, which is just over $10 billion. We have a trade surplus with the European community, Mr. Chairman.

Senator SARBANES. Taiwan is at $10 billion?

Mr. TAYLOR. Taiwan is $10 billion, yes.

Senator SARBANES. And who is after Taiwan?

Mr. TAYLOR. Canada, at $7 billion.

Senator SARBANES. And then who?

Mr. TAYLOR. Well, the European Community as a whole is in surplus. We could look at some of the individual countries. Italy is $4½ billion.

Senator SARBANES. So you're down under $5 billion, then.

Mr. TAYLOR. Mr. Chairman, I think it's very important to point out that, in the context of your question, we view the source of the trade deficit overall as due to the imbalance between savings and investment in our economy.

The focus on competitiveness—the United States versus one particular country is inappropriate in explaining our overall trade deficit. It's a savings and investment macroeconomic imbalance.

Senator SARBANES. Do you think that you can sustain or that you ought to have a situation in which, on a bilateral basis, you have a trade deficit of the magnitude that we have with Japan, particularly when it is about four times larger than the trade deficit we have with any other country, leaving aside the fact that you address your trade balance in the overall? Do you think that having a trade imbalance of that magnitude with one country is wise?

Mr. TAYLOR. I think the approach to dealing with the trade balance of one country is to work at the overall trade balance. In fact, as the overall trade balance has come down gradually, so has the trade balance with Japan. Maybe not as fast as one would like, but it has come down.

After that, the most appropriate policies for us to take are to look for opening markets generally.

Senator SARBANES. Do you think if we were not taking very direct measures with the Japanese, that the trade balance would come down on the basis of the overall balance coming down? How does that square with the efforts that Carla Hills has been making?

Mr. TAYLOR. I think it's very consistent with the efforts of Carla Hills, who always emphasizes the importance of macroeconomic developments for the overall trade deficit, including the impact of savings and investment.

Senator SARBANES. Well, if it's just a macroproblem, why don't we have deficits of a similar magnitude with all our trading partners? There's obviously something present in the Japanese situation that disconnects with a macroproblem.

I mean, that's why I asked you those other questions about where the other trade deficits are to be found. The same thing is true of Taiwan, incidentally, in my opinion.

Mr. TAYLOR. Well, as you know——

Senator SARBANES. Who has been cited by the Treasury Department for currency manipulation in order to sustain their trade balance.

Mr. TAYLOR. As you know, Mr. Chairman, the administration has begun a number of initiatives with Japan, including the Structural Impediments Initiative, which goes at the reduction of this imbalance in our payments. It's directed at that explicitly.

Senator SARBANES. Yes, that is a bilateral approach, not a macroapproach.

Mr. TAYLOR. The No. 1 item of the six items which the United States has raised with Japan is saving and investment. Part of that involves the Japanese raising public infrastructure investment. The United States would raise savings, primarily by lowering the

budget deficit. These two actions together would help to reduce the trade deficit between our two countries.

That's the No. 1 issue on that agenda.

Senator SARBANES. What were the other items?

Mr. TAYLOR. With respect to Japan, we have asked for the distribution sector to be deregulated so that foreign firms can get goods on the shelves. They've proceeded with that and progress is taking place.

With respect to the exclusionary business practices, we've asked for greater enforcement of the antimonopoly law, and they've begun to take those actions.

With respect to the Kiretsu, the large firm groupings, there has been a request for greater disclosure, very similar to our disclosure laws, which they are proceeding to do. And we have an initiative to look at the difference between prices in Japan and prices in the United States to see if there is evidence of additional trade barriers which should be taken down.

Senator SARBANES. Chairman Boskin, I just have a couple of questions to you and then we will draw this to a close.

First of all, I take it that you are going to be announcing some additional major initiatives on the statistical scene in the near future; is that correct?

Mr. BOSKIN. That's correct, Mr. Chairman, and we're looking forward to working with you on that. It is major relative to the statistics issues, but certainly not relative to some of these larger items we've been discussing. But we believe it is major.

Senator SARBANES. We are now down to the microapproach.

Mr. BOSKIN. Well, we're down to the tens of millions and hundreds of millions, rather than into the billions and tens of billions.

Senator SARBANES. We look forward to having a hearing with you on that subject.

Mr. BOSKIN. I'd be delighted to testify.

Senator SARBANES. We must follow it fairly closely, and I think you have made some advances. We want to try to contribute to those.

Mr. BOSKIN. I'm delighted.

Senator SARBANES. We have had some benefit in the Congress. We weren't able to get quite everything. Some of it got lost in conference. But I think, by and large, we came out pretty well, all things considered.

What's the status of your own budget, the CEA's budget? How is the CEA budget?

Mr. BOSKIN. Well, we have a request in the appropriations this year which would be an increase that's above inflation. I believe it was an 8 or 9 percent increase.

The CEA staff was reduced from a level of around 17 in the late 1960's and early 1970's, down to 10 or 11 many years ago. We find that, despite the hard work of a very capable staff—as you know, people who come from academe and from other government agencies for a year—we are spread pretty thin.

So we'd like to be able to hire one additional senior staff, and one additional junior staff person. I believe that the administration has valued the CEA, so they've included that request, even though we were trying to keep overall expenditures under control.

So we've been funded at a level we think is appropriate. We hope we're able to do that in the appropriations process this year. We've struggled, but we have made some major improvements in our own infrastructure, getting—at least 1980's—word processors, replacing some of the ones that were there when you were there, sir.

And so I think we've been able to increase the productivity of the CEA some over the last couple of years and we're pleased with that and we hope that will inure to the benefit of——

Senator SARBANES. How is your recruitment going? Are you pretty successful?

Mr. BOSKIN. Yes. It's always difficult to ask somebody to take a year out of their life to come serve their country, especially in this era when many more young families have two workers and other commitments. I think, at this point, we're ahead of last year. We signed up three or four senior staff people already.

Once the report is over, we generally head into high gear in recruiting.

But we have been able to continue to recruit talented people, despite what has become something more of a pay gap, believe it or not, between universities and the Federal Government.

Senator SARBANES. We thank you all very much for your testimony.

Mr. BOSKIN. Thank you, Mr. Chairman.

Senator SARBANES. The hearing is adjourned.

[Whereupon, at 1:40 p.m., the committee adjourned, subject to the call of the Chair.]

check each week in order to meet their costs, unemployment, of course, can be a tremendous tragedy. In 1990, a study done by the Congressional Budget Office found that almost half of families suffering long-term unemployment would have been in poverty but for the unemployment insurance benefits.

The economy also benefits from the unemployment insurance system during recessions because unemployment insurance cushions household incomes without requiring specific action by Congress or the President and, thus, acts as an automatic economic stabilizer during economic downturns. In other words, the economy starts down, people are laid off, and there is a contracting of the economy. The unemployment insurance helps to counter that. Unemployment insurance also helps raise long-term productivity by allowing jobless workers an opportunity to find new jobs that fit their skills and aspirations.

The unemployment insurance system as it is now is not actually doing the job properly because the 1991 budget agreement does not provide sufficient money to administer the program. Since June, more than 1 million Americans have lost their jobs, and OMB assumes another 1 million will lose their jobs as the year progresses. This is putting a heavy strain on the State unemployment insurance offices and the dedicated workers who administer the system.

The Department of Labor now estimates the unemployment insurance administrative fund shortfall is in the range of $200 million. While the administration requested in the supplemental $100 million for these administrative costs, this would be sufficient only to reimburse States at 75 percent of their costs for administrative expenses.

As a matter of fact, the unemployment insurance trust fund into which the employer-levied taxes are paid has a balance for administrative costs well in excess of its required minimum. The failure to be able to process the administrative claims in a timely fashion is creating difficulties not only on the part of the workers, but we have also heard from a number of employers who feel that what they have been paying into the fund is not being used as it should be in order to address pressing economic need.

Plainly, an emergency exists. The Nation is now in a recession. The unemployment rate has risen from 5.3 to 6.2 percent. We will hold another hearing on Friday to receive the latest unemployment figures for the month of February. Waits of 4 to 6 weeks for benefit checks are not uncommon. It should be noted here, as part of the budget summit discussion last year, there was a proposal to have a 2-week waiting period for benefit checks. That was rejected because it was judged that it would both impose injury or harm on the individuals, in addition to not serving this countercyclical purpose of unemployment insurance. In many States, decreased staff and increased workload have resulted in waiting lines of up to 6 to 8 hours at unemployment offices just simply to file the claim.

Last week, Senators Mitchell, Sasser, and I wrote to the President recommending a $200 million supplemental for the administrative costs and recommending that it be declared an emergency. The increase in claims themselves are not subjected to the budget agreement spending caps; the administrative costs are. That has

now impeded the ability to process the claims. The claims are allowed but, if you don't process them, they don't get paid.

The January 4 hearing also examined more broadly whether the unemployment insurance system as now constructed provided an adequate safety net for jobless workers during this recession. The hearing identified a number of problems with the system, including, in my view, unrealistic triggers for extended benefits for the extra 13 weeks. In many States, it is estimated the unemployment rate would have to go as high as 15 percent before the trigger applied.

Today, the committee plans to look at this inadequate administrative funding of the unemployment insurance, the impact it is having on jobless workers in this recession. Our witnesses are the people who have to deal with the consequences of this every day, the people who administer the system at the State and local level are right on the administrative firing line and, of course, and most importantly, the jobless workers whose lives have been touched by it.

At this point, I will enter in the record a statement I made before the House Subcommittee on Human Resources of the Committee on Ways and Means, together with an attached letter to President Bush.

[The information follows:]

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Statement of

Senator Paul Sarbanes

Chairman of the Joint Economic Committee

before the

Subcommittee on Human Resources

Committee on Ways and Means

on

February 28, 1991

Mr. Chairman and Members of the Subcommittee, it is a pleasure to appear before you today on the problems of the Unemployment Insurance system. As the Nation's economy sinks into recession, these hearings and the legislation that you may be contemplating are most timely.

The Joint Economic Committee, which I chair, has been examining this recession and policies to respond to it. Unemployment compensation is designed to take care of human needs, to act as an economic stabilizer and to help workers find suitable jobs. The JEC's analysis indicates, however, that the UI system today no longer performs its role fully.

FEEBLE RESPONSE OF UI TO THIS RECESSION

As a quick targeted program of income replacement for jobless workers, the UI system is ideally suited to serve as a fiscal stabilizer. Funds are spent immediately without the lags of bureaucratic or political decision-making typical of other countercyclical spending. Moreover, the funds are automatically spent in the locations of greatest distress.

The UI system is not performing its stabilization role as well during this recession as it should. As a result of three key changes, unemployment insurance is replacing workers' lost income only half to two-thirds as well as it did in past recessions. Until a decade ago, the number of UI recipients closely tracked the number of unemployed job losers. Today recipients trail job losers by twenty percent. In addition, the system is triggering far fewer longer term benefits for states than in past recessions. Finally, UI benefits have become fully subject to income taxation.

PURPOSES OF UNEMPLOYMENT INSURANCE

Unemployment insurance provides a vital economic function to families and the economy in good times and bad. In the recent years of economic expansion, 7 million workers received UI benefits that averaged $2,000. During the worst year of the last recession, 11.4 million workers -- more than a tenth of the workforce -- received unemployment benefits. The current recession has raised claims by almost fifty percent over last year so that the Administration projects that 10.7 million workers will receive UI benefits in FY91.

As "social insurance," the unemployment benefits serve humanitarian, economic stabilization, and productivity-enhancing purposes. In humanitarian terms, UI can provide prompt financial assistance to workers at a time of severe economic distress. According to a 1990 study by the Congressional Budget Office, 46 percent of all families receiving UI benefits for more than four months had total income from non-UI sources that put them below the poverty line. As a result of unemployment insurance, only 19 percent of families with long-term unemployment remained below the poverty line. Among those remaining in poverty, their UI income pulled them up much closer to the poverty line.

The unemployment insurance system can also provide an effective fiscal stabilizer during economic downturns. The members of the President's Council of Economic Advisers readily acknowledged this fact at the JEC's February 12 hearing.

Finally, although less well recognized than its humanitarian and stabilization roles, unemployment insurance plays an important role in raising the productivity of the economy. For millions of workers who work hard, pay their bills, but still live paycheck to paycheck, and suddenly find themselves jobless, unemployment benefits provide a reasonable time to survey the job market. The safety net of UI means that they need not desperately take the first available job to keep creditors at bay. They may spend a little extra time to find a job suited to their skills and interests. Better matching of workers and jobs results in a more productive economy.

In addition to improved matching, the UI system provides assurance of some income support to workers considering more productive jobs that carry greater risks of job loss. Without such assurance, our highly productive manufacturing and mining sectors would have greater difficulty in attracting productive workers. By the same token, the program is designed to impose a higher tax for employers with higher layoff rates. Effective employment service and training programs complement these two productivity-enhancing aspects of UI benefits. As your other witnesses today demonstrate, we should strengthen both these programs.

COUNTERPRODUCTIVE CAP ON UI ADMINISTRATIVE FUNDING

The 1990 budget agreement contains an unfortunate anomaly that hinders the effectiveness of the UI program. While the agreement excludes spending on UI benefits from the spending caps, spending on administration of the UI program is included in the domestic discretionary spending cap. The recession which began last fall has so increased UI claims and the burden on UI offices that administrators of the state UI programs estimate additional costs of $200 million. Many unemployed workers living paycheck to paycheck are receiving their first UI benefit check 4 to 6 weeks after application. They are supposed to receive checks within two weeks.

The shift from a deficit cap to spending caps was intended to permit cyclically sensitive programs to respond to the business cycle. Debate over deficit-cutting was to focus on structural aspects of the budget. Yet no provision was made to provide UI administration funding for cyclical increases in the workload. At least in the case of recessions, that defect in the current budget mechanism should be corrected.

As you may know, at our February 12 hearing with Chairman Boskin and the other two members of the Council of Economic Advisers, I along with Congressman Hamilton pressed for consideration of an additional $200 million in administrative funding as an "emergency" under the budget agreement. Subsequently, Majority Leader Mitchell, Budget Committee Chairman Sasser and I sent a letter urging President Bush to recognize the emergency nature of necessary appropriations for UI administration during this recession. I ask that a copy of this letter be included in the record.

However, this emergency funding would only affect FY91. It is also necessary to enact a solution for future fiscal years that permits more flexible spending for UI administration in recessions.

NEW TAXES

In the last decade, the federal government has moved from imposing no tax on UI income to taxing it entirely like ordinary income. For at least two decades, UI benefits have increased roughly in line with inflation; they have not been raised to offset the increase in taxes. The marginal federal income tax rate for most UI recipients is 15 percent. Most states impose income taxes that follow the federal example for taxable income. Thus, for most UI beneficiaries receiving the average $2,000 total payment, the imposition of taxes has reduced net income by $300 to $400. This new taxation without a compensating benefit increase has reduced both the humanitarian and countercyclical effects of the program.

OUTMODED TRIGGER FOR RECESSION BENEFITS

For workers threatened with job loss, the UI system provides "insurance" in the form of income support for a reasonable period to find a new job. In normal times, virtually all states set a maximum income-support period of 26 weeks. However, during a recession (regional or national), the chances of finding a job within 26 weeks are greatly reduced. To provide equivalent "insurance," the reasonable period of time to find a job should be extended. Since 1970, U.S. law has recognized this and provided for "Extended Benefits" (EB) up to an additional 13 weeks during particularly adverse conditions. In addition, during the particularly deep recessions of 1975 and 1982, temporary provisions extended UI benefits even longer.

The formulas used to initiate EB payments have become increasingly outdated due to changes in the UI system and in the labor market. In testimony before the JEC on January 4, Gary Burtless likened the current EB trigger to a malfunctioning thermostat on an air conditioner:

> The broken thermostat will certainly save you a lot of money over the course of a hot summer, but it will not keep the house very comfortable. The [current EB trigger] is like the broken thermostat; it takes a lot of unemployment before this particular thermostat registers recession.

Another witness, Wayne Vroman, estimated that unemployment must reach 15 percent for the EB trigger to be reached in some states.

Since enactment of the EB program in 1970, the level of total unemployment required to trigger Extended Benefits has effectively been raised by forty percent. Half of that increase came as a result of the Gramm-Latta budget provisions of 1981. State responses to the budget pressures of the deep 1982 recession largely account for the other half.

Until the late 1970s, the number of UI recipients closely tracked the number of "job losers," i.e. unemployed who had involuntarily lost their last job. The deep recession of the early 1980's left many states with UI trust funds in substantial debt to the federal government. To repay these debts, many states not only raised UI taxes but also tightened eligibility requirements. In recent years, the number of UI recipients has fallen to four fifths of the number of "job losers." Since EB is triggered by a state's insured unemployment rate ("IUR": the number of UI recipients relative to the number of employed and covered by UI), this has the effect of raising the EB trigger by one fourth. However, the effects are very uneven. While some states would require total unemployment rates as high as fifteen percent to trigger EB, a few states with much lower unemployment rates will be triggering EB in coming months.

To maintain an appropriate level of "insurance," the trigger for longer term UI benefits in a recession should be recalibrated. Given the wide divergence among states in eligibility requirements, and therefore their IUR rates, the recalibrated trigger should not hinge on the IUR. Another measure, such as the total unemployment rate, would better reflect the chances of finding a job within 26 weeks and not the stringency of a state's eligibility criteria.

CONCLUSION

Changes in the UI system over the last decade have left the system unprepared to respond well to this recession. The budget rules have caused a shortfall in administrative funds which have forced delays in processing claims. Over the last dozen years, all UI benefits have become subject to income taxes without any increase in benefits. Changes in UI law and administration over the last decade have put longer term benefits out of reach for most states in recessions short of near-depressions. Each of these shifts has undermined the humanitarian, countercyclical, and productivity purposes of the system.

This Subcommittee has jurisdiction to initiate the legislative effort to revise the UI system to make it more responsive. There is surely ample precedent for you to take action. Since the recession of 1958, Congress has enacted legislation to extend the duration of UI benefits during every recession that was as long as the administration forecasts this one to be. With a million additional jobless workers in the last eight months and another million anticipated by the end of the year, I urge you to strengthen the safety net particularly in case the recession proves worse than projected, and to assure that we build better insurance for the future.

United States Senate

February 25, 1991

The President
The White House
1600 Pennsylvania Avenue
Washington, D.C. 20500

Dear Mr. President,

We write you today to request that you join with us in recognizing the amount of the shortfall in funding for the administrative expenses of the Unemployment Insurance Trust Fund and the emergency nature of the need for UI administrative expense funding. Moreover, we urge you to make such an emergency designation under section 251(b)(2)(D)(i) of the Balanced Budget and Emergency Deficit Control Act of 1985.

In your budget submission to Congress on February 4, you requested a supplemental appropriation of $100 million for Unemployment Insurance administrative expenses. Your original budget request for UI administrative funds for FY 1991 was based on a projected unemployment rate of 5.3 percent. After the midsession review in September of 1990 that projected an unemployment rate of 5.6 percent, you asked for and received $90.7 million in additional funds for FY 1991. By the beginning of the fiscal year, unemployment estimates had increased to 6.1 percent resulting in a shortfall of approximately $84 million in administrative cost funding. Consequently, the Department of Labor implemented a policy of financing about 75 percent of the administrative costs to stretch out the amount of money allocated in the 1991 Appropriations bill.

Since June more than one million Americans have lost their jobs, and the unemployment rate has increased to 6.2 percent. The Office of Management and Budget's review assumes that nearly another one million Americans will lose their jobs as the year progresses. The Department of Labor now estimates the UI administrative fund shortage is in the range of $200 million. A $100 million supplemental would be only sufficient to continue reimbursing states at 75 percent of their costs for administrative activities. Reimbursing states at only 75 percent of their costs is a violation of the Federal-state agreement that the Federal Government pay all state administrative expenses.

Before last year's supplemental appropriation passed most states had already scaled back their services to prepare for the possibility that a supplemental would not pass. As soon as the supplemental did pass, states used that money to deal with the backlog resulting from their previous slow-down in services. Additionally, the Interstate Conference of Employment Security Agencies, the National Conference of State Legislatures, and the

National Governors' Association estimate that states used as much as $140 million of their own money last year to make up for the shortfall in Federal funding for administrative expenses.

We would like to request that you increase your supplemental appropriation request for UI administrative funds to $200 million to fulfill the Federal Government's commitment to states. Furthermore, we request that you designate your request as an "emergency requirement" under the provisions of the recently passed Budget Enforcement Act to prevent the amount from being counted against the discretionary caps established for the Appropriations Committee in last year's budget summit.

Plainly, an emergency exists. Both the Congressional Budget Office and your own Office of Management and Budget have certified that the Nation is in a recession. Unemployment has risen from 5.6 percent in September of last year to the current 6.2 percent. Waits of 4 to 6 weeks for benefit checks are not uncommon in virtually all regions of the United States. In Indiana 17 local offices were closed and 100 staff were laid off as a result of last year's administrative fund shortfall while the number of claims increased from 29,670 per week in October to 57,330 in December of last year. In many states, increased workload and decreased staff result in waiting lines of up to 6 hours. On several occasions in the District of Columbia, staff have been forced to turn people away, asking them to return another day. In one local office in Maine, the backlog caused such delays that the fire marshall forced some of those waiting to leave. In New York last year, an estimated $4.5 million in tax revenues was lost due to redeployment of tax staff to handle the backlog in UI claims activities. The list goes on and on.

Section 251(b)(2)(D)(i) of the Balanced Budget and Emergency Deficit Control Act of 1985 (Gramm-Rudman-Hollings) as amended by section 13101 of the Budget Enforcement Act of 1990 sets forth a procedure to address emergency funding requirements such as this. That section provides that if the President and the Congress each designate appropriations as emergency requirements, then the discretionary spending limits shall be adjusted to allow for legislation to respond to the emergency. We stand ready to move legislation that would so designate the administrative expenses of the Unemployment Insurance Trust Fund as emergency requirements. We invite you to write the Congress to join us in making this designation.

On January 31, 1991, the Senate voted 97 to 2 to continue to cooperate with the administration in maintaining the fiscal discipline of the Budget Enforcement Act of 1990. The Senate chose at that time not to suspend the constraints that Gramm-Rudman-Hollings imposes on the Nation's budget process. The Senate did so with the hope and belief that the Congress could work with the President to make that system work. A number of times during the debate on that vote, Senators cited the ability to fund emergency requirements that the law provides. Continued support for the budget process on which both the

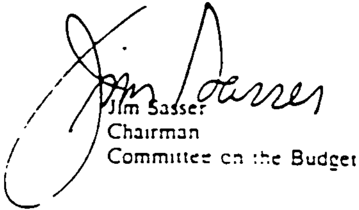
administration and the congressional leadership worked so hard rests on flexibility in its application. We have no desire to see a permissive, wide-spread use of the emergency exceptions to the strictures of the new budget law. But the branch that cannot bend will break.

Designating funding for the administrative expenses of the Unemployment Insurance Trust Fund as an exception to the spending caps of the new law is consistent with the intent of that law. The Budget Enforcement Act of 1990 reformulated the Gramm-Rudman-Hollings law to prohibit expansion of the structural deficit. The new law recognized that the economic cycle will expand and contract the deficit, and the new law unlinked the requirement for deficit reduction from the changes in the deficit caused by the economic cycle. The same logic applies to the administrative expenses of the Unemployment Insurance Trust Fund. They rise and fall with the economic cycle, and the spirit of the new law calls for the Government to fund them fully without cutting other needed Government services as an offset.

The new law focuses on controlling actions that the Congress and the President take to worsen the deficit. The new law generally holds Congress and the President harmless for the effects on the deficit of events outside their control. As much as leaders would like to be able to engineer the economy, factors beyond the control of the Government determine the amount of money needed to fund the administrative expenses of the Unemployment Insurance Trust Fund.

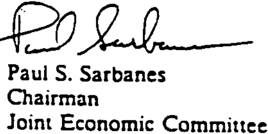
Americans overwhelmingly agree that support for our armed forces in the Persian Gulf rises to the level of an emergency requirement. By the same token, however, the recession dominating the home front has created an emergency right here in our own country. Please join with us, Mr. President, in combatting this emergency.

Most respectfully,



Jim Sasser
Chairman
Committee on the Budget

George J. Mitchell
Majority Leader
United States Senate



Paul S. Sarbanes
Chairman
Joint Economic Committee

Senator SARBANES. I yield to Congresswoman Snowe and then Senator Smith, if they have any opening statements they wish to make.

OPENING STATEMENT OF REPRESENTATIVE SNOWE

Representative SNOWE. Thank you, Mr. Chairman. And I'm pleased that the committee is holding hearings on this issue because I do think it's something that needs to be expeditiously addressed by the Congress.

During the break in February, I had the opportunity to visit some of my State's unemployment offices and to talk with individuals responsible for processing the claims. And there was no question that more needs to be done in providing funding for the processing of these claims. People should not have to wait in line for a very long time, which has been the case; and also to wait 4 or 5 weeks to receive their first unemployment check.

In fact, I have introduced legislation yesterday to provide the $200 million. The difference is I also provided an offset. I do think that we should offset the $200 million by reducing Federal funding in other programs rather than increasing the deficit.

So I chose to take a reduction in the legislative branch appropriations and also from unauthorized projects at the Department of Energy and Water and various other programs that aren't necessary at this time.

I think we have to make choices. And there's no question that we ought to be providing $200 million for administration of the unemployment insurance.

But, second, I do think that we can make some choices in the existing Federal budget according to the Budget Enforcement Act that we passed last October.

And, therefore, I did provide an offset in my legislation so that we do not increase the deficit.

So I'm pleased to be able to be here today and also to hear the witnesses' testimony on this important issue.

Senator SARBANES. Thank you very much, Congresswoman Snowe.

Senator Smith, do you have an opening statement?

OPENING STATEMENT OF SENATOR SMITH

Senator SMITH. Thank you, Mr. Chairman. Yes. I appreciate the opportunity to be here and think that this is a very timely and necessary hearing, and commend you for calling it.

I certainly would like to associate myself with the remarks of Congresswoman Snowe as well.

Many State unemployment insurance programs, including those in New Hampshire, need additional administrative funds. There's no question. In New Hampshire, the unemployment rate has risen 2.2 percent over just the past year. It currently stands at almost 6.3 percent, and more than 40,000 residents are out of work.

In all probability, a supplemental appropriation will be passed in the near future to address this. I think all of us here recognize the need for those funds and are anxious to see the claims processed, and to better serve those constituents. A separate and very impor-

tant issue, however, is how these funds should be financed. And I think it's on that point where there is some disagreement.

Under the budget agreement passed last year, the additional administrative outlays needed for the unemployment insurance program would have to be financed by offsetting reductions in other discretionary programs. Many Members of Congress feel the President should declare the situation an emergency and waive the budget rules. I oppose this course of action for two very important reasons.

First, every Member of the Senate already had the opportunity to waive the budget rules adopted last year and, by a vote of 97 to 2, we agreed not to do that. When two consecutive quarters of negative economic growth were forecasted by the Congressional Budget Office and the Office of Management and Budget on January 23, we knew then that unemployment would be high. We knew that the unemployment insurance program would need the additional funding. In short, we knew then what we know now, and we acted in a fiscally responsible manner, and I think we should do it again.

Second, the notion that we cannot find $100 or $200 million in additional funding, as Congresswoman Snowe just said, without breaching the discretionary spending caps, I believe, is false. Last year's appropriation bills included hundreds of millions of dollars in wasteful government spending. I won't list them all, but there was $6 million in there to upgrade the Senate subway. And there was $500,000 for the Lawrence Welk home.

The spending caps are not the problem. The lack of reasonable priorities is the problem.

I am also currently drafting legislation to rescind some of those unauthorized pork barrel appropriations. If this were done, Congress could achieve significant savings and still have money left to fund the unemployment compensation program.

And I would hope that my colleagues would be able to join me in this effort to trim the unnecessary and wasteful Federal spending and target our resources to more worthy areas, such as the unemployment insurance program, and perhaps even reducing the Federal deficit.

Thank you, Mr. Chairman.

Senator SARBANES. Thank you very much.

If the first panel would come forward and take their places, Ms. Cordone, Mr. Ortis, Mr. Flynn, and Mr. Cichowicz.

While they are taking their seats, to continue the debate, first, I would point out to my colleagues that I think there is an important principle involved in this funding. The claims under the budget agreement were put outside of the spending caps because the spending caps were not to apply to economic conditions that were external to the budget process—in other words, a worsening of the economy and a downturn. The administrative costs to handle those claims were not. It seems logical to me that they should be. And I simply point out that, if the recession worsens and the downturn continues, the demands to meet the claims will grow. The claims will grow, and the administrative costs associated with the claims will grow.

The second point is that employers have been paying money into the trust fund for this very purpose. The part of the trust fund devoted to administrative cost has now built up quite a large balance, well above its stated minimum, and, yet, it is not being used for that purpose. This is obviously an issue on which we will have to join in debate in the Congress in order to try to resolve it.

Ms. Cordone, I gather you are going to introduce the panel, and then we will be prepared to hear from them. Why don't you take over at this point.

STATEMENT OF MARIA CORDONE, LEGISLATIVE REPRESENTATIVE, INTERNATIONAL ASSOCIATION OF MACHINISTS AND AEROSPACE WORKERS

Ms. CORDONE. Thank you.

Mr. Chairman, members of the committee, my name is Maria Cordone. I'm legislative representative for the International Association of Machinists and Aerospace Workers, who are 850,000 members strong.

The IAMAW appreciates the opportunity to appear before the Joint Economic Committee and tell our experiences with the inadequacies and the injustices of the unemployment compensation system.

I have with me today Mr. Frank Ortis, president of the Florida State Council of Machinists; Mr. Mike Flynn, president of our local lodge 1690 in Atlanta, GA; and Mr. Joseph Cichowicz, recording secretary for local lodge 1526 of the International Paper Workers of the Georgia-Pacific plant in Reading, PA.

These American workers are currently experiencing the hardship of what we believe to be discrimination by the unemployment compensation system against the trade union members in the wake of the recent Eastern Airlines disaster, as well as the International Paper Workers situation.

Now I would ask Messrs. Ortis, Flynn, and Cichowicz to tell their own stories for the benefit of the committee. Thank you, Mr. Chairman.

STATEMENT OF FRANK ORTIS, PRESIDENT, FLORIDA STATE COUNCIL OF MACHINISTS, MIAMI SPRINGS, FL

Mr. ORTIS. Mr. Chairman, good morning. Thank you, Senator, Congresswoman.

My name is Frank Ortis and I'm the President of Florida State Council of Machinists in Florida. I just want to say to you I appreciate the opportunity to speak before the Committee.

The unemployment compensation insurance system in Florida is an emergency and should be dealt with as an emergency. Any workers who, of their own volition, are out of work and need funding to sustain themselves and their families until they find a decent job need unemployment compensation and need unemployment compensation rapidly.

In the State of Florida, our unemployment compensation laws are very ambiguous. I'll give you some examples:

In 1989—March 3, 1989—Eastern Airlines locked us out of our jobs. We were escorted from the property. In the State of Florida,

you're not eligible for unemployment compensation if you're locked out.

Also, if you're on strike in the State of Florida, you're not eligible for unemployment compensation.

When people went out and were locked out of work, they went out to get temporary employment. Employers said, "You'll probably go back to work at Eastern, so we're not going to hire you." That was the first strike.

The second was that when you're locked out, you're not eligible for unemployment compensation.

And a third is the strike.

So we went out and tried—our members tried—to get work temporarily. Then, Eastern Airlines, as you're well aware of by now, went bankrupt. Then they had the worker replacement, the permanent replacement that said we were permanently replaced. Even those who were there at that time still could not collect unemployment compensation.

When Eastern shut down on January 18, the unemployment compensation division said:

> That will end the labor dispute because of that massive shutdown. Your people will now be eligible for unemployment compensation.

Except it wasn't true. When our people went to collect unemployment compensation—apply—they were told:

> You did not work the prerequisite number of weeks required from October 1, 1989, to September 1990. You must have worked 20 weeks in that period.

Obviously, we couldn't have worked in that period. Now, you're not eligible for the prerequisite number of weeks worked to collect unemployment compensation, another strike against us.

So, here it is after the shutdown, our people have been unemployed in some cases for 23 months, myself included, have not been able to get unemployment compensation for those reasons.

We think that's wrong. We think that the unemployment division in Florida—which has a trust fund, by the way, of $2 billion in Florida—needs to be addressed on an emergency basis. Our laws need to be cleared up and we need to be eligible for unemployment compensation.

I believe, and I didn't research this, but I believe our unemployment rate right now in Florida is well over 6 percent. Around the Miami area, Eastern was the largest private employer, in Dade County.

When the airlines, in the relaxation of the FAA rules, were allowed to ship maintenance overseas, the contractors at the Miami base lost most of that business. People formerly could get employment in those particular independent contractors along the Miami field.

You cannot do that now because those independent contractors don't have those contracts; some are being maintained, some of the aircraft, in Communist countries today. That's wrong, Senator, and we need to get unemployment compensation.

People are willing to work. And that's all we're asking, is an opportunity for a job. It was a total disaster at Eastern Airlines. I'm a 25-year employee of Eastern. It was our company. We built it,

made it strong. And it's a desert now. It's terrible to see what's happened at that company.

But, the unemployment compensation issue, in my opinion, needs to be addressed as an emergency.

Senator SARBANES. Thank you very much.

Mr. Flynn, please proceed.

STATEMENT OF MIKE FLYNN, PRESIDENT OF LOCAL LODGE 1690, INTERNATIONAL ASSOCIATION OF MACHINISTS AND AEROSPACE WORKERS, FOREST PARK, GA

Mr. FLYNN. Thank you, Senator and Senator Smith and Congresswoman Snowe. Thank you for the opportunity you gave us today to come before your panel to speak on this issue.

In Georgia, similar to Florida, our strikers were also ineligible for unemployment compensation. I first became familiar with the unemployment system in Georgia 2 years prior to the strike.

One of the tools that the company used against our members was to terminate them. We had over 150 terminations in our local alone. Most of the members that were terminated were for unjust cause, though their cases never reached arbitration. It took over 2 years for cases of that type to be arbitrated. Every time, as soon as they were terminated, first, it would take 1 month before they would hear back from the unemployment board. And they were notified that the company had disagreed with their claim.

So they went into a process that took normally between 2 and 3 months before they could even expect their first check. They had to go to three different hearings to appeal before the board because Eastern, each and every time, would claim that they were fired for just cause.

Over 95 percent of those members eventually qualified for unemployment.

Most of our members at the time of the strike had over 15 years seniority at Eastern Airlines, and they never drew one dime of their unemployment. When we went on strike, and I met with the Department of Labor prior to us going on strike, it was obvious the law would not allow us those benefits.

Now, since the shutdown on January 18 of Eastern, there have been over 10,000 employees of Eastern and employees of other companies that provided services to Eastern—like the catering and the different vendors, to the tune of 10,000 people—that found themselves unemployed in the last week of January because of the shutdown.

That number coming into the system all at one time just overwhelmed the system. Our secretaries at the local, we were forced to lay off because of this situation also. I just received a claim back from the unemployment office 2 days ago asking if they were terminated for just cause. So that's been 6 weeks since I had that first step as an employer for their claims. So they've been themselves 6 weeks waiting for that.

So I know at least the backlog is 6 weeks.

The impact in the Atlanta area is close to $1 billion because of the Eastern shutdown. The jobs available to our members right

now are limited to fast food jobs, store jobs—very, very limited job opportunities out there for them.

The State has applied for title III funds through the Department of Labor, trying to find the funding for retraining our people and the other employees of Eastern Airlines that lost their jobs.

One of the main problems that I have seen when people lose their jobs is the continuation of their medical insurance. It's $185 a week that Georgia pays for their unemployment benefits. Most group policies today cost over $600 for a family to continue their medical insurance.

If any family member has a preexisting condition where they need continual medical help, they are forced to pay over 80 percent of their unemployment benefits just to continue their insurance coverage, or they'll be wiped out totally with their house or any other type of assets they may have.

One other problem that we found, and I think it's a very sad state that our country has found itself in, with our members that were on strike, many were reservists and they were activated as a result of Desert Storm.

Today, they're over there still in the Persian Gulf. When they come back here, they'll be deactivated and they won't have a job, and they won't have the benefits, the unemployment benefits, to help them while they're out searching for a job.

I think, out of everything that has happened revolving around the Eastern strike, that is one thing that itself, in my mind, tells a large story of what the problem in this country is by allowing a strike of the magnitude of Eastern to have happened, because of one reason, and that was the ability of Eastern to be able to permanently replace our members, 50 percent of whom are veterans, many of whom were reservists, and some of whom put their lives on the line just recently in the Persian Gulf.

And I feel that, if the permanent replacement of these people wasn't allowed, this whole thing could have been avoided. Many jobs would have been saved. And the knowledge that I have of the inadequacy of the unemployment laws I probably would have never known about.

But, I thank you for the opportunity to speak before the committee.

Senator SARBANES. Thank you very much, sir.

Mr. Cichowicz, please proceed.

STATEMENT OF JOSEPH CICHOWICZ, FORMER EMPLOYEE, GEORGIA-PACIFIC CORP., READING, PA

Mr. CICHOWICZ. Chairman Sarbanes and Congresswoman Snowe and Senator Smith, I want to thank you for this opportunity to speak here.

Like it was stated, I worked at the Georgia-Pacific plant in Reading, which had about 110 employees, and it shut down around June 28, 1990. And my problem is a lot more simple. My unemployment ran out the beginning of January, the second week of January. Since then, I've had to live off my savings and it's been hard to get a job there. The recession has certainly hit that area. I've applied

at least eight different places and I haven't come up with anything. And my unemployment has been cut off at this point.

So, that's about it.

Senator SARBANES. Well, thank you all very much.

I am going to yield to Senator Smith for any questions. We are going to have a vote shortly.

Senator SMITH. They just indicated, apparently, the vote is not going on.

Senator SARBANES. All right. So why don't you go ahead with any questions you might have of this panel before we move on to the other panels. Hopefully, we will be able to conclude this panel before the vote.

Senator SMITH. In the interest of time, Mr. Chairman, I will dispense with questions. I just would make a comment in regard to what Mr. Flynn said.

Yesterday, on the Senate side, in the Armed Services Committee, we did take action to deal with Reservists, Guards people who are coming back who would not have a job waiting for them for whatever reason, to address that unemployment compensation issue for 60 days.

So that has to go through the process, but at least it has begun. I just wanted to point out that out to you.

Thank you, Mr. Chairman.

Senator SARBANES. Congresswoman Snowe.

Representative SNOWE. Thank you, Mr. Chairman.

I want to thank all the panelists for testifying here today. I think there's no question there's broad agreement on the issue of providing additional administrative funding for the distribution of unemployment insurance in this country.

I think the question is whether or not we can arrange our priorities within the $1.4 trillion budget. And I think that's the issue.

Would you disagree with the idea of offsetting the $200 million with reductions in other parts of the budget?

No? You wouldn't?

I mean, I think, you know, that is certainly the issue, is whether or not to declare an emergency or not.

My contention is, and I know Senator Smith's is, to say:

Well, let's see where we can find some reductions in the existing budget to offset the $200 million.

And I just don't think that's an arduous task given what we went through last October. And I know some of the projects that were included in that budget that should never have been in there to begin with because they were never authorized. And, certainly, this would be the time to clean house in that budget and to offset the $200 million by some reductions in various accounts.

I think that's the contention here. I think everybody agrees we need to provide more. And I know, in the final analysis, that will be the case. If we could just enforce some discipline in this institution about reducing Federal spending. I mean, that's what it's all about.

I don't just see how difficult it would be to come out with a $1.4 trillion budget to take out $200 million elsewhere on projects that shouldn't have been funded to begin with.

So, I guess that's the issue.

Yes, Mr. Ortis.

Mr. ORTIS. Congresswoman, just a quick response if I may.

I would agree with that except I would again reiterate that the emergency is the need; rather than going through the process, people need the unemployment insurance. And the administrative moneys, at least in my opinion, need to be dealt with on an emergency basis.

Representative SNOWE. You know, I agree with you. And I would just as soon declare it as an emergency and say, but, let's, in addition to that, find the offsetting—involve ourselves in the offsetting efforts.

The fact is we could do that if we wanted to in this institution, but we choose not to because we don't want to make the tough choices.

And, yet, three-fourths of the States in this country have to balance their budgets; 30 of them have shortfalls, and are having to make some tough choices, not only in the existing fiscal year, they're having to go back and reopen their budgets, but also having to deal with next year and the year thereafter.

And I think we ought to begin that process, and I think this would be a good step in the right direction.

We shouldn't have to hold it up. I, frankly, think that's a bogus argument about whether to be emergency or not emergency. We all agree it's an emergency, but can we at the same time offset that $200 million by some reductions elsewhere.

And so that's my issue. We could do it all. We shouldn't have to hold up this process by looking elsewhere for cuts if we wanted to do that, but no one wants to make those choices at all in a $1.4 trillion budget.

And we're just not facing reality here in Washington. We ought to go back home and face reality about what's happening.

Certainly, Senator Smith can agree to that because of New England. We're facing a very serious recession, and downturn in our economy. And we're all having to make some very tough choices at the local level and at the State level.

And I think we ought to begin that process now.

I just wanted to ask you, Mr. Cichowicz, could you tell me did you get extended benefits at all?

Were they triggered in your State?

Mr. CICHOWICZ. No, I only had 26 weeks.

Representative SNOWE. I see. So, the unemployment rate hasn't risen enough at this point to trigger extended benefits?

Mr. CICHOWICZ. I don't know everything about those laws, how they work, but I guess not.

Senator SARBANES. Mr. Flynn, you were an employer in the example you gave to us, right? With your secretaries?

Mr. FLYNN. At the local lodge level, yes.

Senator SARBANES. You paid money into the employment insurance trust fund, did you not, as an employer, on behalf of those employees?

Mr. FLYNN. Yes, Senator.

Senator SARBANES. When you paid that money in, didn't you expect it would be used for the purposes of the unemployment insurance system if it became necessary?

Mr. FLYNN. Oh, without a doubt. You know, I've never——

Senator SARBANES. Why should the surplus in that fund be used to offset the budget deficit somewhere else? That is not the purpose for which you paid those unemployment insurance taxes, was it?

Mr. FLYNN. No, Senator.

Senator SARBANES. Don't you think your money, in a sense, is not being used for the purpose for which it was levied? You are actually here primarily to testify about the workers, but, you are also in this instance in an employer situation. We are hearing from a lot of employers who are saying they paid unemployment insurance taxes to support this unemployment insurance program that had been developed, that the fund has built up a large amount of money, and it is not being used to process these administrative costs.

As I understand it, it has been 6 weeks already, is that right? When the inquiry came as to whether your secretaries had been let go for just cause; is that right?

Mr. FLYNN. That's correct. And they could probably expect to wait another month before they could draw their first check now.

Senator SARBANES. So it is going to be probably about 10 weeks between the time they got laid off and stopped getting a paycheck before they get an unemployment check; is that correct?

Mr. FLYNN. That's correct.

Senator SARBANES. Do you think working people can go 10 weeks without any income coming in, at least, most working people, without having a family budget crisis of some sort?

Mr. FLYNN. No. I think for many people, the reality is they live week by week. And they're going to be spending probably 4 weeks trying to get their creditors and their mortgage company off their backs, and their phone company and the electric company, waiting for some type of relief.

Senator SARBANES. Well, I'm going to have to go vote.

We thank this panel very much for appearing today. We're most appreciative to you for your testimony.

Mr. FLYNN. Thank you, Senator.

Mr. ORTIS. Thank you.

Senator SARBANES. I think we will have the staff line up the second panel. We will take just a very brief recess and then resume the hearing.

[A brief recess was taken.]

Senator SARBANES. If the witnesses could take their chairs, we are now prepared to hear from a panel of State administrators and managers of local offices. Thomas Hartnett, the commissioner of the New York State Department of Labor; Robert Wagner, the local office manager of the Indiana Department of Employment and Training Services in Bloomington; and Ms. Jeanette Sancricca, the local office manager of the Michigan Employment Security Commission in Sterling Heights, MI. The situation in the Sterling Heights office actually has received some press attention, I think.

We will include your prepared statements in the record and, if you can summarize them. We will get a sort of a State picture, and then we will go to the two local people. We will hear Mr. Hartnett, Ms. Sancricca, and then Mr. Wagner.

Please proceed, Mr. Hartnett.

STATEMENT OF HON. THOMAS F. HARTNETT, COMMISSIONER, NEW YORK STATE DEPARTMENT OF LABOR

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

Good morning, Congresswoman. It's a pleasure to be here, and I appreciate this opportunity to address you on a topic that is crucial to every State in the Nation and the hundreds of thousands of unemployed Americans.

And I speak of course of the availability of unemployment insurance funds during times of economic crisis.

When I accepted Governor Cuomo's appointment as New York State Labor Commissioner in 1987, I came to the job with what I considered to be a fairly unique qualification.

To the best of my knowledge, I was the first labor commissioner in New York State history who had ever spent any period of time on an unemployment line. During 1970 and 1971, I spent more months than I care to remember at the Jerome Avenue office in the Bronx receiving unemployment insurance.

I think I learned a little bit first hand about the intense frustration shared by the men and women who stand on these lines. Frustrations compounded by the knowledge that unemployment benefits are a legal right for those who have become unemployed through no fault of their own.

Yet, to receive these benefits, we must often climb through mountains of redtape and face an almost hostile bureaucracy that sometimes seems more intent on putting up new roadblocks than on taking down old barriers.

Today, in New York State, we have already converted about 40 percent of our offices, our unemployment offices and job service offices, into what we call community service centers. These are conveniently located, one-stop shopping centers for employment-related services. Whether it's helping people secure unemployment insurance benefits, providing job search assistance, offering job training and counseling, or locating meaningful job opportunities for disabled vets, our community service centers are designed to offer these myriad of services to the unemployed.

Over the last 2 years in New York, we've consolidated titles on the personnel side of our operation, colocated with our employment service partners, be they public or private sector, and streamlined all of our services.

And the goal of all of this has been to provide a combination of changes in our service delivery and our physical environment that offer dignity to the people facing the crisis and hardship of being unemployed.

But, now, unfortunately, inadequate Federal funding is threatening to negate many of the changes, the very intelligent management changes that we've made and the breakthroughs that we've accomplished, and to steal away some of the dignity that we have fought so hard to ensure.

During this time of recession, this time of growing unemployment, we, the various State departments of labor, are forced to cut back on our efforts to provide these effective and dignified services to the people in need. In short, we are being critically underfunded.

In New York during 1990, for example, we saw a 27-percent increase in our unemployment insurance claims load.

That 27-percent represents a 1989 figure of approximately 762,000 people that we saw in our offices. In 1990, we saw approximately 965,000 people in our offices dealing with unemployment insurance. Those are the numbers associated with the 27-percent increase.

And, based on our most recent unemployment figures, we know that our claim load will rise significantly in 1991. Yet, we have been unable to hire sufficient staff to meet this crisis.

And all of this has occurred because the administration's request for unemployment insurance administrative funds is based on estimates made 9 months before the beginning of the fiscal year, and 21 months before its end. Official estimates of unemployment for fiscal year 1991 have increased three times: from 5.3 percent in January 1990 to 5.6 to 6.1 percent.

And, Mr. Chairman, as I sit here today on March 6, we are not even through the first quarter of 1991, and the unemployment rate in New York State stands at 7.1 percent. And there are no indications that that rate will drop any time soon.

As a result of these underestimates, hundreds of thousands of people throughout the country are being left to suffer the consequences.

In New York, we're seeing lines that literally go out the door and around the block, people being forced to wait hours and hours for assistance; benefit payments being delayed.

I could describe to you the frustration and despair on the faces of so many of those claimants, but I cannot adequately describe the full impact of the human toll that's taken in these situations.

At the same time, we've been forced to cut back on a lot of our control procedures, procedures designed to correct mistakes and abuse in the system.

Mr. Chairman, we've struggled for 3 years to eliminate some of the topheavy bureaucracy that can often strangle service agencies. As I've indicated, we have streamlined and consolidated personnel and we have used our personnel more effectively.

And, yet, now we are forced to accept cutbacks that do nothing more but reintroduce bureaucratic nightmares for the people who have come to us looking for help.

And, New York is not alone. You will hear in a few moments from several of my colleagues—Jeanette Sancricca, who will talk more about Michigan; and Bob Wagner from Indiana.

Some States, indeed, are looking at, even raising the employer taxes, to offset the crisis that they're seeing. But the worst of it, Mr. Chairman, the part of it that is hardest to accept, is that the money to operate a professional, efficient, and compassionate unemployment insurance program is available but not accessible.

And that is the most difficult thing to explain to the employers, as you so correctly pointed out, who pay into the system, who may well have a continuing relationship with those employees after the economic downturn turns around, who expect their former employees to be treated with dignity and, in many cases, are not; to organized labor, who is very often the recipient of the complaints from their members, who come to them and talk about the treatment

that they have received and the delays that they have encountered. And, last, but certainly not least, indeed, most importantly, the men and women who are awaiting the benefits.

The U.S. Department of Labor estimates that, in this fiscal year, $4.3 billion will be raised through the employer tax, which is the dedicated fund to administer the unemployment insurance program. And, yet, only $1.9 billion is available to administer the program nationally.

This is more than an inconvenience, this is simply an outrage. The fact is it is legal. The Department of Labor's unemployment insurance shortfall means that the Federal Government is now paying about 75 cents on the dollar toward the increased costs associated with the program.

Our goal today is to find ways to meet the challenge that faces the unemployment insurance system today, tomorrow, and well into the future. And I applaud the Joint Economic Committee's convening this meeting and this opportunity to testify before the committee as to solutions. I would like to discuss three possible solutions that have been put forth by my colleagues at ICESA and embraced by unemployment service providers throughout the country.

The first, and you've mentioned it already, that has the backing of the AFL–CIO and the National Governors' Association and many others, calls for an emergency supplemental appropriation of $200 million to deal with today's problems, today's immediate problems. This appropriation must be designated as an emergency in order to avoid the sequestration with other domestic discretionary programs.

Second, the administrative costs of the unemployment insurance program should be removed from a discretionary fund and put in a mandatory fund; in short, to have a fund that is available on the basis of workload requirements. By switching unemployment insurance administration to the mandatory category, these changes in costs due to economic upheavals could be accommodated.

And, finally, the supplemental appropriation bill, as well as future appropriation legislation for unemployment insurance, should include language which would provide additional funds to process claims for unemployment which are not anticipated, a contingency fund, if you will, to meet fluctuations that are not anticipated when the original formula is put in place.

Those three initiatives I think would deal with the immediate and long-term problems associated with funding the administration of this system.

Mr. Chairman, let me close with this thought.

It's interesting to note the very real concern that all of us have expressed and shown over the last several years regarding the work force of the future and the problems associated with that work force. We've seen reports, such as the Work Force 2000 study, which carefully detail how that work force is changing, the types of skills that will be necessary to fill the jobs of the future, and how the United States must improve so many of its skill programs to be able to compete in the international marketplace.

But, when we discuss the work force of the future, who are we talking about?

Well, we're talking about young people who are presently in high school and college. There's no doubt about that. We're certainly talking about women who are returning to the work force in record numbers.

We're talking about people with disabilities, older men and women, trying to make ends meet on pensions and fixed income, and veterans who proudly served their country from World War II to Operation Desert Storm—we are, of course, talking about them.

And all of these people are the ones we traditionally think of when we talk about the work force of the future. But, as we meet here today, a significant percentage of the work force of the future is standing in our unemployment lines around this country.

I can't speak for every State but, in New York, the average age of our unemployment insurance claimant is 37 years old—37.

That means that the average man or woman who is unemployed today has a good 20 to 25 years left in the job market. So, while we're out there gearing up to meet the challenges of the work force of the future, we had best not forget the needs of the unemployed today.

The dignity and compassion that we show them in 1991 will have a lasting impact on the productivity and capabilities of those individuals as we approach the year 2000.

Mr. Chairman, again, I thank you for the opportunity to testify here today. I hope that I've helped in some small way the committee with its deliberations, and I'll be happy to answer any questions at the conclusion of the testimony of my colleagues.

Thank you.

Senator SARBANES. Thank you very much, Commissioner, for your very helpful statement.

[The prepared statement of Mr. Hartnett follows:]

PREPARED STATEMENT OF HON. THOMAS F. HARTNETT

Good morning.

Thank you for this opportunity to address you on a topic that has become crucial to every state in this country and hundreds of thousands of unemployed Americans - - the availability of unemployment insurance during times of economic crisis.

When I accepted Governor Mario Cuomo's appointment as New York State Labor Commissioner in 1987, I came to the job with a fairly unique qualification. To the best of our knowledge, I am the only labor commissioner in New York State history who has ever stood on an unemployment line.

During 1970-71, I learned first-hand about the intense frustrations shared by the men and women who stand on these lines. Frustrations compounded by the knowledge that unemployment benefits are the legal right of those who have become unemployed through no fault of their own.

And yet to receive these benefits we must often climb through mountains of red tape and face a bureaucracy that sometimes seems more intent on putting up new roadblocks than taking down old barriers.

Today, in New York State, we have already converted 40% of our old Unemployment and Job Service offices into Community Service Centers. These centers feature conveniently located one-stop-shopping for all employment-related services, whether it's helping people secure unemployment benefits, providing job search assistance, offering job training and counseling, or locating meaningful job opportunities for disabled veterans, our Community Service Centers offer a myriad of services designed to bring the provision of services to dislocated workers into the next century.

Over the last two years, we have consolidated titles to eliminate the need for claimants to stand on multiple lines to receive the varied services we offer, co-located

with our employment service partners in the public and private sectors and streamlined all of our services.

The goal of our efforts has been to provide a combination of changes in our service delivery and our physical environment that offer a little more dignity to people facing crisis and hardship.

But now, federal cutbacks are threatening to negate some of the intelligent management breakthroughs we have accomplished and steal away some of the dignity we have fought so hard to ensure.

We now face an Unemployment Insurance shortfall at the federal level that means that during this time of recession - - this time of growing unemployment - - we are forced to cut back. Our efforts to provide these effective and dignified services to people in need are being critically underfunded

During 1990, we saw a 27% increase in our unemployment insurance claims load. And, based on our most recent unemployment figures, we know our claims load will rise significantly higher in 1991. Yet we have been unable to hire sufficient staff to meet this increased workload.

And all of this occurred because the Administration's request for unemployment insurance administrative funds is based on estimates of unemployment made nine months before the beginning of the fiscal year, and twenty-one months before its end. Official estimates of unemployment for FY 1991 have increased three times since January 1990--from 5.3% to 5.6% to 6.1%.

Well, Mr. Chairman, today is March 6, we are not even through the first quarter of 1991, and the unemployment rate in New York State stands at 7.1%. And there are no indications that the rate will be dropping anytime soon.

And, as a result of these erroneous projections, hundreds of thousands of people throughout the country are being left to suffer the consequences.

In New York, we are seeing lines out the door and around the block, people being forced to wait for hours for assistance. I can describe for you the looks of frustration and despair on the faces of so many of our claimants. But, I cannot adequately describe the full impact on the human toll that these cutbacks have caused.

We have been forced to reduce the number of in-person visits from claimants as a way of limiting the unmanageable traffic in our offices. This has led to confusion and an increasing number of errors on forms filled out by those seeking benefits.

And yet, at the same time, we have been forced to cut back on our unemployment insurance control procedures, procedures to guard against mistakes, as well as fraud and abuse of the system. As a result, we have seen a larger number of undetected errors by both claimants and workers. This problem alone could potentially cost the system hundreds of thousands of dollars.

The problems we are facing in New York State are serious. Mr. Chairman, please keep in mind that we are talking about a state that has effected a number of significant changes over the past few years designed to improve the system. We've merged titles, reduced management staff, expanded the responsibilities of front-line personnel, all with an eye toward better service. And all in an effort to eliminate some of the top-heavy bureaucracy that can often strangle service agencies.

Yet, we are forced to accept cutbacks that do nothing but reintroduce bureaucratic nightmares for the people who come to us looking for help.

In some states, the hardships these cutbacks have created are reaching crisis proportions and are potentially

destructive to the entire unemployment insurance system. Let me give you some examples.

In Michigan, claimants must now wait a minimum of one month after a layoff before they receive their first benefit check, one month with no money coming in. People must wait up to six or seven hours on line in these offices to file claims.

In Indiana, 17 local offices were closed and 100 staff members were laid off in 1990. At the same time, the claims load in Indiana jumped from 29,670 claims per week in October to 57,330 claims per week in December.

Washington is looking at a staff reduction in excess of 100 people and expects to have to close offices later this year.

Some states are even raising employer taxes to offset the crisis.

But the worst of it, the part that is hardest to accept, is that the money to operate a professional, efficient and compassionate unemployment insurance program is available but not accessible. And, Mr. Chairman, this is the most difficult thing to explain to the men and women on the lines.

The United States Department of Labor estimates that in this fiscal year, $4.3 billion will be raised through the employer tax which is dedicated to fund the administration of the unemployment insurance program. And yet, Congress has only appropriated $1.98 billion. The rest of the money is sitting in an account helping to offset the federal deficit.

The money, paid by employers for the express purpose of administering the unemployment insurance program, is not accessible because it is being used to hide our national deficit. At the same time, the fact that this money is not being used further inflates an account which is $1.16 billion above its statutory ceiling.

This is more than an inconvenience. This is an outrage. But the fact is that it is legal.

That is why I applaud you, Mr. Chairman, the members of the Joint Economic Committee and the Interstate Conference of Employment Security Agencies (ICESA) for addressing this problem and proposing realistic solutions. These are solutions that are supported by a coalition of business, government and labor.

Before I describe these solutions, let me give you some brief background.

As you all recall, the latter part of the 1980s was a time of low unemployment throughout most of the country. As a result, the funds for staff and related overhead costs for the administration of the unemployment insurance program decreased proportionate to the workload decline.

But those days of low unemployment are over. Take a walk through one of our unemployment offices in New York City any day of the week and you'll see that.

And yet, while the lines extend out the door and around the block, the administrative resources required to meet the need continue to drop.

The U.S. Department of Labor's unemployment insurance shortfall means that the federal government is paying only providing 75 cents on the dollar to support all increased costs associated with the unemployment insurance program.

And the ones who suffer are the ones who need our help, the unemployed.

Our goal today is to find ways to meet the challenges facing the unemployment insurance system today, tomorrow and well into the 21st Century. I would like to discuss with you three solutions put forth by my colleagues at ICESA and embraced by intelligent employment service providers throughout the country.

The first solution must be to move the administrative costs of the unemployment insurance program from a discretionary fund to a mandatory fund. In short, to have a fund that is available on the basis on workload requirements.

Administrative costs of the program are directly related to the economy - - the level of unemployment. If unemployment insurance remains in the discretionary category, increases in the cost of unemployment insurance administration due to economic changes will either be ignored, to the detriment of unemployed workers, or funded at the expense of other domestic discretionary programs.

By switching unemployment insurance administration to the mandatory category, these changes in cost due to economic upheaval could be accommodated.

It is important to note that the Unemployment Insurance program is the only state-administered entitlement program that does not have mandatory administrative financing.

A second solution that has the backing of the AFL-CIO, the National Governors Association and many others calls for an emergency supplemental appropriation of $200 million to deal with today's problems. This appropriation must be designated an emergency in order to avoid a sequestration with other domestic discretionary programs.

And, finally, the supplemental appropriation bill, as well as all future appropriation legislation, should include language which would provide additional funds to process claims for unemployment which are not anticipated at the time an appropriation is made. This would insure that funds would be available if unemployment should rise even higher this year, without the necessity of a second supplemental.

Similar "contingency" language already exists for administrative costs of other benefit entitlement programs. Such a mechanism will improve states' ability to plan and manage unemployment insurance administrative resources. This will result in more cost effective use of funds and better service to workers and employers.

In closing, it is interesting to note the very real concern we have all shown over the potential problems of the workforce of the 21st Century.

We have seen reports, such as the Workforce 2000 study, which carefully detail how the workforce is changing, what types of skills are necessary to fill the jobs of the future, and how the U.S. must improve the skills level of our workers if we are to remain an economic leader in the international community.

But when we discuss the workforce of the future, who are we talking about?

Young people who are presently in high school and college? Certainly.

Women who are returning to the workforce in record numbers? Absolutely.

People with disabilities, older men and women trying to make ends meet on a pension, and veterans who proudly served their country from World War II to the Desert Storm? Yes.

All of these people are the ones we traditionally think of when we talk about the "Workforce of the Future."

But, as we meet here today, a significant percentage of the workforce of the future is standing on our unemployment lines today.

In New York State, the average age of an unemployment insurance claimant is 37. That means

that the average man or woman who is unemployed today has a good 20 to 25 years left in the job market.

So, while we're out there gearing up to meet the challenges of the "Workforce of the Future," we had best not forget the needs of the unemployed of today. The dignity and compassion we show them in 1991 may well have a lasting impact on the productivity and capabilities of the workforce of the year 2001.

Thank you.

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Senator SARBANES. Ms. Sancricca, please proceed.

STATEMENT OF JEANETTE SANCRICCA, LOCAL OFFICE MANAGER, MICHIGAN EMPLOYMENT SECURITY COMMISSION, STERLING HEIGHTS, MI

Ms. SANCRICCA. Mr. Chairman, Congresswoman Snowe, good morning. My name is Jeanette Sancricca, and I am the manager of the Michigan Employment Security Commission office in Sterling Heights, MI, which is a northern suburb of Detroit.

I am pleased to be here this morning and I thank you for allowing me to make my comments here at this hearing. I especially wish to thank you, Mr. Chairman, for your concern on this issue. I know that I speak for my staff and the staffs of all the offices in Michigan and around the country and the unemployed workers, and I thank you for your concern.

Last month, the New York Times published an article which focused on the impact of the reduced Federal administrative funding of the national employment security system.

It was my local office that was highlighted. And just to give you an idea of the problems that we have had: Since November of last year, initial and continued claims have increased from 18,500 to almost 32,000 in January this year.

February, although we don't have the final figures in, was as bad as January and, at this point, March looks as if it will be the same as February.

So we are continuing to see this increase in claims, with no end in sight at this point.

In Michigan, on a statewide basis, claims increased dramatically from November 1990 through February 1991. In early November, the statewide claims level was 87,000; 13 weeks later, the weekly claims amounted to over 237,000. That's an increase of 172 percent.

Because of this increase in the insured unemployment rate, it appears that we will be triggering on to extended benefits probably next week. While we welcome this additional assistance for our unemployed workers, at the same time, we dread what this additional workload, possibly 60,000 individuals filing these claims, will do to our system, which is already overburdened.

In the past, we have struggled with rises in the unemployment rate and rises in our claims. But we have always been able to manage by hiring staff and taking care of the situation as it arose.

It has been different lately. Because of the budget situation, we have not been able to hire staff. Now we have hired some temporary workers, but we are so far behind that there is no way for us to catch up at this point, and there's no end in sight of the backlogs that we see.

I can testify that this situation has resulted in concern from employers who call me and wonder how their people are going to get their unemployment checks.

Also, I receive many calls daily from claimants, who are not receiving their checks on time, who are living from week to week, who have to make late payments on even the checks that they receive. And they can't afford it on the reduced budget that they are now living on.

So it's a problem that we see every day and it's very frustrating for us.

As a manager, the shortage of human resources has resulted in very difficult choices. Each morning, I try to decide where to put those resources that I have.

Do we pay the easy claims?

Do we take care of the problem claims?

Do we answer the phones and talk to those many claimants who haven't received those checks?

It's a situation that really can't be taken care of adequately. Each of those areas needs help, but we don't have enough staff to carry on in all the areas where we need the help.

My staff is a wonderful staff. They work very hard. But, they're very frustrated. The harder they work, the more they catch the problems from the individuals who call and say they haven't worked hard enough because that individual's check has not gone out.

It's kind of an unspoken rule in my office that we don't rile each other because everybody is under such a level of stress that we just try to be real nice to each other and just keep going on a daily basis without getting in each other's way.

Someone asked me if this was very stressful, being in front of a Senate and Joint Economic Committee hearing today, and I said: "This stress is nothing compared to what I face on a daily basis. At least, you are friendly." [Laughter.]

The irony of this whole situation is that we know that the money is available. Mr. Darman has indicated that the unemployment insurance system is in great shape.

Well, I welcome him to come out to the Sterling Heights branch office. He'll have to wait in line along with everyone else. But, he will see first hand what the system is really like, and how we are letting down the very individuals that we were hired to take care of.

Not only is it inhumane to expect the unemployed to wait these extended periods of time for their check, but there's also a limit to the amount of stress that my branch office staff can handle.

And I guess the bottom line to me is that it's next to impossible for me to operate an efficient and productive unemployment insurance operation when we don't have the resources necessary, and when we can't cover all the bases, so to speak.

So I thank you for allowing me to make my comments here today.

Thank you.

Senator SARBANES. Thank you very much for a very helpful statement.

I ought to note for the record that both Senators Riegle and Levin indicated to me the respect they have for the effort you're making in the Sterling Heights office.

Ms. SANCRICCA. Thank you.

Senator SARBANES. They are not able to join us because, in fact, Senator Riegle is managing a bill on the floor of the Senate right now. But I did want to put that in the record.

Also, Congressman Hamilton had hoped to be here, but he's chairing a hearing over on the House side and will not be able to join us this morning.

[The prepared statement of Ms. Sancricca follows:]

PREPARED STATEMENT OF JEANETTE SANCRICCA

My name is Jeanette Sancricca and I am the Manager of the Michigan Employment Security Commission local office in Sterling Heights which is just north of Detroit. I am pleased to be here and wanted to thank this Committee for allowing me to testify before you today.

Last month the New York Times published an article which focused on the impact of the reduced federal administrative funding of the national Employment Security system on the unemployed. It was my local office that was highlighted in the story. Since November of last year initial and continued claims have increased from 18,500 to almost 32,000 in January of this year.

In Michigan, on a state-wide basis, claims increased dramatically from November 1990 to February 1991. In early November the weekly statewide claims level was 87,000. Thirteen weeks later, the weekly claims amounted to over 237,000- an increase of 172%. Because of the increase in the level of insured unemployment, it now appears that the Extended Benefit program will be triggering on in the near future which could result in another 60,000 individuals filing claims. The impact of the EB program on an already weakened system could be disastrous.

In the past we have struggled with increasing claims. However when the levels of unemployment increased, we were allowed to hire the staff we needed to help process the workload. With this latest spike in the level of unemployment, we are unable to staff up presumably because of inadequate federal administrative funding. Although recently we have been authorized to hire some temporary staff, it is simply a situation of being too little, too late. Even with overtime, we have been falling behind.

I can testify that this situation has resulted in concern by employers who find out that their former employees cannot receive the checks in a timely manner.

As a manager, this shortage of human resources has also resulted in very difficult choices as far as how staff is directed. That is, do I assign staff to answer the phone or process claims? Should the staff work on problem claims that have been pending for an extended length of time or only process the normal claims? These many uncertainties have affected my ability as a manager to effectively plan for workload increases and has caused a great deal of stress on my staff who must continue to cope with an increasing workload without sufficient support.

The irony is that we are told that sufficient resources currently exist in Washington D.C. to support this program. Please help me to understand so that I can explain to my staff and the long lines of individuals who are very frustrated and angry, why can't we get the needed administrative support for this program?

Not only is it inhumane to expect the unemployed to wait extended periods for their checks, but there is also a limit to the amount of stress that my staff is able to handle. Whatever the cause may be for the lack of adequate administrative support, it is causing extreme difficulties at the local level and I am concerned that the level of frustration is more than people should be asked to endure.

Senator SARBANES. Mr. Wagner, we will be happy to hear from you.

STATEMENT OF ROBERT WAGNER, LOCAL OFFICE MANAGER, INDIANA DEPARTMENT OF EMPLOYMENT AND TRAINING SERVICES, BLOOMINGTON, IN

Mr. WAGNER. Good morning, Chairman Sarbanes and Congresswoman Snowe.

My name is Robert Wagner, and I am employed by the Indiana Department of Employment and Training Services.

Part of my responsibility with the department is to manage our unemployment insurance office in Bloomington, IN, in Monroe County. Bloomington, incidentally, services an area, part of which is included in Indiana's seventh Congressional District, which is very ably represented by Congressman Lee H. Hamilton.

I've never testified before a congressional committee before, but I think I feel comfortable that you don't want me to sit here and read my entire prepared statement, which I hope you have a copy of.

Senator SARBANES. You are very perceptive for a firsttime witness. [Laughter.]

We'll include the entire prepared statement in the record as submitted, and if you could summarize the high points, we would appreciate it. Then we will get to the question period.

Mr. WAGNER. Thank you very much.

I would like to emphasize perhaps a few of the points that I've tried to make in my prepared statement to you.

What I think we're all here to talk about today is the current crisis, in my particular case, in Indiana's delivery of service to unemployed insurance claimants and the crisis that's caused by the lack of adequate Federal funding to meet the dramatically increased workloads.

It is my understanding that the unadjusted unemployment figures for Indiana in January will show an approximate 30 percent jump from the 5 percent rate in December 1990.

Our claim load for the week ending February 16 was 88,000 plus as compared to 58,000 in the previous year and 46,000 in 1989. Our claim load is now the highest that it has been at any time since May of 1983.

Those are some of the numbers that are included in my statement. But what I'd really like to talk to you about today is the effect that this has on three groups of people.

The first group it adversely affected and probably the most vulnerable group is our temporarily unemployed people. These are men and women who have been indefinitely laid off by their employers. It's wintertime. The economy is down. And it's not easy for them to find another job. It is uncertain when or if their employers will call them back to work.

They have mortgage payments, car payments, utilities and groceries to buy for their families, and perhaps children who need medical attention. While the weekly unemployment check may not be enough to meet these obligations, that check combined with the

small savings account and help from family and friends may make it possible for them to survive until they find another job.

And heaven help them if they have no savings.

When they come into my local office on a Monday or Tuesday, they're probably going to find the lobby full. Sometimes, these applicants have to wait several hours just to get to talk to one of my staff.

I can't tell you how many claimants ask me why this is such an unpleasant and degrading experience. And when they don't ask, I can see it in their faces.

Once you've been in the office the first week, you have to come back the second week and go through the same process again. Now, at least though, you will get to sign a voucher and are told in good faith by a member of my staff that: "You probably will get a check next week."

Quite often, they don't. And, when they don't, they call back in and are probably told: "Well, come back in the office and sign another voucher."

Some of the claimants that come to my office have to travel 30 miles or more because the office that's closer to them and served them last year we had to close down last year.

All of their calls are long distance and it doesn't take them very long to become conscious of the cost of the gasoline to drive and make repeated trips to our office.

And it's not an isolated experience, unfortunately. It's repeated week after week despite our efforts to provide them with their checks.

I thought more than once—I look out across my lobby and see those folks out there, and I wonder what I'd be thinking if I were standing out there.

I don't have to wonder very long, Mr. Chairman. I would be absolutely convinced that I am dealing with the most inefficient and uncaring bureaucracy that anyone could possibly ever have to deal with.

That brings me to the group that I represented, dedicated, professional IDETS employees, charged with the responsibility of delivering these services.

About ten years ago, there were nearly 1,800 permanent, full-time employees of the Indiana Employment Security Division. Today, IDETS employs approximately 1,300 people to administer both UI, ES, and JTPA.

During that same 10-year period, our UI field staff allocation has gone from just under 400 positions to just over 250 positions.

I'd like to personalize my staff's feelings a little bit. Imagine you're employed in the IDETS office in Bloomington. You probably got into this business because you saw it as an opportunity to have a rewarding career helping people who really needed it and who would appreciate your efforts.

Your primary responsibility is to adjudicate the claimant's eligibility and the employer's liability when there is an unemployment insurance claim filed in our office. It took you a long time to acquire the necessary knowledge of State and Federal law and how to apply it, and you worked hard at developing your communication and other people skills.

You take pride in your job and you believe you're good at it.

Lately, you're beginning to wonder if you couldn't find something better in private industry. There have been years recently when you got little or no raise at all. You spend countless, uncompensated hours in the evenings or on weekends trying to make sure as many claimants as possible get their check next week.

Management is constantly encouraging you to do more with less.

You listen daily to frustrated claimants accusing you of being responsible for their having lost their home or their car or not being able to buy groceries for the families and pay their bills.

If you're like my staff, you can't understand why. If employers pay enough taxes to support the system, why can't we get the benefits to the claimants when they need it?

Finally, there are the employers who pay the dedicated taxes and who expect accurate and timely determination; timely and fair adjudication of contested unemployment insurance claims; a more effective labor exchange which utilizes available tools to recruit and screen prospective employees; access to useful labor market information, specifically tailored to their needs; and more assistance in assessing the kind of skills needed in their work force today and in the future.

In my opinion, these employers are being cheated. Their dedicated tax dollars which pay my staff's salary and mine are not being returned to Indiana so that we can do our job.

Last year, only 65 cents out of every employer tax dollar sent to Washington was returned to Indiana.

The bottom line in my perspective as a manager is that I cannot ensure the efficient and timely delivery of services without adequate resources.

I cannot be an effective manager with funding levels that ride up and down the roller coaster of unrealistic base allocations, contingency dollars that run out in the third quarter, and supplemental appropriations that historically have been made available in the spring or summer after the worst months of unemployment have already occurred.

I urge you to appropriate adequate supplemental dollars for unemployment insurance administration now.

Please do not wait until the seasonal unemployment rate, hopefully, starts to decline later this spring.

I also ask that you take a close look at the structural deficiencies in our funding system. As long as we are a workload-driven system based upon economic forecasts by OMB and a part of the Federal budget calculations, we are going to have inadequate resources to do our jobs the right way.

I thank you for the opportunity and the honor to address you today. And I would especially like to tell you how impressed I am that you would take your time to listen to the perceptions of an individual who is involved in delivering government services at the grassroots level.

I'd be happy to answer any questions you might have for me.

Senator SARBANES. Well, thank you very much, Mr. Wagner. That is a very perceptive statement. And we are grateful, all of the panel.

[The prepared statement of Mr. Wagner follows:]

PREPARED STATEMENT OF ROBERT WAGNER

My name is Bob Wagner. I am the Unemployment Insurance Local Office Manager in Bloomington, Indiana. I am an employee of Indiana Department of Employment and Training Services. The Bloomington local office service delivery area includes part of the 7th Congressional District which is represented in this body by Congressman Lee Hamilton.

I am here today to tell you about the current crisis in Indiana's delivery of services to unemployment insurance claimants. This crisis is caused by the lack of adequate federal funding to meet a dramatically increased claimload. I want to convey to you the overall picture in the entire state, and then compare and contrast my experiences in Bloomington, which has a relatively healthy economy, with those of my counterpart in the Fort Wayne local office which is experiencing higher unemployment.

It is my understanding that the unadjusted unemployment figures in Indiana for January will show a 30% jump from the 5% rate in December, 1990, and the 1990 overall rate of 5.3%. Our claim load for the week ending February 16 was 88,374; compared to 58,493 during the same week in 1990 and 46,662 in 1989. This is the highest claim load in Indiana since May, 1983.

According to D.O.L. guidelines, we are understaffed by more than 100 people statewide. Staffing levels have not kept pace with the claims load. Last year on March 1, IDETS was forced to reduce service at 17 full-time offices, close 45 part-time offices and lay-off 100 part-time employees because of a shortfall in federal funding. While Indiana eventually did receive approximately $1.2 million in supplemental appropriations; it came at a time when D.O.L. was telling us to prepare for the worst case scenario of over 37% cuts in FY91. Once a budget agreement was reached, the unemployment rate had already started to climb and we were experiencing a growing crisis in service delivery.

Currently there is a statewide backlog of over 14,000 non-monetary determinations. Half of these claims are more than 18 days old. While this represents less than 10% of the new claims we process each year, these numbers translate into 14,000 Hoosiers with families to support and house payments to make. These are people who may be out of work through no fault of their own and have not received the checks they deserve and so badly need. IDETS has allocated 9000 hours of overtime to reduce this backlog.

In Bloomington, Monroe and the surrounding counties, we enjoy a relatively healthy and diverse economy. Indiana University is our largest employer and we have a substantial number of manufacturing firms which include General Electric, a home refrigerator manufacturer who employs 2200 people; Otis Elevator Company a Division of United Technologies which employees 1,086; Thompson Electronics (RCA) which employees 1,380 workers: a Westinghouse (recently acquired by ABB) plant which employs almost 600 and numerous small manufacturing companies which employ between twenty and 500 people.

Bloomington is also the major retail shopping center for a large segment of south central Indiana and the home of numerous service

oriented businesses. As you can see Bloomington's economy is <u>not</u> directly effected by fluctuations in the automobile industry. Historically we have enjoyed one of the lowest unemployment rates in the state and probably in the nation. During the past few years our unemployment rate has ranged between two and four percent.

However, in the last few months we have not been immune to the alarming national and statewide increase in unemployment. GE had several one week lay-offs of their entire workforce. Thompson closed their plant for three weeks during December and January for inventory reduction, and now are in the process of reducing their workforce through indefinite lay-offs to a substantial number of workers. Several of the salaried employees at Westinghouse (ABB) are being notified of indefinite lay-offs. These temporary manufacturing lay-offs are in addition to seasonal construction and stone quarry unemployment.

Our claims load this winter in Bloomington is running over 75% above last winter. Although my local office funding allocation is based on several hundred claims per week, in late December and early January we were processing over 3,000 claims per week in the Bloomington local office.

When we closed the full-time unemployment office in Martinsville last March it became my responsibility to provide U.I. services in Morgan County on an as-needed-basis. Morgan County <u>is</u> effected by the automobile industry downturn. I now send one deputy and three temporary claims-takers there four days a week so that applicants do not have to drive to Bloomington. Last week, 800 claims were processed in Martinsville. Even with these additional responsibilities I am still funded for the same number of permanent staff positions that I had a year ago before the Martinsville office was closed.

Nearly 10% of Monroe County's population or approximately 10,000 people are veterans. With the termination of the war in the Persian Gulf, we can expect to see a substantial increase in the number of veterans who will be needing our assistance at the same time our veterans service funding is also being decreased by the federal government.

Now let me contrast my situation in Bloomington with that of my colleague, Jim Schmidt, who manages our unemployment insurance office in Fort Wayne, Indiana. The Fort Wayne local office this year is handling between 16% and 20% of the statewide claims. For the week ending February 9, 1991, the Fort Wayne office was understaffed by 29 people according to D.O.L. guidelines. To date this quarter, they are understaffed by 17 people. Jim Schmidt, the local office manager, and staff work overtime on weeknights and Saturdays to try to keep up. Some of this is uncompensated hours from dedicated employees.

On Monday Jim Schmidt sent out a "Rapid Response Team" to process claims at the Strick Corporation where 200 employees have been given notice of an indefinite lay-off. Tuesday, part of his staff went to a K-Mart distribution center to process claims for 90 more laid-off workers. Today, his itinerant Auburn office will process 85 claims at the Walker Manufacturing Company and 80 more claims at the NOK Corporation. Next week the Fort Wayne local office will go to the GMC Truck and Bus Plant to process 1400 claims. The following week 1400 more claims will be taken from laid-off workers at the Uni-Royal Goodrich plant.

Jim now faces a backlog of several hundred adjudication determinations which means that a substantial number of eligible claimants will not receive their checks in a timely manner. While Jim's office accounts for almost 20% of the statewide claims, his non-monetary determination backlog accounts for less

than 13% of the statewide backlog. This difference can be accounted for because Jim runs an efficient office, and he and his staff spend hours of uncompensated time making sure that claimants get their checks as soon as possible.

Now that I have given you the numbers I want to explain what they mean in everyday, real terms in my local office. I want to talk to you about the three groups of people that are affected by the shortfall in federal funding. The first group adversely effected and probably the most vulnerable group is our temporarily unemployed workers.

These are men and women who have been indefinitely laid-off by their employer. It's winter time and the economy is down and it's not easy for them to find another job. It is uncertain when, or if, their employers will call them back to work. They have monthly mortgage payments, car payments, utilities, and groceries to buy for their families and perhaps children who need medical attention. While the weekly unemployment check may not be enough to meet these obligations; that check combined with a small savings account, and help from family and friends, make it possible for them to survive until they find another job.

When they come into my local office on a Monday or a Tuesday, the lobby is filled with people. Sometimes these applicants have to wait two or three hours just to talk to the claims-taker or claims-deputy. I can't tell you how many times claimants ask me why this is such an inefficient and humiliating experience. And when they don't ask, I can see it on their faces.

Once they've been into my office in the first week they have to come back the next week and go through the same process. Now at least they get to sign a voucher and are told in good faith by my staff that they will probably receive a check the following week. If they have not received a check by the next week, they call and are told to come back in and sign another voucher. Some of the

claimants that come to my office have to travel thirty miles because the local office in their hometown closed last year. All of their calls to the office are long distance which run up their utility bills at a time that they can least afford to pay. And these are not isolated incidents. This same experience unfortunately is repeated week after week despite our best efforts to provide them with their checks.

Next there is a group that I represent---- dedicated, professional, IDETS employees charged with the responsibility of delivering these services. Ten years ago there was nearly 1800 permanent full-time employees of the Indiana Employment Security Division. Today, IDETS employs approximately 1300 people to administer both U.I. and E.S. services. During that same ten year period our U.I. field staff allocation has gone from just under 400 positions to just over 250.

With your permission, I would like to personalize my staff's feelings. Imagine that you're employed as a claims deputy in my IDETS office in Bloomington. You probably got into this business because you saw it as an opportunity to have a rewarding career helping people who really needed it and who would appreciate your efforts. Your primary responsibility is to adjudicate the claimant's eligibility and the employer's liability when there is an unemployment insurance claim filed in our office. It took you a long time to acquire the necessary knowledge of state and federal law and how to apply it, and you have worked hard at developing your communications and other "people skills". You take pride in your job and believe you're good at it.

Lately you are beginning to wonder if you couldn't find something better in private industry. There have been years recently when you got no raise. You spend countless uncompensated hours in the evenings or on weekends trying to make sure as many claimants as possible get their checks next week. Management is constantly encouraging you to do more with less.

You listen daily to frustrated claimants accusing you of being responsible for their having lost their home or their car, or not being able to buy groceries for their family or pay their bills. If you're like my staff, you can't understand why. If employers pay enough taxes to support the system, why can't we get the benefits to claimants when they need it.

Finally, there are the employers who pay the dedicated taxes for accurate and timely determination of their tax rate; timely and fair adjudication of contested unemployment insurance claims; for a more effective labor exchange which utilizes available tools to recruit and screen prospective employees; for access to useful labor market information specifically tailored to their needs; and for more assistance in assessing the kinds of skills needed in the workforce today and in the future. In my opinion, these employers are being cheated. Their dedicated tax dollars, which pay my and my staff's salary, are not being returned to Indiana so that we can do our job. Last year only sixty-five cents out of every employer tax dollar sent to Washington, D.C. was returned to Indiana.

The bottom line from my perspective as a manager is that Jim Schmidt and I cannot ensure the efficient and timely delivery of services without adequate resources. I cannot be an effective manager while federal funding levels ride up and down the roller-coaster of unrealistic base allocations, contingency dollars that run out by the 3rd quarter and supplemental appropriations that historically have been made available in the spring or summer, after the worst winter months of unemployment have already occurred.

I urge you to appropriate adequate supplemental dollars for unemployment insurance administration <u>now.</u> Please do not wait until the seasonal unemployment rate starts to decline later this spring.

I also ask that you take a close look at the structural deficiencies in our funding system. As long as we are a workload driven system based upon economic forecasts by O.M.B. and a part of the federal budget calculations, we are going to have inadequate resources to do our jobs the right way.

In closing, I want to assure you that Hoosiers do not sit back and complain about our problems and expect the federal government to solve them for us. We act. Hoosiers have a deep-rooted work ethic and strongly held convictions and values. Our leaders take an aggressive an innovative approach to solving problems. They have studied and are aware of the implications of the "Report of the Commission on the Skills of the American Workforce" published by the National Center on Education and the Economy in June of 1990. We have merged the administration of the Jobs Training Partnership Act (JTPA) with the job service and the unemployment insurance administration, and are in the process of integrating the service delivery system of these programs in the seventeen service delivery areas in Indiana.

Governor Evan Bayh's comprehensive Workforce Development plan for the future was announced in the last two months, and includes the reorganization of three state agencies into a new agency called the Department of WorkForce Development. Legislation to support this initiative and an innovative way to create a new funding source through the use of interest from tax dollars now sent to Washington, D.C. has been introduced in our General Assembly. Our local offices will become Workforce Indiana Centers where, in addition to the current services offered, clients will be able to access a menu of job services designed to better equip them to compete in the labor market, and employers will be able to get much needed assistance in defining the specific skills needed in tomorrow's workplace.

Our General Assembly is also considering legislation which will raise unemployment insurance benefits levels, ease some of the eligibility restrictions and provide state extended benefits to disaster victims.

To cope with our current U.I. crisis, IDETS has provided chairs and installed a numbering system in our busiest offices to alleviate the hardship of standing in long lines. We've installed an 800 "Help Line" so claimants with problems can get assistance from our administrative offices in Indianapolis. We have developed "Rapid Response Teams" that go to workplaces experiencing mass layoffs. We have automated our unemployment insurance tax and claim system to provide more efficient and timely services.

Indiana's elected officials in Washington have also acted responsibly in heeding our call for adequate federal funding. Congresswoman Jill Long for the last two years has introduced a bill to remove our funding from federal budget calculations. Our Congressional delegation for two years in a row has circulated a joint delegation letter calling upon the President, Department of Labor, and their colleagues to appropriate supplemental funds.

The support that we get from our elected officials is matched by the support we get from the business and labor coalition that has stood up and said, "These are dedicated tax dollars paid by employers based on the work done by employees. These are tax dollars now being held in Washington as a paper write-off to the federal budget deficit. It is not fair to balance the budget on the backs of Indiana's unemployed workers."

I thank the committee for the honor of testifying before you today. I'll be happy to answer any questions you may have.

Senator SARBANES. Congresswoman Snowe has another hearing that she has to attend, and I am going to defer and allow her to ask a few questions that she would like to put to the panel before she has to leave.

Representative SNOWE. Thank you, Mr. Chairman, for your courtesy and consideration. I haven't figured out how to be two places at once.

I want to thank all of you for your testimony. It is important to us to hear, you know, how government services and programs are running, especially when it's contingent upon, you know, either Federal guidance or Federal funding and Federal support—and especially at this time of high unemployment.

I'd like to ask you at what point, when did it become clear that your offices were having problems in delivering unemployment compensation and processing the claims?

I mean, like was it in January or December? At what time did it become clear that you were becoming overburdened in the offices?

Mr. WAGNER. In my case, it was October.

Representative SNOWE. October. As early as October.

Mr. WAGNER. But, I think, again, it's important to recognize that what we're really dealing with here is the result of a process that's been going on for at least 8 or 10 years.

And it's just all now catching up with us.

Ms. SANCRICCA. I think we noticed it around November. That's our usual heavy season. And then we saw that we weren't going to be able to cope.

And, again, I agree with Mr. Wagner that it's been a continuing problem, but this time we saw that we were not going to be able to get ahead of the game.

Representative SNOWE. Were you all in your respective positions in 1982? No?

Mr. WAGNER. I was in our administrative office in 1982, but I've been with the agency for considerably longer than that.

Mr. HARTNETT. We saw it in our New York City offices in particular a little bit earlier, in September or so, because the brokerage houses and the real estate market in New York City got hit kind of heavy. And they led us into the impact of the recession in New York.

And then it hit the rest of the offices pretty quickly after that, in October and November.

Representative SNOWE. So this has been a problem before, I would gather, in terms of periods of high unemployment in receiving adequate administrative funding?

The reason why I'm asking this question is because I know that, Mr. Hartnett, you raised it in your testimony's suggestions for resolving this problem in the future. I mean taking the fund and separating it and keeping it separate.

You see, right now, it is used to calculate the deficit. And that's the problem.

So, the President could designate it as an emergency issue and, therefore, it would not be required to be offset. I mean, you could do that.

The question is what we ought to do here. And that's the issue. But I think it has to be looked at in the future. Perhaps that it is a

possibility, separating the fund, so that we don't get involved in this kind of issue again, although we're talking about, I gather, a $1.2 billion, a $1.4 billion, that is in the account at this point?

Mr. HARTNETT. It is absolutely impossible to do the kind of planning necessary. I mean, you're basically living hand to mouth on a month-to-month basis. You're never sure of what kind of staff you will have. Magical formulas appear that change funding, sometimes going forward, sometimes going back.

It just becomes very, very difficult. So I urge, at least with respect to my testimony, that we not only deal with the immediate problem we have before us today, but we also put in place something that can have some continuity associated with it. And give us the ability to do some of that planning so that we can monitor and run these programs intelligently.

Representative SNOWE. I would agree with that. And that's something that we ought to look at for the future based on this experience.

Would you say that most States are having this problem? Do you have any idea how many of the States are facing this problem?

Mr. HARTNETT. Most that I talked to are having it.

Ms. SANCRICCA. Can I add some information? On our staffing—I'm sure Mr. Wagner has said this, and I think every State has felt something very similar—between 1980 and 1990, the staffing for the Michigan Employment Security Commission has gone from 6,200 in 1980 to 2,500 in 1990. We've closed 29 full-service offices; we now have 55.

In our Upper Peninsula, which is more rural, we have claimants who must drive up to 80 miles one way for service. And I don't think that that is unusual in the country. I think that you will find that that's a trend around the country.

Representative SNOWE. I know, in my State, for example, some of the job offices are opening on Saturdays just to meet the demands of extended benefits, which have triggered in our State for an additional 13 weeks just to offset, you know, because they cannot handle it during the routine work week.

Ms. SANCRICCA. We're working on Saturdays also.

Representative SNOWE. I wanted to ask you, Mr. Hartnett, in your testimony, I wasn't clear on this.

You said it's important to note that the unemployment insurance program is the only State-administered entitlement program that does not have mandatory administrative financing.

Mr. HARTNETT. That's correct.

Representative SNOWE. What does that mean: "does not have mandatory administrative financing"?

Mr. HARTNETT. That reasonable people could say, based upon this particular figure, the unemployment rate, that that would translate into x number of claims and that would translate into x number of staff, assuming reasonable people could agree on the number of claims that could be processed by an average staff person.

And for most programs, given x, then y automatically follows.

With the present program, given x, almost anything can follow.

And that, again, goes back to the issue that I mentioned in my comments about 75 cents on the dollar for new costs incurred as a result of the increases in claims that have occurred just recently.

Senator SARBANES. You ought to make it clear though that the 75 cents on the dollar idea is that it is not a Federal appropriation out of general revenues to cover these administrative costs. There is a trust fund into which the employers have paid their unemployment taxes for this very purpose.

Mr. HARTNETT. That is right.

Senator SARBANES. And that is the basis on which they accepted those taxes, and you constructed a willingness to pay those taxes. Those moneys are not being returned in an amount adequate to meet the administrative workload.

Ms. SANCRICCA. And we hear that from employers. They know that they're paying this tax.

Senator SARBANES. I am surprised you don't hear even more. We are hearing from them, too, but I would expect it to be much more. I think the protest will build as they come increasingly to perceive the situation, on their part.

Mr. HARTNETT. I absolutely agree with you, Mr. Chairman. An employer will most likely, when the economy turns around, recall a lot of those workers, who they've invested training in and expended the training dollars on. And that individual has had a degree of loyalty to the company.

So, how that person is treated during that period of time when they're unemployed is very important to that employer, particularly since they've paid and there's sufficient funds for that treatment to be dignified and compassionate and civil.

And, in many cases, it's not.

Representative SNOWE. Well, the unfortunate part is we've done this with every trust fund we have. And that's the unfortunate part.

And if we got back on track in terms of creating our priorities, we wouldn't have this kind of problem. But, we're using all the trust funds' surpluses to calculate our deficit, so that we don't have to cut back on spending as much as we really should in all reality.

In this case, obviously, I mean, it is compelling. So this should not be caught up in our problems here. It should be separated.

Yes, Mr. Wagner.

Mr. WAGNER. If I could, Congresswoman Snowe, I think we all encourage trying to get on top of our tremendous deficits, and so forth, and we're all going to be in a lot better shape if we can do that.

The problem I have is that this is one dedicated fund that is not being used to accomplish the needs for which it was collected at a time when it is desperately needed by many folks out there.

Representative SNOWE. No, I agree with you. We've done that with other trust funds. Presumably, it's supposed to be dedicated but, obviously, this is more compelling when we're talking about individuals who depend on receiving a check for basic living necessities. So I don't disagree with you.

I don't personally think that this has to become a dispute here in Congress. It doesn't have to be. But, we can create all kinds of disputes when we want to. That's my personal feeling.

And having seen, and we all paid a price for it in the last election, about some of the programs that we funded here. I heard about it, believe me, in my State and my district when I ran for reelection this last time, about the things that we funded.

I had to answer the questions about why we did. I didn't want to justify it because I didn't vote for it. But, nevertheless, I paid a price for it, too.

So, I guess what I'm saying is there is a time. The time is now. And I think we could do it. If we really wanted to do it, we could pass that and make some offsets.

But, in any event, I appreciate your testimony here today. And, obviously, we need to get this funding to all of your offices.

So I appreciate it. Thank you.

Thank you, Mr. Chairman.

Senator SARBANES. I want to quote to the panel, just to put it in the record, a paragraph from the statement that we received on January 4 from Michael Deisz, the executive director of the job service in North Dakota and president of the Interstate Conference of Employment Security Agencies.

And he said the following:

> The current situation illustrates that the existing administrative funding arrangements for unemployment insurance are in need of an overhaul. The scarcity of funds for unemployment insurance is particularly difficult for employers, workers and State officials to understand because the Federal payroll tax, the Federal unemployment tax, produces revenue which is dedicated to providing administrative funds for unemployment insurance, employment services and certain veterans' employment programs. These funds are held in the Employment Security Administration Account, in the Federal Unemployment Trust Fund, from which appropriations for these programs are made. The Employment Security Administration Account was projected to have a balance at the end of fiscal year 1990 of $1,640,480,000 above its statutory ceiling. More than sufficient Federal unemployment tax revenues are collected for unemployment insurance and employment services. However, they are held hostage like many other trust funds to the Federal budget deficit.
>
> ICESA believes that a first step in reform of administrative funding for unemployment services is to exclude Federal employment trust funds from Federal budget deficit calculations.

And the Department of Labor, in the submission that went with the President's 1992 budget, has a figure of $2,240 million as the balance in the trust fund, which is $600 million above the figure that was cited in this statement. We are going to have to check that discrepancy, so it just may be a more accurate figure. I think that's probably the case. Mr. Wagner, you said they are dedicated. You said:

> In my opinion, these employers are being cheated. Their dedicated tax dollars which pay my and my staff's salary are not being returned to Indiana so that we can do our job.

That's exactly the situation. It is not as though we somehow have to find the money to meet your administrative costs. The money is there. It has been paid for that purpose. It is supposedly being held in a trust fund for that purpose, but it is being held hostage to a broader, different issue which needs to be addressed. I don't minimize the necessity of addressing that broader budget deficit issue, but it ought not to be addressed by, in effect, raiding these trust funds which were committed for a particular purpose.

You have had an incredible increase in your caseload in a very quick period of time. I don't agree with the view that some ex-

pressed that somehow this can be anticipated. I just don't think that is the case.

Ms. SANCRICCA. No. And for an example, when I was in the office on Friday afternoon, we received a call from one of the Chrysler plants, which is right across the street from the office, telling us that they were going down that day; 3,500 individuals would be out of work at the close of business that day.

And we had anticipated it being a few weeks down the road. So, how do you plan services when you receive calls at 4:30 or 5 on a Friday afternoon and find out that that many individuals will be in your office next Monday?

And this occurs now on a regular basis. These situations are occurring time and time again, where the employers don't know until the last minute. They don't tell their personnel people. And then we are left to deal with the problem of trying to incorporate those additional claims into our system.

Senator SARBANES. Do you get many complaints from your claimants about the service when you are working in a normal time?

Ms. SANCRICCA. We don't. In fact, what we used to get was "thank you" letters. Say, last July, when the claim load was very low, we would receive requests for payment on Monday; they'd have a check in the mail on Wednesday. They loved it.

But, then, as the system got worse and worse, they still had the expectations of receiving those checks very quickly, but it didn't come through.

Senator SARBANES. If you're given reasonable resources, you can do the job. You have done it. You have demonstrated that.

It's not something inherently deficient in the system itself; it's just the failure to give you the resources to make the system work. Is that correct?

Ms. SANCRICCA. That's correct.

Mr. WAGNER. That's totally accurate. We can judge the number. The one thing we can plan fairly safely is the number of complaints we're going to get because it depends on how many claims were being filed.

When there aren't that many claims being filed, we do a very efficient job processing them. But when, as in Bloomington, our claims load is 75 percent ahead of what it was for the same period last year, we're getting some complaints. And I don't blame them. I'd be complaining, too.

Senator SARBANES. Well, you have been a very helpful panel. And we are very grateful to you for your testimony. This is obviously an issue we are pushing very hard now.

There are two problems. We need an immediate response to the current situation. There are three problems, in my opinion.

We need an immediate response to the current situation on the administrative costs. We need a more permanent solution on the administrative cost.

I also feel that the unemployment insurance network has been cut down too far over the past decade and the extended benefits are too hard to get, the trigger is too tough. The payments are not adequate in terms of replacing income so that the people are pushed toward poverty. There are a number of other things that

need to be done to just strengthen the overall unemployment insurance.

We want to thank you for the effort you continue to give under this tremendous pressure. I know it is very tough for people that are obviously committed and conscientious to find themselves in a situation where you are doing the very best you can, extending yourself to the limit, and yet you are still overwhelmed by the situation. People take it out on you, although it is not fair to you.

I mean, it's understandable why they do that. As Mr. Wagner indicated, if you were in their shoes, you would see it with the same eyes, I'm sure. It is just a very difficult situation.

We are pushing this $200 million very hard and we are hopeful that we will be able to do something about it very shortly here in the Congress.

Thank you all very much for coming.

Mr. WAGNER. Thank you.

Ms. SANCRICCA. Thank you.

Mr. HARTNETT. Thank you, Mr. Chairman.

Senator SARBANES. Very good panel. If we could take the last panel, we would very much appreciate it. Our last panel consists of unemployment insurance claims processors. Nanine Meiklejohn of the legislation department of AFSCME, I think, is going to present them, or lead into the panel. We have Mr. Byron Nugen, the claims processor from the Indiana Department of Employment and Training Services; and Ms. Faye Mitchell from the Connecticut Job Service in Stanford, CT.

Ms. Meiklejohn, we will be happy to hear from you.

STATEMENT OF NANINE MEIKLEJOHN, LEGISLATION DEPARTMENT, AMERICAN FEDERATION OF STATE, COUNTY AND MUNICIPAL EMPLOYEES (AFSCME)

Ms. MEIKLEJOHN. Thank you, Mr. Chairman.

My name is Nanine Meiklejohn, and I'm in the legislative department of the American Federation of State, County and Municipal Employees.

We very much appreciate your interest in this issue. It has been one that we've spent a lot of time on over the last year or so. AFSCME represents about 25,000 employment security employees around the country. We've provided you with a prepared statement which we would like to have submitted for the record.

Senator SARBANES. It will be included in the record.

Ms. MEIKLEJOHN. I know time is short, so I think it's much more important that you hear from Byron Nugen and Faye Mitchell. So I would like to turn the hearing over to them.

Faye Mitchell is an employment security interviewer in Stanford, CT. And Byron Nugen is a claims deputy in the Indianapolis area of Indiana.

We spent about an hour talking last night about their jobs, and I wish you could have heard it because, if anyone had any doubt that there's an emergency out there, that conversation would have dispelled their doubts.

[The prepared statement of Ms. Meiklejohn follows:]

PREPARED STATEMENT OF NANINE MEIKLEJOHN

The American Federation of State, County and Municipal Employees (AFSCME) appreciates the opportunity to present its views on the financing emergency being faced by the unemployment insurance (UI) program. AFSCME represents over 1.3 million state and local government employees, approximately 25,000 of whom work in local unemployment offices.

The unemployment insurance program was established in 1935 to serve two important functions: to provide unemployed workers with temporary income until they return to work, and, by sustaining consumer buying power, to produce a countercyclical effect on the economy.

Unfortunately, the unemployment insurance system entered the current recession with the least administrative capacity in decades and with its ability to process claims promptly seriously impaired. During the 1980's, the states found it increasingly difficult to maintain an adequate number of offices and experienced employees to process unemployment claims. Since

1983, state unemployment insurance staff levels have declined by 25 percent, from 57,000 to 43,000. As a result, the twin goals of the 1935 law are in jeopardy.

A major reason for the dramatic decrease in staff and offices was declining federal financial support. Indeed, the full extent of the federal retreat has been obscured by about $140 million, which approximately 38 states have contributed to the system. With 28 states now facing serious budget deficits, we expect state support to diminish and conditions in local unemployment offices to worsen.

Federal funding also became less reliable. This year, like last year, the unemployment insurance system is facing a serious administrative funding shortfall. These shortfalls developed because far more workers became unemployed than was anticipated when the President's budget request was developed. This year's shortfall is $200 million.

The effects of the funding reductions and the current shortfall have become distressingly evident. Unemployed workers in the upper peninsula of Michigan have to drive 80 miles one way to reach an unemployment office. It is taking 5 weeks or more to get the first unemployment check in Michigan. Payment delays are increasing in Connecticut, Maine, New Mexico, Indiana, and West Virginia. In Indiana, where the average number of claims per week jumped from 29,670 in October to 57,330 in December, the state is trying to operate without 17 offices that it had to

close last year. A wait of 5, 6 or even 7 hours just to file a claim is not uncommon in many states. Telephones go unanswered, and people are turned away from overcrowded offices. Needless to say, the bill collectors still want their money, and the children still need to be fed. Clearly, the safety net is failing.

Administrative funding shortfalls are not new to the UI system. Indeed, shortfalls have occurred in 10 out of the last 18 years, and supplemental appropriations were routinely provided. What is new now, however, is a budget process that has made it increasingly more difficult to assure adequate and timely funding.

Under the current rules, unemployment benefits are mandatory expenditures, but the administrative funds to pay benefits are classified as discretionary. That means that UI administrative funds must compete with all other domestic discretionary programs under strict spending caps.

It has become much harder to secure adequate UI funding in the regular Labor-HHS appropriation in this environment. This past fall, for example, conferees on the Fiscal Year 1991 appropriations bill increased funds for UI and several domestic programs only to turn around and impose an across-the-board cut on all programs to bring the bill within the required spending ceiling. This action caused UI to lose $49 million of the $90 million increase and to enter the year with a certain shortfall.

Even if the Appropriations Committee fully funds the workload projected at the beginning of the fiscal year, unemployment may increase as the fiscal year progresses. Needless to say, the economy does not conform to the Congressional budget cycle. For example, as Congress was working on a supplemental appropriation for Fiscal Year 1990, unemployment started to escalate. The FY 1990 supplemental came too late to prevent some office closings, and was too little by the time it passed. The estimated unemployment rate for Fiscal Year 1991 has been revised upward three times since last January. It rose from 5.3 percent last January, to 5.8 percent last July, to 6.1 percent last October, and to 6.5 percent this January.

The current method for appropriating administrative funds is too inflexible and unresponsive to changing economic conditions. Surely the authors of the 1935 law never expected the entitlement to unemployment benefits to be jeopardized by a Congressional budget process that prevents administrative funds from rising and falling along with the workload.

Unemployment insurance is the only state-administered benefit entitlement program which is subject to the domestic discretionary spending caps. This classification has caused a breakdown in the reciprocal relationship between the federal and state governments originally established by the unemployment insurance law in 1935. Under that arrangement, the states were charged with the "proper and efficient administration" of the program. The federal government was charged with financing state

administrative expenses from an employer tax levied by the federal government under the Federal Unemployment Tax Act (FUTA).

There is no shortage of money from the Federal unemployment tax. The account presently holding the revenue dedicated exclusively to state administration had a balance of $1.64 billion at the end of Fiscal Year 1990. That was well above the statutory ceiling. The money, however is being held hostage by a rigid budget process that fails to accommodate the effect of economic changes on this entitlement program.

AFSCME strongly supports the following steps to solve to this problem:

* <u>Fiscal Year 1991 Supplemental</u> - It is encouraging that the Administration asked for a $100 million supplemental for FY 1991, and that the House Labor-HHS Appropriations Subcommittee has approved the full $200 million that the system needs. However, the President failed to designate the supplemental an emergency. Without such a designation, corresponding cuts in the domestic discretionary category could be required, or pressure could develop to reduce the appropriation to fund other worthy programs. In our view, the recession justifies designating the appropriation as an emergency.

* <u>Contingency Reserve Fund</u> - Because of the unpredictability of the unemployment rate, we strongly recommend that the

emergency supplemental include language establishing a contingency reserve fund which would release additional funds if the workload continues to increase above the level assumed by the regular and supplemental appropriations. Funds would be released only to the extent that the workload actually increased in each state. If unemployment does not increase, additional expenditures would not be necessary. There is precedent for such a fund. In fact most of the major benefit entitlement programs already have either language such as this or a funding structure that is sensitive to workload increases.

* Financing Reform - Unless more permanent reforms are enacted, the financing problems inherent in treating a workload driven program as a discretionary program will persist. The unemployment insurance program will continue competing for scarce dollars under ever tighter spending caps, and the integrity of the program will remain in jeopardy. AFSCME recommends enactment of legislation creating an appropriated entitlement based on workload.

* Trust Fund Reform - Congresswoman Jill Long has introduced legislation (H.R. 888) to move the Unemployment Trust Fund off budget. We think there is good justification for doing so. The Trust Fund consists of state accounts which hold revenue from employer taxes levied by the states. This money must be used for the unemployment insurance program and is not available for any Federal programs. Moving the

Trust Fund off budget would protect it from the distortions created by the budget process.

In summary, Mr. Chairman, the Employment Security system is badly understaffed. The boom years of the 1980's made it possible to ignore the system's decline. Now the long lines and delayed payments of the recession have brought the atrophy of the system into sharp focus. AFSCME is committed to rebuilding and modernizing the unemployment insurance system, and we are very grateful for the interest and concern of this committee.

Senator SARBANES. We'd be happy to hear from you. Please proceed, Mr. Nugen.

STATEMENT OF BYRON NUGEN, CLAIMS PROCESSOR, INDIANA DEPARTMENT OF EMPLOYMENT AND TRAINING SERVICES, INDIANAPOLIS, IN

Mr. NUGEN. My office in the Indianapolis area comprises a broad spectrum of Hoosier residents. We daily see people who have very highly technical skills in a very specific labor market. We have a great proportion of seasonally unemployed workers who we see on a regularly seasonal basis. And we have a great percentage of what we term just the chronically underemployed or hard to place workers. And, unfortunately, they comprise a significant part of our backlog.

Last month—I just picked out a week of our statistics—in our metro office in downtown Indianapolis, in 1 week, we took 750 new claims. And this overwhelming task was left to three claims takers to try to get these claims processed and entered so that these people could start receiving their benefits within as reasonable a time as possible.

In my specific field as a deputy, I have to interview people who are out of work for a myriad of reasons—termination from employment, voluntarily leaving a job, leave of absences—various issues which must be adjudicated first before we can make any determination of whether or not that individual will be entitled to unemployment benefits.

When I left my office in Indianapolis yesterday, I had a backlog of 270 claims on my desk. Those file folders translate into 270 individuals who are behind in their car payments, behind in their rent, and facing mortgage foreclosure.

And you somehow have to anesthetize yourself to the human plight and deal with the backlog in as expeditious a manner as possible. We have been averaging a 10 to 12 week turnaround time, from the time I interview a man or a woman who has been terminated, quit a job, on a leave of absence for some reason, to when we make what we feel is a fair and impartial determination of eligibility.

And for many of these people there is no safety net, financial or otherwise, in that interim time period.

I cannot begin to tell you the number of claimants who simply have not earned enough due to their lack of job skills and job opportunities to even qualify for unemployment. So there is not even going to be any financial safety net for them; they have to rely on the township trustees, department of welfare, hopefully, for some type of supportive financial service.

We have been beset with constant problems with our new computerized system. We have had continuous hours of downtime through the week. And it's very tough when you sit out there in a lobby full of 400 people who have waited in line an average of 4 to 5 hours, when a man or a woman comes in to find out why he did not get last week's check and your computer terminals are down and you have no backup, and all you can do is painfully tell them

they will have to come in tomorrow or try to call in and, hopefully, they can get through on our telephone line.

I cannot begin to tell you in the past 5 years how many Saturdays and Sundays I have given up of my own time to come into my office, process payment vouchers, so that these people will get their checks maybe a week sooner; write my determinations of eligibility or ineligibility so that they can initiate the appeal process, which is their legal right.

Mr. Wagner has emphasized these points very plainly and very effectively, so I'm not going to elaborate much more. The stress load in our office we cannot put into human terms.

Every day, we're constantly physically threatened or verbally abused. And you just have to tell yourself it's not reflecting on you as an individual, but it is the system you are trying to work in.

Just in closing, I mentioned to my wife:

> It would sure be nice to be able to drive home on a Friday night and feel that you were able to accomplish your workload and be of service to these people, and to not dread Monday morning when you see a line encircling your building.

I will refer my time to any questions that you might have, sir, but, once again, I want to thank you for affording me this opportunity because, hopefully, my perspective is a composite of other deputies, not only in Indiana but throughout the economically hard-pressed Midwest.

Thank you again, sir.

Senator SARBANES. Thank you very much.

Ms. Mitchell, please proceed.

STATEMENT OF FAYE MITCHELL, CLAIMS PROCESSOR, CONNECTICUT JOB SERVICE, STAMFORD, CT

Ms. MITCHELL. Mr. Chairman, I'm Faye Mitchell, and I work for the Connecticut State Labor Department and I have for the last 10 years. And as a State employee, I have to say I hate my job now. I really hate going to work, because I don't feel I'm really doing my job any longer.

The system has had such a breakdown that I'm not allowed to perform my services that I used to love to perform.

I have people coming in. If they're lucky, if they get there early enough, they get a chance to stand in line for 4 hours inside the building. If they're too late, they get a chance to stand in line outside the building for 5 to 6 hours.

To me, that's not being able to do my job. These are people who basically worked all their lives. They don't want to be there in the first place. They've looked for work for the last 4 or 5 weeks. When they can't find anything, they come to us.

And when they come to us, that means they're desperate. They don't want to be told "I'm sorry, you have to wait in line," and they can't find the end of the line.

Then, when they finally get to the front of the line, they're told, "You have to fill out these papers and you'll have a check in a couple of weeks."

A couple of weeks, the mailman comes. There's a telephone bill and the gas bill, but there's no check from the unemployment office. The rent's due. The kids have to have food.

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They come back into the office. What do you do? "I understand. Well, you know you can go to welfare."

And to tell a person who has worked for the last 30 years that the system that's here to help you to get through these hard times is not working because we don't have the people there to make it work. And you have to lower your pride to go to an agency to say, "I need help so I can pay my rent, so I can feed my kids."

It really affects a person. And I have to say most of the people in Connecticut are hard-working people. They have not been into my office for the last 20 years. And to walk in, to them, it's like accepting something that they're not contributing to, even though they've worked and they earned this.

They feel that, if they're not going to work, they're not being productive. If someone is giving them a check and they're not working every morning, it's charity.

People can go hungry. They can go ask for food. But, when you hurt their pride, you really do something to the person. And the way the system is set up now, a lot of pride is being stepped on. It affects the person that you're trying to help; it also affects the employees.

We can no longer afford to be compassionate. And that's something we prided ourselves on—being able to show compassion, putting ourselves in their shoes.

Now, you're there to process a paper, get a paper going so a person can get a check. You cannot afford to listen to their problems, to try to encourage them, to make them feel better any longer.

And this has turned into violence. And in a couple of the big offices, it's quite common to have the police called four or five times a day.

You don't have their check. You're holding their money. You, the person, not the system. And they have attempted to assault employees because they are frustrated. And these are people that would never ever harm anyone or get upset. But they've reached their limit. They're almost out on the street. The landlord's saying: "I'm sorry. I know you don't have a job, but I need my money."

The kids have to eat. The utility bills have to be paid. And people can only be stressed out so much and then they fight back. And that's what's happening in Connecticut. Even the employees who were always pleasant and smiling are now snapping, being nasty. They can't get along with fellow employees—and never mind the public.

I think something has to be done for those people who are affected, and it does end up affecting us all because if the unemployed are not paid, there's no money put into the economy, it's going to affect me, it's going to affect the little guy at the corner store. And it has a rippling effect.

So we're not just helping one group. We're helping every one.

And, thank you very much for your time.

Senator SARBANES. Well, thank you. It's a very strong statement.

Let me ask you, when this pressure builds up, what aspect of the services you provide is jettisoned first, or, does it just all contract? Are there certain things you stop doing that you ought to be doing

but you say, look, we are overwhelmed. We have to somehow try to cut through this.

Ms. MITCHELL. Well, one thing you don't do, you don't pick up the telephone. The telephones, they all could be taken out. You don't answer the phone, period.

If an employee is calling in sick, they have to call a special number; otherwise, they will never get through because a person standing in line does not understand that you're answering a call from some other person from the public. They only see you on the phone.

And that's a no-no. That's a good way to get trouble started. So you just let the phone ring and you try to keep the paper flowing.

Senator SARBANES. Mr. Nugen.

Mr. NUGEN. The time that you would like to allocate to making your determinations, getting your factfinding done with the employer and the claimant has to be set aside because it's 4:15 and you have 150 people still waiting in the lobby.

And, if you're lucky, you might get out of there by 5:30. So, once again, the process is even further delayed due to the lack of deputy staffing. You cannot get to the task at hand, making your determinations of eligibility or ineligibility based on the reason why that person was separated because of the constant influx of new claimants being filed, and you have to lend support assistance to help process the claims and service the public who come in every day.

Senator SARBANES. In a normal time with a reasonable staffing, how quickly can an unemployed person draw his unemployment check?

Mr. NUGEN. Well, Mr. Chairman, if someone is simply laid off, hopefully, within 2 to 3 weeks, because we have such a backlog of claims that need to be put into the system. As I said, 750 claims per week was just a typical week for us in our metro office. You know, some weeks are higher and lower, but that's pretty much the norm.

But, as I said, if there is a separation issue and someone has been discharged, we have to do factfinding, make a determination, and enter it into the terminal, either to allow this person benefits so those checks can be released or to hold those benefits.

As I said, we have been running 10 to 12 weeks behind simply because we're not left at our desk to do it.

Senator SARBANES. Well, now, at an earlier period, when you didn't have such heavy claims on you, what was the time period?

Mr. NUGEN. Two years ago, we were able to meet the Federal time lapse criteria almost every month, particularly in our office.

Senator SARBANES. Why don't you put on the record what the Federal time lapse is?

Mr. NUGEN. Eighty-seven percent.

In other words, if I see an individual on a Monday morning and have to find out why that person was terminated from a job or why that person voluntarily left employment, by Wednesday of the following week, an adjudication has to be made either to allow benefits, deny benefits, or suspend benefits.

In other words, 87 out of every 100 has to be met. We hope by July we might be able to meet that——

Senator SARBANES. That was within 10 days. Is that right?

Mr. NUGEN. Ten days, right.

Senator SARBANES. Now, what about where there is no issue to be determined? It is very clear they've been laid off; they're entitled.

Mr. NUGEN. That individual, in my work as a deputy, technically, I don't have to see. The people I deal with are people who are out of work through other than a layoff.

Senator SARBANES. Two years ago, how long would it take that person to get his check, the one whose just been laid off?

Mr. NUGEN. About 10 days to 2 weeks because they have a 1-week waiting period in Indiana anyway. But, 10 days to 2 weeks.

And now, if we can get someone, if we can get an issue adjudicated and make a decision, if we're lucky, 5 or 6 weeks. And that's 5 or 6 weeks in which they've continued to report, continued to send in their mail-in vouchers and continually call us on the telephone, wanting to know what is the status of their claim at this time—a telephone which I don't have the time to pick up because it's going to hamstring me from other duties I have.

Senator SARBANES. What is it in Connecticut?

Ms. MITCHELL. In Connecticut, the wait was 2 weeks. That was it. If it was a straight layoff, by the second week, you had your check.

And, Mr. Chairman, I'd also like to say that, to correct the problem, we need more people before we get a bigger problem.

What's happened now, we have part-time people working, but we didn't bring them on until the problem was just burying us.

Senator SARBANES. Well, that is a worry I have here, that even if you get this $200 million, you're going to have to go through a very difficult digging out from under. Where do you find the workers? Is there a pool of workers who have some competence in this area that can be drawn in when a situation like this arises?

Ms. MITCHELL. Connecticut has in the past had people who work from time to time when the unemployment rate is high. Now we're getting younger people and they're not staying; they can't take the pressure. They're leaving usually after 2 weeks.

So it has been a problem for us to get part-time people because it is a part-time position, depending on the unemployment problem. And the younger people, they can't take it. They just think it's unbelievable that anybody would work under those conditions. So, they don't stay. The older workers cannot afford to work part time because most of them have mortgages, families that they have to support.

So we really need permanent people in place so, when the problem does happen, we can move them in and we don't have to try and use tape to glue up the system because it never gets glued. We just keep getting deeper and deeper.

And it's really sad. I can identify because I had been laid off from the State for 18 months, and I know what it is to be on the other side of that counter. It's not nice. You don't feel nice.

Senator SARBANES. Of course, I think one of the problems is that the policymakers here have no grasp of how immediate the need for income is on the part of many, many families in the country, and that, if they don't have some income within a week or two, they are in very deep trouble. There is one payment after another on which they start to default. Then they either close on them or

they start dunning them and putting them under that kind of pressure.

I gather that is what leads to some of these outbreaks of violence.

Ms. MITCHELL. That's exactly what leads to it. And I really try and say, well, this could happen to me. I could work for the State from now until I get laid off. I don't get unemployment because the claim load is so high. And I actually have to go to welfare.

I mean, it can happen. I'm seeing it every day where two parents, both, are unemployed. They have kids. So, if neither parent is getting any money, the only place is to go to State welfare and say: "Hey, I need a handout." And people don't like that. They want to contribute, not take away from the system.

Mr. NUGEN. Mr. Chairman, I might point out that, in Indiana, we have one of the lowest rates of unemployment benefits. For example, for a single person, no dependents, $96 is the maximum that they can draw on a weekly basis.

For a family of four, the absolute maximum is $161. And when a claim is filed, it stays established for 1 calendar year, 52 weeks. If that individual draws 26 consecutive weeks, as that gentleman said in the prior testimony, that claim is paid out. There have been no extended benefits in Indiana for the past 5 years. That person has to wait another 6 months before he can file a subsequent claim.

And if he has had no subsequent employment, he is not going to have enough earnings to establish a claim. So, in other words, for many people, this is a one-time opportunity when they can draw unemployment. So, there is no financial backup when that claim is exhausted.

Senator SARBANES. You are touching on some of the larger deficiencies in the program which, as I indicated earlier, I think also need to be addressed.

Did you want to add anything else, Ms. Meiklejohn?

Ms. MEIKLEJOHN. I just want to say that we've been very supportive of the effort to get the $200 million. But, as a response to this present emergency, we strongly support the designation of that appropriation as an emergency.

Senator SARBANES. We have to make it more automatic somehow so, when the caseload starts going up——

Ms. MEIKLEJOHN. Absolutely.

Senator SARBANES [continuing]. The response can go up almost instantaneously, and you don't start falling further and further behind.

Now, even if you get the extra people, then you have to dig out from under. You have to continue to handle what may be an increase in caseload. We have 6.2 percent unemployment. The President's budget projects an unemployment rate nationally for the year, even assuming they are correct—because they're anticipating a short and shallow recession—they project an unemployment rate for the year of 6.7 percent.

If it is 6.2 percent now and they are projecting a rate for the year of 6.7 percent for the whole year, an average, it shows you what it's going to have to go to to come out to an average of 6.7 percent. The rate is going to obviously go well above 6.7 percent at some point.

You are facing, in my view, even on that scenario of a short and shallow recession, which I don't subscribe to, increasing caseloads certainly over the next 6 months, until summer, when the administration is talking about a recovery.

Ms. MEIKLEJOHN. We had supported the inclusion in the supplemental of a contingency reserve fund that would address that very issue. Unfortunately, we understand the House Appropriations Committee did not include that as part of the supplemental appropriation that was reported out of committee yesterday.

We're still hopeful that we could persuade the Senate Appropriations Committee to act favorably on that.

For the longer term, Congressmen Levin and Pease introduced a bill last week to provide for an entitlement spending for administrative funds, which AFSCME strongly supports. And we're hopeful that it will receive consideration either as part of a larger reform bill in the House Ways and Means Committee or, depending on how the political process works, as a freestanding proposal.

And we hope that there will be sponsors of a similar proposal in the Senate.

Senator SARBANES. Very good.

Thank you all very much. You have been a very helpful panel. We appreciate the testimony. We understand the pressures you are working under, and I want to commend you for standing up to them as best you can. I hope you will pass that sentiment on to your coworkers. We thank you very much for coming today.

Mr. NUGEN. Thank you, Mr. Chairman.

Ms. MEIKLEJOHN. Thank you.

Ms. MITCHELL. Thank you.

Senator SARBANES. The hearing is adjourned.

[Whereupon, at 12:40 p.m., the committee adjourned, subject to the call of the Chair.]

THE 1991 ECONOMIC REPORT OF THE PRESIDENT

FRIDAY, MARCH 8, 1991

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 10:30 a.m., in room SD-628, Dirksen Senate Office Building, Hon. Paul S. Sarbanes (chairman of the committee) presiding.

Present: Senators Sarbanes and Symms; and Representatives Hamilton and Armey.

Also present: William Buechner, professional staff member.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

Senator SARBANES. The Joint Economic Committee's second hearing this morning will focus on the recession and the economic outlook and the appropriate policies for the year ahead. This hearing is part of the committee's examination and evaluation of the 1991 Economic Report of the President presented under the Employment Act of 1946.

Our concerns now focus on the recession, how deep it might be, how long it might last. There is a view that the recession will be short and shallow, and that has now been given some impetus by the end of the conflict in the Persian Gulf, which has been perceived as casting considerable doubt on the future and, thereby, undermining confidence.

The administration in its report predicted that the economy would begin to rebound sometime in the second quarter of this year. There are others who look at various factors present on the economic scene, very large accumulation of individual corporate debt, the credit crunch issue which appears to be restricting the availability of credit to households and businesses, and the possibility that a downturn abroad could impact on economic developments in this country, particularly as it impacts on our export sector and, of course, the conduct of recent monetary policy.

For these and other issues in the outlook this morning, we have a panel of distinguished economic forecasters. Roger Brinner, group vice president and executive research director of DRI/McGraw-Hill; David Jones, executive vice president and chief economist at Aubrey Langston & Co.; Geoffrey Moore, director of the Center for International Business Cycle, Research, Graduate School of Business, Columbia University; and Richard Rahn, vice president and chief economist of the U.S. Chamber of Commerce.

Gentlemen, we will include your prepared statements in the record.

I think I will just proceed right across the panel and ask you if you could touch on your main points for the committee and then we will have an opportunity to put questions to the full panel.

Mr. Brinner, please proceed.

STATEMENT OF ROGER E. BRINNER, GROUP VICE PRESIDENT AND EXECUTIVE RESEARCH DIRECTOR, DRI/McGRAW-HILL

Mr. BRINNER. Senator Sarbanes and members of the committee, I want to thank you for this opportunity to share my assessment of economic prospects and policy options with the committee.

The quick, decisive allied victory over Iraq should end the recession this spring. It should give Americans the confidence to resume normal spending patterns because they need not fear the personal loss of life of their neighbors and relatives, the high energy costs, or the financial turmoil that has threatened them since last August.

Our Nation still has economic problems, but none mandate a continued slump. Our economy will be strong and durable if the President and Congress can provide an economic vision as clear as the recent military mandate.

I have summarized in my remarks the forces that thrust us into this recession and the events that need to take place for us to come out of it. A soft landing, in my view, would have been achieved, except for the invasion of Kuwait. I believe that the Federal Reserve would have successfully steered us to a situation where growth slowed but was still positive.

In light of this morning's report, I should note that what I mean is that unemployment would have risen, but only to about 6 percent rather than the 7 percent I now anticipate. Construction and banking would have been in recession, but would not be bordering on depression in certain regions. Exports would have flowed even more freely into expanding European and Asian markets. And expecting only a brief slowdown, businesses would have maintained equipment orders. The invasion did halt this progress and create a situation where a more pronounced recession took place.

I believe the Federal Reserve could and should help more than it has. In his State of the Union Address, President Bush declared interest rates should be lower now. Coincidentally or not, Chairman Greenspan trimmed the discount rate half a percentage point. But this is clearly not enough.

I would argue that we need another full percentage-point cut as soon as possible. Stated another way, the Fed should buy catastrophe insurance for the economy. It needs to lessen the risk tied to a scared consumer, a stressed banking system, and a depressed construction industry. If the economy is sicker than I assume and the Fed does not act, the business and employment losses will be severe.

If the economy is basically healthy and rebounds strongly with greater Fed help, the only cost of buying this policy, this catastrophe insurance for the economy, would be higher inflation for the next few years. This insurance is a good buy.

I also would argue that Congress and the President can help the economy through positive legislation on spending and taxation. The budget summit and its legislative aftermath did not come close to finishing the job. The deficit is too large, it's not on a convincing downtrend. There has been no leadership to fund investment, education, applied science, manufacturing technology, environmental improvement, or our public infrastructure by cutting lower priority programs or, if necessary, raising taxes.

Let me turn now to the immediate cyclical setting. I would argue that estimates of GNP growth during the fourth quarter of 1990 are much better than expected or feared. Consumers cut back in line with historical patterns. They avoided the panic, debt-driven retreat that some predicted. The inventory correction may have arrived early and thus has been relatively mild during this cycle, and certain business markets at home and abroad remain robust.

Almost exactly as we expected, real consumer purchases fell at a 3-percent pace from the third quarter, with auto consumption plunging at an 18-percent rate. The drop in auto-truck output actually exceeded the entire fourth-quarter decline in national GNP.

Automaker activism carries a positive message as the winter ends. The auto industry layoffs have already occurred. Production is below the weak level of sales that we see. Further corrective actions will neither sap the economy nor feed the dreary headlines that Congressman Hamilton was mentioning earlier.

Equally important, the union contracts calling for almost all of these autoworkers' pay to be covered by management imply that the economy has not lost the spending power of the workers, even though the workers have temporarily lost their jobs.

Another positive note is that export volumes in the fourth quarter rose at a 7-percent rate, capping a full year gain of 6 percent. It doesn't match the 11 percent gain in 1989, but the expansion of exports matched with a more slowly growing import burden meant that the real trade gap shrank by $18 billion last year, almost half of the overall real GNP gain.

In the closing months of 1990, the dollar fell sharply against currencies of other major industrial nations and this reinforced a very competitive price-cost position for domestic producers. The recessions in the English-speaking nations and the shift to slower but still positive growth elsewhere will not throw the world economy into reverse.

U.S. producers are grabbing an increasingly larger slice of the still expanding global trade pie. Financial markets have yet to recognize the magnitude of this trade improvement. When they do, the dollar will abruptly reverse its slide and, in fact, we may have seen the beginning of that in the last week.

This momentum will be reinforced by an expected rise in U.S. interest rates relative to those abroad. The best news of the winter for most homeowners and businesses has been the abrupt collapse of oil prices. The gross direct benefit to consumer purchasing power from oil at $17 rather than $30 per barrel is roughly eight-tenths percent of total household income. Putting it another way, this is like a $33 billion personal tax cut, and it is worth $350 per household.

Let me offer some advice on monetary policy in a little greater detail. I have listened to Chairman Greenspan testify that he feared a major recession if war were to be prolonged over the past several months. He may have been prescribing or working for strong medicine behind the scenes, but he has only delivered small doses.

This tightfistedness would be tough on the construction industry in normal times. Coming on top of the lending crackdown by regulators, it's deadly.

We estimate that the de facto rationing of credit has cut new-home construction by 350,000 units per year since mid-1989. That's a quarter of the market. The crunch is now showing up in nonresidential construction. Until recently, the slump here could be fully explained by the high vacancy rates produced by the exaggerated tax incentives of 1983–86. But the failure of new projects to find development funding has now shown up in very strong, harsh commercial construction shortfalls.

I would add that the U.S. central bank is not alone in its policy conservatism. The German central bank announced a half-point increase in its key short-term interest rate just as the Fed was cutting the discount rate. And last year, the Bank of Japan contributed massively to the collapse of the Japanese stock market by its excessive tightening of credit.

Perhaps these bankers don't believe they can reverse the tides, or maybe they're just waiting for the last moment, as in 1982. But the time to cut rates is now. Lower interest rates will be a powerful tool. The direct effect on business or consumer borrowing may be muted or delayed as in the past, but a fundamental new application will be invaluable.

In a highly leveraged economy, lower interest rates have the power to instantly improve asset values and the portfolios of citizens, banks, and the Federal Government, via the Resolution Trust Corporation. This is no time to pursue deflation. Moderate inflation is the proper goal, and that has already been achieved.

I expect consumer prices to rise at a 3.5-percent pace for the next 2 years, during a moderate recovery in which the National unemployment rate settles back to 6 percent.

With regard to today's employment report, fortunately for my forecasting accuracy but unfortunately for the Nation, I did expect unemployment to average 6.5 percent for the first quarter, and that did mean 6.5 percent for February and 6.75 percent for March. The worst will be experienced in late spring or early summer, when the unemployment rate will be near 7 percent.

A study using the DRI model of the economy sizes up the contribution the Fed could make by cutting the Federal funds rate 1 percentage point below the path we assume in our baseline. Housing starts would rise 7 percent within a year, helping to boost national employment by 300,000 workers. And the short-term boost to overall inflation would be a trivial one-tenth percent, even if this stimulus were sustained for 3 years. But tighter labor and product markets would cause inflation to increase by only four-tenths percentage point, to 3.8 versus 3.4 percent.

With regards to advice on taxation and expenditures, let me argue that Congress and the President can do even more than the

Federal Reserve to improve home prices, because you can massively move bond and mortgage rates. In independent testimony in the mid-1980's, Paul Volcker offered the same rule of thumb: Cut the deficit by $50 billion and inflation-adjusted bond rates will be a percentage point lower.

Restated to the scale of current global income, the new deal is each $60 billion in permanent deficit reduction will buy a percentage-point cut in bond rates.

Let me show you the simple back-of-the-envelope calculations that would support that, even though I used a fancier method to count that. Until the 1980's, 10-year Treasury bonds averaged only 2 percent above expected inflation. Today, that margin is 4 percent in the midst of recession, and it will return to 5 percent by yearend unless you act. This exaggerated premium reflects the scarcity of savings versus borrowing requirements.

The financial markets expect Federal budget deficits of at least $175–$225 billion per year, even after the temporary burdens of the recession, the Persian Gulf war operations, and the thrift bailouts are passed. If you have the vision to cut another $125–$150 billion in programs over the next 5 years, or to impose higher taxes, every homeowner, realtor, construction worker, and bank employee will vote for you. Can you imagine the boom in housing construction, the recovery in home prices you could create by pushing home mortgage rates to 7 percent? And the recovery wouldn't stop here.

Can you appreciate the renaissance in American manufacturing and productivity that could be financed with corporate bonds and the prime rate at 7 percent?

Finally, can you envision the new national programs you could legislate in the second half of the 1990's, funded by revenues from a more productive economy on the one hand, and interest savings and reduced national debt at lower rates on the other?

In past testimony I have stated sympathetically to you that it takes courage for an elected official to cut Federal programs. But I think this is an excessively negative description. In truth, perhaps it doesn't take courage to cut the deficit by these proportions. It takes vision and salesmanship.

If the public only hears what it is losing as programs are cut and taxes are raised, you won't be reelected. But if you clearly define and aggressively sell the public and private benefits, the majority will overwhelm the narrow interest groups behind the weak, low-priority programs.

Deficit reduction need not mean sacrifice even for this year's voters. It will certainly yield blessings for future generations. The majority wins now and in the years ahead—and the majority elects you.

Thank you.

[The prepared statement of Mr. Brinner follows:]

PREPARED STATEMENT OF ROGER E. BRINNER

Positive U.S. Economic Prospects and Policy Options

Thank you for the opportunity to share my assessment of economic prospects and policy options with the Joint Economic Committee. The quick, decisive allied victory over Iraq should end the recession this spring. It will no doubt give Americans the confidence to resume normal spending patterns: they need not fear personal losses, high energy costs, nor financial turmoil as they have since August.

Our nation still has economic problems, but none mandating a continued slump. Our recovery will be strong and durable if the President and Congress provide an economic vision as clear as the recent military mandate.

Four broad forces combined to thrust us into recession:

- The normal ebbing of the economy after a long recovery, with particular weakness in investment and consumer durables spending;
- The "credit crunch" imposed on debt-laden businesses, beginning in 1987 for the Federal Reserve and 1988 for regulators like the Controller of the Currency;
- The abrupt end of the cold war, cutting Pentagon orders, and sending German borrowing needs and global bond rates soaring in early 1990; and
- The invasion of Kuwait, propelling an inflation embolism through economic arteries, halting consumers from buying cars and other durables.

The "soft landing" probably would have been achieved except for the critical war shock. Unemployment would have risen about one percentage point from its 5.0–5.2% trough rather than the two points now predicted. Construction and banking would have been in recession but not bordering on depression. Rising exports would have flowed into expanding European and Asian markets. Expecting a brief slump and seeing international demand, businesses would have maintained equipment orders despite domestic weakness.

Saddam Hussein's invasion either broke the camel's back or only temporarily stopped his progress. If the latter, relief from the war may be sufficient to catalyze a moderate recov-

ery. Consumer and business psychology, driven by a conflicting mix fact and fable, will provide the answer over the next six months.

The Fed Can Provide Insurance

The Federal Reserve could and should help more than it has. In his State of the Union address, President Bush declared "interest rates should be lower, now." Coincidentally or not, Federal Reserve Chairman Greenspan trimmed the discount rate one-half percentage point before the week's end. This is clearly not enough.

The federal funds and short-term Treasury bill rates should be cut another full percentage point immediately. This will enhance the Fed's regulatory adjustments to boost banks' profitability and appetite for lending. The inflation-bashing ambitions of the Reserve Board's hawks must be stifled until this economy is clearly out of recession.

Stated another way: "The Fed should buy catastrophic economic insurance." It needs to lessen the risks tied to a scared consumer, a stressed banking system, and a depressed construction industry. If the economy is sicker than assumed and the Fed does not act, the business and employment losses will be severe. If the economy is basically healthy and rebounds strongly with greater Fed help this summer, the only cost of generous policy would be trivially higher inflation for the next few years. In other words, this insurance is a good buy.

We Need Economic Leadership

Congress and the President can also help the economy through positive legislation on spending and taxation. The budget summit and its legislative aftermath did not come close to finishing the job. The deficit is too large and is not on a convincing downtrend. There has been no leadership to fund necessary investments in America—education, applied science, manufacturing technology, environmental improvement, or public infrastructure—by cutting lower priority programs or raising taxes.

Through his management of Desert Storm and Desert Shield, the President showed that the public will make sacrifices for a well-defined goal and give the leader strong popular

support. Why can't one or both political parties propose a new education–enrichment program while announcing the sacrifice of Amtrak subsidies, tobacco crop supports, government employee pensions, and other specific civilian and defense programs? Why doesn't a Congressional leader propose a $1 per gallon gasoline tax (large enough to contribute to U.S. energy security and reduced global warming) combined with a reduction in payroll and capital gains taxes? I'm one voter who will respond with enthusiasm to an elected official willing to pull us out of our vision vacuum.

The Immediate Cyclical Setting

On many counts, estimates of GNP growth during the fourth quarter of 1990 are much better than expected or feared. Consumers cut back in line with historical patterns, avoiding the panicked, debt–driven retreat some predicted; the inventory correction may have arrived early and thus be relatively mild during this cycle; and certain business markets both at home and abroad were robust.

Almost exactly as expected by DRI, real consumer purchases fell at a 3% annual pace from the third quarter, with auto–related consumption plunging at an 18% rate (i.e., down 4.55% from the third quarter). Manufacturers slashed auto and truck production 15%, and DRI predicts a further cut in the current quarter to bring showroom stocks down to an exceptionally low level relative to normal sales. The drop in auto and truck output actually exceeded the entire fourth–quarter decline in GNP.

Automaker activism carries a positive message as the winter ends: the layoffs have already occurred, hence further corrective actions will neither sap the economy nor feed dreary headlines to worried consumers. Equally important, the union contracts calling for almost all of laid–off workers' pay to be covered by management imply the economy has not lost the spending power although the workers have lost their jobs. Profits will suffer, but capital outlays will be cut by less than what would have bled from consumer spending because of these lost wages.

Export volumes rose at an 7% rate, capping a full year gain of 6%; while this doesn't match the 11% advance in 1989, imports have followed suit with 1990 growth of 3% fall-

ing short of the 6% gain for 1989. Thus, the real trade gap shrank by $18 billion last year, making a major contribution to the overall real GNP gain of $38 billion.

In the closing months of 1990, the dollar fell sharply against the currencies of other major industrial nations. This reinforced a very competitive price/cost position for domestic producers. The recessions in the English-speaking nations will not throw the world economy into reverse, and U.S. producers are grabbing an increasingly larger slice of the expanding global trade pie.

Financial markets have yet to recognize the magnitude of the likely trade improvement. When they do, the dollar will abruptly reverse its slide. This momentum will be reinforced by an expected rise in U.S. interest rates relative to German and Japanese rates in the last half of 1991; U.S. interest rates will likely rise with the recovery while foreign rates drift lower as exaggerated inflation fears abate. By year-end, U.S. trade and current account deficits should be only half their late 1990 levels.

The best news of the winter for most homes and businesses has been the abrupt collapse of oil prices. Seeing the allies' air superiority and hearing President Bush's call for sales from the Strategic Petroleum Reserve, traders quickly concluded that oil prices were a one-way bet: the price per barrel fell $10 in one day.

DRI projects an average U.S. refiner price for foreign oil of only $17 per barrel this year and $18-19 in 1992. To put this in perspective, refiners paid $20 last winter (1990), $16 last spring, and then witnessed a jump to a $30 average in October-December. The gross, direct benefit to consumer purchasing power from oil at $17 rather than $30 per barrel equals roughly 0.8% of total household income. Put another way, this is like a $33 billion personal tax cut and is worth $350 per household.

Monetary Policy Advice

Chairman Greenspan testified he feared a major recession if the war were to be prolonged. He may have been prescribing strong medicine behind the scenes, but he has only delivered small doses. Bank reserve requirements were cut, providing a short-term

boon to bank profits; eventually these profits will be passed on in higher yields for depositors and lower charges for borrowers. There are discussions of less draconian assessments of loss reserves for risky loans still being serviced.

Meanwhile, in coping with bank problems and regulatory changes, the federal funds rate was stalled at a 7.0% average in January, while the presumed policy target was 6.5%. Finally, the Fed announced a long overdue cut in the discount rate, but it was only a half point. The federal funds rate averaged just over 6.25% in February, and no promises of further ease have been made.

This tightfistedness would be tough on the construction industry in normal times. Coming on top of the lending crackdown by federal regulators, it is deadly. DRI estimates that this de facto rationing of credit has cut new home construction by 350,000 units per year since mid-1989. The basics of household formation—vacancies and affordability—imply a latent appetite of 1.4-1.5 million units of new construction. Instead, analysts hope that housing can avoid falling below its current trough of 1.0 million.

Moreover, the crunch is now showing up in nonresidential construction. Until recently, the slump could be fully explained by the high vacancy rates produced by the tax incentive-driven boom of 1983-1986; but the failure of new projects to find development funding has now shown up in exaggerated commercial construction shortfalls.

The U.S. central bank is not alone in its policy conservatism. The German central bank announced a half-point increase in their key short-term interest rate just as the Fed was reluctantly cutting the discount rate. Last year, the Bank of Japan contributed massively to the collapse of the Japanese stock market by its excessive tightening of credit.

In the central banks' defense, the global economy has deteriorated more rapidly than expected as consumers have reacted gloomily to the war. A soft landing may have been unpopular in the U.S. just as downturns have been painful in Canada, Australia, and the U.K., but these were necessary measures to cut inflation. The problem has now deteriorated into recession, and policy must be adjusted.

Perhaps these bankers don't believe they can reverse the tides, or perhaps they are waiting for the last possible moment, as in 1982. The time is now. Lower interest rates will

be a powerful tool if used globally. The direct effect on consumer or business borrowing may be muted or delayed, but a fundamental new application will be invaluable: in a highly leveraged economy, lower interest rates have the power to instantly improve asset values.

Central bankers understood this in the wake of the 1987 stock market crash; now they need to recognize its power to bolster home prices, loan valuations, and thus the portfolios of citizens, banks, and the federal government (via the Resolution Trust Corporation and the Federal Deposit Insurance Corporation). This is no time to pursue deflation; moderate inflation is the proper goal and that has already been achieved. I expect consumer prices to rise at a 3.5% pace for the next two years, during a moderate recovery in which the national unemployment rate settles back to 6%.

The Effect of Monetary Policy

A study using the DRI Model of the U.S. economy sizes up the contribution the Fed would make by cutting the federal funds rate one percentage point below the path assumed in the DRI baseline. By the beginning of 1992, mortgage rates would be 0.8 percentage point lower and home prices 2.0% higher; within three years, the home price gain would be about 3.0%. Housing starts would rise 7.0% within a year, helping to boost national employment by 300,000 workers. The short-term boost to overall inflation would be a trivial 0.1%.

Even if the stimulus were sustained for a full three years, tighter labor and product markets would cause inflation to increase by only 0.4 percentage point (to 3.8% for consumer prices in late 1993, versus 3.4% in the baseline). The Fed could certainly reverse course in 1992 if this rise is judged unacceptable, or if the economy is more responsive. The rate cut is cheap economic insurance against the business risks faced today by households and firms.

The proposed one point cut in the funds rate is sufficient because the truth about housing markets is better than the gossip dominating news articles or personal conversations. The fact is that the national median price of an existing single-family home rose 2.5% in 1990

to $95,240; this compares with steady growth of 4.0–6.0% each year from 1985 to 1989. Even new home prices rose 2.0% (to $122,870) last year, on top of gains averaging 9.0% over the prior four years. These data are not significantly distorted by changes in the size or quality of homes; adjusting for such changes, prices were flat throughout 1990 yet still 2.0% above the 1989 average.

There are considerable regional variations, but nothing matches the dismal impression left by anecdotal evidence. Existing home prices in the Northeast dipped 2.5% in 1990, reversing the 1989 gain. Even in the Boston metropolitan area where auctions fill pages in the classified sections, the average sales price has drifted back only to the 1987 level of $176,000 after topping out two years ago at $181,000. There is still plenty of equity held by the 1985 buyers at $131,000, not to mention the 1982 buyers at $80,000, unless they took out excessive homeowner equity loans for luxury cars or college tuitions.

Fiscal Policy Advice

Congress and the President can do even more than the Federal Reserve to improve home prices because you can massively move bond and mortgage rates. Your required minimum contribution must be honest, complete adherence to the spending restrictions of the fall budget compromise. Even greater fiscal restraint would be much preferred.

In independent testimony in the mid–1980s, Paul Volcker and I offered you the same rule of thumb during budget debates: cut the deficit by $50 billion and inflation–adjusted bond rates will be a percentage point lower. Restated to the scale of current global income, the new deal is that each $60 billion of permanent deficit reduction will buy a percentage point cut in bond rates.

Until the 1980s, ten–year Treasury bonds averaged only 2% above expected inflation; today that margin is 4% in the midst of recession and it will return to 5% by year–end unless you act. This exaggerated premium reflects the scarcity of savings versus borrowing requirements: the markets expect Federal budget deficits of at least $175–$225 billion dollars per year even after the temporary burdens of the recession, the Desert operations, and the thrift bailouts are past.

The Effect of Fiscal Policy

If you have the vision to cut another $125–150 billion in programs over the next five years or to impose higher taxes, every homeowner, realtor, construction worker and bank employee will vote for you. Can you imagine the boom in housing construction and the recovery in home prices you would create by pushing mortgage rates to 7%? The recovery wouldn't stop there. Can you appreciate the renaissance in American manufacturing that could be financed with corporate bonds and the prime rate at 7%? Finally, can you envision the new national programs you could legislate in the second half of the 1990s? These would be funded by revenues from a more productive economy on the one hand and interest savings on reduced national debt at lower rates on the other.

It doesn't take courage to cut the deficit by these proportions; it takes vision and salesmanship. If the public only hears what it is losing as programs are cut or taxes are raised, you won't be re-elected. But if you clearly define and aggressively sell the private and public benefits, the majority will overwhelm the narrow interest groups behind weak programs. Deficit reduction need not mean sacrifice for this year's voters. It will certainly yield blessings for future generations. The majority wins now and it wins in the years ahead, and the majority elects you.

Cyclical Forces Shaping the Economy

Four broad forces combined to thrust us into recession:

- The normal ebbing of the economy after a long recovery, with particular weakness in investment and consumer durables spending;
- The "credit crunch" imposed on a debt-laden business community, dating back to 1987 for the Federal Reserve and to 1988 for regulators like the Controller of the Currency;
- The abrupt end of the cold war, cutting Pentagon orders, and sending German borrowing needs and global bond rates soaring at the beginning of 1990; and
- The invasion of Kuwait, propelling a dangerous inflation bubble through international economic arteries and intimidating consumers from buying cars and other durables.

The timing and strength of recovery are keyed to:

- Federal Reserve activism,
- the war's dimensions,
- consumer resilience, and
- lender enthusiasm.

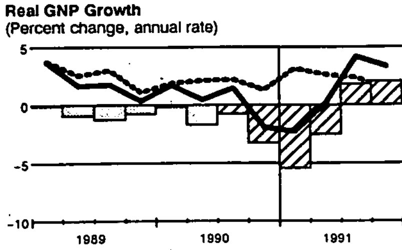
DRI/McGraw-Hill Forecast for the U.S. Economy: CONTROL0391

	1990			1991				Years				
	2	3	4	1	2	3	4	1989	1990	1991	1992	1993
Composition of Real GNP (Annual rate of change)												
Gross National Product	0.4	1.4	-2.0	-2.3	0.1	4.1	3.3	2.5	0.9	0.0	3.3	3.0
Final Sales	-0.7	1.9	0.6	-2.2	1.3	2.6	1.8	2.5	1.6	0.4	2.3	3.0
Excluding CCC Transactions	-1.5	1.9	0.9	-2.2	1.3	2.6	1.8	2.2	1.5	0.4	2.3	3.0
Total Consumption	0.2	2.7	-2.9	-1.9	0.9	2.1	2.3	1.9	1.0	-0.1	2.3	2.6
Nonresidential Fixed Investment	-4.7	8.9	-1.3	-10.2	-4.0	-0.5	6.5	3.9	1.8	-2.6	5.3	8.2
Equipment	-3.3	10.1	4.2	-11.8	-3.1	1.9	8.5	5.2	2.7	-1.2	6.9	8.1
Structures	-9.1	5.1	-17.8	-4.6	-6.7	-8.2	-0.1	0.0	-1.2	-7.0	-0.3	8.6
Residential Fixed Investment	-11.2	-19.8	-18.5	-18.9	3.3	16.1	13.5	-4.0	-5.3	-8.9	10.1	6.9
Exports	-5.0	6.9	7.1	-5.6	1.8	9.3	9.2	11.0	6.2	2.4	8.8	7.3
Imports	0.7	7.6	-9.7	-2.4	-2.5	4.2	7.6	6.0	2.9	-1.1	7.1	7.3
Federal Government	16.4	0.1	2.8	24.0	3.0	-3.3	-14.6	2.1	2.5	6.2	-7.8	-3.5
Excluding CCC Transactions	5.8	-0.1	6.3	24.2	3.0	-3.8	-14.9	-1.2	1.5	6.1	-8.1	-3.6
State and Local Governments	-0.6	2.0	5.3	-2.4	1.5	2.5	2.2	2.4	3.0	1.3	2.0	2.5
Billions of Dollars												
Real GNP (1982 $)	4155.1	4170.0	4149.5	4125.5	4126.5	4168.7	4202.7	4117.7	4156.3	4155.8	4291.3	4422.0
Gross National Product	5443.3	5514.6	5518.9	5538.3	5573.0	5669.0	5753.7	5200.8	5463.1	5633.5	5990.0	6352.1
Prices and Wages (Annual rate of change)												
GNP Price Deflator (Implicit)	4.7	3.7	2.8	3.5	2.4	2.8	2.7	4.1	4.1	3.1	3.0	2.9
GNP Price Index (Fixed-Weight)	3.9	4.2	4.7	3.4	2.2	3.3	3.2	4.5	4.6	3.5	3.5	3.6
CPI—All Urban Consumers	3.9	6.9	7.0	3.2	0.8	3.5	3.2	4.8	5.4	4.0	3.3	3.4
Producer Price Index—Finished Goods	0.2	6.6	10.6	-3.0	-3.5	1.1	3.3	5.2	4.9	1.6	2.8	3.9
Employment Cost Index - Total Comp	5.1	3.9	3.0	5.2	4.1	3.6	3.5	4.6	5.0	4.1	4.1	3.9
Output per Hour	0.0	0.7	0.0	0.1	1.7	3.7	1.9	-0.7	-0.8	1.0	1.5	0.9
Production and Other Key Measures												
Industrial Production (1987=1.000)	1.094	1.105	1.084	1.061	1.061	1.078	1.096	1.081	1.091	1.074	1.129	1.165
Annual Rate of Change	4.3	4.0	-7.5	-8.1	-0.2	6.6	7.0	2.6	1.0	-1.6	5.1	3.2
Nonfarm Inven Accum (Billion 1982 $)	11.6	4.7	-24.0	-25.0	-37.4	-21.6	-6.2	18.7	-4.0	-22.5	16.6	20.4
Housing Starts (Mil units)	1.204	1.131	1.044	0.962	1.076	1.149	1.193	1.381	1.203	1.095	1.264	1.367
Retail Unit Car Sales (Mil units)	9.5	9.7	9.0	8.4	8.6	8.8	9.1	9.9	9.5	8.7	9.3	9.5
Civilian Unemployment Rate (%)	5.3	5.6	5.9	6.5	6.9	6.9	6.9	5.3	5.5	6.8	6.4	5.9
Nonfarm Empl. (Estab. survey, % change)	2.3	0.4	-1.6	-2.0	-0.7	0.4	1.0	2.7	1.8	-0.6	1.2	2.0
Fed. Budget Surplus (Unified, FY, bil. $)	-11.8	-57.8	-86.3	-98.0	-24.5	-90.6	-95.6	-153.3	-220.4	-299.3	-297.1	-230.2
Foreign Trade												
Current Account Balance (Billion $)	-90.4	-102.5	-98.2	-24.6	-25.7	-29.5	-64.5	-110.0	-95.0	-36.1	-63.3	-84.9
Merch. Trade Balance (c.v.b., bil. $)	-81.7	-112.7	-104.6	-87.2	-64.3	-57.6	-58.2	-109.4	-100.4	-66.8	-68.6	-93.9
Foreign Crude Oil ($ per barrel)	15.88	23.51	29.88	19.30	15.73	16.08	17.22	18.06	22.26	17.08	18.58	21.25
U.S. Dollar Exchange Rate (% change)	0.2	-18.5	-15.7	1.7	3.5	8.0	2.4	3.7	-5.2	-3.6	1.3	-1.1
Foreign GDP (% change)	1.8	2.1	0.8	2.1	2.6	3.1	3.7	3.8	3.1	2.1	3.8	4.0
Financial Markets												
Money Supply (M2, billion $)	3284.4	3308.7	3327.2	3353.6	3404.4	3464.5	3521.9	3203.2	3327.2	3521.9	3698.0	3876.8
Percent Change vs Year Ago (Q4/Q4)	6.2	5.2	3.9	3.1	3.7	4.7	5.9	4.7	3.9	5.9	5.0	4.8
AA Corp Utility Rate (%)	9.75	9.75	9.60	9.23	9.49	9.76	9.99	9.55	9.66	9.62	10.33	10.21
Thirty-Year Treasury Bond Rate (%)	8.65	8.80	8.55	8.15	8.23	8.56	8.76	8.45	8.61	8.43	9.15	8.92
Treasury Bill Rate (%)	7.75	7.48	6.99	6.02	5.74	6.00	6.40	8.11	7.49	6.04	7.19	6.99
Federal Funds Rate (%)	8.24	8.16	7.74	6.40	6.03	6.37	6.84	9.22	8.10	6.41	7.85	7.73
Prime Rate (%)	10.00	10.00	10.00	9.18	8.60	8.50	8.82	10.87	10.01	8.78	9.77	9.55
S&P Index of 500 Common Stocks	349.61	335.40	317.05	352.40	366.06	375.53	376.78	322.84	334.59	367.69	370.69	381.69
Incomes												
Personal Income (Billion $)	4622.2	4678.5	4716.7	4741.4	4784.7	4846.3	4912.9	4384.3	4645.1	4821.3	5114.4	5440.4
Real Disposable Income (% change)	0.3	-0.7	-3.7	-0.4	2.8	1.4	1.9	2.4	0.8	-0.1	2.4	2.7
Saving Rate (%)	5.0	4.2	4.0	4.3	4.8	4.7	4.6	4.6	4.5	4.6	4.8	5.0
Profits After Tax (Billion $)	166.1	179.4	175.8	159.3	155.6	175.8	194.3	172.6	172.1	171.3	201.1	196.1
Post-Tax Corp Cash Flow (Billion $)	533.0	527.1	521.8	529.1	526.6	534.2	544.6	522.9	526.4	533.6	566.2	593.4
Percent Change vs Year Ago	2.2	-0.6	-0.4	1.0	-1.2	1.3	4.4	-0.1	0.7	1.4	6.1	4.8

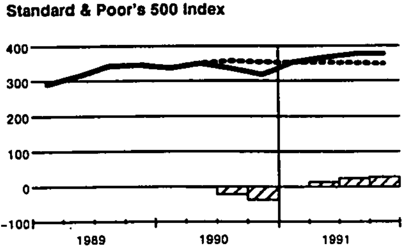
The Economy, Before and After...
(...the war shock and government data revisions)

CONTROL0391 ● ● ● CONTROL0790 Historical Data Revisions Forecast Update

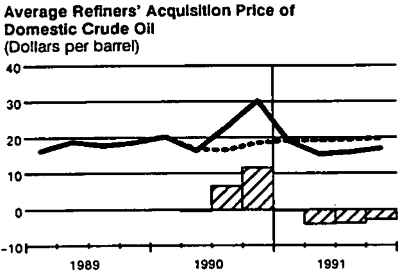
Real GNP Growth
(Percent change, annual rate)



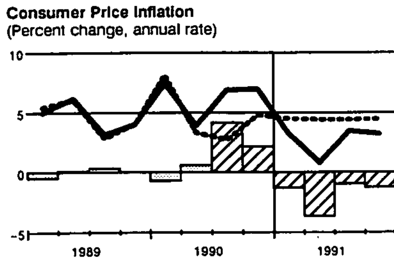
Standard & Poor's 500 Index



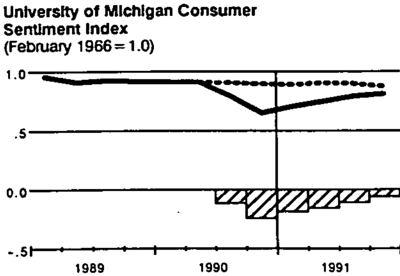
Average Refiners' Acquisition Price of Domestic Crude Oil
(Dollars per barrel)



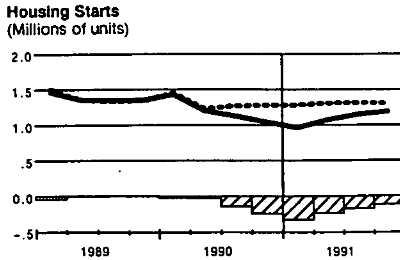
Consumer Price Inflation
(Percent change, annual rate)



University of Michigan Consumer Sentiment Index
(February 1966 = 1.0)



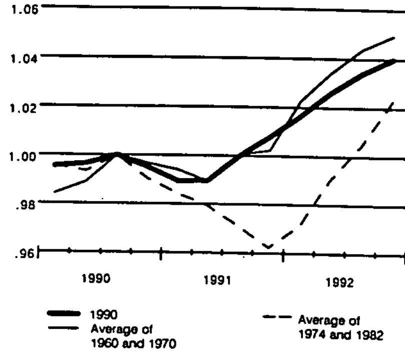
Housing Starts
(Millions of units)



The 1990 Recession Has Gross Similarities to Those in 1960 and 1970, But All Cycles Are Unique

Cyclical Turning Points

Peaks	Troughs
1990:3	1991:1
1960:1	1960:4
1969:3	1970:2
1973:4	1975:1
1981:3	1982:3

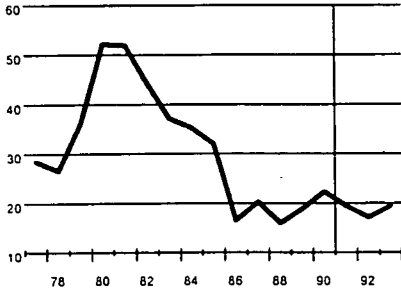


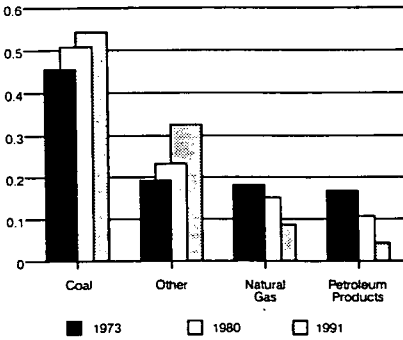
This Recession Is Concentrated in Consumer Durables
(Percent change peak to trough)

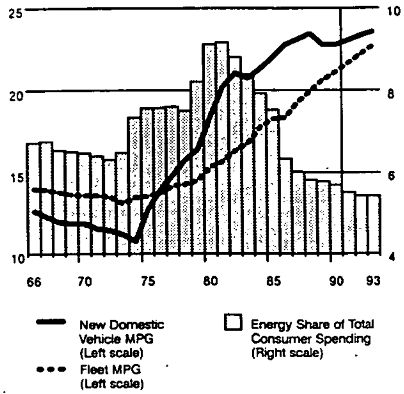
Recession of:	History								CONTROL
	1949	1954	1958	1960	1970	1975	1980	1982	1991
Gross National Product	-2.0	-3.0	-3.5	-1.0	-1.1	-4.3	-2.4	-3.4	-1.1
Consumption	1.8	1.3	-0.7	1.1	1.9	-0.6	-2.0	1.0	-1.2
Durable Goods	13.2	0.4	-5.3	-0.5	-1.2	-9.5	-11.0	-1.5	-6.5
Nondurable Goods	1.2	-0.1	-1.4	0.6	1.9	-1.8	-0.9	1.1	-1.7
Services	0.1	3.2	1.2	1.9	2.7	2.9	-0.6	1.6	0.8
Nonresidential Fixed Investment	-16.8	-1.6	-8.4	-2.2	-3.5	-12.3	-6.2	-11.1	-3.0
Equipment	-21.1	-6.8	-13.7	-7.4	-3.2	-12.0	-7.6	-12.4	-2.1
Structures	-10.3	4.7	-2.1	3.7	-3.9	-12.8	-3.8	-9.0	-5.9
Residential Fixed Investment	11.3	2.7	-2.7	-10.9	-12.4	-29.9	-19.9	-18.2	-9.8
Federal Government	-1.2	-17.3	-1.6	2.9	-8.6	1.1	3.4	4.2	6.3
State and Local Governments	15.1	8.8	5.1	4.9	1.6	3.2	-0.3	0.3	0.7
Exports	-9.5	6.8	-13.0	5.8	6.4	2.3	-1.5	-8.1	0.3
Imports	-1.7	-1.4	3.6	-6.1	1.0	-12.3	-5.9	-0.3	-3.1
Nonfarm Inventory Accumulation (a)	-25.7	-21.2	-46.4	-54.7	-28.5	-61.2	0.8	-43.3	-59.4
Industrial Production	-6.3	-8.1	-9.7	-6.1	-3.5	-12.8	-3.8	-6.1	-4.0
Output per Hour	0.2	0.8	-0.2	-0.3	0.1	-1.7	-0.8	-1.4	0.0
Payroll Employment	-4.2	-2.9	-2.6	-0.9	0.5	-1.3	-0.6	-2.3	-0.9

Note: All peak-to-trough movements calculated using peak and trough quarters in real GNP.
a. Difference, billions of 1982 dollars.

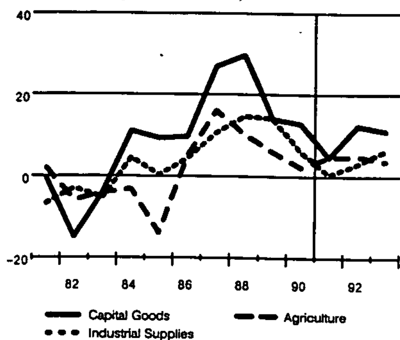
Oil is Not as Important as it Was, But a Large Shock Can Still Create a Recession

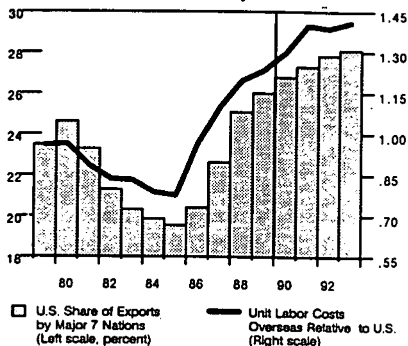


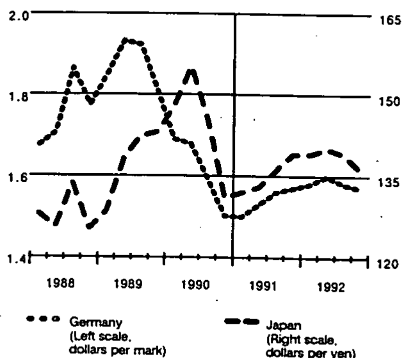


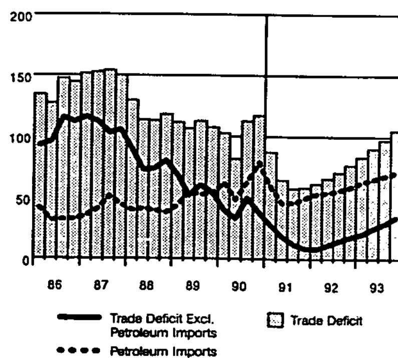


A Weak U.S. Dollar Has Provided for Sustained Export Strength Since 1985—This Support Should Keep This Recession Moderate

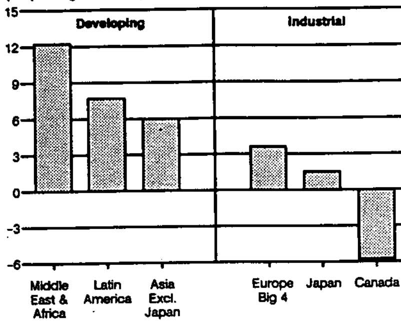








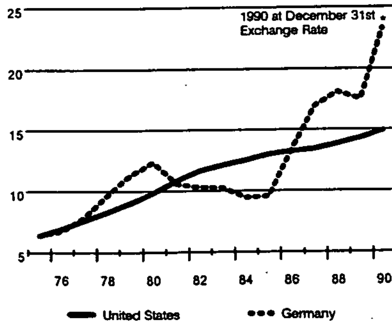
1991 Growth in the Trade Pie
(Import growth by region, percent)



Market Planning for International Sales
(1980 U.S. dollars)

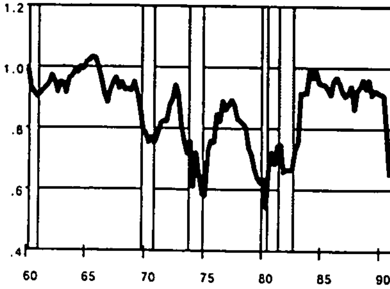
	89	90	91	92
Real Import Growth by Market				
Industrial World	8	5	1	7
Big-4 Europe	9	7	4	7
Japan	14	9	2	8
Canada	5	-1	-6	6
Developing World	12	9	7	8
Asia (excl. Japan)	14	8	6	9
Latin America	9	10	8	10
Middle East & Africa	6	14	12	-1
Trade Drivers				
Real GDP Growth - Industrial	3.3	2.5	1.2	3.2
- Developing	3.9	3.7	4.6	4.8
- Asia	5.2	5.1	5.5	6.3
Real U.S. Exchange Rate - vs. Ind.	6.6	-7.4	-7.7	5.8
- vs. Dev.	3.1	-2.4	-4.4	1.9

Overvalued Currencies and Overpriced Labor: Germany in 1990 Resembles the U.S. in 1985
(Manufacturing hour wages, U.S. dollars per hour)



The War Put a Double Damper on the Economy, Via Purchasing Power and Consumer Attitudes

Consumer Sentiment Plunged
(1966 = 100)

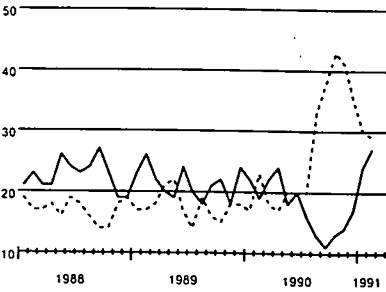


Shaded areas indicate recessions

Early January :	**66**	
January 16-22:	**75**	(Air success)
January 23-29:	**62**	
February:	**70**	

Some Reasons for Hope

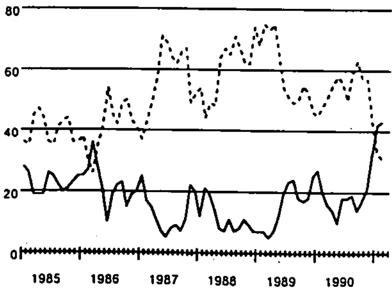
More People Are Thinking the Worst May Be Over



Percent Expecting the Economy to Improve Over the Next Year

Percent Expecting the Economy to Worsen Over the Next Year

For the First Time Since 1986, More People Expect Interest Rates to Fall Rather than Rise

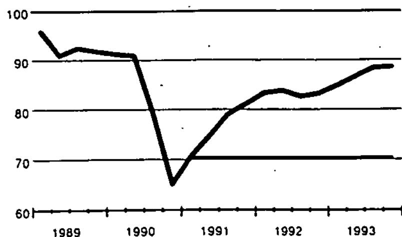


Percent Expecting Interest Rates to Fall

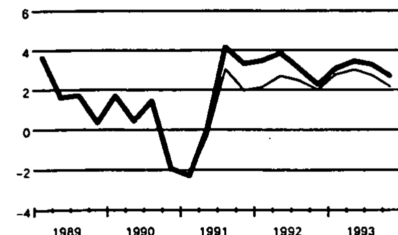
Percent Expecting Interest Rates to Rise

The Role of Confidence in the Projected Recovery

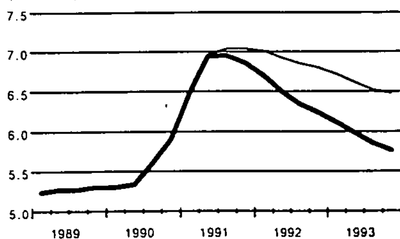
Consumer Sentiment Index
(1966 = 100)



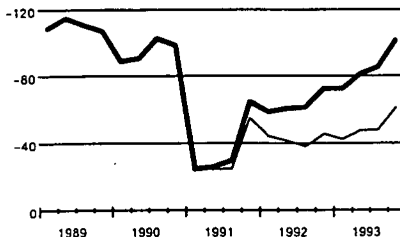
Real GNP
(Percent change, annual rate)



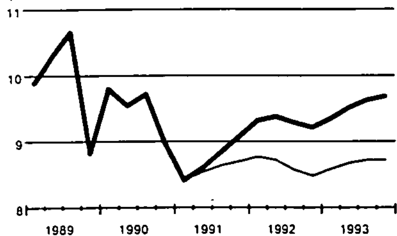
Civilian Unemployment Rate
(Percent)



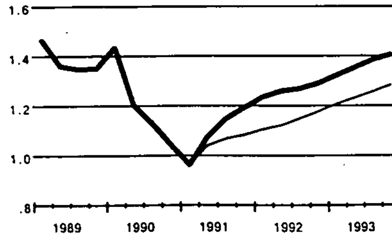
Balance of Payments – Current Account
(Billions of dollars)



Car Sales
(Millions of units, annual rate)



Housing Starts
(Millions of units, annual rate)



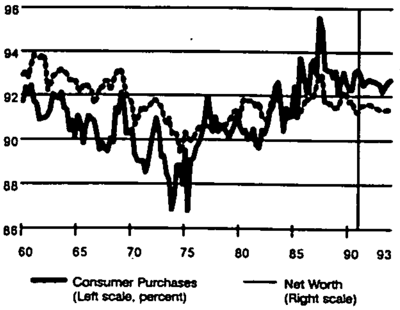
Baseline — Confidence Held At Current Levels

Fact and Fable on the Debt-Burdened Consumer

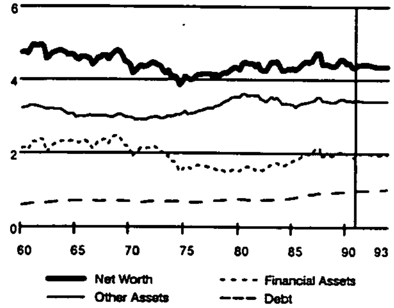
Facts: Consumer spending is very sensitive to net worth (assets minus debts).
The boom in wealth-building (1975-87) has ended.
The population share of high-saving groups (aged 45-64) is increasing.

Fables: The consumer is grossly overburdened by debt.
Home prices have collapsed nationwide.

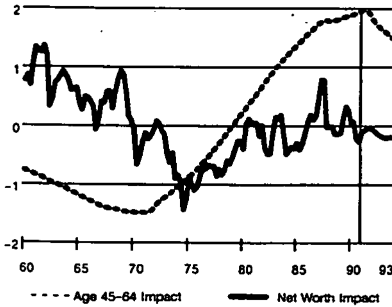
Spending Tracks Wealth
(Ratios of purchases and net worth to income)



Net Worth Has Fallen Since 1987, But Not Dramatically
(Ratios of assets and debt to income)



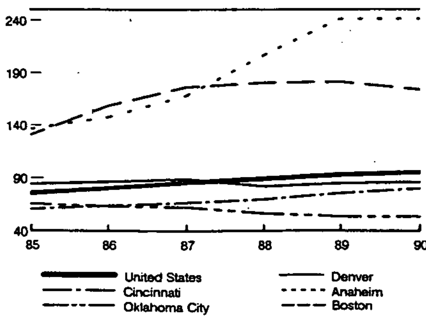
Key Drivers of Consumer Purchasing
(Estimated impacts of net worth and demographics on the percent of income spent by consumers)



Home Prices Are Stronger than Anecdotes Indicate
(Thousands of dollars)

	1985	1986	1987	1988	1989	1990	1990 I	II	III	IV
Median Sales Price of Single Family Homes										
U.S. Total–New Homes										
Level...	84.3	92.2	104.7	113.3	120.4	122.9	123.8	126.7	116.7	124.3
% Change	5.3	9.4	13.5	8.3	6.2	2.1	4.9	6.0	-2.5	-0.1
U.S. Total–Existing Homes										
Level...	75.4	80.3	85.6	89.2	92.9	95.2	95.9	96.2	96.6	92.2
% Change	4.2	6.5	6.6	4.2	4.2	2.5	5.2	3.5	1.8	-0.5
Regional Variations in Existing Home Prices										
Northeast										
Level...	89.0	105.2	132.9	142.5	145.1	141.5	143.7	145.8	141.9	134.7
% Change	13.0	18.3	26.3	7.2	1.8	-2.5	0.2	0.0	-3.5	-6.5
North Central										
Level...	58.7	63.4	66.0	68.2	71.2	74.3	75.0	74.9	75.3	72.1
% Change	2.8	8.0	4.1	3.4	4.3	4.4	8.1	5.6	3.8	0.3
South										
Level...	74.1	78.0	80.6	82.2	84.4	85.5	85.4	86.2	87.2	83.2
% Change	4.0	5.3	3.3	2.0	2.7	1.3	1.6	1.5	1.7	0.5
West										
Level...	95.8	100.5	113.0	124.7	139.8	139.1	140.9	139.2	138.8	137.4
% Change	-2.0	4.9	12.5	10.3	12.1	-0.5	5.4	-0.2	-4.5	-2.5
Metro Area Variations in Existing Home Prices										
Boston,MA										
Level...	130.8	158.2	176.5	180.7	181.4	173.8	177.3	176.2	175.9	165.6
% Change	33.5	20.9	11.6	2.4	0.4	-4.2	0.6	-5.4	-4.0	-8.0
Cinncinati,OH										
Level...	60.2	63.7	66.4	69.6	75.5	79.9	77.7	81.4	81.9	78.5
% Change	2.5	5.8	4.2	4.7	8.5	5.8	6.7	6.3	5.3	4.9
Anaheim,CA										
Level...	136.2	147.3	168.0	206.6	241.5	241.6	243.6	248.9	241.7	232.2
% Change	2.0	8.2	14.0	23.0	16.9	0.0	3.9	1.6	-1.8	-3.5
Portland,OR										
Level...	61.3	62.2	64.3	64.4	70.2	79.5	75.3	79.7	82.3	80.9
% Change	-2.5	1.5	3.4	0.0	9.0	13.4	12.2	15.8	14.6	11.0

Even on the High-Cost Coasts, Home Prices Aren't Collapsing
(Median sales price, thousands of dollars)



Business Spending Plans Have Been Trimmed, Not Slashed

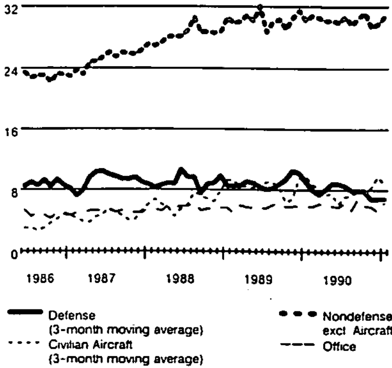
Capital Spending Drivers

	88	89	90	91	92	93
Capacity utilization is Falling, (%)	83.9	84.0	82.3	78.7	81.6	82.6
Cash Flow Remains Weak, (%ch).......	7.0	-3.4	-1.7	0.6	7.6	5.5
Financing is Expensive,						
Corporate Bond Rate (%)...........	9.7	9.3	9.3	9.3	10.0	9.9
After-Tax Debt & Equity Cost (%)..	8.3	8.3	8.6	8.4	8.4	8.2
Thus Spending Will Cycle Down in 1991.						
Equipment (%ch)....................	12.0	5.0	3.0	-2.2	6.8	9.5
Construction (%ch)................	4.7	4.5	0.6	-6.5	1.7	12.7

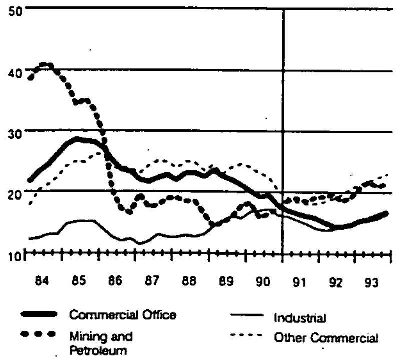
Somber Capital Spending Expectations
(Percent change, current dollars)

	1989	1990	1991	1992
Census Survey				
Total Plant & Equipment	11.4	5.2	2.4	NA.
Manufacturing........	12.5	4.6	0.7	NA.
DRI Analysis				
Total Plant & Equipment	11.4	5.5	0.0	5.4
Manufacturing........	12.3	5.0	-3.3	3.0
Equipment				
Autos.................	-3.5	20.8	-17.5	17.2
Computers.............	4.9	1.4	0.3	5.4
Other.................	5.6	2.0	-1.3	6.3
Construction				
Buildings and Other...	6.9	0.2	-10.8	-0.7
Mining and Petroleum..	-13.9	4.5	13.0	10.4
Public Utilities......	4.0	0.7	3.2	6.3

Capital Goods Orders
(Billions of dollars)

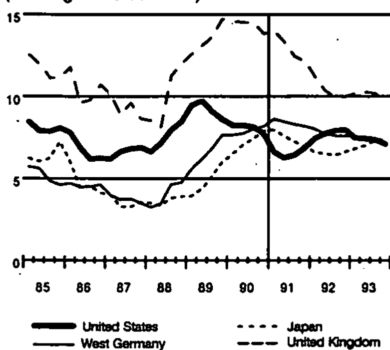


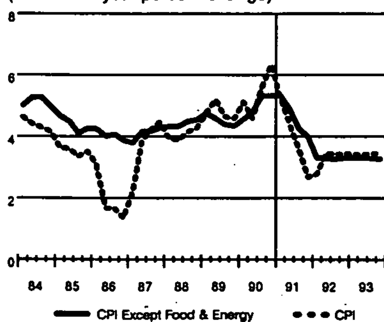
Nonresidential Construction Prospects
(Billions of 1982 dollars)



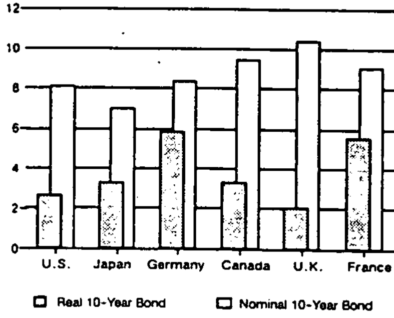
The Federal Reserve Should Focus on Recession

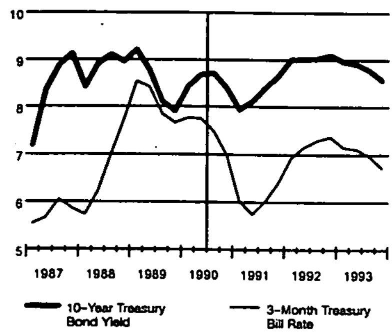
- The Fed is predicted to allow short-term rates to move with the economy.
- The recession will knock inflation down toward 3.5%.

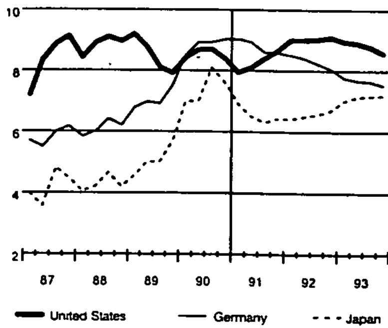


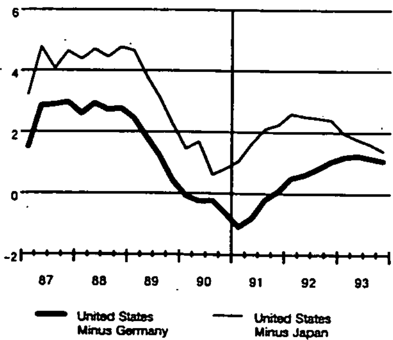


U.S. Bond Yields Will Not Fall Further









The U.S. Still Needs Foreign Funds

We Do Not Save Enough to Finance Government Borrowing

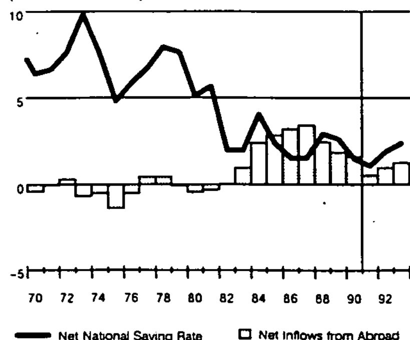
Financial Flows – Private Sector
(Percent of GNP, period averages)

	1960s	1970s	1980s	Forecast 1990	Forecast 1993
Private Saving					
Households	4.6	5.6	3.8	3.3	3.6
Business	11.6	13.2	12.7	11.2	10.9
Private Investment					
Housing	4.6	5.0	4.5	4.1	4.0
Capital Spending	10.9	11.4	11.1	9.6	9.7
Net Private Balance (Saving-Investment)	0.7	2.4	0.9	0.8	0.8

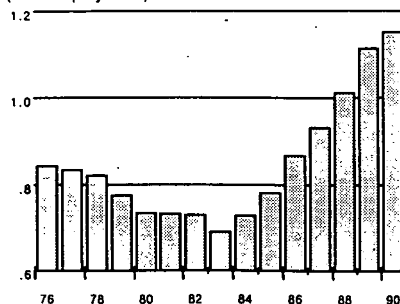
Financial Flows – Economy Wide
(Percent of GNP)

	1960s	1970s	1980s	Forecast 1990	Forecast 1993
Net Private Balance	0.7	2.4	0.9	0.8	0.8
+ Federal Surplus	-0.3	-1.7	-3.7	-3.0	-2.9
+ State-Local Surplus	0.0	0.8	1.2	0.7	1.0
= Net Domestic Funds	0.4	1.5	-1.6	-1.5	-1.1
Current Account Surplus	0.5	0.0	-1.9	-1.7	-1.3

Net Inflows Balance Low National Saving Rate
(Percent of GNP)



Corporate Debt Is at Record High
(Debt equity ratio)



Senator SYMMS. Mr. Chairman, could I just interject for 20 seconds or so?

Senator SARBANES. I am pleased to have Senator Symms join us.

Senator SYMMS. I thank you very much. I apologize I wasn't here earlier when an opening statement was made, and I want to apologize to the witnesses. I have a conflict this morning. I'm going to have to leave. I'll take your testimony and carefully read it. I thank you all for coming.

Mr. Chairman, the reason I asked for the interjection is, today is the first day that our new ranking member of the committee, Congressman Armey, has been here for the Republican side.

I just want to tell him how much I am pleased to see him in this position and for all of us on the committee to have a bona fide economist of our own now as a member of the committee. I think it bodes well for us and I think it should be very interesting and intellectually stimulating for all of us, whether we agree or disagree with Congressman Armey.

But he has the ability to be a lightning rod, and I think it will be good for our committee. So I welcome him here.

Senator SARBANES. Mr. Jones, please proceed.

STATEMENT OF DAVID M. JONES, EXECUTIVE VICE PRESIDENT AND CHIEF ECONOMIST, AUBREY G. LANGSTON & CO., INC.

Mr. JONES. Thank you. The year 1991 will likely be a period of false hopes and false starts. The problem with the economy is not just the war, which obviously depressed consumer spending significantly and, hopefully, will at least temporarily increase it with our victory in the Persian Gulf situation.

But I would also offer the view today that I feel that the basic problem with the economy is attributable to a squeeze on the availability of credit, which is very different and more intractable than anything we've seen really in past episodes. I will go into that in some detail.

The bottom line is that I think you have a recession that's likely to last longer than the typical time frame of about a year, which we have seen for the average recession. I think, moreover, it's going to be very difficult for Federal Reserve policy-easing moves to get us out of this recession quickly.

The current recession is, in many respects, unique. Its primary cause—a pervasive grassroots squeeze on credit—is more basic and more intractable than the basic causes of the preceding post-World War II recessions. Accordingly, the duration of the current recession may be longer, perhaps lasting into 1992, and its depth is at least equal to the average preceding recessions.

More importantly, the current recession's responsiveness to Federal Reserve monetary easing actions may be far more delayed and sluggish than was the case in past recessions.

To make matters worse, neither the Federal Government nor State and local governments are in the position to use fiscal stimulus, thus raising the odds of a potentially longer duration for the current recession. Huge Federal Government borrowing demands and competing foreign credit demands have combined with continued excessive U.S. reliance on foreign investors to keep long-term

interest rates from falling sufficiently to quickly jump start the economy. The threats posed during most of the 1980's were mainly those of financial excess and periodic bouts of too much growth.

The contrasting threats in the early 1990's are a self-reinforcing process of constrained credit availability, asset deflation, and too little growth.

The current recession appears to have begun in August or September 1990 and it's a balance sheet recession, in contrast with the typical post-World War II inventory recessions.

Apart from the temporary impact of the Persian Gulf war, the current recession arises primarily from a clash between an over-leveraged economy, involving mountains of unpaid consumer and business debt built up during the takeover excesses of the 1980's, and banks increasing unwillingness to make new loans.

Past recessions were usually preceded by accelerating inflationary pressures, aggressive Federal Reserve counter moves to push interest rates higher, and large business inventory imbalances. In contrast, the current recession has been, most uncharacteristically, preceded by declining inflationary pressures, at least until the temporary August 1990 oil shock, Federal Reserve easing actions, declining interest rates, and unexpectedly tight inventory control without customary imbalances.

Now a couple of words on the bank credit squeeze. The current recession is primarily attributable to financial sector imbalances rather than real sector imbalances. The current financial strains experienced by U.S. depository institutions, commercial banks, savings and loan associations, savings banks, are more severe than at anytime since the Great Depression of the 1930's. According to one recent estimate, no less than 5 out of the 10 largest U.S. bank holding companies, once allowance is made for extra loan loss reserves required for these bad loans, suffered from capital ratios that threatened to fall below the minimum capital ratios considered safe by regulators.

In addition, the savings and loan industry is in disarray, as we all know, requiring the Bush administration's massive bailout legislation, proposed in February 1989, and finally passed into law in August 1989. The result has been a constriction in credit intermediated by depository institutions, and this has been reflected in sluggish monetary aggregate growth.

To be sure, there has been some substitution of nondepository credit for depository credit. This is reflected in the fact that total debt in the nonfinancial sectors grew at a 7 percent pace in 1990, approximately double that of M2 aggregate growth last year.

However, it should be noted that constraints on the supply of nondepository credit have been also in evidence in important sectors of the credit markets, ranging from commercial paper to corporate "junk bond" debt. In addition, financially hard-pressed insurance companies have also cut back on the supply of credit to key areas such as mortgage finance.

Of course, it remains difficult to precisely quantify the extent of the constraints on the supply of depository and nondepository credit. This is because the credit supply squeeze comes at a time that growth and the demand for credit is moderating in light of increased risks posed by recessionary conditions.

The nature of the current squeeze on the supply of credit by depository institutions contrasts markedly with that of the traditional credit crunch. During the 1960's and 1970's, the typical credit crunch involved a predictable response or process. It involved disintermediation, which arose when the Federal Reserve tightening actions pushed interest rates on alternative money market instruments such as Treasury bills above the prevailing interest rate ceilings on financial institutions' time and savings deposits. This triggered a large but predictable shift of savers' funds out of depository institutions into money market instruments, thereby severely constraining the depository institutions' supply of mortgage credit. Most of the mortgage credit was offered through depository institutions at that time. The result was a sharp decline in housing activity, usually linked to an overall economic downturn.

The current squeeze on the supply of credit comes, most ominously, at a time when the Federal Reserve is easing, rather than tightening. The current squeeze comes at a time of declining, rather than increasing interest rates, and it is occurring long after ceilings on time and savings deposits have been eliminated.

The distinguishing feature of the current grassroots restraint on the supply of credit is that it is arbitrary, selective, and unpredictable, affecting certain types of borrowers in many but not all regions of the country. Among the specific forces currently pressing heavily on banks, has been a belated tightening of capital requirements. In addition, banks face debt downgradings, bad loans, declining real estate values, the negative political fallout from the savings and loan debacle, and a bad case of shaken confidence.

To increase their capital ratios at a time when profits are depressed and the cost of capital is prohibitive, many banks have considered downsizing their balance sheets. These efforts have customarily involved curtailing of new lending activity. The upshot has been the rupture of thousands of credit lifelines between banks and mainstream business borrowers.

The U.S. monetary authorities in the Federal monetary policy area face a dilemma. They want to ease enough to get the economy out of recession, but not so much that they kick off renewed inflationary pressures.

Last December, and again during the first 2 months of this year, the Federal Reserve eased aggressively in the face of growing recessionary tendencies, increasing bank loan stringency and sluggish monetary growth. Previously, the Fed had eased timidly in mid-July, late October, and again in mid-November of last year. Because of the special nature of the current recession, there has been little economic impact so far from these Fed easing steps.

In December 1990, the Federal Reserve policymakers brought all three major policy weapons into the battle. Specifically, the monetary authorities cut reserve requirements, eased reserve pressures through open market operations, and cut the discount rate to 6.5 percent from 7 percent.

In January 1991, Federal Reserve officials again eased reserve requirements and pushed the market rate lower to counter a sluggish monetary growth. In February 1991, following news of extremely weak January employment figures, the Fed again cut the discount rate from 6.5 percent to 6 percent, a move that was paralleled by a

drop in the funds rate to its current rate of 6.25 percent from 6.75 percent.

Currently the Federal Reserve is in a holding pattern. Fed policymakers are waiting to see whether a recent acceleration in M2 growth, following early Fed easing steps, will be sustained. Also, Fed officials are waiting to see if the likely rebound in consumer confidence following the end of the Persian Gulf war will translate into an upturn in a depressed economy.

I'll skip over some service sector figures I'm analyzing here.

Senator SARBANES. We will include the full prepared statement in the record.

Mr. JONES. I would just simply note this morning that our expert testimony about to come from Geoffrey Moore as well as earlier testimony this morning emphasizes a very important fact in the service sector. And that is we've seen a significant decline in February of 86,000 jobs. This weakness is in major areas including banking, real estate, insurance, retailing, transportation, business services, and even State and local governments. I might add that even economists are feeling the pinch.

I was at a meeting of economic forecasters in New York and one of my friends was pointing out one by one the prominent New York forecasters who have lost their jobs. So maybe we can say that the chickens have come home to roost. We're a bit shaky at the table here today.

Consumer spending is the key to recovery. Undoubtedly, consumer confidence will be given at least a temporary lift by the quick and total allied victory in the Persian Gulf war. The question is whether this temporary lift in consumer sentiment is sufficient to kick off a sustained increase in consumer spending. Consumer spending accounts for approximately two-thirds of GNP.

The main problem is that there is a large number of negative factors currently operating on consumer spending that will be difficult to overcome. Most immediately, consumer debt burdens remain abnormally high and difficult to service. In addition, consumer net worth positions are declining with declining real estate values, at least in major areas of the country. Moreover, the job outlook is gloomy, not just for blue-collar workers, but white-collar workers as well. And, most recently, personal income declined by a sharp 0.5 percent in January.

Furthermore, consumer borrowers have failed to benefit, and this is an important point, from Fed easing moves because there has been no decline to speak of in interest rates on things like auto loans, credit cards, and similar types of bank loans, as banks seek to improve their profit margins.

In this bleak environment, consumers are likely to continue to postpone major purchases, thus consumer psychology is deflationary. They wait for a bargain before they buy.

Now, let's look at a couple of positive sectors and then we will sum things up.

To be sure, some contrasting positive factors should be noted that will help provide economic underpinnings, thus lessening the chances of deepening recession. In addition to an absence of inventory imbalances, the rate of growth in exports should continue positive in 1991—exports are about 15 percent of GNP—though at a

somewhat reduced pace compared to 1990, when exports increased 8 percent, or 1989 when they surged by almost 13 percent.

This prospective slowing in export growth in 1990 reflects an expected slowing in both the German and Japanese economies in 1991, as well as the recessions in such major English-speaking countries as Canada and the U.K.

Nevertheless, the potential for a sustainable rebound in the economy is totally lacking at present. The Fed has stopped easing, at least for the time being. And fiscal deficits coming into the current recession have been so huge and unmanageable that even such needed antirecession measures as job programs are in question, especially in view of the tough spending restraints imposed by the deficit-cutting act of 1990.

To conclude, the year 1991 will turn out to be one of false hopes and false starts. After quarterly declines in real GNP in the final quarter last year and the first quarter this year, and I might add that my estimated decline in the first quarter of this year is larger than that in the fourth quarter. The fourth quarter is down a revised 2 percent. I'm guessing that the first quarter 1991 real GNP might have fallen by about 3 percent.

We may see a temporary increase in real GNP in the second quarter, perhaps carrying into the third quarter of 1991. But as we look further into the year, I think the economy will weaken again, thus there's the possibility of dashed hopes in the second half of 1991, as real economic growth remains relatively flat if not declining.

Looking further ahead, additional Fed easing steps will be required to counter economic weakness and avoid massive debt defaults, individual and corporate bankruptcy and bank failures. Although I note again that it's going to be difficult for Fed easing to make a big difference with the economy in this credit squeeze condition.

On the regulatory front, the laws against interstate bank branching should be repealed and mutual trust and respect must be established between banks and regulators. Perhaps also some easing in accounting standards may be needed, although I would emphasize we certainly shouldn't go as far as we went in the savings and loan industry in that connection.

So far, the Bush administration's anticrunch measures have failed to spark much enthusiasm. Perhaps it would be appropriate for the BIS to delay the December 1992 deadline for banks to meet tougher risk-based capital standards. And, obviously, we need to replenish the depleted FDIC insurance fund.

But, in general, monetary policy is going to see a difficult period ahead in trying to get this economy going. And, finally, regarding fiscal policy measures, there is little near-term flexibility, given the already massive size of the Federal deficit, in devising measures to counter the recession.

Thank you.

Senator SARBANES. Thank you, Mr. Jones.

[The prepared statement of Mr. Jones follows:]

PREPARED STATEMENT OF DAVID M. JONES

"Financial and Economic Factors Affecting the Current Recession"

The current recession is in many respects unique. Its primary cause -- a pervasive "grass roots" squeeze on the supply of credit -- is different and more intractable than the main causes of preceding post World War II recessions. Accordingly, the duration of the current recession may be longer (perhaps lasting into 1992) and its depth is at least equal to the average of preceding recessions. Most importantly, the current recession's responsiveness to Federal Reserve monetary easing actions may be far more delayed and sluggish than was the case in past recessions. To make matters worse, fiscal policy at both the Federal and state levels is not in a position to contribute to the recovery. Huge Federal government borrowing demands and competing foreign credit demands, especially in Germany, have combined with continued excessive U.S. reliance on foreign investors to keep long-term U.S. interest rates from falling sufficiently to quickly jump-start the economy. The threats posed during most of the 1980s were mainly those of financial excess and periodic bouts of too much growth; the contrasting threats in the early 1990s are a self-reinforcing process of constrained credit, asset deflation and too little growth .

Unusual Causes of Current Recession

The current recession (which appears to have begun in August or September 1990) is a "balance sheet" recession, in contrast with the typical post World War II "inventory" recessions. Apart from the temporary impact of the Persian Gulf War, the current recession arises primarily from a clash between an overleveraged economy (involving mountains of unpaid consumer and business debt built-up during the takeover excesses of the 1980s) and banks increasingly unwilling to make new loans.

Past recessions were usually preceded by accelerating inflationary pressures, aggressive Federal Reserve counter-moves to push interest rates higher, and large business inventory imbalances. In contrast, the current recession has been, most uncharacteristically, preceded by declining inflationary pressures (at least until the temporary August 1990 oil price shock), Federal Reserve easing actions, declining interest rates and unexpectedly tight business inventory control, without the customary imbalances.

Bank Credit Squeeze

The current recession is primarily attributable to financial sector imbalances (debt, banking, etc.) rather than real sector

imbalances (inventories, productive capacity, etc.). The current financial strains experienced by U.S. depository institutions (commercial banks, savings and loan associations, savings banks) are more severe than at anytime since the Great Depression of the 1930s. According to one recent estimate, no less than five out of the top ten U.S. bank holding companies, once allowance is made for the extra loan loss reserves required to meet bad loans, threaten to fall below the minimum capital ratios considered safe by regulators. In addition, the savings and loan industry is in disarray, requiring the Bush Administration's massive bailout legislation proposed in February 1989 and finally passed into law in August 1989. The result has been a constriction in credit intermediated by depository institutions, and this has been reflected in sluggish monetary aggregate growth.

To be sure, there has been some substitution of non-depository credit for depository credit. This is reflected in the fact that total debt in the nonfinancial sectors (depository plus non-depository) grew at a 7% pace in 1990, approximately double that of M-2 monetary aggregate growth last year. However, it should be noted that constraints on the supply of non-depository credit have also been in evidence in important sectors of the credit markets, ranging from commercial paper to corporate "junk bond" debt. In addition, financially hard-pressed insurance companies have also cut back on the supply of credit to key areas such as mortgage finance. Of course, it remains difficult to precisely quantify the extent of the constraints

on the supply of depository and non-depository credit. This is because the credit supply "squeeze" comes at the same time that growth in the demand for credit is moderating in light of increased risks posed by recessionary conditions.

The nature of the current squeeze on the supply of credit by depository institutions contrasts markedly with that of the traditional "credit crunch". During the 1960s and 1970s, the typical credit "crunch" involved a predictable process. It involved disintermediation which arose when Federal Reserve tightening actions pushed interest rates on alternative money market instruments (e.g. Treasury bills) above the prevailing interest rate ceilings on financial institutions' time and savings deposits. This triggered a large but predictable shift of savers' funds out of depository institutions into money market instruments, thereby severely con-straining the depository institutions' supply of mortgage credit (most mortgage credit was offered through depository institutions at that time). The result was a sharp decline in housing activity usually leading to an overall economic downturn.

The current squeeze on the supply of credit comes, most ominously, at a time when the Federal Reserve is easing, rather than tightening. The current "squeeze" comes at a time of declining, rather than increasing interest rates, and it is occurring long after ceilings on time and savings deposits have been eliminated. The

distinguishing feature of current "grass roots" restraint on the supply of credit is that it is arbitrary, selective and unpredictable, affecting certain types of borrowers in many, though not all, regions of the country.

Banks have become increasingly reluctant to lend as a result of a unique combination of circumstances. Concern about the credit quality of borrowers and pressures on their capital positions have led banks to raise interest margins and tighten nonprice loan terms. One way that banks have increased interest margins is to keep consumer loan rates for auto loans and credit cards high and virtually unchanged despite a sharp decline in the bank cost of lendable funds owing to Fed easing actions.

Among the specific forces currently weighing heavily on banks have been a belated toughening in capital requirements by regulators, bad loans, bank debt downgradings, declining real estate values, the negative political fallout from the savings and loan debacle, and a bad case of shaken confidence. Banks no longer trust regulators who were too lax in the 1980s and now have become too strict at the moment of greatest strain and uncertainty in the early 1990s. To make matters worse, the FDIC deposit insurance fund is on the brink of insolvency. In addition, there is a major need for restructuring, merger, and consolidation among the 12,400 commercial banks. Unfortunately, the Bush Administration's comprehensive bank

reform package could easily fall victim to the negative political climate created by the savings and loan crisis.

To increase their capital ratios at a time when profits are depressed and the cost of capital is prohibitive, many banks have considered down-sizing their balance sheets. These efforts have customarily involved the curtailment of new lending activity. The upshot has been the rupture of thousands of credit lifelines between banks and mainstreet business borrowers.

Federal Reserve Policy

The U.S. monetary authorities face a dilemma. They want to ease enough to get the economy out of recession, but not so much that they kick off renewed inflationary pressures.

Last December, and again during the first two months of this year, the Federal Reserve eased aggressively in the face of growing recessionary tendencies, increasing bank loan stringency and sluggish monetary growth. Previously, the Fed had eased timidly in mid-July, late October, and mid-November of last year. Because of the special nature of the current recession, there has been little economic impact so far from these Fed easing steps.

In December 1990, Fed policymakers brought all three major policy weapons into the battle. Specifically, the monetary authorities cut reserve requirements (using this policy tool for the first time in a decade) in order to counter the bank credit squeeze. The cut in reserve requirements increased the amount of earning assets that banks can hold for a given level of total reserves, thus potentially increasing bank profits. The Fed also eased reserve pressures in two steps through open market operations, thereby reducing the cost of overnight bank funds and potentially improving bank profit margins. In addition, Fed policymakers moved last December to cut the discount rate to 6 1/2% from 7%. In January 1991, Fed officials again eased reserve pressures and pushed the funds rate lower to counter continued sluggishness in monetary growth. On February 1, 1991, following news of extremely weak January employment figures, the Fed again cut the discount rate to 6% from 6 1/2%, a move that was paralleled by a drop in the funds rate to the current level of 6 1/4% from 6 3/4%.

Currently, the Fed is in a holding pattern. Fed policymakers are waiting to see whether a recent acceleration in M-2 growth, following earlier Fed easing steps, will be sustained. Also, Fed officials are waiting to see if the likely rebound in consumer confidence following the end of the Persian Gulf war will translate into an upturn in the depressed economy.

Service Sector Employment Problems

A major threat to an early economic recovery lies in the depressed service sector. This is in marked contrast with earlier recessions when positive growth in service sector jobs (accounting for a whopping 75% of total nonfarm payroll employment) was a major bulwark for the economy. In earlier recessions, service sector job strength helped to facilitate a more prompt post-recession recovery in higher cyclical goods producing jobs (accounting for about 25% of total employment).

Currently, major areas of job weakness in the service sector include banking, real estate, insurance, retailing, transportation, business services, and even State and local governments. Although the transportation sector may get a temporary lift from the ending of the Persian Gulf war, the consolidation and job layoffs in this debt choked sector (most recently experiencing the Eastern and Continental bankruptcies) are likely to continue.

Consumer Spending is Key to Recovery

Undoubtedly, consumer confidence will be given at least a temporary lift by the quick and total allied victory in the Persian Gulf war. But the question is whether this temporary lift in consumer

sentiment is sufficient to kick off a sustained increase in consumer spending. (Consumer spending accounts for approximately two thirds of GNP.)

The main problem is that there are a large number of negative factors currently operating on consumer spending that will be difficult to overcome. Most immediately, consumer debt burdens remain abnormally high and difficult to service. In addition, consumer net worth positions are declining with declining real estate values. Moreover, the job outlook is gloomy (not just for blue collar workers, but white collar as well) and, most recently, personal income declined a sharp .5% in January. Furthermore, consumer borrowers have failed to benefit from Fed easing moves because there have been no declines to speak of in interest rates on auto loans, credit cards and similar types of bank loans as banks seek to improve their profit margins. In this bleak environment, consumers are likely to continue to postpone major purchases. Thus, consumer psychology is deflationary; they wait for a bargain before they buy.

U.S. Exports

To be sure, some contrasting positive factors should help provide economic underpinnings, thus lessening the chances for a deepening recession. In addition to an absence of inventory imbalances, the

rate of growth in exports (exports currently account for about 15% of GNP) should continue positive in 1991, though at a somewhat reduced pace compared with 1990 when exports increased 8.0% or 1989 when they surged by 12.8%. This prospective slowing in export growth reflects an expected slowing in growth in both the Japanese and German economies in 1991 as well as the current recessions in such major English speaking countries as Canada and the U.K..

Nevertheless, the potential for a sustainable rebound in the economy is totally lacking at present. The Federal Reserve has stopped easing, at least for the time being, and fiscal deficits coming into the current recession have been so huge and unmanageable that even much needed anti-recession job programs are in question -- especially in view of the tough spending restraints imposed by the Deficit Cutting Act of 1990.

Conclusions and Appropriate Policy Actions

The year 1991 will likely turn out to be a year of false hopes and false starts. After quarterly declines in real GNP in the final quarter of last year and the first quarter of 1991, false hopes of recovery may be raised by a potential post-Persian Gulf war increase in real GNP in the second quarter of this year. However, this is likely to prove to be a false start, as the Fed fails to ease

sufficiently and U.S. long-term interest rates fail to decline enough to insure sustained economic recovery. Thus, there is a real possibility of dashed hopes in the second half of 1991 as real economic growth remains relatively flat if not declining.

Looking further ahead, additional Fed easing steps will be required to counter economic weakness and avoid massive debt defaults, individual and corporate bankruptcies, and bank failures. On the regulatory front, the laws against interstate bank branching should be repealed and mutual trust and respect must be re-established between bankers and regulators. The cornerstone of such an effort might be found in easing accounting standards so as to allow banks to report lower amounts of nonperforming loans, smaller loan-loss reserves and higher profits. (So far, however, the Bush Administration's anti-crunch measures appear to fall short of what is needed.) In this connection, perhaps it would be appropriate for the BIS (Bank for International Settlements), to delay the December 1992 deadline for banks to meet tougher risk-based capital standards. Needless to say, it is also important to replenish the depleted FDIC deposit insurance fund. Regarding fiscal policy measures, there is little near-term flexibility, given the already massive size of the Federal deficit, in devising measures to counter the recession.

* * *

CHARTS AND TABLES

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CHART 7	Yen, D-Mark Exchange Rates weekly 1989-1991

CHART 1

WEEKLY M-2 vs. FED TARGET•

11/19/90-02/18/91

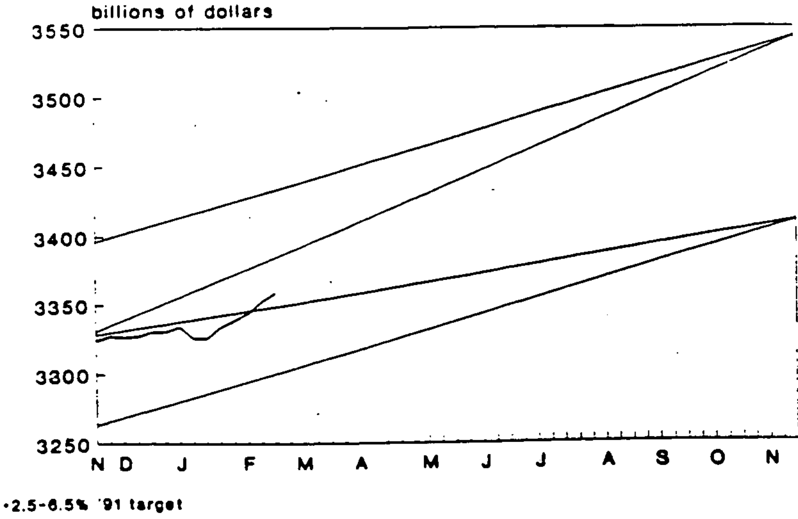

TABLE 1

MONEY AND DEBT AGGREGATES
(Dollar amounts in billions. % change at an annual rate)

Date	M1 Total	M1 Monthly % chg	M1 Qtly % chg	M2 Total	M2 Monthly % chg	M2 Qtly % chg	M3 Total	M3 Monthly % chg	M3 Qtly % chg	L Total	L Monthly % chg	L Qtly % chg	[illegible] Total	[illegible] Monthly % chg	[illegible] Qtly % chg
1987															
Jan	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
Feb	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
Mar	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Apr	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
May	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
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Jul	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
Aug	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
Sep	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Oct	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
Nov	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
Dec	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
4th Qtr/4th Q		[illegible]			[illegible]			[illegible]			[illegible]			[illegible]	
1988															
Jan	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
Feb	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
Mar	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
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May	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
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4th Qtr/4th Q		[illegible]			[illegible]			[illegible]			[illegible]			[illegible]	
1989															
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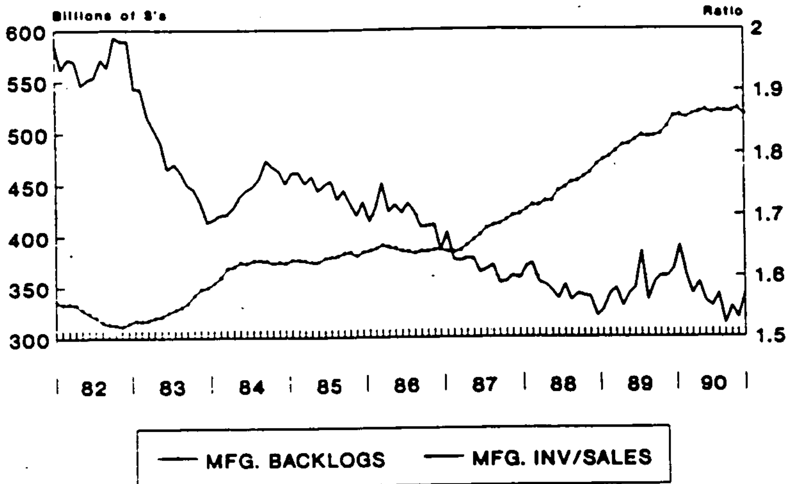
Feb	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
Mar	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Apr	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
May	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
Jun	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Jul	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
Aug	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
Sep	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Oct	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
Nov	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
Dec	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
4th Qtr/4th Q		[illegible]			[illegible]			[illegible]			[illegible]			[illegible]	
1990															
Jan	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
Feb	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
Mar	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Apr	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
May	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
Jun	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Jul	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
Aug	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
Sep	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Oct	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
Nov	[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]		[illegible]	[illegible]	
Dec	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	NA	NA	NA	NA	NA	NA
4th Qtr/4th Q		[illegible]			[illegible]			[illegible]			NA			NA	

Source: Federal Reserve and Aubrey G. Lanston & Co. Inc.

CHART 2

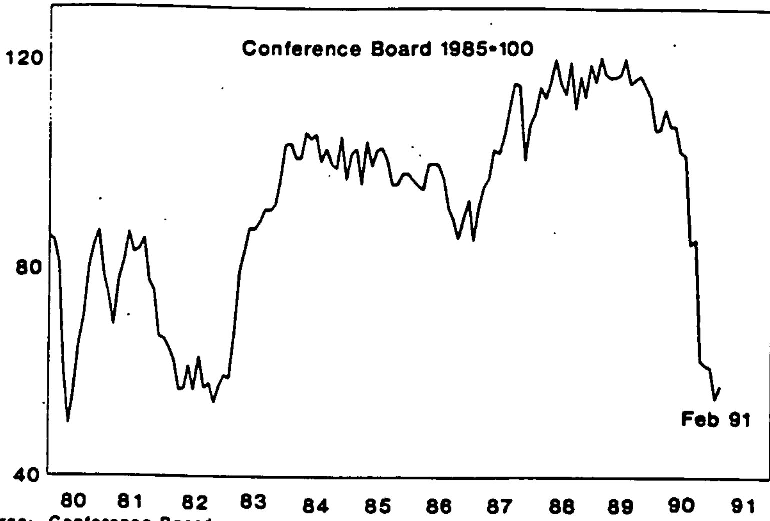
MANUFACTURING INVENTORY-TO-SALES RATIO AND ORDER BACKLOGS



Source: U.S. Department of Commerce

CHART 3

CONSUMER CONFIDENCE INDEX

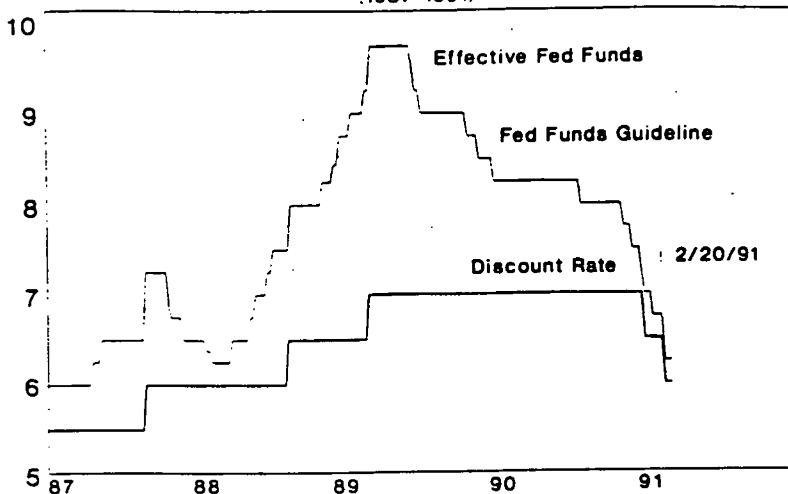


Source: Conference Board

CHART 4

FED FUNDS RATE (EFFECTIVE VS. GUIDELINE) AND DISCOUNT RATE

(1987-1991)



ource: Federal Reserve

TABLE 2

Non-Agricultural Payroll Employment:
(Average monthly change per quarter in thousands of workers)

	1+2+11 TOTAL NON-AGRICUL. PAYROLLS	2+3+5+6 TOTAL GOODS PRODUCING PAYROLLS	3 MINING	4 OIL & GAS	5 CONS-TRUCTION	6+7+10 TOTAL MANUFAC-TURING	7 DURABLE GOODS MFG. PAYROLLS	8 TRANSP. EQUIP.	9 MOTOR VEHICLES	10 NON-DURABLE GOODS MFG. PAYROLLS
1980:1	125	(52)	6	7	(27)	(32)	(13)	(22)	(24)	(19)
1980:2	(346)	(324)	10	12	(56)	(277)	(231)	(46)	(40)	(46)
1980:3	42	(14)	0	8	0	(14)	(10)	8	7	(4)
1980:4	253	104	16	9	8	80	72	14	11	8
1981:1	89	5	13	12	(6)	(2)	(0)	1	0	(3)
1981:2	81	18	9	15	(32)	41	32	8	8	10
1981:3	9	(20)	19	12	(19)	(20)	(22)	(14)	(13)	2
1981:4	(201)	(202)	5	7	(26)	(181)	(141)	(28)	(19)	(40)
1982:1	(162)	(162)	0	4	(29)	(133)	(90)	(8)	0	(43)
1982:2	(165)	(196)	(25)	(12)	(16)	(155)	(117)	(12)	(5)	(38)
1982:3	(216)	(168)	(24)	(16)	(20)	(124)	(110)	(11)	(2)	(14)
1982:4	(159)	(183)	(20)	(10)	(11)	(151)	(125)	(17)	(12)	(27)
1983:1	92	(22)	(18)	(14)	(16)	12	10	8	12	2
1983:2	350	130	(6)	(6)	42	95	70	13	13	25
1983:3	415	150	2	2	45	103	79	15	14	26
1983:4	306	135	5	2	29	102	83	16	13	19
1984:1	408	148	2	1	46	100	79	19	9	21
1984:2	359	102	4	3	42	57	50	5	0	6
1984:3	316	82	3	3	31	47	50	13	12	(3)
1984:4	316	(1)	(7)	(1)	23	(18)	(2)	(1)	(4)	(16)
1985:1	188	(1)	(3)	(3)	16	(14)	(5)	10	2	(10)
1985:2	266	(3)	(1)	(2)	40	(42)	(26)	6	1	(17)
1985:3	197	(30)	(9)	(6)	22	(43)	(39)	2	(2)	(4)
1985:4	204	3	(6)	(6)	14	(4)	(6)	10	3	1
1986:1	115	(27)	(16)	(14)	11	(22)	(18)	1	(3)	(4)
1986:2	61	(68)	(26)	(25)	(4)	(37)	(34)	2	(2)	(3)
1986:3	261	(20)	(14)	(11)	9	(15)	(16)	3	(1)	1
1986:4	213	13	(4)	(4)	20	(3)	(13)	3	0	10
1987:1	211	20	(1)	(0)	14	7	3	5	2	5
1987:2	246	27	2	3	14	11	2	(3)	(4)	9
1987:3	253	64	4	3	3	56	33	5	(1)	23
1987:4	364	74	1	1	29	44	29	(1)	(2)	15
1988:1	274	16	(2)	(1)	8	10	3	(5)	(4)	7
1988:2	288	46	(3)	(1)	19	28	26	7	3	5
1988:3	230	(1)	(5)	(4)	2	2	9	0	2	(7)
1988:4	298	39	(4)	(5)	4	39	28	9	5	11
1989:1	247	1	(0)	(1)	(6)	8	(0)	2	(0)	8
1989:2	184	1	0	1	18	(17)	(16)	(4)	(4)	(2)
1989:3	168	(10)	6	2	12	(28)	(25)	(6)	(6)	(3)
1989:4	172	(29)	3	2	(3)	(29)	(26)	(6)	(5)	(4)
1990:1	246	14	4	2	32	(22)	(12)	(1)	(1)	(11)
1990:2	236	(32)	5	3	(14)	(23)	(20)	(0)	0	(3)
1990:3	(72)	(77)	(3)	(1)	(31)	(43)	(44)	(13)	(7)	1
1990:4	(172)	(160)	2	2	(60)	(102)	(73)	(23)	(12)	(29)

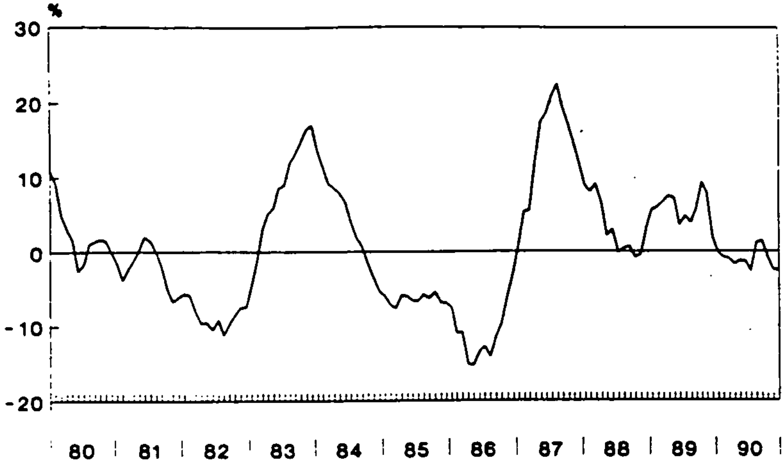
	11+12+13+14+15+16+19 TOTAL SERVICE PRODUCING PAYROLLS	12 TRANS-PORTATION & UTIL.'S	13 WHOLE-SALE TRADE	14 RETAIL TRADE	15 FINANCE INSURANCE REAL ESTATE	16 SERVICES	17 BUSINESS SERVICES	18 HEALTH SERVICES	19 GOVT.
1980:1	177	(6)	16	15	20	84	13	28	47
1980:2	(22)	(19)	(17)	(42)	9	34	(1)	21	33
1980:3	56	(2)	8	7	12	72	18	25	(42)
1980:4	149	6	13	26	17	88	16	27	7
1981:1	84	7	10	29	12	49	8	23	(22)
1981:2	63	3	9	26	9	54	23	22	(37)
1981:3	28	6	3	8	8	57	9	26	(53)
1981:4	0	(12)	(5)	(44)	(0)	48	6	22	33
1982:1	0	(8)	(10)	3	3	26	(4)	19	(14)
1982:2	31	(9)	(12)	28	5	13	(5)	22	7
1982:3	(48)	(17)	(15)	2	2	19	(1)	17	(39)
1982:4	24	(12)	(15)	(6)	3	33	5	14	20
1983:1	134	(12)	(3)	47	12	62	37	11	9
1983:2	220	7	20	66	17	101	47	18	9
1983:3	265	17	21	89	25	103	44	13	9
1983:4	170	(4)	24	75	17	72	44	9	(14)
1984:1	260	28	32	82	18	93	42	11	7
1984:2	257	15	20	67	16	103	37	9	35
1984:3	235	13	22	73	19	67	33	(9)	40
1984:4	317	3	18	126	22	121	26	28	28
1985:1	189	10	11	32	21	101	34	17	15
1985:2	269	4	11	85	25	107	38	17	37
1985:3	227	3	6	31	27	110	37	14	50
1985:4	200	4	5	43	32	100	32	21	16
1986:1	142	(1)	(6)	42	25	64	17	21	18
1986:2	128	(35)	(3)	49	30	79	28	21	9
1986:3	281	39	12	71	27	86	28	23	46
1986:4	201	10	3	33	25	96	30	20	33
1987:1	191	10	10	36	19	104	34	23	11
1987:2	219	8	10	51	20	107	27	22	24
1987:3	189	18	14	37	13	105	22	25	3
1987:4	290	15	16	69	9	110	27	26	71
1988:1	258	14	14	60	9	127	37	25	33
1988:2	242	11	25	43	2	138	34	30	23
1988:3	230	8	15	39	3	132	38	31	35
1988:4	259	12	18	50	9	141	29	35	29
1989:1	265	5	24	63	3	121	12	35	29
1989:2	183	17	12	12	10	94	17	40	37
1989:3	178	8	12	26	13	87	14	40	40
1989:4	200	40	14	25	11	96	2	47	35
1990:1	233	11	6	18	12	109	12	49	77
1990:2	268	15	7	19	8	92	13	53	129
1990:3	5	8	(4)	7	2	72	4	47	(80)
1990:4	(17)	2	(14)	(50)	(7)	45	(14)	51	12

Source: Bureau of Labor Statistics, Aubrey G. Lanston & Co. Inc.

CHART 5

COMMODITY PRICES (JOC INDEX)

year-over-year percent change



Source: Journal of Commerce,
Aubrey G. Lanston & Co. Inc.

CHART 6

SELECTED GLOBAL BOND YIELDS

June 1989-Feb 1991

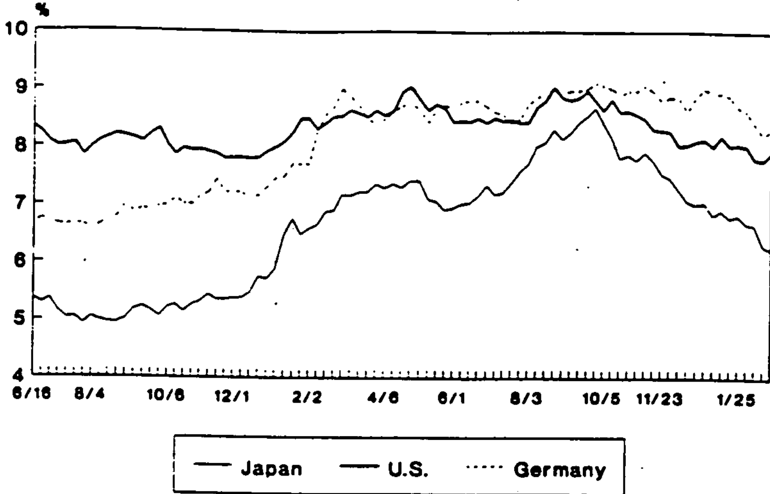
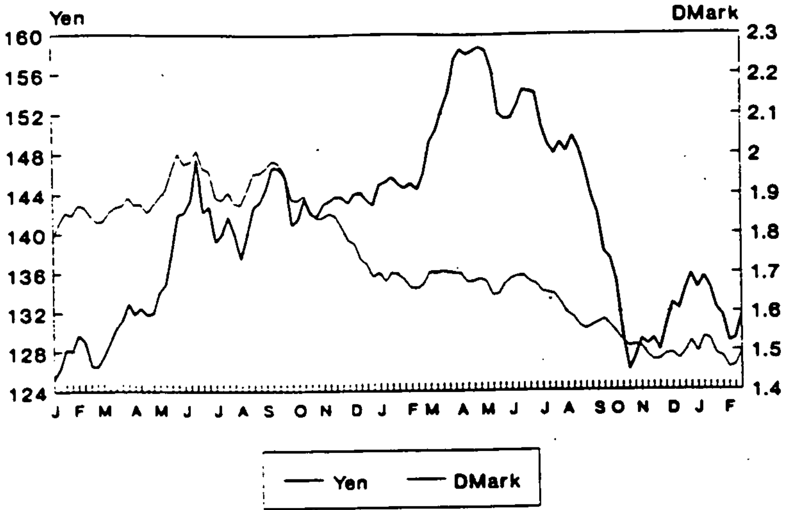


CHART 7

Yen and D-Mark Exchange Rates
Weekly 1989-1991



Senator SARBANES. Mr. Moore, we'd be happy to hear from you.

STATEMENT OF GEOFFREY H. MOORE, DIRECTOR, CENTER FOR INTERNATIONAL BUSINESS CYCLE RESEARCH, GRADUATE SCHOOL OF BUSINESS, COLUMBIA UNIVERSITY

Mr. MOORE. Thank you, Mr. Chairman.

I should like to say first, if I may, it's a special pleasure for me to be here because it's sort of an anniversary for me to attend a meeting of this committee that hears Labor Commissioner Janet Norwood, because it was about 20 years ago that I began hearings before this committee when I had the position that Janet has now. I'm glad to see that it's still continuing in the same vein.

Senator SARBANES. We are very pleased to have you with us, and I must say that office has been in very good hands over the years, and we are very pleased that is the case.

Mr. MOORE. My appraisal of the current recession deals with three major questions, focusing mainly on the United States but bringing in some of the other countries around the world as well.

First, when did the recession begin? That happens to be an easier question to answer than when is it going to end. For the United States, my own view is that June 1990 is an appropriate date for the business cycle peak, after which the recession would begin. Various measures of production, employment, real incomes, and sales reached their highest point in different months. But June seems to me to represent the consensus.

Table 1 attached to my prepared statement, gives a sample of those major aggregate measures of activity. As you will see, some of them reach their high points before June, others after June. But a lot of them, particularly the employment measures, reach their highs in June.

In other countries, the highs in similar measures were reached earlier in 1990 in some countries, later in others. Table 2 in my prepared statement shows the high dates for measures of economic activity in 11 different countries. Some of them reached their highs early in 1990 and others much later. And some, through the latest data we have, which is November or December for the various countries, are still at their highest levels so far.

This means that some of the groundwork for a recession was laid before the Persian Gulf crisis, since some countries were entering into this situation before that happened. And, even in the United States, there were declines going on in some types of measures before the Persian Gulf crisis occurred which, of course, produced a spiraling cost of oil and had a very depressing effect.

The second question is, how severe is the recession likely to be? One tool we have found useful on this point is the growth rate in a long-leading index shortly after the recession begins. This long-leading index is based on indicators that typically have longer leads than most of those in current use. Bond prices are one such indicator. Building permits for new housing are another. The real money supply is a third. In view of the discussion earlier, I should point out that productivity growth is one of these long-lead types of indicators.

Since the long-leading index starts down well before a recession begins and starts up well before it ends, its rate of decline along the way has a bearing on the recession's ultimate severity.

We find that it is presently indicating a recession of about average severity relative to those experienced since 1948. Chart 1 in my collection of statistics shows how that looked over the period since 1948. For the current recession, in terms of the decline in real GNP, we forcast a decline of 2.6 percent during the entire recession.

Another factor pertaining to the severity of recessions is to what extent they become international in scope. We have found that the more widespread recessions are internationally, the worse they are in the United States. One of the major reasons for this is that recessions abroad weaken the demand for U.S. exports. Our current measure of the international scope of recession shows that declines are occurring in about two-thirds of the leading and coincident indexes available for 11 countries. We cover these countries currently on a monthly basis.

And chart 2 in my prepared statement, as well as chart 3, shows what is happening to the leading and coincident indexes for the 11 countries looked at as a group.

Judging from its past record, this measure of the scope of the international recession also suggests that the current recession is apt to be of about average severity in the United States. Table 3 in my prepared statement gives some evidence of the correlation between the scope of the recession internationally and its severity in the United States.

The trade balance has come to have a very important effect on the U.S. economy, and variations in the way the trade balance is measured can make a big difference in the size of movements in real GNP.

In the fourth quarter, for example, real GNP declined at an annual rate of 2.1 percent according to estimates by the Department of Commerce. We have adjusted the trade balance—net exports—for price changes by a different procedure, and find that real GNP fell at the rate of 4.6 percent in the fourth quarter; this is shown in table 4 of my prepared statement. In other words, although the only change we made was in how you deflate the net export figure, our measure makes the recession more than twice as severe through the fourth quarter. So the question, which method is more reasonable, has an important bearing on the question of how severe the current recession may turn out to be.

The method that we use is one that was developed by Solomon Fabricant and Simon Kuznets back in the 1950's and uses a general measure of inflation; namely, the deflator for gross domestic purchases, to deflate the trade imbalance or the net export component. In the present instance, that makes a very large difference in how severe the decline in real GNP turns out to be.

The final question is, are there signs that the recession is ending? The long-leading index that I mentioned earlier does not yet signal an upturn, but it did improve slightly in January, the latest figure that we have. Chart 4 in my prepared statement gives a picture of its historical record. And you can see that it's been going down and then up slightly. But it's not really signaling any-

thing in the way of an upturn. Its average lead before the end of a recession has been about 8 months.

Several other leading indexes including one pertaining to the services sector, which is in chart 5 of my prepared statement, and one based entirely on employment data, in chart 6, have yet to signal an upturn.

When I put these charts together a couple of days ago, we didn't have the February data for the leading employment index. But this morning I called my office in New York about 9 and they had calculated our leading index of employment for February. That shows a further decline from the January figure, which was already on the down side. So it looks to me, from the leading employment type of information, which includes such measures as the average workweek, layoff rate calculated from the household survey, voluntary part-time employment, initial claims for unemployment insurance and so on, that the employment situation is likely to get worse before it gets better.

One bit of positive evidence can be found in our leading index of inflation, which has moved down sharply through January, the latest figure we have. This is shown in chart 7 of my prepared statement. This suggests that inflation is likely to subside further than it already has and, hence, bring interest rates down and put the Federal Reserve in a stronger position to stimulate the economy.

That's a quick summary of the things I've been able to put together that have been the subject of your interest.

Thank you, Mr. Chairman

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

[The prepared statement of Mr. Moore follows:]

PREPARED STATEMENT OF GEOFFREY H. MOORE

Appraising the 1990-91 Recession

Summary

My appraisal of the current recession deals with three major questions, focusing mainly on the United States but bringing in some other countries as well. First, when did the recession begin? For the U.S., my own view is that June 1990 is an appropriate date for the business cycle peak, after which a recession ensues. Various measures of production, employment, real income and sales reached their highest point in different months but June seems to me to represent the consensus (Table 1). In other countries the highs in similar measures were reached earlier in 1990 in some countries, later in others (Table 2). This means that some of the groundwork for a recession was laid before the Persian Gulf crisis and the spiraling cost of oil burst upon us, although that clearly had a depressing effect.

Our second question is how severe is the recession likely to be? One tool that we have found useful on this point is the growth rate in a long leading index shortly after a recession begins. The long leading index is based on indicators that typically have longer leads than most of those in current use. Bond prices is one such indicator, building permits for new housing is another, and the real money supply is a third. Since the long leading index starts down well before a recession begins and starts up well before it ends, its rate of decline along the way has a bearing on the recession's severity. We find that it is presently indicating a recession of about average severity relative to those experienced since 1948 (Chart 1).

Another factor pertaining to the severity of recessions is to what extent they become international in scope. We have found that the more widespread recessions are internationally, the worse they are in the U.S. One of the major reasons for this is that recessions abroad weaken the demand for U.S. exports. Our current measure of the

international scope of recession shows that declines are occurring in about two-thirds of the leading and coincident indexes available for eleven countries (Charts 2, 3). Judging from its past record, this measure also suggests that the current recession is apt to be of about average severity (Table 3).

The trade balance has come to have a very important effect on the U.S. economy, and variations in the way the trade balance is measured can make a big difference in the size of movements in real GNP. In the fourth quarter, for example, real GNP declined at an annual rate of -2.1%, according to estimates by the Department of Commerce. We have adjusted the trade balance (net exports) for price changes by a different procedure, and find that real GNP fell at the rate of -4.6% in the fourth quarter (Table 4). Our measure makes the recession more than twice as severe, so the question which method is more reasonable has an important bearing on the question how severe is the current recession.

My final question is: Are there signs that the recession is ending? The long leading index mentioned above has not yet signalled an upturn, but did improve slightly in January (Chart 4). Its average lead before the end of recessions has been about eight months. Several other leading indexes, including one pertaining to the service sector (Chart 5), and one based entirely on employment data (Chart 6), also have yet to signal an upturn. Hence it would be surprising to see the recession end before mid-summer. One bit of positive evidence can be found in our leading index of inflation, which has moved down sharply through January (Chart 7). This suggests that inflation is likely to subside, and hence bring interest rates down and put the Federal Reserve in a stronger position to stimulate the economy.

The attached tables and charts provide documentation for the points made above, which I'll be glad to discuss in further detail if you wish.

TABLE 1.
WHEN DID THE 1990-91 RECESSION START:
LATEST HIGHS IN NINE MEASURES OF AGGREGATE ECONOMIC ACTIVITY

High Month, 1990	Measure of Aggregate Activity	Number Reaching High
January	Retail Sales, 1982$	1
March	Nonfarm employment, household survey	1
June	Nonfarm employment, payroll survey Nonfarm employee hours Unemployment rate (low) Coincident index, Commerce Department	4
July	Personal income, 1982$	1
August	Manufacturing & Trade sales, 1982$	1
September	Industrial production index	1

TABLE 2.
LATEST HIGHS IN COINCIDENT INDEXES, ELEVEN COUNTRIES

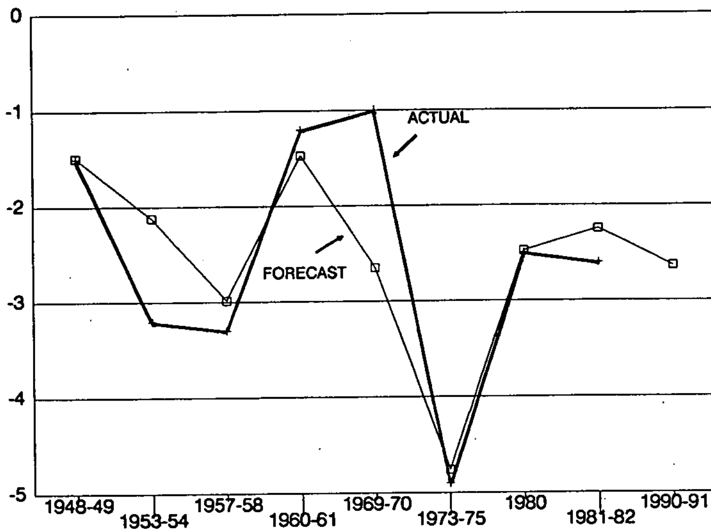
1990	Country	Percent Decline to Date	Latest Available Month
January	Australia	-5.4	Dec.
	Taiwan, R.O.C.	-1.9	Nov.
February	–		
March	Canada	-3.2	Nov.
April	–		
May	New Zealand	-1.4	Nov.
June	United Kingdom	-1.1	Dec.
	United States	-3.2	Dec.
July	–		
August	–		
September	Italy	-0.1	Oct.
October	France	-0.5	Dec.
November	Germany	-0.6	Dec.
December	Japan	---	Dec.
	Korea, R.O.K.	---	Dec.

Based upon indexes compiled by the Center for International Business Cycle Research, February 1991.

CHART 1.

FORECASTS OF RECESSION SEVERITY BASED ON LONG LEADING INDEX

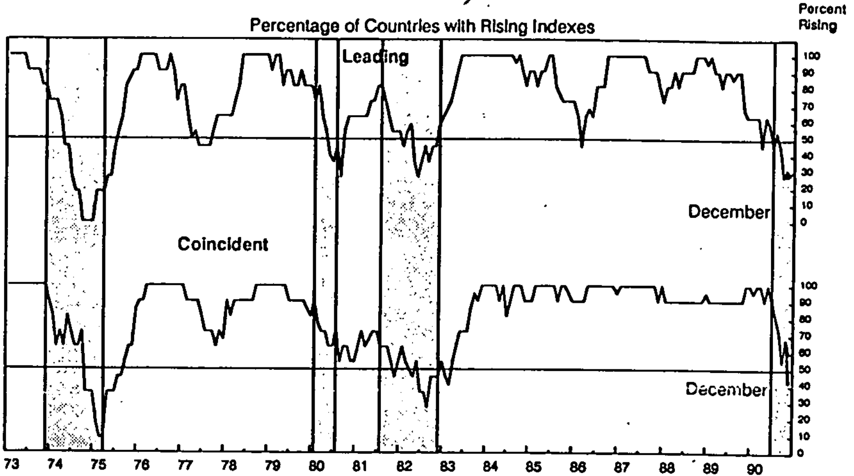
Forecast and Actual Percent Change in Real GNP from High to Low Quarters



Note: Forecasts are based on the six-month smoothed growth rate in the long-leading index 6 months after the business cycle peak. For 1990 the business cycle peak is tentatively set at June.

Center for International Business Cycle Research, March 1991.

CHART 2.
LEADING AND COINCIDENT DIFFUSION INDEXES, ELEVEN COUNTRIES



Shaded areas represent periods of recession in the U.S. economy. The diffusion indexes show what proportion of the eleven countries have rising leading or coincident indexes, based on whether the current month's index is higher or lower than the preceding 12-month average. The countries are: United States, Canada, United Kingdom, West Germany, France, Italy, Japan, Australia, Taiwan, South Korea, and New Zealand.
Center for International Business Cycle Research, February 1991.

LEADING AND COINCIDENT DIFFUSION INDEXES, ELEVEN COUNTRIES

	Percent Rising		
	Leading	Coincident	Leading and Coincident
1989:			
Jan.	100	91	95
Feb.	91	91	91
Mar.	91	91	91
Apr.	82	91	86
May	91	91	91
June	91	91	91
July	82r	91	89
Aug.	86r	91	91
Sep.	91	91	82r
Oct.	73r	91	82r
Nov.	64	100	82
Dec.	55r	100	77r
1990:			
Jan.	64	96	80
Feb.	64	100	82
Mar.	46	100	73
Apr.	64	91	77
May	59	100	80
June	46	91	68
July	55	82	68
Aug.	46	73	59
Sep.	32r	55	43r
Oct.	27r	68	48r
Nov.	27(11)r	50(10)	39(21)r
Dec.	29(7)	43(7)	36(14)

Note: Numbers in parentheses are the number of indexes included when not all are available. When the growth rate is 0.0, the index is counted as 1/2 rising. r = revised.
Center for International Business Cycle Research, February 1991.

TABLE 3.

SEVERITY AND INTERNATIONAL SCOPE OF U.S. RECESSIONS

Recession Dates Peak	Trough	Percent Change in Real GNP from High to Low	Lowest Percent of Leading and Coincident Indexes Rising, 11 countries Percent	Date
(1)	(2)	(3)	(4)	(5)
8/57	4/58	-3.5	46	11/57
4/60	2/61	-1.0	62	2/61
12/69	11/70	-1.1	55	7/70
11/73	3/75	-4.3	14	2/75
1/80	7/80	-2.3	41	8/80
7/81	11/82	-3.4	32	8/82
Averages:				
3 Mild Recessions ('60,'69,'80)		-1.5	53	
3 Sharp Recessions ('57,'73,'81)		-3.7	31	
6 Recessions		-2.6	42	

Correlation between Severity and International Scope (Cols. 3 and 4): RSQ = .79

Center for International Business Cycle Research, November 1990.

CHART 3.

RECESSIONARY OUTLOOK IN MOST COUNTRIES

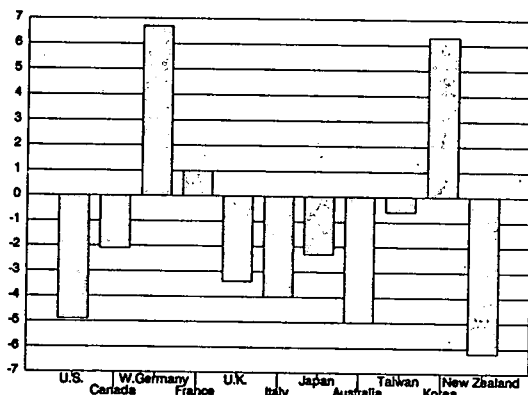
CIBCR's International Economic Indicators a slowdown in growth or outright recession ahead for most major market economies, Germany and Korea, R.O.K. being the prominent expections.

LATEST FIGURES ON THE INTERNATIONAL LEADING INDEXES FROM CIBCR

	Indexes			Growth Rates			
International Economic Leading Indexes* (1980=100)	6 mos. ago	3 mos. ago	Latest Month	6 mos. ago	3 mos. ago	Latest Month	Latest Date
United States	140	138	135	1	-2	-5	Jan.
Canada	120	121	120	-5	-3	-2	Nov.
West Germany	130	133	136	3	5	7	Nov.
France	131	130	130	4	2	1	Dec.
United Kingdom	117	116	115	-1	-1	-3	Dec.
Italy	118	118	115	1	0	-4	Nov.
Japan	170	167	166	4	-1	-2	Dec.
Australia	124	123	121	-6	-6	-5	Dec.
Taiwan, R.O.C.	234	229	235	-1	-5	-1	Dec.
Korea, R.O.K.	225	235	235	1	9	6	Dec.
New Zealand	117	116	113	-2	-3	-6	Nov.
10 Countries excl. U.S.	140	140	140	2	1	0	Nov.
11 Countries	140	140	138	1	1	-2	Nov.

Note: Growth rates are six-month smoothed percent changes at annual rate.

LATEST LEADING INDEX GROWTH RATES (%),11 COUNTRIES



*©1991 CENTER FOR INTERNATIONAL BUSINESS CYCLE RESEARCH, COLUMBIA UNIVERSITY BUSINESS SCHOOL

TABLE 4.
AN ALTERNATIVE ESTIMATE OF REAL GNP, 1990

	I	II	III	IV	Percent Change, Annual Rate I-II	II-III	III-IV
In current dollars (bil.)							
1. Gross Domestic Purchases	5405.3	5468.2	5555.9	5563.5	4.7	6.6	1.4
2. Net Exports	-30.0	-24.9	-41.3	-42.3			
3. Gross National Product (1+2)	5375.4	5443.3	5514.6	5521.2	5.1	5.3	0.5
In 1982 dollars (bil.)							
4. Gross Domestic Purchases	4185.9	4199.7	4216.5	4168.0	1.3	1.6	-4.5
Net Exports							
5a. Commerce*	-35.3	-44.6	-46.5	-18.5			
5b. CIBCR**	-23.2	-19.1	-31.3	-31.7			
Gross National Product							
6a. Commerce(4+5a)	4150.6	4155.1	4170.0	4149.5	0.4	1.4	-2.0
6b. CIBCR (4+5b)	4162.7	4180.6	4185.2	4136.3	1.7	0.4	-4.6
Implicit Price Deflator (1982=100)							
7. Gross Domestic Purchases (1+4)	129.1	130.2	131.8	133.5	3.5	5.0	5.3
Gross National Product							
8a. Commerce (3+6a)	129.5	131.0	132.2	133.1	4.7	3.7	2.8
8b. CIBCR (1+4)	129.1	130.2	131.8	133.5	3.5	5.0	5.3

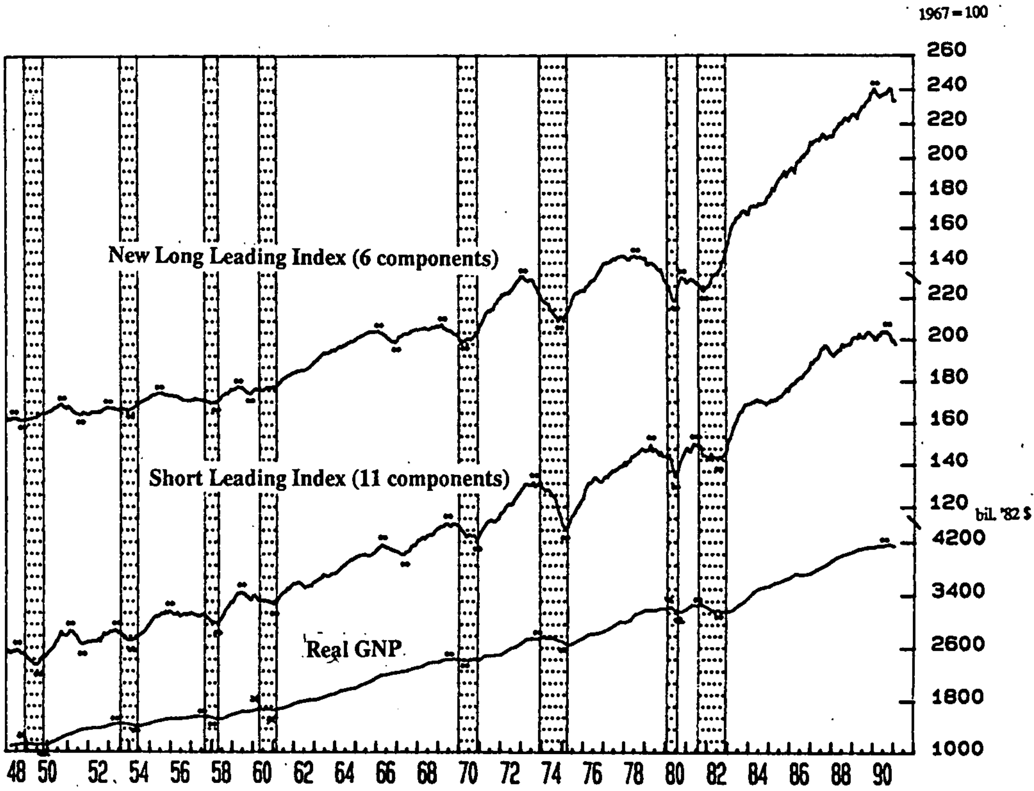
*Exports deflated by export prices less imports deflated by import prices.

**Net exports deflated by implicit price deflator for gross domestic purchases.

Note: For further discussion of the alternative method see Moore, G.H., *Business Cycles, Inflation and Forecasting*, Ballinger, 2nd ed., 1983, Chapter 19.

Center for International Business Cycle Research, Columbia University Business School, New York, N.Y., March 1991, based on figures published by the U.S. Department of Commerce, February 27, 1991.

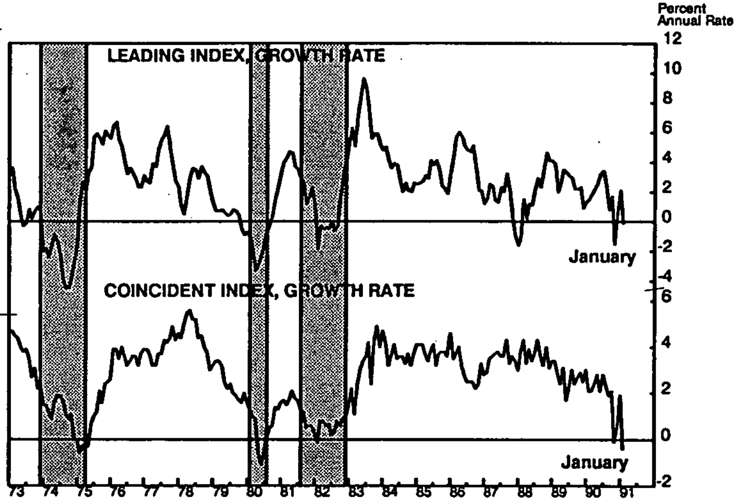
CHART 4. LONG AND SHORT LEADING INDEXES AND REAL GNP



Shaded areas are business cycle recessions.

CHART 5.

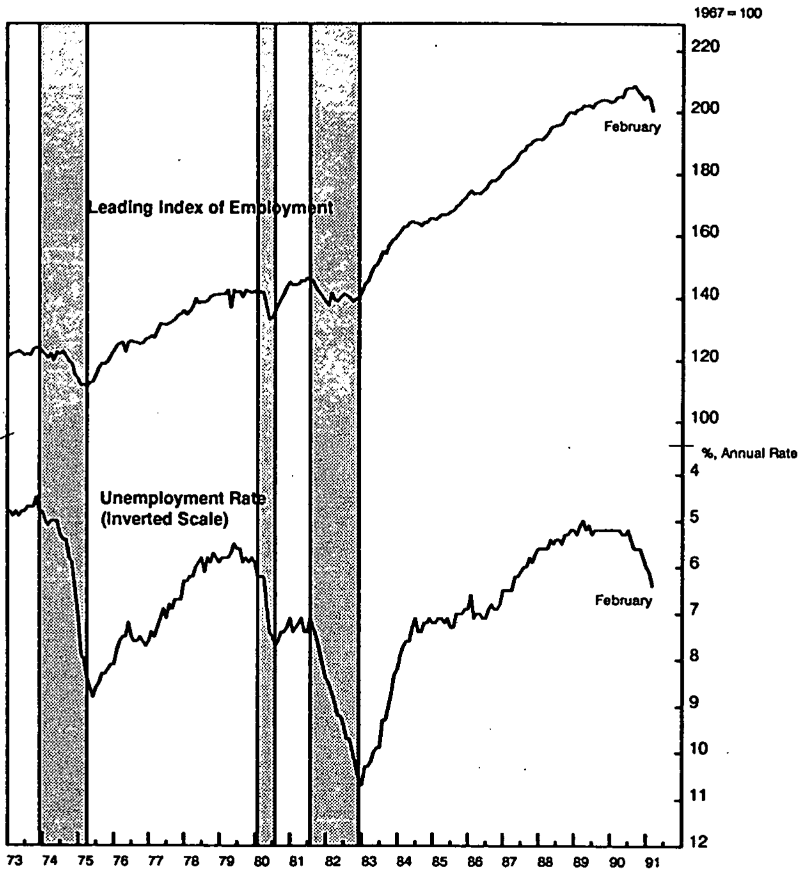
LEADING AND COINCIDENT INDEXES FOR SERVICES, GROWTH RATES



Shaded areas represent business cycle recessions.

Chart 6.

Leading Employment Index and Unemployment Rate

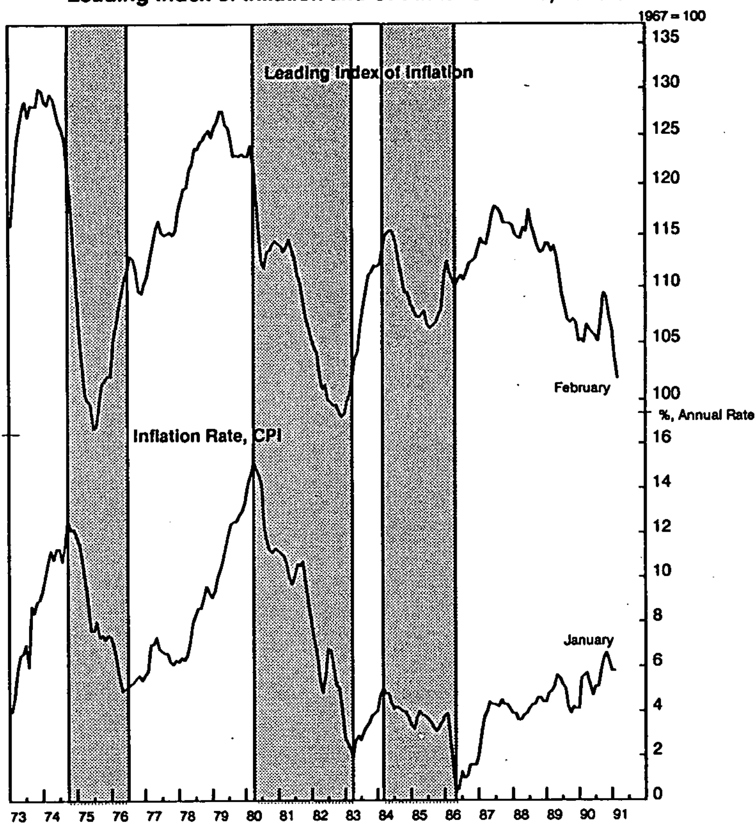


Shaded areas are business cycle recessions.

Center for International Business Cycle Research, Columbia University Business School

Chart 7.

Leading Index of Inflation and CPI Inflation Rate, 1973-91



Shaded areas represent cyclical downturns in inflation, based upon the six-month smoothed growth rates in the consumer price index for all consumers (shown above).
Center for International Business Cycle Research, Columbia University Business School

Senator SARBANES. The final panelist will be Mr. Richard Rahn of the Chamber of Commerce, who has been with us on many occasions and we are very glad to have him with us today.

STATEMENT OF RICHARD W. RAHN, VICE PRESIDENT AND CHIEF ECONOMIST, U.S. CHAMBER OF COMMERCE

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

In addition to my prepared statement being made a part of the record, we have several attachments and we request that they be made part of the record also.

Senator SARBANES. Without objection, it is so ordered.

Mr. RAHN. Mr. Chairman, last July before the Persian Gulf incident, we had forecast a recession. We had forecast a two-quarter, mild recession, the first recession we had forecast since 1981-82.

Unfortunately, now we see a longer and deeper recession with a weak recovery. In fact, we see no economic growth at all this year and the unemployment rate will be up to about 8 percent with only a small decline in inflation.

In the years 1983 through 1988 we did extraordinarily well. We had an economy growing at an average rate of about 4 percent per year. I think it is important that we take a look at how we got into the current dilemma.

It starts off with the Fed, as some of my colleagues here today have already noted. It is clear that the Fed has misjudged the state of the economy over the last 2 years and has been unduly restrictive. There are a number of fine individuals on the Fed and I know they have all done their best. And I would hope that, maybe over the longer run, this committee could take a look at the role of the Fed. Perhaps we have given them an impossible task.

If you look at the performance of the Fed, it has not been good. And surely, it is not the result of lack of trying of individuals there. But I think we may want to rethink totally how to go about monetary policy in the absence of monetary rules.

The second reason we got into the current difficulty is tax policy. The 1986 act, which we at the chamber supported because it did significantly reduce the disincentives on labor by bringing down high marginal tax rates and getting better resource allocations as a result in the drops of high marginal tax rates. But at the same time, it greatly increased the cost of capital. We were concerned about it at that time, and made our concerns known. But even we underestimated the impact of the increase of cost of capital, particularly the increase in the capital gains rate, restrictions on loss limitations, increases in the alternative minimum tax, the cutbacks, depreciations, and so forth.

It is now estimated that the 40 percent increase in the capital gains tax rate reduced the value of commercial real estate by about 17 percent and residential housing by about 9.2 percent.

In addition, we had a very rapid rise in regulatory cost. The Clean Air Act alone cost about $40 billion, and if you look at the total amount of increase in regulation, an estimate coming from Murray Weidenbaum is around $200 billion for this year alone in additional regulatory costs.

We cannot continue to add costs to the economic arteries of our economy without ultimately paying a price.

If we take a look at the deficit number, last year when the Office of Management and Budget came out with their deficit number for 5 years, 1991 through 1995, their estimate of the 5-year total was $62.4 billion, a couple of years of deficits and a couple of years of surpluses. In 1 year that has changed to $865.2 billion or an $803 billion swing in one year. Again, for the same time period—it's coming out of OMB—at the same time, the Congress believed that they were or at least stated that they were reducing the 5-year deficit by $500 billion.

If you literally took all these numbers, you would have to argue there was a $1.3 trillion swing in the estimate of the deficit over this 5-year period occurring over the last 12 months. Clearly, that's absurd.

I would hope that the Congress would really go back and seriously revisit what happened and look at their methodology for estimating particular changes in tax revenues, the impacts of tax increases on economic growth. Estimates have been made that the budget agreement alone cost us 0.7 percent or reduced economic growth by 0.7 percent or 400,000 jobs.

Many of the models that have been used over the years clearly are unrealistic and I note Congressman Armey has been greatly concerned about that and I am glad to see him on this committee. Because these models still involve too much static revenue analysis which is clearly absurd. It gives you people in the Congress the wrong information and, if you have bad information, you're going to make bad policy.

We also know that increases in spending clearly reduce economic growth. A recent study made by Professor Scully of Texas indicates that for about every 10 percent increase in government spending, GNP growth is reduced by 1 percent. Here we've gone from Federal Government spending of 22½ percent of GNP in 1989 to an estimated 25.1 percent in 1991, about 10 percent growth. That's 1 percent right there you can knock off.

This empirical evidence, again, backs up a lot of other studies and things we have done at the U.S. Chamber of Commerce, which is quite different from the old Keynesian models.

Clearly we have got diminished growth potential, increased taxes, uncertainly erratic and overly tight policies from the Federal Reserve, increased regulation, and increased government spending. All of these things have served to reduce our growth potential. What should be done?

Again, my colleagues here this morning have talked about the need for the Fed to loosen and we are clearly in agreement with that. The Fed has been following down the market rather than leading the market in the interest rate drops. They need to do more.

But even though the Fed was the primary culprit to get us into the mess, they cannot get us out of the mess alone. We need to go back to a growth strategy like we had in the mid-1980's.

There are a number of bills that have been put forth by Members of Congress which would help the problem. There is one in particular that has a number of components that we are quite en-

thusiastic about. The Wallop, DeLay, and Tallon bill, which is Senate bill 381 or H.R. 960, the Economic Growth and Jobs Creation Act of 1991. This would reduce Social Security taxes by 1.8 percent, half going to the employer, half going to the employee. It would increase IRA's using Senator Roth's formula of a backward-loaded IRA, no deduction going in. It would reduce the capital gains rate to 15 percent for most people and to 7½ percent for low-income people. And it would protect business people when they invest against inflation by having the neutral capital cost recovery system.

We did a survey, members of the U.S. Chamber of Commerce, our business ballot, and this was answered by more than 8,000 business people; 75 percent wanted to cut the payroll tax by about 2 percent. Only 20 percent were opposed; 81 percent thought it would be desirable to cut the capital gains tax to 15 percent—only 15 percent were opposed. To improve the capital provisions, 74 percent were in favor of that, only 16 percent opposed. And only 24 percent of our members this last month felt our economy would go up; 52 percent thought it would continue to go down.

Finally, Mr. Chairman, the proponents of increased regulation, higher taxes and new spending often defend such changes in terms of economic fairness, claiming that the benefits of any such proposal far outweigh its seemingly insignificant impact on total economic growth.

Unfortunately, the impact of one tax increase which reduced growth by one-tenth of 1 percent when added to other tax changes, new regulations, and spending programs, is altogether significant. That cumulative burden results in economic stagnation and recession. Ironically, regulatory tax and spending legislation, ostensibly intended to promote economic fairness, ultimately produces results that are particularly unfair.

More important than fluctuations in industrial production, the Consumer Price Index, or the Federal budget deficit, is the real economic pain and suffering that recession and low growth inflicts upon those Americans least able to withstand it. Economic stagnation literally kicks those individuals and families now desperately clinging to the lowest rungs of the economic ladder, into unemployment and poverty.

We cannot undo the considerable economic damage we've already created by past policy mistakes. We can, however, avoid more of the same dismal economic performance by reversing past mistakes and, with sound policies which restore economic incentives to work, invest, produce, and save. The truly compassionate economic policies are those which promote strong sustainable economic growth.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Rahn, together with additional material, follows:]

PREPARED STATEMENT OF RICHARD W. RAHN

The Outlook for the U.S. Economy

I am Richard W. Rahn, Vice President and Chief Economist of the U.S. Chamber of Commerce. On behalf of our 180,000 member businesses, associations, and local and state chambers of commerce, we thank you for the opportunity to present a statement on the outlook for the U.S. economy.

Last July, before the crisis in the Middle East erupted, we projected a mild, two-quarter-long recession beginning with the fourth quarter of 1990. Unfortunately for the American economy, the sixty thousand failed businesses and the over 1 million newly unemployed, our previous forecast of a recession apparently has come to pass.

Preliminary estimates of fourth quarter GNP show an annualized decline of 2.0 percent, the first quarterly decline since the second quarter of 1986. Initial data on January 1991 employment show a rise in the unemployment rate to 6.2 percent and a loss of 232,000 nonfarm jobs. In addition, the purchasing manager's index of economic conditions for February is just above 38, the kind of number associated with business contraction. Personal income and outlays dropped sharply in January, an indication that households are suffering from rising unemployment.

Clearly, the first quarter of 1991 has gotten off to a poor start. Such discouraging economic news almost guarantees a second consecutive quarter of decline in real GNP resulting in the first recession experienced since 1981-82. After a careful analysis of the current recession, we have found the following:

- The principal causes of slow economic growth and the recession are rooted in policy mistakes of the federal government. These anti-growth policies persist and are growing more burdensome to the economy.

- Anti-growth Federal Reserve Board policy was the major reason the economy slowed strongly and slipped into recession. However, fiscal and regulatory policies have also contributed to the decline and permanently lowered the growth potential of the economy.

- Slow economic growth with the possibility of intermittent recession is a likely future course for the economy. Although the current recession may prove milder and shorter than previous recessions, *the economy will not rebound with its traditional strength leaving the future course of economic events in considerable doubt.*

- The burden of anemic growth falls mainly on lower- and middle-income workers and smaller businesses in the form of lost job opportunities, bankruptcy and business failures.

- Congress can promote a more robust and sustainable economic recovery by acting immediately to pass the Economic Growth and Jobs Creation Act of 1991 (S. 381 and H.R. 960).

THE CHANGING ECONOMY FROM 1989 THROUGH 1992

Based upon new evidence of further decline, we have modified our economic forecast to show a longer and somewhat deeper recession than we originally predicted last July. Our current forecast table is attached to this statement.

We foresee an economy that will not grow between now and the middle of next year. The unemployment rate will steadily rise to near 8 percent during this time. We also expect an eventual decline in inflation from current rates of over 5 percent to 4 percent by the middle of 1992. The most positive influence on real GNP will come from net exports. We do not expect consumer and business spending to revive the economy any time soon.

The current recession follows seven consecutive quarters of consistently sluggish economic growth under 2 percent. Real GNP increased only by a compound annual rate of 1.1 percent from the beginning of 1989 to the end of 1990.

By contrast, between 1983 and 1988, real GNP rose at a compound annual rate of 4.0 percent. Inflation, after averaging about 3.5 percent during the same 6-year period, has risen to over 5 percent in the last two years.

It is our opinion that the robust growth experienced between 1983 and 1988 was sustainable and that the unemployment rate should have continued to fall to this day without fueling higher inflation. Instead, the Fed devised an ill-fated high-interest rate policy designed to dampen the expansion in the hope that an economic slowdown would lower inflation. The Fed enlisted Congress and the Administration in its efforts to kill economic growth by insisting on deficit reduction by any means -- even a massive tax increase -- as the price for allowing interest rates to fall. Other policy mistakes, including tax increases dating back to the 1986 Tax Reform Act, more regulations and renewed increases in the growth of federal spending rendered an otherwise avoidable recession inevitable.

These policy mistakes have become so pervasive that we now believe the economy will continue to face prospects of persistently slow growth and intermittent recession. Unlike one-time shocks to the economy such as oil price hikes and quick wars, the anti-growth policies of the government are cumulative. Taxes have gone up this year and will rise again next year. Federal spending is expected to consume a 25 percent share of the economy. New regulations are adding to business compliance costs. And interest rates, despite the rhetoric of the Fed, are still much too high.

If the more optimistic consensus of private forecasters is correct, between 1989 and 1992 the economy will have grown only by a compound annual average of 1.5 percent. This would represent the slowest 4-year growth period since the 1930s.

That alone should be reason enough to focus attention on growth-enhancing policies. However, we believe that there is more than a reasonable likelihood that growth over this four-year period will be even lower than the consensus forecast if current policies persist. Under the status quo, we expect the 1991-92 period again to average a dismal 1.1 percent growth rate.

The average length of the six postwar recessions was 11 months. The average fall in real GNP from the peak preceding the recession to the end of the recession was 2.6 percent. The consensus of private forecasters is that the current recession will be shorter and shallower than the postwar average. But this is due largely to the pervasive weakness of the economy going into the recession. Unlike previous postwar contractions, the "corrections" the supply-side of the economy must make to match depressed demand during the recession are less severe and may take a shorter time to complete.

Because the current recession may fall short of historical averages, many policy leaders now argue that the economy will right itself quickly and then proceed directly back to a path of sustained moderate growth. Corrective actions to stimulate the economy are not necessary, they claim.

This all-is-well, short, mild recession viewpoint is reflected in the recent forecasts of the Congressional Budget Office (CBO) and the Bush Administration's Office of Management and Budget (OMB). Both forecasts project a two-quarter recession followed by very slow growth in the second quarter of 1991 and moderate to robust growth thereafter. Chairman Greenspan appears to share this view.

Despite the lack of concern over the future expressed by government forecasters, the prevailing consensus of private forecasters for the expected recovery is exceptionally low. For a full year following postwar recessions, real GNP rose on average 6.7 percent. The current consensus of private forecasters is for a recovery of just 2.8 percent. Several forecasts, including those of the CBO and OMB, project the recovery growth rate to be between 3 and 4 percent, somewhat higher than the consensus, but still quite a bit below the average postwar experience.

What concerns us the most is not how long and deep the recession may turn out to be, but how strong and sustainable will be the eventual recovery.

THE ORIGINS OF SLOW GROWTH AND RECESSION

The economic events leading up to this recession are different from what has occurred in the past. The recession did not come upon us all of a sudden. It was a result of cumulative anti-growth policies that first slowed the economy's strong growth and then removed significant amounts of growth potential. In the process, asset values, particularly real estate values, declined and accumulated debt became a severe burden on corporate cash flows.

Our pessimistic outlook has its origins in anti-growth policies found in the Tax Reform Act of 1986. On the positive side, that Act improved work incentives by significantly reducing marginal tax rates, reduced economic distortions by eliminating many inefficient tax subsidies, and the Act also removed millions of low-income people from the income tax rolls altogether. However, the Act also made other changes to the tax code that have greatly raised the cost of capital and stifled economic growth. The Act raised the top tax rate on capital gains to 28 percent, made it difficult to deduct legitimate business expenses by limiting losses on "passive" investments, curtailing depreciation schedules on commercial real estate, and repealing the 10-year amortization of construction-period costs and taxes. The Act also tightened the Alternative Minimum Tax (AMT) rules, changed and tightened the rules on real estate tax shelters and real estate investment trusts, and made a number of changes in real estate accounting rules. As a predictable result, asset values have slipped, especially real estate values. Falling real estate values not only increased the insolvency of thrifts and reduced the solvency of many banks, but also put a damper on the rise in household and business asset values. For example, a study done for the Chamber last year and updated just recently by Fiscal Associates, Inc., a Virginia economic consulting firm, found that the 40 percent increase in capital gains rates in 1986 has reduced the value of commercial real estate by 17 percent and residential home values by 9.2 percent.

The 1986 Act was designed to raise business and corporate taxes by about $120 billion over five years. By limiting proper deductions on capital investment, the Act raised

taxes on capital-intensive industries – the backbone of the U.S. export business. Coupled with onerous taxes on foreign activities of U.S. companies, the Act reduced U.S. competitiveness. It also completely eliminated the investment tax credit for all businesses, thereby reducing business investment.

One perverse aspect of the 1986 Act emanates from the AMT provisions. They have caused a rise in the effective corporate tax rate during the current recession. Normally, tax policy is designed to cushion the effects of an economic downturn by curtailing tax liability by more than the fall in earnings. Unfortunately, many corporations facing falling profits are finding their tax liabilities rising due to the AMT.

Even though the 1986 Tax Reform Act contained numerous positive elements, on balance the anti-growth provisions, when fully implemented by 1989, more than offset pro-growth effects. In short, the overall effect of the Act has been decidedly anti-growth.

The economy is not where it is today strictly because of this gradual rise in business taxes. The severe and unceasing high interest rate policy by the Federal Reserve Board deserves blame as well.

Fed high interest rate policy dates back to the spring of 1988 as a much ballyhooed step to quell what the Fed believed was rising inflationary pressures. The Fed redoubled its anti-growth efforts in early 1989 and has continued its slowdown policy to date in spite of the fact that interest rates have fallen over the past six months.

In fact, since August 1987 when Alan Greenspan became Federal Reserve Board Chairman, *bank reserves have barely increased.* The Fed consciously drove up interest rates by over 300 basis points in 1988 and 1989 by holding down bank reserve growth. However, during the subsequent decline in interest rates by nearly that amount to date, the Fed has hardly let bank reserves rise. Indeed, during a long period in 1989 and 1990, when market interest rates were falling, bank reserves declined and the Fed funds rate – the interest rate used by the Fed to signal its policy intentions – stayed steady.

Up until January, the reduction in the Fed funds rate had followed market interest rates down. Growth in bank reserves and money supply declined between June and

December last year, indicating that monetary policy was becoming "tighter" as the economy dipped into a recession. It is fair to conclude that the Fed has merely been reluctantly following credit market interest rates on government securities downward since the middle of 1990 and may have intended to moderate interest rate declines.

What did the Fed accomplish with its orchestrated assault on inflation? At the beginning of the Fed's anti-inflation campaign, inflation stood at 4.4 percent. Today, it is over 5 percent. The Fed may defend this gap between its rhetoric and the inflationary realities by claiming that inflation would have been *even higher* without its restrictive policies. We have heard similar claims before. In particular, we are reminded of the actual results of last year's much-celebrated "deficit reduction agreement."

Back in 1988 and 1989, the Fed had to take extraordinary action to slow a robust economy down. In doing so, it discouraged capital formation and destroyed growth potential. Today, the Fed would have to take extraordinary action to induce added growth. But loose monetary policy cannot increase growth potential without igniting inflation and creating a situation where the Fed must revert to the very policy that started the economy down in the first place. This is why we have admonished the Fed to follow clear rules governing their actions instead of stop-go policies that only confuse credit markets and devastate the economy.

The credit situation is so strained that even if the Fed aggressively begins to lead rates down with increased reserves, there is little reason to believe that Fed policy can bring the economy back. Fed policy alone cannot induce businesses to invest again. Even now that the monetary and bank regulatory authorities more fully realize the extent of the present slowdown, a shift in Fed policy is still likely to be thwarted by fiscal and regulatory policies that also are hitting the economy hard.

The regulatory budget of the government will rise in fiscal years 1991 and 1992. Although there are no precise measures on a program-by-program basis, it has been estimated by former Council of Economic Advisors Chairman Murray Weidenbaum that an overall increase of $1 in regulatory spending will increase business compliance costs by

$20. Consequently, the economy may incur additional compliance cost expenditures of over $200 billion in 1991 and again in 1992. When the Clean Air Act is eventually implemented, that legislation alone may add as much as $40 billion a year to compliance costs. Such costs reduce output, lower productivity and raise prices -- exactly what has occurred in 1989 and 1990 and precisely the opposite of what is needed to reverse persistently sluggish growth.

There are other prominent explanations for the long economic slowdown and the eventual recession. Some analysts point to an excessive public and private debt build-up and large budget deficits during the Reagan years as primary causes of the current economic malaise. However, the rise in debt was caused by tax law changes that gave tax preference to debt relative to equity financing and raised the cost of capital. As long as the economy continued to grow, that debt accumulation was cost-efficient. But with the slowdown, accumulated debt has become a burden. Thus, the drive to manage debt to accommodate reduced cash flows -- a situation that many businesses now face -- was prompted not by the debt alone, but by the slowdown and eventual recession.

The persistent federal budget deficit was caused primarily by excessive increases in federal spending. Although tax revenues doubled in the 1980s, spending *more* than doubled. Today's growing budget deficit reflects both reduced revenues due to poor economic performance and record levels of federal spending. Hence, to make a clear determination of what has caused the slowdown in economic growth, it is extremely important to separate those events that are symptoms of the slowdown from those that are the causes.

WHY THE FUTURE FOR THE ECONOMY LOOKS POOR

If budget deficits were the source of the problem, rather than its symptom, few people would be sanguine about future economic growth. Both CBO and OMB estimate a budget deficit in fiscal year 1991 above $300 billion. Yet, at the same time the deficit is rising above any amount recorded during the 1980s, forecasters foresee an economic

recovery.

Perhaps some analysts have been deceived into believing that the budget deficit will actually fall. After all, it has been widely publicized that nearly $500 billion in deficit reduction was accomplished last year. However, as the attached table indicates, the Administration's cumulative five-year deficit projection has increased an astounding $803 billion from where it was just one year ago. The actual outcome of last fall's "deficit reduction agreement" should lead those who fear the effects of rising deficits on the economy to lower their forecasts.

Of course, rising budget deficits, rather than being seen as the result of an economic slowdown and excessive spending increases, are seen by some analysts as a stimulus to economic growth. Contrary to this popular misunderstanding, fiscal policy is acting as a drag on the economy. It is well understood among economists that tax increases stifle economic growth. In 1991 alone, taxes have been raised by some $20 billion as part of the largest tax increase law in U.S. history -- an increase that was signed into law after the economy had already entered recession! By way of comparison, the amount of this tax is equivalent to $30-per-barrel oil lasting for several months, a large enough oil price hike to reduce any forecast of economic growth. These tax increases played a major role in reducing personal income in January. Additional tax increases next year will come on top of 1991 increases and will act to stifle incentives to produce and invest, further retarding economic growth.

Empirical confirmation of these conclusions can be found in a study by William C. Dunkelberg and John Skorburg.[1] Mr. Chairman, I would like to submit a copy of this study for the record.

Dunkelberg and Skorburg show that recent tax increases will raise the federal tax burden on American workers to an all-time peak. Their study looks at the effect of tax

[1] Dunkelberg, William C. and John Skorburg,"How Rising Tax Burdens Can Produce Recession," Policy Analysis No. 148, Cato Institute, February 21, 1991.

increases on economic growth. They find that since 1960 a rising tax burden, like current law, has led to a reduction in economic growth.

Likewise, Dunkelberg and Skorburg find that tax reductions raise economic growth and employment. Specifically, the authors estimate that as a result of last year's budget package, economic growth will be 0.7 percent per year lower than it would otherwise be and that 400,000 fewer jobs per year will be created than would otherwise be the case. They believe that the tax burden will rise to 20.7 percent of GNP by 1992, noticeably increasing the severity of any subsequent economic recession. Using a CBO rule of thumb that translates changes in economic growth into a change in the budget deficit, the authors estimate that most of the anticipated 1990 deficit reduction will be lost due to the impact of tax increases on real GNP growth.

Dunkelberg and Skorburg rightly are critical of CBO and OMB budget estimates because the economic models OMB and CBO use assume no adverse economic effects from higher taxes, despite empirical evidence to the contrary. Indeed, the authors correctly argue that those models cannot be taken seriously because they anticipate positive economic responses to more taxes.

Of course, OMB and CBO models are not alone. The bulk of the economic models used today are very insensitive to tax policy changes unless model users correct certain equations before running the model. The more tax-sensitive models such as the one employed by Chicago Economics generates quite pessimistic forecasts for 1991 and 1992.

Researchers are just beginning to understand that government spending, instead of being a stimulus to the economy, often serves as an inhibitor to economic growth. Governments tend to spend beyond a prudent amount and, often, well beyond their present means. Comparing the experience of various industrialized nations, a study by Gerald W. Scully[2] shows that a 10 percent rise in government spending as a percentage

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[2] Scully, Gerald W., "The Size of the State, Economic Growth and the Efficient Utilization of National Resources," Public Choice, 63: 149-164, 1989.

of GNP would reduce economic growth by 1 percent. That is, if federal spending were to increase to 25 percent of GNP as projected for 1991 and 1992, from where it stood in 1989 at about 22.5 percent, real GNP growth would permanently decline by about 1 percentage point. Mr. Chairman, I would also like to submit a copy of this study for the record.

In an economy the size of the U.S., this amounts to about $55 billion in lost output in 1991 and an increase in the deficit of about $10 billion. This may appear to be a modest amount as compared to the size of the federal budget alone, but this dampening effect on GNP increases and compounds itself each year as long as federal spending stays up as a percent of GNP. For example, after 5 years of 1 percent lower growth, the deficit would be over $100 billion larger. We project that federal spending as a percent of GNP will stay above 25 percent in 1992.

Not only does increased federal spending drain the private economy of resources -- either by raising taxes or diverting funds that could have been loaned for private use -- but Scully also finds that rising federal spending reduces productivity growth. The statistically significant drop in productivity occurs, Scully argues, because governments use resources less efficiently than private industry. Scully found that nations with relatively large government sectors suffered from lower productivity when resource differences among nations were accounted for.

The magnitude of excessive federal spending can be illustrated by the lag between expenditures and revenues. Not until 1995 will the federal government take in sufficient revenues to sustain the level of spending now proposed for 1992. And this large amount of revenues will only be collected if economic growth is robust and sustainable over the next four years.

Thus, the federal government is at least three full years ahead of its income on the spending side. If the ordinary American were faced with such a "deficit," he would be compelled to cut expenditures. Even if he sought a loan, lenders would require that he bring expenditures into line with income in short order.

DIMINISHED GROWTH POTENTIAL

What we are left with is an economy with diminished growth potential. Higher tax rates, an increased percentage of GNP devoted to government spending, increased regulation, destructive capital gains tax rates and a credit crunch on business that stifles what productive investments remain all contribute to a decline in capital accumulation. At the same time, regulatory failure and a socialized system of deposit insurance are draining capital from the economy in order to keep insolvent and poorly run banks and thrifts in business.

This period of extremely slow growth in the U.S. economy is an anomaly. Generally speaking, market economies produce strong economic growth performance. As prerequisites for growth, market economies rely primarily on well-defined private property rights and established rules of doing business in free markets. But one key to success is to allow failing businesses to go under so that they do not continue to drain capital from successful businesses throughout the remainder of the economy.

Schemes such as deposit insurance keep failing firms in business by encouraging poorly run banks and thrifts to make unsound loans, thereby destroying incentives to reduce those activities that are unprofitable and wasteful. But, of course, as socialist Eastern Europe discovered, government cannot indefinitely prop up economically-rotten activities. The banking crisis today, no less than the failing economies of Eastern Europe, is the direct result of the dry-rot produced by the artificial preservatives of government subsidies and protection.

Most forecasters rely on demand-side based models of the economy that have no mechanism to record abrupt slips in economic growth potential. These models merely assume the economy will bounce back to whatever rate of potential growth the model assumes. In most cases, analysts have not adjusted their estimates of growth potential downward since the end of 1988.

The loss of potential growth is a debatable point, but recent economic performance suggests that maintaining the same growth-potential assumption is inconsistent with the

basic demand-side approach. For example, the nation's unemployment rate held steady at 5.3 percent during the last half of 1989 and most of 1990. According to demand-side modelling, a steady unemployment rate is an indication that the economy is at or near full employment potential. However, during all that time, real GNP growth was falling. The unemployment rate did not edge upward until economic growth fell to close to 1 percent.

But there are other models that can incorporate changes in the economy from a variety of sources. The Minneapolis Federal Reserve employs such a model. The most recent forecast using this model conforms to the Chamber's pessimistic view. Surely, the diversity of opinion about the near-term forecast of the economy should cause policy-makers to weigh the wisdom of all forecasting approaches and pay special heed to avoiding the worst outcomes. As Dunkelberg and Skorburg point out, due to poor economic performance, to date $100 billion of the planned $494 billion deficit reduction has already been lost. Again, they conclude that if the tax increases voted last year remain on the books, almost all of the deficit reduction will be lost over the next four years and $200 billion-plus deficits will result as far as the eye can see.

Our real concern is with the future of economic growth. Market economies naturally grow (which is why so much of the communist world is seeking to get in on a good thing). We don't doubt that the U.S. economy could experience 5 percent real GNP growth over many years if policy impediments to growth are removed. But these impediments are so pervasive today that the economy will be fortunate to grow by 2 percent for any extended period of time during the next several years. The threat of recession and the inhibiting effect of that threat on consumer and business confidence will remain an important policy concern for many years to come.

Unfortunately, we have also concluded that the policies that have led to such low growth potential will not be changed any time soon. Some policy-makers, it seems, would rather blame poor economic performance on certain foreign nations or higher oil prices or even on sunspots than examine and alter their own failed policies and the false presuppositions on which they rest.

In Washington today there continues to be widespread optimism on the future course of the economy. The only basis for such optimism is the expectation that export growth will pull the economy forward. Exports continue to be the bright spot in the overall economic picture. However, leading indicators for 7 of our 9 largest trading partners have turned downward. Canada and Great Britain are already in recession. The future for exports rides on how well our trading partners do. It is a risky gamble to let interest rates do all the work at home while relying on strong growth elsewhere to keep the U.S. economy growing.

The administration's budget for 1992 is being praised by some observers for its honesty. CBO and OMB project economic growth at or above 3 percent for 1992 through 1996. Unfortunately, this is a far cry from what current government policies are likely to produce.

THE ROAD TO SUSTAINABLE, ROBUST ECONOMIC GROWTH

If the recession lasts longer than the public has been led to believe, or even if the recovery falters next year, American voters may hold Congress accountable for its failure to address economic problems. There is a reasonable likelihood that unemployment will stay high, businesses and banks will continue to fail, and slowly rising income in the face of continued inflation will reduce real purchasing power and disposable income in households across the nation.

The Chamber's most recent "Business Ballot" poll based on 8,390 responses shows that more businesses plan to fire workers than hire them in the next six months. In addition, just as many businesses expect their sales to fall as rise in that time. A healthy economy occurs when twice as many businesses expect to grow than expect to slow. The economy is so far from health and has been for such a long time that it is time to do something about it.

There are clear policy actions that always lead to more economic growth, greater income and enhanced employment. The Economic Growth and Jobs Creation Act of 1991

(S. 381 and H.R. 960) combines a number of these policies into a single bill, and the Chamber urges Congress to pass it. This Act is not revolutionary. It merely utilizes what has worked in the past to promote sustainable economic growth.

The Act proposes to raise worker income and lower the cost of labor to business by rolling back Social Security taxes to 10.6 percent (from the current 12.4 percent). Not only would this provision raise current income, but it would stimulate added job growth. Mr. Chairman, I have a concise statement of Chamber policy on the matter of the payroll tax, which I would like to submit for the hearing record.

The Act also would implement a new type of savings account called the "IRA Plus" to allow people to make deposits with after-tax funds and to make withdrawals of principal and interest tax-free after age 59 and one-half. The proposal also would allow tax-free withdrawals for the first-time purchase of a home, for a college education for a family member or for catastrophic medical expenses. This provision would encourage more savings and encourage first-time home purchases.

In addition, the Act seeks to reduce the cost of capital by reducing the capital gains tax rate to 15 percent along with indexing of capital gains. Capital gains revenues are small compared to overall federal revenues. But the impact of this tax cut could greatly improve investment and growth in the economy.

A lower capital gains tax rate would increase asset values, improve the solvency of financial services institutions and stimulate economic growth. Thus, a cut in the capital gains tax would significantly lower the cost of the thrift bailout and shore-up the asset values of many banks.

As a powerful added investment incentive, the Act also includes a Neutral Cost Recovery System provision to protect depreciation writeoffs against inflation and guarantee that businesses are able to recover the full replacement cost of equipment investment.

The same February "Business Ballot" poll shows that 75 percent of the respondents favor a Social Security tax cut and 81 percent favor a cut in the capital gains tax to 15

percent. A full 74 percent of business respondents support faster write-offs of facilities as embodied in the Act. The poll's results are attached.

CONCLUSION

The proponents of increased regulation, higher taxes and new spending often defend such changes in terms of economic fairness, claiming that the benefits of any such proposal far outweigh its small, seemingly insignificant impact on total economic growth. Unfortunately, the impact of one tax increase which reduces growth by one tenth of one percent, when added to other tax changes, new regulations and spending programs, is altogether significant. That cumulative burden results in economic stagnation and recession.

Ironically, regulatory, tax, and spending legislation ostensibly intended to promote economic fairness ultimately produces results that are particularly unfair. More important than fluctuations in industrial production, the consumer price index, or the federal budget deficit is the real economic pain and suffering that recession and low growth inflicts upon those Americans least able to withstand it. Economic stagnation literally kicks those individuals and families now desperately clinging to the lowest rungs of the economic ladder into unemployment and poverty.

We cannot undo the considerable economic damage already created by past policy mistakes. We can, however, avoid more of the same dismal economic performance by reversing past mistakes with sound policies which will restore economic incentives to work, invest, produce and save. The truly compassionate economic policies are those that promote strong, sustainable economic growth.

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UNITED STATES ECONOMIC OUTLOOK 1990 - 1991
Prepared by the U.S. Chamber of Commerce
First Quarter 1991

(Percent change from previous periods at seasonally adjusted annual rates unless otherwise indicated by shading.)

	QUARTERS							YEARS				
	Actual	Forecast						Actual Annual Average			Forecast	
	90/4	91/1	91/2	91/3	91/4	92/1	92/2	'83-'88	1989	1990	1991	1992
GROSS NATIONAL PRODUCT												
Nominal GNP	0.5	2.2	3.2	3.8	4.1	4.3	4.6	7.5	6.7	5.1	2.9	4.4
Real GNP	-2.0	-2.2	-1.2	-0.3	0.0	1.7	1.9	4.0	2.5	0.9	-1.0	1.1
Consumption	-2.9	-2.6	-1.6	-0.5	0.2	1.1	1.7	4.1	1.9	1.0	-1.2	0.9
Residential Investment	-18.5	-10.5	-3.6	2.3	3.3	4.0	4.5	10.8	-4.1	-5.3	-9.2	3.2
Nonresidential Investment	-1.3	-6.3	-4.6	-2.3	-2.0	-0.4	1.2	4.8	3.9	1.8	-3.0	-0.5
Equipment	4.2	-4.5	-3.5	-1.0	-1.5	0.7	1.9	8.5	5.2	2.7	-1.2	0.2
Structures	-17.9	-12.2	-8.5	-6.7	-3.6	-4.4	-1.2	-2.6	0.0	-1.2	-8.8	-3.3
Exports	7.1	0.1	3.5	2.5	3.7	3.8	3.5	6.7	11.0	6.2	3.2	3.4
Real Net Exports (82$B)	-18.5	-22.1	-13.8	-12.4	-10.5	-7.3	-5.0	-88.7	-54.1	-36.3	-14.7	-5.0
Imports	-9.7	-0.8	-1.6	1.6	2.5	1.8	2.1	10.5	6.0	2.9	-0.4	1.9
Government Purchases	4.2	0.3	-0.3	-0.9	-1.1	-0.9	-1.3	3.2	2.3	2.8	1.3	-1.3
Final Sales	0.6	-2.7	-1.0	-0.6	0.0	1.0	1.4	3.8	2.5	1.6	-0.8	0.6
Change in Business Inventories (82$B)	-22.2	-11.4	-13.5	-10.9	-10.7	-8.1	-5.8	21.6	23.8	-2.6	-11.6	-0.8
Industrial Production	-7.4	-6.1	-2.9	-0.4	1.3	2.1	2.7	4.9	1.7	0.9	-2.6	1.4
New Car Sales (mill.)	9.0	8.2	8.0	8.4	8.9	9.1	9.2	10.5	9.9	9.5	8.4	9.3
Domestic Car Sales (mill.)	6.6	5.9	5.8	6.1	6.3	6.5	6.6	7.6	7.1	6.9	6.0	6.7
New Housing Starts (mill.)	1.05	1.00	1.03	1.05	1.12	1.15	1.20	1.68	1.39	1.21	1.05	1.21
EMPLOYMENT, WAGES AND PRICES												
Civilian Unemployment Rate (%)	5.9	6.3	6.8	7.2	7.5	7.6	7.7	7.2	5.3	5.5	6.9	7.6
Compensation	4.0	5.1	5.0	3.9	4.2	5.8	4.7	4.3	3.0	3.5	4.6	4.8
Productivity	0.3	-0.9	0.6	0.6	0.4	0.7	0.9	1.9	-0.3	-0.8	0.1	0.8
Unit Labor Costs	3.7	6.0	4.4	3.3	3.8	5.1	3.8	2.3	3.3	4.3	4.5	4.0
Consumer Price Index	6.9	5.0	4.6	4.0	3.4	4.5	4.3	3.5	4.6	5.4	5.2	4.2
Implicit GNP Deflator	2.8	4.2	4.4	4.1	4.0	3.1	3.0	3.3	4.1	4.1	4.0	3.4
Prime Interest Rate (%)	10.0	9.2	8.8	8.5	8.5	8.5	8.5	9.8	10.9	10.0	8.8	8.5
3-mos. Treasury Bill Rate (%)	7.0	6.1	5.9	5.8	5.7	5.8	5.9	7.8	8.1	7.5	5.9	5.9
Corporate Bond Rate (%)	9.3	8.9	8.7	8.7	8.8	8.7	8.6	10.7	9.3	9.3	8.8	8.6
Real Personal Disposable Income	-3.8	-1.3	-0.2	0.7	2.3	1.5	1.2	3.6	2.4	0.8	-0.9	1.6
Changes in Profits from Current Production ($B)1	-6.8*	-3.2	0.9	5.6	7.1	4.1	1.6	29.8	-26.0	-12.1	-3.6	-15.9

*Estimated fourth quarter profits.
·Corporate profits with inventory valuation and capital consumption allowances.

FORECAST ASSUMPTIONS

This forecast table contains preliminary estimates of the National Income and Product Accounts for the fourth quarter of 1990. The nation's money supply M(2) is assumed to grow by 4.4 percent in 1991 and by 4.8 percent in 1992. The trade weighted exchange value of the dollar falls by 1.5 percent in 1991 and rises by 3.0 percent in 1992.

SOURCE: U.S. Chamber of Commerce, Forecast Section, using the Washington University macro model of the U.S. economy.

U.S. Chamber of Commerce

Washington, D.C. 20062

THE PROJECTED CUMULATIVE BUDGET DEFICIT, 1991-1995

As the data below demonstrates, the Administration's cumulative 5 year deficit projection has increased by an amazing $ 802.8 billion since one year ago. Compare this figure with the nearly $500 billion in deficit reduction supposedly contained in last year's budget agreement. Like outlays and revenues, there is a wide gap between the rhetoric of last year's budget agreement and the reality of the budget deficit. While meaningful deficit reduction will not be realized in the foreseeable future, the impact of the largest tax increase in the history of the United States on both the economy and the deficit is already being felt.

YEAR	PROJECTED DEFICIT, 1991 BUDGET	PROJECTED DEFICIT, 1992 BUDGET	INCREASE IN DEFICIT
1991	-63.1	-318.1	255
1992	-25.1	-280.9	255.8
1993	+5.7	-201.5	207.2
1994	+10.7	-61.8	72.5
1995	+9.4	-2.9	12.3
TOTAL	-62.4	-865.2	802.8

(Deficit figures in billions of dollars; all data taken from *Budget of the United States Government*, fiscal years 1991 and 1992.)

U. S. Chamber of Commerce
Business Ballot
February, 1991

METHODOLOGY

Business owners and managers throughout the U.S. were mailed a Business Ballot with *The Business Advocate*, a bi-monthly supplement to *Nation's Business*. These individuals were predominantly members of the U.S. Chamber of Commerce.

The following report outlines the February Business Ballot results. The report is based on 8,390 responses.

CUT THE SOCIAL SECURITY PAYROLL TAX RATE BY 2.2 POINTS?

	%
YES	75
NO	20
UNDECIDED	5

BASE: 8,390
NO ANSWER: 72

REDUCE THE CAPITAL-GAINS TAX RATE TO 15 PERCENT?

	%
YES	81
NO	15
UNDECIDED	4

BASE: 8,390
NO ANSWER: 32

PROVIDE TAX INCENTIVES TO FOSTER FASTER WRITE-OFFS OF FACILITIES?

	%
YES	74
NO	16
UNDECIDED	10

BASE: 8,390
NO ANSWER:71

WHERE IS THE ECONOMY HEADED?

	%
UP	24
DOWN	52
NO CHANGE	24

BASE: 8,390
NO ANSWER: 116

WHAT IS THE SIX-MONTH OUTLOOK FOR YOUR SALES VOLUME?

	%
UP	35
DOWN	34
NO CHANGE	31

BASE: 8,390
NO ANSWER: 51

WHAT IS THE SIX-MONTH OUTLOOK FOR YOUR FIRM'S EMPLOYMENT?

	%
UP	18
DOWN	22
NO CHANGE	60

BASE: 8,390
NO ANSWER: 58

TYPE OF FIRM

	%
MANUFACTURING	24
RETAIL/WHOLESALE	30
CONSTRUCTION	11
INSURANCE	4
FINANCE/BANKING	2
REAL ESTATE	2
COMMUNICATIONS/ TRANSPORTATION	4
AGRICULTURE/ FORESTRY	2
PROFESSIONAL	9
OTHER	12

BASE:8,390
N/A: 1198

U.S. Chamber of Commerce

Washington, D.C. 20062

CUTTING THE SOCIAL SECURITY TAX

The U. S. Chamber of Commerce was one of the earliest advocates of cutting the Social Security payroll tax and returning the system to a pay-as-you-go basis. In 1987, the Chamber's Board of Directors fully endorsed the recommendation of the 1986 White House Conference on Small Business to freeze FICA taxes. Since that time, the Social Security tax burden has increased substantially.

Last year, the Chamber's Board reaffirmed its support of a reduction of the payroll tax rate and urged that the study of private alternatives to ensure the long run soundness of the nation's retirement system be accelerated.

Reducing the Social Security tax burden is all that more important this year because of the current recession. Jobs have been lost and incomes are suffering. Last fall we estimated that by lowering the cost of labor, a cut in the payroll tax would stimulate much-needed economic growth, increasing GNP by $100 billion and creating 600,000 new jobs through 1995. Just last month, the Chamber's Board once again went on record in favor of a payroll tax rate cut.

At that time, the Chamber's Board made it clear that it opposes raising the Social Security taxable wage base. The wage base is already at an all-time high, and the proportion of wages that are subject to the FICA tax, now over 90 percent, also is at an all-time high. Raising the wage base to $82,200 in 1996 from the current law projection of $69,300 in 1996, for example, would cut the number of new jobs created by the tax reduction in half. While such a proposal still contains a net tax reduction, large numbers of workers would receive only a tiny tax cut, and the macroeconomic benefits would be substantially less than those generated by cutting the payroll tax rate without tampering with the wage base.

The U.S. Chamber will oppose vigorously any rate cut accompanied by outright elimination of the wage base cap. Such a proposal would result in a net tax increase for many Americans. More importantly, elimination of the wage base cap would be nothing short of merging the Social Security payroll tax with the income tax. Severing the link between what workers pay into the Social Security retirement fund and what they get out in benefits, as this proposal does, would undermine the entire concept of Social Security as a supplemental retirement program and convert it into the world's largest welfare program. Social Security is not an income redistribution program, it is a retirement program. The U.S. Chamber wants nothing to do with such an irresponsible act that would undermine the decades-old public support for Social Security.

Likewise, the Chamber will oppose vigorously any attempt to deny a reduction in FICA taxes paid by employers by restricting the cut to those taxes paid by workers. This proposal offers no incentive to small businesses to hire more workers. Both this idea and the proposal to raise the wage base cap threaten to shatter the growing bipartisan coalition in support of a payroll tax rate reduction.

A properly crafted reduction in the Social Security payroll tax will create much-needed new jobs and substantially boost economic growth. The Chamber believes there is an opportunity to strengthen the coalition for a payroll tax cut and at the same time give the economy an additional boost. This could be accomplished by combining a payroll tax rate cut with a reduction in the capital gains tax rate.

Coupled with a reduction in the capital gains tax rate, a Social Security tax cut would provide even stronger medicine for our ailing economy. For example, based upon the work of Allen Sinai, we estimate that combining a two percentage point reduction in the payroll tax with a reduction of the capital gains tax rate to 15 percent would increase real GNP by almost 3 percent and create upwards of 3 million new jobs over the next five years. This means that federal revenues derived from increased economic growth would rise.

Equally important in terms of final congressional approval, the inclusion of a capital gains tax cut in the final legislative package would broaden its bipartisan political appeal. The Chamber urges Congress and the President not to let this golden opportunity to jump start the economy slip away.

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The size of the state, economic growth and the efficient utilization of national resources

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1. Introduction

The size of the state, measured conventionally as government expenditures as a fraction of national output, has grown enormously in modern times.[1] During this century, among developed nations, government spending has risen from under a tenth to more than a third of a share of GNP. The rise of government control over national resources is ubiquitous.[2] Is this substitution of public choice for private choice beneficial or harmful to society based on some objective criterion? Obviously, an array of criteria must be specified and their interrelationships modeled before a definitive, overall judgment can be made. The objective in this paper is more limited. Evidence is offered on the effect of the size of the fiscal sector, net of resource growth, on economic growth and on the efficiency of resource allocation for 115 market economies for the period 1960 to 1980. The overall conclusion is that for these criteria at least the growth in the size of the state has been harmful.

2. Increases in the size of government: Beneficial or harmful?

Several caricatures of the state are found in the literature. In the English-speaking public finance tradition the democratic state is characterized as benevolent. The agents (politicians and bureaucrats) benignly serve the polity in performing the Musgravian (1959: Ch. 1) fiscal functions. From a public choice perspective, the bureaucratic state in majoritarian, representative democracies is fiscally expansionist, redistributive, and self-serving, with public resources being allocated in a political market (Downs, 1957; Buchanan and Tullock, 1962; Tullock, 1965; Olsen, 1965; and Niskanen, 1971). In the Italian public finance tradition (Buchanan, 1960) and in Buchanan (1975) and Brennan and Buchanan (1980) the state is characterized as malevolent. Unshackled

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of constitutional rules, revenue maximizing Leviathan drives the polity to penury (Brennan and Buchanan, 1980: 40).

While malevolence for its own sake cannot be ruled out, political self-seeking with guile naturally is linked with rent-seeking (Tollison, 1982). In majoritarian, representative democracies logrolling politicians redistribute public income by concentrating net benefits (benefits minus taxes) among the majority coalitions electing them. This tends to lead to a growth of the public sector (Buchanan and Tullock, 1962) and toward a redistribution of public resources toward the middle class (Stigler, 1970; Tullock, 1983, 1986). In non-representative governments the public sector is a source of rents to the ruling class and a source of much mischief. Tullock's (1967) important theoretical insight on rent-seeking identifies tariff induced rents as a prize up for grabs (also, see Krueger, 1974). In a laissez-faire, free trade, market economy, competition erodes rents. State command of resources through its fiscal function and government rules, regulations, licensing, etc. give rise to political markets for rents. Resources flow into the pursuit of those rents. Buchanan (1980: 9) argues that the level of rent-seeking and the resources devoted to this socially unproductive pursuit are directly related to the relative size of the public sector in the economy. Therefore, the increased size of government is harmful. Resources are reallocated from productive activities into directly unproductive, rent-seeking pursuits. A consequence of the rent-induced distortions in resource allocation is a decline in economic growth and in efficiency.

Traditional arguments also plausibly link the size of the government sector with a reduction in national economic performance. Value added in the government sector is lower than in the private sector. Resources are not allocated to highest valued use but on political (bureaucratic) criterion. High taxes, tax progressivity, and the substitution in consumption of politically priced public goods for market priced private goods reduces the incentives of economic actors.

The secular rise in the size of the state and the near universal appeal of the relatively large government sector suggests that large segments of these societies find this result desirable. Arguments that the increased size of the public sector is beneficial and may promote growth and efficiency briefly would be of the following sort. (1) The larger the government sector the greater the macroeconomic stability, since government expenditures exhibit less variance than private sector expenditures. *Ceteris paribus*, economies with low variance in GNP grow at a higher rate than those with a high variance in GNP. (2) The larger the size of the government, the greater is the scope for income redistribution. Too much income inequality may create incentives for the low income types to seek another social order. Redistributions may reduce work incentives, but may be an inexpensive (efficient) means of preserving the social order. Satisfying the demand for income redistribution promotes political and social

stability, which are preconditions for growth and efficiency. Thus, the income distribution partly may reflect the opportunity cost of rebellion. (3) Traditional public goods-externalities (market failure) arguments and the effect of reduced transaction costs are associated with the government supplied infrastructure. (4) In a less developed country context a belief that the private sector is incapable of modern transformation of the economy.

Empirical testing of the hypothesis of a rent-seeking Leviathan is difficult. The relatively little empirical evidence that exists is conflicting.[3] Ideally, the vector of government policies (tariffs, quantitative restrictions, licenses, export marketing boards, foreign exchange controls, etc.) that give rise to rent-seeking and that yield negative net social benefits would be identified and their effects estimated. Data limitations preclude wide testing of this proposition.

Alternatively, but, less adequately, the effect of the size of the state sector on economic growth and efficiency can be tested. Utilizing IMF, World Bank and United Nations sources Landau (undated) found that the size of government was negatively correlated with the compound growth rate of per capita gross domestic product for a sample of 65 less developed countries over the period 1960 to 1980. A weakness of the Landau study is that a multiplicity of regressors (frequently more than 20) appear in the equations without concern for a theoretical specification of relationships and interrelationships among the variables. Using an earlier version of the data set employed here (i.e., Summers and Heston, 1984), Landau (1983) found for a sample of 104 developed and less developed countries over the period 1961–76 a negative relationship between size of government and the growth rate of per capita GDP. Marlow (1986) found a negative relationship between the size of the state sector and the compound growth rate of real gross domestic product for the industrialized countries over the period 1960–70. In sharp contrast, Ram (1986) using the Summers and Heston data for the period 1960–80 concluded that the size of the public sector had a positive effect on growth. Ram's dependent variable is the country specific trend (per capita growth) regression coefficient; the independent variables measuring the growth rate of government expenditure and population are also trend regression coefficients. This procedure violates the normality assumption of the underlying distribution of the estimators. In the Ram specification the growth rate of the government sector and the growth rate multiplied by the size of the government sector are entered as separate regressors, when in fact they are not independent. Econometric difficulties of this sort weaken his findings.

A major limitation of these empirical studies on the effect of the size of the public sector on the economy is that a growth model has not been specified, nor has the effect of state allocation of resources on economic efficiency been studied. The growth rate of inputs such as the capital stock and the labor force affect the growth rate of output. Failure to adjust for input growth may render

inaccurate the estimates of the effect of the size of the state sector on economic growth.

3. Data and variable construction

The cross-country economic data employed in this study comes from Robert Summers and Alan Heston (1984) (in collaboration with Irving Kravis). Summers and Heston have constructed internationally comparable economic series for a large number of countries over time. The economic data used as variables in this study is for the period 1960 to 1980. The Summers and Heston data are made comparable across countries through the employment of a common set of world average prices. Intercountry per capita income figures suffer from the intractable index numbers problem, differences in national accounting systems and in the coverage and statistical reliability of the accounts data, and in exchange rate conversion problems in translating income data in different national currencies to the US dollar, the conventional, common numeraire. The Summers-Heston-Kravis technique tackles some of these problems and provides the only available comparable set of international product and product composition data.[4] The World Bank now uses this approach.

3.1. Economic growth and the size of the state

Let an economy be described by a simple, aggregate, neoclassical production function homogeneous of degree one in the inputs.[5] In intensive form the production function is $y = f(k)$, where y is output per capita and k is capital per capita. Differentiating the production function with respect to time and dividing by y yields $g_y = e_k \cdot g_k$, where g_y is the growth rate of output per head, g_k is the growth rate of the capital-labor ratio and e_k is the elasticity of output per head with respect to the capital-labor ratio.

Given data on output and inputs in the private and government sectors, production functions could be estimated separately for each sector. The economy wide growth rate would be a weighted average of the growth rates of each sector and the effect of the increased size of the government sector on growth would be simply measured. This approach is not feasible, since the data is not available. The alternative is to adopt the traditional approach in the literature and add the size of the government sector as a regressor in the stochastic version of the growth equation. Since the effect of the growth rate of the input ratio on the growth rate of per capita output has been held constant, the coefficient of relative government size on economic growth is unbiased. Since the dependent variable is the growth rate of per capita output, the appropriate specifi-

cation of the relative government size variable would include its initial or starting value and the interperiod change in the variable.

3.2. Measuring efficiency

One or more of the economies described by the production function will have values of output per capita that are greater than those of other economies with similar values of the input ratio. These economies are the most technically efficient in converting inputs into output. Such economies are said to be frontier efficient. Designate the efficient economies y^* – the efficiency frontier. Economies can be compared to the efficiency frontier, and a measure of efficiency, EFF, is defined as $EFF = y/y^*$, with $0 < EFF \leq 1$.[6]

3.3. Econometric specification

The estimation technique for the production function depends on the nature of the assumption regarding the error term in the stochastic version of the production function. Three specifications are employed here: (1) the deterministic frontier function of Aigner and Chu (1968); (2) the stochastic frontier function of Aigner, Lovell, and Schmidt (1977), as extended by Huang (1984); and (3) the maximum likelihood Gamma frontier function by Green (1980).

The deterministic frontier function is estimated by minimizing the sum of the absolute residuals. The approach, therefore, considers all deviations from the efficient, frontier function as arising from technical inefficiency. A criticism is that only part of the error may be deterministic; part may be truly stochastic. The error term may be of the form $\delta = u + v$, where u is a one-sided disturbance term representing the degree of technical inefficiency and v is a symmetric, normally distributed random influence.

The EM (expected maximization) algorithm is a general approach for computing maximum likelihood estimates from incomplete data and is given by Dempster, Laird, and Rubin (1977). Huang (1984) utilizes the algorithm as a method of decomposing the estimated error, δ, into separate components, u and v. The Huang approach is an extension of Aigner, Lovell and Schmidt (1977).

The EM algorithm technique consists of a two-step iterative procedure. The first procedure is to estimate the sufficient statistics of the stochastic frontier function. The estimation step utilizes the predicted sufficient statistics to estimate the parameter Θ by maximum likelihood. Once the estimated Θ is obtained by the EM algorithm, the individual stochastic efficient frontier can then be estimated by the conditional mean. Huang (1984: 848–850) can be consulted for further details.

A second criticism of the deterministic frontier approach is the assumption that the error term is normally distributed. Green (1980) has worked through the estimation of stochastic frontier functions with the assumption that the stochastic disturbance is Gamma distributed. Assume that the density function follows the two parameter probability law: $f(\delta) = G(\Omega,p) = \Omega^{p}\delta^{p-1}\, e^{-\Omega\epsilon}\Gamma(p)$, where $\delta \geq 0$, $\Omega > 0$, $p > 2$, and, where $\Gamma(p)$ is the Gamma function evaluated at p. This disturbance has $\mu = p/\Omega$ and $\sigma^2 = p/\Omega^2$ is always positive. The parameters of the log likelihood function are estimated using a Newton-Raphson algorithm. The Gamma function and its derivatives are approximated utilizing a SAS subroutine known as the LIFEREG procedure. Following Green (1980), the starting value for the frontier function is obtained by OLS.

Data on real gross domestic product per capita, population, and the percentage of real gross domestic product devoted to gross domestic investment were available annually for 115 market economies for the period 1960 to 1980. From these data the following variables were calculated (the procedures of calculation are discussed subsequently):

CAPGWTH	= the compound growth rate of real per capita gross domestic product from 1960 to 1980;
L	= the estimated labor force (population) annually from 1960 to 1980;
K	= the estimated capital stock (buildings and machinery and equipment) annually from 1960 to 1980; and,
KLGWTH	= the compound growth rate in the capital-labor (K/L) ratio from 1960 to 1980);
GOVT60	= government expenditures as a percent of gross domestic product, 1960;
GOVT80	= government expenditures as a percent of gross domestic product, 1980;
CHGGOVT	= GOVT80−GOVT60.

3.4. Labor force

The use of population as a proxy for the labor force is disagreeable but conventional. Data on labor force participation rates is available for the OECD countries and Greece, Iceland, Luxembourg, and Turkey. Data for some non-OECD countries is available from United Nations sources. These labor force participation rates generally are not very reliable.[7]

3.5. *Capital stock*

The construction of the series on the annual capital stock by country over the period 1960–80 is based on the methodology suggested by Arnold C. Harberger (1978). The Summers and Heston annual data series on real gross per capita domestic product, population, and the percentage of real domestic product devoted to gross domestic investment provide the basic data for the construction of the capital stock series.

Gross investment is decomposed into three components: buildings, machinery and equipment, and inventories. The United Nations provides country data on the composition of gross domestic investment.[8] The series on the composition of gross investment hardly covers all countries in all years, but the coverage is fairly extensive. To avoid annual anomalies the composition share data by country was averaged over the period 1965–75, and this average was used for the country specific composition of gross domestic investment. For those countries lacking data on the composition of capital formation, regionally averaged data was utilized. While there is intercountry dispersion in these sectoral shares of gross domestic investment, it is not so extensive as to render a regional average an unreasonable substitute for the missing data. The largest regional coefficient of variation was 23 percent.[9] Inventories are ignored in this study. Therefore, the gross investment series employed here is gross capital formation in buildings and in machinery and equipment.[10]

3.6. *Size of government*

The variable chosen to capture the effect of the presence of the state on economic growth and economic efficiency is government expenditure as a share of gross domestic product. Peltzman (1980: 209) points out that the role of government is far more pervasive in economic life than is implied by this variable (e.g., statutes and administrative rules, regulation, etc. reallocate resources as much as fiscal activities), but data limitations dictate the choice. Not withstanding this *caveat* the size of the government sector so measured represents a substitution of public choice for private choice in the allocation of resources, and this substitution is hypothesized to adversely affect economic growth and efficiency. The three government expenditure variables measure the initial, terminal and comparative static absolute percentage point change in government share over the period of study.

Table 1. Regressions relating the effects of government expenditures on economic growth, 1960–80[a]

(Eq. no.) variable	All economies (1) CAPGWTH	(2) CAPGWTH	Less-developed economies (3) CAPGWTH	(4) CAPGWTH
CONSTANT	.0467	.0372	.0466	.0361
	(7.04)	(6.70)	(5.14)	(4.73)
KLGWTH		.4752		.4571
		(7.61)		(6.58)
GOVT60	−.1123	−.0889	−.1129	−.0842
	(3.16)	(3.05)	(2.47)	2.22)
CHGGOVT	−.1140	−.0871	−.1159	−.0856
	(3.66)	(3.41)	(3.05)	(2.70)
R**2(Adj.)	.1007	.4039	.0758	.3713
(N)	(115)	(115)	(93)	(93)

[a] Student-t values are in parentheses below the coefficients.

4. Empirical evidence on the relationship between government expenditure and economic growth and economic efficiency

4.1. The size of the state and economic growth

The relationship between economic growth, as measured by the compound growth rate of real gross domestic product over the period 1960–80, and the share of government in the national economy (GOVT60) and the interperiod change in the share of government (CHGGOVT) was estimated by linear OLS. The error term is assumed to be normally distributed.[11] The regression results appear in Table 1. In equation (1) in the table only the government share variables appear as regressors. In equation (2) in the table the compound growth rate of the capital-labor ratio over the period is included as a regressor. As the size of the state sector grows, government plays a more direct role in the allocation of physical capital.[12] While state investment may be less productive than private investment, such investment (positively) affects growth. Hence, due to the absence of the compound growth rate in the capital-labor ratio, the negative effect of government share on growth may be overstated.

Both GOVT60 and CHGGOVT are of the correct sign and are statistically significant in a one-tail test at better than the one percent level. Setting all of the independent variables in equation (2) in the table equal to zero, the compound growth rate is 3.7 percent. Each one percentage point increase in the compound growth rate of the capital-labor ratio (mean CHGKL = .0104, st. dev. = .0245) adds about a half of a percentage point to the growth rate. Each

Table 2. Predicted average growth rates for various levels of GOVT60 and CHGGOVT[a]

CHGGOVT \ GOVT60	0	10	20	30	40
0	4.2	3.3	2.4	1.5	0.6
5	3.8	2.9	2.0	1.1	0.2
10	3.3	2.5	1.6	0.7	−0.2
15	2.9	2.0	1.1	0.2	−0.6
20	2.5	1.6	0.7	−0.2	−1.1

[a] Based on equation (2) in Table 1 with KLGWTH set equal to its mean value.

one percentage point increase in government expenditures as a fraction of GDP in 1960 (GOVT60) or in the interperiod change in the fraction reduces the growth rate by roughly one-tenth of a percentage point. The average value of GOVT60 is .162 percent (st. dev. = .066), the average value of CHGGOVT is .0308 percent (st. dev. = .0756), and the average real per capita growth rate is .0251 (st. dev. = .0209).

The negative effect of government expenditure on economic growth can be seen more clearly in Table 2 where average predicted growth rates based on equation 2 in Table 1 for a range of values of GOVT60 and CHGGOVT across these 115 market economies are presented. At one standard deviation below the mean the least interventionist states have values of GOVT60 = .0955 and CHGGOVT = −.0448. Such hypothetical economies would have real per capita growth rates of 3.76 per annum. The most interventionist states (at one standard deviation above the mean) have values of GOVT60 = .2278 and CHGGOVT = .1064. Such hypothetical economies would have real per capita growth rates of 1.26 per annum. Obviously, the negative impact of the size of government on growth is of an important order of magnitude.

An objection to the analysis is that the sample of economies contains developed and developing countries, where the objectives of government expenditures may differ. Among developed countries a larger fraction of government expenditure is directly redistributive, while in developing countries a larger fraction may be for "productive", development purposes. The equations were re-estimated for the sample of less developed countries (n = 93). The results appear in Table 1. Naturally, there are changes in the size of the coefficients and standard errors, but these changes are trivial. The signs of the coefficients remain unchanged and the results remain statistically significant.

4.2. The size of the state and economic efficiency

Efficiency measures were calculated for each economy utilizing the various production function specifications discussed above. The technical efficiency

Table 3. Regressions relating the effect of size of the government sector on economic efficiency[a]

(Eq. no.) variable	All economies (1) EFF80	(2) Logit EFF80	Less-developed economies (3) EFF80	(4) Logit EFF80
CONSTANT	.8426	- 2.1152	.6766	- 1.6082
	(12.83)	(4.56)	(8.41)	(2.61)
GOVT80	- 1.8477	10.6936	- 1.2183	8.9630
	(5.65)	(4.67)	(3.25)	(3.12)
R**2(Adj.)	.2136	.1542	.0939	.0866
(N)	(115)	(115)	(93)	(93)

[a] Student-t values are in parentheses below the coefficients.

measures obtained are for 1980 and the best of these were regressed against the share of government expenditures in GDP for 1980 (GOVT80). The conclusions are not sensitive to the choice of the efficiency specification. The result appears in Table 3. Setting GOVT80 = 0, the technical efficiency of the average economy among the 115 countries is EFF80 = 0.84. Thus, on average such an hypothetical economy produces 84 percent of its potential or frontier real GDP per worker with its observed capital-labor ratio. For each one percentage point increase in the size of the state sector there is a loss of technical efficiency of about 1.8 percentage points. The coefficient relating GOVT80 to EFF80 is very highly statistically significant. At one standard deviation above and below the mean, the difference between the most interventionist and the least interventionist state is 12.5 percentage points. This difference yields a 23 percentage point difference in technical efficiency. Alternatively, the least interventionist state hypothetically produces 62 percent more output per worker with the same input ratio as the most interventionist state.

Restricting the sample of countries to the less developed countries does not change the conclusion that government expenditures and economic efficiency are inversely related and that this tradeoff is statistically significant. On the whole, the less developed countries are less technically efficient in transforming inputs into output (i.e., the intercept in equation (3) in Table 3 is 0.1660 less than that of equation (1)). While there may be other reasons for this difference, most of the difference in terms of the model is due to the fact that the less developed countries are more interventionist than the developed economies. There is a 7.1 percentage point difference in the size of the government sector in 1980 between these two groups of countries. The higher mean GOVT80 for the LDC's and the lower variance yields the somewhat smaller coefficient relating GOVT80 to EFF80 in equation (3)

It is clear from these results that increments in the relative amount of re-

Table 4. Regressions relating the effects of gross investment share on economic efficiency in 1980 and the change in economic efficiency, 1960–80[a]

	All economies		Less-developed economies	
(Eq. no.) variable	(1) EFF80	(2) CHGEFF	(3) EFF80	(4) CHGEFF
CONSTANT	.1407	−.1315	.1542	−.1621
	(2.74)	(3.88)	(3.05)	(4.35)
I60		.9481		1.2197
		(5.72)		(6.07)
I80	1.7438		1.4379	
	(7.40)		(5.85)	
CHGI		.8215		.8892
		(5.10)		(5.15)
R**2(Adj.)	.3204	.2333	.2655	.2912
(N)	(115)	(115)	(93)	(93)

[a] Student-t values are in parentheses below the coefficients.

sources allocated by the government sector reduce the efficiency of the economy in transforming inputs into output. Symmetricality of argument requires that the greater the share of private sector allocation in the economy the greater the efficiency by which inputs are transformed into output. To test this proposition the efficiency measure was regressed against the share of gross investment out of GDP in 1980 (I80). Since some government investment in state-owned enterprises is included in the gross investment data, the coefficient of I80 on efficiency will be biased downward to some unknown degree. The results appear as equations (1) and (3) in Table 4. The coefficient of I80 on EFF80 is positive and very highly significant. Moreover, the size of these coefficients are on the same order of magnitude as the absolute value of the coefficients of GOVT80 on EFF80 in equations (1) and (3) in Table 3. As such, bearing in mind the potential bias in the coefficient, each unit of resource converted from private sector allocation to public sector allocation is associated with a unit proportional loss of efficiency for the economy.

It is well known that bounded variables such as EFF80 may have distributions that are truncated, which limits the power of the tests on the hypothesis. The appropriate solution econometrically is to transform the dependent variable into the logit of the variable.[13] The dependent variable then is interpreted as the logarithm of the ratio of the odds of the event and the coefficient, the signs of which change naturally, is interpreted as the effect of the independent variable on changing the log of the relative odds. The empirical results appear in Table 3 as equations (2) and (4). OLS estimation of the logistic specification is a maximum likelihood estimate of the parameters. The results of equation

Table 5. Regressions relating the effects of size of the government sector and changes in size to changes in economic efficiency, 1960–80[a]

All economies	Less-developed economies	
(Eq. no.) variable	(1) CHGEFF	(2) CHGEFF
CONSTANT	.1769	.2256
	(3.74)	(3.57)
GOVT60	−.6324	−.8383
	(2.49)	(2.63)
CHGGOVT	−.5986	−.7692
	(2.70)	(2.90)
R**2(Adj.)	.0533	.0721
(N)	(115)	(93)

[a] Student-t values are in parentheses under the coefficient.

(2) and (4) in the table confirm that the negative relationship between the size of the government sector and economic efficiency remains robust. The standard errors are marginally larger in the logit specification, but the coefficients remain statistically significant at above the one percent level. Apparently, the distribution of EFF80 is approximately normal, which offers some futher assurance about the strength of the findings reported here.

4.3. The size of the state and the comparative change in efficiency

The negative effect of the share of government expenditure out of GDP on economic growth and on economic efficiency has been shown. A possible source of a decline in the rate of economic growth is a decline in economic efficiency resulting from the observed growth in the size of the government sector. It is an important natural extension of the empirical argument to test for the effect of these observed changes in the size of the government sector on interperiod economic efficiency.

Comparative static changes in economic efficiency for each economy in the sample were calculated by estimating the frontier production functions for 1960, calculating the efficiency measure for 1960, and constructing the variable CHGEFF = EFF80 − EFF60. CHGEFF was regressed against GOVT60 and CHGGOVT. The results appear in Table 5. Both coefficients are negative and are statistically significant at the one percent level. For the least interventionist hypothetical state (i.e., at one standard deviation below the mean for GOVT60 and CHGGOVT) economic efficiency between 1960 and 1980 improved (predicted CHGEFF = 0.1433). For the most interventionist hypothetical state

(i.e., at one standard deviation above the mean) interperiod economic efficiency declined (predicted CHGEFF = −0.0267).

If the increase in the size of the government sector between 1960 and 1980 resulted in a reduction in efficiency, symmetricality of argument requires that an increase in private sector allocation of resources result in an increase in interperiod efficiency. To test this proposition, CHGEFF was regressed against the share of gross domestic investment out of GDP in 1960 (I60) and the absolute interperiod change in the share of gross investment (CHGI = I80−I60). The results appear as equations (2) and (4) in Table 4. The coefficients are positive and highly significant. Economies with relatively high levels of gross domestic investment as a share of GDP in 1960 and with increases in that share during the period of study, increased their efficiency in transforming inputs into output. Economies with relatively high levels of government expenditure as a fraction of GDP in 1960 and with increases in the size of the government sector during the period experienced a decline in the efficiency in transforming inputs into outputs.

5. Summary and conclusions

The motives of the state in projecting a more than minimal presence in the economy may be conceived of as benevolent or malevolent. Whatever the characterization of the motivation, increases in the size of the government share of the economy adversely affect economic growth and the allocation of resources. Nations with relatively large government shares in 1960 on the whole grew more slowly than nations with relatively small state sectors. Interperiod increases in the size of government were associated with lower growth rates over the period. The size of the government share coefficients in the regressions were of sufficiently large magnitude to conclude that the rise in the size of the government has had a substantial depressing effect on economic growth. These results are consistent with those reported by Landau (1983) and Marlow (1986). Landau did not adjust economic growth for the growth in factor endowment. Consequently, his results overstate the adverse effect of government size.

Government allocation of resources is thought to be less efficient than private allocation. For the first time in the literature, this hypothesis was tested directly by comparing efficiency measures with the measures of the size of the government sector. It was found that the size of the government share in the economy was negatively correlated with economic efficiency and with the interperiod change in economic efficiency. Nations with relatively large state sectors produced less output per head with the same input ratio than nations with relatively small government sectors.

Notes

1. Peltzman (1980) presents data on the share of government out of GNP for the period 1860–1974 for the U.S., United Kingdom, Federal Republic of Germany and Sweden.
2. Marlow (1986) presents data on the share of government expenditures out of GDP for 19 OECD countries. The average increase in the share (G/GDP) over the period 1960 to 1980 was 25 percent.
3. Oates (1985) has examined the hypothesis that decentralization of the fiscal function induces intergovernmental competition for resources, which constrains the taxing power of the state. For data consisting of state and local government units in the United States and for a sample of 43 countries, Oates could not confirm the decentralization hypothesis. Employing a different measure of decentralization Nelson (1987) finds support for the hypothesis.
4. For criticisms of the Summers-Heston-Kravis technique see Caves, Christensen and Diewert (1982).
5. The production function was tested for the assumption of homogeneity of degree one and for heteroskedasticity. Neither difficulty emerged. See Scully (1988) for results.
6. For further discussion of this techniques and an application of measuring the impact of the rights structure on economic development see Scully (1988).
7. In developed countries the labor force participation rates of young adults is relatively low due to higher schooling participation and length of schooling. Also, labor force participation is lower among older workers, because alternative income sources are available (pensions, social security, etc.). Among males, population as a proxy for the labor force overstates the labor input in the developed countries relative to the less developed. Among females, the pattern of intercountry labor force participation differences is less clear. Much of the developed West has witnessed a secular increase in female labor force participation rates, even among married women. In less developed agricultural economies the labor force participation rate of women as family workers may be quite high. On the other hand, in some cultures there is a taboo against female employment.
8. United Nations, *Yearbook of national accounts statistics*, various years.
9. For buildings the regional coefficients of variation were as follows: Africa, 20%; Asia, 20%; Europe, 9%; the Americas, 22%. For machinery and equipment the regional coefficients of variation were: Africa, 21%; Asia, 17%; Europe, 17%; the Americas, 23%.
10. Harberger assumes a depreciation rate of 2.5 percent per annum for buildings and 8.0 percent per year for machinery and equipment. These are the depreciation rates used in this study. To obtain country estimates for the capital stock in the initial year gross investment for 1960 is multiplied by the fraction of non-inventory investment and divided by the weighted depreciation rate:

$$K60 = I60(1-c)/[.025(a) + .08(b)], \qquad (1)$$

where a is the share of gross investment in buildings, b is the share in machinery and equipment, and c is the share in inventories.

Capital stock for each subsequent year is obtained by depreciating the previous year's capital stock and adding current gross investment:

$$K(t) = K(t-1)\,(1-d) + I(t)\,(1-c), \qquad (2)$$

where $d = [.025(a) + .08(b)]$.

There is no denying that anomalies in the investment data utilized in calculating the initial capital stock may impart error into the capital stock series. One could reduce such possible

errors by averaging the gross investment series for say the period 1960–62. This has not been done. Examination of the data across countries revealed nothing extraordinary. More convincingly, as Harberger has pointed out, the longer the period used in the construction of the estimates the less sensitive is the capital stock to an error imparted in the initial capital stock. "This is because, if the base year is twenty years back, much of the 'initial' capital stock estimated for that year will in the interim have been 'depreciated' away." (Harberger: 19).

11. Heteroskedasticity is a possibility in cross-section studies. Given the wide range of sizes of economies in this study, the violation of constant variance across countries ranked by size is a possibility. Three procedures were employed to test for heteroskedasticity: (1) the residuals were ranked by 1980 population (a measure of the size of the economy); (2) the residuals were squared and regressed against 1980 population; and, (3) the Goldfeld-Quandt test was employed with 1980 population as the exogenous ordering variable. Examination of the residuals plotted against 1980 population indicated normality. The t-statistic of the squared residuals on 1980 population was well below the 5 percent acceptance level. For the Goldfeld-Quandt test the data was ranked by 1980 population size and the sample divided into thirds. Two regressions were estimated: one for countries with small populations; one for countries with large populations. An F-test on the ratio of the residual sum of the squares was well below the 5 percent significance level. The assumption of normality is validated.
12. The simple correlation between the share of national investment going to state owned enterprises averaged over the period 1970 to 1980 and GOVT80 (GOVT70) was $r = .41$ (.37), which is statistically significant at above the one percent level for the sample size ($n = 69$). The data on the share of national investment going to state owned enterprise is from Peter Short (1984).
13. The logit transformation is $1/1 + e^{-X\beta + \alpha}$. Hence, $\log(1-p/p) = -X\beta + \alpha$. Compared with the linear specification the logit transformation changes the signs of the coefficients.

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UNPRECEDENTED TAX LEVEL TO BLAME FOR RECESSION, STUDY FINDS

WASHINGTON, February 21, 1991--The record-high tax hikes enacted by President Bush and Congress in 1990, slated to raise $135 billion by 1995, are directly responsible for the United States' current slide into recession, argue William C. Dunkelberg and John Skorburg in a recent study for the Cato Institute.

Dunkelberg, dean of the School of Business and Management at Temple University, and Skorburg, chief economist for the Chicago Association of Commerce and Industry, use a dynamic model to determine the effects of high tax burdens on all sectors of the U.S. economy. "The budget package enacted last year cannot reduce the deficit as advertised. Indeed, by ignoring the impact of taxes on the economy, federal lawmakers have dramatically overestimated the reduction in deficit spending that their grand-compromise budget yields," the authors argue. They write that the budget deficit will probably remain above $300 billion for at least the next three years.

Highlights of the study follow.

* "Whenever the tax burden rises above 20.0 percent of GNP, the nation enters an economic danger zone in which it runs a high risk of a recession." The authors' model shows that "taxes will rise to 20.4 percent of GNP in 1991, 20.7 percent in 1992, and 20.8 percent between 1993 and 1995."

* "Each 1.0 percent rise in the federal tax burden leads to a 1.8 percent reduction in economic growth." GNP growth will therefore average 0.7 percent less than it would without new taxes between 1991 and 1995.

* The increases in income tax rates, gasoline taxes, and excise taxes on

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Cato/Tax burden/2-2-2

items such as beer and cigarettes, which will total more than $150 billion over the next five years, "will raise the federal tax burden on American workers to an all-time peak."

* The new tax increases will destroy 400,000 jobs. The unemployment rate will be 0.45 percentage points higher over the next five years than it would be without the 1990 tax hikes.

* "Ever since Bush announced his 'yes, new taxes' campaign, the Dow Jones Industrial Average--one of the most reliable economic barometers--has tumbled in free fall. . . . Stocks have forfeited roughly 15 percent of their value since last summer when tax talks gained momentum."

* The authors conclude that "any realistic anti-recession economic package this year should contain three reforms": repeal of the new gasoline, excise, and income taxes; cancellation of any plans to increase taxes in 1991, such as Rep. Dan Rostenkowski's suggested 10 percent income tax surcharge on Americans earning over $1 million annually; and enactment of pro-growth tax cuts, such as the capital gains tax cut or the social security payroll tax cut.

"How Rising Tax Burdens Can Produce Recession" is no. 148 in the Policy Analysis series published by the Cato Institute, an independent public policy organization in Washington, D.C.

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Policy Analysis

No. 148 February 21, 1991

Routing

HOW RISING TAX BURDENS CAN PRODUCE RECESSION

by William C. Dunkelberg and John Skorburg

Last year's highly touted, grand-compromise budget agreement reached between President Bush and Congress will raise roughly $150 billion in new taxes over the next five years--making it the second largest tax increase in American history.[1] New revenues will come from increases in income tax rates, gasoline taxes, and beer and cigarette levies, and from a combination of other excise taxes. Altogether those taxes will raise the federal tax burden on American workers to an all-time peak.

Now it appears that the tax frenzy is not complete on Capitol Hill. To promote "tax fairness," Rep. Dan Rostenkowski, the Democratic chairman of the House Ways and Means Committee, has announced that he may soon introduce legislation to place a 10 percent income tax surcharge on Americans with incomes over $1 million. Others are calling for a new tax on energy usage to pay for the Persian Gulf War.

Politicians and many economists have been applauding the move to new taxes, insisting that higher revenues are necessary to reduce the deficit and thereby stimulate long-term economic expansion. President Bush, for one, has argued that the 1990 budget package sent a reassuring message to jittery U.S. financial markets that Washington is serious about tackling the deficit.

Yet so far the financial markets have responded not positively but negatively to higher taxes, contrary to the assurances of lawmakers. Ever since Bush announced his "yes, new taxes" campaign, the Dow Jones Industrial Average--one of the most reliable economic barometers--has tumbled in free fall (see Figure 1). On average, stocks have forfeited roughly 15 percent of their value since last summer when tax talks gained momentum.

William C. Dunkelberg is dean of the School of Business and Management at Temple University, and John Skorburg is chief economist for the Chicago Association of Commerce and Industry.

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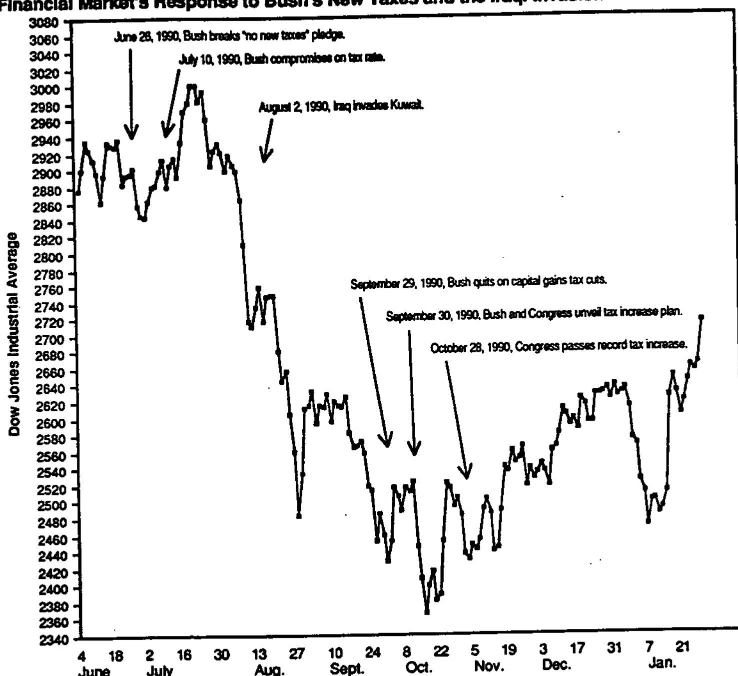
Figure 1
Financial Market's Response to Bush's New Taxes and the Iraqi Invasion



Of course, part of the fall in prices is attributable to the Persian Gulf crisis. Still, the data in the figure underscore two points: First, the signs of a bear market originally emerged before the Persian Gulf crisis but after Bush capitulated on taxes. Second, the completion of the budget deal has done nothing to arrest the decline in stock prices that accelerated after the Iraqi invasion of Kuwait.

Yet with all the legislative sweat, the deficit is not going to decline as expected and will probably rise in the next several years. The Congressional Budget Office reported in December that the deficit would climb to record dollar totals of $250 billion to $300 billion in 1991 and 1992.[2] The CBO also has estimated that at least $100 billion in the purported five-year $490 billion in deficit reduction has

already vanished because of continued deterioration of the economy. Others, including the Office of Management and Budget, are saying that the CBO is too optimistic and that the deficit will rise above the $300 billion mark.[3]

Why are the new taxes producing such unexpected consequences?

One primary reason is that the adverse impact of new taxes on the economy has been ignored entirely. President Bush and congressional leaders have carefully avoided discussing the possibility that the steep downturn in the economy is directly related to the contents of the anti-growth budget package itself. The economic models engineered by the OMB and the CBO do not assume _any_ adverse economic effects from higher taxes--indeed, those models anticipate _positive_ economic responses to more taxes. The OMB predicts, for instance, that because new taxes will lower government borrowing, interest rates on Treasury bills will fall by 1995 by 3 percentage points--to their lowest level in a quarter century.[4]

This study presents solid statistical evidence demonstrating that taxes do harm the economy in a significant and consistent way. Since 1960 tax increases (measured by total tax receipts as a percentage of gross national product) have led to slowdowns in economic growth, and often to recessions. Likewise, when Washington has reduced federal tax burdens over the past 30 years, there has been a statistically significant positive economic and employment stimulus in the following year.

The implication of this model is straightforward: by enacting tax increases last year that will bring the tax burden to record levels, President Bush and Congress have directly contributed to the current economic erosion, rather than combatted it. Specifically, from our historical model, we predict the following economic response to the budget package:

* Economic growth will be 0.7 percent per year lower than it would otherwise be.

* Four hundred thousand fewer jobs per year will be created than would otherwise be created.

* The tax burden will rise to 20.7 percent of GNP by 1992 (the greatest tax burden since World War II), which will increase the severity of any subsequent economic recession.[5]

* Approximately $330 billion, or roughly two-thirds, of the projected $491 billion in deficit savings from the budget package will be eliminated by the adverse economic impact of new taxes on the economy.

The model suggests that any realistic anti-recession economic package this year should contain three reforms. First, President Bush and Congress must begin to systematically repeal major tax components of the 1990 budget pact. Second, Congress should cancel any plans to raise more tax revenues in 1991, such as an income tax surcharge on the rich or an energy tax. Third, as measures to stimulate economic expansion and new jobs, Congress should consider pro-growth tax cut proposals, such as a reduction in the tax rate on capital gains or Sen. Daniel Patrick Moynihan's (D-N.Y.) rollback of social security payroll taxes and the proposal by Rep. Tom DeLay (R-Tex.) and Sen. Malcolm Wallop (R-Wyo.) to combine social security tax cuts with expansion of tax breaks for Individual Retirement Accounts and a reduction of the capital gains tax rate. Finally, deficit reduction should come in the form of expenditure reductions, not just reductions of _projected increases_ in spending.

Taxes and Economic Behavior

Most static economic models ignore completely the negative economic effects of taxation.[6] In fact, it was not until the 1980s, when the election of President Ronald Reagan brought supply-side economists into ascendance, that the importance of marginal tax rates gained the attention of federal policymakers and some feedback models were put into use.[7] Most economists now acknowledge that punitive marginal income tax rates of 90 or 70 or 50 percent can stifle economic activity and growth. Indeed, a wealth of economic literature on the subject of taxes and economic growth now verifies that contention.[8]

The emphasis that supply-side economics places on the incentive effects of marginal tax rates has led some economists to conclude that _only_ marginal income tax rates have negative economic effects. Hence policymakers have attempted to raise revenues by increasing consumption and sin taxes, as was done in the recent budget package. Because those taxes do not directly influence people's work effort or investment behavior, many analysts argue that their economic effect is fundamentally benign. Some even argue that taxing consumption has a positive effect; it may encourage people to consume less and save more.[9]

But aggregate tax burdens--that is, the total amount of the economy's resources directly transferred to the government--may be critically important to economic growth too, regardless of how those tax dollars are collected. If the resources allocated to the government are used inefficiently, or less efficiently than in private hands, economic growth is diminished and production falls. If additional tax dollars are used for a project that makes no contribution to productive capacity, and if the tax dollars raised prevent some private expenditure or investment that would have provided output and jobs in future years, growth is diminished.

Examples of government projects with low social returns abound in the federal budget. One need only look at the 24-volume 1982 Grace Commission report, which identified tens of billions of dollars of potential savings that could be realized by eliminating unnecessary government programs.[10] In such cases greater economic efficiency would be achieved by keeping in the hands of the private sector the tax dollars that are used to finance those activities.

Of course, some functions that are carried out by government may add to our future growth potential--such as law enforcement and national defense.[11] Modest taxes to pay for those essential government services may promote economic growth.

As increasing amounts of taxes are collected, they will almost assuredly be used by government to finance projects that offer declining social returns. One study by economist Gerald Scully of the University of Texas in Dallas found that taxes deter economic growth if they are above a certain minimum threshold of about 12 percent of GNP.[12] Scully also discovered that most nations--including the United States--impose taxes that are well above the rate at which economic growth is maximized.

Measuring the Economic Impact of Federal Taxes

If rising aggregate tax burdens do have an adverse economic impact, then over time we should be able to detect a pattern of higher levels of taxation associated with lower levels of economic performance in subsequent periods and vice versa.

Our model analyzes the impact of annual tax burdens (total federal tax receipts as a percentage of GNP) over the 1960-87 period on two measures of economic performance in the following year: (1) growth of GNP and (2) job creation.

The GNP is an imperfect but fairly reliable and consistent measure of economic growth. For instance, it is highly correlated with other measures of economic and social well-being. To measure job creation, we use the Labor Department's calculation of total nonagricultural employment. We also add to the model a variable that measures the annual change in oil prices in the previous year to further explain variations in growth and job creation. The effect of rising world oil prices can be similar to that of a "tax" on American consumers.

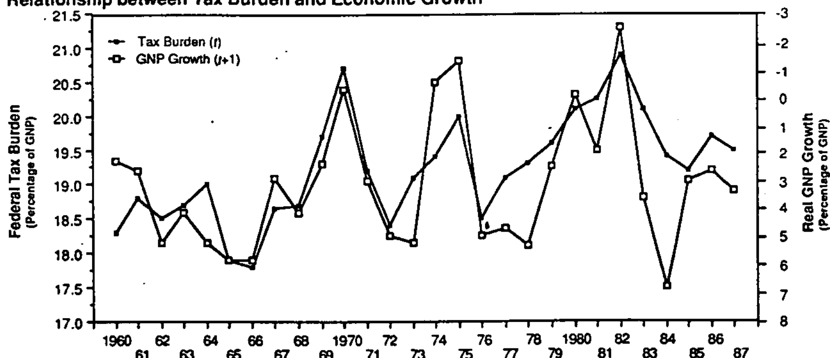
The model confirms the theory that taxes are a leading indicator of employment creation and economic growth. (See Appendix for more detailed information on the economic model used.) Figure 2 shows the relationship between the tax burden and the economic growth rate with a one-year lag. Using the simple model, we have uncovered the following statistically significant relationships:

* Each 1.0 percent rise in the federal tax burden leads to a 1.8 percent reduction in economic growth. The model explains over half of the variation from year to year in growth rate.

* Each 1.0 percent rise in the federal tax burden leads to a 1.14 percent decline in national employment. In the employment model more than 40 percent of the growth in new jobs is explained by the federal tax burden and changes in oil prices.

In sum, when taxes as a percentage of GNP rise, the very next year growth in real GNP and employment will de-

Figure 2
Relationship between Tax Burden and Economic Growth



cline. The converse is also true: when federal tax burdens fall, economic growth and the unemployment picture will improve the following year.

Implications of Recent Budget Actions

Figure 3 shows the tradeoff that emerges from the model relating economic growth to the federal tax burden from 1960 through 1987. Figure 4 shows the same inverse relationship for employment growth.

Figure 3
Relationship between Taxes and Economic Growth

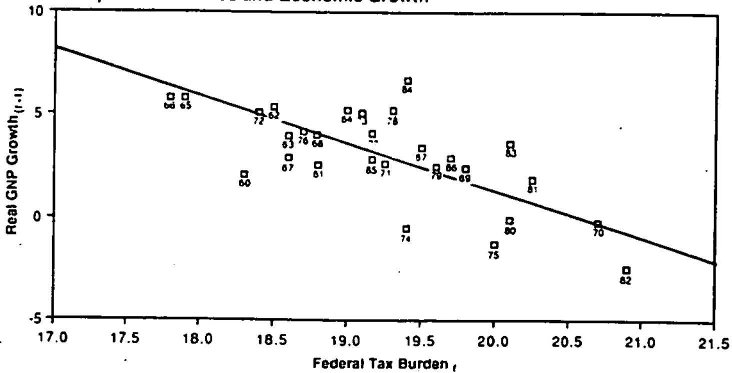
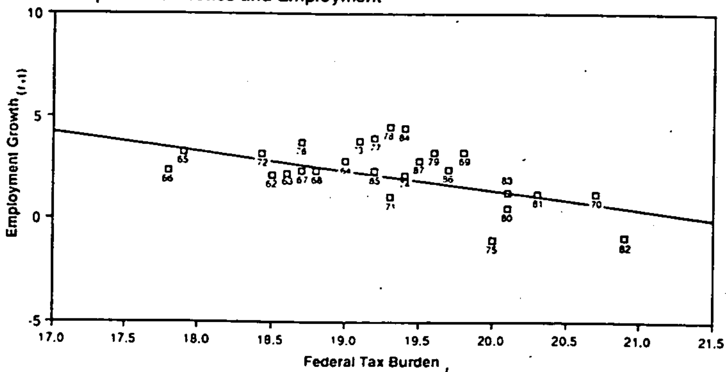


Figure 4
Relationship between Taxes and Employment



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$52 billion in the second year, $60 billion in the third year, $66 billion in the fourth year, and $73 billion in the fifth year, because fewer people are working and paying income and social security taxes and more people are collecting unemployment benefits. By multiplying those numbers by the percentages in the third line of Table 1 (annual impact of the new taxes on employment), we derived estimates of the increase in the deficit due to higher unemployment.

Table 2 points to two important conclusions: First, we predict that the adverse impact of the new taxes will keep the deficit over $300 billion for the next four years, in contrast to the official government forecasts. Second, when we subtract the added deficit spending, which will occur as a result of poorer economic performance, from the levels projected by the OMB, we find that $340 billion, or two-thirds, of the purported $491 billion in budget savings is erased. Of course, that change does not mean that the remaining budget savings would occur. Those savings depend on promised entitlement reforms and reductions in spending below the projected CBO baseline. According to some experts, even those savings are highly suspect.[13]

Taxes and the Recession

Several theories have been proposed about why America has fallen into an economic recession after eight consecutive years of prosperity. One, which certainly has some validity, is that the shock to world oil markets in the wake of the Persian Gulf crisis has unsettled the nation's economy.[14] Another is that the half-trillion-dollar savings-and-loan debacle is responsible. A third theory is that the onslaught of new government regulations, such as the Clean Air Act, has impeded business expansion.[15] A fourth popular notion is that the chickens of Reagan's budget deficits have finally come home to roost.

Although each of those theories may offer a partial explanation of the business downturn, none tells the whole story. Few economic analysts have identified rising tax burdens on American workers as a possible culprit, even though the economic slump began when Bush capitulated on new taxes last summer. Our model provides solid evidence that taxes have contributed in a major way to the decline in the economy.

It is not just the most recent tax hike that has contributed to the fall in economic growth; taxes have been slowly rising since 1982. Over that period, 14 separate tax increases have been enacted. Thanks in large part to the

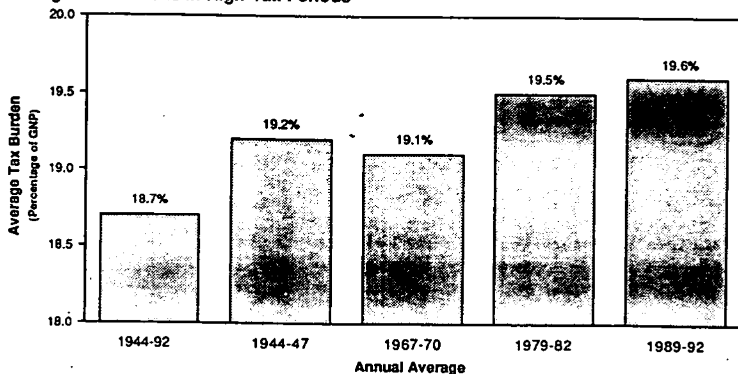
rising burden of social security payroll taxes during the 1980s, between fiscal years 1989 and 1992 total federal tax receipts as a percentage of GNP will be higher than they have been in any previous four-year period. Over the current period, taxes will average 19.6 percent of GNP versus 19.5 percent from 1979 to 1982 (the turbulent period before the Reagan tax cuts) and 19.1 percent from 1967 to 1970 (the last time the federal budget was balanced). Even during the war years of 1944-47, the tax burden averaged only 19.2 percent of GNP (see Figure 5).[16]

The tax estimates for 1989-92 do not include the new taxes approved as part of the 1990 budget agreement. When the new taxes are included, next year's tax burden may rise to 20 percent of GNP, the highest level in the post-World War II era.

Our model indicates that whenever the tax burden rises above 20.0 percent of GNP, the nation enters an economic danger zone in which it runs a high risk of a recession. Indeed, only twice before in peacetime has the federal government collected more than 20 cents of every dollar earned by American families. The first time was in 1969--and in 1970 the economy slipped into a mild recession. The second occasion was 1981--the year before the most severe economic recession since the Great Depression. If the tax increases are imposed as scheduled over the next five years, our model suggests that the slowdown in economic activity could be long lasting, as opposed to the "soft-landing" scenario that the administration hopefully predicts.

Figure 5

Average Tax Burdens in High-Tax Periods



Conclusion

We have shown empirically that there is a direct relationship between the amount of taxes that the federal government receives and growth in real GNP and jobs over time. Although some kinds of taxes--such as income taxes--are clearly more damaging to the economy than others, the model demonstrates that the aggregate federal tax burden has an adverse economic impact, regardless of how taxes are collected. Taxes have a negative effect because they deprive the private sector of resources to expand growth and often produce negative incentives for desirable activities, such as business investment or increasing work effort.

The estimates of the negative impacts of rising taxes derived from such a simple model may not always be right on the mark and should be interpreted with some caution. They do, however, show a consistent negative relationship between higher tax burdens and activities essential to economic growth. Our model also suggests that the most dangerous types of taxes are levies that could become government "money machines," such as the proposed value-added tax or a national sales tax. Under both of those tax plans, minor revisions in the tax schedule can pull significant amounts of productive resources out of the private sector and into the hands of government.

Policymakers must now ask themselves what economic remedies will pull the nation out of the current economic recession. Our model provides one overarching policy prescription for federal lawmakers: to end the current recession, they should be easing Americans' tax burdens, not raising them. The way to start may be by repealing the new gasoline, excise, and income taxes in the 1990 budget package.

Appendix

GNP is composed of three major components: consumption--expenditures on goods and services (about two-thirds of GNP); investment--private-sector outlays for new capital equipment, production facilities, and related goods; and government--public-sector purchases of goods and services. (The government component excludes all activities of the government related to the transfer of income. Those amounts show up in the consumption figures.)

The Simple Model

The simplest model focuses on the relationship between the share of resources taken (ignoring the structure of the

tax code) by the federal government and economic growth. Economic growth is measured by the annual growth rate of real GNP. If our hypothesis that taxes harm economic growth is correct, then a ratio of federal taxes collected to GNP that accelerates rapidly during one year may lead to decelerating economic growth in the very next year. The model would look like this:

% Change Real GNP_{t} = f [Federal Tax $Receipts/GNP_{(t+1)}$]

% Change in $Employment_{t}$ = f [Federal Tax $Receipts/GNP_{(t+1)}$]

Federal tax receipts are defined as personal income tax receipts, corporate income tax receipts, federal excise tax receipts, and social security tax receipts. A simple mathematical relationship based on annual data from 1960 to 1987 yields the following results: The federal tax burden in year t relative to

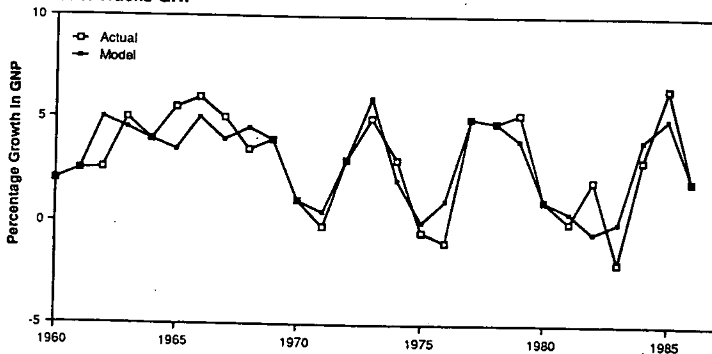
% Change in Real GNP in Year t+1: r = 0.70

% Change in Employment in Year t+1: r = 0.50

Figure 6 shows graphically the "fit" of the model. The figure compares the model's predicted GNP growth with actual GNP growth over the 1960-87 period.

If we omit the 1960 recession from our data and begin our model at the start of an upturn in the business cycle in 1962, the relationship becomes even stronger. The federal tax burden in year t relative to

Figure 6
Tax Model Tracks GNP



% Change in Real GNP in Year $\underline{t}$+1: $\underline{r}$ = 0.75

% Change in Employment in Year $\underline{t}$+1: $\underline{r}$ = 0.69

According to the above representation, last year's federal tax burden explains more than three-fourths of this year's change in real GNP growth and more than two-thirds of this year's change in employment growth. Also, as the ratio rises, future growth will decelerate.

The Revised Model

Next, in our revised model, we adjust the two relationships with regard to the percentage change in GNP (GNP) and the percentage change in employment (EMPLOYMENT) for oil price shocks--assuming that an increase in the price of foreign oil has the same economic effect as another "tax" on the American consumer (or an oil price decrease is a "tax cut" for consumers). If we add the percentage change in oil prices (OIL) as a second explanatory variable, our model becomes the following:

$$GNP_{(t+1)} = 38.4 - 1.83\ TAX_t - 0.02\ OIL_t$$

In this model more than 50 percent of the change in real GNP growth is explained by the federal tax burden and changes in oil prices.

The refined employment model that adds oil price changes as an explanatory variable is as follows:

$$EMPLOYMENT_{(t+1)} = 24.4 - 1.14\ TAX_t - 0.02\ OIL_t$$

In this model more than 40 percent of the growth in new jobs is explained by taxes and oil prices. The model shows that higher federal tax burdens lead to lower employment growth, and lower federal tax burdens lead to higher employment growth.

If we drop the 1960-61 recession from our sample period so we may begin the analysis at the start of a business cycle, the "fit" becomes even more impressive. The model becomes

$$GNP_{(t+1)} = 43.1 - 2.06\ TAX_t - 0.02\ OIL_t$$

This model, based solely on the federal tax burden and oil prices, explains almost two-thirds of the growth in the economy over the past 26 years.

Employment is also inversely related to the aggregate tax burden. Our regression equation is

$$EMPLOYMENT_{(t+1)} = 29 - 1.36\ TAX_t - 0.02\ OIL_t$$

The employment model, based on the federal tax burden and oil price fluctuations, also explains almost two-thirds of the growth in new jobs in the economy over the past 26 years. In both cases the effect of higher taxes is negative and significant.

Final Note

Tests of the model over other time periods have produced largely the same results, which suggests that the model is robust. We tested the model over the 1950-87 period and found a similar, though less significant, negative impact of taxes. In particular, the negative impact of taxes on job growth was not as strong. Also, when we added estimates for 1988-91, the relationship held.

Notes

1. The largest single-year tax increase of all time came under the 1982 Tax Equity and Fiscal Responsibility Act.

2. Congressional Budget Office, "The Economic and Budget Outlook: Fiscal Years 1991-1996," January 1991.

3. Office of Management and Budget, Budget of the United States Government: Fiscal Year 1992, and Aldona and Gary Robbins, "Latest Budget Package As Bad As Recession," National Center for Policy Analysis, Dallas, Texas, January 1991.

4. For a critical assessment of the economic assumptions used by the budget summiteers to derive their deficit reduction numbers, see Daniel J. Mitchell, "The Budget Summit Agreement: Faulty Economic Assumptions," Backgrounder Update, Heritage Foundation, Washington, D.C., October 3, 1990.

5. Figures are based on National Income Product Account numbers, which tend to be higher than the numbers in the budget.

6. Paul Craig Roberts, "The Breakdown of the Keynesian Model," in Supply-Side Economics: A Critical Appraisal, ed.

Richard H. Fink (Frederick, Md.: University Publications of America, 1982).

7. One criticism of the White House's budget-negotiating team during the 1990 budget summit is that it abandoned dynamic models, which predict economic responses to fiscal policy changes, and instead agreed to static models. That move sealed the fate of the capital gains tax cut idea and exaggerated the economic benefits of new taxes.

8. See, for example, Carl E. Ferguson, "The Impact of Taxes on Economic Growth," University of Alabama, Center for Business Economic Research, Birmingham, November 1985; Robert Genetski, "The Impact of Taxes on Economic Growth: 1963-1980," Harris Economics, Harris Bank, Chicago, 1982; Robert Genetski, Taking the Voodoo Out of Economics (Chicago: Regnery Books, 1986); John Gruenstein, "Can Philadelphia Afford to Raise Taxes?" Federal Reserve Bank of Philadelphia Business Review, May-June 1980; Lawrence Lindsey, The Growth Experiment (New York: Basic Books, 1990); Keith Marsden, "Taxes and Economic Growth," World Bank working paper, Washington, D.C., 1983.

9. For example, the American Council for Capital Formation believes that a value-added tax would improve prospects for new capital investment but supports a reduction in capital gains taxes.

10. See also Citizens Against Government Waste, "Cutting Waste: How to Avoid Increased Taxation," Washington, D.C., June 1990, and Stephen Moore, Slashing the Deficit: Fiscal 1990, The Heritage Foundation, Washington, D.C., 1989.

11. Other parts of infrastructure that the government provides may promote economic efficiency--good roads, safe drinking water, and education. But there is substantial evidence that those things are produced more efficiently by the private sector. Privatization of many government activities typically reduces costs by 20 to 50 percent.

12. Gerald Scully, "The Hidden Growth Tax in the United States," University of Texas at Dallas, 1990.

13. Daniel J. Mitchell, "Darman's Disaster: Bush's Responsibility," National Review, December 17, 1990, pp. 38-40.

14. Our model controls for the impact of rising oil prices on economic growth and unemployment.

15. Warren Brookes, "America Dragged Down," National Review, October 15, 1990, pp. 34-43; Paul Craig Roberts, "Get Ready for Recession by Strangulation," Business Week, September 24, 1990, p. 22.

16. These numbers are not based on a National Income Product Account and thus differ slightly from the tax numbers used in other parts of this paper. These data come from the historical tables of the Budget of the United States.

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Senator SARBANES. Thank you, Mr. Rahn. And we thank the panel very much.

Gentlemen, Chairman Boskin of the CEA said, when he was before the committee, that the administration anticipated an unemployment rate for the year on the average of 6.7 percent rate. I would like to hear from each of you.

Mr. Rahn, you indicated that you expect the rate to go to 8 percent.

Mr. RAHN. For the year, we expect it to average 6.9 percent, next year 7.6 percent.

Senator SARBANES. You have 6.9 percent for this year and 7.6 percent for next year.

Mr. RAHN. In fact, after today's numbers if anything we'd revise that upward.

Senator SARBANES. I would like to hear from each of the others.

Mr. BRINNER. If you look at my prepared statement, one of the supplementary exhibits I submitted shows you that we are slightly more pessimistic, expecting a 6.8 percent average for 1991, versus the 6.7 OMB number. And for 1992, we actually are a little bit lower. The difference there is that OMB assumes, I think, unattainably high productivity growth rates, and therefore they don't get the employment pop that we do out of the roughly similar growth.

Senator SARBANES. So what's your figure for next year? I'm sorry.

Mr. BRINNER. For 1991, 6.8 percent; 6.4 percent for 1992.

Senator SARBANES. OK.

Mr. JONES. 1991 on average 7 percent and 1992 on average 7.2 percent.

I would simply add that if we had labor force growth at the same rate now we have been used to over time, that these numbers would probably be a percentage point higher. That's one very important point to make here. We have fewer people coming into the labor force demographically, and we have fewer people in terms of labor force growth. It's giving us a very different environment for the unemployment rate.

For example, we would be around 8½ percent unemployment at this moment instead of 6½ civilian unemployment if we just allowed for normal labor force growth over a longer period of time. Normal growth over time is in the vicinity of 1.3 percent or so a year.

Senator SARBANES. When you say normal, you mean if you simply assume the historical rate? Of course, that may not be the right thing to do because, for one thing, your demographics are changing.

Mr. JONES. I completely agree. All I'm saying is that these numbers would be substantially higher if we were on a normal growth trend. We're not. I accept that.

But it's remarkable that those numbers would already be that high if we had been on the historical growth trend in the labor force.

Senator SARBANES. The point to draw out of that is that we have to have an analysis that shows perhaps the lower figure may reflect a somewhat softer economy than it used to in terms of people

losing jobs. There isn't the same entry into the work force taking place.

Mr. JONES. Precisely my point, particularly if you look at the data on employment, the kind of weakness we've seen in jobs both in the goods producing side and the services producing side. That's essentially the only point I would make with that.

Obviously, the demographics are different at the moment but, in effect, I think these numbers are covering up a fundamentally weaker economy definitely.

Senator SARBANES. Did you want to comment on that Mr. Brinner? Then I will come to you, Mr. Moore.

Mr. BRINNER. I would disagree with that on two scores.

The first is, that if you did have all these extra members of the population available and eager to join the labor force, that would have had a moderating influence on inflation. Also, to the extent that these people were hired, because you would have the motivation to feed them, clothe them, house them, there would have been extra demand in the economy, too.

So I don't think you can just say that you would have had the same demand, the same production in the face of much higher population labor-force growth.

Senator SARBANES. Mr. Moore.

Mr. MOORE. I haven't made a forecast of unemployment. But judging from the behavior of this leading employment index, I would think an average for 1991 of about 7 percent would be in the range of what that's suggested through today.

Senator SARBANES. That is for 1991?

Mr. MOORE. Yes.

Senator SARBANES. Do you have any suggestion on next year?

Mr. MOORE. No. The leading index doesn't look that far ahead unfortunately.

Senator SARBANES. I wanted to pick up on one point you made, Mr. Rahn, very briefly. I don't want to argue the statement that there are a number of fine individuals on the board of the Federal Reserve. You made some criticism about their policy. It is not for lack of trying on their part, you said. But I must say to you and to the other panelists and, perhaps, some of you may want to comment, it is my perception that there has been a lowering of the standard in this sense, that the only position on the Fed that attracts a lot of attention when it is being filled and the focus on the competence of the person and the real judgment of "whether they're really up to the job," is the chairmanship. Those are 14-year terms. My view, historically, looking back, is that in earlier periods there was more attention focused on all the members of the Federal Reserve when the positions were being filled. You had some very competent people who went on the Federal Reserve Board, not as chairmen only but as members, who then served for an extended period of time. As members of the Fed, they made something of a 14-year term.

Now two things are happening. A somewhat lower standard is being applied and the people get on and stay only a few years and then they get off. Now that may or may not be desirable, but it is a change in the way the Fed does business, and a change I think in how the Fed is perceived. I wonder if you have any reaction.

Mr. RAHN. I do have a reaction. The Fed is supposed to lean against the wind. For them to do that, they would have to have better information, a greater stock of knowledge than all the rest of us do. And, of course, the fact of the matter is that they have the same information that you do and we do. That's why we find the Fed often accelerating the economic cycles, rather than leaning against the cycles, because they don't have a better understanding than anybody else. And I don't think it's just a matter of getting wiser people on the Fed.

I have often been critical of the Fed chairmanship and I have been very critical of Mr. Greenspan, but I think we have a much more fundamental institution problem. We have given them a set of responsibilities that no group of humans can carry out to the degree of perfection that we want without some kind of mandated rules. And I realize one could spend a whole day on how we ought to operate the Fed in detail.

But once we got away from any kind of external anchor, we used to have an anchor in gold but I'm not advocating a gold standard. But we need to have external anchors and firm price rules because, to expect a group of people, men and women, to operate on discretion and to always be ahead of markets and to be able to see into the future with much greater clarity than all the rest of us is not realistic.

And my own feeling is, it's not a chamber position but it's something that I have said from time to time in public, that I think if you look at the evidence of the economy, post- and pre-Fed, that you would not now establish the Federal Reserve system.

Just one number alone, the Producer Price Index, if you established 1913 as an index number of 100, I think—and I'm sure Mr. Moore knows far more about this than I do—it was about 105 back in 1795 looking at some of the wholesale numbers. But now that number is around 900. We've only had the pervasive inflation since the Fed. There is no evidence that the economy in aggregate has performed better.

Yes, we used to have panics, but they tended to be short lived. And clearly in terms of bank failures and these other things, objectively the Fed has not performed well. And I think if you people had to do it over again, you probably would not establish a Federal Reserve system with the type of powers and structures that it now has.

Senator SARBANES. Let me just ask this. How long have you been the chief economist at the chamber?

Mr. RAHN. Eleven years.

Senator SARBANES. Do you think you are better at the job having had a certain length of tenure and historical knowledge and perspective that comes with that?

Mr. RAHN. I would hope so.

Senator SARBANES. That is one of my points about the members of the Fed.

Mr. RAHN. We still make errors, though.

Senator SARBANES. I know, but that is one of my points about the members of the Federal Reserve Board. I have to say to you very frankly I think there was a day when people said, there is the chairman and he is a person of weight and then there is this

member and that member and that member who are also persons of weight. I think we have moved to a situation where the focus really of nomination time and judgment is the chairman only. The rest of the members have just kind of faded.

I would like to hear what the others have to say.

Mr. BRINNER. I think that if you judge the Fed on the basis of the performance of the economy during this decade, you would have to say that they have done at least as well as Federal Reserve Boards in the past. They had an enormous task to bring inflation down. They did create several recessions along the way. Unfortunately, that is the only way in any industrial economy that we can cure inflation.

So as long as we tell them, and we do, that their primary job is to control inflation, they have to be the bad guys. This time, they got to share the bad guy role with the Comptroller of the Currency and Saddam Hussein. But essentially, they're the ones who, as the saying goes, have to fill the punch bowl and go away just when the party is really getting going.

Another way you might judge whether the standards have been lower is to look at the jobs that members of the Fed have received after they leave. It's my estimate that nonchair members of the board are still getting excellent jobs.

I don't think you can make the case, either by the performance of the economy or the private sector's response to the members after they leave the Fed, that you have any inferiority compared to past performance.

I would argue that, on the basis of economic performance, it's superior.

Now with regard to the other question that you were raising about length of term, I share your worry. I have been with DRI/McGraw-Hill now since 1971. I am certain that I can avoid mistakes now that I would never have avoided back in the 1970's or early 1980's.

I think that the Fed faced very severe constraints on recruiting people because of their pay. Actually, I believe that has been relieved now in the past year. But in talking to members of that board, they have to make extreme sacrifices to join the board, compared with private sector compensation. Only part of that is made up by lucrative job offers after they leave.

These are public-spirited citizens who made sacrifices to serve. Some of them felt that, after 2, 3, or 4 years they couldn't continue making those sacrifices and send their children to college, et cetera.

I think you actually can do something about that.

Mr. JONES. I would just like to add, I certainly agree with Roger Brinner that the history of the Fed in the 1980's has been a success story, starting with Volcker's assault on inflation in the early 1980's, and in bringing it down and allowing the economy to grow in a sustained way. The Greenspan Fed followed up on that success in the same way by keeping inflation from taking off again.

But I would quickly add that I think your point is extremely well taken, Mr. Chairman. I look upon the Fed—I'm writing a book—and I'm throwing in a commercial—entitled "The Politics of Money," on Greenspan and the Fed.

I look upon the Fed as the supreme court of finance. And in the same way that we have a supreme court of laws in this country, the Fed as the supreme court of finance is just as important. So members chosen on the Federal Reserve Board of Governors should be looked at with the same scrutiny that we look at members on the Supreme Court.

I think, in fact, it would be incumbent upon Congress to scrutinize nominees more closely for the Federal Reserve Board of Governors. Indeed, the Chairman of the Federal Reserve Board of Governors is the second most powerful person in our government. Certainly this may be the case when it comes down to periods of tight money. The Chairman, the other six members of the Board of Governors, and indeed the other members of the Federal Reserve System, staff, presidents of the Federal Reserve banks as well, are really a critically functioning agency in our government. The Federal Reserve is important to our government and equally as important, I think, to finance as the Supreme Court is to law.

So I second your suggestion and I think greater scrutiny of Fed nominees is very important as we look ahead.

Senator SARBANES. Mr. Moore, do you have any comments?

Mr. MOORE. I have a little bit different view of the Fed's historical role than Mr. Rahn. If you look at the period since the Fed began in 1914 through about the 1930's, there was virtually no increase secularly in the rate of inflation. It was zero.

The inflation rate has grown almost entirely since the 1930's, without ever seeming to stop appreciably. So that it wasn't the creation of the Fed that caused the inflation to do this since the 1930's. A lot of other things contributed, including the fact that recessions have become milder than they were prior to the 1930's.

And if we want mild recessions, we're very likely I think to take quite a bit of inflation along with it, especially since that means recessions are shorter and expansions are longer. And we've had the best example of a long expansion in 1990.

I don't have an opinion on the duration of the terms of office as to whether they're too long or too short. I do have an unusual experience, though, that I might just mention.

One of the Chairmen of the Fed was a professor of mine when I was a student. And another Chairman of the Fed was a student of mine, the present Chairman. So I can look at it from——

Senator SARBANES. You can see them coming and going. [Laughter.]

Mr. MOORE. And they both have my great admiration. One of them was Arthur Burns. He was my professor.

Senator SARBANES. Thank you, sir.

Congressman Armey.

Representative ARMEY. Thank you, Senator Sarbanes.

Let me thank the panel. This has been a real treat for me on my first day on the committee.

Richard Rahn knows that I'm a micro economist by trade, so I don't get a chance to talk to real live forecasters very often. And I never really sought out the opportunity. Just kidding.

But forecasting, obviously, you know by virtue of your decision to practice this as a profession is an extremely important enterprise. And I think it is particularly important for us up here on the Hill

because we must not only be able to forecast with some degree of accuracy where are we heading with the economy, but then, of course, make determinations on what must be done. And sometimes, in total disregard of that, what will we do. And then evaluate ex ante what is the potential impact of this policy option or that policy option.

My general impression is that we don't have a very good track record up here. And I am very much concerned about where the source of error could be. What might we do to improve things by way of our ability to say, maybe, advantage ourselves with the best of the science of economics, which I happen to agree with Paul Samuelson, is in fact the queen of the social sciences in terms of its ability to access and massage a database.

So it strikes me that, in order to have sound forecasting, you must have a thorough and reliable database. You have to have a good methodology, a good model, and then you have to be free from bias. Then, obviously, we know what we can do.

And I wonder with respect to the agencies that I find myself relying on most, the Joint Economic Committee and CBO, if any of you could give me some insight into how well do they perform, how reliable is their database, how sophisticated and contemporary is their modeling, and are these organizations in fact as free of political bias as good policy would require them to be.

Now if any of you would be willing to give me a comment, I think I will just follow your example, Mr. Chairman, and start right off on down the line.

If you could give me some insight on any of those points with respect to the Joint Economic Committee or CBO, I would like to hear that.

Mr. BRINNER. Since they are both my customers, they obviously have access to the very best. [Laughter.]

Representative ARMEY. Database, or method?

Mr. BRINNER. Actually, they use a nice, diverse portfolio of models. They do not just use our models.

They use several other models, and they read the literature to discover what less-than-mainstream models would suggest.

Obviously they also work for the members of the committee and I am sure, like all Americans, there are some political influences on their conclusions.

You just cannot avoid it, if you are human.

But I think that they do have access to a good statistical base, and their knowledge of how to use it is right there at the top. I enjoy reading their materials, and I use them.

Mr. JONES. I have nothing to add to that in terms of specifics.

Let me just make a couple of points as to how important this process is at this very moment.

If I am half right in my analysis, we do not have a good precedent for the process we are in right now.

Typically the recession has been an inventory recession, a fairly predictable process.

As Geoffrey Moore would say, recessions last about a year. Inventories build up, come down sharply, and we see a quick rebound in the economy as consumer demand picks up, usually because of easier money.

It is a very predictable process.

The average of our historical experience gives us a pretty good ability to predict the kind of process we go through.

But this recession is different in that you have this grassroots credit squeeze. It is not a Fed-induced credit squeeze which is the normal one we see. It's not an old-fashioned crunch but a new kind of crunch or squeeze which is bank induced. Banks have felt all kinds of special pressures and have begun to tighten up on loan availability.

Now obviously if the Fed pumps enough reserves into the banking system and the banks would buy enough securities to finally get money growth rolling again and get interest rates down again we may some day get us out of this.

But the point is that this recession will last longer than average; that its sources are more difficult to identify. The current recession is more difficult to fit into an economic model that is based on average historical experience.

What I would say is this: What you need in this process, in addition to competent people looking at big models, is a lot of real-world analysis right now getting down to the trenches where Main Street U.S.A. is. So you need to broaden your base.

The agencies need to meet more with each other.

The appropriate congressional committees should meet with the Fed staff. The Fed staff should meet with the Treasury staff, or the Commerce Department staff, or anybody in the government economic policy decisionmaking process.

You need more interchange there.

Most importantly, what you need is an ability to go out and sample anecdotal data and qualitative data, as well as quantitative data.

One of the weaknesses I would see in the current Fed is that, by their nature, they are obsessive numbers crunchers.

Fed policymakers look at quantitative data and follow inventories. They follow primarily quantitative data to diagnose the economy. They can handle it fine.

But if my guess is right this recession is unusual. It began to sneak up on us. The clues emerged sort of anecdotally. For example, I talked to a banker who has cut off a business customer who has been with his bank for 30 years—and you begin to see the kind of negative psychological impact which is perhaps as important as the economic impact.

The moral of the story is: Forecasting is an art as much as it is a science.

Representative ARMEY. Let me make a quick point, and then let me go on to the other two gentlemen.

It seems to me you are saying they have to get a better feel for the dynamics between agencies of the Government and between they themselves and the private sector.

Mr. JONES. That is right. The dynamics is the key word.

Representative ARMEY. Mr. Moore.

Mr. MOORE. Some years ago I made a study of the record of the forecasts made by the Council of Economic Advisers in the Economic Report of the President, which is one of the things we are supposed to be talking about today.

What I found is, since the 1960's, the year-by-year forecast 1 year ahead came out with an average degree of accuracy about equal to that of the consensus of economic forecasters.

There are surveys like the Blue Chip Indicators and other surveys that have been made with an average absolute error, as I remember, of about 1 percentage point; and a correlation, as I recall, in the 0.7 to 0.8 percent range.

Also what was curious to me was that I did not really see any perceptible bias in the Council's forecast.

A lot of people argue that they must have an upward bias as compared with the average economist's bias.

They both have a somewhat optimistic slant, but they are not that much different one from the other.

Representative ARMEY. Excuse me, but you raised a fascinating point because I too have been taught that as a student, that you would expect and anticipate an upward point in the JEC forecasting.

So you are saying that the Joint Economic Committee tends to be more accurate than what we would suppose by way of that whole teaching?

Mr. MOORE. The Council of Economic Advisers. The JEC I am sure is always accurate.

Representative ARMEY. May I ask, as I am running out of time, I did want to hear Mr. Rahn.

I would like to remind you that I am particularly concerned about the agencies that will support things we will recommend for Congress, the Joint Tax Committee and the CBO.

It is a fascinating point, but I am going to be asked to rely on the scoring of the Joint Tax and CBO forecasts.

Mr. RAHN. Congressman, I agree on the CEA forecast.

I served there in the Reagan years.

For a number of years they did not anticipate as much growth as we actually had.

That is not what concerns me.

What concerns me are the estimates as a result of tax changes.

I go back to the 1978 capital gains tax.

We were getting official numbers from the Congress of a more than $2 billion loss.

I remember that I testified that I estimated a $1 billion gain.

I was dead wrong.

It was a $2 billion gain in the first year. But at least I had the direction of my sign right.

In 1981 the estimates were dreadfully wrong. In 1986, again, the estimates were dreadfully wrong.

The problem is, there is too much static analysis.

There are a number of people who prefer to be precisely incorrect rather than approximately correct.

If any businessman ever applied a static revenue estimate to a price change for any kind of consumer product, they would quickly lose their job in the corporation.

It is ludicrous the kind of numbers that are given you people.

In fact, I would like to see a more detailed study than we have done of just going back and disaggregating on these tax estimates,

looking at it area by area, because I think you would find it dreadful.

Finally, again I want to bring up to me what is the worst number I have ever seen, or the worst change I have ever seen in 1 year.

For last year, we were told the 5-year projected deficit was $62 billion.

This year we are told it is $865 billion, and you save $500 billion through the budget summit.

Now just look at those numbers.

They are laughable. That is an embarrassment to I think the Congress, the economics profession, and everybody else.

To make policy judgments when you have those kind of numerical swings, that should tell everybody here there is something very fundamentally wrong with this whole system.

Representative ARMEY. One other question.

Senator SARBANES. Did you want to add to that Mr. Brinner?

Mr. BRINNER. I wanted to add to your question a little more fully. You said you were particularly interested in the analysis coming from the CBO and the Joint Economic Committee. They are prepared to answer dynamic revenue analysis questions. They can, and they have built models in the past that would allow them to say: What if? Based on past responses, you had certain labor-force and capital-spending responses.

But I believe the legislation under the Gramm–Rudman bill and others has explicitly told them they may not do that.

Why was that legislation passed? It was passed because of political abuse of the right to assume responses in the economy in order to assume away the deficits that would be created by spending, or a tax initiative.

It was not the economists who created the abuse of the models to drive you into this inappropriate situation of static revenue analysis.

It really was political abuse.

Representative ARMEY. Thank you, again.

Part of my motive for pursuing this line of thought is I am still trying to figure out did I did right, or did I did wrong.

We have to rely on some official story in order to determine what will be this impact or that impact.

I was taught and always believed, and it always seemed to make sense to me, that you would get more scientific, intellectual objectivity from the Fed and from the Chairman of the Fed.

I remember the great debate between William McChesney Martin and President Johnson.

From a Texan's point of view, we always got a kick out of Johnson inviting Martin down to Texas for a barbecue, and everybody was wondering what they were going to get for the menu, or who.

The impression I always had was that, by virtue of the institutional structure of the Chairman of the Fed that it was a place where you could rely on more intellectual objectivity and more scientific rigor, not less, and not intrusion of political bias.

Would you say that holds up today?

Mr. JONES. I certainly would.

I think the Fed staff is outstanding, and the advice they give the Chairman is relatively unbiased in terms of policy decisions.

That is why I think coordination among all government economic policymakers is important in terms of this economic analysis.

I have to add that I heard a tidbit about that trip of Martin to Texas.

I heard that he raised the discount rate and made President Johnson furious.

I heard that after Martin arrived in Texas Johnson put him in a big Lincoln convertible and drove him around on dusty Texas roads at 80 miles an hour, Martin, of course, was a little short man, and the President was a big, tall fellow. Johnson's fast ride blew dust and dirt in Martin's face and scared him to death on these roads, but Martin still kept the discount rate where he had it.

Representative ARMEY. Which suggests that the Chairman not only is independent, but courageous.

Mr. JONES. That is right, despite the dust and the danger.

Mr. RAHN. I do not understand why you want to use government numbers at all in terms of forecasting.

The Government is a great collection agency, but in the forecasting we have a lot of private sector firms out there, some represented by my colleagues on the panel, and others such as the Blue Chip Indicators.

Why not take an average of say the best 10 forecasters, and then update each year and show who was wrong and who was right.

And then also ask private firms to give them estimates of these changes in tax revenues.

You could clearly see a track record of who does a good job and who does not and, you know, Roger Brinner's firm and others would have a great stake in trying to come out with the best number, not one that is politically biased if they knew that the actual performance of their number was going to be compared against what happened.

That is how the private sector works, and I believe the Government sector does not.

Representative ARMEY. I appreciate that, too.

Mr. Chairman, I am going to have to leave, but I do want to say that where we go to work, and our rubber hits the road, we do not have that choice.

We take what is mandated with the CBO, or whatever. We are going to have to put that guard in the slot and put a half a million people's fate on the line based on that forecast.

What I am looking for is, what can we do to make sure that we have the best scientists working for us in this decisionmaking process?

Mr. MOORE. It seems to me that this suggestion was a good one, Congressman Armey, and it would not prevent you from going to private forecasters to ask the same questions that we really have to ask of the Government agencies that have the responsibility, and then to act on the differences if we find them and decide which one is right.

Representative ARMEY. I appreciate that, but unhappily it is not always permitted in legitimate testimony and debate on the floor.

You know, information and good analysis is only valuable to the extent it can be used to move one to the right conclusions.

But thank you again, gentlemen. I do want to tell you this has been very much a treat for me. Thank you, too, Mr. Chairman.

Senator SARBANES. We are very pleased to have you on the committee.

I want to put one question and get a response from each panelist. I am going to put the question and let you think about it. Then I want to try to draw Mr. Rahn out on a point he obviously feels keenly about, and he has asserted more than once this morning.

The question will be: What do you see as the biggest risk for a deep recession? Hopefully it is going to be short and shallow, but if you are looking on the down side, what factor as you see it is the one that carries with it the greatest danger for a deep or longer downturn? While you have a chance to think about that, I will let you answer that question last, Mr. Rahn.

I want you to walk through these figures that you, Mr. Rahn, have cited for this incredible shift in numbers. I am looking now—I guess I should look at this table of the projected cumulative budget deficit. Is that right at the end of your prepared statement?

Mr. RAHN. That is correct.

Senator SARBANES. I take it your view is to contrast the projected deficit. These are numbers of course used by the administration?

Mr. RAHN. Yes. This is the report from Dick Darman in the Office of Management and Budget.

Senator SARBANES. I do not often find myself sort of carrying Darman's brief, but I just want to be sure that it is apples and apples that are being compared. Your assertion is that in the 1991 budget they projected these deficit figures, which are in your first column; then in the 1992 budget they projected these deficit figures, which are quite different, and over a 5-year period a difference of $800 billion, which is now.

Let me ask the first question.

Is the Social Security system in one column and not in the other?

Mr. RAHN. No. The figures are comparable.

In fact, I have asked my associates to give a breakdown of how this difference could occur.

I have those numbers, and I will quickly run through them and make them part of the record, if you so desire. The revenue shortfall, primarily due to the recession, comes out to $297 billion.

The net interest increase is $267 billion. Commerce and housing, including S&L's, $140 billion. Income security—this means entitlement programs—$136 billion. Health, up $79 billion. Social Security, up $37 billion. And Desert Storm, $14 billion.

What I am arguing is that the magnitude of those errors is so great, or the assumptions for 1 year, as to put in doubt all that kind of effort.

Look at the huge torture you all went through on the budget negotiations, supposedly saving us $500 billion.

In 1 year here, we have a shift, even after that, of $803 billion.

Senator SARBANES. Let me ask you this question: Were the S&L's excluded from column 1, but included in column 2?

Is that not correct?

Mr. RAHN. No. I think they were put in both of them. They are in both numbers.

Mr. BRINNER. Mr. Chairman, I think I can help you a little bit on these numbers.

If you look at my handout, I go through and show you the sources of the changes since the midsession review, which is most of the change since the last budget.

If you look at a table headed "Unpleasant Budget Realities" of my prepared statement, these are numbers taken from OMB itself.

What I show you are the changes that have been due just to the recession, they now acknowledge, for 1991. They show receipts lower by $49 billion that year.

Then, holding through that lower trajectory, but still assuming very strong growth rates from that point on, they are averaging something like $50 or $60 billion a year lower.

So you multiply that by 5 and you have about a $300 billion difference, just because you start from a recession and recover more slowly.

So that unemployment rate averages higher throughout, and hence, revenues average lower throughout.

On outlays, you have a similar kind of story.

You see the different categories: inflation, unemployment, changed assumptions on interest rates, interest on changes in borrowing due to the other factors.

The total increase in the deficit averages about $100 billion per year from those factors. Does this mean, as my title might suggest, "Washington Confesses—Budget Impacts of Economic Realism," we've finally gotten all of this behind us?

Not at all. Because if you look at the right-hand table, I show you that OMB still believes in miracles for the medium term.

They have a 3.2-percent real growth rate for the economy from 1993 to 1995. That is inconsistent with the productivity gains we are likely to achieve. So they have confessed that we are in a recession, and that we will be depressed from the path that they had achieved. But the path still rises at just an unbelievable rate for the medium term.

That is why I said that my firm and Wall Street really expect that $200 billion deficit is as far as the eye can see, unless there are major new steps taken.

Senator SARBANES. Do you want to add anything to that, Mr. Rahn?

Mr. RAHN. No. I agree with Mr. Brinner's analysis.

The thing I find disturbing, maybe because I have spent so much time working inside the beltway, is that I know economists and people in the administration and on the Hill here knew, and stated to me, that the Federal Reserve policies were clearly going to result in lower economic growth.

Mr. Greenspan and company had been too tight.

They knew that Congress was spending more money than it admitted.

They knew that the various regulatory changes you were making were going to have more of a negative impact on the economy than admitted.

And it is still going on, as Mr. Brinner pointed out.

We are not dealing here in an honest world.

It is no one person or individual, but it is the whole institution of the way that government now operates.

Senator SARBANES. What was your economic forecast last year? I do not recall.

Mr. RAHN. Initially we were fairly optimistic.

I do not have my one from last year, but we never believed that 5-year deficit projection.

Senator SARBANES. No, what was your forecast on what would happen? Did you predict a recession a year ago?

Mr. RAHN. We predicted a slowdown, but it started in the spring. No, we did not have a recession more than a year ago.

Senator SARBANES. They came in with these 1991 figures a year ago. What would be an interesting exercise I guess——

Mr. RAHN. We can do a deficit projection and we will not be as low as they were, nor as high as these numbers.

Senator SARBANES. But I assume what would be an interesting exercise would be to take your prediction of the economy a year ago, and assume that as what the Office of Management and Budget would have done, and then see how much of this shift which you have emphasized here is the result of that prediction not being carried through.

Mr. RAHN. We can do that.

Senator SARBANES. As I listened to you read the components, a large part of those components were the consequence of a recession, were they not?

Mr. RAHN. That is right. But you also have a good 40 percent which is not part of the recession, even though the recession scenario, any forecast any of us give is based on a certain set of assumed policies. You cannot divorce policy from forecasts.

So we are also able to state that we were overoptimistic at times because we are overoptimistic on policy.

We have been assuming for quite some time that the Fed would shift.

We have been urging them to. I think all of us were astounded that the Fed stuck with an overly tight policy as long as they did.

I know people in the administration, and I know people on the Hill here were, but let us say you take out the first two items, the revenue shortfall and net interest and attributed all that to the recession.

Senator SARBANES. You also have to take out the automatic countercyclical increases in costs which I think you listed there, too.

Mr. RAHN. Well, in income security and Social Security you will have some of that, a little bit in health, but most of those changes will not be explained by that.

There were still large amounts of discretionary spending increases.

I am not saying that we were perfect and you guys were all wrong, or anything like that.

Senator SARBANES. It is not "us guys." These are Mr. Darman's numbers.

Mr. RAHN. That is right. We are now illustrating Mr. Darman.

Senator SARBANES. We have separate branches of government.

It is tough enough hearing our own words knocked, as well.

Mr. RAHN. Clearly I used Mr. Darman's numbers because they show the biggest shift here from one set of numbers produced by the same person from 1 year to the next.

But I think it is illustrative of the fundamental problem.

I mean, a year ago if you had seen these numbers, I can just imagine the hue and cry from both sides of the aisle from Capitol Hill.

Now there has been barely a whimper because everybody had their fingers in the pot in this $500 billion deficit reduction package.

And suddenly to have this thing spring up another $800 billion, I think most of us here on the panel believe this number, if anything, is an understatement.

Senator SARBANES. Of course that point was made at the time of the budget summit. People said, look, we are moving into a recession. The numbers are going to be much bigger. We said, look, we have to do the best we can under the circumstances.

I find it hard, particularly when you did not predict a recession yourself.

Mr. RAHN. We predicted it earlier than the Administration.

Senator SARBANES. But you did not predict it at the time that you would have made the judgment that led to the figures that are in column 1 of your chart. At that time, your prediction, I take it, was roughly about what their prediction was, maybe somewhat more, I do not know. We can check that. They had to make it at that time, and they came in with it.

Mr. RAHN. The thing is, it was evident to a lot of us that the situation was not turning out well.

At that point, you all went into the budget negotiations.

It is also unambiguously clearly now that those tax numbers are clearly adding to the recession and making it a whole lot deeper.

The evidence that we have is that what you are going to lose in revenue and the automatic driveup in costs resulting from the tax increases on the economic baseline, you gain absolutely nothing from the huge tax increase.

You have lost that all in terms of slower economic growth and higher levels of government spending.

Senator SARBANES. If you make the assumption you made about it. I do not know that that is reasonable to do.

Mr. BRINNER. I would agree with you, Mr. Chairman.

If you had not come up with the 5-year plan, the financial markets would have punished this economy by more than the tax increases that have gone on.

I agree that there is a depressing effect on economic activity from tax increases, if nothing else changes, but certainly the financial markets were demanding that kind of action. They would love to see more.

The Federal Reserve would have loved to have acted earlier, but there was such a protracted debate on what programs to reduce, what taxes to increase or to cut, that the Federal Reserve did not act.

It did not trust you to put together a large enough package—you, the Congress, not you personally—neither did the financial mar-

kets. Therefore, the credit easing that you need to come 6 months to a year in advance of fiscal restraint did come then.

Well, now we have the first down payment by the Congress and the President on the fiscal restraint.

I argue in my testimony that the Federal Reserve was not sufficiently forthcoming in its credit easing to help you to offset that burden. They need to do more.

Senator SARBANES. What about the question I put? I would like to get a response from each of you.

What is the biggest risk for a deep recession?

Mr. BRINNER. I think the biggest risk remains tight credit policy of the type that my colleagues here were mentioning, the nontraditional type as well as the traditional type of interest rates.

I disagree that the Federal Reserve eased until January or February, and then only trivially.

If you look at interest rates adjusted for inflation, they were higher in January of 1991 than in January of 1990. If you look at real money growth, if that is your preference, trivial. So the Fed stayed tight throughout 1990. And finally, under political pressure, it relaxed.

If you look at their own forecasts, they believed that they were creating a modest rise in unemployment to cap inflation. They thought that was their objective.

Of the whole scheme of responsibilities for managing the economy, theirs is to manage inflation.

So they thought that if they created just a modest rise in unemployment, that would be politically tolerable.

I think they would have achieved that if we had not had the invasion of Kuwait. Now that we have had the invasion of Kuwait, the shock to confidence is compounding the vicious cycle effects.

It is time, as I said, to buy some catastrophy insurance for this economy. Take a chance.

Be more generous than you think you need to be. If you have to reverse course a little bit a year or two from now, so be it. But we need that boost today.

Mr. JONES. I think the biggest threat is to the financial system in the sense of unwinding the excesses from the 1980's.

That means corporate debt in particular is extremely high.

That process has to be unwound. It could lead to corporate bankruptcies.

It kind of surprises me. I would just note in particular Chrysler being forced to reduce its dividends by half.

What did Mr. Iacocca say? "I am going to commit suicide if I have to reduce dividends" or something like that.

The essence of the problem lies in the potential for financial difficulties: corporate bankruptcies, bank problems that are significant; the fact that regulators in some agencies who may have been too lax in the 1980's have now become too restrictive.

It is, to some degree, a microfinancial problem.

It is bank by bank we are talking about here.

It is not just a question of the Federal Reserve.

They have finally begun to ease the pressure, and probably will after a pause ease it some more.

But I am not at all sure how quickly that is going to show up in the banking system.

It is a little bit, in this nature, like the 1930's in which the Fed is having trouble in the sense of trying to push on a string.

Banks will eventually build up investments, as I mentioned earlier, and finally get some money growth.

They will get lower interest rates, and perhaps dig our way out of this, but there will be a significantly longer pause before we see the effects of monetary easing.

The dangers lie to the financial system.

They lie in the potential for bankruptcies, bank difficulties, as we look ahead, and I think that risk is greater than perhaps the consensus forecast of a mild and short recession being suggested right now.

Senator SARBANES. Mr. Moore.

Mr. MOORE. I think there are two major things that might make the recession serious.

One is the international scope of it. Namely, if a lot of other countries get into the same sort of recessionary difficulties that we are in and persist that way, then ours could become a lot worse.

And that, unfortunately, is something that we have relatively little control over.

We do not have a Federal Reserve that can control Japan, Germany, the U.K., et cetera.

So that is, I think, a real and serious danger.

The other one I would refer you has been noted by the preceding speaker; namely, that the financial system is a serious problem. If we cannot put our hands on the solution to that, that could make the recession much more serious than it has been so far, or that seems likely to me.

And there, there are some controls, fortunately, and some things we can do. The fact that we have come some distance toward solving the S&L crisis I think is one sign of the kind of thing that can be done.

Senator SARBANES. Mr. Rahn.

Mr. RAHN. Clearly, I agree with the financial structure.

The biggest problem is the fact that the Fed has consistently been too tight.

Just look at their testimony for the last 2 years and compare that with what we have said month by month.

It seems to us, and many of the other people in the private sector, that we have been right and the Fed has been wrong.

I am still concerned that they are too tight.

I am also concerned about the point that Mr. Moore made about the international situation.

And finally, I hear some Members of Congress talking about big tax increases and big increases in regulation.

That would clearly be suicidal to us, also.

As I suggested in my testimony, we should not add more tax and regulatory burdens to an already overburdened economy.

Senator SARBANES. Is it your view that a revenue loss which would increase the deficit is nevertheless desirable, as you have outlined it, even though it may have an impact on the Fed's policy and lead to tighter credit?

Mr. RAHN. I looked at this last year. We had a big tax increase. The deficit has soared. We were being told last year that we had to go ahead and have a tax increase to reduce the deficit to get eased interest rates.

Now interest rates have been coming down, not as rapidly as I would like, but we had a tax increase which, if anything, gave us a bigger deficit, not a smaller one.

Clearly we have too much tax burden on capital.

I think most economists who have seriously studied this agree that our taxation of capital in this country has really gotten out of hand.

Senator SARBANES. We have had some hearings on that, and the thing is that if you try to lower the tax burden on capital, raise the deficit and resulting increase in the interest rates, which again affects the availability of capital, then you return to this argument where you have more than lost with one hand what you have gained with the other.

Mr. RAHN. I think the evidence is rather overwhelming that by increasing taxes on capital, even if you could just have a one-to-one substitution of that for reduced government deficit, there is no reason to believe you are going to get a better resource allocation.

The evidence is that it is worse.

If you reduce the burden on capital—and I have no doubt that if you reduce the capital gains' tax between 1978 and 1981—the benefits of that would be enormous. You would get this huge surge of revenues. The empirical evidence is overwhelming on that. We increased the capital gains' tax rate in 1986. Did you get more revenue? No. You clearly drove down the prices of assets on real estate. You aggravated the S&L crisis, because most of these assets were real property. I look at this kind of policy which we have seen as clearly detrimental to economic growth and causing a lot of hardship to people out there.

I mean, I have been in the debate on capital gains. I kept saying to people, what is the revenue-maximizing rate on capital gains? I am told by the other side that it is whatever the rate is at the time. Well, that is nonsense. It is quite obvious that the current rate in capital gains is above the revenue-maximizing rate. I do not know any good economist who has seriously looked at that. We have seen the studies, the Treasury studies, and the others where people think it is clearly between 15 and 20 percent, and some people argue it is over that.

Senator SARBANES. We thank the panel very much. We appreciate your testimony.

The committee stands adjourned.

[Whereupon, at 12:25 p.m., the committee adjourned, subject to the call of the Chair.]

THE FINANCING. FROM MY PERSPECTIVE, THE PROBLEM IS NOT WITH THE DEMAND FOR CREDIT, THE PROBLEM IS WITH THE SUPPLY. THE CAPITAL JUST ISN'T AVAILABLE.

WHAT IS EQUALLY DISTURBING IS THE FACT THAT THINGS JUST AREN'T CHANGING. IN YOUR WRITTEN TESTIMONY, YOU NOTE SEVERAL OF THE STEPS THAT THE FEDERAL RESERVE HAS TAKEN TO RELIEVE SOME OF THE CONSTRAINTS ON CREDIT SUPPLIES. TO DATE, THEY HAVE HAD NO EFFECT ON THE RECESSION IN NEW HAMPSHIRE.

I REALIZE THAT AS CHAIRMAN OF THE FEDERAL RESERVE, YOU HAVE TO CONSIDER THE ECONOMY AS A WHOLE. I JUST NEED TO STRESS THAT SOME REGIONS ARE SUFFERING CONSIDERABLY MORE THAN OTHERS -- AND FURTHER ACTION MAY BE NECESSARY TO RELIEVE THIS CAPITAL CRUNCH. I CERTAINLY LOOK FORWARD TO HEARING ANY FURTHER COMMENTS OR SUGGESTIONS YOU MAY HAVE REGARDING THIS PROBLEM.

AGAIN, THANK YOU FOR COMING BEFORE THE JOINT ECONOMIC COMMITTEE, AND I LOOK FORWARD TO FOLLOWING UP ON THIS ISSUE WITH YOU DURING THE QUESTION AND ANSWER SESSION.

Senator SARBANES. Congresswoman Snowe, did you have any opening statement?

Representative SNOWE. No, I don't have an opening statement, Mr. Chairman.

I did want to welcome our witness here this morning.

Thank you.

Senator SARBANES. Chairman Greenspan, we are happy to have you here, and would be pleased to hear from you.

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

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

I have a rather long statement which I would appreciate being included in the record and I will excerpt from it, without objection.

Senator SARBANES. We will include the full prepared statement in the record.

Mr. GREENSPAN. Thank you. Mr. Chairman and members of the committee, as always, I am pleased to have the opportunity to appear before you.

As you know, the Federal Reserve's semiannual monetary policy report and testimony were submitted to the Congress last month. Rather than take you through the details of that report this morning, I would like to focus on a few of the most critical considerations affecting the outlook for the economy and the formulation of monetary and fiscal policies.

The recently available readings on business activity indicate that the economic contraction that began during the latter part of 1990 continued through February. The economic data of the past few weeks also included further indications of reduced cost pressures on prices and provided scope for a further easing of monetary policy last Friday.

The combination of lower interest rates, reduction in oil prices, and the resolution of the situation in the gulf continue on balance to suggest an upturn in real activity later this year in line with the central tendency forecast of the FOMC members and other reserve bank presidents that we presented to the Congress a month ago.

In discussing those projections, we stressed the extent to which uncertainties associated both with the situation in the gulf and with a number of unresolved problems in the economy made the outlook unusually difficult to assess; to a somewhat lesser extent, that is still the case.

Certainly, the successful end to the hostilities in the gulf has removed a troublesome uncertainty and should provide some lift to consumer and business confidence. But the other factors that we noted earlier—concerns about credit availability and problems in real estate markets—continue to restrain activity and to weigh importantly on business thinking.

The restraint on credit availability at depository institutions represents a continuing clear risk to the outlook and therefore, is a critical challenge for policy. To date, our assessment is that reduced demand for credit stemming from the decline in real activity accounts for most of the recent weakness in bank lending.

Nonetheless, developments on the supply side also have had a noticeable effect. Several factors underline the tightening in bank lending practices. Given the uncertain economic environment, banks are appropriately taking a closer look at prospective borrowers in some specific industries. But what is of most concern to us is restraint on lending by commercial bankers to otherwise creditworthy customers. For borrowers whose riskiness was essentially unaffected by the recession or by developments in specific markets, the reluctance of banks to lend seems to arise from attempts to bolster capital positions.

In some cases, loan losses and pressures on capital may be exacerbated by the degree to which examination standards are forcing loans to be written down inappropriately or by market reaction to aggregated data on problem credits on certain categories of loans.

Available information indicates that the majority of those who have been turned away or who have been discouraged from borrowing at depository institutions have been able to fund financing elsewhere. But one must assume that the alternatives, when they exist, are only available at a higher price.

How much production has been lost as a result of sound projects cut back or unable to go forward because of the rise in financing costs or because of an actual or feared lack of financing is difficult to assess.

A number of steps have been taken by the Federal Reserve that should relieve constraints on credit supplies. These include lowering interest rates, reducing reserve requirements, and working with other depository supervisory agencies to identify and correct practices that may be unnecessarily discouraging the flow of funds to creditworthy borrowers. Taken together, these steps may well prove sufficient to foster the growth of credit needed to finance economic expansion. But we recognize the risk that problems in this area could persist and could warrant further actions.

Another clear negative in the outlook remains the real estate sector, whose problems have exacerbated the difficulties of financial institutions. In the commercial sector, the overhang of vacant space is still substantial, implying that further declines in new construction will probably occur, even during a period of renewed economic growth. It would be most unwise to ignore the possibility that these negative factors could cause the contraction in economic activity to last longer or be more serious than is currently anticipated. Nonetheless, a number of elements appear to be moving into place that should enhance prospects for recovery. On balance, when these positive forces are weighed against the negatives, the scales appear to tip slightly in favor of suggesting that the current downturn might well prove milder than most of the recessions in the past 40 years.

One important factor on the positive side of the outlook is the sharp drop in petroleum prices that accompanied the onset of the war in the gulf. While the secondary effects of the cutbacks in employment and income are still running their course, the relief from lower energy prices, along with the apparent upturn in confidence from the end of the gulf war, should be laying the groundwork for some firming in consumer spending in coming months.

Indeed, in the days following the termination of hostilities, the anecdotal reports of increased traffic in real estate offices and auto showrooms raise the possibility that stronger consumer demand may be emerging. But I would caution that such early signals can be quite difficult to read, particularly at this time of the year when activity in some sectors picks up seasonally.

Another important influence that is expected to provide support for economic activity as the year progresses is the decline in interest rates, which began more than a year and a half ago, but was especially sharp in the past several months. Since late October, the Federal Reserve has moved aggressively in a series of actions to ease money market conditions. The substantial drop in short-term market rates has been accompanied by a net decline in long-term rates as well. In particular, fixed-rate mortgage interest rates are close to their lowest level since the late 1970's, and the resulting improvement in the affordability of single-family housing eventually should show through in a pickup in sales and homebuilding.

Other sectors also are expected to respond to lower financing costs as the year progresses.

Since the onset of the recession last year, the areas of greatest concern in the economy had been those related to domestic spending for which the dropoff has been most pronounced. Nonetheless, it is also important to consider how domestic production has been affected by the trends in exports and imports in recent months and to assess prospects for sustained stimulus from net exports. In the 6 months prior to the downturn, manufacturing production was rising at about a 2½ percent annual rate, boosted considerably by a recovery in motor vehicle assemblies and relatively robust domestic demand for business equipment and industrial materials. At the same time, export demand was providing little impetus to manufacturing production. The slowdown in exports of industrial goods marked a sharp departure from the trend over the preceding 4 years, when the share of exports in our factory output rose 5 percentage points to 13¾ percent.

However, since the peak in industrial production last September, the situation has reversed. Between last September and this January, there was a resumption of growth in foreign demand for U.S. manufactured goods and a reduction in domestic demand for imported manufactured products and materials including oil. These developments have cushioned the steep declines that have occurred as production has responded unusually promptly to the weakness in the domestic economy.

The brisk expansion in nonagricultural merchandise exports late last year occurred in a variety of industrial supplies and materials, as well as in consumer goods and in many types of capital equipment. This increase in export growth came despite a weakening of activity in several of our key markets abroad and it undoubtedly reflected the gains in U.S. international price competitiveness that had been building for sometime.

As a result of the decline in the foreign exchange value of the dollar and only moderate increases in U.S. export prices, the average price of U.S. exports measured in foreign currencies has fallen nearly 15 percent since mid-1989. At the same time, the prices of goods produced abroad have been rising. In the past, such gains in

U.S. price competitiveness have led to significant growth in our exports and if the recent improvement is sustained, continued expansion of U.S. exports would seem to be on track. Even if growth abroad were to slow somewhat, an increasing share of foreign markets would provide considerable support for our exports.

Of course, the prospects for sustained strong growth in our exports of goods and services depend importantly on the outlook for economic activity among our trading partners as well. As you know, Canada and the United Kingdom both moved into recession in 1990 and signs of a turnaround are not yet evident in either case. In contrast to the weakness in those two countries, activity remains vigorous in Germany, owing to the stimulus of reunification. In Japan, despite some indications of a moderation in economic growth, prospects for a continued expansion are still favorable. On balance, it is quite possible that growth among our major industrial trading partners will strengthen somewhat later this year, particularly if those countries experiencing recession start to recover.

The gulf war has been overshadowing developments elsewhere, particularly in Europe, and in the sphere of international trade negotiations. As the Western European economies move closer to the 1992 single internal market, they will benefit from structural adjustment and increased competition. A stronger, more vibrant European economy in the long run will be a more vigorous trading partner for the U.S. economy. In addition, progress in the historic transformation of the economies of Eastern Europe can be expected to lead to new opportunities for U.S. producers.

The focus on our export prospects highlights the importance of a successful conclusion to the Uruguay Round of trade negotiations. If those negotiations were to fail, we all would lose opportunities to strengthen trade flows and realize efficiencies that could enhance standards of living worldwide.

And with inventories relatively lean at most businesses, a recovery in demand should show through fairly promptly in a higher level of production.

Mr. Chairman, our monetary policy objective for 1991 is to promote economic recovery and to sustain growth at a rate that is consistent with progress over time toward price stability. Whether further adjustments to policy will be required to foster an upturn in output and employment is not yet clear. Any decision in that regard will depend on how trends in real activity, inflation, and the monetary aggregates unfold.

Until clear signals of a recovery in economic activity emerge, fiscal policymakers are likely to remain under persistent pressure to take actions to offset other contractionary forces. Concerns about the appropriateness of maintaining a policy of fiscal restraint during a period of weak economic performance are understandable. However, they must be balanced against the benefits that will flow from adhering to a budget strategy that is geared to the longer run needs of the economy. Those needs can best be met by keeping the underlying or structural deficit firmly on a downward path, even as the actual deficit is being swollen temporarily by the effects of a weak economy. That path promises to improve prospects for increased capital accumulation and higher productivity. It will com-

plement monetary policy in the attainment of the Nation's overall economic objectives for the longer run.

Thank you, Mr. Chairman.

Senator SARBANES. Thank you very much, Chairman Greenspan.

[The prepared statement of Mr. Greenspan follows:]

PREPARED STATEMENT OF HON. ALAN GREENSPAN

Mr. Chairman and members of the Committee, I am pleased to have the opportunity to appear before you again. As you know, the Federal Reserve's semiannual Monetary Policy Report and testimony, which were submitted to the Congress last month, provided an extensive review of recent and prospective economic developments and of monetary policy actions and intentions. Rather than take you through the details of that report this morning, I would like, first, to focus on a few of the most critical considerations affecting the outlook for the economy and the formulation of monetary policy and, then, to turn briefly to budgetary issues.

The Economic Outlook and Monetary Policy

The recently available readings on business activity indicate that the economic contraction that began during the latter part of 1990 continued through February. The economic data of the past few weeks also included further indications of reduced cost pressures on prices and provided scope for a further easing of monetary policy last Friday. The combination of lower interest rates, the reduction in oil prices, and the resolution of the situation in the Gulf continue, on balance, to suggest an upturn in real activity later this year, in line with the "central tendency" forecast of the FOMC members and other Reserve Bank presidents that we presented a month ago.

In discussing those projections, we stressed the extent to which uncertainties associated both with the situation in the Gulf and with a number of unresolved problems in the economy made the outlook unusually difficult to assess; to a somewhat lesser extent, that is still the case. Certainly, the successful end to the hostilities in the

Gulf has removed a troublesome uncertainty and should provide some lift to consumer and business confidence. But the other factors that we noted earlier--concerns about credit availability and problems in real estate markets--continue to restrain activity and to weigh importantly on business thinking.

The restraint on credit availability at depository institutions represents a continuing clear risk to the outlook and, therefore, is a critical challenge for policy. To date, our assessment is that reduced demand for credit stemming from the decline in real activity accounts for most of the recent weakness in bank lending. Nonetheless, developments on the supply side also have had a noticeable effect. The surveys of senior loan officers that are conducted by the Federal Reserve at three-month intervals have shown progressive tightening of business credit terms since last spring. Banks report that they have been applying more stringent credit standards and have made the price and nonprice terms of business credit less favorable to a wide range of customers.

Several factors underlie these changes in lending practices. Given the uncertain economic environment, banks are appropriately taking a closer look at prospective borrowers in some specific industries. But what is of most concern to us is restraint on lending by commercial bankers to otherwise creditworthy customers. For borrowers whose riskiness has been essentially unaffected by the recession or by developments in specific markets, the reluctance of banks to lend seems to arise from attempts to bolster capital positions. Banks are trying to raise capital-asset ratios, or at least hold down declines in those

ratios that might result from losses on outstanding loans. In some cases, loan losses and pressures on capital may be exacerbated by the degree to which examination standards are forcing loans to be written down inappropriately or by market reaction to aggregated data on problem credits on certain categories of loans.

Information from our surveys and estimates of funds supplied in financial markets indicate that the majority of those who have been turned away or who have been discouraged from borrowing at depository institutions have been able to find financing elsewhere. But one must assume that the alternatives, when they exist, are only available at a higher price. The problems of locating other sources of credit may be especially severe for some types of borrowers--small businesses and those in commercial real estate, for instance--who may not have ready access to securities markets. How much production has been lost as a result of sound projects cut back or unable to go forward because of a rise in financing costs or because of an actual or feared lack of financing is difficult to assess. But it is clear that the restraint on credit availability, along with the deterioration in profits, began to enter importantly in business decisionmaking even before the onset of the recession.

A number of steps have been taken by the Federal Reserve that should relieve constraints on credit supplies. These include lowering interest rates, reducing reserve requirements, and working with other depository supervisory agencies to identify and correct practices that may be unnecessarily discouraging the flow of funds to creditworthy borrowers. Taken together, these steps may well prove sufficient to

foster the growth of credit needed to finance economic expansion. But, we recognize the risk that problems in this area could persist and could warrant further actions.

Another clear negative in the outlook remains the real estate sector, whose problems have exacerbated the difficulties of financial institutions. In the commercial sector, the overhang of vacant space is still substantial, implying that further declines in new construction will probably occur, even during a period of renewed economic growth. Beyond the impact on new construction, the existence of a sizable stock of underused properties whose asset values have declined has repercussions for financial institutions that are carrying them on their balance sheets.

The most notable feature of the current downturn has been the marked erosion of business attitudes and consumer confidence that occurred after July. In the business sector, the clearest manifestation of the deterioration in attitudes was the rapidity with which producers moved to cut output and to pare inventories in response to actual or anticipated weakness in sales. Judging from readings of anticipated hiring, inventory accumulation, and capital spending, businesses remained in this cautious stance early this year, awaiting firm indications of the timing and strength of any recovery in demand.

Consumer confidence also registered an unprecedented plunge between July and October of last year, which probably was an element depressing business expectations for sales. Such a decline in sentiment also might have been expected to result in a rise in precautionary saving. But, income growth also was depressed, and when the sudden rise

in oil prices forced households to devote a significantly higher share of their disposable income to energy bills, both saving and spending, in real terms, were cut back sharply.

It would be most unwise to ignore the possibility that all or some combination of these negative factors could cause the contraction in economic activity to last longer or be more serious than is currently anticipated.

Nonetheless, a number of elements appear to be moving into place that should enhance prospects for recovery. On balance, when these positive forces are weighed against the negatives, the scales appear to tip slightly in favor of suggesting that the current downturn might well prove milder than most of the recessions in the past forty years.

One important factor on the positive side of the outlook is the sharp drop in petroleum prices that accompanied the onset of the war in the Gulf. The price of gasoline is back to its late-July level; the cost of home heating oil should retreat further as well in coming months. While the secondary effects of the cutbacks in employment and income are still running their course, the relief from lower energy prices, along with the apparent boost to confidence from the end of the Gulf war, should be laying the groundwork for some firming in consumer spending in coming months.

Indeed, in the days following the termination of hostilities, the anecdotal reports of increased traffic in real estate offices and auto showrooms raise the possibility that stronger consumer demand may be emerging. But, I would caution that such early signals can be quite

difficult to read, particularly at this time of the year. Typically, sales of houses and autos surge in March. For example, as the weather improves, sales of new and existing homes register their sharpest month-to-month gains between February and March--jumps of 35 and 25 percent respectively. The usual over-the-month pickup in domestic car sales also is sizable (almost 19 percent). What is difficult to judge from the very recent reports is how much more than the seasonal rise, if any, is occurring as psychology improves. Hard economic data for the period following the successful ground war will not be available for some weeks.

Another important influence that is expected to provide support for economic activity as the year progresses is the decline in interest rates, which began more than a year and a half ago, but was especially sharp in the past several months. Since late October, when the budget accord was reached and economic activity showed clear signs of weakening, the Federal Reserve has moved aggressively in a series of actions to ease money market conditions. Because a lessening of cost pressures has improved the outlook for prices, the easing of policy has been possible without raising new concerns in financial markets about inflation prospects. Such concerns could have had adverse consequences for the foreign exchange value of the dollar and for long-term interest rates.

But, in the prevailing circumstances, the substantial drop in short-term market rates was accompanied by a net decline in long-term rates as well. In particular, fixed-rate mortgage interest rates are close to their lowest levels since the late 1970s, and the resulting

improvement in the affordability of single-family housing eventually should show through in a pickup in sales and homebuilding. Other sectors also are expected to respond to lower financing costs as the year progresses. Although long-term interest rates have risen a bit in recent weeks, this should not materially interfere with an upturn in activity. The increase seems to reflect new optimism about the prospects for the U.S. economy as the Gulf war came to a successful conclusion. Indeed, yields on non-investment-grade bonds actually declined in response to that expectation.

Since the onset of the recession last year, the areas of greatest concern in the economy have been those related to domestic spending, because it has been in those sectors--consumption, homebuilding, nonresidential construction, and business inventory investment--that the dropoff in activity has been most pronounced. Nonetheless, it is also important to consider how domestic production has been affected by the trends in exports and imports in recent months and to assess prospects for sustained stimulus from net exports.

Viewed at the manufacturing level, the sources of changes in production can be examined by combining monthly data on factory output, inventories, and sales with data on international trade flows. A comparison of the six-month period prior to the downturn in industrial activity last October and the four months of contraction through January offers some interesting results.

In the six months prior to the downturn, manufacturing production was rising at about a 2-1/2 percent annual rate, boosted considerably by a recovery in motor vehicle assemblies from the very low

levels earlier in the year. Domestic demand for business equipment and for industrial materials also was relatively robust, although rising imports drained some of that strength away from domestic producers. At the same time, export demand was providing little impetus to manufacturing production. The slowdown in exports of industrial goods marked a sharp departure from the trend over the preceding four years, when the share of exports in our factory output rose 5 percentage points to 13-3/4 percent.

However, since the peak in industrial production last September, the situation has reversed. Between last September and this January, there has been a resumption of growth in foreign demand for U.S.-manufactured goods and a reduction in domestic demand for imported manufactured products and materials, including oil. For example, imports as a proportion of our overall domestic demand for manufactured goods stabilized late last year. When combined with rising exports, net imports of industrial goods as a proportion of manufacturing production declined from about 4-1/4 percent late last summer to less than 4 percent at the turn of the year. These developments have cushioned the steep declines that have occurred as production has responded unusually promptly to the weakness in the domestic economy. Cutbacks in domestic purchases and inventory holdings of a wide range of domestically manufactured consumer goods, business equipment, construction supplies, and industrial materials have more than accounted for the drop of almost 4 percent (not annualized) in manufacturing industrial production between September and January.

The brisk expansion in nonagricultural merchandise exports late last year occurred in a variety of industrial supplies and materials, as well as in consumer goods and many types of capital equipment. The sharpest gains were in shipments destined for countries in Western Europe. This increase in export growth came despite a weakening of activity in several of our key markets abroad, and it undoubtedly reflected the gains in U.S. international price competitiveness that had been building for some time.

As a result of the decline in the foreign exchange value of the dollar and only moderate increases in U.S. export prices, the average price of U.S. exports measured in terms of foreign currencies has fallen nearly 15 percent since mid-1989; at the same time, the prices of goods produced abroad have been rising. In the past, such gains in U.S. price competitiveness have led to significant growth in our exports, and if the recent improvement is sustained, continued expansion of U.S. exports would seem to be on track. Even if growth abroad were to slow somewhat, an increasing share of foreign markets would provide considerable support for our exports.

Of course, the prospects for sustained strong growth in our exports of goods and services depend importantly on the outlook for economic activity among our trading partners as well. Among the major foreign industrial countries, significant divergences in economic performance emerged last year and are likely to continue this year. Canada and the United Kingdom both moved into recession in 1990, and signs of a turnaround are not yet evident in either case.

In contrast to the weakness in those two countries, activity remains vigorous in Germany, where the stimulus of reunification between East and West Germany has produced rapid real growth and has sustained very high rates of utilization in industry in the western region. Indeed, the continued strength of aggregate demand in Germany has been a major cause of recent upward movements in German interest rates. In Japan, despite some indications of a moderation in economic growth, prospects for a continued expansion are still favorable. On balance, it is quite possible that growth among our major industrial trading partners will strengthen somewhat later this year, particularly if those countries experiencing recession start to recover.

Among developing countries, recent economic performance has been uneven as well. Mexico continues to achieve success in maintaining growth while pursuing economic reforms. However, in other Western Hemisphere countries, slowdown or even recession has accompanied current programs aimed at macroeconomic stabilization. The crisis in the Persian Gulf has disrupted output for some Middle East countries, but has permitted other developing country exporters of oil to expand. In the period ahead, the reconstruction in the Middle East is likely to provide a significant boost to the exports of the United States and of a number of other industrial countries.

The Gulf war has been overshadowing developments elsewhere, particularly in Europe, and in the sphere of international trade negotiations; these factors have potentially important implications for both the U.S. economy and the economies of our major trading partners. As the Western European economies move closer to the 1992 single

internal market, they will benefit from structural adjustment and increased competition. A stronger, more vibrant European economy in the long run will be a more vigorous trading partner for the U.S. economy. In addition, progress in the historic transformation of the economies of Eastern Europe can be expected to lead to new opportunities for U.S. producers of consumer and capital goods. As these economies become more fully integrated into the world trading order, they will broaden opportunities for two-way trade with mutual benefits to all.

The focus on our export prospects highlights the importance of a successful conclusion to the Uruguay Round of trade negotiations. Indeed, the costs of a failure of that effort could be serious. We all would lose opportunities to strengthen trade flows and realize efficiencies that could enhance standards of living worldwide. It certainly would be unfortunate if, instead, moves toward protectionism elicited retaliation, which would have particularly adverse consequences for U.S. producers just when their competitive position is so strong.

Taken together, the favorable factors at work abroad and the stimulative forces in train in the domestic economy suggest the likelihood of a pickup in aggregate demand over coming months. And, with inventories relatively lean at most businesses, a recovery in demand should show through fairly promptly in a higher level of production.

Our monetary policy objective for 1991 is to promote economic recovery and to sustain growth at a rate that is consistent with progress over time toward price stability. Whether further adjustments to policy will be required to foster an upturn in output and employment

is not yet clear. Any decision in that regard will depend on how trends in real activity, inflation, and the monetary aggregates unfold.

Fiscal Policy Considerations

Until clear signs of a recovery in economic activity emerge, fiscal policymakers are likely to remain under persistent pressure to take actions to offset other contractionary forces. Concerns about the appropriateness of maintaining a policy of fiscal restraint during a period of weak economic performance are understandable. However, they must be balanced against the benefits that will flow from adhering to a budget strategy that is geared to the longer-run needs of the economy. Those needs can best be met by keeping the underlying or "structural" deficit firmly on a downward path, even as the actual deficit is being swollen temporarily by the effects of a weak economy.

In light of these considerations, voting to suspend the enforcement provisions of the budget reconciliation act would be a mistake. Together with the Administration, you worked long and hard last year to reach an acceptable package of tax and spending changes and budget process reforms. The budget agreement gave financial markets some assurance of stability and of a future easing of federal credit demands. Undercutting this commitment now risks adverse effects on long-term interest rates and thus well might be self-defeating.

The new budget procedures make it easier than under the previous Gramm-Rudman-Hollings procedures for fiscal policy to have a stabilizing effect on the economy. Among other things, because the focus over the next several years is on the reduction in the deficit brought about by legislative action, rather than the level of the

deficit per se, the need for policy adjustments to offset the effects of changes in economic conditions has been eliminated. As a consequence, the automatic stabilizers that are in place can function as intended.

Moreover, the historical evidence on the implementation of discretionary countercyclical fiscal policy is not encouraging. In the past, programs designed to stimulate the economy during a contraction frequently did not come on stream until well after the recovery was under way. If assessments of prospects for a turnaround in the economy this year are on target, the adoption of new programs now may only end up repeating that pattern.

The military operations in the Gulf will cause some unplanned addition to spending in the current fiscal year. Defense purchases already have been raised somewhat by the war, and, as weapons are replaced, the new production will boost GNP. Current estimates suggest that a substantial part of the incremental expense ultimately will be paid by other nations, cushioning the effect on the budget deficit. Moreover, it is important to bear in mind that the successful conclusion of the Gulf war now ensures that these expenditures will be limited, with only minimal consequences for the longer-term thrust of fiscal policy.

On the whole, the budget accord provides a useful framework for conducting fiscal policy. It provides sufficient flexibility for specific tax and spending policies to be altered, if deemed desirable, to improve economic incentives or to reset priorities. Such specific changes in fiscal policy tools are possible while still moving along a steady path toward fiscal balance. That path promises to improve

prospects for increased capital accumulation and higher productivity. It will complement monetary policy in the attainment of the nation's overall economic objectives for the longer run.

Senator SARBANES. In view of the number of members that are here, we will go to a 5-minute round, then we can have a second round.

Chairman Greenspan, in your prepared statement, you say, having reviewed some of the factors of concern, that it would be most unwise to ignore the possibility that all or some combination of these negative factors could cause the contraction in economic activity to last longer or be more serious than is currently anticipated.

I was curious. Of the downside risks with respect to the economic outlook, which give you the most concern?

Mr. GREENSPAN. I would say those in the financial area, those which many commentators have described as financial fragility. What we are getting is balance sheet pressures on the economy which are relatively rare and we don't have a great deal of evidence as to how they work their way through the economy. But I think they are of sufficient concern not only with respect to the financial part, which everyone is discussing, but also to a significant overhang of a lot of physical items in the balance sheet—commercial real estate, some residential structures, perhaps, but it's not clear, motor vehicles.

Senator SARBANES. Most of the forecasts for a relatively short and shallow recession assume a strong export growth as they analyze the economic sectors. There is considerable concern, and you have alluded to it in your testimony this morning, that the world may be going into a recession, that all of the major trading nations may be moving into a downturn. Geoffrey Moore, director of the Columbia University Center on International Business Cycle Research, testified before the committee last week, that his international leading indicators suggest that many of our trading partners appear to be either in a recession or going into a recession. Now if that's true, I think it's reasonable to assume that it will hurt U.S. exports and it may offset much of the benefit of the declining dollar.

To what extent does the Fed's forecast of the economy depend on the assumption of strong export growth?

Mr. GREENSPAN. It depends in part, Mr. Chairman. But obviously, the far more relevant part are domestic elements—specifically consumer expenditures and domestic capital investment.

Obviously, if exports were to tail off very considerably, it would put some downward pressure on the economy. But even though exports have climbed to a very significant part of our economy from a rather negligible part 5 or 10 years ago, they are still relatively small. It would require a fairly pronounced contraction in exports to have a major effect on domestic activity in the sense that it, in and of itself, would turn us down. That would be very difficult to conceive.

Senator SARBANES. Do you agree with the observation that the international economy may be moving into a recession?

Mr. GREENSPAN. I do not. The results of the work of our staff, which is fairly extensive for most of the major economies of the world, does not square with Geoffrey Moore's leading indicators at this stage.

I think eventually we will find out which of the two procedures works out. But I would say at this point, I think there's enough support in the world economy to suggest that a recession is not the most reasonable forecast.

Senator SARBANES. Then is your lack of concern about this factor as contributing to a downturn in this country premised more on your perception that there will not be an international recession, and therefore, we will experience the impact of that, or that even if there is an international recession, it won't have a significant impact on this country?

Mr. GREENSPAN. Well, first, let me say, Mr. Chairman, when we're in a period such as this, when economies are in flux and significant recessions underway in several of the major countries, lots of things, accidents and the like, can happen which are utterly unforecastable.

I would be most cautious in making definitive forecasts. I think that what we try to do is to evaluate not only the most likely outcome, but also try to seriously think through what can go wrong with the forecast and what type of policy responses might or might not be required should that occur.

All I can say to you at this stage is that it is certainly the case that we have been revising down, as have others, in a somewhat progressive way in the last 6 months or more our various forecasts around the world. They've come down marginally, but the best judgment that our staff can make and a number of other analysts in the international arena—OECD, Bank for International Settlements, and so forth—is that the probability of recession at this particular stage on a worldwide interactive basis is certainly less than 50-50.

Senator SARBANES. In his testimony before this committee, Roger Brinner of DRI made a case for a 1-percentage point cut in the Federal funds rate. Let me read you what he said, and then I want to ask you to comment on it. Perhaps you have already had a chance to examine it.

He said:

> The Federal funds and short-term Treasury bill rates should be cut another full percentage point immediately.

Stated another way:

> The Fed should buy catastrophic economic insurance. It needs to lessen the risks tied to a scared consumer, a stressed banking system, and a depressed construction industry. If the economy is sicker than assumed and the Fed does not act, the business and employment losses will be severe. If the economy is basically healthy and rebounds strongly with greater Fed help this summer, the only cost of generous policy would be a trivially higher inflation for the next few years. In other words, this insurance is a good buy.

Is it?

Mr. GREENSPAN. I don't want to comment on a specific policy action on a specific tradeoff.

I'm a little puzzled, I must say, because DRI is, in a sense, forecasting a rather early upturn and, in a certain sense, reading their material, they're somewhat more optimistic about the near-turn outlook than I am.

They have in their control forecast the Federal funds rate averaging, for example, a little over 6 percent in the second quarter.

They have the economy in a small positive in the second quarter and growing at 4.1 percent in the third quarter and 3.3 percent in the fourth quarter, if I read it correctly.

Now, if I understand what Roger Brinner is saying is that that is a forecast which requires additional impetus at this particular stage.

As a constructor of models over the years myself, I am really quite hesitant to use modular simulation to get a judgment as to what's going to happen on models which we all know have not worked all that well over the years.

Roger Brinner is a first-rate economist and he is as good an econometrician as I know. But I don't know of any way in which you can create a forecast the way we are forced by, as we say in econometrics, changing the ad factors on our equations—which is suggestive of the fact that we don't trust the numbers all that well—and then use the model to simulate and have very great confidence in the way the result comes out.

So, in my judgement, I would be very careful in making assumptions about what type of responses occur to very large changes in monetary policy.

In the past, we found that because of the long leads that occur with policy, that we're often moving to respond to current events and find that when the policy force takes hold, that things have changed.

I think it's a very tough tradeoff. I mean, I don't wish to say that it's not something that should be studied. Obviously, we study that type of thing all the time. But I would be very cautious in how one looks at various different tradeoffs and I think it's important for us to be aware of the fact not only of the short-term consequences of our actions, but also most importantly, the longer term.

Senator SARBANES. Well, my time has expired. I may come back to it.

I would just observe that, in his testimony, Brinner was trying to get, as he terms it, an insurance policy against catastrophic economic developments, and his view was that you wouldn't pay much of a price for it, given the movements on the price front and that you would contribute to guarding against the high cost of a deepening downturn.

Mr. GREENSPAN. If I may just take a second to respond. It's obviously a very crucial policy question because if you have a policy where you're sure the cost of a mistake is minimal, it's the type of policy you ought to try to undertake.

Indeed, I would say a very goodly part of our policies rest on our evaluation of what is the cost if we're wrong. And I think that Mr. Brinner is raising the right question. In other words, what is the basic tradeoff.

If I felt comfortable with the type of econometric evaluation that is involved there, I perhaps could agree with him. But I must tell you that I am much more cautious about what one can realistically obtain from modular simulations.

The whole policy question surrounding how one comes at that issue really is at the root of policy formulation, but it's in periods such as this that one often makes major policy mistakes in both directions. And I think we have to be very cautious.

Senator SARBANES. Congressman Armey.

Representative ARMEY. Thank you, Chairman Sarbanes.

Chairman Greenspan, I can't resist making the observation that one gets compliments often from the most unusual places. My critics over my academic years used to refer to me as a freed maniac. I always appreciated the compliment. I'm not sure they intended it as such.

But when I had the privilege of being at the University of Chicago in 1969, one of the most colorful things that we heard from Milton Friedman was that if you can't say anything bad about the Fed, don't say anything at all. [Laughter.]

I suspect, Mr. Greenspan, you've observed that there are a few people that took that as a genuine dictum to be followed forever and ever.

I'm fascinated by that and I wonder if, in fact, we don't have people who got so involved in the money matters controversy of the 1960's and the 1970's, that they became convinced that the power of the Fed was in fact greater than it really indeed is.

I hear people so glibly say, the Fed must expand M2. The Fed must lower the interest rates. Or the Fed must increase the interest rates.

Now, the fact of the matter is the Fed has no authority, no power, to directly increase or decrease the money supply, nor directly to increase or decrease interest rates. Is that not correct?

Mr. GREENSPAN. Well, Congressman, obviously, to the extent that the money supply relates to the degree of reserves that are in the system, we can indirectly affect the money supply. We cannot affect it directly. That is, we cannot set it directly.

We can, if we chose, fix the Federal funds rate—that is, the price of overnight money, since we have a strong influence on the supply of that product.

In other words, we can create as much of that as we want or contract it.

But having said that, that's about as far as we can go because, clearly, that is the only instrument which directly relates to interest rates and we only very indirectly affect the interest rates on private instruments or longer term issues.

So I would say that I would agree with you partly, but only partly in that respect.

Representative ARMEY. Well, first let me say, understand, I'm not disparaging the power and the importance of the Fed, but I do think we need to have it within context.

I recall during the late 1960's and early 1970's, I believe the Chairman was William McCheney Martin, if I'm not mistaken. He used every instrument of the Fed to the most extreme ability, trying to combat inflation. Even though interest rates soared by recent standards, there just did not seem to be much of an impact on the expansion of the money supply simply because the demand for borrowing, given the inflationary expectations, was so great that, irrespective of how high the rates went, people were still rushing to get in now, before it got worse later.

Now in recent months, we all seem to be in agreement that the Fed must expand the money supply and lower the rates. You are criticized by a great many people because you have not lowered the

rates enough, and that you're in fact pulling on the string rather than trying to push on the string.

And yet, it seems to me that some of the things you cited in your testimony, which I was very pleased to see you mention, with respect to examination standards and some of the regulators, have really diminished the willingness to supply on the part of the institutions. In this case, irrespective of the potential demand, the institutional responsiveness is not to your best efforts.

Should I join that gang that says the problem is really that the Fed isn't trying hard enough? Or should we look for some real explanation in the real behavior of the institutional players in the marketplace?

Mr. GREENSPAN. No, I think it's quite correct to start on the whole financial system and look at both supply and demand.

The only thing that we can affect is the supply of certain financial variables in the system. That does have a profound effect on certain aspects of the financial system.

But you are quite correct in the sense that there are many other forces which are at play over which we have very little control.

We can endeavor to offset them, but not without consequences. And I think the crucial question is always—when confronted with very strong elements within the monetary or financial system which we'd like to confront—at what expense? Which is the real question, often.

Representative ARMEY. Thank you. Thank you, Mr. Chairman.

Senator SARBANES. Senator Bryan.

Senator BRYAN. Thank you, Mr. Chairman.

Chairman Greenspan, there's been a great deal of talk, and some have suggested that it's more fanciful than real, but there have been at least some anecdotal reports recently that with the decline in rates, that maybe lending has increased, traffic in real estate offices has increased, traffic in automobile showrooms has increased.

That's at this point essentially anecdotal, from what I'm able to understand.

Can you share with us with the hard data that we have, what the impact has been of the reduction in rates. Have we actually seen additional lending on the part of major financial institutions that would address at least the perception of many that there is a real credit crunch in this country?

Mr. GREENSPAN. I think that you're raising an important question. If you look at the weekly data which we do in some detail on lending in various different categories and try to adjust it for technical changes in the structure of banks, we pick up a very small rise in lending in recent weeks.

That is, we see it in part in the consumer area. We see it in real estate loans, very small.

I would be very careful at this point in reading those data. It is very easy to take a few weeks and draw a trend and then find out that it basically turns down.

All I can say to you is that the data are not inconsistent with those anecdotal reports. But it's really quite fragmentary at this stage and I would be very cautious in reading very much into it.

Senator BRYAN. I thank you for your answer.

Are you satisfied, Mr. Greenspan, that there is in fact a credit crunch? You'll get a difference of opinion, as you know, on that issue. What's your own reading?

Mr. Greenspan. I think the reason why there is a lot of discussion of whether there is or there isn't is a question of what one means by that.

There are those who are concerned, who define it that individuals who were able to get credit under comparable conditions, say 2 or 3 years ago, are unable to do so now. That is an inappropriate definition because, in a sense, there has been a tightening of credit standards on the part of the commercial banking system, part of which I think is healthy, not something we should be concerned about.

I do think, however, that we got to the point sometime during the summer of 1990 when we went over the line, if one could basically draw it, and credit was being deprived in a number of instances from otherwise creditworthy borrowers who by any set of criteria were good loan candidates and candidates which would be profitable to the commercial bank and generally would enhance the franchise for the commercial bank.

In a sense, I am saying that the commercial bankers, the loan officers, are acting against their own long-term self-interests in that they are not basically looking at the fact that it is customers and relationships which create the franchise value of a depository institution.

Senator Bryan. There have been some pointing to the rather substantial declines that we've seen in values of commercial real estate in particular that say that this is a consequence of the change in 1986 of the tax treatment of real estate transactions. And a number of people have visited with, I'm sure, virtually every member of this committee, if not the entire Congress, that suggest that we ought to go back to those passive loss rules, among others, and if we did so, that we would see considerably more activity in terms of commercial real estate, that activity there would rebound. Also suggest that we might save a considerable amount of money in terms of this ongoing disaster that we face with the bailout of the savings and loans.

Would you share your own views in terms of what the impact, if any, would be of those kinds of changes if the Congress were of a mind to consider those changes?

Mr. Greenspan. I think the evaluation is partly correct in the sense that the 1981 act created a degree of incentives within real estate which, in retrospect, were deemed to be excessive and indeed were the basis of the changes in the rules in the 1986 act.

If one looks at the extraordinary expansion of commercial real estate that occurred in the 1980's, I think it's difficult to disagree that the earlier rules in part created a fairly dramatic expansion which had to come to an end at some point because we were creating more commercial properties than could be absorbed by the markets.

When we reversed a lot of the incentives, in the 1986 act what we essentially did was to turn the markets very sharply. And one can see the timing of that having a dramatic effect on total commercial real estate.

In my judgment, it would be a mistake to go back to the earlier rules. I think that it's a difficult period to go through, but I see no other way than to absorb the excess that exists in these markets. It's clearly having a negative effect more on financial institutions than it is on the economy as a whole.

I should say it's having its effect on the economy more through its effect on financial institutions than in the approximately 1 percent of the GNP which is commercial construction.

But I don't see any reasonableness in some of the arguments that suggest we should reverse a number of the characteristics of the 1986 act.

Senator BRYAN. Thank you very much, Mr. Greenspan.

Thank you very much, Mr. Chairman. My time has expired.

Senator SARBANES. Senator Smith.

Senator SMITH. Thank you, Mr. Chairman.

Mr. Greenspan, I'd like to focus a little bit on following up on what Senator Bryan said, about the capital and credit crunch.

In New England, although certainly credit is a problem in the New England region, I see it more as simply a lack of availability of capital.

You do address it to some extent in your remarks, but I think the greater focus seems to be on credit rather than capital crunch.

Could you just comment on that, perhaps with a little bit of a tilt toward New England?

Mr. GREENSPAN. Yes. I assume you're referring to capital in the banks.

Senator SMITH. Right. There is just simply not enough capital there. The banks apparently, at least the ones that I talk to, are trying to claw their way back to the ratios and just simply don't have the capital there, even for a good customer.

Mr. GREENSPAN. I think that it's very difficult to distinguish between capital and credit crunch. It's the same process.

What is happening on a day-by-day basis are commercial bankers who had been overly lax in lending standards specifically on commercial real estate in the mid-1980's, are finding that the nonperforming loans that occurred as a consequence get written off, thus lowering their capital. They continuously look at the asset side of their balance sheet and say that the quality of my loan portfolio is deteriorating. It's going to cut into my capital and therefore the reason that I'm pulling back is I'm fearful of capital.

So it really is the same process and I don't think much is gained by trying to differentiate it. It is obvious, however, especially in New England, that we could very significantly alter that credit crunch if we could wave a wand and add 6 or 7 percentage points to the capital asset ratios of a number of institutions.

That's not feasible and it's not a realistic way to go. But it does underscore that it really is capital which is at the root of the problem.

Senator SMITH. OK. Well, I see what you're saying. You're not using the term "identically," but it's in the same framework.

I understand your point. I don't need to dwell on it.

Some have said, though, some bankers tell me that the problem in New England may be the fact that if the market has to work itself out and the bad banks simply have to go under, mergers have

to take place and the market has to take its course. Some say that's the route that has to happen. I think some of that does have to happen.

However, if, in doing this, mergers take place and banks from other regions of the country, I'm speaking strictly now about New England, were to come in and bring that capital in through a merger or an outright purchase with the approval of the FDIC, that's not going to help this particular region in New England, if in fact those assets are then loaned out to other regions in the country.

Mr. GREENSPAN. Sure. It's obvious that if you lend outside of the region in which the bank is located, and you're picking up deposits locally, wherever the capital comes from, it's clear that if those loans are not being made in the region, it's not helping the local enterprises.

I might add that that's one of the reasons why I think that a number of the community banks have a fairly potential competitive edge because they have the local knowledge and the local capabilities which a number of people who come in from out of state do not have. They are often somewhat surprised as to why they have such a tough time with all of their resources and beating out what seems to be a small, little operation in a local area.

Senator SMITH. I agree with that. And just one other quick point, Mr. Greenspan.

A gentleman by the name of Chris Gallagher of New Hampshire, he's a legislative counsel to the New Hampshire Bankers Association, made an interesting observation in a recent statement. I'd just like to ask you to respond to it.

"Monetary manipulation can't do the job any longer. Control by bank regulation is too painful and growth locally or nationally won't lead us out of the woods."

He quotes Pogo, saying, "we have met the enemy and it is us."

Essentially, we've produced this economic situation—we being, I suppose, the American people and the politicians whom they represent, or are supposed to represent, by producing huge debt, $3.5 trillion debt, and $300 billion estimated deficit this year.

This has to be the engine driving some of the economic problems that we face today.

Just comment on that. Are we flogging a dead horse?

How in the world, how can monetary policy or any other policy by your agency or any other agency be able to deal with this situation as long as we keep driving the debt up and essentially the Government moving further and further into competition with the private individual for borrowing money and credit?

Mr. GREENSPAN. Well, I think that that was a very important argument as to why some form of sharp reduction in the Federal deficit, and hence in the Federal borrowing requirements, was so essential.

I may not have agreed—in fact, I felt somewhat uncomfortable—with some of the elements involved in the budget package that was struck late last year. But as best I can judge from observing the process which was enacted into law, it is going to significantly reduce the borrowing requirements of the Federal Government and hopefully unleash a goodly part of the private savings that is being

absorbed in the Federal deficit to be employed in more productive purposes in private investment, which will increase standards of living and productivity.

So in that sense, I think that we're trying to come to grips with the problem that you raise and, hopefully, successfully over the next several years. That's one of the reasons why I would be concerned if we began to see the budget package unravel and suggest that borrowing requirements by the Federal Government were going to escalate in an inordinate manner.

Senator SMITH. Thank you, Mr. Greenspan. Thank you, Mr. Chairman.

Senator SARBANES. Congressman Solarz.

Representative SOLARZ. Thank you very much, Mr. Chairman. You'll have to forgive me. My voice isn't up to par today.

Mr. Greenspan, do I understand your testimony in effect to be saying that there is in effect nothing the Congress either can do or, for that matter, should do, to shorten the duration of the current recession?

Mr. GREENSPAN. Well, I think that a good deal of uncertainty was removed from the markets in the budget accord. I think that long-term interest rates were lowered, not a great amount, but enough to make a difference. And that has been, in my judgment, a contributing factor.

I would be concerned if a number of, say, public works packages were introduced whose central purpose was not to rebuild infrastructure for obvious other reasons, but as an economic, anticyclical measure.

I would be concerned if we went in that direction.

Representative SOLARZ. You made that point. But I interpreted your testimony to indicate that, in effect, you thought there really was nothing constructive or productive that Congress could do to shorten the duration of the recession.

Is that in fact your view, or is there something you think we could do that would be helpful in that regard?

Mr. GREENSPAN. I would be inclined at this stage essentially to stand pat. Should it turn out that the evolving expectations, which are fairly broad at this stage, that the recession will bottom out fails to occur, then I think it has to be rethought. But in today's context, I would say no.

Representative SOLARZ. Let's assume it didn't bottom out as quickly as we hope. Wouldn't the same arguments you've advanced against some kind of countercyclical package be equally applicable and from the perspective of those who think it's inapplicable now?

Mr. GREENSPAN. Well, I'm talking about using fiscal policy as a countercyclical tool.

Representative SOLARZ. Yes.

Mr. GREENSPAN. If the economy starts to turn up, then I think it's pretty evident that further actions would be counterproductive.

Representative SOLARZ. But you think if it doesn't turn up or begins to further deteriorate, then it might be?

Mr. GREENSPAN. If the economy were to fail to stabilize and recover in the months ahead, it would be suggesting that there were other forces at play. And I think that that would clearly require an evaluation by the Congress, by ourselves, and others.

Representative SOLARZ. Now you have a very carefully balanced, and I might even say, hedged, prediction about what's likely to happen with the economy, and that of course is understandable. There are a range of possibilities.

Could you share with us what might be characterized as your best case and your worst case scenario over the course of the next 1 or 2 years in terms of where the economy might be if everything worked out well on the upside, and where it might be if everything turned out for the worst on the downside?

Mr. GREENSPAN. Well, the number of scenarios that one can basically spin are innumerable, but I can give you representative ones. It's clear that the best case scenario is one in which the recovery begins in the next several months and starts up in a manner in which inflation goes down, as it sometimes does but not too often, which would in my judgment support a fairly strong, long, extended recovery.

The growth rate is difficult to judge largely because we've had a slowdown in the rate of growth of our labor force. The rate of participation of women, which had been so dramatic a factor in the expansion of our labor force, is now clearly slowing down.

But I think if productivity picks up, as we expect it will, I think we will have a fairly solid longer term growth out of this business cycle.

Representative SOLARZ. What would be a sort of realistic worst case scenario in the next year or two?

Mr. GREENSPAN. The worst case is very difficult to judge because so many things can go wrong, and what specifically goes wrong will determine what essentially the outcome is.

But, as I indicated to Chairman Sarbanes early on, I think the most likely concern is something that might occur from the financial system, from the fragility of the system, which is, as best I can judge, less fragile than it was, say, 6 months ago. But that's where the dangers would lie.

Representative SOLARZ. If I may ask one final question. Could you possibly share your thoughts with us about the capacity of the country to effectively compete economically over the longer run with Japan, a unified Germany, and an increasingly integrated European economy? And how concerned are you about our capacity to do that in relationship to your concerns about the short-term economic problems we now confront?

Mr. GREENSPAN. Well, I think that both Japan and Germany, and in Europe generally, have exhibited a really quite remarkable expansion in recent decades, especially coming from cultures which are rather old. I think we have extraordinary capabilities in this country. I do subscribe to the concerns of the Council of Economic Advisers on the issue of education, and that's a crucial issue.

But I think that our technical capabilities are really extraordinary and the scale of this economy is such that we have the possibilities of continuing to remain the major economic power in the world for as far out as I can envisage.

Senator SARBANES. We're very pleased that Congressman Mfume has joined the committee as a new member and we want to welcome him to the committee. We look forward to the very positive contributions that I know will be coming on his part. I am pleased

to recognize Congressman Mfume now. I know you have a vote on, but until the vote absolutely calls you away, the time is yours.

Representative MFUME. Thank you very much, Mr. Chairman.

It is a delight to be a member of the committee and a delight also to have the opportunity to talk to Mr. Greenspan again, which I seem to have been doing quite a bit these days.

Mr. Greenspan, I want to go back first of all and thank you for your definition of capital availability, as opposed to credit crunch. I happen to share your views that they are one and the same.

A lot of it has grown out of the reluctance of banks to lend money. That arises, I think, from attempts for them to bolster their own positions, or as you say in your prepared statement, that banks are trying to raise capital asset ratios or at least hold down declines in those ratios that come about as a result of bad loans.

But like anything else, I think too much of something is bad. In this case, the issue of restraint seemingly has caught up with persons who could be most affected by that restraint.

I agree with you. Tightening of credit standards is healthy. I wish that that sort of prudence had been exhibited over the years in a number of financial institutions in this country. Perhaps we would be in a different position now.

But that not being the case, we're faced with a very difficult situation, particularly in the State of Maryland. I met this past week with the Maryland Association of Homebuilders. They essentially have said that their industry is in a coma, that building in the Greater Baltimore area and in the Washington suburbs, and indeed, other parts of the State, has come to a virtual stand-still. And because of this credit crunch or this notion of no credit availability, that there are effects that spin off from that industry and the inability of that industry to continue.

Obviously, it's the area of employment and jobs. And beyond that, the ability to buy supplies and materials. And there are other industries that are affected. The tax bases of States now are starting to feel, I think to some extent, the effects of that.

I would ask, as Chairman of the Fed, if you would say something this morning perhaps to the commercial banks of this nation, who, for their own reason and I think in their own ways, have come to these decisions, this extra prudence that they seem to be exhibiting.

But what would you say as Chairman of the Fed that speaks to this issue and speaks to the need, I think, perhaps to move away from too much restraint and too much resistance as it relates to being able to lend and to make capital available for industries that are, as the homebuilders of Maryland indicate, in a virtual coma at this point?

Mr. GREENSPAN. Well, Congressman, I think that I would repeat what I said before, that what concerns me about this is what I consider inappropriate pulling back from lending. It's in the commercial banker's self-interest—if he is looking at the franchise value of his depository institution—to look at these lending possibilities as a means by which his business will expand and flourish, as distinct from pulling back.

Commercial banking, by its very nature, is a risk-taking enterprise. In a sense, a commercial loan is an illiquid asset. It is by its

nature riskier. It is one which creates a higher degree of profit as a consequence, but that's the business that commercial banking is in.

And when I say I'm concerned about the pulling back, I'm concerned in the sense that I think franchise values of a lot of institutions are being undercut and I don't think that is good, either for the owners of that institution or for their communities as well.

Representative MFUME. How do you see us moving off of the deadlock or this dime that we seem to be stuck on? If the banks are taking this very prudent and conservative approach to these nonliquid loans, and yet, there's an industry that their entire lifeblood is tied to the ability to get these loans?

Mr. GREENSPAN. I would think that the procedures that we've employed—bringing down the cost of funds to the banks, lowering reserve requirements which has much the same effect and initiating a series of essentially clarifications in the way that examinations should be made—are enough to unwind this particular process.

But Congressman, as I've said previously, if it turns out that that is inadequate, we're going to do other things and we're going to continue to push until we find the unraveling of the credit crunch evident.

Representative MFUME. Mr. Greenspan, my time is just about up. But before I leave to get over to the floor to vote, I want to go, if I can, back to a section of your prepared statement, where you indicate strongly that it's your position that voting to suspend the enforcement provisions of the Budget Reconciliation Act would be a mistake.

I share that and I've heard the rumors that are floating around that there may in fact be some idea to do something like that in particular areas.

I think that that would be a grave mistake.

Equally so, however, we had a great deal of rancor on the floor of the House yesterday as to whether or not and in what fashion we would move for this recapitalization of the RTC for $30 billion. And there was a great deal of resistance to the concept of pay as you go, which was something which was built into the budget agreement. I was wondering if you had any thoughts on that at all.

Mr. GREENSPAN. Yes. I don't believe that this particular authorization should be pay as you go. I think that, first, a tax increase at this particular stage, for example, would be counterproductive to the economy. And it's very difficult for me to envisage an easy pairing on the expenditure side which would offset the amounts of money that are involved.

But perhaps just as importantly, while the deficit is very important, there is something different about the effect of borrowing by the Federal Government to fill the hole in the savings and loan industry. There's something different from that process than borrowing to buy goods and services.

The latter has a significant impact on savings and investment in the economy. The savings and loan funding does not.

Its effect is much less on the economy—it has some, but it is much less than the run-of-the-mill budget deficits that we've had to finance over the years.

So that, as a consequence of both of those facts, I would think it would be inappropriate to try to fund this particular request from the administration. I think it has to be made in that we have already guaranteed these deposits as a government and it's only a means of resolving it. So that one way or another, we have to do this.

Representative MFUME. I thank you very much for your answer and Mr. Chairman, I would yield back the balance of my time.

Senator SARBANES. Thank you very much. Again, we welcome you to the committee, Congressman Mfume.

Mr. Greenspan, I have to say to you, in all candor, as I have listened this morning, I have become increasingly concerned. I don't see how, when we've gone from an unemployment rate of 5.3 percent last July to 6.5 percent in February, when we have these difficulties with the financial sector, that you in effect can simply sit there and say, well, we just have to stand pat. How deep do we have to get into this recession before addressing it and stemming its downturn?

I come back to the question that I put to you earlier about what risks are we running on the other side if we try to address it? Now, the Secretary of the Treasury said recently that there is plenty of room in the economy for lower interest rates. Do you agree with that?

Mr. GREENSPAN. I think there's certainly more now than there was a few months ago. But I would be cautious in making that sort of evaluation because it is not clear that we are getting significant responses in the long end of the bond market which suggests there's some resistance.

Now that resistance may in fact be nothing more than a general expectation throughout the market that the economy is about to turn. And in fact, as I indicate in my prepared statement, I think that, to the extent that we've seen a significant decline in the spreads of noninvestment grade bonds relative to the U.S. Treasury, for example, that is suggestive of the fact that the market does anticipate the economy turning up.

At this particular stage, moving against those types of expectations is not easy.

Senator SARBANES. Here is my concern. We have done a staff study of the forecasts of the Blue Chip Economic Indicators at the time of the 1981-82 recession. You probably can't see this chart from there, but this solid line is how the unemployment rate actually moved. In effect, it remains the top line throughout. These dotted lines that move across this way, well below the solid line, are what the consensus forecasters were predicting at every stage through that recession. In effect, what happened is you had a bias apparently in the forecasting toward, if not short and shallow, at least not as deep and long as actually occurred. And then the question, of course, I think reasonable to ask off the basis of this experience, is are we in effect doing the same thing once again?

Mr. GREENSPAN. Well, Mr. Chairman, I think if you drew the chart going in the other direction, you'd find the same result.

It's a tendency of forecasters to invariably underestimate the extent of declines in activity and recoveries. And if you were to draw the unemployment rate, say first going up and then coming

down, and you drew those forecast lines, you'd find that in most of the cycles that we look at, there is a tendency on the part of forecasters in both directions to underestimate the extent of the change.

Senator SARBANES. But that doesn't answer the question. I mean that doesn't answer the point.

The point is, even accepting that, if you're going to assert that position, your policy decisions in effect ought to compensate for this kind of prediction. In other words, what you are telling me is you are conceding, in effect, that the forecasters now may well be overly optimistic.

Mr. GREENSPAN. No, let me go further. You'll also find that as a group, they also miss the turning points. I think that having observed this phenomenon now for many decades, you come to two conclusions.

One, there is no alternative in making monetary policy other than to make a forecast. I wish it were otherwise. There is no way to somehow say there must be some mechanical rule we could adhere to and that would solve all of our problems. I wish that were the case; it is not.

Second, that the ability to forecast is really marginal in the sense that even though we get a big cluster of forecasters saying very much the same thing, we're all looking at the same data, same evidence. The fact of what the consensus is is not always correct by any means.

It does, however, tend to be correct more often than not. I mean, it's not a time-cost operation. Forecasting probably using the appropriate tools is right maybe 60 percent of the time.

We have moved interest rates down really quite substantially. The presumption that we are not responding, considering the fact that we've been moving down since the spring of 1989 as we saw inflationary pressures unravel, is in part a reflection of being aware of the type of chart that you exhibit, which we agree with. We think there is a tendency to underestimate.

Senator SARBANES. All right. Now, let me just follow along, then.

Are you familiar with the article about a month ago in the Wall Street Journal by Alan Meltzer, saying that the "banks are not sitting on excess reserves. They are lending, investing, and adding to deposits and money as fast as the Federal Reserve permits." And he concludes: "If the Fed supplied more reserves, none of the reserves would be held idle."

His assertion in that article is that while the interest rates have come down, you have not in effect put more money into the system. He said: "The Federal Reserve has been lagging behind the market as it usually does at the start of a recession. Beguiled by the decline in rates it believes that it has been easing. But quarter-point cut after quarter-point cut in short-term rates has failed to raise growth of reserves and money, a sure sign that the Fed is following the market down rather than boldly moving to limit the depth and duration of the recession." And he has other figures about how much M2 has grown, and so forth and so on, to make his point. What's your response to that?

Mr. GREENSPAN. Well, let me just say first that one of the things that became clear when we were running into the credit crunch is

that as we were pushing reserves into the system, they were not catching. So we just kept accelerating.

If you look at the numbers, first of all, in November, total reserves seasonally adjusted went up over 3 percent.

In December, they were up more than 15 percent. And in January and February, they were up more than 6 and 8 percent in each of the 2 months.

So what I think is fairly clear is that, to whatever extent those reserves were lagging because of the credit crunch, we have driven them significantly higher and the more relevant consideration which I considered in Professor Meltzer's article was the fact that M2 was lagging badly and we were most concerned about that.

One of the reasons we started to move as aggressively as we did is to move M2 back into its target range, which we have succeeded in doing. That, in our judgment, is one of the important things to make certain that there is no draining of liquidity from the system.

Senator SARBANES. Having said that, what is your explanation, then, simply put, for the concern over credit crunch? There is a difference in perception. What we are hearing of course from constituents on an anecdotal basis, certainly it's demonstrated, is that you have perfectly worthy borrowers, good projects and so forth, now finding themselves unable to get credit. You go over it with them very carefully as you hear these stories out, and in effect, they're making the point and it seems to be a valid point. They can show others who have looked at their situation and agree. There's no reason whatever why they ought not to be receiving credit and being able to move with economic activity.

Now why is that happening? If the banks have, according to you, sufficient liquidity, they have the reserves, interest rates are down, you have these borrowers wanting to incur loans, why are the lenders cutting them off? I'm not talking about the ones that you can look at and say, well, you used to get credit in a different set of circumstances and those circumstances don't apply any more. I'm talking about the ones under any examination. As I understand your testimony today, you've conceded as much, that there are such creditworthy borrowers who could carry out very worthwhile economic activity who are just not getting credit.

Mr. GREENSPAN. I think that what is involved is that banks are fearful that extending new loans for certain industries or for certain purposes will end up nonperforming and cut into their capital base.

So long as they believe that, it is very difficult to induce them to lend. You can obviously increase their balance sheets. They will buy Treasury bills. But you cannot make them pick up commercial loans or real estate loans unless they believe that they will be paid back and the loans will be profitable.

Senator SARBANES. Well, now, they assert that the regulators are frightening the banks. When you put it to them, they assert that the regulators are frightening them. They concede that there are some loans that they would ordinarily make and they don't really see the risks that you're talking about. But that the regulators have them intimidated that they have to meet higher capital standards under the international effort. Should that effort be slowed down?

Mr. GREENSPAN. No, I certainly think not, Mr. Chairman.

Senator SARBANES. OK. The banks find themselves frightened by what's coming to them from the regulators and, to some extent, from the Fed, who they see as essentially going with this general approach or attitude toward them. What's your response to that?

Mr. GREENSPAN. Well, I think I've heard innumerable anecdotal concerns about regulators and I think that the stories are partially true.

In an odd way, I would be surprised if they weren't partially true because we saw lax lending standards for real estate in the commercial banking area in the mid-1980's. We had examiners who essentially looked at those appraisals and said, that's fine. And when the loans became nonperforming, both the loan officers and the examiners had a personally traumatic experience which induced them both to pull back and I sense that we're seeing what is excessive in the way of pulling back on both the parts of the loan officers and on the parts of some examiners.

Senator SARBANES. Well, how do we draw the line so it's not excessive in either direction because we're in a downturn. Unemployment is worsening. The economy is going deeper into recession. There is some worthwhile economic activity out there to be done. There are people who assert they are prepared to do it. By any objective standard, they represent a good risk and ought to have access to credit. You are asserting that you are trying to make it possible for the banks to extend credit by increasing the money supply, lowering the interest rates. And yet, nothing's happening at the far end. I don't think it's satisfactory for the Fed to sort of say, well, we're doing these overall things. We're pumping in money—I won't argue now the extent to which you've done that and how far it may have fallen short. And I won't argue about whether the interest rates are being brought down quickly enough, whether there is, in fact, as Mr. Brady says, plenty of room for lower interest rates. But even with what you've done, you're not getting a response at the grassroots level.

Mr. GREENSPAN. I think that that issue is something which has been of grave concern to us; namely, that we have instituted a number of measures to try essentially to break the back of this credit crunch.

I think, as I indicated earlier, there's some very early signs that something may be happening, but I think it's fragmentary. It's not conclusive. And I think it would be a mistake on our part to merely assume that that was the beginning of a resolution of the issue.

But as I've said before and I will repeat here this morning, Mr. Chairman, we will continue to move forward with additional instruments, if necessary, on the credit crunch problem.

My judgment at this stage is that we may well have done enough to get it going. But unless and until we have confirmation of that, I think we have to continue to focus on other means.

Senator SARBANES. Do you think the Fed should establish some process of interacting with the lenders and borrowers in a way that enables a focus to be placed on this issue and get the lines drawn in the right place? In other words, the Fed is doing things at this upper level. It's not being translated out at the grassroots level.

Now should the Fed engage in a process of discussion and dialog with the borrowers and lenders that apparently are, in one way or another, frustrating the breakthrough that you want to see happen?

Mr. GREENSPAN. Well, Mr. Chairman, I think the first step which we took a week or so ago on indicating what we consider an appropriate approach to examination is clearly a step in that direction.

I myself have been most concerned about the extent to which real estate appraisals, which, by their very nature tend to be cyclical, have been employed inordinately for purposes of lending both on the upside and on the downside and have created, in my judgment, a significant problem in bank examination and supervision.

The rationalization of this process I think is important. I don't think it's a question of just merely looking at the downside. I think we ought to look at the upside and the downside insofar as examination is concerned.

Insofar as the Federal Reserve or the other regulators getting directly involved in the process, we do have a considerable amount of supervisory interface. But one of the things that I think would be most inappropriate for us to try to do is to actually get into the business of regulating the specific type of loans that are made—in other words, to basically directly or indirectly either get the central bank or the other regulatory agencies creating some form of credit allocation.

What history tells us about that process is to stay away from it. So I think we can go up to a certain point, but be certain we don't go over the point which becomes credit allocation because the long-term consequences to this economy are clearly undesirable.

Senator SARBANES. Let me ask you a question on this stand-pat view which you expressed toward any fiscal policy action by the Congress. Perhaps the most effective and certainly the quickest automatic stabilizer that we have is the unemployment insurance system. Amongst other things, of course, it ensures that the money goes to the area of greatest need because, by definition, it goes to the unemployed. Now that system is not working very well. The claims were excluded from the budget agreement last year as, I think, a wise effort to put outside of the budget agreement framework changes that would come about because of downturns in economic conditions. So the claims are not offset against the spending caps. But there is not sufficient money to pay the administrative costs which are associated with increased claims. The consequence of that is that unemployment insurance which should be received within a week or two weeks after unemployment in many parts of the country is being delayed six to eight weeks. Well, that's a loss of purchasing power over that period of time.

Employers have paid that money into a trust fund. There's more than enough money in the trust fund to meet the costs of the program, but it's not working the way it ought to be working. Now, don't you think we at least ought to make the unemployment insurance program work the way it's supposed to work?

Mr. GREENSPAN. Well, Mr. Chairman, what I was referring to in response to the question was basically a view of aggregative fiscal policy. I wasn't referring to actions that might or might not be

taken in individual expenditure items, individual tax items, or in the mix that is possible, under the budget agreement.

It turns out that the administrative costs question is one that I suspect no one really thought was going to come up as an issue. I assume the issue that you are raising is whether the category of administrative costs for the unemployment insurance system which now, if it were increased, would require cuts in other programs, should be freed from that obligation. I assume that's what your concern is.

Senator SARBANES. Well, I'm raising two concerns. It's my own view that, since it's logically consistent that if the claims are to be outside of the budget agreement, recognizing that they're the consequence of an economic downturn, that the administrative costs associated with processing those claims and making them available should also be outside of the budget agreement.

But furthermore, those administrative costs ought to be available so that you don't have this situation in the country where this automatic stabilizer is not able to work the way it's supposed to work.

I think it's outrageous that people are unemployed and employers have paid in. The unemployed have to stand in line all day long, maybe come back the next day to file their claim, and then instead of getting it within 1 to 2 weeks, which is supposed to be the standard time period, they get it 4, 6, or 8 weeks later.

It causes incredible individual suffering, and of course, in an overall sense, it means that you are not putting that purchasing power into the economy at the very time that you seem to need it.

Mr. GREENSPAN. Yes. I find that argument very difficult to go against.

Senator SARBANES. The other question is whether we should address the trigger for the extended benefits. That trigger has been revised in a way that makes it very difficult to come in with a program for the additional 13 weeks of benefits after the first 26 weeks. In fact, in some States, analysis has shown that the unemployment levels, because it's calculated off of the unemployment insurance rate in a very complicated fashion, would have to go to 12 to 15 percent before the extended benefits would kick in.

It seems to me that we need a reasonable figure for kicking in the extended benefits.

Again, here's another automatic stabilizer. If the recession is not short and shallow and continues on down, it seems to me, at the end of the 26 weeks, you would want to kick in with another 13 weeks of benefits. Do you have difficulty with that?

Mr. GREENSPAN. No. In fact, that was one of the issues to which I was implicitly responding earlier when I said that if the expected recovery which everyone is beginning to focus on, fails to emerge and/or the economy sinks lower, that sort of issue would be clearly an appropriate issue for the Congress to consider.

Senator SARBANES. The trust funds for airports and highways have built up very large reserves in them. That money was paid in for a purpose. When the taxes upon which that rests were put into place, people were told, well, you're going to pay these taxes for these purposes. And on that basis, people assumed the tax burden, and were prepared to carry the tax burden. Over the years, we

have maintained that linkage. It's the same sort of linkage that exists with the Social Security trust fund and the Social Security taxes, which also has built up a surplus and in fact is not contributing to the deficit, but offsetting it.

With this deficit pressure, as an accounting device essentially, administrations have held balances in there and then they use it to offset the deficit which is being incurred somewhere else. Of course, again, we're in a downturn. There's a general view that we are experiencing a third deficit problem, and that is the deficit in investment in our infrastructure.

At a minimum, what would be wrong with working within the budget figures for the year, a faster spendout of that amount for the current fiscal year, quicker movement on, say, transportation projects that are programmed to occur in any event over the course of 12 months in order to provide some early stimulus?

Mr. GREENSPAN. Well, Mr. Chairman, the difficulty that most economists, myself included, have with the process is that even though you can spin out the moneys faster, if that were the decision of the Congress to do so, the timing between the actual construction operations and the stimulus to the economy invariably is quite delayed.

Unless one were to presume that there is a very extended recession in front of us, which I think the evidence clearly is not supporting, you will end up with much of those activities beginning to emerge as the economy is accelerating. And if the purpose is countercyclical, it would be counterproductive.

Senator SARBANES. Well, if they're going to emerge anyhow, if they're programmed to emerge anyhow over the course of the next 12 months, what is wrong with trying to move them as quickly as you can?

I'm not now talking about adding to what's programmed. I'm talking about speeding up what's programmed.

Mr. GREENSPAN. No, but they in fact would engender construction activity as a consequence of letting the funds.

If it's the Congress' purpose to put a particular project onstream as an infrastructure issue or as an expenditure out of the various trust funds, and it is not stipulated as a countercyclical issue, that's a normal budgetary outlay.

The only concern that I have is the evidence suggests that when long-term projects, even those that seem to have a short fuse, are initiated, the vast majority of them come on as an economic stimulus well after the recovery is underway.

At least the theory of countercyclical fiscal policy in that respect would be violated.

So unless you were willing to make the proposition that the economy is going to go lower or just stay down, I think it's difficult to support that particular activity as a countercyclical action.

Senator SARBANES. Well, on the premise that the recession is going to be short and shallow. If the recession isn't short and shallow, you may get some benefit by doing it, and, in any event, you're not going to be doing something that you wouldn't be doing within a fairly short time period anyhow.

Mr. GREENSPAN. That is a fair statement.

Senator SARBANES. I'm back to the question I put to you earlier—why can't we do at least some of these things that will give us some protection on the downside and, as I perceive it, carry with them very little cost on the other side? These will help to give us some protection from the downturn. These are going to happen anyhow. But they may not happen until next September.

Mr. GREENSPAN. You mean the actual construction process.

Senator SARBANES. No, I mean getting it moving. Some of it can move fairly quickly, because it's not as though you're talking about instituting an entirely new program. In many instances, you're talking about continuing on and carrying through existing construction projects.

Mr. GREENSPAN. Let me suggest, it's quite possible that if instead of talking in the abstract we were talking about specific projects at specific times and specific areas, I might be less inclined to be concerned about it.

It's just that it's difficult to generalize when the historic evidence, at least the weight of it, suggests that caution is required in doing this type of thing.

Senator SARBANES. I have just a couple of questions about the Fed itself.

Are you concerned by the fact that while the statute provides 14-year terms for members of the Federal Reserve Board for yourself and your colleagues, and while historically, members tended if not to serve at least all of the term, some served all of it, and then even a second term—would serve substantial portions of that 14-year term, that it looks increasingly that members come on the Fed and stay for a few years and then leave the Fed. So that they are not using whatever the purpose of the 14-year term was.

Have circumstances changed so that we should not have the 14-year term, rethink the length of the term, or is something else amiss that results in members not staying for the full term or a good portion of the term, and is the Fed and the country the loser because of that?

Mr. GREENSPAN. I think there is a problem, Mr. Chairman, and it has disturbed me.

I think the 14-year term was a sound judgment when the Federal Reserve Act was initiated. I think it's sound today for the same reasons.

The people who have left, as best I can judge, have generally been confronted with a salary ceiling which, in many instances, created problems for them. In some cases, they are individuals who have children going to school and have increasingly felt incapable of maintaining the incomes that they perceive they need for their families and have not been able to stay for the full terms.

As a consequence of that, there tends to be or will tend to be a bias in the Federal Reserve Board for those who are independently wealthy. And I think that that would be a very bad mistake.

I don't know what the solution to this particular problem is, but it may well be that the increase in Federal Reserve Board Governors' salaries, as of the first of this year, may be a major contribution to helping to resolve this question. I certainly hope so.

Senator SARBANES. There's been some movement on the salary front, hasn't there?

Mr. GREENSPAN. Yes, there has. The salaries of the Federal Reserve Board have moved with the Congress' increase.

Senator SARBANES. How much do you think that has helped address the problem?

Mr. GREENSPAN. It's too soon to tell, but it is clearly significant enough to make a difference.

Senator SARBANES. When does your term as Chairman end?

Mr. GREENSPAN. In August of this year.

Senator SARBANES. Do we have any indication as to what is going to happen come August?

Mr. GREENSPAN. I think it is much too soon to focus on that and I would not expect to see the issue focused upon until we get very much closer to the deadline.

Senator SARBANES. The Fed, of course, is an independent institution. You get advice from lots of different sides, from the administration and from the Congress. I think while we are often quick to offer advice and criticism, at the same time, we don't want to undercut or abridge the Federal Reserve, the independence of the Fed. We recognize its importance in the operation of our system.

Actually, Chairman Martin once said that it was intended the Federal Reserve should be independent and not responsible directly to the executive branch of the Government, but should be accountable to the Congress. I would like to think of a trustee relationship to see that the Treasury does not engage in the natural temptation to depreciate the currency or engage in practices which would harm the general welfare.

What's your view on the current status of the independence of the Fed and the sort of pressures you are subjected to?

Mr. GREENSPAN. I think that we get pressures from time to time. But my general impression is that there is considerable respect for the need for the central bank to be independent in this country. And while, invariably, we get lots of criticisms, lots of recommendations, and things which people call pressure, I think it's frankly a healthy process which I in no way perceive as undercutting our independence or our capability of doing what we believe to be appropriate in a context of the oversight of the Congress.

Senator SARBANES. Well, Mr. Chairman, let me make this observation. I was surprised in the State of the Union Address when the President put forward the idea that you should be drawn into this capital gains issue. It's a highly controversial issue in the Congress, obviously, with strong partisan divisions. Actually, it is an issue on which you yourself have taken a position, as I understand it, in the past, a rather clear position. It is not clear to me how the involvement of the Chairman of the Fed in that kind of role would be consistent with how we have traditionally regarded the role of the Federal Reserve Board.

Mr. GREENSPAN. Well, I think, Mr. Chairman, it comes out of special conditions that surrounded the Social Security Commission in which, as you may recall, we had a major problem in 1982 with respect to the Social Security system and a national commission was set up with some fairly sharp political differences with respect to positions taken by the various members.

We eventually resolved a number of the issues because we were able to separate the value judgments which were obviously the

major issues, from the technical statistical issues which we all were able to agree upon, and that made the ultimate conclusion, a resolution of the issue, easier.

Senator SARBANES. Well, Mr. Chairman, you weren't Chairman of the Federal Reserve at that time.

Mr. GREENSPAN. No. I was chairman of that commission.

Senator SARBANES. Well, I understand that. But you took that job as a private citizen.

Mr. GREENSPAN. Yes, but let me——

Senator SARBANES. The question here is whether the Chairman of the Federal Reserve or the Federal Reserve is going to be drawn into this kind of an arena.

Mr. GREENSPAN. Well, I was merely trying to create some background to try to suggest where it's coming from.

Senator SARBANES. Yes, but that difference, it seems to me, is an essential one.

Mr. GREENSPAN. I don't say it's irrelevant. All I'm saying to you is that when requested by the President, joined by the bipartisan leadership of the Congress, to assist in a technical evaluation of certain statistical data and concepts, I frankly don't think it would be appropriate for me to decline.

Now, I don't know how this will ultimately resolve itself, and my own view of what the President is requesting is something similar to that technical issue, the technical statistical evaluation which took place in the Social Security Commission.

Senator SARBANES. I take it you had agreed to undertake to do this.

Mr. GREENSPAN. In the context of the joining of the President with the bipartisan leadership of the Congress.

Senator SARBANES. And you don't see that it's drawing the Federal Reserve into an arena in which, given the role of the Fed, it would be wise for it to abstain?

Mr. GREENSPAN. I would say if we could do it and if we restricted it to certain technical issues which had nothing to do with the basic issues of one's view of capital gains—which is very largely a philosophical question, I would say that I see no difficulty in that area.

Senator SARBANES. Well, I must say to you that it seems to me fraught with dangers for the Fed. I am surprised that the Chairman of the Fed would even consider being drawn into that sort of situation. I don't think it's advisable for the Fed or for the Fed's role in the workings of our economic system.

Well, thank you very much for your testimony today. We appreciate this opportunity to have you back before the committee.

The committee stands adjourned.

[Whereupon, at 12:03 p.m., the committee adjourned, subject to the call of the Chair.]

THE 1991 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, MARCH 14, 1991

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room SD-106, Dirksen Senate Office Building, Hon. Paul S. Sarbanes (chairman of the committee) presiding.

Present: Senator Sarbanes and Representative Armey.

Also present: William Buechner and Chris Frenze, professional staff members.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

Senator SARBANES. The committee will come to order.

Today, the Joint Economic Committee is meeting to examine the fiscal condition of the Nation's State and local governments.

This year, it is estimated that as many as 30 of the 50 States will incur deficits unless they either cut spending or raise taxes or some combination of the two. Numerous cities and local governments are also experiencing fiscal difficulty.

In this area, for instance, the States of Maryland and Virginia both face budget shortfalls in excess of 5 percent. The District of Columbia, Fairfax County, and Montgomery County are planning significant cuts in services to deal with deficits, as are a number of other local jurisdictions. The same story is being told across the country.

The weak economy of the past 2 years has left many governments with little or no reserves to weather the current recession. Their fiscal problems leave no options other than, as the economy declines, to cut spending and employment or to raise taxes.

We have a concern that in acting in this way, the State and local government sector may be in effect becoming an automatic destabilizer in the current recession, with this fiscal action required of them pushing the Nation's economy even further down and offsetting the stimulus that might come from automatic stabilizers elsewhere, for example, unemployment insurance.

We also are concerned about the impact of this on the Nation's economic strength in the long run. During the 1980's, many responsibilities were shifted from Federal to State and local governments, who often find themselves without adequate resources with which to deal with these responsibilities. State and local governments are the main source of infrastructure spending, the front line in the

battle against drugs and crime. That's where the prime responsibility for the education of our young people is to be found. They face problems of the homeless and the medical care for the indigent, and so forth.

We have today four witnesses with us to help the Committee examine the current fiscal condition of State and local governments: Ray Scheppach, the executive director of the National Governors' Association; Frank Shafroth, director of the Center for Policy and Federal Relations for the National League of Cities; Professor Steven Gold, director of the Center for the Study of the States at the State University of New York at Albany; and Professor Richard Vedder of Ohio University in Athens, Ohio.

Gentlemen, before I turn to the panel, I'll turn to Congressman Armey to see if he has an opening statement.

OPENING STATEMENT OF REPRESENTATIVE ARMEY

Representative ARMEY. Thank you, Chairman Sarbanes.

I do have an opening statement I would like to read this morning. It's a rather brief statement.

First, let me say good morning to the panel and to all our audience.

I am very pleased to welcome our panel of witnesses today to discuss the fiscal condition of our States. It is clear that the States are experiencing financial difficulties; 30 States are operating under budget deficits which must be eliminated according to their State constitution.

The National Conference of State Legislatures has reported that State fiscal conditions are at their lowest ebb since 1983. The current national economic recession, although not a cause of the current State and local government fiscal crisis, has exacerbated the problem. Many government officials would argue that the only solution to their budget deficits would be to increase taxes. This is certainly not the answer and would in fact continue the States' financial decline.

The States' fiscal problem is not the result of lower tax rates or revenues. States' per capita tax receipts have doubled since 1980 and quadrupled since 1970. State revenues now consume 8.4 percent of gross national product—the highest level in 30 years, up from just 5 percent in 1960. Last year, 24 States approved more than $10 billion of new taxes making 1990 the second biggest year ever for new State taxes.

If State revenues have increased this dramatically in the last decade and if deficits still exist, then the problem is overspending. Between 1984 and 1990, aggregate State spending climbed 8.4 percent or 75 percent faster than inflation. The National Center for Policy Analysis has found that between 1981 and 1988, outlays escalated by 101 percent in Connecticut, 92 percent in Massachusetts, 84 percent in New Jersey, and 81 percent in New York.

The 1980's prosperity produced conditions that should have provided fiscal cushions for the States. A decline in population growth, a decline in school enrollment, and an overall decline in unemployment are factors that could have provided financial ease for the

States. Unfortunately, spending and high tax rates to cover the overspending were seen.

As a result of increased tax rates, States are now experiencing slower economic growth which in turn lowers overall tax revenues. Studies such as the 1981 Joint Economic Committee report titled, "State and Local Economic Development Strategy: A 'Supply Side' Perspective," found that State economic growth is said to vary inversely with the burden of State and local government taxes; the fastest growth States, by and large, are States with relatively low tax rates.

The increase in State spending is not solely the fault of the States. Clearly, federally mandated spending has forced the States to spend resources in areas they might not have otherwise. Federal matching grants, which require States to spend in order to receive aid are also a contributing factor to the States' current budget shortfalls. It is estimated that on average, 60 percent of a State's expenditures are due to Federal mandates. The States need to be relieved of Federal handcuffs which determine State allocations.

In conclusion, it is clear that the current State fiscal crisis is the result of increased spending fueled by high tax rates and slow national economic growth. It is also clear that Federal mandates have contributed to the problem. To remedy the States' fiscal crisis, States should lower their current tax rates and decrease their current spending excesses. Second, the Federal Government should discontinue strangling Federal spending mandates.

Thank you, Mr. Chairman. I look forward to hearing from our witnesses.

Senator SARBANES. Mr. Scheppach, I think we'll hear from you from the National Governors' Association first, and then Mr. Shafroth from the National League of Cities, and then we'll go to Mr. Gold and Mr. Vedder.

If you would go ahead, sir.

STATEMENT OF RAYMOND C. SCHEPPACH, EXECUTIVE DIRECTOR, NATIONAL GOVERNORS' ASSOCIATION, WASHINGTON, DC

Mr. SCHEPPACH. Thank you, Mr. Chairman. I'd like to submit the full prepared statement for the record and I will briefly summarize my statement.

Senator SARBANES. The full prepared statement will be included in the record.

Mr. SCHEPPACH. The States are in their most difficult financial shape since the 1982 recession. If they took no action, they would have a revenue shortfall of about $10 billion for the current fiscal year, or somewhat in excess of 3.3 percent of total spending.

We have over 30 States in deficit, with 11 States facing shortfalls of 5 percent or more. Most of the problem seems to be east of the Mississippi River, with the exception of California, which also has a significant problem.

Revenue growth by States over the last 10 years has been about 8.5 percent. Our best guess now for 1991 is that revenues will probably be up about 2 to 3 percent. In real terms this means essentially a 2- to 3-percent reduction, which supports your point, Mr.

Chairman that State action this year will probably be procyclical as opposed to an automatic stabilizer.

This year, the recession is quite different from the 1982 to 1983 period. First, States entered that particular recession with substantial surpluses. In 1980 or 1981, we had a surplus of about 9 percent going into that recession.

Second, the Federal Government pre-empted a number of State revenue sources in the last reconciliation bill. Oftentimes for small additions to revenues, Governors will look for gasoline, cigarette, and alcohol taxes, but because the Federal Government raised those, they are less likely to be able to move into those areas.

Third, the tax climate is very different out there now than it was in 1982. At that particular time a large number of States were forced to raise either sales or income taxes by as much as 40 or 50 percent. But in 1990, we had 23 incumbent Governors up for reelection. Six Governors were defeated.

Taxes and increased taxes did play a role in that.

So that's a fairly high rate, 25, 26 percent of incumbents being defeated. So there's a very, very different attitude about taxes out there.

So why do we have a deficit right now? I'd suggest three reasons. First, the recession is obviously the major impact. It has decreased revenues and it has increased spending for AFDC, Medicaid, as unemployed people go on those particular rolls.

Second, however, I think that Federal policy has not been particularly supportive.

Over the last 10 years, grants to State governments have been cut about 25 percent in real terms.

Most importantly, however, I think that the mandates in the Medicaid area have created substantial problems. Medicaid for last year was up 18.4 percent. Our best estimate right now is that Medicaid spending for this fiscal year will be up 25 percent. And I see that Steve Gold's number is 27 percent.

Medicaid currently represents about 14 percent of State budgets, and we have not yet seen the major new mandates that were in the reconciliation bill last year.

We have a number of States this year where a total of 80 to 90 percent of their revenue growth is going to pay for Medicaid expansions. Health care in the States, and particularly the Medicaid program, is virtually out of control.

The third reason, other than the Federal Government action and the fall off in revenues and increase in spending from the recession, is the fact that we have continued long run pressures for spending. Not only in the health care area, but due to prison overcrowding; 41 States are currently under court order to alleviate overcrowding. We went through a period in this country where we tried to be tough on crime and that meant "lock them up." We are now on the biggest prison construction program that we have ever seen.

In 1990, prison construction cost close to $18 billion, which is up 29 percent from 1988. So you're talking about a 15-percent growth per year in prison overcrowding, when revenues are increasing just 3 percent.

Education—I think most Governors are trying to put more money into education. They have been substantially increasing the per capita spending, particularly in grades K through 12. This is now the point at which that population cohort is beginning to grow again, which will create some longrun spending pressures.

Finally, if you look at some of the numbers, local government has probably been hit harder by Federal cutbacks than have States over the last 10 years. Some of that slack has been picked up by States. The aid both for targeted and nontargeted money going to local government has increased over the last 10 years.

As you can see we have significant underlying, longrun demands on the budget. My concern is that when we come out of this recession, growth will be slowed, we will continue to have some very significant fiscal problems.

If you were to ask, what can Congress do, I would say, first, please don't create any more mandates in the Medicaid area. I suspect that the growth there is going to approach 30 percent per year once we get the additional mandates that were required in the last reconciliation bill. And in fact, we would ask that you go back to that reconciliation bill and try to make some of those mandates options for States.

The mandates require bad utilization of money in States. States are closing charity hospitals and clinics now to pay for emergency care in Medicaid, which is not a very cost-effective program.

Second, please don't shift any additional costs. Governors are particularly concerned about the administration's highway bill, although they support the block grant portion of it.

If you look at the changes in the Federal-State shares, that will increase the State share about $50 billion over the next 5 years.

Third, we plan to submit our block grant proposal to the Congress and the administration within the next couple of weeks and we would appreciate your support on that.

Mr. Chairman, that concludes my comments. I'd be happy to answer any questions.

Senator SARBANES. Thank you very much, Mr. Scheppach. We will hear from the other panelists before we go to questions.

[The prepared statement of Mr. Scheppach follows:]

PREPARED STATEMENT OF RAYMOND C. SCHEPPACH

Good afternoon Mr. Chairman and members of the committee. I welcome the opportunity to be here on behalf of the National Governors' Association to talk with you about the current fiscal condition of the states.

This was the primary topic of discussion among the Governors during our recent three-day meeting, both publicly and in our Governors-only session. Hit hard by shrinking revenues and mounting pressures for more spending, state budgets are facing the most difficult fiscal outlook since the 1982 recession. Not only is the economic downturn creating a fiscal crisis, but there are also an expanding array of needs for long-run investment -- in education, highways and bridges, and health care.

These concerns were the impetus for a new policy the nation's Governors just adopted, calling for a new state-federal partnership to:

- provide states some fiscal relief and stabilize the economy; and

- develop a blueprint for renewed economic growth and a better quality of life.

THE FISCAL PRESSURES ON THE STATES

The Economic Downturn. The economic downturn is creating significant fiscal pressure in states. Corporate profits, sales, and personal income tax revenues are all substantially below expectations. As many as 30 states must cut their budgets -- or raise revenues -- to avoid deficits in fiscal 1991.

Eleven states face shortfalls in excess of 5 percent. Total state revenue shortfalls are estimated at $9.6 billion, or 3.2 percent of appropriated expenditures. Most states already face operating deficits in fiscal 1991, and fiscal 1992 may be even worse. Since 49 states require balanced budgets, Governors' options are limited (See Figure 1).

In 1990 states increased taxes $10.3 billion, the largest single-year increase ever recorded, and federal taxes were also increased. In that climate, additional tax increases in fiscal 1991 will be difficult. Clearly, cutback management will be the critical state budget theme until national economic growth is positive again.

The downturn is going to hurt states well into fiscal 1992, which begins in July 1991 in most states. Recovery from this recession is expected to be slow. Unlike the 1981-82 period, when states went into the recession with budget surpluses of about 9 percent, today state ending balances are at their lowest levels since fiscal 1983 and continue to drop precipitously.

Not only are revenues lower than expected, but the demand for services such as unemployment insurance, Medicaid, and Aid to Families with Dependent Children grow as unemployment increases during the downturn. Already considerably more workers are collecting unemployment. Caseloads for Medicaid and Aid to Families with Dependent Children are increasing dramatically and at least 32 states say costs for each program are more than they budgeted.

Mandates and Cost Shifts. While the economic downturn is clearly the major cause of the fiscal crisis, the federal government and the courts are contributing to the problem.

Health Care

The cost of the federal Medicaid program to the states has risen rapidly over the past decade: in 1980 Medicaid spending accounted for 9 percent of state budgets overall, but in 1990 it accounted for nearly 14 percent of all state spending (See Figure 2 and Table 3).

State Medicaid spending increased by 18.4 percent in 1990 alone, and is expected to increase nearly 25 percent this year. Over the next five years, Medicaid is projected to increase by $75 billion — costing the federal government an extra $42 billion and states $33 billion more annually. By 1995, it is estimated that states will spend $66 billion a year on Medicaid, compared to $31.4 billion they spent in fiscal 1990.

Federal mandates enacted since 1987 will cost states more than $5.4 billion in fiscal 1991 and 1992 and provisions of the Omnibus Budget Reconciliation Act of 1990 are estimated to cost states $3.0 billion during fiscal 1991-95. The total state cost of all of these mandates is estimated to be $17.4 billion over five years (through 1995). In fiscal 1991, Medicaid expansions will include: $916 million from the provisions left in the catastrophic health care legislation; $461 million to cover new nursing home regulations; $479 million for Medicaid coverage for pregnant women and children up to 6 years old up to 133 percent of poverty; $163.3 million for early and periodic screening, diagnostic, and treatment services; and $199 million for Medicaid costs relating to welfare reform.

The $916 million state cost for the catastrophic legislation provisions is an interesting case. When Congress drafted the catastrophic health care bill, it expanded Medicaid coverage of Medicare recipients, anticipating that new Medicare benefits would offset the additional costs to states. Congress later repealed the catastrophic care coverage that would have offset state costs, but left the new state requirements in place.

In addition to matching requirements in Medicaid, states also provide matching funds for the Maternal and Child Health Care Block Grant. The federal government appropriated $587.3 million for fiscal 1991, including $499.2 million (85 percent) to states, which must spend $3 for every $4 the federal government spends.

Transportation

U.S. Transportation Secretary Samuel K. Skinner is proposing policy that would reduce the federal share of transportation spending, even though states and local governments already finance the vast majority of the nation's transportation infrastructure. His proposed policy would lower the federal matching rate on federal projects (currently 90 percent on Interstate, 75 percent on most other projects).

Governors are concerned about this proposal to shift more responsibility to state and local governments and the private sector, particularly since the federal government is not spending money that has already been collected. Currently $32.5 billion is sitting in the transportation trust funds.

States want Congress and the administration to restore "trust" to the trust funds by making this money available. A first step was made during the last session of Congress when governors won an increase in the highway obligation ceiling for fiscal 1991. Congress set the highway obligation ceiling at an unprecedented $14.5 billion (a $2.3 billion increase over the fiscal 1990 ceiling of $12.2 billion). However, this increase is only for one year and a similar fiscal 1992 funding level cannot be guaranteed.

State and local government pay for the lion's share of the nation's transportation infrastructure.

- State and local government financed 78 percent of t: - $69 billion spent on highway improvements in 1988. In recent years, outlays from the highway trust fund have not kept pace with outlays from state and local governments.

- Between 1980 and 1990, state and local spending on highways increased by nearly 90 percent, while federal expenditures on highways increased by only 52 percent.

- Between 1986 and 1990 federal spending on highways dropped 1.5 percent, while state and local expenditures increased almost 30 percent.

Transportation funding faces a threat from another area as well: 1990 was the first time federal motor fuel taxes have been diverted for a purpose other than transportation. The budget agreement passed late in the 101st Congress increased motor fuel taxes 5 cents — 50 percent of which would be dedicated to the transportation trust funds and 50 percent dedicated for deficit reduction. There is no current provision to spend the new revenues. Governors feel strongly that these funds should be dedicated to the trust fund and obligated accordingly.

The reconciliation bill last year included a new provision to withhold a percentage of highway funds to states that don't revoke or suspend the driver's licenses of convicted drug offenders. The total amount at risk in all states would have been $890 million if the provision had been in place in the current fiscal year. In all, states now face 13 different financial

penalties if they don't comply with federal requirements. Under these penalties, states can lose from 5 percent to 100 percent of their highway funds. These requirements range from control of junkyards and outdoor advertising to national minimum drinking age laws. The newest provision can be waived -- if both the governor and the state legislature provide written certification that they oppose the law.

Intergovernmental Funding Shifts

The economic landscape has changed considerably since the nation last faced a recession, particularly in intergovernmental relations. Major changes in funding patterns and continual growth in federal mandates have had an impact on state budgets.

Since the last recession, the federal government has ended the broad-based federal grants-in-aid that once helped fund basic governmental services and provide countercyclical assistance. In 1981, these grants provided $10.2 billion to states and local governments, funding which is no longer available. This decrease in aid has been paralleled by dramatic growth in federal programs that require states to pay a matching share. In 1991 states spent $23.5 billion more on the Medicaid program than they did ten years earlier.

Although federal grants-in-aid to state and local governments have increased from $95 billion to an estimated $150 billion between 1981 and 1991, most of this "increase" consists of the federal share of individual entitlement programs such as Medicaid, which require state matching shares. Payments for non-entitlement programs have increased from $58 billion to an estimated $67 billion. Factoring in inflation, this is a net decrease of 27 percent over the decade.

Corrections

Corrections is another area where states must increase funding. In fiscal 1990, 41 states and two territories were under court orders to relieve prison overcrowding or improve conditions. In eight states, the entire prison system was under court order. Twenty-six percent of all local jails are now under court orders. The financial demand created by those mandates is a very rapidly expanding state expenditure.

At the same time, more offenders — especially those who commit drug offenses or violent crimes — are being convicted. States are exploring alternative ways to deal with the increasing number of offenders, but the public still wants most criminals to be incarcerated.

In 1990, states spent an estimated $17.9 billion on corrections, more than 29 percent above their 1988 spending.

In 1988:

- 18 states built 42 new prisons at a cost of more than $1 billion -- an average of $28.6 million per institution;

- 182 prisons or prison additions were under construction in 36 states at a cost of more than $2.8 billion; and

- states spent more than $10.9 billion to operate prisons.

OTHER SPENDING PRESSURES

Even without the economic downturn and the federal government and court mandates and cost shifting, there are major unmet needs that are driving state expenditures.

Education

In education, state expenditures have grown substantially in recent years and are expected to keep growing as enrollment increases and efforts to achieve national education goals continue.

- Between 1982 and 1987, average state elementary and secondary education spending per pupil grew by 22 percent.

- In 1987-1988, public elementary and secondary schools spent in excess of $164.5 billion on current operations — roughly $4,243 per pupil. About half comes from state sources, more than 40 percent from local sources, and about 6 percent from the federal government.

- Total fall enrollment in public elementary and secondary schools is projected to rise from 40.8 million in 1990 to 43.7 million in 1995, according to the National Center for Education Statistics.

- The needs for school facilities continue to increase. A 1989 Education Writers Association report estimated the nation needs to spend $85 billion for new or remodeled school buildings and an additional $41 billion for school maintenance and repairs. The nation's investment in school buildings is an estimated $422 billion.

Governors also must continue the education reforms that will be needed to attain the national education goals they adopted with President Bush.

State Aid to Local Governments

State aid to local government has been increasing faster than overall state spending. In 1988 local governments received 61.9 percent more aid from the states than in 1982, while the states' general fund expenditures grew only 51.5 percent in that period. Local governments received $142.6 billion in state aid, and just $20 billion federal grants-in-aid. State aid to local governments was $88.1 billion in 1982.

In 1988:

- Unrestricted state aid to local governments was about $17 billion -- four times higher than federal revenue sharing (which was discontinued for local governments in 1986). This unrestricted state aid to local governments almost equaled the total of restricted federal aid to local governments that year.

- Restricted state aid was $126.1 billion -- six times more than all federal aid to local governments.

In comparison, federal grants-in-aid to local governments were about $20 billion in 1988 -- down $4 billion since 1982 ($8 billion when adjusted for inflation). Local governments began to look to the states for aid more intently when federal general revenue sharing with local governments was eliminated in 1986, and many states stepped in to make up for that loss.

Most big cities and many other local governments also lack funds to meet basic services. The natural demand and logical responsibility falls to the state. The average local government raises only 63 percent of its revenues from its own sources. By far, the balance comes from the states. States cannot maintain current local aid when their own revenues are falling and spending is increasing.

SUMMARY AND RECOMMENDATIONS

In summary, the states are under pressure from federally mandated spending increases in Medicaid and other health programs, threatened with potential cuts in the federal share of funding for transportation projects, and facing increasing demands in education, corrections, and other areas.

The Governors commend Congress for meaningful deficit reduction in the midst of slow growth and for starting a re-investment in highways and airports while protecting the environment. We applaud the new child care initiative that fully recognizes state discretion and flexible administration, and the continued commitment to the safety net programs for the poor, especially the education, health, and nutrition of our children. We urge that these vital initiatives continue as a basic investment in our nation's future.

The Governors' recommendations are both short-term and long-term.

Short-Term Action. The Governors recommend five short-term actions the federal government can take to help stabilize the economy and provide fiscal relief to states.

1. Relax the new Medicaid mandates included in the final budget agreement for fiscal 1991 and 1992 by making these expansions optional. Incremental Medicaid mandates and extensions are a poor solution to the nation's health care problems. The nation's Governors are working to help develop a more effective partnership on health care reform, but fiscal relief is necessary.

2. Provide emergency supplemental administrative funds to states for services to the increasing number of unemployed workers. Federal funds to provide services to jobless workers will be at least $150 million short and state revenues are not available to meet this emergency.

3. Freeze any further cost shifts to the states. Current federal matching rates should be maintained. This is particularly important in the area of federal highway and transit programs.

4. Use the dedicated highway, transit, airport, and land and water conservation trust funds for their intended purposes. This would have the dual benefit of stimulating economic activity while making much-needed infrastructure improvements at a lower cost since construction expenses are traditionally lower during an economic downturn.

5. Protect traditional state tax resources and preserve the deductibility of state and local taxes and the tax-exempt status of bonds, all of which are essential to state revenue-raising capability. Refrain from enacting legislation that preempts state taxation of interstate industries, such as financial institutions, railroads, telecommunications, interstate gas pipelines, and trucking.

6. Help states collect sales taxes from out-of-state direct marketers by approving legislation to overturn the National Bellas Hess decision.

Long-Term Action. The Governors call for a blueprint for renewed economic growth and a better quality of life. We must be full partners in major domestic policy development and ask Congress and the administration to work with us to:

1. Restructure the health care system to increase access to appropriate levels of care, including preventive, acute, and long-term care, at affordable costs.

2. Fulfill our commitment to achieve the national education goals.

3. Develop a national energy policy that, recognizing the fragility of the international oil situation, will seek to ensure the long-term availability of affordable, adequate energy supplies by emphasizing domestic resources and increased efficiency.

4. Enact a long-term national transportation policy, beginning with the reauthorization of the surface transportation program in 1991.

5. Embark on a national program for waste management and clean water that relies on state leadership.

6. Create a long-term strategy for investment in human resources, worker training, education, infrastructure, and research and development, and to reform the unemployment insurance program.

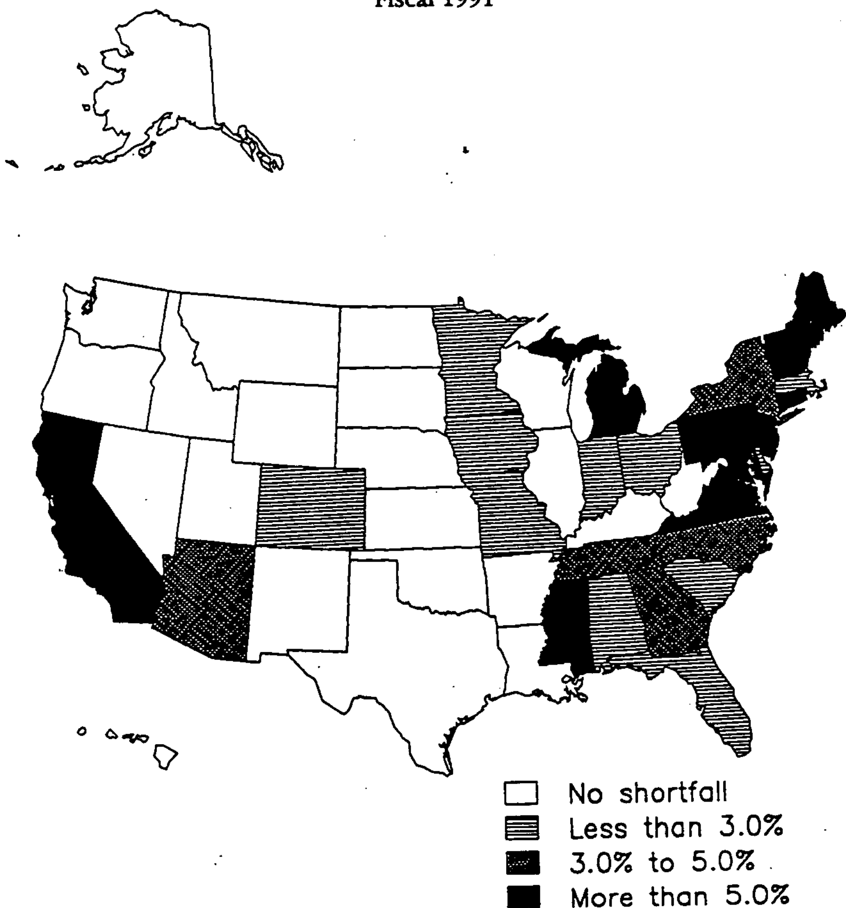
As the federal government has sought to reduce its budget deficit, the states have attempted to continue providing services, because it is good public policy or, in some cases, because of federal or judicial mandates. With the national economic situation adversely affecting every state's budget and with state balanced budget requirements, Governors can no longer afford -- and our federal partners can no longer ask us -- to make up the difference.

It is time to work together as a nation to maintain critical services and to make the long-term investments necessary for our country's continued growth and well-being. Governors stand ready to work on a bipartisan basis to address these challenges.

FIGURE 1

STATE SHORTFALLS AS A PERCENT OF GENERAL FUND APPROPRIATIONS

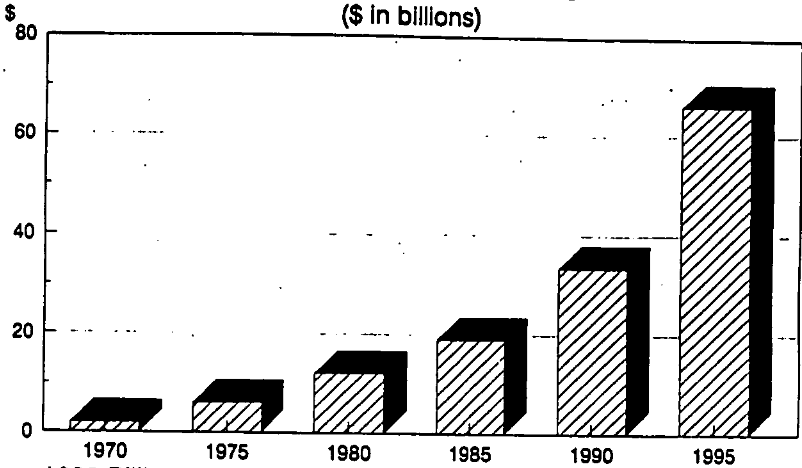
Fiscal 1991



Source: National Association of State Budget Officers, December 1990.

Figure 2

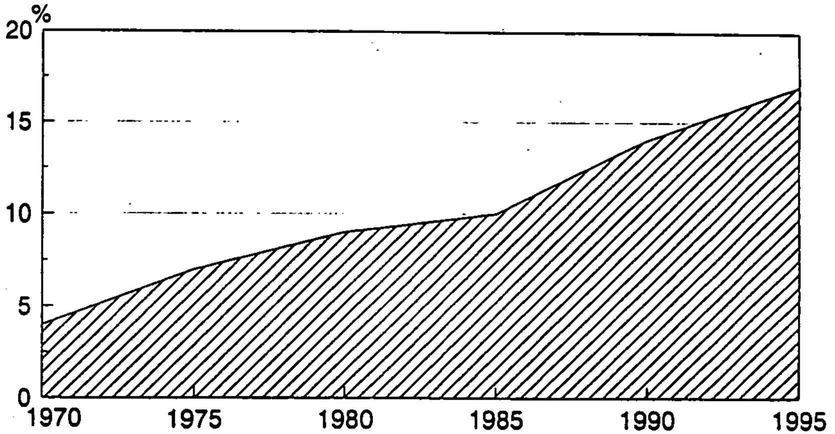
Medicaid Spending



*$33 Billion state expenditures in 1990 going to $66 Billion in 1995

*248% spending increase from 1985 to 1995

Medicaid Spending as a Percent of State Budgets



*10% of State Budgets in 1985

*14% of State Budgets in 1990

*17% of State Budgets in 1995

TABLE 3. STATE-OWN SOURCE SPENDING FOR MEDICAID, SELECTED YEARS
(federal fiscal years; dollars in thousands)

STATE	1979	1980	1981	1990	1991	INCREASE 1981-91	% CHANGE 1991/81
ALABAMA	$67,788	$91,388	$87,782	$223,425	$312,477	$224,695	256.0%
ALASKA	14,224	18,716	22,126	75,445	84,997	62,871	284.1%
ARIZONA	0	0	0	241,007	408,009	408,009	N/A
ARKANSAS	58,810	69,311	79,598	166,314	174,192	94,594	118.8%
CALIFORNIA	1,369,357	1,522,677	1,945,168	3,810,277	4,410,177	2,465,009	126.7%
COLORADO	78,965	89,879	104,471	270,739	319,058	214,587	205.4%
CONNECTICUT	153,622	174,551	196,662	616,345	699,784	503,122	255.8%
DELAWARE	19,965	22,640	28,064	64,718	81,506	53,442	190.4%
DISTRICT OF COL	74,260	88,683	83,850	221,240	243,094	159,244	189.9%
FLORIDA	168,732	176,010	219,665	1,176,574	1,536,906	1,317,241	599.7%
GEORGIA	144,845	166,270	192,300	604,906	760,490	568,190	295.5%
HAWAII	43,199	48,190	56,922	100,298	104,421	47,499	83.4%
IDAHO	18,013	18,552	21,845	46,873	69,556	47,711	218.4%
ILLINOIS	495,389	639,497	763,677	1,261,221	1,326,648	562,971	73.7%
INDIANA	140,906	168,538	199,336	540,940	617,980	418,644	210.0%
IOWA	101,664	105,806	124,013	249,924	269,033	145,020	116.9%
KANSAS	85,108	92,959	106,676	239,637	257,243	150,567	141.1%
KENTUCKY	84,064	106,360	125,171	287,017	376,125	250,954	200.5%
LOUISIANA	107,171	135,788	142,925	396,447	466,643	323,718	226.5%
MAINE	39,766	47,183	52,157	153,187	173,795	121,638	233.2%
MARYLAND	175,232	222,902	248,360	626,332	649,092	400,732	161.4%
MASSACHUSETTS	474,531	530,869	571,874	1,565,143	1,722,867	1,150,993	201.3%
MICHIGAN	569,333	604,255	707,392	1,273,226	1,374,020	666,628	94.2%
MINNESOTA	226,325	271,384	311,391	706,730	813,152	501,761	161.1%
MISSISSIPPI	49,339	55,012	61,055	131,590	165,099	104,044	170.4%
MISSOURI	96,616	123,760	157,165	401,535	461,427	304,262	193.6%
MONTANA	22,626	24,109	32,828	55,509	61,208	28,380	86.5%
NEBRASKA	47,352	49,480	56,672	130,443	153,421	96,749	170.7%
NEVADA	17,840	24,071	32,932	82,118	117,771	84,839	257.6%
NEW HAMPSHIRE	24,273	29,905	34,452	118,186	118,575	84,123	244.2%
NEW JERSEY	353,985	375,264	431,586	1,224,043	1,469,215	1,037,629	240.4%
NEW MEXICO	18,561	23,999	30,197	84,515	101,694	71,497	236.8%
NEW YORK	1,884,461	2,260,021	2,646,008	6,211,089	7,066,715	4,420,707	167.1%
NORTH CAROLINA	121,615	148,392	170,222	507,520	619,085	448,863	263.7%
NORTH DAKOTA	22,378	20,328	24,962	65,474	69,843	44,881	179.8%
OHIO	319,336	383,704	487,986	1,354,691	1,605,257	1,117,271	229.0%
OKLAHOMA	98,321	108,130	142,459	254,051	250,761	108,302	76.0%
OREGON	77,026	88,669	95,726	225,325	259,639	163,913	171.2%
PENNSYLVANIA	532,441	579,705	697,885	1,363,258	1,613,291	915,406	131.2%
RHODE ISLAND	59,811	67,088	79,714	204,334	231,142	151,428	190.0%
SOUTH CAROLINA	59,476	80,944	91,737	245,064	319,099	227,362	247.8%
SOUTH DAKOTA	18,537	18,588	23,188	50,126	50,760	27,572	118.9%
TENNESSEE	105,624	122,420	138,171	437,538	624,908	486,737	352.3%
TEXAS	389,996	433,388	529,934	1,260,489	1,677,105	1,147,171	216.5%
UTAH	24,947	25,486	31,806	75,929	83,341	51,535	162.0%
VERMONT	18,332	20,460	24,250	63,890	66,476	42,226	174.1%
VIRGINIA	135,038	162,896	197,510	543,230	705,376	507,866	257.1%
WASHINGTON	152,747	190,947	218,502	592,269	714,554	496,052	227.0%
WEST VIRGINIA	30,596	38,021	45,648	102,351	112,836	67,188	147.2%
WISCONSIN	266,833	312,443	357,555	620,326	723,464	365,909	102.3%
WYOMING	5,562	7,632	8,824	24,090	22,600	13,776	156.1%
PUERTO RICO	34,791	44,986	46,906	66,258	79,000	32,094	68.4%
TERRITORIES	2,110	2,209	2,978	8,966	9,871	6,893	231.5%
U.S.	$9,701,839	$11,234,465	$13,290,283	$31,422,172	$36,804,798	$23,514,515	173.9%

NOTE: Arizona has only recently begun a medicaid program. For comparability purposes, Arizona's 1991 medicaid spending has been subtracted from total spending for calculating percent growth.

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Senator SARBANES. Please proceed, Mr. Shafroth.

STATEMENT OF FRANK SHAFROTH, DIRECTOR, CENTER FOR POLICY AND FEDERAL RELATIONS, NATIONAL LEAGUE OF CITIES, WASHINGTON, DC, ACCOMPANIED BY DOUGLAS PETERSON, SENIOR POLICY ANALYST

Mr. SHAFROTH. Thank you, Mr. Chairman.

I am Frank Shafroth and I have with me today Douglas Peterson, who is our senior policy analyst. He's the director of our annual fiscal survey we do of cities and towns and our annual survey of municipal elected officials.

He will provide some comments.

The National League of Cities is the largest and oldest organization representing municipal elected officials. We represent directly and indirectly some 17,000 cities and towns throughout the United States.

I wanted to present and submit for the record this morning a special report which was completed on Tuesday of this week which we believe demonstrates a severe, but quiet and accelerating crisis growing in our largest cities in the United States and our smallest rural towns, in addition to submitting our most recent annual fiscal survey and our elected official survey which was completed in January this year.

Senator SARBANES. We are happy to receive the surveys.

Thank you very much.

Mr. SHAFROTH. Thank you. We believe that this special report we're submitting to you this morning makes it critical for the Congress and the administration to determine the causes for the abrupt and serious acceleration of disparities between communities in our country and to act on behalf of the Americans who happen to live both in those rural small towns and the cities.

We believe the report demonstrates that the combined forces of industrial restructuring, demographic shifts, and fiscal pressures on cities and towns due to the changes in our intergovernmental system, particularly over the last decade, have exacerbated the difficult fiscal circumstances many of our cities are facing.

According to our study, Mr. Chairman, per capita income in the largest central cities in the United States by 1987 was at a level of approximately 58.5 percent of what it was in the suburbs. That contrasts sharply in the 24 years prior to 1980. There were gradual improvements in that ratio, reaching a peak in 1980 of 89 percent.

We don't know the causes of this sudden, abrupt, and sharp change. We note, moreover, for the record that this report we are presenting to you this morning is based on data collected in 1987, so it precedes final data coming in from the 1990 census, and it certainly does not represent further exacerbation we are concerned about from the recession.

Senator SARBANES. Do you know what the figure was 20 years before the 1980 figure?

Mr. SHAFROTH. That's from the ACIR, Mr. Chairman. The ACIR did a report on fiscal disparity.

Senator SARBANES. What was the figure in 1960? You say it went up to 89 percent and now has gone back down to 59 percent.

45-290 0 - 91 -- 14

MORE EQUITABLE AND BROADER TAX BASE. SINCE 1980 THE FEDERAL GOVERNMENT HAS ALSO CUT BACK SHARPLY ON THE COMMUNITY DEVELOPMENT BLOCK GRANT PROGRAM - THE SINGLE MOST IMPORTANT PROGRAM OF THE FEDERAL GOVERNMENT TO REDUCE PHYSICAL DISPARITIES - AND A PROGRAM THE ADMINISTRATION HAS NOW PROPOSED TO CUT STILL FURTHER AND ELIMINATE BY TRADING IN FOR A VERSION OF STATE REVENUE SHARING.

THE RESULTS OF THESE DISPARITIES LEADS TO A VICIOUS SPIRAL, MR. CHAIRMAN:

THE POOR BECOME POORER IN A CYCLE THAT FEEDS UPON ITSELF, WHILE THE FEDERAL GOVERNMENT MORE AND MORE TERMS THIS A "LOCAL PROBLEM" FOR WHICH THERE IS NEITHER A FEDERAL ROLE NOR RESPONSIBILITY.

* IN RURAL AREAS IN SMALL TOWNS, AN AVERAGE OF HALF THE GRADUATING HIGH SCHOOL STUDENTS WILL LEAVE THE TOWN NEVER TO RETURN AGAIN. THEIR LOSS DEPRIVES THEIR TOWN OF THE HUMAN RESOURCES NECESSARY TO COMPETE, REDUCES THE ECONOMIC POTENTIAL, AND ERODES THE TAX BASE.

* IN URBAN AREAS, FAMILIES WITH CHILDREN CAN LOOK TO THE SUBURBS AS PLACES WHERE TAXES ARE ACTUALLY LOWER, CRIME IS LOWER, BUT THE SCHOOLS AND INFRASTRUCTURE ARE BETTER. MEANWHILE, THE CENTRAL CITY - WHICH NOT ONLY HAS TO PROVIDE PUBLIC SERVICES AND INFRASTRUCTURE FOR THE ENTIRE METROPOLITAN AREA ON ITS WEAKER TAX BASE - CAN ONLY PROVIDE EQUIVALENT SCHOOLS AND SERVICES THROUGH STILL HIGHER PROPERTY TAXES: DRIVING OUT MIDDLE INCOME BUSINESSES AND FAMILIES.

IT IS A SPIRAL TOO OFTEN IN TODAY'S HEADLINES OF CRIME AND VIOLENCE BY THOSE LEFT BEHIND AND FORGOTTEN.

THERE ARE ALSO SIGNIFICANT DIFFERENCES IN RATES OF UNEMPLOYMENT BETWEEN ALMOST ALL CITIES AND SUBURBS. IN A FEW CITIES, SUCH AS DETROIT, BALTIMORE AND ST. LOUIS, UNEMPLOYMENT RATES IN THE CENTRAL CITY ARE ALMOST DOUBLE THOSE IN NEIGHBORING SUBURBS, OUR STUDY FOUND.

EVEN WITHOUT A RECESSION AND WITH THE BEST FISCAL MANAGEMENT, THESE CHANGES WOULD PRODUCE SEVERE FISCAL STRESS AND AN INABILITY TO DEAL WITH THE CONCENTRATION OF POVERTY IN OUR CENTRAL CITIES.

THE REPORT DEMONSTRATES CLEARLY THE ACCELERATING GAPS BETWEEN RICH AND POOR AMERICA. A DECADE OF DISINVESTMENT THREATENS TO ERODE THE CENTERS OF AMERICA'S ECONOMY.

NEW TECHNOLOGIES, CHANGING TASTES AND VALUES OF CONSUMERS AND CHANGING PATTERNS OF REGIONAL AND INTERNATIONAL COMPETITION HAVE UNDERMINED THE INDUSTRIAL BASE AND LED TO SEVERE POPULATION LOSSES IN SOME CITIES AND TO INCREASING PER CAPITA INCOME DIFFERENTIALS BETWEEN CITY AND SUBURB.

HERE IS HOW CITIES ACROSS THE NATION STACK UP VIS A VIS THEIR SUBURBS: NEWARK, NEW JERSEY HAS A PER CAPITA INCOME THAT IS A MERE 32.1 PERCENT OF ITS SURROUNDING SUBURBS. FOR EL PASO, THE FIGURE IS 42.1 PERCENT; FOR SAN JOSE, IT IS 46.5 PERCENT; FOR BALTIMORE, IT IS 47.4 PERCENT; FOR TUCSON IT IS 54.2 PERCENT; FOR MIAMI, IT IS 58.0 PERCENT.

WE ARE DEEPLY APPREHENSIVE AT THESE ACCELERATING DISPARITIES, WHICH CREATE THE POTENTIAL FOR BUILDING "BERLIN WALLS" SEPARATING TOO MANY CITIES FROM THE REST OF AMERICA.

THE INCREASING CONCENTRATION OF POVERTY IN THE NATION'S CENTRAL CITIES HAS RESULTED IN SYSTEMATIC DIFFERENCES IN TERMS OF POVERTY AND INCOME. THIS CENTRAL CITY POVERTY HAS ERODED THE TAX BASE AT THE SAME TIME THAT THE NEEDS FOR PUBLIC ASSISTANCE COSTS AND DEMANDS HAVE INCREASED. THESE CHANGES IN DEMOGRAPHICS HAVE BEEN ACCOMPANIED BY FEDERAL CUTBACKS AND FISCAL RETRENCHMENT IN MANY STATES THAT HAVE COMBINED TO REDUCE SEVERELY THE SHARE OF LOCAL REVENUES PROVIDED BY THE FEDERAL GOVERNMENT AND THE STATES.

WITH OVER 30 STATES TODAY FACING SERIOUS STATE DEFICITS AND REQUIREMENTS FOR ANNUAL BALANCED BUDGETS - BUT EXPENSIVE AND GROWING MANDATES FROM THE FEDERAL GOVERNMENT - AID TO CITIES IS OFTEN ONE OF THE FIRST VICTIMS. COMBINED WITH CITIZEN INITIATIVES OR OTHER STATE LIMITATIONS ON LOCAL REVENUE RESOURCES, CITIES ARE CAUGHT AT THE BOTTOM OF A TOTEM POLL - BUT AT THE VERY FIRST PLACE ANY FAMILY IN TROUBLE WILL TURN TO IN A CRISIS.

CITIES AND TOWNS ARE THE GOVERNMENT OF LAST RESORT IN OUR COUNTRY.

FROM COAST TO COAST, WE ARE A NATION OF ENORMOUS WEALTH AND RESOURCES; YET IN THE MIDST OF THIS GREAT WEALTH, OUR CENTRAL CITIES ARE STRUGGLING TO KEEP UP WITH ENORMOUS NEEDS WITHOUT THE TAX BASE AND FEDERAL COMMITMENT TO MEET THESE PROBLEMS HEAD-ON. THE INFORMATION

CONTAINED IN OUR REPORT SHOWS THE ENORMITY OF THE TASKS AHEAD AND THE URGENCY OF OUR MISSION.

THESE CONCERNS ARE ONLY NUMBERS UNTIL YOU UNDERSTAND THE HUMAN TOLL.

THREE-FOURTHS OF THE NATION LIVES IN METROPOLITAN AREAS WITH POPULATIONS OF AT LEAST ONE HUNDRED THOUSAND.

TODAY, IN NEW YORK CITY, MORE THAN FORTY PER CENT OF ALL CHILDREN LIVE IN HOMES WITH INCOMES BELOW THE FEDERAL POVERTY LEVEL.

WHAT DOES THAT MEAN FOR THEIR LIVES?

IT MEANS, FOR ONE THING, THAT THEIR LIVES ARE LIKELY TO BE BRIEF. CHILDREN IN CENTRAL HARLEM ARE LESS LIKELY TO LIVE TO THE FIRST YEAR OF LIFE THAN ARE CHILDREN IN CUBA, COSTA RICA, SINGAPORE AND MANY OTHER SO-CALLED "THIRD WORLD" COUNTRIES. THE MOST RECENT AVAILABLE STATISTICS PUT INFANT MORTALITY IN CENTRAL HARLEM AT TWENTY-THREE POINT FOUR PER ONE THOUSAND LIVE BIRTHS.

COMMUNICABLE DISEASES SUCH AS TUBERCULOSIS--THE "SLUM DISEASE" WE ONCE THOUGHT HAD BEEN VIRTUALLY ERADICATED IN THE U.S.-- ARE AGAIN ON THE RISE. DURING THE 1980S, THE INCIDENCE OF TUBERCULOSIS IN NEW YORK CITY ROSE SIXTY-EIGHT PER CENT. MORE THAN THREE THOUSAND NEW CASES WERE REPORTED DURING 1990 ALONE. THIS NEW EPIDEMIC OF TB IS SPREADING MOST RAPIDLY AMONG THE YOUNG AND POOR.

THE AIDS EPIDEMIC, NOW ENTERING ITS SECOND DECADE, ALSO THREATENS OUR CHILDREN. HIV INFECTION IS SPREADING FASTEST AMONG POOR WOMEN IN THEIR CHILD-BEARING YEARS. WOMEN NOW ARE TWENTY PERCENT OF THE PEOPLE WITH AIDS IN NEW YORK CITY.

MEDICAL INSURANCE IN POORER CITIES AND TOWNS IS DISPROPORTIONATELY AND WOEFULLY INADEQUATE. THEY ARE COMMUNITIES WITH WELL-DOCUMENTED SHORTAGES OF PHYSICIANS AND PRIMARY CARE HEALTH CLINICS.

ILLITERACY AND IGNORANCE ALSO RAVAGE THE CHILDREN OF THESE PLAGUE-RIDDEN COMMUNITIES. THE NATIONAL URBAN LEAGUE ESTIMATES THAT THROUGHOUT OUR NATION, HALF OF ALL SEVENTEEN-YEAR-OLD AFRICAN AMERICAN YOUNGSTERS ARE UTTERLY OR PRACTICALLY ILLITERATE.

ILLITERACY IS ESPECIALLY ACUTE AMONG YOUNG AFRICAN-AMERICAN AND HISPANIC WOMEN IN OUR CITIES-- AND THAT MAKES ILLITERACY EVEN MORE DANGEROUS. THE BUREAU OF THE CENSUS REPORTS THAT A FAMILY WITH ONE OR MORE CHILDREN, HEADED BY A WOMAN WHO HAS NOT COMPLETED HIGH SCHOOL HAS AN EIGHTY-NINE PER CENT CHANCE OF LIVING IN POVERTY.

LITTLE WONDER THAT THE YOUNG PEOPLE IN SUCH COMMUNITIES FALL PREY TO CRIME AND VIOLENCE -- THAT AFRICAN-AMERICAN MALES IN OUR NATION HAVE A ONE-IN-TWENTY-ONE CHANCE OF BEING MURDERED BEFORE THE AGE OF 25, OR ARE MORE LIKELY TO BE IN JAIL, PRISON OR ON PROBATION THAN TO BE ENROLLED IN COLLEGE -- OR THAT CENTRAL CITIES FACE SUCH HIGH COSTS IN TERMS OF POLICE, JAILS, COURTS, AND HUMAN LIVES COMPARED TO OTHER JURISDICTIONS.

IN OUR CITIES, THERE ARE THOUSANDS OF GALLANT FREEDOM FIGHTERS, WORKING UNDER IMPOSSIBLE CONDITION IN CLINICS AND CLASSROOMS, HOUSING PROJECTS AND DRUG TREATMENT CENTERS, BATTLING THESE THREATS TO OUR NATION'S FUTURE.

OUR CITIES ARE IN DESPERATE NEED OF LARGE-SCALE FEDERAL ASSISTANCE SIMPLY TO PROVIDE TRANSPORTATION, WATER AND OTHER BASIC SERVICES. MANY OF THE MOST DISTRESSED ARE AT THE LIMIT OF WHAT THEY CAN BORROW IN THE BOND MARKET -- AND FORCED TO PAY AT A HIGHER INTEREST RATE FOR WHAT THEY DO BORROW -- AND STILL FACE MASSIVE TASKS OF REBUILDING BRIDGES, STREETS, HIGHWAYS, SEWAGE SYSTEMS AND OTHER ELEMENTS OF INFRASTRUCTURE.

LAST SUMMER, MR. CHAIRMAN, OUR NATION REACHED AN AGREEMENT WITH JAPAN, THE STRATEGIC IMPEDIMENTS INITIATIVE. IN THAT AGREEMENT, JAPAN AGREED TO DOUBLE ITS PUBLIC CAPITAL INVESTMENT IN THE INFRASTRUCTURE OF JAPANESE CITIES AND TOWNS. WE AGREED TO MEET THE THEN-GRAMM-RUDMAN DEFICIT REDUCTION TARGET OF $65 BILLION.

IT APPEARS THEY WILL MEET THEIR END OF THE DEAL - MAKING A MASSIVE INVESTMENT IN THE FUTURE PRODUCTIVITY OF THE JAPANESE ECONOMY AND ITS CITIES AND TOWNS. WE WILL NOT MAKE OUR END. INSTEAD WE APPEAR HEADED TOWARDS A RECORD DEFICIT, AND A BUDGET REQUEST TO FURTHER REDUCE FEDERAL INVESTMENT IN AMERICAN PUBLIC INFRASTRUCTURE.

SOMEHOW, MR. CHAIRMAN, OUR IMPRESSION IS THAT THE PRIORITIES ARE BACKWARD.

CITY FISCAL DISTRESS:

STRUCTURAL, DEMOGRAPHIC AND INSTITUTIONAL CAUSES

Prepared by

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March 1991

A Research Report
from the
National League of Cities

ABOUT THE NATIONAL LEAGUE OF CITIES

The National League of Cities was established in 1924. It now represents 49 leagues and some 1,400 cities and towns directly and, through the membership of the state municipal leagues, more than 16,000 cities and towns indirectly.

NLC serves as an advocate for its members in Washington in the legislative, administrative, and judicial processes that affect them; develops and pursues a national urban policy that meets the present and future needs of our nation's cities and the people who live in them; offers training, technical assistance and information to municipal official to help them improve the quality of local government in our urban nation; and undertakes research and analysis on topics and issues of importance to the nation's cities.

CITY FISCAL DISTRESS

INTRODUCTION

The roots of local fiscal stress and crisis can be found in converging patterns of economic, social, and intergovernmental change. It is these deeper patterns, rather than short-term political or management behavior that dominates headlines, that require the attention of policy-makers at all levels.

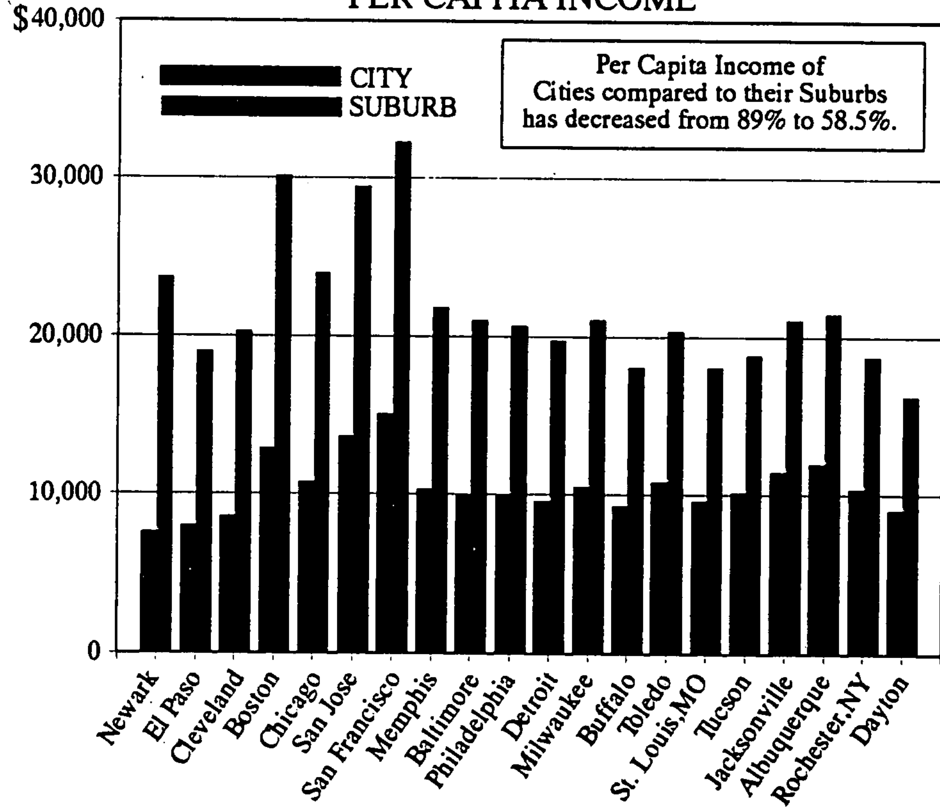
1. The United States is undergoing a major industrial restructuring. All cities and metropolitan areas are affected by this process of economic change. For many, particularly the nation's central cities, the consequence of this process of economic change is steady erosion of their tax bases concurrent with increasing joblessness.

    - Per capita income in the largest central cities is approximately 58.5 percent of that of their suburbs on average. The range of these income disparities between cities and suburbs around this average, however, is great. The magnitude of these income disparities is a clear indicator of the disparities in their tax bases.
    - The evidence suggests that disparities in per capita income between cities and suburbs may have increased dramatically in the 1980s. Confirmation of this trend must await availability of data from the 1990 Census.
    - There are also significant differences in rates of unemployment between almost all cities and their suburbs. In a few, such as Detroit, Baltimore and St. Louis, central city unemployment rates are almost double those experienced in their suburbs.

2. *Major demographic shifts* have combined with structural economic change to erode the tax bases of central cities. More than 5.5 million more people lived in poverty at the end of the decade of the 1980s than ten years previously. Over this period, poverty became increasingly concentrated in the nation's central cities. These trends result in systematic differentials among localities in income, wealth, and poverty. These differences create fiscal stresses in many central cities.

3. *Changes in the intergovernmental system* are increasing the fiscal squeeze on cities and towns throughout the United States.

    - Federal cutbacks and fiscal retrenchment in many states have significantly reduced the share of local revenues provided by the federal government and states.
    - The escalating costs of federal and stated mandated programs are placing growing fiscal burdens on cities.
    - Some states impoverish their cities by tightly regulating types of taxes cities can use and by exercising detailed controls over tax rates and assessment practices.


CITY/SUBURBAN INCOME DISPARITIES
PER CAPITA INCOME
$40,000
30,000
20,000
10,000
0
CITY
SUBURB
Per Capita Income of
Cities compared to their Suburbs
has decreased from 89% to 58.5%.
Newark
El Paso
Cleveland
Boston
Chicago
San Jose
San Francisco
Memphis
Baltimore
Philadelphia
Detroit
Milwaukee
Buffalo
Toledo
St. Louis,MO
Tucson
Jacksonville
Albuquerque
Rochester,NY
Dayton

The current economic recession compounds the problems of cities already attempting to cope with difficult fiscal circumstances. Even without a recession and with the best practices of fiscal management, many cities and towns will face severe fiscal difficulties in the 1990s as a result of the differential effects of these trends.

I. ECONOMIC RESTRUCTURING AND FISCAL DISPARITIES

Even as all levels of government--federal, state, and local--attempt to deal with the fiscal pressures created by the recession, their economies are undergoing a process of industrial restructuring. This process is driven by new technologies, changing tastes and values of consumers, and changing patterns of regional and international competition.

No region, city or town will be immune to these forces of economic change. A 1988 study of the future of the U.S. economy concluded:[1]

> *During the next two decades, new technologies, rapid increases in foreign trade, and the tastes and values of a new generation of Americans are likely to reshape virtually every product, every service, and every job in the United States. These forces will shake the foundations of the most secure American businesses. Few features of the change seem inevitable.*

This process of industrial transformation is essential to the long-term competitiveness of the nation in the global economy and to that of U.S. regions. The strength of cities and their regional economies is directly related to their capacity to facilitate the transition to new economic functions in response to the changing requirements of the national and global economies.

But these patterns of economic change differ across regions, states, and localities. As a consequence, different cities and towns attempt to meet the needs of their residents and to balance their budgets with very different resource bases from which to derive revenues. Many jurisdictions in the United States have been adversely affected by the ongoing restructuring of their economies.

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[1]U.S. Congress, Office of Technology Assessment, *Technology and the American Economic Transition: Choices for the Future* OTA-TET-283, (Washington, D.C.: U.S. Government Printing Office, May 1988), p.3.

Per capita income is a measure of the economic health of places, a reflection of the potential tax base, and an indicator of the economic welfare of a city's residents. The magnitude of disparities between per capita income of cities and their suburbs are a mirror of differences in their tax bases. For some, these disparities are sharp and distinct.

Figure 1 identifies 20 larger cities with very large city/suburban differences in per capita income. A list of 62 large cities identifying per capita income differentials with their suburbs is presented in Appendix 1.[2] On average for these 62 cities, per capita income in the central cities was 59.5 percent of their suburbs.

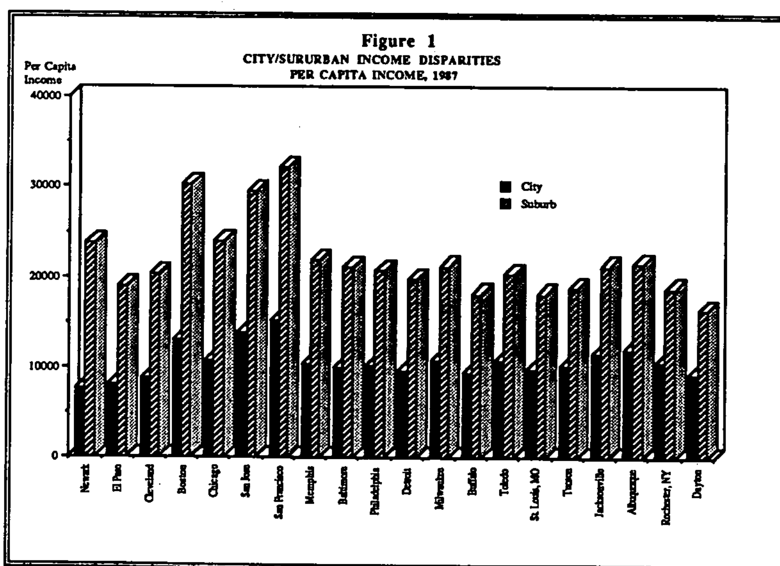

Figure 1
CITY/SUBURBAN INCOME DISPARITIES
PER CAPITA INCOME, 1987

In stark contrast, the ratio of central city per capita income to that of the suburbs was 89 percent in 1980.[3] After narrowing for the previous 24 years, this change in the ratio of average central city per capita income to suburban per capita income between 1980 and 1987 is dramatic.

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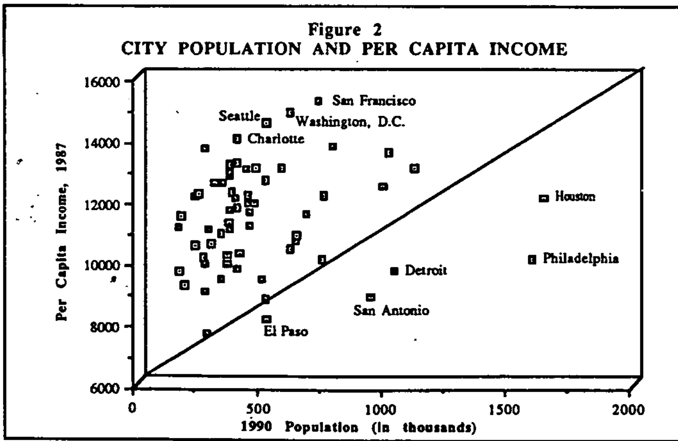
[2]This sample is a majority of of large cities for which 1990 Census data initially became available. It does not include the nation's three largest cities, New York, Los Angeles, and Chicago.

[3]This figure is based on a sample of the 85 largest cities in 1980. See Advisory Commission on Intergovernmental Relations, *Fiscal Disparities: Central Cities and Suburbs, 1981* (Washington, D.C.: U.S. Government Printing Office, 1984)

These data and comparisons between 1980 and 1987 must be viewed with caution.[4] Nonetheless, the orders of magnitude are striking. A great deal of attention has focused on the polarization of incomes in the United States in the last decade. These data provide a geographical dimension to this issue. We exist in communities. Quality of life is directly related to geographical places and the economic vitality of these places. If, indeed, we are witnessing increasing disparities between per capita incomes in cities and their suburbs, the issue of the fiscal limitations of cities must be addressed anew. Final documentation of this trend toward increasing city-suburb income disparities must await the availability of data from the 1990 Census.

There does not appear to be any consistent relationship between population size of cities and economic health, as measured by per capita income. As illustrated in Figure 2, the range of variation is great. Per capita income among these cities in 1987 ranged from over $15,000 in San Francisco to less than $8,000 in Louisville.[5] Some cities, such as San Francisco, Washington D.C., Seattle, and Charlotte are doing well by this measure of economic health. Other large cities like Philadelphia, Detroit, San Antonio and Philadelphia have relatively low per capita incomes. Even within the set of cities with populations between 100,000 and a half million, the variation in per capita income is extremely wide.

Figure 2
CITY POPULATION AND PER CAPITA INCOME

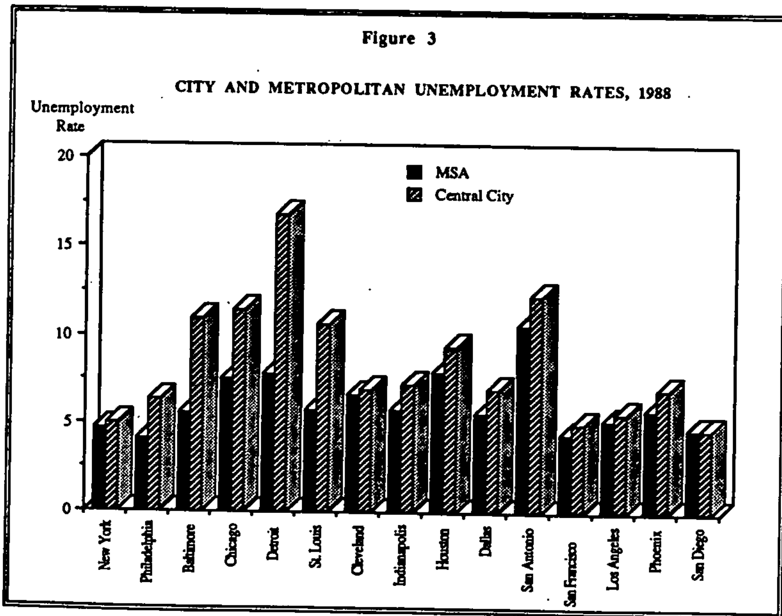


[4]Caution is required both because of the computational steps necessary to estimate 1897 per capita income for suburbs and the slightly different samples of cities used to generate the average figures for the two years:
[5]Clearly, the cost of living differs significantly among the cities in Figure 3. The differences in real or cost of living adjusted per capita income would be less.

Unemployment is another measure of both the economic vitality of a city and the potential service demands of an affected population. Although data are limited, the evidence is strong that central city unemployment rates greatly exceed those of many metropolitan areas. Figure 3 examines the differentials of 15 metropolitan areas for which data are available. With the single exception of San Diego, the central cities of these areas are more sharply impacted by joblessness.

Figure 3

CITY AND METROPOLITAN UNEMPLOYMENT RATES, 1988



Demographic trends also provide a mirror of the changing economic fortunes of cities and their suburbs. Between 1980 and 1990, 19 major cities lost population (Figure 4). Of these only five were in metropolitan areas that lost population. The rest were in growing metropolitan areas, some of which were growing rapidly even as their central cities declined in size.

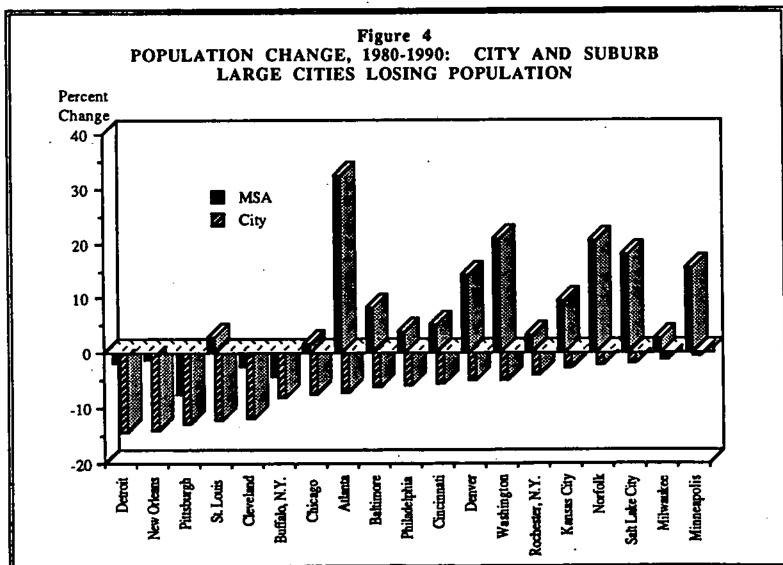


Figure 4
POPULATION CHANGE, 1980-1990: CITY AND SUBURB
LARGE CITIES LOSING POPULATION

II. THE BURDEN OF POVERTY

Demographic change has combined with the dramatic structural changes in the economies of central cities to erode the tax bases of many of these jurisdictions. Most important of these are the movement of higher income households from cities to suburbs and the increasing concentration of poverty in central cities and cities and towns in nonmetropolitan areas.

In 1987, NLC pointed to the linkage between the performance of the national economy and poverty (*Poverty in America: New Data, New Perspectives).*

> *The direction of this causation, however, is not only from the national economy to poverty. Poverty has a breaking influence on the vitality of the economy. Responding to the critical needs of those in poverty directs scarce national resources from other uses which might spur economic growth. Further, the segment of the poverty population which might be added to the workforce should be viewed as a national resource whose potential can promote economic growth.*

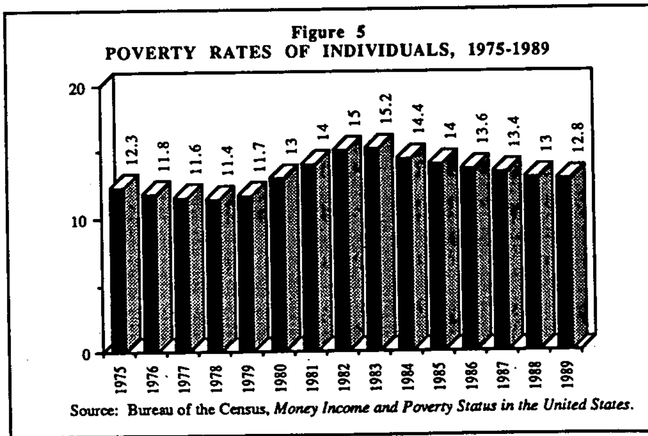
This 1987 research report documented the increasing urbanization of poverty in the United States between 1979 and 1985, a year when the rate of poverty stood at a twenty-year high (1970-1989).

A decade of structural economic change and recessions in the 1980s and early 1990s have increased poverty in the United States.

> *More than 5.5 million more people were living in poverty in 1989 than ten years previously.*

The rate at which poverty afflicted Americans increased by one percent over the decade 1979-1989 (Figure 5). This increased poverty rate accounted for fully one-half of the increase in poverty between the beginning and end of the decade. The other half occurred because of overall population growth. Recession in the early 1980s sharply increased poverty. Relative prosperity in the last five years of the decade brought this rate back to levels similar to those at the beginning of the decade.

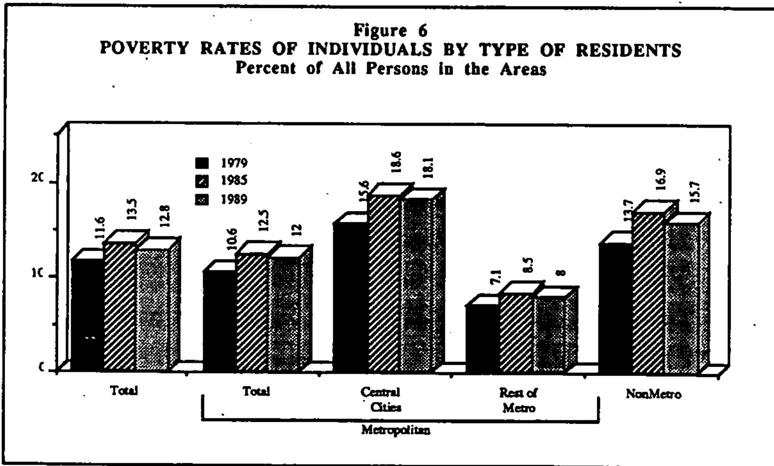
Figure 5
POVERTY RATES OF INDIVIDUALS, 1975-1989



Source: Bureau of the Census, *Money Income and Poverty Status in the United States.*

Central cities experienced the highest rates of poverty again in 1989, as they did in 1985 and in 1979 (Figure 6). By 1989, there were approximately 4.4 million more persons in poverty in central cities than in 1979. Nonmetropolitan areas continued to experience high rates of poverty. The incidence of poverty increased by two percentage points over the decade, although the number of those in poverty in nonmetropolitan areas decreased by slightly more than one million over this ten-year period.

Figure 6
POVERTY RATES OF INDIVIDUALS BY TYPE OF RESIDENTS
Percent of All Persons in the Areas



The relative prosperity of the last five years of the decade did not, by this measure, favor the suburbs. Although suburbs had the lowest rates of poverty in each of the three years examined, the incidence of poverty in the suburbs of metropolitan areas decreased by only one-half of one percentage point between 1985 and 1989, the same as in the metropolitan area as a whole and in their central cities.

Slightly more than 60 percent of all those afflicted by poverty lived in metropolitan areas in 1979. The remainder lived in nonmetropolitan areas. The data do not identify how many of these were in nonmetropolitan cities and towns. The urban share of those in poverty, however, is clearly greater than simply that of central cities and their suburbs.

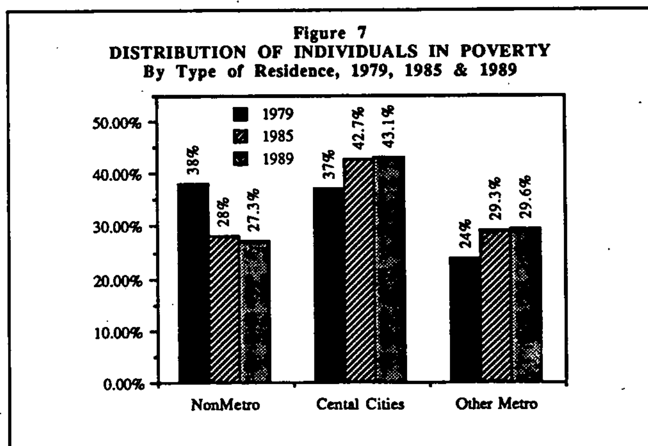


Figure 7
DISTRIBUTION OF INDIVIDUALS IN POVERTY
By Type of Residence, 1979, 1985 & 1989

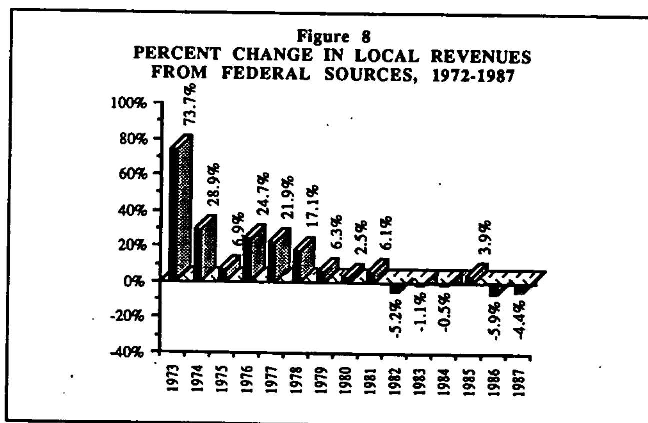
Ten years later, by 1989, 72.7 percent of those in poverty were in metropolitan areas. This represents an increase of over 10 percentage points in the metropolitan share of poverty.

Poverty is increasingly concentrated in central cities in the United States. Over the decade, the central city's share of the nation's poor increased from 37 to 43 percent or by six percentage points. The economic recovery of the 1980s had little effect on the incidence of poverty in central cities, and their share of the nation's poor increased as the national economy grew. Although the proportion of those in poverty in suburban rings increased by over this period, sharp disparities between central cities and suburbs in both rates and shares of poverty remained at the end of the decade.

III. CHANGES WITHIN FEDERAL SYSTEM

Critics of urban fiscal management often fail to recognize how these changes within the intergovernmental systems, as well as the control states exercise over taxing sources available to cities, affect the fiscal conditions. Federal cutbacks, current budget shortfalls in many states, and escalating mandated costs are increasing the fiscal burdens of cities and towns, even as many attempt to cope with the costs of economic and demographic change.

The federal government has retreated from its commitment to the welfare of cities made in the late 1960s. Since roughly 1986, federal assistance to local governments has been declining (Figure 8).[6] Adjustment of federal assistance to local governments for inflation would further accentuate the precipitousness of the federal retreat in its commitment to local governments.



[6]Data for Figures 8-12 are from Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, (Washington, D.C.: January 1989).

The share of total local government revenues provided by the federal government, after increasing throughout the 1970s, began to decline precipitously in 1980 (Figure 9). In 1978 intergovernmental transfers from the federal government constituted 9 percent of local government revenues. By 1987, this figure had decreased to 4.2 percent. In 1986, as part of the New Federalism, general revenue sharing, a major source of unrestricted funding for cities, was eliminated. Other programs providing assistance to cities have been systematically pared or eliminated.

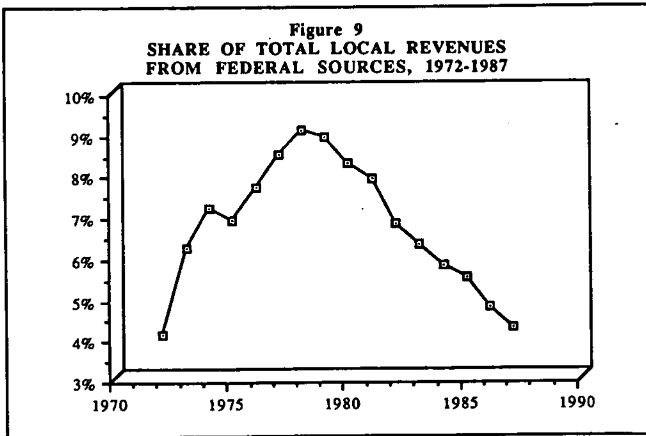
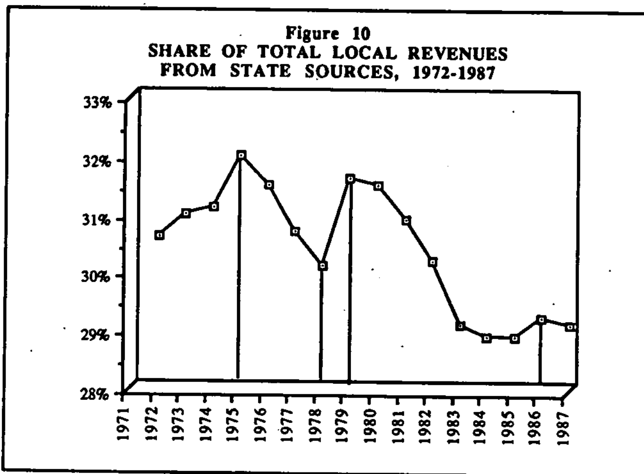


Figure 9
SHARE OF TOTAL LOCAL REVENUES FROM FEDERAL SOURCES, 1972-1987

Prospects for increased federal funding to meet domestic priorities and address the problems of the nation's cities are extremely limited. Continuing federal deficits, the growing federal debt, political opposition to new taxes, and lack of political consensus on national goals effectively preclude any federal response to the needs of cities.

Even as federal assistance to cities has declined, the cost of federal mandates to cities has soared. In particular, environmental and medical care mandates, unaccompanied by federal funds for implementation, now pose major challenges to city fiscal capacities. In addition, new controls on the ability of local governments to issue bonds legislated in the 1986 Tax Act further handicap cities as they attempt to address their fiscal needs.

The ability of states to assist cities has been constrained by their own expanded responsibilities under the New Federalism and by their own budgetary problems. Between 1980 and 1985, the state share of total local revenues declined (Figure 10). Since 1985, this contribution appears to have stabilized. In 1975, the state share of total local revenues was 32 percent. By 1987, this share was 29 percent.



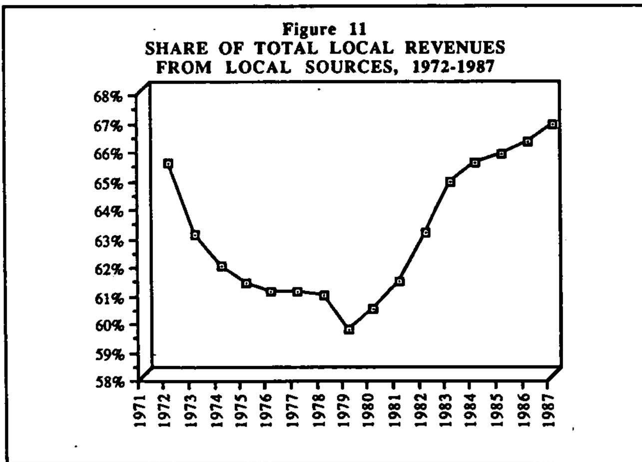
In the current recession, however, 28 states confront serious deficits that will require cutbacks in programs, including those benefiting cities, and, in some cases, tax increases. This will hamper the ability of many states to respond to fiscal stress of cities through increased assistance.

States have also increased fiscal pressures on cities through mandates. In many cases, cities are mandated by states to provide services without any state provision for funding. Some states have attempted to address this problem. California and Florida, for example, have passed reimbursement acts that require mandates to be accompanied by funding. Florida legislation permits any mandates for which funding is not provided to be ignored by local governments. Other states require fiscal notes which are financial impact

statements of the costs to local governments of pending mandate legislation. Fiscal notes, by specifying the costs of pending mandates, are intended to force consideration of costs in the legislative process.

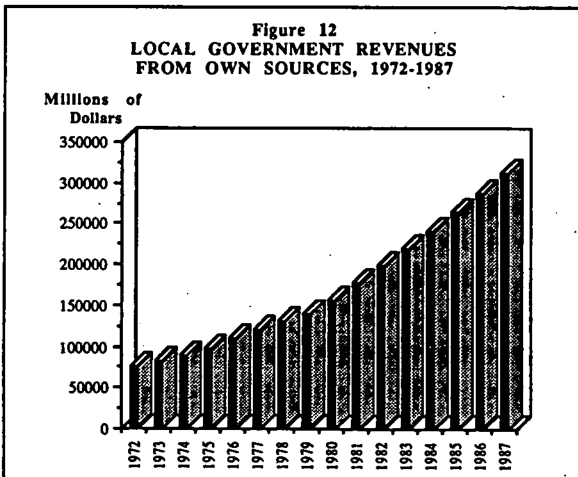
States can impoverish their cities through state policies regulating the type of taxes local governments can use. In some states, cities may use any taxes not prohibited by state legislation. In others, cities must be authorized to used particular taxes by state legislation. In addition, some states exercise fairly detailed controls over local tax rates and assessment practices.

Local governments have not been passive over this period. The share of local revenues that had to be derived from local sources has increased sharply since 1980, after falling consistently throughout the 1970s (Figure 11). In 1979, local governments derived slightly less than 60 percent of their revenues from local sources. By 1987, this figure was almost 67 percent.



This increased local share is not an artifact of federal cutbacks. During this period local governments were significantly increasing the revenues they derived from their own sources (Figure 12). Between 1979 and 1987, locally generated revenues increased by 84.4 percent.

Despite this increased level of local revenue effort, some cities and towns are experiencing fiscal distress because of economic and demographic change, and changes and restrictions within the intergovernmental system. Fiscal crises resulting from these structural and institutional problems cannot be addressed by cities acting alone, particularly where local revenue efforts are already high.



Answers must be found within the intergovernmental system, in metropolitan regionalism, and by addressing the negative tax climate that pervades cities and states. Among these are:

- The federal and state governments must recognize that cities, acting alone, cannot effectively address structural and institutionally induced fiscal distress. Both of these levels of government should consider programs to assist cities confronting budgetary problems due to these sources.

NATIONAL LEAGUE OF CITIES

1990 ELECTED OFFICIALS SURVEY

SUMMARY OF RESULTS

January, 1991

How have each of these conditions changed during the last year in your community?

	Improved	No Change	Worsened
Overall Economic Conditions	27	37	36
Unemployment	20	43	37
Cost of Living	3	37	60
Supply of Energy	6	80	14
Cost of Energy	2	27	71
City Fiscal Conditions	28	42	30
Interest Rates on City Borrowing	23	57	20
Water and Sewer Treatment	39	47	14
Street, Roads & Sidewalks	40	41	19
Public Transportation	12	71	17
Local Mortgage Conditions	15	48	37
Availability of Low Income Housing	14	55	31
Homelessness	3	61	36
Affordability of House Prices	18	40	42
Affordability of Rental Housing	11	49	40
Crime	16	51	33
Poverty	1	63	36
Availability of Social Services	11	72	17
Drugs	16	38	46
Education	16	66	18
Health Care	10	69	21
AIDS	4	58	38
Air Quality	11	72	17
Solid Waste	37	39	24

Percentage of officials reporting worsening conditions in their community in the following areas:

Year Survey Released	1987	1988	1989	1990	1991
Cost of Energy	41	41	40	41	70
Cost of Living	38	36	43	45	60
Drugs	NR	54	67	58	46
Affordability of House Prices	42	40	51	42	42
Affordability of Rental Housing	27	38	45	34	40
AIDS	NR	35	36	13	38
Mortgage Conditions	12	32	35	12	37
Unemployment	26	18	15	8	37
Homelessness	28	40	43	18	36
Overall Economic Conditions	27	22	17	14	36
Poverty	33	35	38	19	36
Crime	23	41	45	37	33
Availability of Low Income Housing	27	37	40	24	31
City Fiscal Conditions	31	33	30	17	30
Solid Waste	NR	35	39	36	24
Health Care	NR	23	21	15	21
Interest Rates on City Borrowing	13	22	32	9	20
Streets, Roads & Sidewalks	27	30	30	20	19
Education	NR	20	17	12	18
Availability of Social Services	NR	26	22	8	17
Air Quality	NR	19	24	13	17
Public Transportation	18	19	19	10	17
Supply of Energy	5	5	8	4	14
Water & Sewer Treatment	13	17	24	13	14

NR = Not Rated, the seven conditions marked this way in 1987 did not appear on the list of conditions to be evaluated in that survey.

1987 through 1989 surveys were done on-site at the annual Congress of Cities and results are not strictly comparable to the latter two surveys.

Which three of the conditions listed are creating the most important problems in your community?

	Percent
Overall Economic Conditions	34%
Drugs	31%
Solid Waste Disposal	28%
City Fiscal Conditions	23%
Crime	22%
Streets,Roads & Sidewalks	21%
Education	20%
Unemployment	17%
Cost of Living	17%
Water and Sewer Treatment	15%
Availability of Low Income Housing	14%
Affordability of House Prices	11%
Cost of Energy	8%
Affordability of Rental Housing	7%
Health Care	6%
Public Transportation	5%
Homelessness	5%
Local Mortgage Conditions	4%
Air Quality	3%
Availability of Social Services	3%
Poverty	2%
Interest Rates on City Borrowing	2%
AIDS	1%
Supply of Energy	1%

Which three of the conditions listed have deteriorated the most in your community during the past five years?

	Percent
Drugs	31%
Crime	24%
Streets, Roads & Sidewalks	24%
Affordability of House Prices	22%
Overall Economic Conditions	22%
Solid Waste Disposal	18%
Cost of Energy	16%
City Fiscal Conditions	15%
Cost of Living	14%
Affordability of Rental Housing	14%
Education	14%
Unemployment	13%
Availability of Low Income Housing	13%
Water and Sewer Treatment	9%
Local Mortgage Conditions	8%
Health Care	7%
Homelessness	7%
Public Transportation	6%
Poverty	5%
Air Quality	5%
AIDS	4%
Availability of Social Services	3%
Interest Rates on City Borrowing	2%
Supply of Energy	2%

Which three of the conditions listed are going to be the most difficult to deal with during the next two years?

	Percent
Solid Waste Disposal	34%
Drugs	32%
City Fiscal Conditions	31%
Overall Economic Conditions	29%
Crime	25%
Education	24%
Streets, Roads & Sidewalks	15%
Water and Sewer Treatment	14%
Unemployment	12%
Cost of Living	11%
Cost of Energy	11%
Homelessness	9%
Health Care	8%
Availability of Low Income Housing	7%
Poverty	7%
Air Quality	6%
Availability of Social Services	5%
Affordability of House Prices	5%
AIDS	4%
Affordability of Rental Housing	4%
Interest Rates on City Borrowing	3%
Public Transportation	2%
Local Mortgage Conditions	1%
Supply of Energy	1%

Which three of the conditions listed have improved the most in your community during the past five years?

	Percent
Water and Sewer Treatment	36%
Streets, Roads & Sidewalks	33%
Solid Waste Disposal	26%
Overall Economic Conditions	25%
City Fiscal Conditions	24%
Education	20%
Unemployment	19%
Affordability of House Prices	14%
Availability of Social Services	13%
Crime	11%
Public Transportation	11%
Health Care	10%
Interest Rates on City Borrowing	10%
Affordability of Rental Housing	8%
Air Quality	8%
Drugs	7%
Local Mortgage Conditions	7%
Availability of Low Income Housing	5%
Supply of Energy	4%
Homelessness	3%
Cost of Living	3%
Cost of Energy	2%
AIDS	1%
Poverty	0%

Overall, how would you say your state government is currently responding to the needs of your city or town?

Excellent	1%
Good	21%
Fair	46%
Poor	27%
Fail	5%

If city tax rates are not increased, how would city services in your community be affected next year?

Will Expand Service Levels	4%
Will Maintain Service Levels	56%
Will Decrease Service Levels	40%

During the past year (1990) overall city service levels have:

Increased	31%
Decreased	12%
Remained Constant	57%

During the next year (1991) overall city service levels will:

Increase	20%
Decrease	20%
Remain Constant	60%

Characterize your community's capacity to keep up with infrastructure needs:

Keeping up	52%
Not keeping up	27%
Unable to get ahead	21%

About This Report

The sixth annual National League of Cities (NLC) survey of municipal elected officials reported on these pages is the result of a mail and phone survey conducted the latter part of November 1990 through early January 1991. A random sample of 700 elected city and town officials was drawn from a list of all elected municipal officials with a 1980 population of more than 10,000.

Two hundred sixty nine responses were received and tabulated, with this level of response it would be expected, with a 95 percent degree of confidence, that answers would vary by no more than six percent from the results which would be obtained if all elected officials in this size class of cities were polled.

The survey was restricted to communities with populations greater than 10,000 because the NLC elected officials data base from which the sample was drawn, is not complete for the over 20,400 cities and towns with populations of less than 10,000.

Who Responded

Reflecting the composition of the group of officials from which the sample was drawn 17 percent of the responding officials were mayors, while 83 percent were council members or other municipal officials.

Again reflecting the sample, 76 percent of the officials were from communities of 10,000 to 49,999 population, 13 percent were from communities between 50,000 and 99,999, 7 percent were from communities of 100,000 to 299,999 and 4 percent were from the 50 communities with populations in excess of 300,000.

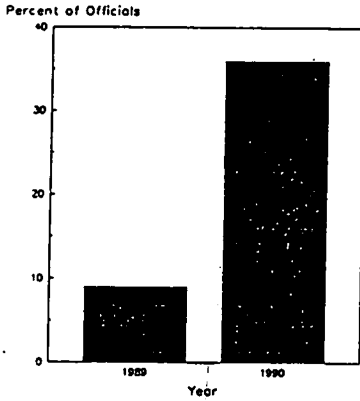
Conducting the Survey

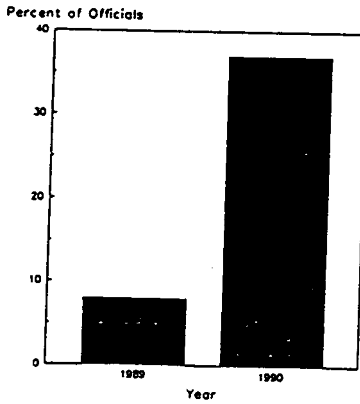
Questions were developed and the sample was drawn by the National League of Cities.

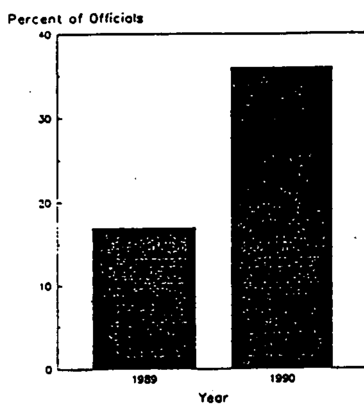
The survey was conducted by the Survey and Evaluation Services Center for Urban Studies, College of Urban, Labor and Metropolitan Affairs, Wayne State University, Detroit, Michigan.

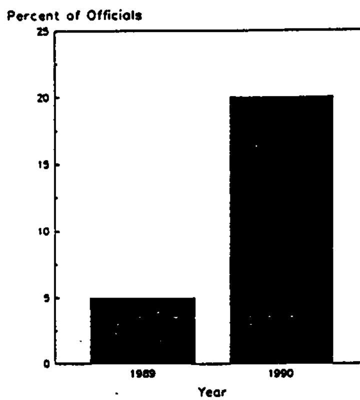
The Center for Urban Studies provides a central focus for interdisciplinary research on urban issues at Wayne State University. The Center is located in the College of Urban, Labor and Metropolitan Affairs, a new college created to focus and enhance the University's efforts to fulfill its urban mission.

Survey and Evaluation Services (SES) is directed by Neva Nahan and is one of six programs within the Center. SES specializes in survey research and program evaluation.

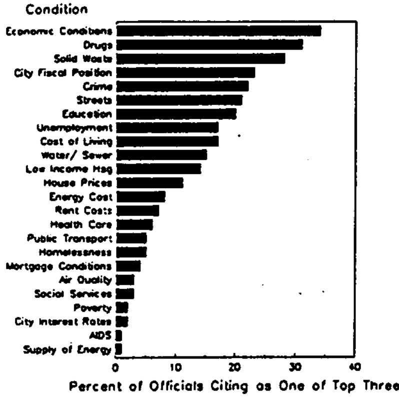

Worsening of Economic Conditions
in Their Community Reported by
Increased Percentage of Officials
Percent of Officials
40
30
20
10
0
1989
1990
Year


Worsening Unemployment
Reported by Increased Percentage
of Municipal Officials
Percent of Officials
40
30
20
10
0
1989
1990
Year

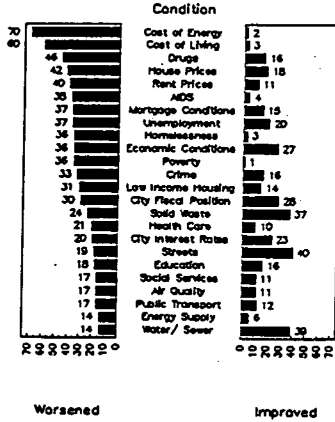

City Fiscal Conditions Worsening
According to Increased Number of City Officials
Percent of Officials
40
30
20
10
0
1989
1990
Year


Service Cuts Expected
By Increased Numbers of City Officials
Percent of Officials
25
20
15
10
5
0
1989
1990
Year

Most Important Community Problems



Change in Community Conditions



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CITY FISCAL CONDITIONS IN 1990

By

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National League of Cities

July 1990

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PREFACE

This report, the National League of Cities' eighth annual report on city fiscal conditions, presents the results of a survey sent to city finance and budget officials during April 1990. It is one of a series of reports on trends and issues affecting American cities and towns published by NLC.

The objective of the annual fiscal conditions studies, of which this publication is the most recent, is to monitor the actions cities take to balance their budgets. It thus examines rates of overall spending and revenue growth, the revenue and expenditure adjustments made in the past year, and some of the factors placing pressure on city budgets. This series is part of NLC's continuing research activities supervised by William Barnes, Research Director.

It is hoped that this report will make a contribution to explaining the conditions in America's cities and towns, improving the relationships between the governments of our federal system, and helping to inform and thereby improve policy making that will lead to investments in these communities, in which a majority of America's people live and work.

The survey was conducted by NLC's Office of Policy Analysis and Development in cooperation with the Center for Public Management and Regional Affairs, Miami University, Oxford, Ohio. Professor Michael A. Pagano of the Political Science faculty at Miami University served as the University's representative during the conduct of the survey.

Douglas D. Peterson, NLC Senior Research Associate was responsible for preparing this report.

Donald J. Borut
Executive Director
National League of Cities

William E.Davis III
Director, Office of Policy
Analysis and Development

ACKNOWLEDGEMENTS

First recognition must go to the more than 570 municipal finance and budget officials who responded to the survey questionnaire that is the foundation of this report. Preparation of the report would be impossible without their prompt and conscientious participation.

Thanks should also go to William Davis, Director of NLC's Office of Policy Analysis and Development, and William Barnes, NLC's Research Director, for the continuing support that makes this project possible.

Thanks also to the Center for Public Management and Regional Affairs, Miami University, which provided valuable data support for the project, and particularly to Professor Michael A. Pagano, who arranged this cooperative effort, and Dr. Philip A. Russo, Jr., the Director of the center.

Appreciation is also due to David Colodny, a student intern at NLC from Duke University, who assisted in the preparation of the report. Special thanks must also be extended to Laura Miller of the Center for Public Management for her conscientious computer entry of the thousands of numbers that compose the foundation of the report, to Althea Ray of NLC for her help in managing all the paper and computer formats that eventually emerge as a single document, and to Clint Page for editing and producing the publication for NLC.

Douglas D. Peterson
Senior Policy Analyst
Office of Policy Analysis and Development
National League of Cities

EXECUTIVE SUMMARY

CITY FISCAL CONDITIONS IN 1990

by Douglas D. Peterson
National League of Cities

July 1990

Municipal officials are responding to their cities' changing financial conditions by both cutting expenditures and raising revenues. Despite widespread activity on these two budget fronts – revenue increases and spending restraints – 68 percent of the municipal finance and budget officials responding to the eighth annual National League of Cities Fiscal Conditions Survey report that overall their city is less able to meet financial needs in 1990 than last year.

Fifty-four percent of the cities expect expenditures to outpace revenues in 1990, forcing them to balance their budgets, as they are required to do by state law, by drawing down their beginning balances and thus reducing their capacity to respond to future unforeseen emergencies.

Twice as large a percentage (22 percent) of cities expect general fund revenue to decline as experienced a revenue decline in 1989 (11%).

The imbalance index, a measure of the extent of imbalance between revenues and expenditures, is expected to show a deterioration in 1990. Only 6 percent of these cities had an imbalance index worse than -5% in 1989; more than twice that proportion, 16 percent, expect a similar situation 1990.

When asked to identify the factor most adversely affecting the revenue growth of their cities, 47 percent cited the economy, 15 percent cited the loss of federal and/or state grants, and 12 percent cited state tax limitations.

On the expenditure side of the budget, 42 percent said that coping with the costs of municipal personnel was the most adverse expenditure pressure, 13 percent said it was the growth of population and service demands, and 9 percent said the most adverse factor was federal and state mandates.

Budget Adjustments Reported by Cities

To cope with these demands and constraints, the city officials have used a combination of means to raise revenues and control spending. Increased fee levels and new fees on activities were the most prevalent revenue raising means, and even in the face of restrictive state regulation, 41 percent of the cities said that property tax rates had been increased.

Revenue Actions

	Percent of Cities
Increased level of fees and charges	76
Implemented new fees and charges	43
Increased property tax rates	41
Imposed/raised impact or development fees	27
Increased rates of other taxes	15
Implemented a new tax or taxes	9
Increased sales tax rates	5
Increased income tax rates	2

The most frequently mentioned ways to reduce spending were reductions in the growth rate of operating spending, contracting out of services, and actual reductions in capital spending.

Expenditure Actions

	Percent of Cities
Reduced the growth rate of operating spending	51
Contracted out services	39
Reduced actual capital spending	37
Reduced the number of city employees	23
Froze municipal hiring	22
Reduced city service levels	11
Shifted service responsibilities to another government	6

The officials were asked to evaluate the effect of seventeen specific areas on their city budgets. Ten of these factors were cited as having unfavorable effects on local budgets by a majority of the cities and towns in the survey, with employee health benefit costs and solid waste disposal costs being cited by the greatest number of respondents. Some of the factors are more localized. For example, while only 13 percent of the officials cited the savings and

loan crisis and its impact in lowering the property tax base as impacting unfavorably on their budget, 59 percent of the Texas cities responding viewed this situation as an unfavorable factor.

Percentage of Cities Reporting These Factors Having Unfavorable Impact on City Budget

	Percent of Cities
Cost of employee health benefits	94
Costs of solid waste disposal	75
Change in amount of federal aid	69
Demand for traffic improvements	66
Demands for drug law enforcement	63
Employee pension costs	62
Sewage collection and treatment	58
Liability claims/awards against city	55
Change in amount of state aid	54
State tax limitations on cities	51
Change in local economy	48
Drinking water standards (EPA)	42
Demands for drug treatment	22
Reduction of defense contracting	15
Savings and loan foreclosed property	
Not paying taxes	14
Reducing tax base	13
Proposed closure of military bases in area	7

Prescription for the Future

While local officials will continue to use the coping mechanisms discussed above, they did have suggestions about constructive actions that could be taken by state and federal governments.

When asked "What is the most constructive action which could be taken for your city by the state government, apart from increasing the amount of money given to your city," 35 percent of the officials urged a reduction in the level of state mandates, and 10 percent urged that the state grant more authority to enact local option taxes.

When the same question was asked about the federal government, a reduction in the level of mandates, this time federal mandates, was again the leading response. The second most frequently advocated helpful federal government action was a lessening of restrictions on the use of tax-exempt municipal bonds.

The problems and recommendations advanced by these officials could well form the basis for constructive intergovernmental discussions to better equip city governments for the future.

THE GENERAL FUND BUDGET

Cities are a critical part of America's social, economic, and cultural life. The governmental institutions that serve them are crucial – they provide the framework within which the life of the city occurs. In order to gauge the changing financial challenges to American cities, the National League of Cities has for a number of years conducted an annual survey to gather indicators of the financial health of municipal governments.

This report is the eighth installment in this series. The survey instrument on which this report is based was sent to all municipal governments with populations greater than 50,000 and to a random sample of 970 communities between 10,000 and 50,000 in population. A more complete description of the methods used is presented in Appendix A.

Before reviewing the specific budgetary actions taken by the cities, discussing the pressures they feel, or describing the constructive actions that might be taken by federal and state officials to ease some of the pressures, it is important to outline the financial environment in which cities operate.

The survey asked the respondents (city finance or budget officials) for three-year histories of their cities' general fund spending in order to show municipal budget trends. Where actual 1990 figures were not yet available, the respondents were asked to provide budgeted or projected figures.

The survey asked for information on municipal general funds for three important reasons.

- The general fund typically includes all of a city's resources except those specially reserved or segregated for specified purposes.
- The general fund is frequently a central focus of local budget deliberations, since it usually finances the core municipal functions – police, fire, public works, planning and central administrative departments. It is also the area where state limits

on taxing and spending are often most restrictive. For most cities and towns, it is also the fund that receives most of the property tax revenues, which is often a central concern of local financial administration.

- The general fund, while not perfectly consistent from community to community, is the only accounting entity common to most cities and towns.

The proportion of a city's spending that is incorporated in the general fund can vary substantially depending on:

- the complexity of a city's accounting system and the dictates of federal or state laws;
- borrowing requirements imposed by lenders, which may require segregation of both loan proceeds (typically from the sale of tax-exempt municipal bonds) and the funds collected to repay the loan; and
- the functions a city carries out.

As mentioned before, in some very small communities one hundred percent of the budget may be in one general fund. In most communities, even those of modest size, a number of funds are required. Examples of operations that are frequently set up in funds separate from the general fund would include:

- **Enterprise funds:** municipally operated sewer, water, and electric utilities, for example, which are established to be self-sustaining through customer service charges.
- **Debt service funds:** set up to receive dedicated revenues used to make principal and interest payments on city debt.
- **Trust funds:** bequests to be spent only for particular purposes.
- **Special revenue funds:** funds set up as accounts for federal or state grants given to accomplish particular projects.

The general fund was chosen as a focus of this report because it finances those general operations of the city that do not have special or dedicated revenue sources.

To provide some idea of the representative nature of the general fund, the respondents were asked the percentage of total city spending contained in the general fund.

As the description above indicates, the results would be expected to vary, and they did. The average percentage of city spending encompassed in the general fund was 54 percent. The most frequent answer was 50 percent, and there were equal numbers of cities reporting percentages above and below 51 percent.

The city finance officials were asked to provide four figures for each year.

- **Beginning balance:** Simply speaking, these are the resources with which the city's general fund begins the year. If the city's general fund were a personal checking

account, this would be roughly equivalent to the balance carried forward from the previous month.

- **Revenues (and transfers in):** This is the grand total of all taxes, fees, charges, federal and state grants, and other monies deposited into the general fund. While revenues are generally recurring items, the "transfers into general fund" also lumped into this item probably are not. These transfers occur when, for a variety of reasons, a city brings funds from one of its other specialized funds into the general fund.
- **Expenditures (and transfers out):** This is the total of all spending by the city's general fund and may include both operating and capital spending. Transfers out of the general fund to other funds are also included here.
- **Ending balance:** The resources with which the city's general fund is left at the end of the year. The ending balance is easily calculated:

BEGINNING BALANCE + REVENUE - EXPENDITURES = ENDING BALANCE

The ending balance of one year becomes the beginning balance of the next.

The cities were asked to provide these general fund summary figures for each of three years – the fiscal years ending in 1988, 1989, and 1990. Because the surveys were completed in April and May of 1990, respondents had to use estimated or budget figures for 1990. Actual 1990 figures are expected to differ somewhat from those reported here.

The twelve month budget periods (fiscal years) this report describes are not the same for all of the cities. The fiscal year used by cities within a state tend to be uniform; they are often specified by state law. This year's survey found that in about 44 percent of the cities the fiscal year ends on June 30. In 32 percent, it ends in December, and in 15 percent it ends in September (like the federal government). The remaining 8 percent reported that their fiscal years end in some other month.

Revenues

This section of the report looks at the rates of growth in general fund revenues experienced by the surveyed cities during two time periods – fiscal year 1988 to 1989 and fiscal year 1989 to 1990.

While most of the communities report revenue growth, as would be expected with an expanding economy and population growth, a significant portion report revenue declines (Table I-1).

Table I-1
General Fund Revenue Change

	Percent of Cities	
	FY 88 to 89	FY 89 to 90
Revenue declined	11	22
Revenue holding constant	0	0
Revenue increasing	89	78
Total	100	100

Almost one quarter (22 percent) of the cities expect to see their revenues decline during the 1990 fiscal year, twice the 11 percent that experienced this one year ago. Conversely, 78 percent expect to see revenues increase, down from 89 percent in the previous year.

The regional differences are not pronounced. In fact, the central regional characteristic is that in each region about twice as many cities expect declining general revenues as had revenue drops last year (Table I-2).

Table I-2
Cities with Declining General Revenue - by Regions

	Percent of Cities	
	FY 88 to 89	FY 89 to 90
All Cities	11	22
Northeast	13	21
Midwest	9	22
South	10	22
West	12	21

A strong pattern appears when this data is considered by population class (Table I-3). The larger the size class of city, the fewer the communities expecting to experience a revenue decline. In fact, among the largest cities (those over 300,000), a lower percentage expects to see a revenue decline than experienced one last year. This is counter to the trends in all of the other size classifications and for all cities. In the other size classes the proportions

Table I-3
Percent of Cities in Each Size Class With a General Fund Revenue Decline

	Percent of Cities	
City Size	FY 88 to 89	FY 89 to 90
All Cities	11	22
300,000 and over	13	7
100,000 to 299,999	7	11
50,000 to 99,999	8	20
10,000 to 49,999	2	26

expecting to see revenue declines increased steeply. This deteriorating trend is most pronounced in the communities between 10,000 and 50,000 in population. Only two percent of these communities experienced revenue declines in 1989, but 26 percent expect to suffer a revenue drop in 1990.

What about those cities expecting a revenue increase? Twenty-one percent of the cities said that they experienced a modest revenue increase of between one and five percent in 1989, and 32 percent expect to experience an increase of this magnitude in 1990.

Since the rate of inflation for municipalities, as measured by the Price Deflator for State and Local Governments, is running at about 5 percent a year, communities with revenue growth of 5 percent or less are losing purchasing power. Their ability to provide municipal services is being reduced.

When the communities with a decline in nominal revenues and those experiencing a nominal increase of less than 5 percent are considered together, the extent of the problem of keeping up with costs is illustrated more realistically. In 1989, in 32 percent of these communities, revenues did not keep pace with inflation. In 1990, 53 percent of the communities do not believe that revenue growth will keep pace with inflationary pressures, an increase of 21 points or 66 percent.

Those that expect general fund revenue increases in excess of five percent come from the following regions and size classes. As will be described later in the report these revenue increases do not come automatically; they require decisions by city and town officials to raise the rates of fees and taxes.

Smaller percentages of the cities in all regions expect revenue growth exceeding 5 percent during 1990 than experienced such growth in 1989. The sharpest percentage decline is in the Midwest, where there is 26 point drop from 68 percent to 42 percent, equivalent to a 38 percent decline. The drop is the least extreme in the Northeast.

Table I-4
City Revenue Increases Over Five Percent by Region

	Percent of Cities	
	FY 88 to 89	FY 89 to 90
All Cities	68	47
Northeast	67	57
Midwest	68	42
South	68	45
West	71	48

As Table I-5 shows, there are drops in all size classes from 1989 to 1990. The drop is least extreme in the smaller cities, a majority of which still expect robust revenue growth, exceeding five percent, in 1990. In the other population classes a minority expect to see this level of revenue increase in 1990, although a majority saw a strong revenue increase in 1989.

Table I-5
City Revenue Increases Exceeding Five Percent by Population

Population Class	Percent of Cities FY 88 to 89	FY 89 to 90
All Cities	68	47
300,000 and over	59	46
100,000 to 299,999	72	44
50,000 to 99,999	63	48
10,000 to 49,999	70	61

Expenditures

City general fund spending patterns are just as varied as the revenue growth patterns described above.

Table I-6
Expenditure Change

	Percent of Cities FY 88 to 89	FY 89 to 90
Decline	10	10
Be constant	0	0
Increase	90	90
Total	100	100

The percentages of cities falling into these three broad categories are absolutely consistent from year to year.

The biggest change is in the Northeast, where three times as many cities expect lower city spending. A somewhat larger percentage of the southern cities expect lower spending in 1990 than cities in the other regions.

Table I-7
Lower City Spending by Region

	Percent of Cities FY 88 to 89	FY 89 to 90
Total	10	10
Northeast	3	10
Midwest	11	8
South	11	13
West	14	10

The results are quite consistent from population class to population class and from year to year.

Table I-8
Lower Spending by Population Size of City

Population Class	Percent of Cities FY 88 to 89	FY 89 to 90
All Cities	10	10
300,000 and over	9	10
100 to 299,999	8	7
50 to 99,999	12	10
10,000 to 49,999	10	11

Table I-9
City Spending Increases Over Five Percent

Region	Percent of Cities FY 88 to 89	FY 89 to 90
All Cities	64	71
Northeast	81	68
Midwest	60	77
South	62	64
West	57	74
By Population		
All Cities	64	71
300,000 and over	50	61
100,000 to 299,999	58	77
50,000 to 99,999	52	70
10,000 to 49,999	71	71

An interesting pattern emerges, however, from the cases where expenditure increases in 1988 are expected to exceed the higher figure of fifteen percent (Table I-10). Generally, as city size decreases, the percentage of cities expecting an expenditure increase exceeding fifteen percent increases. The exception to this general pattern is the largest communities.

Table I-10
Spending Increases Over 15 Percent - FY1990

By Population	Percent of Cities
300,000 and over	16
100,000 to 299,999	10
50,000 to 99,999	12
10,000 to 49,999	24
By Region	
Northeast	11
South	18
Midwest	20
West	27

Looking at this high growth in expenditures on a regional basis, still another pattern emerges. A greater percentage of the western cities are experiencing rapid spending growth than are cities and towns in the other regions. The Northeast has the smallest percentage of communities expecting rapid spending growth.

How Do Cities See Their Revenues Matching Up With Expenditures?

Expenditures and revenues are not independent but interdependent. At times, tax and revenue policy will be consciously designed to underwrite expanded programs; at other times, natural revenue increases will permit program expansions, tax cuts, or attacks on backlogged capital spending needs. Revenue decreases often force reductions in levels of service and spending levels. At other times, cities make conscious decisions to reduce revenues and provide a smaller package of service.

Most cities are required by state or municipal law to produce budgets that balance. That is, total resources must exceed total spending. Resources include beginning balances and revenues not just revenue alone.

The first step in this analysis is to see how current year revenues and expenditures match up, without the consideration of beginning balances (Table I-11).

Table I-11
City General Fund Expenditure/Revenue Relationship

	Percent of Cities		
Fiscal Year	**1988**	**1989**	**1990**
Expenditure exceeding Revenue	37	32	54
Expenditure equaling Revenue	1	2	19
Expenditure less than Revenue	62	66	27
Total	100	100	100

During 1990, 54 percent of the cities expect expenditures to exceed revenues. If this pattern is borne out in actual results, it will force the drawing down of beginning balances. This would represent a 69 percent increase from 1989 results. There is a natural pessimistic bent to city government budgeting practices, so actual results in 1990 probably won't be quite this extreme. In order to guarantee a positive balance, revenue estimates must be conservative while expenditure requirements must be pessimistic. Even when this predictable budgeting tendency is discounted, it is clear that this is not an optimistic trend.

It is particularly revealing to look at those fiscal years for which actual results are reported. While there appears to have been some improvement from 1988 the figure is still worse than for 1984 or 1985 (Table I-12).

45-290 0 - 91 -- 16

A factor that makes this figure even more important, when examining the municipal budgetary control efforts, is the continuing large percentage (37 percent in this year's survey) of cities that report reductions in capital spending. Capital spending, particularly for the

Table I-12
Percentage of Cities Reporting Expenditures Exceeding Revenues in General Fund Budgets

Year	1984	1985	1986	1987	1988	1989
Percent of Cities	24	30	40	33	37	32

1984 through 1987 figures were taken from previous NLC Fiscal Conditions Surveys.

smaller construction projects often reflected in general fund budgets, is often used as a budget relief valve. The full cost of a capital project will be budgeted, but the planning and design processes may not have the project ready for contract award until the end of the fiscal year. If the budget is tight, the project award may be deferred, resulting in immediate savings, which in turn helps in budget control.

With lower levels of capital spending reported by cities, this means that greater portions of municipal budgets will be operating spending, primarily salaries and attendant fringe benefits, for municipal employees. These expenses are much harder to control as they are spent regularly over the course of the fiscal year. If a budget reduction is required at the middle of a year, for example, personnel cost reductions have to be "doubled." If personnel costs are $1,000,000 with fifty employees (average cost $20,000) and a savings of $100,000 is required at mid-year, then ten employees must be laid off, not five as might first be guessed, since the required savings have to be realized in only half the year (1/2 x $20,000 x 10 = $100,000).

This simplified example does not even consider a variety of factors with which cities must deal – minimum notice periods for layoff, varying salary levels, termination benefits, unemployment payments, and many others. Delayed budget spending decisions by the federal and state governments about levels of municipal assistance to be included in their budgets only make these problems more extreme.

Nineteen percent of the cities expect their revenues and expenditures to be in exact balance. This expected mathematical precision results from the fact that many communities are reporting budget expectations for 1990; actual results can be expected to show some variation. The fact remains that one fifth of the cities expect revenue and spending to be very close.

The General Fund Revenue-Expenditure Imbalance Index

What is the extent of the expected mismatch between current revenues and spending?

Because general fund budget vary in size from city to city, it is necessary to reduce the revenue and expenditure figures to some common index. To do this for the most current year, 1990 expenditures are subtracted from 1990 revenues to yield the dollar amount of the imbalance.

Because city budget sizes vary so much it is useful to translate this figure to a comparative base. To produce this comparative index, the basic imbalance figure is divided by 1990 expenditures.

Thus, for a city with revenues of $1,000,000 and expenditures of $1,100,000 the imbalance index would be -9 percent – a negative index. For a city with revenues equaling expenditures, the index would be zero. For a city with revenues of $1,100,000 and expenditures of $1,000,000, the index would be 10 percent – a positive index.

A five percent variation in either direction from the index allows for normal budget variations (Table I-13).

This tabulation, as would be expected, shows significant clustering around the middle values. The same negative trends seen before are apparent here. Two and a half times as large a

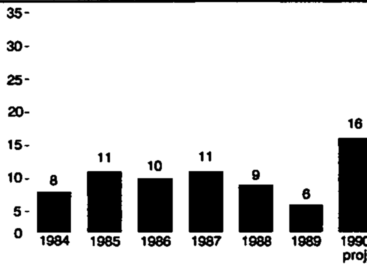
Table I-13
Imbalance Index 1988, 1989 and 1990 Projected

		Percent of Cities	
Imbalance Index*	**1988**	**1989**	**1990**
Worse than -5%	9	6	16
-5 to +5%	68	72	79
Better than +5%	23	22	5
Total	100	100	100

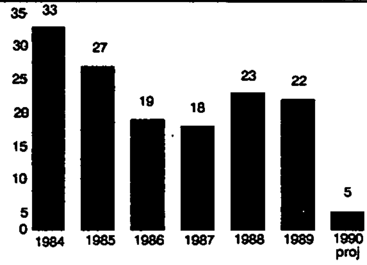
*Imbalance Index = $\frac{\text{Revenue–Expenditure}}{\text{Expenditure}}$

percentage of cities show a negative imbalance index exceeding five percent in 1990 as had one in 1989. At the other extreme, only eight percent of the cities show a positive balance index exceeding five percent, a sixty-two percent decline from 1987. (Remember that municipal financial estimates tend to be conservative.)

Percent of Cities with Negative Imbalance Greater than -5



Percent of Cities with Positive Imbalance Greater than 5



By looking at years for which there is final data, we see that the figures for 1988 and 1989 are virtually the same (Table I-14).

Table I-14
Percent of Cities Reporting Revenue-Expenditure Imbalances

Year	1984	1985	1986	1987	1988	1989
Worse than -5%	8	11	10	11	9	8
Better than +5%	33	27	19	18	23	22

When the data is viewed by region and city population, other trends can be seen. In all regions a greater proporion of cities project 1990 imbalance indexes worse than -5 percent (Table I-15). And while there is a deterioration in cities of all sizes, there appears to be a general pattern of deterioration as city size decreases (Table I-16). In the relatively smaller budgets of these communities, dollar variations that are hardly felt in the budgets of larger communities can produce shockwaves. This fact may produce more conservative budgetary projections and account for the larger percentages of smaller cities showing large negative index numbers.

Table I-15
Percent of Cities in Each Region With Imbalance Indexes Worse Than -5%

	Percent of Cities		
Region	1988	1989	1990
All Cities	9	6	16
Northeast	3	3	17
Midwest	8	3	18
South	13	6	13
West	7	11	18

Table I-16
Percent of Cities in Each Population Class With Imbalance Indexes Worse Than -5%

	Percent of Cities		
Size Class	1988	1989	1990
All Cities	9	6	16
300,000 and over	3	6	7
100,000 to 299,999	7	0	9
50,000 to 99,999	9	4	17
10,000 to 49,999	9	8	19

Cushioning the Expenditure-Revenue Imbalance

In order to examine the entire picture, the third, and so far missing component of the budget balancing act – the beginning balance – needs to be examined.

In basic terms, the beginning balance is the amount of funds with which the city starts the year. To the extent that cities have beginning balances, they can use them to cushion a current year mismatch between revenues and expenditures.

It is very important to recognize that not all amounts included in the beginning balance are readily available to cushion a mismatch between revenues and expenditures. Some portions of the balance may be legally restricted or reserved for a specific purpose and thus are not available to cover general spending requirements. Some resources reflected in the balance are not all held in the form of cash; they may instead represent unpaid taxes or charges that are legally owed to the city but not yet paid.

The majority of the reporting communities will not increase their balances during the course of fiscal 1990. As the discussion of revenues and expenditures would suggest, most of the communities will draw down their beginning balances during the course of the year. Fifty-four percent of the communities expect to reduce their balances, and 19 percent will just maintain the dollar amount of their balance. Twenty-seven percent expect to build up their balances in 1990 because revenues are projected to exceed expenditures

Summing Up

During fiscal 1990, more than half of the cities in this survey expect to draw down their beginning balances. For some cities, this will be the normal process of leveling out uneven revenues and expenditures from year to year. But for others it is a forced choice that will reduce future financial adaptability in order to meet the service needs of today.

BUDGET ADJUSTMENTS

In most states, state law requires that cities balance their operating budgets. This balancing process does not occur automatically; it relies instead on the decisions that elected and appointed city officials make throughout the year, but primarily as part of the city's annual budget process.

Typically, a city's operating departments compile budget estimates and budget requests, which are in turn submitted to the city council for its approval.

Revenue estimates are also prepared. These two sides of the budget are then compared and must be brought together—either by increasing revenues or decreasing expenditures or some combination of both.

The NLC fiscal conditions survey asked the respondents which of fifteen listed actions they took over the past year to bring about the required fiscal balance.

The majority of the cities surveyed used one or more of the listed actions during the past year. Raising fees and charges was by far the most common action, used by 76 percent of the cities. Other frequently used revenue strategies were: implementing new fees or charges (43 percent), increasing property tax rates (41 percent), and imposing or raising impact or development fees (27 percent).

On the spending side of the budget, reducing the growth rate of operating spending, used by 51 percent of the cities, was the most common budget cutting strategy, followed by contracting out of services (39 percent), reducing actual capital spending (37 percent), and reducing the number of city employees (23 percent).

Table II-1 shows the frequency of the 15 budget adjustment actions, and Table II-2 shows how the use of each of the techniques has varied over the past three years. Probably the most striking thing about the statistics is how relatively constant their use has remained.

Table II-1
Budget Adjustments Reported by Cities

Revenue Actions	% of Cities Reporting
Increasing level of fees and charges	76
Implementing new fees and charges	43
Increasing property tax rates	41
Imposing/raising impact or development fees	27
Increasing rates of other taxes	15
Implementing a new tax or taxes	9
Increasing sales tax rates	5
Increasing income tax rates	2
Expenditure Actions	
Reducing the growth rate of operating spending	51
Contracting out services	39
Reducing actual capital spending	37
Reducing the number of city employees	23
Freezing municipal hiring	22
Reducing city service levels	11
Shifting service responsibilities to another government	6

Table II-2
Frequency of Budget Actions, FY 1988 through FY 1990

	Percent of Cities Reporting In		
Revenue Actions	FY 1988	FY 1989	FY 1990
Increasing level of fees and charges	67	69	76
Implementing new fees and charges	37	36	43
Increasing property tax rates	41	41	41
Imposing/raising impact or development fees	24	18	27
Increasing rates of other taxes	16	13	15
Implementing a new tax or taxes	10	10	9
Increasing sales tax rates	8	5	5
Increasing income tax rates	1	3	2
Expenditure Actions			
Reducing the growth rate of operating spending	55	43	51
Contracting out services	35	32	39
Reducing actual capital spending	44	36	37
Reducing the number of city employees	25	24	23
Freezing municipal hiring	22	19	22
Reducing city service levels	14	7	11
Shifting service responsibilities to another government	5	6	6

Revenue Actions

Increasing Fees and Charges

The action most frequently taken to enhance revenues was to increase the level of fees and charges. Cities charge fees for a variety of services and activities, including building inspection services, park and recreation fees, zoning and planning fees, as well as a variety of other services.

According to U.S. Census Bureau statistics for 1988, fees and charges provide 29 percent of municipal revenues, compared to 34 percent from taxes. Utilities such as water, electricity, gas, and transit, as well as city-operated liquor stores, provide 17 percent of all municipal revenues; hospital and school charges provide 2 percent; and a wide variety of other fees make up the other 10 percent of the 29 percent of municipal revenues that come from fees and charges.

Restricted by tax limitations in many states, cities and towns are turning increasingly to the use of fees to fund various aspects of municipal operations. As federal funds have been withdrawn from cities, and the influence of an entrepreneurial climate has increased, many municipalities have begun to more aggressively monitor and adjust fee levels to keep pace with the increasing costs of the services.

Within limits, this approach – requiring the user of the service to pay a greater portion of the costs of service, or "the benefit principle" – has met with public support. One evidence of this general level of acceptability is that practically none of the communities (less than one percent), reported that they do not have the authority to adjust the fees they charge. Compare this to the tax adjustment actions about which the officials were queried: sizable percentages of cities reported that they do not have the authority to impose or raise the listed tax. Of course, if the pace of fee adjustment continues or accelerates, fee adjustments may reach the limits of political acceptability, leading in turn to increased restrictions through the state or local political process.

When this adjustment of fees and charges is examined, several trends can be seen. While between 80 and 90 percent of the larger cities reported increased fees, only 69 percent of the smaller communities included in this survey (between 10,000 and 49,999 in population) report the same action. Eighty-three percent of the western and northeastern cities reported fee adjustments in the past year, compared to 67 percent of the midwestern cities and 73 percent of the southern cities. Eighty-two percent of the central cities, 73 percent of the suburban cities, and 71 percent of the rural communities reported fee adjustments in the past year.

Implementing New Fees

Two-fifths (43 percent) of the communities reported that during the past year they implemented a new fee or charge. It is possible that municipal officials, encouraged by their past success in raising funds through the use of fees, have grown more comfortable with the charge-for-services concept, more comfortable with the type of cost recovery analysis frequently used to justify fee increases, and more comfortable with the necessity of raising revenues from those sources that are less regulated. A number of these fees are also based on the regulatory authority granted to the municipality, which reinforces the legitimacy of these fees.

New fees and charges were reported most frequently by middle-sized cities. Fifty-eight percent of the cities with populations from 100,000 to 299,999, and 49 percent of those between 50,000 and 100,000, reported new fees and charges. Thirty-eight percent of both the largest cities (over 300,000) and the smaller communities (10,000 to 50,000 population) reported implementing new fees or charges.

New fees or charges were reported most frequently by northeastern (48 percent) and western (48 percent) cities, while only 39 percent of the midwestern and southern cities reported imposing new fees or charges.

While 45 percent each of the central and suburban cities reported new fees, only 34 percent of the rural communities reported the initiation of a new fee or charge during the past year.

Development or Impact Fees

The survey specifically asked if the city had "imposed or raised impact or development fees." Twenty-seven percent of the cities said that this distinctive type of fee was raised or imposed in their community.

Impact or development fees are imposed on developers so a city can recoup a portion of the incremental cost of new public facilities required because of new development – the city is partly reimbursed for the development's impactp.

For the most part, these fees are imposed to defray the costs of infrastructure – roads, sewer, water, drainage, parks, schools, libraries, and fire stations. While fees and special assessments have long been imposed to help recover direct costs of on-site public improvements, such as water and sewer pipes directly serving the property and streets and sidewalks directly fronting on the property, impact fees typically have a more ambitious objective.

While the design and management of impact fees will differ from city to city, they typically attempt to cover a significant share of the incremental facility needs that will accumulate until major capital investments are required.

For example, while the construction of one new dwelling unit or a single commercial structure generally will not require the expansion of a sewage treatment plant or widening

of a major road, the added demand of numbers of such units will eventually require major public investments. Impact fees are thus designed to charge each development project a prorated share of projected or already expended costs for major central public facilities. In simplest terms, an impact fee can be termed a "buy-in fee". Such fees are an attempt to build into private development costs the major public investments that the private development will require over time.

Western communities are almost twice as active in the use of such fees as cities in other regions of the country. Forty-three percent of the western cities reported some action on these fees in the past year, followed by northeastern cities (29 percent), southern cities (21 percent), and midwestern cities (16 percent).

Suburban cities in this survey appear somewhat more active in this area than the other two city classifications. Thirty-one percent of the suburban cities reported development fee action during the past year, followed by 26 percent of the central cities, and 17 percent of the rural communities (those located outside of metropolitan areas).

Taxes

Taxes contribute 45 percent of city and town general revenues, according to U.S. Census Bureau statistics for 1988. Under the Census Bureau classification scheme, general revenues include all revenues except those from retirement systems, utility systems, and municipally operated liquor stores.

Property taxes provide the largest share of city tax revenues (54 percent). General sales taxes account for 16 percent, income taxes for 13 percent, and all other taxes for 17 percent.

The survey asked five questions about different types of taxes.

Property Taxes

Forty-one percent of the cities reported that property tax rates were increased in the past year—despite the fact that in most states there are limits on the rate or adjustment of property taxes.

This adjustment requires tough decision making by municipal officials, since according to a recent poll by the Advisory Commission on Intergovernmental Relations, the property tax has regained its position as the tax felt by the public to be "the worst—the least fair tax". Thirty-two percent of the public now rate the property tax as the least fair tax, followed by the federal income tax at 27 percent, state sales tax at 18 percent, and state income tax at 10 percent; 13 percent had no response (*Changing Public Attitudes on Governments and Taxes*, ACIR, 1989). These unfavorable results for the property tax represent a return to the status that it held prior to 1979, the peak of the national property tax revolt.

In explaining the rising level of dissatisfaction with property tax at the same time that the public feels that the unfairness of the federal income tax is lessening, the ACIR report says:

> "It is possible, therefore that the federal Tax Reform Act of 1986 is having an impact on public opinion. At the same time, however, with declining federal aid and rising costs, many local governments are experiencing pressures to raise revenues. Together, changes in federal taxes and rising local revenue pressure may be contributing to the increased dissatisfaction with property taxes."

Other factors that may be contributing to the unpopularity of the property tax include the following trends.

- The emphasis on the need to improve the educational system has increased the pressure on the property tax to produce the necessary funding. Since financing education is still one of the chief purposes of the local property tax, this increases the burden on the local property taxpayer. This occurs despite the increasing proportion of school finance being provided by state budgets.
- A central defect of the property tax is that it is a tax on unrealized capital gains. As a property's value (potential sales price) increases, there is not necessarily an accompanying increase in the current income of the property owner to permit increased tax payments.
- A number of major newspapers' analyses have questioned the uniformity and hence the fairness of local proberty tax assessment administration.

In NLC's fiscal conditions survey, slightly more than two-fifths all of the cities reported an increase in property tax rates during the past year, while slightly less than one quarter of the largest cities (those over 300,000 population) reported raising property tax rates.

The most marked differences, however, are regional ones. Seventy-seven percent of the northeastern cities reported raising property tax rates, compared to 39 percent of the southern cities, 30 percent of the midwestern cities, and 25 percent of the western cities.

The prevalence of property tax rate adjustments in the Northeast is probably driven by cut-backs or slowing growth in state payments to cities in these states where tight state budgets are the rule. A major part of the difference in the West is explained by state-imposed statutory and constitutional limitations on property tax adjustments. In fact, 19 percent of the western cities in this survey reported that they do not have the authority to increase the property tax rate.

There are differences, too, among types of cities: 46 percent of the suburban cities reported an upward adjustment of property tax rates, followed by 34 percent of the central cities and 20 percent of the communities outside metropolitan areas.

Sales Taxes

The municipal sales tax, second to the property tax as a source of general city revenue, appears to be adjusted less often than the property tax. Only 5 percent of the cities reported that they increased sales tax rates in the past year. With so few communities reporting adjusted sales tax rates, there is no way to examine the use of sales tax increase by region and size. What is probably most striking, however, is that 46 percent of the cities reported that they do not have the authority to raise municipal sales tax rates.

Income Tax Rates

The municipal income tax contributes 13 percent of municipal tax revenues nationally, but this is somewhat misleading because state law prohibits most cities from using this tax.

The survey results reinforce this statement: 74 percent of the cities reported that they do not have the authority to levy a municipal income tax. Only 2 percent of the cities reported raising income tax rates.

What accounts for the apparent inconsistency between the large contribution municipal income taxes make to municipal treasuries nationally and their use by only by a minority of cities? Use of the municipal income tax is very concentrated. Virtually all of the cities in the states of Ohio and Pennsylvania, and a number of communities in Kentucky, Michigan and Indiana, impose a municipal income tax. In a few other states, one or more of the largest cities are authorized to do so. With these exceptions, the income tax is unavailable to cities.

Other Taxes

Taxes other than the big three (property, income and sales tax) contribute 17 percent of municipal tax revenue. These other taxes combined provide more city revenue than the general sales tax (16 percent) or the municipal income tax (13 percent).

Among the taxes in this category are taxes on hotel and motel rooms (transient occupancy taxes), taxes on utility bills, taxes on amusements and admissions (ticket taxes), and taxes on liquor or motor fuels.

Fifteen percent of the cities and towns in the survey reported increasing the rate of such other taxes during the past year.

Thirty-one percent of the largest cities (over 300,000), 22 percent of the next largest cities (100,000 to 299,999), and less than 15 percent of the smaller cities reported increasing such other taxes during the past year.

New Taxes

Nine percent of the communities indicate that they implemented some new tax during the past year. The survey did not ask what specific new tax was implemented.

There appears to be a trend toward more new taxes among the larger cities. Twenty-seven percent of the largest cities (over 300,000), compared to 15 percent of the communities between 100,000 and 299,999 and 6 percent of the cities between 50,000 and 99,999, and 8 percent of those between 10,000 and 49,999 reported a new tax in the past year.

Controls on Expenditures

Spending received considerable attention during the municipal budget process in the past year. A majority of the cities (51 percent) reported reducing the growth rate of operating spending in the past year, 37 percent said that actual capital spending was reduced, and 39 percent reported that they contracted out municipal services.

Restraints on Operating Spending

Slightly more than half of the cities surveyed reported reducing the growth rate of operating spending in the past year. Sixty-six percent of the northeastern cities and 53 percent of the southern cities did so in the past year. The economic slowdown in the Northeast and the well publicized budget difficulties of the northeastern states have no doubt contributed to this stiffening of spending discipline by the northeastern cities.

Substantial percentages of western and midwestern cities, 48 percent and 42 percent respectively, also imposed spending restraint.

Central cities (56 percent) reported somewhat more frequent use of this control than suburban cities at 51 percent, and rural cities at 44 percent. The question did not explore the extent of the cuts expected as a result of these restraints or the differences in absolute spending levels.

Reductions in Actual Capital Spending

Municipal capital spending includes construction expenditures for major infrastructure (roads, sewers, water, public buildings) as well as for equipment required for municipal operations.

Thirty-seven percent of the cities reported that they cut actual capital spending in the past year. Reduced capital spending was reported by larger percentages of northeastern cities (45 percent), western cities (42 percent) and southern cities (38 percent), than midwestern cities (29 percent).

Reductions in capital spending appear to vary according to the type of city. Forty-two percent of the central cities, 37 percent of the suburban cities, and 30 percent of those communities located outside of metropolitan areas, reported capital spending cuts in the past year

Municipal Personnel

Because cities are service organizations, large proportions of their operating spending goes for personnel. When spending restraint or cuts are required, personnel costs are frequent targets. The results of this survey confirm that fact.

Almost one quarter (23 percent) of the cities reported reducing the number of municipal employees during the past year. While around 20 percent of the cities under 300,000 reported personnel reductions, 49 percent of the largest cities (those over 300,000) reported reductions in municipal personnel.

Reductions in the number of city workers were reported twice as frequently by northeastern cities as by cities in the other regions of the country. Thirty-eight percent of the northeastern cities reported personnel reductions in the past year, a high rate consistent with the greater occurrence of cuts in operating spending also reported by the northeastern cities. Clearly, greater numbers of northeastern cities and towns are feeling fiscal stress.

There is little variation according to city type. A slightly higher percentage of the central cities (29 percent) reported personnel cuts in the past year than did rural (22 percent) or suburban cities (20 percent).

Another frequently used strategy for reducing personnel spending, besides an explicit reduction in the work force, is a freeze on hiring. A hiring freeze can take various forms: the total number of authorized positions may not be allowed to increase above a specific number, vacancies may not be filled when they occur, or some more formal review process may be required before refilling vacancies that occur. These techniques can be imposed across all city departments and job classifications, or they can be applied selectively to specific departments or classifications. All hiring in the parks and recreation department could be frozen, for example, or all secretarial or management positions could be frozen.

The survey asked if municipal hiring had been frozen during the past year, but it did not explore the specific freeze mechanism used.

Twenty-two percent of the cities reported hiring freezes during the past year. Once again, northeastern cities and central cities, reported hiring freezes most often.

Thirty-three percent of the northeastern cities report a municipal hiring freeze in the past year, followed by 22 percent of the southern cities, 19 percent of the western cities, and 18 percent of the midwestern cities.

More central cities (33 percent) reported hiring freezes in the past year (33 percent), compared to 18 percent of the rural cities and 17 percent of the suburban cities.

There appears to be a direct relationship between hiring freezes and population. Fifty-six percent of the largest cities (over 300,000) reported hiring freezes, compared to only 15 percent of the smallest cities (10,000 to 49,999). Twenty-five percent of the communities between 50,000 and 100,000 and 39 percent of the cities between 100,000 and 299,999 reported hiring freezes last year.

Other Budget Adjustment Strategies

The survey asked about three other methods of controlling, shifting, and managing expenditures – contracting out services, shifting service responsibilities to another level of government, or reducing levels of service.

Contracting out was the most frequently reported of these three alternatives. This question and its responses must be read carefully, however. The survey *did not* ask if new services had been contracted out during the past year, but whether "During the past year your city has contracted out services". Thus the responses to this question probably indicate the percentage of cities contracting for some services rather any rate of change in the level of contracting out city services.

Thirty-nine percent of the cities reported that some city services were contracted out in the past year. Contracting out was reported most by the largest cities (59 percent) and by the western cities (49 percent). While roughly 40 percent of the central and suburban cities reported contracting of services in the past year, only 33 percent of the cities outside metropolitan areas did.

The larger and metropolitan cities are probably more likely to use this strategy because of the wider variety of services they offer and because the more populous areas offer more potential service providers (other governmental units, non-profit groups, or private firms) from which to choose.

Another method of controlling costs in the municipal budget is to shed the responsibility of providing the service by shifting it to another governmental unit, which not only provides the service but assumes financial responsibility for it. This approach is really a reorganization or sorting out of service responsibilities.

It is not surprising that only 6 percent of the cities reported such service shifts in the past year. Most often, the reasons that make shifting a service away look attractive to the surrendering government are the same reasons that make acceptance of the responsibility unattractive to the receiving jurisdiction. There are, however, occasions when this type of shift does make sense. While the absolute numbers are quite low, making generalizations difficult, it appears that the largest and central cities are more likely to have made such shifts in the past year.

Sixteen percent of the cities over 300,000 (5 cities) reported shifting some responsibilities in the past year. Similarly while only 4 percent of the suburban communities and 5 percent

of the rural communities reported such service shifts in the past year, 8 percent of the central cities reported shifting a service to another government in the past year.

The last area to be explored in this series of questions was whether the city reduced service levels during the past year. While the two techniques discussed above involve locating an alternative supplier of the service, this strategy involves an explicit or implicit decision to reduce a service being provided to the public.

Eleven percent of the cities said that some services were reduced in the past year. Seventeen percent of the northeastern cities indicate that service reductions have occurred, followed by western cities (13 percent), midwestern cities (9 percent), and southern cities (6 percent). Once again the current fiscal strains in the northeastern region can be seen in these numbers.

There is also some variation based on city size and type. Thirty-five percent of the largest cities (over 300,000) reported reducing services, followed by 15 percent of the cities between 100,000 and 299,999, 8 percent of the cities between 50,000 and 99,999, and 8 percent of the cities between 10,000 and 49,999. The central cities, like the largest cities, most frequently reported reducing services. Fourteen percent of the central cities, 10 percent of the suburban cities, and 8 percent of those cities and towns outside metropolitan areas reported a service reduction in the past year.

PRESSURES AND PROSPECTS

This survey was completed by city financial and budget officials, who have professional responsibility for municipal financial matters. These experienced observers were asked for their opinions on the trends in the financial health of their cities, the factors adversely affecting the revenues and expenditures of their cities, the impact of 17 specific situations on their communities' budgets, and the most constructive actions that federal and state governments could take to ease the financial pressures, apart from the direct provision of funds.

Factor Most Adversely Affecting Revenues

When city finance officials were asked for the factor most adversely affecting the revenues of their communities, they were asked an open-ended question. There was no fixed list of responses, and the respondents had complete freedom to answer in any way they chose. Table III-1 shows the major categories of their responses.

A majority of the respondents considered some aspect of the local economic climate to be the most important adverse effect on municipal revenues.

These responses included slow growth or decline in the local tax base, adverse population shifts changing the economic potential of the community, some aspect of economic shift or transition being experienced by the community, and the loss of commercial and retail activity within the community.

While city revenues are not generally as responsive to changes in incomes as are state and federal revenues, the financial officers surveyed still judge that the revenue health of their cities is closely tied to the overall economic health of their communities.

Table III-1
Factors Adversely Affecting Revenues

	Percent of Cities Citing
The economy	47
Tax and expenditure limitations	12
Loss of state grants	11
Loss of federal grants	1
Loss of federal and state grants	3
Reliance on property tax	3
Taxpayer unwillingness to pay higher taxes	3
"Other factors"	17
No adverse factor	3
Total	100

For 53 percent of the central cities, and 47 percent of the rural cities, the economy was the most adverse influence on the city's revenues. Only 37 percent of the suburban communities cited the economy as the most adverse influence on city revenues.

Tax Limitations

Twelve percent of the cities listed state tax limitations as the most adverse influence on their municipal revenues.

A majority of the states limit the ability of cities to raise revenues, particularly from the property tax. This state constraint of local revenue raising authority was listed as the foremost adverse factor on municipal revenue raising capacity. Nineteen percent of the western cities reported these limitations as their most significant revenue constraint, followed by 13 percent of the midwestern cities, 8 percent of the northeastern cities, and 7 percent of the southern communities.

More variation is apparent among types of city. A greater proportion of the suburban cities (15 percent) said that these limits are their most significant constraint, while central cities (10 percent) and rural cities (7 percent) report this as their most significant revenue constraint.

Loss of Grants from Other Levels of Government

Through the last decade, cities have become less dependent on revenue from other levels of government, but this has not been a painless process for local officials or local taxpayers. Fifteen percent of the city finance officials volunteered "the loss of state aid" or "the loss of federal aid" or "the loss of federal and state aid" as the most adverse factor for the revenue side of their budget. Eleven percent of the cities listed the loss of state grants only, 1 percent

listed the loss of federal grants only, and 3 percent listed the combined loss of federal and state grants.

Other Adverse Influences on Revenues

Three percent of the cities cited reliance on the property tax as the factor most adversely affecting their cities' income, and another 3 percent cited taxpayer resistance to higher taxes.

Seventeen percent of the respondents provided answers outside any of the categories listed above; none of these individually rose to the level of one percent of responses. The variety of revenue challenges facing cities can be seen in the following responses selected at random: "restrictive state regulations," "lack of control over revenue growth," "high housing costs resulting in the relocation of sales/business offices," and "the state's use of 1980 census for determining revenue sharing is incorrect".

Three percent of the cities said that there was no adverse factor affecting the revenues of their city.

Expenditures

The respondents were asked to indicate the factor that most adversely affected their cities' expenditures. This question was asked in an open-ended fashion, and the officials were invited to answer in their own words. As would be expected given the diversity of American communities, there was a wide variety of answers, but some groupings could be clearly seen.

Pressures rising out of personnel costs were clearly the leading source of expenditure concern to these officials. Forty-two percent said that these costs (including salaries, pensions, health insurance costs, and other benefits for municipal employees) were the most pronounced pressure on the expenditure side of the city budget. Growth of population and services demanded by the population followed at 13 percent. Other factors driving expenditures that were frequently cited included:

- federal and state mandates (9 percent),
- solid waste disposal issues and other environmental concerns (9 percent), and
- infrastructure and capital needs (8 percent).

Table III-2 summarizes the results.

Personnel Costs

As a category, the cost factors surrounding municipal personnel far outdistanced all other items in the survey. Given the role of cities as direct service providers, the importance of these costs to municipal budgets is not surprising. While 42 percent of all the cities surveyed

Table III-2
Factor Most Adversely Affecting City's Expenditures

Factor	Percent of cities citing
Personnel costs	42
Growth of population & service demands	13
Federal and state mandates	9
Infrastructure and capital needs	8
Cost of living and inflation	7
Solid waste issues	7
Public safety and crime	3
Environmental issues (other than solid waste)	2
"Other factors"	9
Total	100

reported this as the leading stress factor on municipal expenditures, a larger proportion (53 percent) of the largest cities (those over 300,000) cited this as the most pronounced pressure on their city's spending. There are some differences among regions and city types, but they are not extreme, as Table III-3 shows.

Table III-3
Personnel Costs as Most Adverse Factor on City Expenditures

By Region	Percent of cities citing
Midwest	48
Northeast	45
West	38
South	37
By Type	
Central	45
Suburban	41
Rural	38

Rapid Growth

The pressures on expenditures produced by population growth or shifts in the composition of the population, as well as by service demands, were listed next most often as an adverse pressure on expenditures. This group of pressures was reported by 13 percent of the cities overall.

Western cities cited these pressure at almost twice the rate of the rest of the country. Twenty three percent of the western cities cited growing service demands as the most adverse pressure on their budget, followed by midwestern cities at 13 percent, southern cities at 11 percent and northeastern cities at 6 percent. Thirteen percent of the suburban cities said that this was their biggest expenditure stress, followed by 13 percent of the central cities and 7 percent of rural cities.

Federal and State Mandates

Duties and costs imposed by the federal and state governments through laws and regulations on units of local government are termed mandates, in that they are mandatory responsibilities that must be complied with regardless of whether increased funding or new tax authority is provided to finance them. These mandates seem to be most numerous and costly in the areas of environmental regulation and personnel administration.

These mandates appear to be a particular concern of southern and rural communities, as they were listed by these communities at roughly twice the rate of other communities. Thirteen percent of the southern cities cited these mandates as their leading topic of expenditure; so did, 11 percent of the northeastern cities, 7 percent of the midwestern cities, and 5 percent of the western cities.

Sixeteen percent of the rural communities cited these mandates as their leading expenditure concern, followed by 8 percent of the central cities and 7 percent of the suburban cities.

Other Areas of Expenditure Concern

Eight percent of the communities said that infrastructure and other capital needs represent the most adverse factor affecting expenditures.

Inflationary pressures were reported by 7 percent of the communities as their top expenditure stress. While the responses were quite uniform for all sizes of cities and all regions, there was a noticable variotion among city types. Twelve percent of the rural communities cited inflation as the chief expenditure stress, twice the proportion of central cities (6 percent) and suburban cities (5 percent).

Solid waste concerns, termed the most adverse expenditure pressure by 7 percent of all communities, were cited by 14 percent of the northeastern communities. The disposal problems of this region have been extensively publicized. Some communities have had to seek out-of-state disposal sites because of the political and physical difficulties of locating acceptable disposal sites within the community. In contrast, less than one percent of the western cities called solid waste disposal their leading expenditure pressure. In between the extremes are midwestern (7 percent) and southern cities (6 percent).

Three percent of the cities judged that crime and public safety needs were the items most adversely impacting expenditures, and 2 percent cited environmental concerns other than solid waste. Nine percent of the cities cited a wide range of issues outside the categories listed above, none of the subjects representing one percent. Here are a few random examples.

- "retrenchment of federal government on domestic spending"
- "operational needs of new capital construction"

- "cost of education"
- "new debt service requirements"
- "settlements from past lawsuits"

Factors Influencing the Budget

Respondents to the survey were asked to report how seventeen specific factors influenced their ability to balance the city budget. They were given four choices into which they could categorize their judgments: favorable, no impact, unfavorable, and not applicable. Table III-4 shows the factors discussed and the percentage of cities whose responses fell into each of the four categories.

Table III-4
How Factors Affected City Budgets

	Percent of Cities Citing as			
Factors	**Unfavorable**	**Favorable**	**No Impact**	**Not Applicable**
Cost of employee health benefits	94	3	3	0
Costs of solid waste disposal	75	3	16	6
Change in amount of federal aid	69	2	22	7
Demand for traffic improvements	66	2	29	3
Demands for drug law enforcement	63	3	29	5
Employee pension costs	62	8	29	1
Sewage collection and treatment	58	3	26	13
Liability claims/awards against city	55	1	41	3
Change in amount of state aid	54	13	29	4
State tax limitations on cities	51	1	33	15
Change in local economy	48	28	23	1
Drinking water standards (EPA)	42	2	36	20
Demands for drug treatment	22	1	50	27
Reduction of private defense contracting	15	1	30	54
Savings and loan foreclosed property				
not paying taxes	14	1	54	31
reducing tax base	13	1	57	29
Proposed closure of military bases in area	7	1	22	70

Costs of Employee Health Benefits

Medical price inflation, the rising numbers of catastrophic claims, and increasing outpatient costs are driving health care expenditures towards unprecedented levels, and making health care one of the hottest national issues due to rising costs for hospitals, doctors, and employers. Currently, health care represents approximately 10 percent of the federal budget. It is estimated that health care will represent 15 percent of the gross national product by the year 2000. (Janet Kline, *CRS Issue Brief; Health Care.* Congressional Research Service: The Library of Congress, November 2,1989.)

Municipalities are not immune to the stresses caused by the current health care system. The costs to cities as employers are having widespread effects on their ability to balance their budgets and in turn on the ability to provide a full range of services to their residents.

Municipal spending on health care is estimated at more than $5.5 billion per year. Cities of all sizes and types and in all regions of the country are having difficulty containing these costs. In 1989, cities spent an average of $2,857 for each employee's health plan, while states spent an average of $2,660 per employee and private employers spent $2,748 per employee. (Foster Higgins: *Health Care Benefits Survey* 1989)

In addition to the large amounts that municipalities currently spend on employee health plans, there is the possibility that the federal government will add to the local burden. One of the considerations for the fiscal 1991 federal budget is a proposed requirement that state and local governments provide Medicare coverage for all of their employees by paying the related payroll taxes. Currently, state and local governments that are not fully enrolled in the social security system (including Medicare) must only provide Medicare for employees hired on or after April 1, 1986.

The 1990 Fiscal Conditions Survey found that 94 percent of city governments were adversely affected by the costs of health care programs for employees. This "unfavorable" response rate was the highest for any of the topics in question. It reflects the rising health care costs across the country and the serious need for reforms.

Solid Waste Disposal

Solid waste disposal was also a major problem for cities in fiscal 1990. As the space for waste disposal continues to decrease, cities are having a difficult time keeping the costs under control. More than 400,000 tons of municipal solid waste are created every day across the country; with 80 percent of this solid waste disposed of in landfills. Yet the Environmental Protection Agency estimates that almost one-half of all the landfills in use in 1986 will be closed by 1991. (James E. McCarthy, *CRS Issue Brief: Solid Waste Management*, Congressional Research Service: The Library of Congress, April 20, 1990)

As large numbers of landfills are closing, fewer are opening because of increases in construction and operation costs. Landfill operators are finding it expensive to meet the requirements set forth by the EPA. Cities are also having difficulty finding locations close to the areas creating the waste. As a result, cities must transport waste greater distances to the nearest landfill, further driving up costs.

Incineration and recycling are helping reduce the amount of landfill space needed for solid waste disposal. Unfortunately, these options are not yet developed fully enough to have a substantial impact on cost containment.

While 75 percent of municipalities reported that solid waste was having an unfavorable effect on their ability to balance the budget, certain types of cities reported trouble more

often than others. A larger proportion of larger cities, and of southern cities, reported these stresses than did cities of other sizes or in other regions.

Table III-5
Solid Waste Disposal

	Percent of Cities Citing as			
	Unfavorable	Favorable	No Impact	Not Applicable
By Size				
10,000-49,999	71	5	17	7
50,000-99,999	78	0	15	7
100,000-299,999	82	1	14	3
300,000 and over	91	0	9	0
By Region				
Midwest	77	2	15	6
Northeast	74	9	13	4
South	82	2	14	2
West	65	1	22	12

Change In Federal Aid

Changes in the amount of aid municipalities received from the federal government was also one of the more difficult factors that cities endured in fiscal 1990. Overall, 70 percent of the cities surveyed said their ability to balance the budget was adversely affected by these changes. These "unfavorable" effects were more prevalent in larger cities than in smaller cities.

Table III-6
Change in Federal Aid

	Percent of Cities Citing as			
City Size	Unfavorable	Favorable	No Impact	Not Applicable
10,000-49,999	65	3	24	8
50,000-99,999	67	0	26	7
100,000-299,999	85	3	8	4
300,000 and over	82	3	12	3

Traffic Improvements

Surface transportation promises to become a rising part of municipal budgets over the coming years as America reinvests in its infrastructure. A variety of groups are studying America's transportation needs for the future and these deliberations are likely to result in a push for major spending across the country on traffic and transportation issues.

In addition, the Department of Transportation and President Bush have pledged that future transportation plans should involve increased levels of local financing. As the Federal

Highway Administration reinterprets its laws to meet this objective, cities will likely be faced with rising costs for traffic improvements.

Suburban and central cities responded more often than rural cities that traffic was having an unfavorable impact on their budgets. Cities in the West also reported having trouble with greater frequency.

Table III-7
Traffic Improvements

	Percent of Cities Citing as			
	Unfavorable	Favorable	No Impact	Not Applicable
By City Type				
Central	68	1	28	3
Suburban	69	2	27	2
Rural	58	3	35	4
By Region				
Midwest	67	1	31	1
Northeast	55	4	36	5
South	61	2	34	3
West	82	1	14	3

Demands for Drug Law Enforcement and Treatment

The demands on municipal governments for law enforcement relating to drugs reflect the national drug abuse epidemic. A breakdown of the statistics reveals that a higher percentage of large cities reported financial difficulty due to enforcement demands than smaller cities (Table III-8).

Table III-8
Demands for Drug Law Enforcement by Size

	Percent of Cities Citing as			
City Size	Unfavorable	Favorable	No Impact	Not Applicable
10,000-49,999	56	4	34	6
50,000-99,999	68	5	24	3
100,000-299,999	82	1	17	0
300,000 and over	79	0	18	3

Demands for drug treatment caused fewer budget problems for cities than did demands for law enforcement. Yet once again, the larger cities suffered at a rate disproportionate to the smaller cities (Table III-9). Fifty percent of cities with populations greater than 300,000 felt the call for drug treatment had an unfavorable impact, while only 14 percent of cities with populations in the range of 10,000-50,000 felt similar pressures.

This difference can be partially accounted for by the role local governments play in the drug treatment process. Many smaller cities have treatment programs paid for by county and state

Table III-9
Demands for Drug Treatment by Size

City Size	Percent of Cities Citing as Unfavorable	Favorable	No Impact	Not Applicable
10,000-49,999	14	1	55	30
50,000-99,999	26	2	51	21
100,000-299,999	38	0	37	25
300,000 and over	50	0	29	21

government, while larger cities are more likely to run their own. This observation is supported by the greater percentages of smaller communities that report drug treatment has no impact or is not applicable to their city budget.

Employee Pension Costs

The contributions required to soundly fund municipal employees' pensions are large cost factors for most cities. While some cities maintain their own plans most participate in state-wide plans administered by state governments. While some states have recently been able to lower required rates of city contribution because of the good performance of their investment portfolios, the cost of city employee pensions has had significant implications for municipal finances.

Sewage Collection and Treatment

Table III-10
Employee Pension Costs

	Percent of Cities Citing as Unfavorable	Favorable	No Impact	Not Applicable
By Size				
10,000-49,999	58	8	34	0
50,000-99,999	68	6	25	1
100,000-299,999	68	8	24	0
300,000 and over	68	15	17	0
By Region				
Midwest	69	3	27	1
Northeast	61	16	23	0
South	63	5	31	1
West	54	10	36	0

Sewage collection and treatment was costly for a considerable number of cities, and these costs could grow higher in the coming years. The EPA currently offers grants to local governments to help them meet the regulations of the Clean Water Act. Cities building new waste water treatment facilities have been able to receive federal grants to help cover construction costs. The 1987 amendments to the Clean Water Act phased out these grants

and replaced them with a State Revolving Loan Fund (SRF). Beginning in fiscal 1991, only repayable loans will be available for construction of municipal waste-water treatment plants.

Fifty-eight percent of responding cities identified sewage collection and treatment as having a negative effect on their ability to balance the budget (Table III-11). While responses were similar among cities of different sizes, there was a slight difference among the different regions. A lower percentage of western municipalities, and a slightly higher percentage of southern cities, compared to all cities, cited sewage disposal and treatment as having an adverse effect on municipal budgets.

Table III-11
Sewage Collection and Treatment by Region

	Percent of Cities Citing as			
Region	Unfavorable	Favorable	No Impact	Not Applicable
Midwest	58	2	27	13
Northeast	57	5	21	17
South	63	4	24	9
West	52	2	33	13

Liability Claims/Awards

Fifty-five percent of the cities said that liability claims and awards were having a negative impact on their ability to balance the budget. A higher percentage of central cities reported trouble with liability claims than suburban and rural municipalities. Western cities also gave unfavorable responses more often than cities in other regions.

Table III-12
Liability Claims/Awards

	Percent of Cities Citing as			
	Unfavorable	Favorable	No Impact	Not Applicable
By City Type				
Central	60	0	39	1
Suburban	56	2	39	3
Rural	45	2	47	6
By Region				
Midwest	51	2	42	5
Northeast	45	3	48	4
South	54	1	42	3
West	69	0	31	0

Change in Amount of State Aid

State payments to cities are significant sources of municipal funding in many states. The high level of unfavorable response by the northeastern officials reflects the recent strains in the intergovernmental fiscal relationship caused by state and local budgetary problems in this region, strains that are reflected throughout this report.

Table III-13
Change in Amount of State Aid

	Percent of Cities Citing as			
	Unfavorable	Favorable	No Impact	Not Applicable
By Size				
10,000-49,999	51	14	30	5
50,000-99,999	56	11	29	4
100,000-299,999	67	8	25	0
300,000 and over	38	27	29	6
By Region				
Midwest	38	26	31	5
Northeast	74	10	13	3
South	55	7	33	5
West	53	10	34	3

State Tax Limitations on Cities

The limitations imposed on municipal taxing authority by state law were cited by more than half of the central cities and western and midwestern cities as having an unfavorable impact on their ability to balance their budgets (Table III-14).

Table III-14
State Tax Limitations

	Percent of Cities Citing as			
	Unfavorable	Favorable	No Impact	Not Applicable
By City Type				
Central	56	2	29	13
Suburban	48	1	35	16
Rural	49	2	36	13
By Region				
Midwest	51	0	36	13
Northeast	47	3	21	29
South	47	1	40	12
West	59	2	31	8

Change in Local Economy

The local economy shapes the capacity of a city's resources and also many of the demands placed on the budget. Northeastern cities and southern cities cited this as an unfavorable budget pressure to a greater degree than cities in the other regions. The southern region includes Texas and other states heavily impacted by the savings and loan crisis.

Table III-15
Change in Local Economy

	Percent of Cities Citing as			
	Unfavorable	Favorable	No Impact	Not Applicable
By Size				
10,000-49,999	45	29	25	1
50,000-99,999	50	27	22	1
100,000-299,999	53	25	22	0
300,000 and over	59	29	12	0
By Region				
Midwest	32	36	31	1
Northeast	60	17	21	2
South	57	20	21	2
West	45	38	17	0
By City Type				
Central City	51	26	22	1
Suburban City	44	30	25	1
Rural City	50	27	22	1

The importance of the local economy to city budgetary health is underscored by the fact that the economy was cited in the earlier open ended question as the factor most adversely affecting the city's revenues.

Drinking Water Standards

Drinking water standards mandated by Congress have caused cities to spend money to improve water quality for residents and comply with new regulations; increasing levels of expenditure can be expected in the future. This statute required that the Environmental Protection Agency set maximum permitted concentration levels for 83 substances that might exist in a water supply. The EPA is in early stages of producing this list and the related standards. Upon completion of the initial 83 standards, EPA is required by Congress to establish standards for an additional 25 substances annually. This process has introduced a great deal of uncertainty into municipal water supply planning and finance.

The survey showed that 42 percent of the cities were adversely affected by the drinking water standards.

The survey also found some variance in the response rates among different groups of cities.

Table III-16
Drinking Water Standards by Region

Region	Percent of Cities Citing as Unfavorable	Favorable	No Impact	Not Applicable
Midwest	41	1	41	17
Northeast	27	2	33	38
South	51	4	30	15
West	44	1	40	15

Cuts in Defense Spending

The closure of military bases across the country because of cuts in the defense budget has caused difficulties for some of the nation's cities. The low overall percentage of cities affected by the closures does not reflect the severity of the effects felt by cities losing installations. Although most cities were not affected by the closures, central and suburban cities, more often than rural cities, reported that the cuts were having an impact on their budgets.

The initial list of base closures produced by a special federal commission has been supplemented by two additional lists produced by the Defense Department. As further defense cuts and reorganizations are made to reflect the changing international situation, further base closings and realignments will introduce added uncertainty for more communities.

Table III-17
Military Base Closure by City Type

City Type	Percent of Cities Citing as Unfavorable	Favorable	No Impact	Not Applicable
Central City	11	1	20	68
Suburban City	7	1	23	69
Rural City	2	0	21	77

In addition, city budgeting was impacted by the reduction of private sector defense contracting (Table III-18). Central cities again responded more often than the suburban or rural cities that they were adversely affected. As the shape of the U.S. military structure becomes clearer, the effect of reduced contracting can be expected to become more pronounced and spread more broadly.

Table III-18
Private Sector Reductions Because of Defense Cuts by City Type

City Type	Percent of Cities Citing as Unfavorable	Favorable	No Impact	Not Applicable
Central City	23	0	30	47
Suburban City	11	2	33	54
Rural City	12	1	24	63

Savings and Loan Foreclosures

The closure of many savings and loan institutions and the related drop of many property values, left many cities without revenues they had anticipated from property taxes. Although only 13 percent reported being troubled by this factor, the figure does not represent the severity of effects felt by those cities.

Municipalities that gave an "unfavorable" response were located in Texas (33 percent) and in Arizona, California, Colorado, Florida, and Illinois (32 percent).

Fifty-nine percent of the Texas municipalities identified this factor as having an unfavorable influence on their ability to balance the budget.

Some cities were also left without revenues they anticipated because of governmental control of foreclosed properties. Much uncertainty surrounds the subject of property tax collections while the property is held by the federal institutions assigned to work out these situations. While the federal bail-out statute is clear on the requirement to pay current real property taxes, it is less than clear on a number of other questions including:

- how past-due taxes and the related interest and penalties will be handled,
- what responsibility will be assumed for past-due taxes incurred before the federal government takes possession of a foreclosed property, and
- how aggressively federal authorities will challenge the values placed on such properties by local assessors.

According to federal reports the total value of foreclosed real property held by federal authorities from the bail-out stands at $14.9 billion and includes 35,908 properties. Properties in Texas account for 53 percent of the foreclosed parcels and represent an estimated 68 percent of the value held. The responses to this survey reflect the same type of concentration. But William Seidman, chairman of the Resolution Trust Corporation, (the federal agency set up to deal with the savings and loan bail-out), said in the June 14, 1990, *Wall Street Journal*, that "Later reports will show a much broader spread of properties around the country." It would not be unreasonable to assume that in the future a broader geographic range of cities will be reporting problems from this situation.

Most Constructive State Action

State governments are critically important to cities. States shape, and in many cases determine, the cities' responsibilities and abilities to respond to needs within their communities.

Table III-21
Most Constructive State Action for Your City

State Action	Percent of Cities Citing
Reduce the level of state mandates	35
Give authority for local option taxes	10
Lift tax and expenditure limitations	8
Provide more local authority	6
Help with transportation & traffic	5
Assistance with solid waste problems	4
Stimulate economic development	3
Assume city functions	2
Provide for easier tax adjustment	2
Facilitate cooperative service delivery	2
Revise personnel arbitration procedures	1
"Other"	22
Total	100

Reduce the Level of State Mandates

Requirements imposed by the state government are clearly the leading concern of these officials. Thirty-five percent of the officials reported that a lessening of the level of state mandates is the most constructive action their state government could take. The largest cities list this recommendation with less frequency than cities in the other size classifications. This doesn't indicate that state mandates are not a concern to these cities but that the many other concerns and challenges on their agenda simply push it out of first place.

Southern and western city officials urge lessening of mandates as the top recommended action at a higher rate than officials in the other two regions (Table III-22).

Table III-22
Reduction of Mandates as Most Constructive State Action

	Percent of Cities
By Size	
10,000 to 49,999	38
50,000 to 99,999	40
100,00 to 299,999	30
300,000 and over	13
By Region	
South	39
West	38
Midwest	31
Northeast	31

Authority for Local Option Taxes

The second most frequently urged action is increased authority for cities to use local option taxes. Ten percent said that granting a broader menu of tax alternatives would be the most constructive action taken at their statehouse. Since states regulate the taxes that cities in the state can use, this request to diversify local tax choices is understandable. This request also probably reflects the growing resistance to further increases in local property taxes. Such increased options generally do not come into being automatically but as their name indicates are a local option, requiring some action at the local level such as voter approval before they become effective. Larger percentages of the largest cities and those in the South view an increased list of local tax possibilities as the key state contribution than do other cities.

Table III-23
Local Option Taxes as Most Constructive State Action

	Percent of Cities
By Size	
10,000 to 49,999	6
50,000 to 99,999	7
100,000 to 299,999	13
300,000 and over	26
By Region	
South	13
Northeast	11
West	9
Midwest	6

Other Actions Urged

A wide range of other actions were urged on the states:

- lift tax and expenditure limitations (8 percent),
- provide more local authority (6 percent),
- help with transportation and traffic (5 percent),
- assistance with solid waste problems (4 percent),
- stimulate economic development (3 percent),
- assume city functions (2 percent),
- provide for easier tax adjustment (2 percent),
- facilitate cooperative service delivery (2 percent), and
- revise personnel arbitration procedures (1 percent).

An even wider range of response didn't fit into the categories discussed above. A few random examples: "communication with local officials","leave police and fire pensions alone", "clearer legislation", and "help with education."

Most Constructive Federal Action

While the federal government has reduced its financial contribution to cities over the past decade its involvement in city affairs through laws, regulations, and court rulings continues to grow. When the municipal budget officials were asked to provide the most constructive action that could be taken by the federal government, apart from the provision of increased funding, they put reducing federal mandates at the top of the list.

Table III-24
Most Constructive Federal Action

	Percent of Cities
Reduce the level of federal mandates	37
Lessen restrictions on municipal bonds	17
Reduce the federal deficit	7
Provide assistance in complying with environmental regulations	7
Maintain federal aid	5
Help with drug law enforcement	2
"Other"	25
Total	100

Reduce the Level of Federal Mandates

The continuing increase in federally mandated actions leads municipal officials to urge that the level of federal mandates be reduced. These mandates are particularly marked in the areas of environmental issues and municipal personnel. The request for lessened mandates is particularly pronounced from rural and southern cities (Table III-25).

Lessen the Restrictions on Municipal Bonds

Seventeen percent of the cities recommend lessening restrictions on municipal bonds as the most constructive action that the federal government could take for their cities.

The federal Tax Reform Law of 1986 imposed a variety of restrictions on the use of municipal bonds. These changes in federal law changed the permitted uses of such bonds, gave investors in such bonds less favorable and less certain treatment under income tax laws, imposed restrictions on the investment of municipal bond proceeds (arbitrage restrictions), and imposed a variety of procedural and compliance regulations.

Table III-25
Percent of Cities Urging Reduction in Federal Mandates

	Percent of Cities
By City Type	
Rural cities	47
Central cities	36
Suburban cities	33
By Region	
South	42
West	40
Midwest	36
Northeast	25

More southern and central communities put this concern at the top of their list than did cities and towns in other regions and other types of cities (Table II-26).

Table III-26
Reduction of Federal Municipal Bond Restrictions as most Constructive Federal Action

	Percent of Cities Citing
By Region	
South	23
West	18
Northeast	14
Region	12
By City Type	
Central cities	21
Suburban cities	18
Rural cities	10

The 1986 Tax Reform Act originally imposed a complicated formula restricting the interest earnings that could be earned through the investment of municipal bond proceeds and imposed tough penalties of retroactive determinations that could convert tax-free bonds to taxable bonds as the penalty for violation. Last year some of these restrictions were lessened by substituting a spending rate test, which assumes regulatory compliance as long as specified percentages of the proceeds are expended by specified times after the bond proceeds are received by the city. While these amendments have eased the compliance burdens, roughly half of the officials urging relaxation of municipal bond restrictions specifically mentioned arbitrage restrictions.

Other Constructive Actions

The other actions mentioned by a sizable proportion of the officials were:

- reductions in the federal deficit (7 percent),

- provide increased assistance in complying with environmental regulations (7 percent),
- maintain levels of federal aid (5 percent) and,
- help with drug law enforcement (2 percent).

One quarter of the officials listed concerns that didn't fall into one of the larger categories discussed above. Some random examples of these "other constructive actions" include

- more direct communication
- establish long term regulatory parameters for state and local environmental implementation
- contain health insurance costs
- assume responsibility for issues of national concern (housing costs, homelessness, drug related crimes, etc.)

Conclusions

This report has discussed a wide range of stresses on the municipal budgets of America's cities and towns and a wide range of constructive actions that federal and state governments could take to help reduce the level of these problems. While city budgeting will always involve decision-making and trade-offs between competing objectives, the municipal officials whose views have been summarized in this report outline a broad agenda for productive intergovernmental discussion to ease some of the strains and more effectively serve the citizens whom all these governments have in common and to whom they are responsible.

APPENDIX A

How the Survey Was Done

In April, 1990, a city fiscal conditions questionnaire was sent to budget and fiscal officers of 1,457 American cities and towns by NLC's Office of Policy Analysis and Development.

The questionnaire asked for a three-year history of financial and tax items and included a series of questions about budget adjustment strategies and factors putting pressure on city budgets. Surveys from more than 570 cities were received in time to be included in the tabulations included in this report.

The questionnaires were returned to the Center for Public Management and Regional Affairs, Miami University, Oxford, Ohio, where they were compiled and coded and the data was put into a computer-readable format.

Tables A-1 and A-2 summarize the response rates by population classes and the regional and population size distribution of the responding cities. Table A-3 shows the respondents by state and population size.

Table A-1
Cities Surveyed by City Size

City Population	Number of Cities In This Class	Number of Surveys Sent	Number Returned	Percent Responses
300,000 and over	51	51	34	66
100,000–299,999	132	132	77	58
50,000–99,999	304	304	114	38
10,000–49,999	2185	970	351	36
Total	2672	1457	576	40

Table A-2
Responding Cities by Region and Population Size

	Total	300,000 and over	100,000 to 299,999	50,000 to 99,999	10,000 to 49,999
Northeast	112	4	9	21	78
Midwest	158	11	16	33	98
South	172	10	32	29	101
West	134	9	20	31	74
Total	576	34	77	114	351

Table A-3
1990 NLC Financial Survey Cities Tabulated by State and Population Size

States	10,000 to 49,999	50,000 to 99,999	100,000 to 299,999	300,000 and over	Total
Alabama	5	1	3	0	9
Alaska	0	0	1	0	1
Arizona	4	2	2	2	10
Arkansas	2	2	1	0	5
California	30	20	8	4	62
Colorado	6	3	3	0	12
Connecticut	5	5	4	0	14
Delaware	0	1	0	0	1
District of Columbia	0	0	0	1	1
Florida	15	5	5	2	27
Georgia	3	1	3	1	8
Hawaii	1	0	0	1	2
Idaho	2	0	1	0	3
Illinois	22	7	0	1	30
Indiana	5	2	3	1	11
Iowa	2	1	1	0	4
Kansas	4	1	1	0	6
Kentucky	6	1	2	0	9
Louisiana	6	5	2	0	13
Maine	5	1	0	0	6
Maryland	5	0	0	1	6
Massachusetts	9	3	0	1	13
Michigan	6	7	5	0	18
Minnesota	8	1	1	1	11
Mississippi	1	0	1	0	2
Missouri	13	3	1	2	19
Montana	2	1	0	0	3
Nebraska	2	0	1	1	4
Nevada	1	0	1	0	2
New Hampshire	2	1	0	0	3
New Jersey	19	4	2	0	25
New Mexico	5	0	0	1	6
New York	13	2	1	1	17
North Carolina	11	2	2	1	16
North Dakota	1	0	0	0	1
Ohio	26	5	2	4	37
Oklahoma	5	1	0	1	7
Oregon	7	0	1	1	9
Pennsylvania	22	3	2	2	29
Rhode Island	1	2	0	0	3
South Carolina	0	0	1	0	1
South Dakota	2	1	0	0	3
Tennessee	10	0	0	1	11
Texas	23	9	7	2	41
Utah	3	4	1	0	8
Vermont	2	0	0	0	2
Virginia	7	0	5	0	12
Washington	11	1	2	0	14
West Virginia	2	1	0	0	3
Wisconsin	7	5	1	1	14
Wyoming	2	0	0	0	2
Totals	351	114	77	34	576

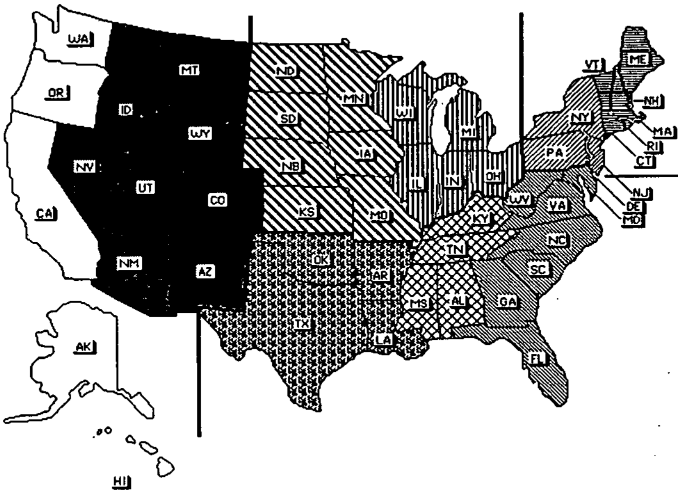


Table A-4
Regions and Divisions

Northeast
- **New England**
  - Connecticut
  - Maine
  - Massachusetts
  - New Hampshire
  - Rhode Island
  - Vermont
- **Mid-Atlantic**
  - New Jersey
  - New York
  - Pennsylvania

Midwest
- **East North Central**
  - Illinois
  - Indiana
  - Michigan
  - Ohio
  - Wisconsin
- **West North Central**
  - Iowa
  - Kansas
  - Minnesota
  - Missouri
  - Nebraska
  - North Dakota
  - South Dakota

South
- **South Atlantic**
  - Delaware
  - District of Columbia
  - Florida
  - Georgia
  - Maryland
  - North Carolina
  - South Carolina
  - Virginia
  - West Virginia
- **East South Central**
  - Alabama
  - Kentucky
  - Mississippi
  - Tennessee
- **West South Central**
  - Arkansas
  - Louisiana
  - Oklahoma
  - Texas

West
- **Mountain**
  - Arizona
  - Colorado
  - Idaho
  - Montana
  - Nevada
  - New Mexico
  - Utah
  - Wyoming
- **Pacific**
  - Alaska
  - California
  - Hawaii
  - Oregon
  - Washington

Cities Responding to the 1990 Fiscal Conditions Survey

ALASKA
Anchorage

ALABAMA
Bessemer
Birmingham
Decatur
Eufala
Huntsville
Montgomery
Mountain Brook
Ozark
Tuscaloosa

ARKANSAS
Camden
Fort Smith
Little Rock
Malvern
Pine Bluff

ARIZONA
Bullhead City
Flagstaff
Glendale
Mesa
Peoria
Phoenix
Scottsdale
Tempe
Tucson
Yuma

CALIFORNIA
Alhambra
Anaheim
Azusa
Bell
Beverly Hills
Burbank
Chico
Chula Vista
Compton
Corona
Costa Mesa
Cupertino
Daly City
Eureka
Fairfield
Folsom
Fresno
Fullerton
Garden Grove
Gardena
Glendora
Hesperia
Indio
Irvine
Laguna Beach
La Mesa
La Verne
Lawndale
Lemon Grove
Long Beach
Los Angeles
Menlo Park
Modesto
Monrovia
Montclair
Moreno Valley
Ontario
Palo Alto
Pomona
Rancho Palos Verdes
Redlands
Richmond
Rohnert Park
Sacramento
Salinas
San Carlos
San Diego
San Francisco
San Gabriel
San Leandro
San Mateo
Santa Ana
Santa Barbara
Seaside
Suisun City
Tracy
Turlock
Victorville
Walnut Creek
West Covina
West Hollywood
Whittier
Yuba City

COLORADO
Arvada
Brighton
Colorado Springs
Durango
Fort Collins
Grand Junction
Lakewood
Longmont
Northglenn
Pueblo
Thornton
Westminster

CONNECTICUT
Bridgeport
Bristol
Greenwich
Groton
Hartford
Milford
New Britain
Norwalk
Plainville
Stamford
Torrington
Waterbury
Waterford
West Hartford

DELAWARE
Wilmington

DISTRICT OF COLUMBIA
Washington

FLORIDA
Clearwater
Cooper City
De Land
Deerfield Beach
Fort Lauderdale
Fort Pierce
Gulfport
Hollywood
Jacksonville
Largo
Melbourne
Miami Beach
Miami
New Smyrna Beach
North Miami
Orlando
Ormond Beach
Pembroke Pines
Pompano Beach
Port Orange
Sanford
South Miami
St. Petersburg
Tampa
Temple Terrace
Wilton Manors
Winter Haven

GEORGIA
Albany
Atlanta
Columbus
Douglas
Macon
Savannah
Smyrna
Waycross

HAWAII
Hilo
Honolulu

IDAHO
Boise
Moscow
Pocatello

ILLINOIS
Addison
Alton
Arlington Heights
Bartlett
Bloomingdale
Chicago
Crystal Lake
Decatur
Des Plaines
Elk Grove Village
Evanston
Forest Park
Freeport
Highland Park
Hoffman Estates
Kewanee
LaGrange
Lake Forest
Maywood

Mount Prospect
Mundelein
Normal
North Chicago
O'Fallon
Oak Park
Quincy
Rock Island
Streator
Urbana
Waukegan

INDIANA
Bloomington
Evansville
Fort Wayne
Frankfort
Gary
Goshen
Hobart
Indianapolis
La Porte
Muncie
New Castle

IOWA
Bettendorf
Des Moines
Ottumwa
Sioux City

KANSAS
Great Bend
Hutchinson
Leawood
Manhattan
Overland Park
Wichita

KENTUCKY
Florence
Frankfort
Jeffersontown
Lexington
Louisville
Madisonville
Owensboro
Somerset
Winchester

LOUISIANA
Alexandria
Baton Rouge
Bossier City
Houma
Kenner
Lafayette
Lake Charles
Minden
Monroe
New Orleans
Opelousas
Shreveport
Slidell
Thibodaux

MASSACHUSETTS
Amherst
Boston
Chicopee
Concord
Gardner
Hudson
Longmeadow
Medford
Oxford
Peabody
Quincy
Shrewsbury
Stoneham

MARYLAND
Baltimore
Bowie
College Park
Frederick
Laurel
Takoma Park

MAINE
Augusta
Lewiston
Portland
Saco
Scarborough
South Portland

MICHIGAN
Ann Arbor
Auburn Hills
Bay City
Detroit
Farmington Hills
Flint
Fraser
Kentwood
Lansing
Livonia
Mount Clemens
Pontiac
Roseville
Royal Oak
Saginaw
Sterling Heights
Traverse City
Troy
Wyoming

MINNESOTA
Anoka
Brooklyn
Fairmont
Fridley
Minneapolis
Moorhead
Owatonna
Rochester
St. Paul
St. Cloud
West St. Paul

MISSOURI
Arnold
Bellefontaine
Blue Springs
Clayton
Columbia
Excelsior Springs
Ferguson
Florissant
Joplin
Kansas City
Kirksville
Maplewood
Overland
Raytown
Rolla
Springfield
St. Charles
St. Louis
St. Joseph

MISSISSIPPI
Biloxi
Jackson

MONTANA
Billings
Helena
Missoula

NEBRASKA
Hastings
Lincoln
Omaha
Scottsbluff

NEVADA
North Las Vegas
Reno

NEW HAMPSHIRE
Derry
Durham
Nashua

NEW JERSEY
Asbury Park
Bayonne
Brick Township
Carteret
Denville
Dover
East Brunswick
Elizabeth
Fort Lee
Hillsdale
Jersey City
Linden
Maplewood
Middletown
Montville Township
Morristown
Mount Laurel
Old Bridge
Paramus
Patterson
Rahway
Randolph
River Edge
Saddle Brook
Teaneck
Woodbridge

NEW MEXICO
Albuquerque
Artesia
Gallup
Grants
Los Alamos
Santa Fe

NEW YORK
Buffalo
Corning

Freeport
Garden City
Harrison
Hornell
Jamestown
Lackawanna
Newburgh
Ogdensburg
Plattsburgh
Saratoga Springs
Spring Valley
Tonawanda
Troy
Utica
Yonkers

NORTH CAROLINA

Albemarle
Asheville
Burlington
Charlotte
Concord
Greensboro
Henderson
High Point
Kannapolis
Laurinburg
Lumberton
Morganton
Reidsville
Statesville
Wilmington
Winston-Salem

NORTH DAKOTA

Dickinson

OHIO

Akron
Ashland
Bellefontaine
Broadview Heights
Brunswick
Centerville
Cincinnati
Circleville
Cleveland
Columbus
Coshocton
Dayton
Elyria
Euclid
Forest Park
Garfield Heights
Kettering
Lakewood
Mansfield
Marietta
Mount Vernon
New Philadelphia
Newark
North Royalton
Oregon
Painesville
Sandusky
Sheffield Lake
Sidney
Sylvania
Tiffin
Toledo
University Heights
Urbana
Wickcliffe
Wooster
Xenia

OKLAHOMA

Claremore
El Reno
Lawton
Moore
Oklahoma City
Okmulgee
The Village
Tulsa

OREGON

Ashland
Eugene
Hillsboro
Medford
Newberg
Oregon City
Pendleton
Portland
Woodburn

PENNSYLVANIA

Allentown
Aston
Bloomsburg
Chambersburg
Erie
Greensburg
Hempfield Township
Lansdowne
Lebanon
Lower Allen Township
Lower Merion
McCandless
Meadville
Monroeville
Mount Lebanon
Norristown
Philadelphia
Phoenixville
Pittsburgh
Pottsville
Reading
Ridley
Sunbury
Swissvale
Upper St. Clair
Wilkes-Barre
Williamsport
Yardley
York

RHODE ISLAND

Barrington
East Providence
Pawtucket

SOUTH CAROLINA

Columbia

SOUTH DAKOTA

Pierre
Sioux Falls
Watertown

TENNESSEE

Cookeville
Gallatin
Germantown
Humboldt
Johnson City
McMinnville
Memphis
Morristown
Oak Ridge
Paris
Springfield

TEXAS

Amarillo
Arlington
Austin
Bellaire
Benbrook
Borger
Brownfield
Bryan
Burleson
Copperas Cove
Corpus Christi
Deer Park
Edinburg
Fort Worth
Freeport
Garland
Greenville
Haltom City
Irving
Kingsville
Laredo
Lubbock
McAllen
Nacogdoches
Pearland
Plainview
Plano
Port Arthur
Port Neches
Richardson
Round Rock
San Antonio
San Marcos
Sweetwater
Tyler
Uvalde
Victoria
Waco
Weatherford
Weslaco
White Settlement
Wichita Falls

UTAH

Layton
Murray
North Ogden
Ogden
Orem
Salt Lake City
Sandy City
West Valley City

VIRGINIA
Alexandria
Blacksburg
Charlottesville
Chesapeake
Front Royal
Hopewell
Leesburg
Newport News
Portsmouth
Roanoke
Staunton
Waynesboro

VERMONT
Brattleboro
Essex Junction

WASHINGTON
Bellevue
Bremerton
Edmonds
Kelso
Kent
Kirkland
Lacey
Lynnwood
Olympia
Puyallup
Spokane
Tacoma
Vancouver
Wenatchee

WISCONSIN
Brookfield
Green Bay
Greendale
Janesville
Kenosha
Madison
Mequon
Milwaukee
Oak Creek
Sheboygan
Watertown
Waukesha
West Allis
West Bend
Whitewater

WEST VIRGINIA
Charleston
Vienna
Wheeling

WYOMING
Gillette
Sheridan

APPENDIX B

About the Center for Public Management and Regional Affairs

The Center for Public Management and Regional Affairs, Miami University, Oxford, Ohio, engages in applied research, technical assistance services, training and education, and database development to serve rural and other small local governments in southwestern Ohio. Funded by the Rural University Project, the center assists local governments in such areas as public administration, technical assistance, capacity building, local government economic development and planning, public program evaluation, and policy research.

Center projects are basically of two types: those initiated upon the request of local governments or those initiated by center staff as ongoing programs for local governments in the region.

To carry out its projects, the center draws upon faculty and graduate and undergraduate students in such fields as public administration, policy analysis, political science, environmental sciences, geography, and economics.

Services are delivered through field associates, project teams, or faculty consultants.

The Director of the center is Dr. Philip A. Russo, Jr.

Related NLC Publications

This report has discussed how local financial conditions affect other municipal programs and intergovernmental fiscal relationships generally. This year's survey questionnaire highlighted issues relating to infrastructure finance and impact fees, drug abuse treatment, liability, local tax rate plans, and state aid to municipalities.

NLC also has published more in-depth studies relating to these issues, which are highlighted below. To order these publications, simply check the box next to the publication you wish to order, fill out the order form, and return it to the NLC Publications Sales Office at the address below.

☐ FINANCING INFRASTRUCTURE: INNOVATIONS AT THE LOCAL LEVEL. Analyzes 24 case studies of innovative financing techniques for public works, including examples of special districts, exactions, utilities, and public-private equity arrangements. 140 pages. $20/NLC members $15.

☐ LOCAL STRATEGIES IN THE WAR AGAINST DRUGS. Provides 74 short case-study descriptions of innovative and effective local government programs to combat drug abuse, including efforts dealing with education and prevention, treatment, and prevention of drug-related crime. 155 pages. $20/NLC members $15.

☐ STATE AID TO CITIES AND TOWNS. Analyzes the major components of state financial aid to cities and compares varying levels of assistance between states, including data on total aid, aid by function, aid per city resident, and other indicators. 36 pages. $15/NLC members $10.

☐ LOCAL GOVERNMENT TAX AUTHORITY AND USE. Analyzes a wide variety of taxes local governments use to finance operations, including highlights of local property, sales, and income tax rates, selective sales taxes (hotel-motel, gasoline, alcohol) and local user charges and their use by local governments. 156 pages. $20/NLC members $15.

☐ MUNICIPAL LIABILITY: WHAT SHOULD BE DONE ABOUT SECTION 1983? Discusses the 1871 law and its impact on cities, highlights problems caused by the loss of sovereign immunity and attorney fee award provisions, and analyzes policy proposals for changing Section 1983. 50 pages. $15/NLC members $10.

☐ CITY FISCAL CONDITIONS IN 1989/1988/1987. Presents the results of NLC's annual survey of city officials on current economic and fiscal conditions in their cities and the outlook for the future. $20/NLC members $15/each.

YES, please send me the publications I have checked above.

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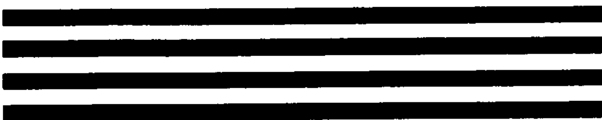
About The National League of Cities

The National League of Cities was established in 1924 by and for reform-minded state municipal leagues. It now represents 49 leagues and more than 1,400 cities directly and, through the membership of the state municipal leagues, more than 16,000 cities indirectly.

NLC serves as an advocate for its members in Washington in the legislative, administrative, and judicial processes that affect them; develops and pursues a national urban policy that meets the present and future needs of our nation's cities and the people who live in them; offers training, technical assistance and information to municipal officials to help them improve the quality of local government in our urban nation; and undertakes research and analysis on topics and issues of importance to the nation's cities.



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1301 Pennsylvania Avenue NW
Washington, D.C. 20004
(202) 626-3000

Senator SARBANES. Mr. Gold, please proceed.

STATEMENT OF STEVEN D. GOLD, DIRECTOR, CENTER FOR THE STUDY OF THE STATES, NELSON A. ROCKEFELLER INSTITUTE OF GOVERNMENT, STATE UNIVERSITY OF NEW YORK, ALBANY

Mr. GOLD. Thank you, Mr. Chairman, for the opportunity to testify. I'd like to summarize my prepared statement.

State fiscal conditions today are at their lowest ebb since the 1983 recession. State finances rebounded powerfully after that period of weakness because States raised taxes and because the economy was strong.

For most States, the period from 1984 to 1989 was relatively unstressed. If the aftermath of the current period of fiscal stress were similar to that from the 1983 low point, the outlook for the States would not be very bleak. But I believe that the analogy to 1983 is not perfect at all.

Because of economic and demographic trends, the 1990's are likely to be considerably more stressful for States than the last half of the 1980's. State fiscal problems of 1991 are not just a one-shot phenomenon and not just due to the recession.

Because Ray Scheppach has already talked about the recent survey by the National Governors' Association, I won't go into the specifics on that. I do want to mention a survey recently published by my Center for the Study of the States which shows that were it not for the tax increases passed last year, State tax revenue would be decreasing in real terms.

The rest of my testimony will cover three topics: First, some figures that show the increasing effort being made by State and local governments to raise revenue; second, the reasons why I think the 1990's are going to be stressful; and third, some comments on the situation policywise in 1991.

The first chart, table 5 in my prepared statement, that I have here shows State and local tax revenue, and also user charges relative to personal income. What it shows is that since 1982, State and local taxes and charges have been rising faster than people's income. They're up to about $14.14 per $100 of personal income as of 1989, and they're within 3 percent of the all-time peak which was reached in 1973.

Now this information includes both State and local governments. If you look just at State governments alone, you would find that taxes and charges are now a higher percentage of personal income than they've ever been before. This is a sign of the fact that they are taking on a bigger role in our Federal system.

The second point is that the State tax increases in 1990 were unusually large, about 3 percent of total tax collections. And as the chart shows, this was the highest year since 1983 as a percentage, and you have to go all the way back to 1971 to find another year where State tax increases were larger as a percentage of total State tax revenue.

Even though it was an election year, many States found it necessary to raise taxes last year.

And the third point is that even as States have been raising taxes, in the 1980's, local taxes were rising faster. In fact, in 8 of the last 10 years, local taxes rose more than State taxes.

So, in part because Federal aid reductions were much greater for local governments than for State governments, local tax increases have been outpacing State tax increases in most recent years.

Now looking ahead at the 1990's I believe that State and local taxes will continue to rise relative to personal income because of the pressure to increase spending. And State and local governments are going to experience considerable fiscal stress in the 1990's.

There are strong upward pressures on spending that have already been mentioned. I have two charts that show what those pressures have been like in the past.

This first one shows Medicaid spending relative to personal income, and you can see that it rose quite steadily from 1976 to 1989. But since 1989, it's been rising even faster and the curve is going up at a higher rate.

The graph also shows that welfare spending—other services for poor people in the States—actually were big budget losers through 1983 and have been holding their own from 1983 to 1989.

But even though Medicaid was going up a lot in the 1980's, corrections spending was going up even faster. And corrections was the fastest growing part of State spending in the 1980's, although in the 1990's, it's now being overtaken by Medicaid.

And as Ray Scheppach mentioned, in the current year, Medicaid is estimated to rise by 25 to 27 percent.

Senator SARBANES. When you use the word "corrections," what are you encompassing?

Mr. GOLD. By corrections spending, I mean prisons and other expenditures to take care of criminals.

Senator SARBANES. Not the police.

Mr. GOLD. No, not the police. Police spending is a separate thing. It's only taking care of the people after they're sentenced, including parole and probation, prison construction and running the prisons.

So there's strong pressure on spending. To make matters worse, the State revenue systems have some problems. The responsiveness of revenue to economic growth, which economists call the "elasticity of the tax system," has been falling. In part, that's because of the trend toward flatter income tax rates which was part of Federal reform and many State reforms. It's also because 15 States index their income tax and the growth of the service sector has slowed the growth rate of the sales tax base.

Besides the problems of strong increases in spending and weaker revenue growth, there are some other factors adding to State problems in the 1990's. Slower economic growth, fierce intergovernmental competition, Federal mandates, the aging of the population, rising school enrollment, court decisions, health cost inflation, AIDS, and the drug war are all going to add to State fiscal troubles in the 1990's.

Now I'd like to make a few comments about the policies this year.

There is considerable uncertainty about the direction of State budget and tax policy in 1991. There's been a lot of publicity about certain Governors, such as those in Massachusetts and Virginia, who are dealing with their budget deficits by proposing spending cuts and avoiding tax increases.

However, this is not necessarily typical of all States, and in fact, approximately half of the Governors have proposed tax increases. In one of my tables I listed 19 of them.

The most important tax increase proposals are in Connecticut and Tennessee, where the Governors have proposed new income taxes, and Oregon, where the Governor proposed a new sales tax.

But there are also big tax increase proposals in Rhode Island and Vermont, and as part of the strategy for balancing the budget, States like Arkansas, California, Kansas, Nevada, New York, North Carolina, and Pennsylvania are all relying on some significant tax increases.

Moreover, I think that after the budgets are finally passed, the tax increases that are adopted will be greater than those recommended by the Governors. While some Governors who recommended tax increases will not have success in having them endorsed, there will be more States where the legislature goes beyond the Governor in enacting tax increases.

So, in conclusion, many States are experiencing considerable fiscal stress now. A prompt end to the recession would be very helpful in reducing some of the stress. It will not, however, be sufficient by itself to return the budgets of many States to fiscal soundness because many States have structural deficits with spending increases needed to maintain current services rising faster than revenue from the existing tax system.

Now States can do a great deal to restore their fiscal health by reforming their tax, spending, and intergovernmental policies. But the economic and demographic trends of the 1990's are likely to cause persistent stress for many States. And therefore, it's important for the Federal Government not to make the already bleak picture even worse by imposing new, unfunded mandates, by further reductions in Federal aid, or by implementing tax policies that add to State fiscal difficulties.

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

[The prepared statement of Mr. Gold follows:]

PREPARED STATEMENT OF STEVEN D. GOLD

STATE FISCAL CONDITIONS AS OF EARLY 1991

Steven D. Gold, Director
Center for the Study of the States
Nelson A. Rockefeller Institute of Government
State University of New York
Albany, New York

Joint Economic Committee
Washington, D.C.

March 14, 1991

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State fiscal conditions are at their lowest ebb since 1983. State finances rebounded powerfully from their weakness eight years ago as a result of two developments--major increases in taxes and a stronger economy. For most states, the period from 1984 to 1989 was relatively unstressed.

If the aftermath of the current period of fiscal distress were similar to that from the 1983 low point, the outlook for the states would not be very bleak. The analogy to 1983 is, however, far from perfect. Because of economic and demographic trends, the 1990s are likely to be considerably more stressful for states than the last half of the 1980s. The state fiscal problems of 1991 are not a one shot phenomenon.

This presentation consists of eight parts: (1) an overview of the current fiscal situation; (2) trends in year-end balances held by states; (3) spending trends; (4) patterns of past state tax increases; (5) the relationship of state to local fiscal trends; (6) likely trends in the remainder of the 1990s; (7) major policy choices this year; and (8) a brief conclusion.[1]

1. Current trends in budget deficits and revenue growth

Recent surveys by both National Governors' Association/National Association of State Budget Officers and National Conference State Legislatures document that state fiscal distress is widespread. According to both surveys, more

than half of the states have seen revenue inflows below the levels expected when budgets were adopted. Both surveys also understate the severity of revenue shortfalls since they are based on the situation as of mid-December. At that time data were available for at most five months of the current state fiscal year (which generally started in July). Since the severe economic decline did not begin until October (and there is usually a one month lag between economic activity and tax revenue), revenue trends are surely more adverse than the surveys indicate.

The Center for the Study of the States recently reported that state tax revenue in the October-December 1990 quarter was up 6.4 percent from the corresponding period in 1989. Without tax increases passed last year, the growth would have been only 4.2 percent, considerably less than the 6 percent rate of inflation. The sales tax--the biggest source of state tax revenue--was particularly weak. Revenue from it was only 3.1 percent higher than in 1989, when the effects of legislated tax increases are eliminated.

NCSL's survey also reported that 28 states were projecting budget deficits, not only because of the revenue shortfalls but also because of underestimates of spending, particularly for Medicaid. *State Budget and Tax News*, an authoritative newsletter tracking state fiscal trends, reports that the situation is even worse. Eighteen of the 20 largest states have unbalanced budgets in the current fiscal year (the only exceptions being Texas and

Washington). The proportion of deficit budgets is lower among smaller states, but it is nevertheless higher than the figure reported by NGA/NASBO and NCSL.

It is important to clear up a semantic confusion about deficits.[2] Since 49 states have constitutional or legislative prohibitions against deficits, how can so many states have deficits? There are at least four answers to this question:

1. When the term *deficit* is used in the states, it may have two distinct meanings. One meaning is like the *federal* usage, indicating that the flow of revenue during a year is less than the flow of spending. States do *not* have deficit prohibitions in that sense. The other meaning takes into account balances of revenue carried over from previous years. A state would have a deficit if its spending exceeded the sum of its current revenue and balances carried forward. That is the sense in which deficits are prohibited. (It is even more complicated, because some states do not include budget stabilization funds--Rainy Day Funds--in their deficit calculations, while others do.)
2. States differ in the strictness of their prohibitions against budget deficits. Some require only that the governor submit a balanced budget proposal; others require only that the budget as

enacted by the legislature should be balanced; others require that the budget be balanced over the course of a biennial budget cycle, not at the end of each fiscal year; and some require that the actual budget be balanced every year (ACIR: 6-7).

3. States in fiscal difficulties often use stop gap measures to balance budgets, such as deferral of spending (including delays in payments to vendors and in distribution of financial aid to local governments), acceleration of tax collections, and borrowing from trust funds. In some cases, states even borrow from private lenders to obtain revenue to "balance" their budgets. In many of these cases, there is a deficit according to Generally Accepted Accounting Principles even though a deficit may be avoided on a cash accounting basis.
4. States with prospective deficits usually act to reduce spending or raise taxes to avoid incurring an actual deficit.

Additional perspective on the current state of state finances can be obtained by considering past trends in fund balances, spending, and tax increases.

2. **Year-end balances**

As Table 1 shows, states ended fiscal year 1990 with balances of about $9.1 billion, representing 3.3 percent of general fund spending. These balances include both the general fund and budget stabilization funds. Except in

1987, when balances were slightly lower, this was the lowest level of balances relative to total spending in any year following 1983.

The major shortcoming of the national aggregate figures in Table 1 is that they mask considerable variation among states. As of the end of fiscal 1990, 10 states had deficits or balances less than 1 percent of spending; 8 states had balances between 1 percent and 2.9 percent of spending; 10 states had balances between 3 percent and 4.9 percent of spending; and 22 states had balances equal to at least 5 percent of spending.

In other words, close to half of the states went into the current fiscal year with at least a moderate cushion to protect them from the depredations of the recession. The situation in 1991 is not really comparable for most states to that in 1983 because in the earlier period states had already been battling depressed economic conditions for several years--the brief recession of 1980 and the long, severe recession of 1981-82.

In relation to national economic trends, there is a closer analogy between the winter of 1981-82 and the current period than there is with the winter of 1982-83. When state budgets were proposed in January 1982, the consensus economic forecast was that the recession would end near the middle of the year. Accepting this forecast, most states assumed that the improving economy would help them avoid the need to raise taxes.

In fact, the recession did not end until November 1982. By the start of 1983 sessions, states had already exhausted the potential for stop gap measures and had gone through rounds of budget cuts, so they were prepared to raise taxes to keep their budgets in the black.

The current economic situation is similar to that in early 1982, with many economists predicting that the recession will end by summer. There is a temptation for states to accept this forecast because it makes it much easier to enact a fiscal 1992 budget without raising taxes. At this point, it is too early to tell whether many states will base their budgets on that forecast.

3. Spending

Increases in state general fund spending from 1978 to the present are shown in Table 2. As they indicate, between fiscal years 1984 and 1990, inflation-adjusted state general fund spending rose at varying rates between 2.6 percent and 4.6 percent per year. During the two previous years, 1982 and 1983, real spending decreased.

Insight into the forces driving up state spending may be obtained by examining its main components. Table 3 shows state spending per $100 of personal income from 1976 to 1989. Because the intent in preparing the table was to focus on spending paid for by taxes, the figures shown exclude spending financed by federal aid and user charges. It was not, however, possible to exclude all spending except for that paid for by taxes, so the table includes a

considerable amount of other spending, such as outlays paid for by miscellaneous revenue and from borrowing.[3]

Some important trends are apparent in state spending patterns:

- o Medicaid and corrections have been growing much faster than other parts of the budget. Their increases have restricted the amount of revenue that could be spent on other programs.
- o Non-Medicaid welfare spending (e.g., Aid to Families with Dependent Children, other income maintenance programs, and services for the poor) was the slowest growing part of state budgets from 1976 to 1983, falling sharply relative to personal income and total state spending. It has grown about in line with personal income since then. The decrease occurred both in income maintenance and in other programs.
- o Elementary-secondary education is by far the largest component of state budgets. School spending has risen since 1983, when *A Nation at Risk* was published highlighting the deficiencies of schools, but its increase relative to personal income has not been dramatic.[6]
- o Public higher education spending has grown somewhat less rapidly than personal income. It does not appear to have benefited from the linkage between higher education and economic development that was

widely discussed in the 1980s. One important result of the slow growth of appropriations for higher education has been increased reliance on tuition. A major shift occurred in about 1983; before then, appropriations increases tended to exceed tuition increases, but the opposite pattern has prevailed since then (Wittstruck and Bragg).

- Health and hospital spending has grown about in line with personal income. This reflects rapid growth in health spending offset by relatively slow growth in hospital spending as a result of deinstitutionalization.
- Highway spending has risen considerably since 1984, but recent increases do not fully offset low spending in the late 1970s and early 1980s.

Although comparing spending to personal income is a useful way of analyzing changes over time, it is also appropriate to use some other perspectives in analyzing particular types of spending. For example, real per pupil state spending for elementary-secondary education rose 22 percent between 1983 and 1988, and real spending per full-time-equivalent student in higher education increased 12 percent. These increases appear somewhat more impressive than the changes in spending relative to personal income (Gold 1990b: 15).

Medicaid and corrections merit special attention because of their dynamic rates of increase. The most

important force driving up Medicaid spending during this period was inflation in health care costs. Despite strenuous state and federal efforts to contain the growth of Medicaid costs, the high rate of price increase for medical services (twice the general inflation rate) kept Medicaid growing faster than other state spending (Chang and Holahan; Holahan and Cohen). Federal mandates to expand coverage to additional services and more people have added to Medicaid spending increases.

The impact of federal mandates is highly uneven, with relatively small effects in states that had previously elected to provide optional services and major effects in states providing the bare minimum required by the Medicaid program. Low-income states in the Southeast have been among those hardest hit by the mandates.

Corrections spending rose even faster than Medicaid in the 1980s, as prison populations mushroomed. The main cause of higher corrections spending was not a crime wave. In fact, the crime rate fell sharply between 1980 and 1984 before rising through 1988. The number of crimes per 100,000 population was 5,664 in 1988, considerably lower than its 1980 level, 5,950. Demographic changes helped to keep the crime rate moderate in the 1980s, since there was a sharp decrease in the number of males between the ages of 16 and 24, the cohort that has the highest propensity to commit crimes. This decrease reflected the small number of births in the period following the baby boom (Gold 1990b: 78-79).

The main reason for the boom in corrections spending was the national trend to "get tough" on criminals, imposing more and longer sentences. This policy has major spending implications, since the average cost to construct a prison cell is at least $50,000 and the average cost of maintaining a prisoner is $25,000 per year. Another factor driving up spending was court orders to relieve overcrowding and improve conditions in other respects. As of January 1990, more than three-fourths of the states were under court order or consent decree to make such improvements, and the tally was similar through much of the 1980s.

Three recent figures dramatically highlight the pressures on state spending: in fiscal 1990, Medicaid and corrections rose 18 percent and 17 percent, respectively. In fiscal 1991, because of competition from those programs, appropriations for higher education institutions rose less than 4 percent, the smallest increase since at least the 1950s. (Eckl et al; Illinois State University).

The latest estimate of Medicaid growth indicates that spending this year is increasing even faster than in 1990. According to the federal budget recently submitted by President Bush, the increase of Medicaid spending is ~~27~~ 25 percent in the current federal fiscal year, with an additional 16 percent increase projected in fiscal year 1992.

4. Tax increases

Table 4 reports the estimated tax increases enacted by states annually since 1963. The year 1990 stands out for the relatively high level of tax increases--$8.6 billion, representing 3 percent of annual tax revenue.[4] Except for 1983, when tax increases were about 4.8 percent of annual tax revenue, this was the largest tax increase since 1971 (when tax increases represented 9.7 percent of revenue). The high level of tax increases indicates that considerable fiscal stress was already present even though the nation was not in recession.

Table 4 also shows clearly that there is a strong tendency for tax increases to be greater in years following elections than in years before elections. Precedent would lead one to expect, other things being equal, that tax increases in 1991 would be much greater than in 1990.

Other things are not, however, equal. The weak economic conditions prevalent in many parts of the nation would normally result in more tax increases because of the need to avoid deficits. On the other hand, the widespread perception of taxpayer resistance to higher taxes tends to inhibit tax increases. This conflict is discussed further in section 6 of this paper.

It is important to focus on more than just legislated tax increases because most of the growth of tax revenue occurs as a result of personal income growth. State tax revenue relative to personal income has been on a plateau

since 1984, fluctuating between $6.91 and $7.03 per $100 of personal income. This level is considerably higher than the 1980-82 period but below the peak level reached in 1978 ($7.10), as Figure 1 shows.

When revenue from user charges is considered, the picture changes somewhat, since user charges have been growing faster than taxes. As indicated in Table 5, the sum of revenue from state taxes and charges reached a new peak in 1989 ($7.98 per $100 of personal income), slightly higher than the previous peak ($7.94 in 1978).

Local government taxes and charges also should be considered. As shown in Table 5, in 1989 state-local revenue from both taxes and charges amounted to $14.14 per $100 of personal income. That is the highest level since 1978, but it is still about 2 percent below the peak reached in 1973.[5]

Table 6 shows how the composition of state tax revenue has been changing. There have been gradual increases in reliance on personal income and general sales taxes, although the movement in that direction has been much slower in the 1980s than in the 1970s.

A significant development during the past five years is an apparent decrease in the elasticity of state personal income and general sales taxes. (Elasticity is the percentage increase in tax revenue for each 1 percent increase in personal income.) This decrease in elasticity

means that revenue will not grow automatically by as much as it used to.

There are several reasons for the reductions in elasticity. For the personal income tax, the main considerations are legislated changes, particularly the trend toward flatter tax rates that accelerated in response to federal tax reform (Galper and Pollock). Fifteen states (more than one-third of the 40 states with broad-based income taxes) also have some degree of indexation for inflation. The increased proportion of income received by retirees has also tended to reduce elasticity, since retirement income is usually treated preferentially in comparison with labor and capital income. For the sales tax, the major development has been the growth of the service sector, which is taxed much less than the goods producing sector of the economy. Several states now estimate that the elasticity of their sales tax is approximately 0.9, considerably below the 1.1 figure estimated several years ago by the U.S. Treasury Department (1986).

A decrease in elasticity implies that states will have to raise tax rates more often in the 1990s than was necessary in the past, if they want to maintain the same rate of increase in revenue. Alternatively, states may increase elasticity by reforming their tax systems through such actions as broadening the sales tax to services, increasing reliance on the personal income tax, reducing the

extent to which the income tax is indexed, and increasing the progressivity of income tax rates.

5. Relationship to local fiscal trends

Although this report is concerned with state fiscal conditions, it is important to take account of trends at the local government level. Unfortunately, the data on local fiscal conditions and trends are not as complete as for states, in considerable measure because of the large number of local governments and the diversity among them.

Local governments have been increasing their taxes at a higher rate than states, even though their tax systems usually have a lower elasticity than state tax systems. As Figure 2 shows, in eight out of 10 years between 1980 and 1990, local taxes rose at a higher rate than state taxes. For the entire period, local tax revenue rose an estimated 136 percent and state tax revenue 117 percent.[6]

Local governments in the 1980s lost much more federal aid than states and increased taxes and user charges more. The largest local tax increases, as shown in Table 7, have been imposed by county governments, which have substantial responsibility for social services and health programs and suffered the most from federal aid reductions. Tax increases by cities and school districts lagged behind. (Special districts had even larger tax increases than counties, but they started from a low level. In 1988, they raised only 3.5 percent of local tax revenue.)

Several factors account for the difference in the path of federal aid for state and local governments in the 1980s. The majority of federal aid to states is for welfare (especially Medicaid and Aid to Families with Dependent Children) and highways, programs that were not as vulnerable to federal cutbacks as the newer aid programs that were established in the 1960s and 1970s and provided aid directly to cities (Ladd). In fact, as noted above, Medicaid grew at a high rate, primarily because of inflation in health care costs. Another consideration was the Reagan policy of consolidating aid into block grants; this involved converting many former federal-local programs into federal-state grants, with states distributing funds to localities (Gold 1990a).

State aid to local governments assumed increasing importance in the 1980s as the federal government reduced its financial support for localities. For example, in 1978, municipalities received $0.84 of state aid for every dollar of federal aid (excluding aid for welfare and education programs, which are not municipal functions in most states). By 1988, municipalities received $2.75 of such state aid for every dollar of federal aid (Peterson).

Considerable care is needed in analyzing trends in state aid for several reasons. As reported by the U.S. Census Bureau, between 1980 and 1989 state aid rose 96.4 percent, which is less than the growth of total state general spending (105.6 percent) or local direct general

spending (103.7 percent). The National Association of State Budget Officers (1989) has reported, however, that between 1982 and 1987 state aid rose more than total state spending, although the opposite pattern was indicated by Census Bureau data. The major reason for the difference is that Census data counts as state aid money that states receive from the federal government to be passed through to local governments; the amount of such "pass through" aid fell in the 1980s, reducing the apparent increase in state aid to localities.

The second reason for the difference between Census and NASBO data is the assumption of local functions by states. When a state takes over a function, any aid that it previously provided disappears, and its spending is counted as state spending, not assistance to local governments. NASBO identified 18 states that had assumed local programs between 1982 and 1987, most often in the area of the courts.

Both Census and NASBO data are needed to adequately describe trends in state aid. While NASBO data are preferable because of the two adjustments discussed above, they are available only for selected years, and the reporting methodology used in various states is not as consistent as in Census reports.

6. Likely trends in the 1990s

The most likely prospect is that state and local tax revenue will continue to grow faster than personal income, pushed up by pressures for increased spending. State and

local governments will experience considerable fiscal stress. Although space does not permit a full discussion of the nature of this fiscal stress, some of its major sources can be noted here:[7]

- Economic growth is likely to be slower than it has been since the economy emerged from the last recession in 1983. This is due both to the likely slow growth of the labor force and to the existence of much less unemployed productive capacity than there was in 1983.
- Intergovernmental competition for economic development is likely to intensify, in part because of the slowing of economic growth. States where the economic growth rate is below average are more likely to have contracting economies when the national equilibrium growth rate is slower.[8] A contracting economy is a powerful spur to competitive action.
- Federal mandates may add to spending increases, and federal aid is not likely to keep pace. Federal tax changes, curtailing the deductibility of state and local taxes and increasing excise taxes, may also have adverse effects.
- The aging of the population will add to the costs of Medicaid and health services for retired employees. A 43 percent increase is projected in the age group

75 years and older, which accounts for a high proportion of long-term care costs.

- School enrollment will increase moderately (7.5 percent over the decade), according to the National Center for Education Statistics, considerably faster than it did in the 1980s.
- Court decisions are likely to have adverse budget impacts. State courts may become considerably more active in requiring reform of school finance. After a lull for a number of years, three state supreme courts (Kentucky, New Jersey, and Texas) forced major tax increases to reduce educational disparities in 1989 and 1990. Other adverse rulings will drive up costs for mental health, corrections, and Medicaid.
- Medical care prices will continue to increase rapidly.
- AIDS and the drug war will be more expensive. The National Council on Crime and Delinquency, for example, projects a 68 percent increase in prison populations in 12 states between 1989 and 1994, with the trend toward imprisoning drug offenders being a major contributor (Austin and McVey).

Most of the above mentioned pressures for higher spending are not the result of service enhancements. If higher levels of service are sought, for example, to expand

early childhood education programs or increase teacher salaries, that will add to prospective tax increases.

A major question is the willingness of taxpayers to pay the higher taxes that appear likely. The first test of this occurred in November 1990, when tax protest initiatives appeared on the ballot in seven states. Although all but one of these proposals was defeated, many of them had considerable support. Moreover, the unexpectedly narrow re-election of Senator Bill Bradley in New Jersey provided impressive evidence of the virulence of the tax revolt backlash in that state, where large increases in both the personal income and general sales taxes had been enacted. A further test of voter tolerance for tax increases is likely in 1992 if, as the author expects, widespread state tax increases are enacted in 1991 legislative sessions.

Much depends on how skillfully elected officials explain the need for tax increases. With the two biggest causes of higher taxes being increased spending for Medicaid and corrections, tax increases could be hard to sell to middle- and high-income voters. Unless an effective educational campaign is launched, they may not see any improvement in service levels commensurate with the higher taxes they are paying. The direct beneficiaries of Medicaid are the poor, and the connection between the drug war and higher taxes may not be appreciated.

7. Policies in 1991

There is considerable uncertainty about the direction of state budget and tax policy in 1991. Although at least 19 governors have proposed tax increases, fewer major tax increases have been proposed than would be expected in view of the precarious state of state finances.

There are at least four major reasons: To a considerable extent it is because of the perception of voter reluctance to pay higher taxes. Another important reason is that many governors, recognizing the bleak long-run fiscal outlook, are attempting to cut back and reform programs, even though this entails difficult political fights. Third, as discussed above, some states may be counting on a promt end to the recession to improve their revenue situation. Finally, tax increases will be more politically acceptable if they are arrived at following an extended education process in which the implications of the alternatives are thoroughly explored.

Table 8 lists the major tax increases proposed by governors. The most significant actions are new personal income taxes proposed in Connecticut and Tennessee and a new general sales tax in Oregon. The next largest increases have been proposed in Rhode Island and Vermont. Other states, such as Arkansas, California, Kansas, North Carolina, and Pennsylvania, also are relying on tax increases as a significant part of their strategy for balancing the budget in fiscal year 1992.

It is very likely that the tax increases eventually enacted in many states will exceed those proposed by governors thus far. There are some other very important questions that remain to be answered:

- What shape will the tax increases take? Will states opt for regressive sales and excise taxes, or will they raise income taxes and use tax credits to offset the regressivity of the regressive taxes they increase? Unfortunately, while Congress showed considerable concern about the distributional impact of tax changes in 1986 and 1990, not many states have done likewise.
- How deep will the cuts be in spending?
- To what extent will budget reductions be targeted at programs for the poor and aid to local government? Quite a few governors have proposed sharp reductions in general assistance and/or Aid to Families with Dependent Children. Some governors have identified revenue sharing for local governments as a program where especially large reductions are proposed.
- How much reform will be incorporated in the cutback strategies? The environment prevailing in 1991 is a good one for attacking "sacred cows" and thereby making state government operations more efficient and effective.

8. Conclusion

Many states are experiencing considerable fiscal stress now. A prompt end of the recession would be very helpful in reducing some of the stress. It will not, however, be sufficient by itself to return the budgets of many states to fiscal soundness because they have structural deficits, with spending increases needed to maintain current services rising faster than revenue from the existing tax system.

States can do a great deal to restore fiscal health by reforming their tax, spending and intergovernmental policies. But the economic and demographic trends of the 1990s are likely to cause persistent stress for many states. It is important that the federal government not make the already bleak picture even worse by increasing unfunded mandates, reducing aid, or implementing tax policies that add to state fiscal difficulties.

NOTES

1. For fuller discussion of the issues discussed here, see Gold (1990b) and Gold (1991c) and the sources cited therein.

2. Another source of confusion is that many analysts rely upon National Income and Product Account (NIPA) data rather than general fund data to track trends in state finances. (Gold, 1986) The use of NIPA for this purpose is inappropriate for several reasons. (None of these criticisms detract from NIPA's value for its primary purpose, macroeconomic analysis.)

- When state and local governments borrow for capital spending, NIPA counts the spending but not the revenue, creating a negative bias in the reported balance during periods when capital spending is increasing.
- NIPA data that separate state and local government finances are available only with a long time lag, so the only timely information fails to make that separation. Consequently, NIPA does not enable one to distinguish between fiscal problems at the state and local levels.
- NIPA data do not distinguish between core state activities that are funded by general taxes and fringe programs that are financed with earmarked taxes and non-tax revenue.
- NIPA data do not make it possible to tell if a small number of states are responsible for the aggregate trends that are reported.

On the other hand, general fund data have an important shortcoming, namely that states do not always follow consistent practices in reporting their financial condition. As explained in the text, they can adopt practices and accounting conventions that understate fiscal problems when conditions are negative and also understate available resources when conditions are positive.

Although NIPA and general fund data do not always provide inconsistent indications, that was the case in mid-1989, when general funds were in relatively healthy condition while NIPA was reporting large deficits. Currently, some analysts relying on NIPA have stated that deficits are worse than any in the 1980s, while general fund data do not suggest that conditions are that severe.

3. The figures for total spending and "other" spending tend to overstate net spending increases through 1989 because they include very large increases in interest payments, which were paralleled by large increases in interest revenue. In 1989, 49 percent of long-term state general debt was classified as "public debt for private purposes." Even excluding interest payments, "other" spending had a large increase that is not explainable with available information. The principal value of Table 5 is its depiction of how specific components of spending have changed over time, rather than how it indicates total spending has changed.

4. Primarily because of conceptual differences in the definition of tax increases, NASBO reported a higher figure for 1990 tax increases than NCSL. For example, NASBO included a California gas tax increase enacted by initiative and New York's decision to postpone a scheduled tax rate decrease. NCSL's estimate is more consistent with the methodology used in earlier years.

5. This analysis omits one other component of state-local tax revenue reported by the U.S. Census Bureau--miscellaneous revenue. In 1988, for state governments, miscellaneous revenue was $1.06 per $100 of personal income, substantially more than in 1970 ($0.45), 1978 ($0.55), and 1980 ($0.77) Most of this increase is accounted for by interest receipts, which represented 58 percent of miscellaneous revenue in 1988; these rose from $0.19 in 1970 to $0.61 per $100 of personal income in 1988. As noted in the previous footnote, this huge increase in interest earnings has been paralleled by a similar increase in interest paid out. Because much of the growth of interest revenue is related to arbitrage activity, private activity municipal bonds, and programs that subsidize home mortgages, it greatly exaggerates the revenue available for operating general state programs. The tables also omit intergovernmental payments from states to local governments, which are a relatively small amount ($0.20 per $100 of personal income in 1988).

6. The tax increases in fiscal year 1990 are estimated from information in U.S. Census Bureau, *Quarterly Summary of Federal, State and Local Tax Revenue: April-June 1990*.

7. For a fuller discussion, see Gold (1990b: ch. 2) and Gold (1991a).

8. For example, if national economic growth is 3 percent, a state that is 2 percentage points below average will grow at a 1 percent rate. If national economic growth is 1.5 percent, such a state would have negative growth.

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Table 1

Total State Year-End Balances, Fiscal Year 1978 to Fiscal Year 1991

Fiscal Year	Total Balance ($ in billions)	Total Balance (as % of expenditures)
1991	$ 7.4 (est)	2.5%
1990	9.1 (est)	3.3
1989	12.5	4.8
1988	9.8	4.2
1987	6.7	3.1
1986	7.2	3.5
1985	9.7	5.2
1984	6.4	3.8
1983	2.3	1.5
1982	4.5	2.9
1981	6.5	4.4
1980	11.8	9.0
1979	11.2	8.7
1978	8.9	8.6

SOURCE: National Association of State Budget Officers, *Fiscal Survey of the States: September 1990*

Table 2

Nominal and Real General Fund Budget Increases, Fiscal Year 1979 to Fiscal Year 1991

Fiscal Year	Nominal Increase (est)	Real Increase
1991	6.5% (est)	1.0% (est)
1990	7.7 (est)	2.6 (est)
1989	8.7	3.5
1988	7.0	2.9
1987	6.3	2.6
1986	8.9	3.7
1985	10.2	4.6
1984	8.0	3.3
1983	-0.7	-6.3
1982	6.4	-1.1
1981	16.3	6.1
1980	10.0	-0.6
1979	10.1	1.5
1979-91 average	8.1%	1.8%

Note: The state and local government implicit price deflator was used for state expenditures in determining real changes.

SOURCE: National Association of State Budget Officers, *Fiscal Survey of the States: September 1990*

Table 3

State Spending per $100 of Personal Income Excluding Spending Paid for by Federal Aid and User Charges 1976 to 1989

Year	Total	Higher Education	Elem-Sec Education	Medicaid	Other Welfare	Health & Hospitals	Highways	Corrections	Other
1989	$7.80	$0.91	$2.30	$0.61	$0.40	$0.63	$0.64	$0.37	$1.94
1988	7.91	0.91	2.32	0.60	0.37	0.62	0.66	0.35	2.08
1987	7.86	0.92	2.33	0.56	0.39	0.61	0.66	0.33	2.06
1986	7.67	0.93	2.30	0.55	0.38	0.61	0.63	0.33	1.94
1985	7.55	0.92	2.23	0.55	0.38	0.59	0.60	0.30	1.98
1984	7.37	0.90	2.18	0.56	0.41	0.57	0.59	0.27	1.87
1983	7.27	0.90	2.17	0.56	0.36	0.59	0.60	0.25	1.83
1982	7.28	0.91	2.18	0.51	0.44	0.60	0.61	0.24	1.79
1981	7.43	0.93	2.29	0.49	0.51	0.62	0.65	0.23	1.71
1980	7.41	0.94	2.37	0.45	0.51	0.60	0.74	0.22	1.57
1979	7.28	0.94	2.31	0.41	0.51	0.58	0.72	0.21	1.60
1978	7.27	0.97	2.28	0.38	0.61	0.59	0.70	0.21	1.53
1977	7.49	0.96	2.29	0.38	0.60	0.61	0.69	0.20	1.76
1976	7.68	0.97	2.35	0.33	0.68	0.60	0.83	0.19	1.72

Source: Unless otherwise noted, U.S. Census Bureau, *State Government Finances in (year)*; for higher education, Center for Higher Education, Illinois State University, *Grapevine*; for elementary-secondary education, National Education Association, *Estimates of School Statistics (annual)*; for Medicaid, U.S. Health Care Financing Administration.

Table 4

Net State Tax Changes by Year of Enactment, Fiscal Year 1964 to Fiscal Year 1990

Fiscal Year	Billions of Dollars	Percent of Annual Collections
1990	$ 8.6	3.0%
1989	3.5	1.3
1988	0.6	0.2
1987	4.5	1.9
1986	1.1	0.5
1985	-1.3	-0.6
1984	2.3	1.2
1983	8.3	4.8
1982	2.9	1.8
1981	3.8	2.5
1980	0.4	0.3
1979	-2.0	-1.6
1978	-2.3	-2.0
1977	0.2	0.5
1976	1.0	0.9
1975	1.6	2.0
1974	0.4	0.5
1973	0.5	0.7
1972	0.9	1.5
1971	5.0	9.7
1970	0.8	1.7
1969	4.0	9.5
1968	1.3	3.6
1967	2.5	7.8
1966	0.5	1.7
1965	1.3	5.0
1964	0.1	0.5

Note: The second column shows tax increases legislated during a calendar year as a proportion of total tax revenue during the fiscal year which ends during that calendar year.

SOURCE: Corina Eckl et al, *State Budget and Tax Actions: 1990* (Denver: National Conference of States Legislatures); The Tax Foundation, cited in Steven D. Gold, "State Tax Increases of 1983: Prelude to Another Tax Revolt?", *National Tax Journal* (March 1984, p. 14.

Table 5

State-Local Revenue from Taxes and User Charges per $100 of Personal Income 1970 to 1989

Year	State-Local			State			Local		
	Taxes	Charges	Total	Taxes	Charges	Total	Taxes	Charges	Total
1970	11.32%	1.94%	13.26%	6.29%	0.80%	7.08%	5.07%	1.14%	6.21%
1971	11.50%	2.05%	13.55%	6.27%	0.86%	7.13%	5.26%	1.19%	6.45%
1972	12.24%	2.11%	14.35%	6.77%	0.88%	7.66%	5.51%	1.23%	6.73%
1973	12.41%	2.14%	14.55%	7.01%	0.89%	7.89%	5.43%	1.26%	6.69%
1974	11.93%	2.12%	14.05%	6.81%	0.88%	7.69%	5.16%	1.24%	6.40%
1975	11.74%	2.12%	13.86%	6.68%	0.87%	7.55%	5.09%	1.26%	6.35%
1976	11.98%	2.24%	14.23%	6.85%	0.89%	7.75%	5.16%	1.35%	6.51%
1977	12.15%	2.19%	14.35%	7.02%	0.84%	7.85%	5.17%	1.36%	6.53%
1978	12.08%	2.16%	14.25%	7.10%	0.85%	7.94%	5.01%	1.32%	6.33%
1979	11.37%	2.18%	13.56%	6.94%	0.83%	7.77%	4.46%	1.36%	5.82%
1980	11.02%	2.19%	13.20%	6.78%	0.82%	7.60%	4.26%	1.37%	5.63%
1981	10.85%	2.23%	13.08%	6.67%	0.84%	7.50%	4.20%	1.40%	5.60%
1982	10.59%	2.23%	12.82%	6.49%	0.84%	7.33%	4.12%	1.39%	5.52%
1983	10.68%	2.35%	13.04%	6.46%	0.87%	7.33%	4.25%	1.48%	5.73%
1984	11.30%	2.44%	13.73%	6.97%	0.91%	7.88%	4.35%	1.53%	5.88%
1985	11.28%	2.40%	13.68%	6.99%	0.89%	7.87%	4.32%	1.52%	5.83%
1986	11.24%	2.42%	13.66%	6.91%	0.91%	7.82%	4.35%	1.52%	5.87%
1987	11.48%	2.44%	13.92%	7.04%	0.91%	7.95%	4.48%	1.54%	6.02%
1988	11.57%	2.51%	14.08%	7.04%	0.92%	7.95%	4.55%	1.60%	6.15%
1989	11.56%	2.58%	14.14%	7.03%	0.95%	7.98%	4.55%	1.63%	6.18%

SOURCE: U.S. Census Bureau

Center for the Study of the States

Table 6

State and Local Tax Revenue Per $100 of Personal Income, 1970 to 1989

Fiscal Year	Total	Local	State	State: General Sales	State: Personal Income	State: Corporation Income	State: Severance	State: Other
1989	$11.55	$4.55	$7.02	$2.31	$2.20	$0.59	$0.10	$1.83
1988	11.60	4.57	7.05	2.32	2.13	0.58	0.12	1.88
1987	11.48	4.48	7.02	2.26	2.16	0.59	0.12	1.89
1986	11.24	4.37	6.89	2.26	2.04	0.55	0.19	1.85
1985	11.28	4.34	6.97	2.25	2.06	0.57	0.23	1.86
1984	11.30	4.35	6.96	2.21	2.09	0.55	0.26	1.85
1983	10.68	4.25	6.46	2.02	1.88	0.50	0.28	1.78
1982	10.59	4.12	6.49	2.01	1.82	0.56	0.31	1.79
1981	10.85	4.20	6.67	2.07	1.82	0.63	0.28	1.87
1980	11.02	4.26	6.78	2.14	1.84	0.66	0.21	1.93
1979	11.37	4.46	6.94	2.19	1.81	0.67	0.16	2.11
1978	12.08	5.01	7.10	2.21	1.82	0.67	0.16	2.23
1977	12.15	5.17	7.02	2.14	1.77	0.64	0.15	2.32
1976	11.98	5.17	6.85	2.10	1.65	0.56	0.16	2.38
1975	11.74	5.09	6.68	2.07	1.57	0.55	0.15	2.34
1974	11.93	5.16	6.81	2.07	1.57	0.55	0.11	2.51
1973	12.41	5.43	7.01	2.04	1.60	0.56	0.09	2.72
1972	12.24	5.51	6.77	1.99	1.47	0.50	0.09	2.72
1971	11.50	5.26	6.27	1.88	1.24	0.42	0.09	2.64
1970	11.32	5.07	6.29	1.86	1.20	0.49	0.09	2.65

Note: Revenue for each fiscal year is divided by personal income in the calendar year that ended during it.

Sources: For tax revenue, U.S. Census Bureau, *State Government Finances* (Washington, D.C.: U.S. Government Printing Office, various years). For personal income, U.S. Department of Commerce, *Survey of Current Business* 67(August 1987): 44; U.S. Department of Commerce, *Survey of Current Business* 68(August 1988): 30.

Center for the Study of the States

Table 7

Changes in Local Government Revenue, 1980 to 1988

	All	Counties	Municipalities	School Districts
Federal aid	-19.0%	-46.6%	-32.9%	-5.0%
State aid	79.1	81.4	76.2	78.1
Taxes	98.6	115.7	91.3	91.5
Property	93.9	107.6	77.6	94.1
Nonproperty	113.7	141.4	107.3	28.1
Total	86.7	94.4	78.6	82.4

Note: Changes in miscellaneous revenue are not shown, nor are figures for townships and special districts.

Source: U.S. Census Bureau, *Governmental Finances in {year}*

Table 8

Tax Increases Proposed by Governors

Arkansas (adopted)--1/2 cent sales tax, motor fuel

California--minor sales tax broadening (snacks, candy, newspapers, periodicals); alcoholic beverage taxes; motor vehicle registration fee

Connecticut--new income tax; broadening sales tax base

Georgia--abandoned scheduled exemption of food from sales tax

Idaho--motor fuel tax

Iowa--cigarette tax

Kansas--broaden sales tax base to more services

Maryland--sales tax rate; and broaden sales tax base to gasoline and selected services

Minnesota--cigarette, alcoholic beverages

Nevada--payroll tax

New Hampshire--business income tax

New York--gas tax, minor sales tax broadening

North Carolina--local sales tax to offset state aid reduction

Oregon--new sales tax

Pennsylvania--Corporation income tax, cigarette tax

Rhode Island (adopted)--personal income tax, corporation income tax, gas tax

South Dakota--sales tax

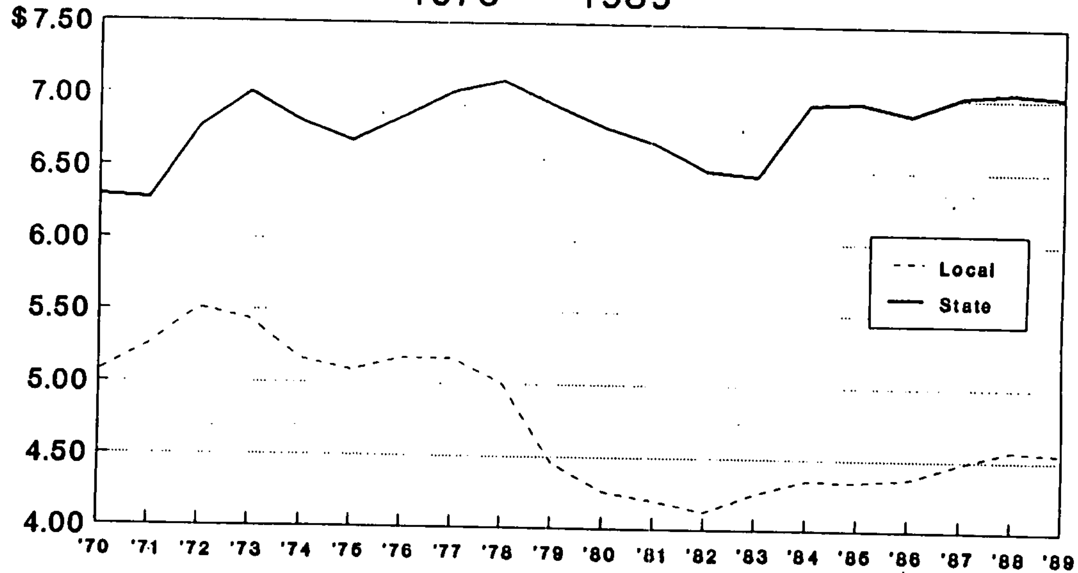
Tennessee--new income tax

Vermont--personal income tax, sales tax, cigarette tax; extend sales tax to beer, soft drinks, snacks

Sources: State Budget and Tax News; Tax Notes.

Figure 1

State and Local Tax Revenue per $100 of Personal Income



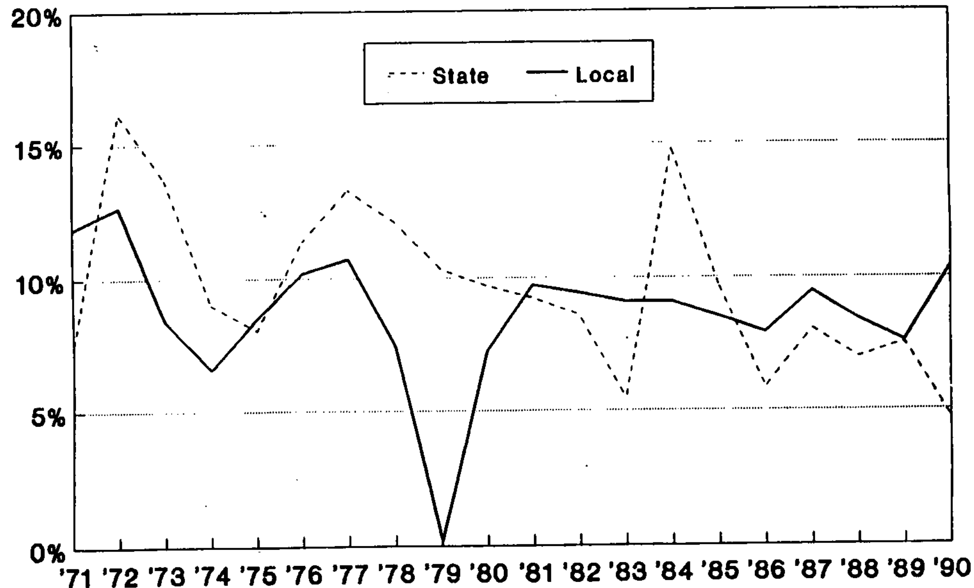
SOURCE: U.S. Census Bureau

Center for the Study of the States

Figure 2

Percentage Increase of State and Local Tax Revenue

1970 - 71 to 1989 - 90



SOURCE: U.S. Census Bureau

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Senator SARBANES. Mr. Vedder, please proceed.

STATEMENT OF RICHARD K. VEDDER, DISTINGUISHED PROFESSOR OF ECONOMICS AND FACULTY ASSOCIATE, CONTEMPORARY HISTORY INSTITUTE, OHIO UNIVERSITY, ATHENS

Mr. VEDDER. Thank you, Senator. I will summarize my prepared statement.

Senator SARBANES. We will place all the full prepared statements in the record.

Mr. VEDDER. Thank you. I would suggest the following:

First, that State and local governments went on a large-scale spending spree in the 1980's.

Second, that they did not accumulate the cash balances that would have given them some security in recessions.

Third, that in recessions, most State governments do not face absolute reductions in revenues, but a reduction in the rate of growth in revenues.

Fourth, I would also suggest that recessions are relatively short-lived, cyclical occurrences, and the imposition of new taxes to deal with short-term fiscal stress can have serious longrun, negative economic consequences.

And fifth, accordingly, States should meet cyclically related revenue shortfalls by drawing down on rainy down funds to assure budget stabilization. But where those funds don't exist, and they don't in many States, States should engage in asset sales to raise cash to meet immediate needs rather than going ahead with growth-impeding tax increases.

In the last year of the 1970's, State and local governments spent $326 billion on direct general expenditures. A decade later, 1988–89, they spent $759 billion.

Now deflating these prices for price changes and for population growth, real per capita direct general expenditures rose 23 percent in the 1980's.

Because the growth in Federal support was less rapid, however, general revenues financed by State and local governments themselves grew nearly 44 percent in real terms, or 30 percent on a per capita basis.

This growth in spending was in spite of the fact that there were a number of factors in the 1980's that should have led to reduced levels of State and local expenditure, or at least some moderation. Population growth, for example, continued to slow in the 1980's, reducing the need somewhat for capital outlays.

There was an absolute decline in the number of students in public education in the 1980's, which is the largest single component of State and local expenditures.

The prosperity of the 1980's reduced the need for large increases in the needs for funding for the economically disadvantaged.

Adjusting for all these factors, I think the spending increase of the 1980's was particularly more significant and, some would say, alarming.

Now, as revenues rose in the 1980's, and prosperity persisted, States increased their spending faster. My own State of Ohio is a fairly good example. In fiscal year 1981–82, with the economy be-

ginning to sink into a recession, the State ran a surplus in a general revenue fund that had less than $6 billion in revenue; 8 years later, in 1989–90, the culmination of the greatest peacetime expansion in the Nation's history, with revenues at $11½ billion, almost double 8 years earlier, the State ran a deficit in a cash-flow sense.

Turning to recessions, it's argued that during recessions, tax revenues decline and expenditures rise. I would suggest that the rate of growth in revenues certainly does moderate, sometimes to below the rate of inflation, but there certainly hasn't been an absolute decline. It is true that some of the expenditures that are cyclical—there are cyclical expenditures in recessions, but that problem sometimes is exaggerated.

For example, unemployment compensation payments are generally funded out of separate trust funds rather than out of general revenues.

Some States can postpone expenditures of a discretionary nature to reduce the fiscal impact of recession, such as capital outlays.

The evidence also suggests that public assistance expenditures, and I'm particularly excluding Medicaid from the consideration here, tend to lag behind the business cycle, rising only after the recession is on the way to being over. There is some lag there.

For example, in fiscal year 1983, which was probably the worst year in a business cycle sense since the Great Depression by many measures, State and local expenditures for the category entitled "public welfare" rose a modest 5 percent and almost nothing in real terms. But in the following year, when the economy was booming, 1983–84, public welfare expenditures rose by a vigorous 9 percent, at a time when State and local revenues were rising at a double-digit rate because of economic recovery.

Now this isn't to deny that there are problems. I'm suggesting, however, that some of the problems have been brought upon by the States themselves. Many of the States that have been crying the most about their fiscal woes are the ones that have had the most explosive spending increases over the past decade.

That factor, not recent revenue shortfalls, is probably the root cause of the present fiscal difficulties.

For example, in New York State, real per capita direct general expenditures for State and local governments are estimated to have risen an astonishing 61.7 percent in the past decade, nearly triple the average growth of all the States.

In Massachusettes, the growth exceeded 50 percent, again, more than double the average.

Seeing you, Senator Sarbanes, it's interesting to compare Massachusetts and Maryland, two States with similar traditions and similar sizes.

In 1979, spending per capita in Massachusetts was 2 percent above Maryland's. In 1989, however, Massachusetts was spending 23 percent more per capita than Maryland.

Was Maryland on an austerity binge? Not exactly, as per capita spending in real terms rose more than 25 percent in that State.

This gets to the question of taxes and growth.

It seems to me the evidence is very strong that raising taxes has profound long-term negative consequences on the rate of economic growth. There's a whole variety of studies on this and one could

cite an exhaustive literature. But I think what is perhaps interesting to do, and admittedly, from a methodological view, this is awfully simplistic, is simply to divide the States in the 1980's by their growth experience into five categories—quintiles—those with the highest growth, the second highest growth, and so on, down to the lowest rate of growth. And then look at what happened in terms of their expenditure and revenue experience.

This is done in my prepared statement in table 1. What it suggests is that the States with the highest real per capita income growth in the 1980's tended to be the States that lowered their revenues, that lowered taxes per thousand dollars of income. Also, their expenditures grew less rapidly—indeed, grew less rapidly than income, so they had declines in expenditures per thousand dollars in income. The States with the lowest growth in the 1980's tended to have taxes that stayed stable and, in some cases, went up in relation to income. They tended to have expenditure increases that were substantially greater than the rate of income growth for the general population.

There's all kinds of case studies that illustrate that. For example, Illinois reduced its tax and spending burden in the 1980's relative to income levels, while Ohio increased its burden. Illinois had about a third more growth than Ohio, widening an already existing differential between those two States.

Going back in long term over a longer period, you see the effects even more.

In 1929, New York had 25 percent higher income than its next-door neighbor, New Jersey; 60 years later, New Jersey's income was 13 percent higher than New York's.

In that 60-year period, New York, in general, pursued higher tax and spending levels in relation to income than New Jersey.

Thus, taxes do matter. They don't alone matter. There are many other things that matter. We have to consider this in devising a longer term strategy.

Now what I said may be true or it may not be true. To some it is debatable. But even if one accepts it to be true, one can argue there still is a fiscal crisis in the States and something needs to be done about it.

On this, everyone agrees. The question is, what should be done?

My only suggestion is that the States themselves need to engage in vigorous pruning of expenditures. Legitimate equity concerns exist in the area of public assistance, for example, but I don't think that any economist would argue that it would hurt economic growth to make reductions in that area.

In the area of education, there's a vast research literature on the learning-educational spending relationship that suggests that most incremental funds in this area have had little or no payoff in terms of forming human capital skills.

In short, curtailment of spending growth in several important budgetary areas can occur, it seems to me, without dramatic negative economic consequences.

Another financing option that would help States in the short run, it would seem to me, would be in the area of asset sales. State and local governments typically own vast resources which could be

privatized—turnpikes, liquor stores, airports, and publicly owned utilities are just four examples.

As the experience of Eastern Europe has certainly vividly told us governments generally do not do a good job of running business enterprises.

New York, for example, could raise hundreds of millions of dollars by privatizing its tollway system. We have publicly owned railroads, phone companies, and airlines to transport goods, people, and ideas. Why not highways as well?

In the longer run, it would make sense for the States to maintain budget stabilization funds of a greater level in the past to help cushion the impact of business cycle effects.

What about the Federal Government? It seems to me with a deficit of over $300 billion a year, it seems a bit strange for the Federal Government to be worrying about what are really comparatively trivial fiscal problems in terms of dollar magnitudes.

I do agree with the previous witnesses who have said that a rationalization of the Medicaid program is needed, and this is a terrible strain on governments. But I do think the Federal Government does need to get its own house in order before turning its attention to other governmental jurisdictions.

Thank you.

[The prepared statement of Mr. Vedder follows:]

PREPARED STATEMENT OF RICHARD K. VEDDER[1]

Recession and State and Local Fiscal Policies: An Unorthodox View

Conventional wisdom suggests the following:

1) We are in a recession;

2) State and local tax revenues are falling, and expenditures are growing to meet human needs;

3) Therefore, taxes must be increased to close projected budget deficits, which are constitutionally prohibited.

I will not quarrel with the notion that we are in a recession, and it is certainly true that states are generally mandated to spend no more than they have in revenues. I decidedly demur, however, from the view that the current financial crisis facing many states and their local governments has largely arisen because of the present recession. I also would argue that raising taxes to solve the problems will have profound negative economic consequences.

Indeed, I would suggest an alternative explanation for state and local fiscal stress:

1) State and local governments went on a large scale spending spree in the 1980's;

2) They did not accumulate the cash balances that they should have given the long period of prosperity that occurred;

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[1]Distinguished Professor of Economics and Faculty Associate, Contemporary History Institute, Ohio University.

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3) In recessions, most state governments do not face an absolute reduction in revenues, but merely a reduction in the rate of growth in revenues;

4) Recessions are short-lived cyclical occurrences, and the imposition of new taxes to deal with short term fiscal stress can have serious long run negative economic consequences;

5) Accordingly, states should meet cyclically related revenue shortfalls from drawing down on "rainy day funds" established to assure budget stabilization; in the absence of such funds, states should engage in assets sales to raise cash to meet immediate needs, avoiding growth-impeding tax increases.

State and Local Spending in the 1980's

To many, the 1980's was a conservative decade in which breaks were put on the expansion of governmental activity. The tax revolt reached many states, putting a limit on the growth in both revenues and expenditures.[2] Yet the Eighties were hardly a decade of fiscal austerity for state and local governments. In the last full year of the Seventies, 1978-89, state and local governments spent $326.0 billion on "direct general expenditures."[3] A decade later, in 1988-89, they spent

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[2]From fiscal year 1979 to fiscal year 1989, total state and local governmental revenues per $1000 in personal income in the U.S. fell from $200.92 to $194.51, a decline of about 3.2 percent. The decline in tax revenues per $1000 in personal income was about 3.6 percent, whereas direct general expenditures per $1000 in personal income fell less, only 1.5 percent. The fiscal year 1979 figures are from Bureau of the Census, Governmental Finances in 1978-79. The fiscal year 1989 findings are calculated using Governmental Finances: 1988-89 (Preliminary Report), using personal income data used by the Census in another related publication (State Government Finances in 1989).

[3]Direct general expenditures excludes spending for various quasi-business operations of government, including insurance trust activities, liquor stores, and utilities.

$759.2 billion. Deflating these numbers for price changes, I calculated that spending rose 36 percent in real terms over the decade.[4] Allowing for population growth, real per capita direct general expenditures rose 23 percent. The state and local public sector was hardly starved for funds in the 1980's.

Because the growth in federal support was less rapid, general revenues financed by the state and local governments themselves grew nearly 44 percent in real terms, or 30 percent on a per capita basis. While tax revenues rose substantially, increasingly state and local governments relied on charges and miscellaneous revenue sources to fund their activities.[5]

Several factors in the 1980's were favorable to reduced or at least stable levels of state and local funding. First, population growth continued to slow, reducing the capital outlay needs of government for such things as new schools, additional highways, and new sewer systems. Although capital outlays grew in the 1980's, they grew less than expenditures for operating purposes. Second, there was a absolute decline in the number of students in public education, the single largest component of state and local expenditures. While college enrollments rose roughly equal to the growth in population, high school enrollments dropped sharply in absolute terms. Third, the prosperity of the 1980's reduced the need for large increases in funding for the economically disadvantaged. True, there was a moderate growth in the poverty rate, but offsetting that was a decline by the late

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[4]The CPI-U-X1 price index is used; the XI variants is considered superior to the conventional CPI-U by the Department of Labor when making historical comparisons.

[5]Real per capita revenues from charges and miscellaneous sources rose an astounding 61.4 percent.

1980's in unemployment from decade earlier levels, and a pronounced increase in the employment-population ratio. Adjusting for these factors enhances the judgment that in fact state and local governments truly engaged in a large increase in spending in the 1980's.

Fiscally Irresponsible Behavior

While the revenues available to the state and local governments on average rose significantly in the 1980's, expenditures on balance rose faster, so most states did not have large cash reserves at the end of the 1980's. Amidst the longest peacetime expansion in American history, state and local governments should have built significant cash cushions to protect themselves from the vagaries of the business cycle. While some did, many did not.

My own state of Ohio is a superb example. In fiscal year 1981-82, with the economy beginning to sink into a recession, the state ran a surplus in its general revenue fund with less than $6 billion in income. In 1989-90, at the culmination of the greatest peacetime expansion and with revenues at $11.5 billion, almost double the amount available only eight years earlier, the state ran a deficit in a cash flow sense. Despite a growth in real per capita tax revenues of over four percent a year, the state had done very little to prepare it for a recession.[6] Expenditures had doubled in an eight year period in a state with essentially zero population growth.

Tax and Expenditures During Recession

Most observers believe the current recession will be relatively mild, with the

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[6]It had created a Budget Stabilization Fund, which had less than $400 million in it at the end of the 1990 fiscal year, less than two weeks spending from the state's general revenue fund.

upturn beginning either in the second or third quarter of 1991, in keeping with the typical recession of perhaps 10 months or so in length. Few economists believe the unemployment rate will rise much above seven percent. Thus the fiscal impact of the recession in general should be far less than that observed during the much more severe recession that peaked during the 1982-83 fiscal year. To be sure, some states will feel the brunt of the recession more than others, and for them the impact will be moderately severe.

It is argued that during recessions tax revenues decline and expenditures rise. That is not strictly correct. During recent recessions, the rate of growth in revenues has moderated, but there has been no absolute decline. Some expenditures that are cyclical do indeed grow with recession, but that problem tends to be exaggerated for two reasons. First, some cyclical expenditures, notably unemployment compensation payments, are funded out of separate trust funds, not general revenues. Second, states can often postpone some expenditures of a discretionary nature to reduce the fiscal impact of recessions, notably in the area of capital outlays.

The evidence suggests that public assistance expenditures tend to lag behind the business cycle, rising only after the recession is on the way to being over. For example, from mid-1982 to mid-1983, which for most states was a fiscal year, the national unemployment rate was below 10 percent in only two months, and was sharply higher than in the previous fiscal year. By many measures, it was the worst fiscal year in a business cycle sense since the Great Depression. Yet total state and local expenditures for the category of expenditures entitled "public welfare" rose a modest five percent, and almost nothing in real terms.

The following year, however, when the economy was booming, public welfare expenditures rose by a vigorous nine percent - at a time when state and local revenues were rising at a double digit rate because of the economic recovery.[7] Indeed, public welfare spending rose far less in fiscal year 1983 than other forms of state and local expenditure.

This is not to deny that there are exceptions to the general pattern, and that some states are more impacted by recession fiscally than others. Yet many of the states that have been crying the most about their fiscal woes are the ones that have had the most explosive spending increase over the past decade. That factor, not recent revenue shortfalls, is the root cause of present fiscal difficulties. For example, in New York, real per capita direct general expenditure per capita for state and local governments is estimated to have risen an astonishing 61.7 per cent in the decade, nearly triple the average growth. In Massachusetts, the growth exceeded 50 percent, again more than double the national average. These growth rates are simply not sustainable for long time periods.

Compare Massachusetts and Maryland, two East Coast states with similar population size and liberal political traditions. In fiscal 1979, spending per capita in Massachusetts was barely two percent above Maryland. By 1989, however, Massachusetts was spending nearly 23 percent more per head than Maryland. Was Maryland on an austerity binge? Not exactly, as per capita spending in real terms rose more than 25 percent.

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[7] 1991 Economic Report of the President (Washington, D.C.: Government Printing Office, 1991), p.383.

Taxes and Growth

To get themselves out of a budgetary bind that may be aggravated by cyclical business conditions, states are tempted to raise taxes. For example, in 1982-83, my own state of Ohio raised its income tax 90 percent to deal with a projected budget shortfall of several hundred million dollars. Several other Midwestern states did similar things.

The evidence is overwhelming that such policies have pronounced negative long term consequences. Put most simply, other things else equal, higher taxes mean lower economic growth. A whole variety of empirical studies verify that states and other jurisdictions that raise taxes tend to have lower economic growth as a consequence. To be sure, that statement needs some qualification. The adverse impact of tax increases is probably not felt strongly for two or three years.[8] The negative impact of taxes varies with the way that funds are spent.[9] Some forms of taxes are distinctly more harmful than others.[10] Finally, it is very clear that many non-tax factors impact in important ways on economic growth. While it is accurate to say "taxes matter", it is incorrect to say "taxes alone matter" in assessing economic growth.

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[8]See Bruce L. Benson and Ronald N. Johnson, "The Lagged Impact of State and Local Taxes on Economic Activity and Political Behavior," Economic Inquiry, July 1986.

[9]See Jay L. Helms, "The Effect of State and Local Taxes on Economic Growth: A Time-Series-Cross Section Approach," Review of Economics and Statistics, November 1985.

[10]See Richard K. Vedder, "State and Local Economic Development Strategy: A Supply Side Approach," Staff Study, Joint Economic Committee of Congress (Washington, D.C.: Government Printing Office, 1981.)

Nonetheless, tax and expenditure decisions are something that elected officials can control. The evidence from the 1980's suggests that state and local governments that increased their revenues the most relative to income were, in general, the states that witnessed the least growth. I formulated some statistical models (using multiple regression analysis) that examined variations in the growth in real per capita income in the decade between the 1979 and 1989 fiscal years. These models included not only changing tax burdens but several other explanatory factors. The results strongly suggested that government revenue enhancement had a strong negative relationship to economic growth.

While more crude and subject to some methodological problems, it is clearer to simply compare states with different growth experiences with respect to key fiscal variables. This is done in Table 1. The states are divided into quintiles of 10 states each. For example, the first quintile represents the 10 states with the highest recorded growth in real per capita income in the 1979-89 period. Within each quintile, I took the median (middle) value with respect to the indicated revenue and expenditure indicators, all of which are measured in relation to personal income.

The ten highest growth states lowered their general revenues by $23.88 per $1000 personal income during the 1980's, while the ten lowest growth states raised their general revenues by $8.19 per $1000 personal income. Generally speaking, the greater the decrease in governmental revenues (in total and for tax revenues) and expenditures, the greater the rate of economic growth. The growth-enhancing effects of governmental expenditures were more than offset by the growth-impeding effects of taxes imposed to finance those expenditures.

Table 1

FISCAL POLICY INDICATORS AND GROWTH, 50 STATES, 1979-89

Quintile of States	Changes, Per $1000 in Personal Income: Gen. Revenues	Taxes	Expenditures*
Highest Growth+	-$23.88	-$9.06	-$17.46
2nd Highest Growth#	- 8.06	-5.98	- 6.37
Middle Growth Rates@	- 9.30	-5.90	- 8.49
2nd Lowest Growth++	- 0.02	-3.76	- 0.04
Lowest Growth##	+ 8.19	-0.90	+14.95

*Direct General Expenditures; all numbers are medians of the ten states within the quintile.

+Connecticut, Massachusetts, New Hampshire, New Jersey, New York, Maine, Maryland, Vermont, Virginia, and Rhode Island.

#Florida, Georgia, North Carolina, Minnesota, Pennsylvania, California, Missouri, Tennessee, Hawaii, and Colorado.

@Alabama, Arizona, Arkansas, Delaware, Illinois, Mississippi, Montana, South Carolina, Wisconsin, and Alaska.

++Kansas, Utah, Idaho, Nebraska, Kentucky, Ohio, South Dakota, Washington, Michigan, and Nevada.

##Louisiana, North Dakota, Oklahoma, West Virginia, Wyoming, Iowa, New Mexico, Oregon, Indiana, and Texas.

SOURCE: Author's calculations from U.S. Bureau of the Census and U.S. Bureau of Economic Analysis data.

A few examples help illustrate the point. In the East North Central states, Illinois reduced its tax and spending burden while Ohio increased its burden significantly. Illinois had nearly one-third more growth, widening an already existing differential between the Land of Lincoln and the Buckeye State. In Oregon, governmental revenues increased slightly in relation to income, while they fell noticeably in Washington. Oregon had very little growth, barely half the amount of the state of Washington.

Over longer periods of time, the debilitating impact of persistent high taxes becomes even more noticeable. In 1929, New Hampshire's per capita income was less than 10 percent higher than neighboring Vermont's. Over the next six decades, Vermont generally followed a higher tax and spend policy than did New Hampshire. In 1989, New Hampshire's income per capita was nearly 24 percent greater than Vermont's. In 1929, New York's income was over 25 percent higher on a per capita basis than New Jersey's. Sixty years later, New Jersey's income was nearly 13 percent higher than New York's. In the interim, New York in general pursued higher taxes and spending levels in relation to income than did New Jersey. Connecticut, too, went from well behind to comfortably ahead of higher tax New York.

Thus to raise taxes to deal with a business cycle related shortfall in revenues is to sacrifice long run growth to meet short term fiscal expediencies. Such policies tragically disadvantage the disenfranchised children who bear the consequences of such short sighted decisions.

Solving the Fiscal Problems

Even if the entire testimony to this point were conceded to be completely

valid, it is legitimate to point out that the fiscal crisis still exists and something needs to be done about it. The empirical evidence suggests budget balance should come from vigorous pruning of state and local expenditures. While legitimate equity concerns exist, virtually no economist would argue that curtailment of public assistance expenditures would harm economic growth, and some would argue it would help growth and perhaps even reduce what might be viewed as discretionary poverty. The vast research literature on the learning-educational spending relationship suggests that most incremental funds in this area have had little or no payoff in terms of forming human capital skills.[11]
In short, curtailment of spending growth in several important budgetary areas can occur without dramatically negative economic consequences.

Another financing option that would help states until the recession is over is asset sales. State and local governments typically own vast resources which could be privatized without loss of services to the public. Turnpikes, liquor stores, airports and publicly owned utilities are but four examples. As the experience of Eastern Europe has vividly told us, governments generally do not do a good job of running business enterprises. New York could raise hundreds of millions by privatizing its tollway system, for example. With toll collection facilities in place, there is no compelling argument why that facility needs to be publicly owned. If we have publicly owned railroads, phone companies and airlines to transport goods, people and ideas, why not highways as well?

In the longer run, it would make sense for states to maintain budget

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[11]See Eric A. Hanushek, "The Economics of Schooling," Journal of Economic Literature, September 1986, for a report on over 100 studies.

stabilization funds to help cushion the impact of the business cycle on state and local activities. What about the federal government? With a deficit of over $300 billion a year, it seems a bit strange to suggest that it should be worrying about the comparatively trivial fiscal problems of the state and local governments. Moreover, any attempts to provide financial assistance to states with fiscal strain would appear to be a bailout rewarding those states that have been fiscally irresponsible relative to the ones that have carefully prepared themselves for economic downturns. Our experiences with the savings and loan industry suggests this approach should be avoided at all costs. The federal government needs to get its own house in order before turning its attention to other governmental jurisdictions.

Senator SARBANES. I want to be clear on one point, Mr. Vedder. Although I know you discounted it by saying it was crude and subject to some methodological problems, I take it this correlation you establish between the high growth States, which is, of course, something we want, high economic growth, and lowering the general revenues per $1,000 of personal income, is if they lower the tax burden, it contributes to the economic growth. Is that correct?

Mr. VEDDER. The thesis is that States that maintain low taxes or lower their tax burden will tend to have more economic growth than States that raise their tax burden.

Senator SARBANES. Under your chart which are the highest growth States, according to your analysis?

Mr. VEDDER. The highest growth States are highest growth in terms of per capita income, Senator, not in terms of taxes or that.

They're listed in the chart—Connecticut, Massachusetts, New Hampshire, New Jersey, New York, Maine, Maryland, Vermont, Virginia, and Rhode Island, were the States in the 1980's from U.S. Department of Commerce data that had the largest growth, not in total income, but in per capita income.

Now those numbers, by the way, are probably subject to some revision because the population estimates for each year, for 1988 and 1989, will probably be revised somewhat in light of the 1990 census, I suspect.

Senator SARBANES. So by this analysis, the States that most reflected the approach you approved of were Connecticut, Massachusetts, New Hampshire, New Jersey, New York, Maine, Maryland, Vermont, Virginia and Rhode Island. Is that correct?

Mr. VEDDER. They're the States—I'm not saying I approve or disapprove. I'm saying they're the States that had the highest growth rates and that, in general, these States had some lowering of their burdens, taxes in relation to income, in part, because incomes were rising rapidly, not so much that rates were changing, but in part, there was some moderation in tax policies in some of those States.

Senator SARBANES. The 10 lowest growth States which raise their general revenues at the other end of the scale were Louisiana, North Dakota, Oklahoma, West Virginia, Wyoming, Iowa, New Mexico, Oregon, Indiana, and Texas. Is that correct?

Mr. VEDDER. That's correct.

Mr. SCHEPPACH. Mr. Chairman, may I comment on that?

There have probably been 15 or 20 similar studies and what you find is that the dates over which those analyses are done really determine the outcome. If you use other periods of time, you get completely the opposite conclusion.

So I think you have to be very, very careful in the interpretation.

Mr. VEDDER. Well, I think the way to deal with that problem would be to look over a 50- or 60-year period of time when an individual year wouldn't make as much difference.

And if one looks at fiscal relationships from 1929, which is when the first U.S. census data is available per State, to the present, and I haven't done it for 1989 yet, which was the latest data, but I've done it through the mid-1980's, one sees a very striking relationship over the long run.

It is true, there are periods where the relationships are not as strong, short periods. But over the long period they are strong, and

economic growth is a longrun concept, because in the long run, we are not dead—at least some of us. I would suggest a relationship does in fact exist.

Senator SARBANES. I don't necessarily know that it's going to add much to pursue it.

I just make the observation that having savaged New York and Massachusetts in your earlier analysis, you then establish this correlation and give us a table that finds both New York and Massachusetts in your top 10 States.

Mr. VEDDER. They had a very high growth rate in the 1980's. They increased their spending a lot in the 1980's. But they were able to because of the high growth rates. I would suggest in the case of both States that reflected reduced taxes—for example, New York reduced their personal income tax rate from, I think, a maximum 14 or 15 percent down to 10 percent.

Massachusetts had the famous Proposition 2½, that brought about some tax relief in that State. And I would suggest that those things had a very positive effect, Senator.

Senator SARBANES. Well, that may be. But they got sharply criticized and then they got into the best 10 list.

Mr. VEDDER. Well, I'm just citing facts.

Senator SARBANES. Mr. Scheppach, let me ask you a question. About what percent of State expenditures is for aid to local governments? Is there a general benchmark for that?

Mr. SCHEPPACH. It's a significant number, but I think that a lot of it is targeted, so it goes specifically to education. The amount of flexible discretionary money is probably only 6 or 8 percent.

But I don't know. Steve Gold may have a better number. My sense is, in total, it's probably about 50 percent. But most of that is designated to specific uses.

Mr. GOLD. About 35 percent of State budgets is for aid to schools. And then besides that, there's money—there's another, say, roughly 10 percent or perhaps a little more that goes for aid to cities and counties.

So, as Ray Scheppach said, nearly half of State budgets in the average State goes for aid to locals. But 62 percent overall of all the aid is for aid to education.

Senator SARBANES. Now that's money raised at the State level, but returned to the local level.

Mr. SCHEPPACH. That's right. That's State revenues that are given to locals for designated purposes.

Senator SARBANES. Those are expenditures that are carried at the local level. Is that correct?

Mr. SCHEPPACH. That's right. And that has increased over the last 10 years somewhat faster than State revenue growth.

Senator SARBANES. That was the question I wanted to ask. Has there been a trend for a greater role on the part of States in providing aid to the localities?

Mr. SCHEPPACH. Yes. I would say from the very early 1980's up through—our last data are for 1989—that trend continues through 1989, where the amount of money going to local government increased more rapidly than States' own revenues.

Now that that may change in 1990 or 1991, from what we're seeing, because there's some cutbacks there.

Senator SARBANES. Yes, Mr. Peterson.
Mr. PETERSON. Mr. Chairman, if I could——
Senator SARBANES. Now we'll hear it from the local level.
Mr. PETERSON. I would agree with the overall statement. I think education has been a big part of that, as States have moved in their educational reforms and also, in some States, they have moved in response to constitutional cases about equity in school funding. Both of those trends have converged and that's a large part of the increase.

I could provide the committee with some numbers that show some variation in the States. Particularly, I have looked at aid to general purpose municipal governments when you take out the impact of education and public welfare, which most cities do not provide, and it's a very mixed pattern in the States. There's a tremendous variation in local government receipts from the State government, varying from the high States, Alaska and Massachusetts, and then low States such as West Virginia and Texas, which provide virtually no general assistance aid to their city governments, their municipal governments on a per capita basis.

Senator SARBANES. What is the range in the assistance between high States and low States?

Mr. PETERSON. It's less, considerably less than $10 per resident of cities in the low States and in the high States, Alaska, because of its unique structure, is really off the scale. They're up in the multiple hundreds of dollars.

But I can provide those if you wish. I just don't have that with me at this point.

Senator SARBANES. Leaving Alaska out, which I know is unique, what about the high States other than that?

Mr. PETERSON. I just don't recall that off the top of my head, Mr. Chairman.

Senator SARBANES. Can you get that for us?
Mr. PETERSON. Absolutely.
Mr. SCHEPPACH. Just one comment. You have to be careful about that because of the different responsibilities; some States take over more responsibilities than local governments. So I think you have got to look at what the spending is for, as well as the amount of money.

Senator SARBANES. I'm going to yield to Congressman Armey, but one question and then I'll come back because I have some other questions, for Mr. Gold.

Could you, Mr. Gold, just elaborate for a minute on this runup in the corrections costs? What is the dimension of that?

How big of a runup are we talking about in corrections costs?
Mr. GOLD. We're talking—as I recall, the figure was something like more than a tripling of State spending for corrections.

The average cost of——
Senator SARBANES. Is some of that assuming correction costs previously borne by the local governments?
Mr. GOLD. Very little.
Senator SARBANES. Very little. OK.
Mr. GOLD. Generally, the average cost of maintaining a prisoner is about $25,000 a year. The average cost of constructing a cell is about $50,000 a year.

And one of the interesting things about the corrections increase is that, contrary to what some people think, it is not primarily because there's been a big increase in crime.

Most of the increase in corrections spending which led to a doubling in the number of prisoners in 10 years was because of changes in sentencing practices. The States decided to get tough on criminals and had longer and more determinant sentences, most recently, for drug offenses, but earlier, for other offenses.

And it was the sentencing that is the major reason why the corrections spending has gone up as it has.

Senator SARBANES. Congressman Armey.

Representative ARMEY. Thank you, Chairman Sarbanes. Let me first express my appreciation to you, Mr. Chairman, for calling this hearing and for inviting such an excellent panel of witnesses. It's been very interesting for me.

I must say that I've had the opportunity to work with Mr. Shafroth a couple of years ago. I was instrumental in helping to afford 88 communities across the Nation with extraordinary opportunity to acquire assets from the Federal Government. We did have a chance to work with your organization at that time.

I should also observe that as I was growing up, my father was the mayor of a little town called Cando, ND, and my younger brother is now the city treasurer of Devil's Lake, ND.

And perhaps just hearing their testimony has helped me to intuitively understand that I did not want to seek office at the State and local level. [Laughter.]

Because the problems were not only more difficult, but closer to home. But, at any rate, I do appreciate that you do deal with enormous problems.

I want to see if I can develop sort of an information line here. Mr. Gold, I believe, if I heard you correctly, you said that the revenue elasticity of tax rates is declining?

Mr. GOLD. Yes.

Representative ARMEY. Now you're saying the absolute size of the coefficient is declining. Is that what you're saying?

Mr. GOLD. Right. For example, previously, there might have been a 1.6 percent increase in revenue for every 1 percent increase in personal income. And that might have gone down on the income tax to, say, 1.4 percent.

Representative ARMEY. Now that's on income taxes.

Mr. GOLD. Right. It's happened with the income tax and it's happened with the sales tax. Those two taxes account for about two-thirds of State tax revenue.

Representative ARMEY. Income and sales. Property tax, where does that come in?

Mr. GOLD. Property is mainly a local tax.

Representative ARMEY. Now you suggest, though, by your answer to this question that the sign of the coefficient, then, is positive, not negative.

Mr. GOLD. Right. As income goes up, the revenue of the States still goes up. Just not as much as it did before.

Representative ARMEY. OK. Now I think we're moving on to a different coefficient of elasticity. I was talking expressly about the coefficient of elasticity with the tax rate as——

Mr. GOLD. There are different kinds of elasticity.

You're talking about a rate elasticity.

Representative ARMEY. Right.

Mr. GOLD. And I'm talking about income elasticity.

Representative ARMEY. Income elasticity of tax revenues.

Mr. GOLD. Yes.

Representative ARMEY. OK. So that's where you have a positive sign.

Mr. GOLD. Right. And what I'm saying is that, in the past, at the Federal level and at the State level, there used to be an automatic growth bonus. It's very important at the State and local level because they rely much more on excise taxes, which have a very low growth.

So now the two strongest taxes, the income and sales tax, are not growing as fast as they used to, and that is going to have negative implications for the future fiscal balance.

Representative ARMEY. Well, let me then ask you about the rate elasticity coefficient.

Is that sign positive or negative? Do you know?

Mr. GOLD. When a State raises its rates for the income of the sales tax, it does produce more revenue.

Now, I agree with Mr. Vedder that in some cases when you raise the rates, particularly, say, the cigarette tax where you might have bootlegging, it can have some negative effects on the amount, say, sold.

But the loss in the amount sold or in the amount produced is overwhelmed by the fact that the rate goes up enough to produce more revenue.

Representative ARMEY. Any elasticity coefficient is purely an empirical phenomenon. I mean, you basically collect this database and juxtapose it against that database with the percentage change in one variable divided into the percentage change in the other.

It would seem to me that perhaps the coefficient of elasticity for excise or sales taxes would be higher than that for income tax simply because of the mobility factors involved.

Mr. SCHEPPACH. Let me make a point, too, Mr. Armey. When you do the elasticities, you must differentiate between a shortrun elasticity and a longrun elasticity. A lot of times in the shortrun, those elasticities are going to be negative. But say you raise taxes to invest in education and you do it over a 6-year period. So you have significant lag.

At the end of 10 years, you may actually have a positive elasticity, depending upon where that investment went, even though for the next year after the tax increase, you may have a negative elasticity.

Representative ARMEY. You have a negative sign.

Mr. SCHEPPACH. So I think you have got to be real careful about the timing.

Representative ARMEY. Are you suggesting that if you took a shortrun elasticity measure, you might have a positive sign to the coefficient?

Mr. SCHEPPACH. I'm saying it would not surprise me to have a negative. If you raise taxes in the short run, you have a decline in

real income. But I'm saying that, depending on where the spending is, your signs may well reverse in the long run.

Representative ARMEY. I don't want to belabor this point. I'm simply reflecting my own lack of empirical experience here.

Now, the reason that sort of pricked my curiosity and, incidentally, in terms of per capita incomes and comparisons, you have to be a little careful there. I've always found it very curious that my home State of North Dakota has more millionaires per capita than any State in the Union. It's a statistical aberration that's an irritation to the folks up there because they don't feel like millionaires.

And per capita income, incidentally, as income shows different. The other thing you end up with given all that millionaires, which is a wealth phenomenon, you don't necessarily see that translate into revenue for the States because of the favorable treatment given the farm land and so forth.

So one has to be a little careful about that. Nevertheless, I'd like to go back.

It seems to me that there seems to be throughout the 1980's at least, a fairly consistent historical empirical experience that States with relatively lower and declining tax rates experience growth, economic growth in the State and then, subsequently, revenue increases to the States' coffers. And at the same time, States with relatively high and increasing tax rates experience economic decline in the State and then subsequently, decreases in revenues to States.

Now what I'm curious about, since we seem to have a set of winners and a set of losers, are we just basically seeing a phenomenon where one State's loss is another State's gain?

For example, my own congressional district has throughout the entire length of the 1980's been the fastest growing congressional district in America, which I also connect with the fact that we have had an enormously successful record of attracting business moving into the State.

Now, obviously, if General Telephone moves into, has the good judgment, as it has had to moving to the 26th Congressional District of Texas, then that's clearly somebody else's loss.

So I'm wondering to what extent in terms of the national impact the one gain more or less counterbalances the other loss. And then the other thing that I was wondering is to what extent in this process is the tax rate relative and absolute and the change?

Is this a determined variable as over and against other variables? I wonder if anybody's done, for example, a stepwise regression or some form of model to determine that sort of thing.

Mr. GOLD. I would make the point that Mr. Vedder mentioned Oklahoma and Texas as States that had slow growth. Now its simplistic to relate that to taxes. Of course, the reason why they had slow growth was primarily because of the low price of oil, which fell so sharply in the mid-1980's. So you need to hold those other things constant.

Some of the best research on the issue that he was discussing about the connection between taxes and economic growth is by a professor named Michael Wasylenko at Syracuse University. He had found that in earlier periods, taxes did matter when you hold other things constant.

But in updating that research to the 1980's, he found that the effect of taxes was not as great and, in fact, it was no longer statistically significant, even though he had found in the 1970's it was. And he suggested that that might be because there's been a convergence among the States with some of the higher tax States coming down and some of the lower tax States rising.

So you're seeing States like Tennessee and Texas that don't have income taxes considering them now, and you're seeing States like Minnesota, New York, and Massachusetts that used to have very high taxes, have tended to reduce them.

So you're seeing a convergence among the States in terms of their tax rates.

Representative ARMEY. Well, let me ask one final question, then I'll yield back to the chairman. I'd like to come back again, too.

I gather from what you've presented here today in our discussions, then, that we are able to develop some fairly sophisticated models by which we can model on the basis of sound empirical data.

Do you find fairly reliable coefficients for such things as elasticity and so forth and test out the dynamics of alternative policies?

I see some people saying yes and some people saying no. Is there a division on opinion? How reliable is our ability in terms of the science of the State and local finance?

Mr. GOLD. As Ray Scheppach said, the coefficients are not robust. They work in some periods, but not other periods.

Mr. SCHEPPACH. I've looked at a lot of this analysis over time and I just don't think you can do that.

For example, Mr. Vedder indicated that you can do it over rates of change. But it's also true that if you look at absolute levels of income and correlate that against absolute levels of taxes, you'll find that higher income States have higher tax rates—New York, Connecticut, California, and Massachusetts. High per capita income States, high tax States.

And so, you can do it across absolute levels, and get a very different answer than these minor year-to-year changes.

I think if we know anything, and if we know anything going into the 21st century, to compete, we have got to have a first-class labor force and a first-class infrastructure. And the only place that that money can come from is State and local government because the Federal Government can't do it.

We do know that. We do know, no matter what study you looked at in terms of productivity, that 75 percent of the productivity change, and we can change that back to Mr. Vedder's 1929 or 1948, 75 percent of the change in productivity is due to the education and training of the labor force.

Representative ARMEY. Thank you. I must say, though, in all due respect, that if you're looking for change, you must look to the derivative.

Mr. SCHEPPACH. Over what period of time?

Representative ARMEY. Certainly. No doubt about it.

Mr. SCHEPPACH. I would propose that it's a much longer time period. I don't think you look at it on a quarterly or a yearly basis. You have to look at it on a 10-year moving average of some sort.

Representative ARMEY. I think we go back to Mr. Vedder's point that over a longer period of time, your dynamics become more discernible. Is that correct, Mr. Vedder?

Mr. VEDDER. Yes. I would say one thing in agreement with my colleagues at this table. The point was made about Oklahoma and Texas had low growths and the price of energy fell in the 1980's. That's absolutely correct. There's no question about that.

So, obviously, what one needs to do is to develop more sophisticated models. If one's using, say, regression analysis, one introduces a variable measuring energy use or energy intensity into the model and so on to control for other things.

Congressman Armey, in my judgment, it's very appropriate to do those things and to control for these other factors. But in doing that, you still get a relationship between taxes and growth.

I sort of sympathize with the comment earlier. I thought that convergence of tax systems might have made this thing less important in the 1980's, although I would point out that the reduction in Federal marginal rates has in some sense increased the cost to the States of raising taxes because now the taxpayers no longer can reduce the Federal liability as much.

But my own research shows that in the 1980's, that negative tax growth relationship, controlling for other factors, is there still and is as strong as ever.

The growth patterns of the States in the 1980's was different than the growth pattern of the States in the 1970's. The winners in the 1970's were not Massachusetts and New York. They were losers in terms of growth. Texas was a winner in the 1970's and a loser in the 1980's. Part of the explanation is energy. Part of it is a lot of other things.

But one factor, and I'm saying it's only one factor, but it's the one factor that State and local governments have some control over, is taxes. They don't have control over foreign exchange rates. They don't have control over the amount of sunshine. They don't have a control over energy prices, really.

But they do have control over State and local taxes.

With respect to education, I'm probably the only one here who's a local government official. I am a member of a local school board. I've, incidentally, championed three levies being passed in my community. So I'm not against taxes and I'm not against local government. I'm a local government official.

But I would say this. There are at least a hundred studies out, and I can cite you the survey article in the Journal of Economic Literature, that say that the relationship between educational performance and per capita expenditures is not well established. And there are many studies that find no relationship at all.

Representative ARMEY. Thank you. Mr. Chairman, thank you for your patience.

Mr. SHAFROTH. If I could add a noneconomist part to your question.

There's a concern I have with this idea that for every State that is a loser, there's some other State that is a winner.

I think if one looks back at the decade of the 1980's, that is not necessarily the case any more. As the economy has become global, unfortunately, and I think this is where Mr. Scheppach's comments

are critical, sometimes the United States is the loser because the winner is some other country that has made an investment in productivity.

I point out specifically concern we have with the new Strategic Impediments Initiative which will have Japan double its investment in infrastructure, which I believe will produce a significant economic and productivity gain in the next century. And that is a gain which, unless we're able to deal with either the ability of the State and local governments to finance the infrastructure in this country, which will require changes in the 1986 Tax Reform Act, or in some other way, it will be a loss to all States, not just between States.

Representative ARMEY. Thank you.

Senator SARBANES. It's an interesting phenomenon. We put enormous pressure on the Japanese for them to do something that is going to enhance their productivity and therefore, their ability to compete with us. A very interesting phenomenon.

I would ask my colleague, did I understand correctly that North Dakota has more millionaires per capita than any State in the Union? Is that correct?

Representative ARMEY. Yes. But what it is, it's the book value of agricultural land that produces products that have very little market value in and of themselves. So it's an aberration that is particularly obnoxious to the poor farmers up there. It's a curiosity.

Senator SARBANES. We had a concern with Chairman Greenspan yesterday about the difficulty of private sector borrowers getting credit, the so-called credit crunch problem. Are State and local governments experiencing any problem of that sort?

Mr. SHAFROTH. Yes, Mr. Chairman. It works in a variety of ways. Mayor Lee Cook, who I believe you know, Congressman, the mayor of Austin, TX, says that the assessed property values of the city of Austin, TX, the capital of the State, have declined from a base of about $21 billion in 1987 to approximately $17 billion today.

Since the city derives its taxes from property taxes, you can get some idea of what that means in terms of his ability to provide public services.

We're beginning to see a similar phenomenon occurring in the Northeast. So the vitality of banks, their ability to lend to small businesses, has an immediate impact on assessed property values which translates very quickly into State and local, and particularly local, tax bases and their ability to realize revenue to provide services, including infrastructure, which is vital if you're going to have local economic development.

Senator SARBANES. Are the figures that you have been giving us on the shortfall for the operating budget or does it encompass the capital budgets as well?

Mr. SCHEPPACH. It's essentially an operating budget, but they include that sort of depreciation component in the operating budget.

Senator SARBANES. What is happening on the capital budgets? Are the States cutting back there as well?

Mr. SCHEPPACH. Yes. There's been cutbacks on the infrastructure side of it.

Senator SARBANES. And how about local?

Mr. PETERSON. Our survey shows, and this is aimed mainly at the general funds, but they consistently show a high percentage of the communities cutting back on the absolute level of capital spending.

I think that, if you look at the census statistics and some others, you may see some growth in capital spending. I would guess that most of that is being driven by mandated expenditures for wastewater treatment and clean water.

We just concluded our meeting here in Washington and there are tremendous increases. I believe the city of Bangor, ME, says that they're increasing their rates every 6 months on their sewage treatment plants in order to meet the capital and operating requirements to maintain that.

So I think that a lot of the capital spending at the local level is driven by those environmental expenditures.

Senator SARBANES. What fraction of State and local budgets is covered by Federal assistance now compared with, say, 10 years ago?

Mr. SHAFROTH. In our report, Mr. Chairman, in terms of local assistance, Federal assistance was about 9 percent of local revenue resources in 1979. Today, or as of 1987, it declined to about 4.2 percent. It certainly declined since that point.

Mr. PETERSON. In terms of all local governments. At the city level, according to census statistics, the levels even through the mid-1980's, a level in excess of $10 billion a year was being received by city governments. It's now $7 billion or slightly less in nominal dollars, no adjustment for inflation, population increase, or mandates.

So the actual dollars have decreased to the municipal governments.

Mr. GOLD. I would like to note that the study by Mr. Peterson which he mentioned earlier had some interesting comparisons showing the change that's taken place in State aid to cities relative to Federal aid to cities.

In 1978, in his study, municipalities received 84 cents of State aid for every dollar they received from the Federal Government.

In 1988, they got $2.75 of State aid for every dollar they received from the Federal Government.

So, in other words, cities have to turn much more to the States now in part because of the reduction in Federal aid, and also in part because States have, as Mr. Scheppach said, somewhat increased their aid to cities.

Those figures, as Mr. Peterson said, do not count education and welfare aid, which is not part of the city budget in most States.

Senator SARBANES. Did you want to answer, Mr. Scheppach?

Mr. SCHEPPACH. Yes. We don't consider the Medicaid and AFDC payments which go to individuals as part of the money coming to States. But if you set aside the entitlements, I don't have the exact number, but if you add up all other grants that go just to States over the last 10 years, it's been cut about 25 percent in real terms.

In terms of a share, it's shrinking. As I remember, it's gone from 16 or 17 percent down to around 11 or 12 percent, is my sense of the nonentitlement moneys.

Senator SARBANES. I would like to hear a bit about how much the States have provided under these rainy day funds, which apparently a number of States undertook subsequent to the 1981–1982 recession. Is that correct, not having done it prior to that time?

Mr. SCHEPPACH. I think you had a huge acceleration of rainy day funds.

As I remember, as of about 1989, you had somewhere around 35, 38 States that had rainy day funds. Most of the moneys were small. I think that they never got more than like $2 to $3 billion into it.

Senator SARBANES. Total.

Mr. SCHEPPACH. In total.

Senator SARBANES. Yes.

Mr. SCHEPPACH. I mean, substantively, they make a lot of sense. Politically, they're difficult. If you look at a lot of the testimony about why the Federal Government cut grants to State government, one of the first things was always, well, look, with rainy day funds, the States now have a 6-percent surplus. Let's cut their aid. So that was No. 1.

No. 2, it caused some pressures between legislatures and Governors that when a rainy day fund got built up, sometimes there were pressures to spend it.

So politically, it's a difficult concept.

Mr. GOLD. Also, the increase——

Senator SARBANES. There is a pressure to spend it or there is a pressure to cut taxes so you don't have it because it's argued that you're taxing unnecessarily.

Mr. SCHEPPACH. Both. I mean, it was just difficult to keep it. It made a lot of sense. We have recommended at one time that they ought to keep 3 to 5 percent in rainy day funds. But a lot of times it was pressure—Governors felt it was pressure from State legislatures to spend it.

Mr. GOLD. As Ray Scheppach said, the rainy day funds got up to about $3 to $3½ billion. But my analysis is that rather than being supplements to the money States would have held in reserve normally, to a considerable extent, they were a substitute.

So, in other words, States have always had in normal times some money in reserve in their general fund balances.

And to a considerable extent, what happened in the 1980's was instead of just holding it in general fund balances, more and more they put it into rainy day funds. But it didn't lead to an overall increase in the amount of money that they held in reserve.

Senator SARBANES. I would like to ask you if a decision was made to try to move more quickly on public works as a counter cyclical action, how responsive could the State and local governments be in moving on public works? Or is there such a long lag time on that, that by the time it has an impact, you're very far down the trail?

Mr. SCHEPPACH. Mr. Chairman, I would say that the place that I think you can do it and do it relatively quickly is to increase the obligation ceiling and the highway trust fund. There's about a $13 billion surplus in that fund now.

Plans are available at the State level. A lot of them have been approved. So if that money were obligated, I would suspect that it could start to be spent in 3 to 6 to 9 months.

Now it's true that the bulk of the spending does not take place the first year, I think it spends out about 20 percent to 25 percent in the first year and then about 40 percent in the second year.

But I think if you were going to do it, that's a place where it makes a lot of sense, although it would add to the deficit. In the short run, that money can't be legally used for anything else, anyway, and it's the one place that I think States are ready to go. Plans have been approved.

Senator SARBANES. Of course, one of the things you could do that wouldn't add to the deficit is just intensify the time schedule on the spending projected for the fiscal year in which we find ourselves and bring all of that forward. If you had done it at the beginning of the fiscal year, you're talking 12 months.

Mr. SCHEPPACH. That's right.

Senator SARBANES. We are now into the fiscal year. That is one thing you could do that would not—you are going to have that impact in any event because you get a concern out of the Fed that you're going to contribute to an inflationary pressure. You're going to have that impact in any event, and it would be better coming sooner rather than later, given the economic situation in which we find ourselves.

Mr. SCHEPPACH. That's right. The problem is that the obligation ceiling now is nowhere near the revenues plus interest in the trust fund. And of course, the administration is trying to keep that down so that it camouflages the deficit in the short run.

Senator SARBANES. Well, that is true of every one of these dedicated funds.

Mr. SCHEPPACH. Trust funds.

Senator SARBANES. Unfortunately, we're pressing them very hard to get money for the administrative costs of paying the unemployment insurance claims.

Mr. SCHEPPACH. Right.

Senator SARBANES. So that they get paid in a week or two as they are supposed to, rather than in 6 to 8 weeks, and you don't have this catastrophic situation which exists in many of the unemployment offices.

Mr. SCHEPPACH. You need to make that administrative cost an entitlement, Senator. They are entitlements in the other categories, and that ought to be an entitlement.

We come back oftentimes for three and four supplementals for unemployment insurance. It just doesn't make any sense. It's not a lot of money. You have got a trust fund again. Money is available.

Senator SARBANES. We are getting complaints from employers, interestingly enough, now.

Mr. SCHEPPACH. That the money isn't being spent.

Senator SARBANES. That's right. The employers say that they have made that payment in under the unemployment taxes and the program isn't working the way it's supposed to work. Of course, in many instances, they have potentially a continuing relationship with these employees who have been laid off because they hope to bring them back on. If the system isn't working the way it's supposed to be, their people, in effect, are being adversely affected.

Mr. SCHEPPACH. That's right. We're getting long queues in a number of the States in terms of claims.

Mr. SHAFROTH. I think one other area, Mr. Chairman, is the Clean Water Act which Congress is, I think, going to try to deal with this year.

According to EPA, we have a backlog of about $186 billion in federally mandated spending between now and the year 2000. Under current law, the State revolving loan funds are to be curtailed in fiscal year 1994.

And what that means is, given the fiscal situation of States, it's almost impossible today to go to the bond market to leverage additional funds. In many cases, such as Ohio, I think, 30 States now have State revolving loan funds which can provide both short- and long-term capital loans for drinking water, storm water, and waste water.

But with this uncertainty over whether there will be revolving loan funds after 2 more years, we will see a severe curtailment in the short-term of any long-term bond issuances to continue those programs.

So I think there's a place where the quicker the Congress moves to provide some clarity about what the future Federal role in meeting the Federal set standards, the sooner we will see State and local governments going back to borrow to meet those capital needs.

Senator SARBANES. Congressman Armey.

Representative. ARMEY. Thank you very much, Mr. Chairman.

I'm fascinated by this whole menagerie of dual federalistic relationships.

I think one of the things we find that is almost perfectly a point of agreement is whether you're coming to Washington from a school board, from a city council, or from the State government, the clear thing is please don't send us mandates without funding.

And we've had some interesting things. A State or a municipality or a school district essentially, I guess, has two sources of revenue—that which they raise on their own through their own taxing authority, or that which they receive through the largesse of the Federal Government.

And we talked a little bit about this concept to what share of a total budget a local agency gets from the Government.

Isn't it quite possible, though, to underestimate that? I'm sure that the decisions that one makes in deciding what to be included as a Federal contribution to our expenses here could be difficult. I'm just going to try a couple of ideas on.

I noticed, for example, that Stanford University got their fat in the fire if you've been watching the papers with John Dingell. That is not, I think, a very happy situation for anyone to find themselves in.

John Dingell has the reputation, incidentally, for being the meanest man in the House. I dare say he's rarely disappointed anybody on that point. [Laughter.]

At any rate, John is a wonderful man, and I say this in only kindest admiration and affection for him.

Here is a case in point where the university, which is not a Federal entity, has—as in some cases we're finding in some universities—received a Federal grant for research, with as much as 105 percent of the actual variable cost covered in overhead cost.

I could make the argument that the entire budget of the U.S. Department of Education should be considered as an in-kind contribution to the school districts of America. Assuming that the Department of Education of the Federal Government contributes to improved education of our children, we would have to count it as such. Otherwise, we could count it on the cost side, one or the other.

But it seems to me that it would be fairly easy to underestimate that. Well, perhaps I should ask you for your reaction to that.

Mr. PETERSON. I think what you mentioned, some of the accounting rules and procedural rules, that Congress could be very helpful. We recognize that some of the mandates are to meet national purposes. In fact, the Congress has so determined that they are.

We submitted a proposal to the House Government Operations Committee to provide a better estimate of costs when bills are being considered, and that type of thing, as well as perhaps the computations that go into overhead and are allowable under Federal grants, are things that perhaps are not terribly sexy politically, but I think the Congress could make some very constructive steps in looking at some of those procedures more closely.

We would welcome some of that attention.

Representative ARMEY. Let me just point out, they may not have been terribly sexy politically, but I have an idea that Congressman Dingell is about to change that.

Let me go on. Now we focus so much on the revenue side, and it's been very instructive and valuable to me. But there's also the cost side, and I think you've mentioned that there's so much pressure to increase spending, and certainly, you've alleged that apparently the two big items for the State are—let me get this right—Medicaid and your corrections costs.

I'm guessing that some of that corrections cost is also coming from the courts. But the courts in some States—I know in my State—mandated the nature of the corrections facility, which has been an enormous expense.

Mr. SCHEPPACH. That's right.

Representative. ARMEY. My guess would also be that there probably has been some pressure to increase spending that's come from the citizens of the State. Again, we go back to corrections. If the citizens demand tougher sentencing, then that figures in here.

But has there been fairly significant—and I think we have to look over a 10- or 20-year period—change in the expectations the citizens have for the nature and type of services that they obtain from the State government?

We see a rather dramatic transformation of the Federal Government's budget from 1960 to 1990, and that now what we call the entitlements portion has grown to 52 percent.

There's been a structural redefinition of the Federal Government away from, incidentally, public assets like growth and so forth, given us America in ruins and all that.

But has this phenomenon occurred also in the States by way of the citizens asking for different services from the State and city governments?

Mr. VEDDER. I think there's been some historic change, Congressman Armey, in the composition of State government expenditures.

I unfortunately cannot cite you chapter and verse on this, but, for example, in the area of public assistance expenditures, while public assistance of the traditional kind has declined, as was indicated on the chart earlier, Medicaid expenditures have increased as a share of the budget and particularly at the State levels this is becoming an increasingly important item.

Strangely, in several States that I've looked at, public education expenditures as a proportion of the total State budget has undergone some modest decline in the last 10 years, despite the renewed concerns about education. So there's been some shifts that way.

In outlays, capital outlays as a percentage of total State spending underwent a significant decline for a period, particularly in the area of highways. But in the 1980's, that has leveled off somewhat.

Perhaps Mr. Gold could give you more details on that.

Mr. GOLD. Earlier I talked about some of the existing programs and how there's pressure to increase them. But there are some new areas, like early childhood education, where about two-thirds of the States now have started new programs that didn't exist 10 years ago. I think that's going to be a growing area in the 1990's, not just putting money into elementary and secondary schools, but putting money into early childhood education.

And also adult education. With the shortage of labor that we might have in the 1990's because of the demographics and slow growth of the labor force, States are paying more attention to training nontraditional students. Those are two of the big areas that are going to add to State spending in the 1990's.

In the 1980's, one of the fastest growing areas was foster care. Even though overall, spending on social services just about grew in proportion to the economy, spending on certain kinds of programs for children like foster care increased much more rapidly than other kinds of spending.

Representative ARMEY. Let me ask you another interesting point.

One of the things that has become very popular, and it has had a few people crusading on behalf of it, most notably a woman from the city of Chicago, is the whole concept of educational choice.

I know in Texas it's going through a terrible turmoil now with respect to State equalization funds and so forth.

Would there be an opportunity for the States to relieve themselves of some financial burden by implementing an innovation like this in their educational options?

Mr. SCHEPPACH. We've done a lot of work on choice. I guess there are different concepts on choice—it can be done at kindergarten through 12 and it can be done between kindergarten through 12 and community colleges and so on.

We find that it can be effective as a competitive model in certain areas, particularly Minnesota, which has been fairly successful on it. But there's a lot of other areas due to racial mixes and so on, which is difficult, where it's probably not effective—we see it as one of 12 to 15 strategies that can be helpful in education reform right now. But it should not be looked at as the major strategy.

Representative ARMEY. Has there been any secular impact on cities' and States' bond ratings? Have we seen anything in here in the last 10 years in terms of their cost of borrowing?

Mr. GOLD. I think the bond rating, there have been more decreases than increases in terms of——

Representative ARMEY. I'm sorry; what?

Mr. GOLD. There have been more decreases in bond ratings than increases in bond ratings.

Representative ARMEY. Showing up by way of assessing of this financial statement of the city tax revenues versus expenses. Bond rating is being dropped. Am I correct?

Mr. SHAFROTH. Well, in addition, if you look at this survey report we presented you this morning, Congressman, you see that the growing disparities in average per capita income and those rural towns that don't have millionaires in North Dakota and central cities, it has had a clear impact on the ratings that Standard & Poor and Moody's provide. So it creates this disparity, so that when New York City goes to repair its bridges and highways, it will pay 1 percent higher, which, on a billion dollars over 30-year borrowing, is a huge amount of money that would go in the way of interest costs rather than public infrastructure improvements.

So there's a change that's related to these structural economic and fiscal changes that have occurred within and between cities and towns throughout the country that has had a huge impact over this period.

Mr. GOLD. I'd like to follow up on your previous question about choice.

I think that one of the things that's happening—and it's going to continue to happen in the 1990's—is that because of fiscal stress, States are looking for and finding new ways to provide services so that they can maintain service levels with less money or mitigate tax increases.

School choice is one of the examples where we have to experiment. There's a lot of experimentation going on with States as laboratories. It's too early to tell, I think, how much good the choice effort is going to produce, but more than a half dozen States are pursuing it.

But there are other programs like that, like decentralizing programs from the State level down to the local level, some privatization. Also, moving from, say, taking care of mental patients at the State level, doing more of it at the community level. Instead of having people incarcerated in prisons, having more of them in community corrections programs. More targeting of programs.

So one of the main things that's happening this year in 1991, and I think will continue to happen, is that many Governors are proposing some significant changes in the way the State government operates. That promises to help to hold down the increases in taxes that are necessary.

Representative ARMEY. Thank you. That is very good.

I just want to close on a note basically asking you for an impressionistic response. I don't know if we could have any empirical data here.

I'm also fascinated by all the vagaries of public choice and public representation in a democratic system. I always like to illustrate the dilemma by pointing out that I love and know my wife more than I love and know anybody in the world other than myself. And in all the years we've been married, I have not yet been able to

pick out the right Christmas present for her. I think you may know the dilemma.

If I have that difficulty with my wife, whom I love and know so intimately, I wonder how can I pick out the right thing from among so many options, leading me to wonder about the rationality of our process in terms of allocating scarce resources among these competing options.

Now it strikes me that if you go to the local level, to a fairly great extent, and then move on to the State and then finally to the National level, you find with decreasing viability the opportunity for the citizens themselves to participate in the choice process. I'm thinking in terms of local referendums.

If I might just punctuate this with this observation, then see your reaction.

I have one of my communities that had the city fathers put out for referendum two items on a referendum ballot.

One was a new library, the other was a new overpass across the railroad in one of the busiest intersections in town.

Predictably, the citizens voted for the overpass and against the library, a rationing choice. Most of the city fathers were disappointed in their bad judgment by virtue of their response.

My response was that they clearly voted to allocate their scarce tax dollars to something they would use more rather than something they would use less. It seemed a quite rational process that got us to in fact what would be the optimal outcome.

Now I guess my question is, do you think that the opportunity to use local referendums that occurs with increasing viability as you go from Federal to local helps us to provide a more rational government process at the local level than what we're able to achieve at the National level?

I know this is an impressionistic thing and this is your time to bash the Federal Government if you like. But I just would be curious what your response would be as students of both.

Mr. VEDDER. You're presenting an argument for a strong and vital local government. I believe I would agree with the proposition.

As a person who lives in a small town in Ohio, everything I do in my little school board is watched by the community, even who I approve as a cheerleader adviser. The smallest, minute decisions undergo public scrutiny.

And thus, the public officials are very responsive to the citizenry, which is the essence of democracy.

Whereas, with all respect, I question whether that often happens or always happens at the Federal level, where sometimes decisions are made which the public knows little about because of what we in public choice economics call rational ignorance.

It's not worth our time to learn about a project that they're going to build in Baltimore. The people in Ohio shouldn't go out and find out if Senator Sarbanes' project or your project in Texas is a good project or not because, first of all, we probably aren't going to be able to change the outcome, and two, it's very small money out of our pocket.

So why bother get involved?

So, at the local level, it is worth getting involved because we can make a difference. And it also more directly impacts on our own lives. So we tend to be more responsive.

So from a public choice perspective, it seems to me that there's a very compelling argument to help toward having strong State and local activity relative to Federal activity.

But I don't know what that says for sure about what this hearing is about today. But I think that's a direction to work toward.

Senator SARBANES. I just need to make this observation, as one who lives in an urban jurisdiction and was interested in the 59 percent income figure compared with the suburbs.

I live in a major city, Baltimore, whose tax rate, property tax rate, is about double the property tax rate in the surrounding jurisdictions. It's a city that is stressed because of the nature of the population with which it has to deal, which present the whole gamut of the urban problems—on education, on welfare, on health, on crime, and so forth and so on.

Now, you can't say the city isn't trying to do what it can. It's trying to pull itself up by its own bootstraps. It's taxing its people double—in fact, we've reached the point where it's counterproductive because people leave the city.

They say, well, I have an option. Most of them don't have options, but some have options. They say, well, I'm just not going to continue to carry this burden. I'm going to move, not very far away, and significantly cut my tax burden and move in with an entirely different kind of population with a lot less set of problems.

Now I don't know how that locality gets out of the box in which it is in by itself. There are enough such localities across the country that I don't think you can somehow attribute it to some personal deficiencies in the people running the locality. In fact, we just had a mayor who was regarded as the best in the country for 15 years in the delivery of services, the efficiency of the government, et cetera, et cetera.

So there's a systemic problem here nationally, as I see it. And you have a mismatch because the geographical boundaries don't—I mean, they mismatch the problems and the resources. I don't know how you address those if you don't take it to the next level, which of course would be the State and then, conceivably, to the Federal. I mean, you have something of the same problem at State levels, perhaps not quite as exacerbated, but you have the problem of Mississippi, for instance, just to pick one State.

So I appreciate trying to come at it locally and I'm in favor of that, but to do that as a determining principle, you have to have some assurance that you're going to be able to match the problem and the resources. Otherwise, you're just creating an impossible situation.

Mr. SHAFROTH. I will start by saying your example is interesting because I live across the river where I chaired the economic opportunities commission. I'm on the board of directors of the senior citizens commission. And in our community, the city fathers and mothers for the last 10 years have urgently wanted to build an overpass.

It's clear the community will not permit them to do that and would much prefer a library.

But having said that, the issue is whether the options or the choices are the same. I believe that the structural physical distress means that they simply—that too many cities and too many towns in rural areas today simply don't have the same options before them.

So, certainly, we're strongly supportive of anything to make local government vital and to make sure all citizens are involved. But I think what we've said to you today, somehow, it's going to take resources beyond the city limits to try and make sure those options and choices are the same.

Senator SARBANES. You have been a very helpful panel. We appreciate your testimony.

The committee is adjourned.

[Whereupon, at 12:05 p.m., the committee adjourned, subject to the call of the Chair.]

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