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BEFORE THE

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ONE HUNDRED SECOND CONGRESS

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JANUARY 9, 10, 13 AND 31, 1992

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THE 1992 ECONOMIC REPORT OF THE PRESIDENT: ECONOMY RECOVERY AND GROWTH

THURSDAY, JANUARY 9, 1992

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

The Committee met, pursuant to notice, at 10:05 a.m., in room SD–608, Dirksen Senate Office Building, Honorable Paul S. Sarbanes (chairman of the Committee) presiding.

Present: Senator Sarbanes and Representatives Hamilton and 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.

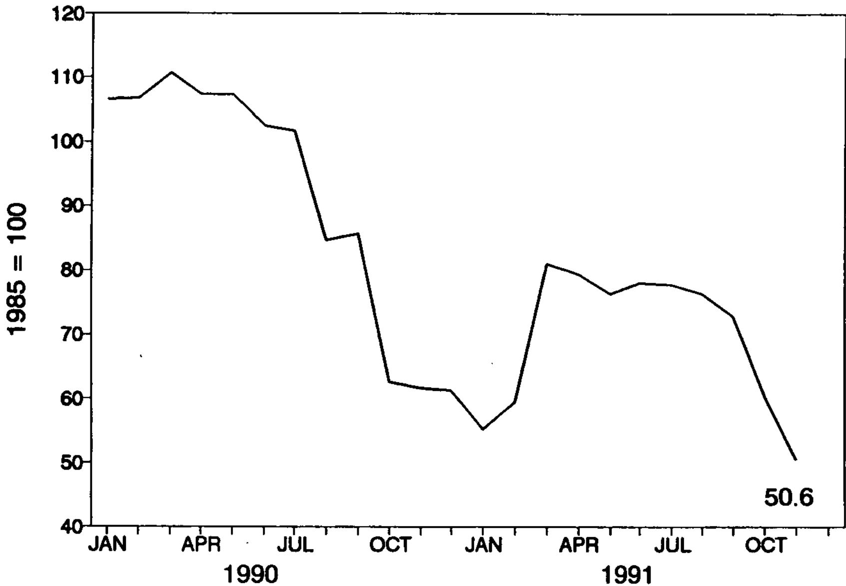
This morning the Joint Economic Committee begins a series of hearings on the economy and the need for new economic policies to address both the short-term problems of recovery from recession and the long-term challenge of increasing the growth rate of the American economy.

We have a very distinguished panel of witnesses with us this morning—Professor Paul Samuelson, Professor James Tobin, George Perry, and Lawrence Kudlow—and we are very much looking forward to their testimony.

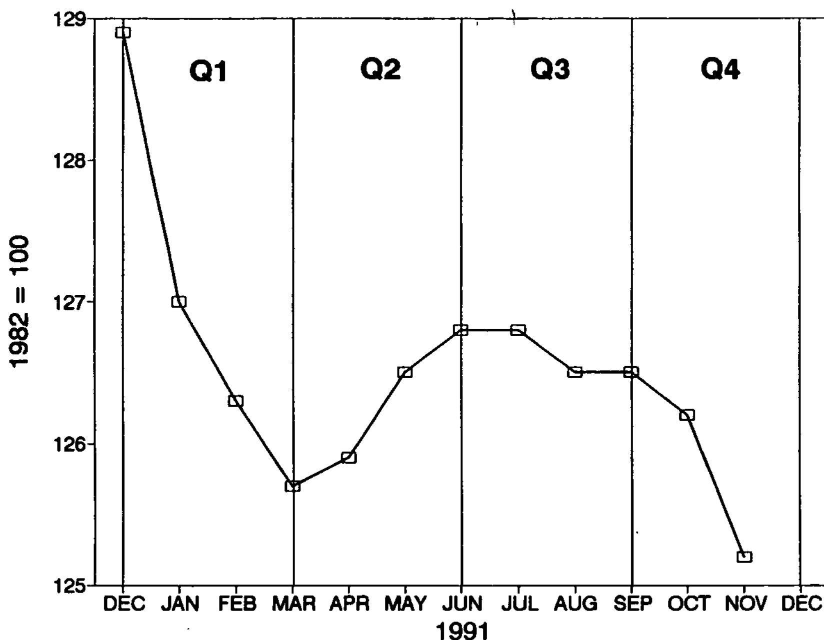
I want to take just a few moments, at the outset of this hearing, to discuss the economic situation and the difficulties confronting the economy.

Today's hearing comes at a time when the economy appears to be stagnant in the water. There was a weak rebound in the third quarter, but the economy has weakened again, making this recession the longest sustained period of recession since the Great Depression of the 1930s. Many key economic indicators suggest that weakness is likely to persist for months into the future.

Consumer confidence has plunged 35 percent over the last six months and now stands even below its trough during the 1981-82 recession. This chart shows the plunge in consumer confidence (see chart below). This is where we find ourselves today. This is where we were in March at the time when it was estimated that we were at the trough of this recession. So, there has been a very sharp drop in consumer confidence over the last few months; as I said, a 35 percent drop over the last six months.



The index of leading indicators fell three-tenths of a percent in November, the largest setback in ten months. This index is a composite of statistics that include a number of different items, and it is used to signal the direction of the economy in the months ahead. The index of coincident indicators is also falling (see chart below). This tracks the current pace of economic activity, and regrettably it fell eight-tenths of a point in November. It is now at its lowest level during this recession. It is at a lower level now than it was in March, when many people were saying that they thought the recession was on its way to being over. This is where the index of coincident indicators was in March, and this is where it is today. It came back up for a while, but regrettably it has now started back down again.



The number of people filing initial claims for unemployment insurance has risen steadily over the past six months. The National Association of Purchasing Managers Index, derived from a survey of large manufacturing firms, has now dropped below 50, indicating that the manufacturing sector is turning down. We lost a quarter of a million jobs in November, a decline in nonfarm payroll employment as large as any monthly decline earlier in the recession.

It is important, I think, to understand that the number of jobs lost in this recession, according to the household survey, has been on a par with the 1981-82 recession, which was widely recognized as the worst since the Depression. The unemployment rate in 1981 and 1982 went up much higher; it went above 10 percent. But the major reason why the unemployment rate has not gone up as much in this recession is because two million people have simply disappeared from the work force, too discouraged to look for work in the current environment.

Many of our largest companies have announced plans for massive layoffs in 1992, including first and foremost, General Motors, which has already announced plans to terminate 74,000 jobs.

For months the Administration encouraged the country to believe that the recession would be short and shallow, that it would soon be over with, that nothing needed to be done, and we would then have a period of rapid economic growth. When the Congress tried to address at least one small part of the problem; namely, the human suffering that came from the exhaustion of unemployment benefits, the Administration fought the proposal on the grounds that conditions were not serious enough. And

as recent as late July, Budget Director Darman was asserting that the recession was over.

Late last year, the Administration finally recognized the seriousness of the economic situation, signed the congressional initiative to provide jobless workers with additional weeks of unemployment benefits, and began for the first time to talk about the fact that the Nation faced economic difficulties. Admitting we have a problem is, of course, an essential first step. I was asked a few months ago, "What do we need to do to address the economic situation," and I said, "Well, the first thing we need to do is to get the President of the United States to recognize that there is a problem."

If you deny there is a problem and assert that everything is going to work out all right, obviously you are not going to do anything about it. Hopefully, we have now crossed that threshold.

In my view, this recognition must be followed by effective action to get the economy moving again in the short run and by new policies which will improve the long-run performance of the economy. The Administration has yet to come forward with such a program, although the President and his advisers have indicated that the economic situation will be a major focus when he makes the State of the Union Address, which is now scheduled for the 28th of January.

I believe it is long past time for a comprehensive rethinking of our economic policies and priorities. Last week I joined with my colleague, Senator Sasser—the able chairman of the Senate Budget Committee—in proposing a program to address both our short-term and long-term economic problems. Our proposal starts with a temporary program of countercyclical stimulus designed to end the recession and get the economy growing again. It is our view that fiscal policy at the federal, state, and local levels is now exerting a substantial drag on the economy, in effect, pushing down a private economy struggling to emerge from recession. We believe that fiscal policy should provide a stimulus, not be restrictive, and that a temporary, limited program of fiscal stimulus from the Federal Government is justified.

We have suggested three broad components of such a package: temporary assistance to state and local governments, which all across the country are cutting back on essential services; a tax cut for the middle class; and a further extension of unemployment insurance benefits for laid-off workers. The extension that was passed by the Congress last year will begin to expire in early March. People will once again face a difficult job market. It does not look like the economic situation will improve at a pace that will hold out the prospect to them of reemployment, and yet they will have exhausted their benefits.

We have also suggested the need for further changes in monetary policy to bring interest rates—especially long-term interest rates—down further, and we need to promote agreement among the major industrial nations on the need for faster worldwide economic growth.

Finally, we do not believe that economic policy should be concerned only with the short run. In pursuit of improved long-term performance, we believe that there must be a shift in federal budget priorities, away from military spending and toward public investments that enhance future growth. To this end, we have called for elimination of the current budget walls which protect military spending, and have advocated the transfer of resources out of the military category for purposes of deficit reduction and enhanced investments in education, research and development, worker training, and infrastructure.

For today's hearings, we are fortunate to have an opportunity to hear from several of the Nation's most distinguished economists on the state of the economy and what must be done to both end the recession and improve the long-term growth prospects for the American economy. I can assure our witnesses that close attention will be paid to their testimony, not only by the members of the Committee and the Congress, but by the country as well. Our Nation faces serious economic challenges in the months and years ahead, and we need to mobilize the best economic thinking in the country on behalf of a program for economic recovery and growth.

Our four distinguished witnesses this morning are: Paul Samuelson, professor of economics at MIT, winner of the Nobel Prize in Economics in 1970; James Tobin, professor of economics at Yale, winner of the Nobel Prize in Economics in 1981; Lawrence Kudlow, senior managing director and chief economist for Bear, Stearns & Company; and George Perry, senior fellow at The Brookings Institution here in Washington.

Now, gentlemen, before I turn to you for your statements, I am going to yield first to Congressman Armey, who is the ranking Republican member of the Committee, for any statement he may have, and then to Congressman Hamilton, the Vice Chairman of the Committee.

Congressman Armey, please proceed.

OPENING STATEMENT OF REPRESENTATIVE ARMEY

Representative Armey. Thank you, Mr. Chairman. It is a pleasure to be back. I hope you had as good vacation as I did.

It is also a pleasure to join you in welcoming these witnesses. I am familiar with all of them by their writings, but particularly Professor Samuelson who, in his great book, "The Foundations," taught me the joy of searching for constrained extrema, and I think implicitly that in there is the joy of knowing that the constraint was there to make it a challenging job. Thank you, Professor Samuelson.

According to the materials distributed recently by the Joint Economic Committee Democrats, this hearing will include an evaluation of the recent economic policy statement issued by Senators Sarbanes and Sasser, chairmen of the Joint Economic Committee and the Senate Budget Committee, respectively. As such, I would offer a few thoughts of my own on

this three-page document, which would trigger even higher levels of congressional spending and taxes.

As a former member of the House Budget Committee and a professional economist, I am a bit dismayed by what I can only describe as the paucity of this proposal. Generally, budget and economic proposals are substantiated, even in Congress, with some factual information about the impact of the plan on the economy and the budget. Unfortunately, the JEC/SBC Democratic release does not contain any dollar amount for any of its components or even a total amount of budget effects. In other words, its fiscal policy approach fails to provide any information on its impact on federal spending, taxes, and deficits. Advancing such a proposal without even calculating its effects on the already-huge deficit, not to mention the economy, strikes me as bordering on irresponsible. It appears that the taxpayers are being asked to buy a pig-in-the-poke so that Congress can enact more election-year, pork-barrel spending.

As a leader in the fight against the 1990 tax increase, I welcome the new recognition by congressional Democrats that this policy was a mistake that slowed the economy and destroyed many thousands of jobs. However, those who voted for this failed policy have an obligation to offer more than talking points to remedy the situation that they helped to create. Specific congressional actions created this problem, and actions, not words, press conferences, and hearings, are needed to correct it. Anything less is an insult to the intelligence of the American people.

The rationale of the Democratic proposal is that the record $360 billion deficit is not large enough. However, it is absurd to argue that $360 billion deficits are not providing sufficient fiscal stimulus. The budget and the deficit are already large enough, thank you. The answer to an ineffective $360 billion deficit is not an ineffective $420 billion deficit. The solution is not an increase in the burden of government spending on the economy even more.

The proposal argues in general terms for a temporary increase in the deficit. However, once new spending is built into the baseline, it will be a permanent burden on the economy and taxpayers. It is nice to talk in very general terms about increasing investment and other popular purposes, but the bottom line is that Congress and its politically self-serving largess will define what pork-barrel spending can be covered under these terms.

I am anxious to see this proposal emerge from its present foggy form. How much money are we talking about for public works spending? How much would come from defense; how much from new taxes? What would be the effect on the deficit? And what would be the effect on the economy?

Thank you, and, Mr. Chairman, I wonder, I am a little confused, having looked at the press release from the JEC, are we holding joint hearings here between ourselves and the Senate Budget Committee?

SENATOR SARBANES. No. The JEC is holding some hearings, and the Senate Budget Committee is holding some hearings. Senator Sasser

indicated an interest in sitting in, and I said to him that that was certainly acceptable. In fact, I understand that you intend to sit in, or have asked to sit in, on the Senate Budget Committee hearing this afternoon. And I understand that the Senate Budget Committee has indicated to you that that is fine by them. But, no, in fact, the announcement of the hearing schedule indicates that very clearly. It says that certain hearings are being held by the JEC and other hearings are being held by the Senate Budget Committee. The Senate Budget Committee will hold a hearing this afternoon, as I understand it.

Is that correct, Chairman Sasser?

SENATOR SASSER. That is correct, Mr. Chairman. The Senate Budget Committee will hold a hearing beginning at 2:00 p.m. this afternoon in this room.

SENATOR SARBANES. And who will you have as witnesses for that hearing?

SENATOR SASSER. As witnesses we have two leaders of labor and some business witnesses to give us their view of the status of the economy from both the labor and business points of view.

REPRESENTATIVE ARMEY. Thank you for that clarification.

Let me say, Senator Sasser, it is a pleasure for me to see you here. You are my wife's Democratic aunt's favorite senator. She, from Tennessee, thinks the world of you and advised me when I was elected to office that I should always treat you with great respect, and I can assure you that, in all deference to protocol and everything else, the last thing I would want is Aunt Thelma to be angry with me for my treatment of you. So, let me express to you my sincere appreciation for your being here today.

SENATOR SARBANES. Given that comment about your aunt's view of Senator Sasser—a view I share—I have to say that she is a very wise and discerning person. [Laughter.]

SENATOR SASSER. You are very kind, Mr. Chairman.

SENATOR SARBANES. Congressman Hamilton, please proceed.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON

REPRESENTATIVE HAMILTON. Thank you very much, Senator Sarbanes.

I, of course, welcome our distinguished witnesses and look forward to hearing what they have to say. I think the only thing I can add to the discussion here is to let them know what is on my mind. I have two questions: The first question is how you get out of the recession; the second question is how you restore long-term, healthy, sustainable, noninflationary growth to the American economy, which we haven't had for quite a while.

Both of those questions are very important, but just so you know my frame of mind, the second question is more important to me than the first. I hope that whatever the Congress does in the next few weeks and what-

ever the President does—of course, we have to address the immediate question of how do you get out of the recession—but I think by far the more important question is the question of how you get long-term, sustainable growth in this country. And that is the frame of mind that I bring to these hearings.

I commend you, Senator Sarbanes and Senator Sasser, for the leadership that you are giving in the Senate and in the Congress on the questions of economic policy. I think these hearings are going to be outstanding. I thank you.

SENATOR SARBANES. Thank you very much.

Chairman Sasser, we are pleased that you have been able to join us. Do you have anything that you want to say at the outset?

SENATOR SASSER. No, Mr. Chairman. I want to express my appreciation to you and the Joint Economic Committee for allowing me to sit in and observe these hearings today, and to compliment you, Mr. Chairman, and the Joint Economic Committee for this very distinguished and learned panel that you have assembled today to discuss the present status of the economy in this country.

I would hope, Mr. Chairman, at some juncture during the hearing that I might propound a couple of questions to a couple of the panelists and do so with the hope that I will not abuse the hospitality of the Committee in doing so.

SENATOR SARBANES. Certainly. When the Committee members have completed their questioning, we would be quite happy to provide you that opportunity.

We will now turn to the panel.

Gentlemen, we will hear from each of you and then, following that, we will go into our question period. We will start with Professor Samuelson; we will then go to Professor Tobin, and then Mr. Kudlow, and then we will conclude with Mr. Perry. So, if we could proceed in that fashion.

REPRESENTATIVE ARMEY. Mr. Chairman, I would mention that Senator Lott has just joined us.

SENATOR SARBANES. We are pleased to have him here.

Do you have any comments you want to make?

SENATOR LOTT. Not at this time, Mr. Chairman. I appreciate your letting me join you. This is a very interesting panel.

SENATOR SARBANES. It is a very good and interesting panel.

SENATOR LOTT. I know that this is an issue we are going to be working on, both the Joint Economic and the Budget Committees. The Budget Committee will meet this afternoon. So, with your okay, I would like to just stay here and participate.

SENATOR SARBANES. Certainly.

SENATOR SARBANES. Professor Samuelson, we would be very happy to hear from you, sir. Thank you very much for coming.

STATEMENT OF PAUL SAMUELSON, PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

MR. SAMUELSON. The title of my testimony is "Dramatic Need for Federal Reserve Expansion and Fiscal Reinforcement." The recession began in 1990 before the Gulf war was in sight. When it will be pronounced to have ended is still unclear. But in any case, after the recession had gone on a year, past July 1991, it would have been historically normal and economically desirable that the U.S. economy grow in at least a 4 percent per annum real rate. That is a very conservative figure. The actual historical figures cluster around numbers like 6 percent, and even more in the first year of recovery. That has not been occurring. No one expects it to occur. Therefore, a first priority is for the Federal Reserve to lean harder against the wind of stagnation and slump.

Dr. Alan Greenspan and his Fed associates have, in my judgment, not been responsible and optimal stewards of monetary policy in the 1989-92 period. They have repeatedly been too little and too late. They have had plenty of advice from academic consultants warning them that they should not be too little and too late during that period.

So, my first recommendation is this: The dramatic December 20, 1991, full 1 percent cut in the discount rate should be followed up by a January-February open-market operation expansion, effective to lower federal fund rates by another half or 1 percent, and a cooperative effort by the Fed and the Treasury involving a tilt toward new, shorter maturity offerings. Also, Fed open-market purchases of existing long-term Treasury issues should be explored in order to use the current window of opportunity for bringing down long rates of interest and for reducing the steepness of the Treasury yield curve.

There is much technical information available on the economic history of Operation Nudge and Operation Twist, and I do not think that the last word on that subject was arrived at in the period of the 1960s.

Now, let me make a few remarks about this first recommendation: Monetary policy is the first line of defense for short-term business cycles, particularly in this post-Reagan epoch when structural—that is, full-employment—budget deficits have decimated American thriftiness and blunted the potency and limited the availability of anticyclical fiscal policies.

Recommendation 2: It is not true that Fed policy has been proved to be futile after repeated lowerings of interest rates. What is suggested by the strong evidence of economic history is that the weapon of militant credit expansion is mandatory and useful when (1) there is a capital and credit crunch in the banking system; (2) when there is a past real estate bubble that has weakened the prices of houses and other real estate; (3) when a key industry, like the automobile industry, is cyclically and

perhaps secularly weak; (4) when there is retrenchment in the defense industry that is under way and ought to be intensified even further; (5) what is not intimately related to the current short-term business cycle when there now goes on in America a strong and permanent contraction in employment that is quite unrelated to the ups and downs of the traditional business cycle and which serves to meet ongoing dynamic challenges from abroad to a our previous comparative advantage in many manufacturing industries—this is a move to rationalize belatedly corporate operations that became bloated and inefficient during the 1980s' years of takeovers and buyouts—frenzied finance; and (6) the forces making for acceleration of inflation are now more favorable than they have been since 1982 when Chairman Paul Volcker correctly discerned that fact and used the window of opportunity in a very successful and strong operation to get the American economy moving again, an operation which was welcomed by the money market.

Remark 3: For our Nation's long-run problem of low thriftiness—I am addressing Mr. Hamilton's considerations—and our chronic payment deficits, we have had to tap foreign savings so as to maintain domestic capital formation, even at the cost of America's further becoming a debtor nation. And so there is a special current need to put emphasis on Federal Reserve policy and on any policies which promote investment, rather than putting emphasis on conventional budget expenditure and tax policies.

Remark 4: The art of prudent policy is sage judgment concerning the irreducible risks involved in the inexactitude of economic science in an uncertain world. Paul Volcker judiciously overdid monetary expansion in the first months following the cycle turning point of November 1982—behavior for which he was castigated by the monetarists. He did this because he understood the importance of ensuring a vigorous recovery, and he made a correct calculation of what would be the social significance of the two kinds of errors that he could make: doing too little or too much at that point. And then utilizing the flexibility inherent in monetary policy, Mr. Volcker later overdid the reversal of monetary expansion, understanding that the risks of inflationary overheating had begun to outweigh those of inadequate further real growth. Was he rewarded by the monetarists for this behavior? Not at all. He was castigated for his double crime. He had run over the patient, they complained, and then he had run the Mack truck back over them again. Those who are expert on sailing know that the proper art of navigation is tacking: You go on one tack and then you go on the other tack. That's how you sail into the wind. Two compensating tacks are not a double error. So, I can recommend with good conscience strong and dramatic Fed expansion now, precisely because we, I, shall be able to recommend with good conscience firm credit programs at that future date when the recovery has been assured, and overheating begins to threaten.

Now, I come to the second part of my title. Recommendation 2: Because monetary policy has been too little and too late; because, at best, looking into the future involves variable lags in taking effect, the weaken-

ing of our economy in the October-January period persuades me to change my mind, and persuades me that judicious and limited fiscal expansions can favor job opportunity and investment in the short run without prejudicing productivity and capital formation in the long run. The fiscal expansion should target needs during the short-run weakness in the American economy. They should be devised to be temporary so as to avoid further worsening America's long-run thriftiness, capital formation, and chronic structural payments deficit.

And I may say, Congressman Armey, I have tried to take into account your concern as to what would be the incremental effects of extra fiscal policy at this time, given that we have had for more than a decade an overage of expansionary fiscal policy from the standpoint of the long-run rate of productivity growth of the American economy.

Now, just a few remarks with respect to the kind of fiscal expansion that I think is justified. I think it would be wise to provide federal finance to enable states and localities to meet, without raising their tax rates, human needs intensified by the weak economy. To be effective, these expenditures must be recognized to worsen the short-run federal deficit. This cannot be an operation where you say, "Yes, my darling daughter, you can go swimming, but don't get near the water. Don't get your clothes wet."

If you finance a change in fiscal policy by a cut in some other place in the budget picture which negates its macro effects on total effective demand, you may be getting a more rational long-run fiscal policy, but you are not doing anything for the short-run business cycle.

By the way, in the discussion that follows—if I am asked to—I would like to elaborate on the terrible things that are happening in the States. I come from Massachusetts—"Taxachusetts," as it is called elsewhere in the country—and I know what the situation is also in Michigan. And, candidly, I never thought that I would live to see again the day when things that I saw all the time in Illinois and Indiana in the 1932 period prevail, when, if you were literally starving, there was no place you could go for any help because there was no money. There was no money to pay the teachers. There was no money for assistance at the local and state levels. That was the pre-election picture of 1932. And in states like Michigan and Massachusetts, we have now seen and are creating Swiss-cheese holes in the network of assistance to people who are in dire straits. This is not a question of malingering. The Governor of Michigan may say those people ought to get out like bird dogs and look for jobs. Imagine such unrealism in a state with very high unemployment rates.

Do extend the duration of unemployment benefits and widen their availability. Even within the legal provisions for unemployment before their period was extended, a lot of people who qualified for it were not getting it. The way the law is administered is as important a part of the effective picture. Later, after hundreds of thousands of new jobs have been created or restored and after the natural recovery of the system, these additions to the federal cash deficit will mostly self-destruct. And that is

the direction in which, from a long-run viewpoint, you ought to view how short-run fiscal policy should be structured.

Yes, do accelerate forward in time those deferred needs for roads and infrastructure that deserve to be addressed for their own sake in the long run, even if that means higher tax rates in the future.

I presume there will be future hearings to which you might invite academics to evaluate some version of a temporary investment tax credit. One might explore and discover whether such an investment credit could be indicated later in the year, perhaps announced to be retroactive if the above monetary and budget measures fail to reverse the downward avalanche of business activity, and there is continued stagnation.

Now, I have two brief remarks on fiscal proposals. (1) At 1992's beginning, the economy still looks weak. The global economy, led or misled by Germany and Japan, has been weakening. A sharp gyration of consumers' confidence, disproportionate to the current degree of weakness in the American economy, is an important element in the picture, and it is a psychological element that could well reverse itself once effective policy measures succeed in getting the country moving again. Since the degree and duration of extreme weakness in the economy must necessarily remain problematic, there is as yet no warrant for election-year crash programs to open the flood gates of fiscal stimulus.

(2) It would be a pity if the election-year 1992 and a transient weakness in the economy conspired to bring in the future a federal budget which is at a new, higher plateau of structural deficit. I think there is a grave danger that that may occur. The danger from that would be neither an impending inflation nor an impending triple-dip slump. The danger is the insidious one that the long-run upward trend of American wages and earnings and international competitiveness will be weakened in the decade surrounding the year 2000 by a crowding-out of American-owned capital formation, as the already-present weakness of private thriftiness at both the family and corporation level is then compounded by new public dissavings involved in still higher high-employment structural budget deficits.

Thank you.

[The prepared statement of Mr. Samuelson follows:]

STATEMENT OF PAUL SAMUELSON

After the year of recession that began in July 1990, it would be historically normal and economically desirable that the U.S. economy grow in at least a 4 percent per annum rate. That has not been occurring. No one expects it to occur.

Therefore, a first priority is for the Federal Reserve to lean harder against the wind of stagnation and slump. Dr. Alan Greenspan and his Fed associates have not been responsible and optimal stewards of monetary policy in the 1989-1992 period. They have been repeatedly: Too little and too late.

> Recommendation 1. The dramatic December 20, 1991 full 1 percent cut in the Discount Rate should be followed up by a January-February open-market expansion effective to lower Federal Funds rates by one-to-one-half a percent. A cooperative effort by the Fed and the Treasury -- involving a tilt toward shorter maturity new offerings and possible Fed open-market purchases of existing longer-term treasury issues -- should utilize the

current market window of opportunity for bringing down long rates of interest and for reducing the steepness of the treasury-yield curve.

Remark 1. Monetary policy is the first line of defense for short term business cycles -- particularly in this post-Reagan epoch when structural (full-employment) budget deficits have decimated American thriftiness and have blunted the potency and limited the availability of anti-cyclical fiscal policies.

Remark 2. It is not true that Fed policy has been proved to be futile after repeated lowerings of interest rates. What is suggested by the evidence of economic history is that the weapon of militant credit expansion is mandatory when

(1) There is a capital and credit crunch in the banking system;

(2) A past real estate bubble has weakened the prices of houses and other real estate;

(3) The automobile industry is cyclically weak;

(4) A retrenchment in the Defense industry is under way and ought to be intensified further;

(5) There now goes on a strong and permanent contraction in employment that is quite unrelated to the ups and downs of the traditional business cycle and which serves to meet ongoing dynamic challenges from abroad to our onetime comparative advantage in many manufacturing industries, and to belatedly rationalize corporate operations that became bloated and inefficient during the 1980s'

years of takeovers and buyouts.

(6) The forces making for acceleration of inflation are more favorable now than they have been since 1982.

Remark 3. For our nation's longrun problem of low thriftiness and chronic payments deficits designed to tap foreign savings so as to maintain domestic capital formation even at the cost of America's further becoming a debtor nation, there is a special current need to put emphasis on Federal Reserve policy rather than on budget expenditure and tax policies.

Remark 4. The art of prudent policy is sage judgment concerning the irreducible risks involved in the inexactitude of economic science in an uncertain world. Chairman Paul Volcker judiciously overdid monetary expansion in 1982-83, understanding the importance of ensuring a vigorous recovery. Utilizing the flexibility inherent in monetary policy, Volcker later overdid the reversal of monetary expansion, understanding that the risks of inflationary overheating had begun to outweigh those of slow real growth. We can recommend with good conscience strong and dramatic Fed expansion now precisely because we shall be able to recommend with good conscience firm credit programs at the future date when the recovery has been assured and overheating begins to threaten.

> **Recommendation 2.** Because monetary policy has been too little and late, because at best it inevitably involves variable lags in taking effect, the weakening of our economy in the October-January period persuades me that

judicious fiscal expansions can favor job opportunity and investment in the short run without prejudiciary productivity and capital formation in the long run. The fiscal expansions should target needs during the short-run weakness in the U.S. economy; they should be devised so as to avoid further worsening America's long-run thriftiness, capital formation, and chronic structural payments deficit.

Specifically,

A. Provide federal finance to enable states and localities to meet (without raising their tax rates) human needs intensified by the weak economy. To be effective, these expenditures must be recognized to worsen the shortrun federal deficit.

B. Do extend the duration of unemployment benefits and widen their availability. After hundreds of thousands of new jobs have been created or restored, these additions to the federal cash deficit will mostly self-destruct.

C. Accelerate forward in time those deferred needs for roads and infrastructure that deserve to be addressed for their own sake in the long run even if that means higher tax rates in the future.

D. Some version of a temporary "investment tax credit" could be indicated later in the year if the above

monetary and budget measures fail to reverse the downward avalanche of business activity and a continued stagnation.

Remark 1. At 1992's beginning the economy looks weak. The global economy -- led or misled by Germany and Japan -- has been weakening. A sharp gyration of consumers' confidence, disproportionate to the current degree of weakness in the American economy, is an important element in the picture and is a psychological element that could well reverse itself once effective policy measures succeed in getting the country moving again. Since the degree and duration of extreme weakness in the economy must necessarily remain problematic, there is as yet no warrant for election-year crash programs to open the flood gates of fiscal stimulus.

Remark 2. It would be a pity if the election year 1992 and a transient weakness in the economy conspired to bring in the future the federal budget to a new higher plateau of structural deficit. The danger from that would be neither an impending inflation nor an impending triple-dip slump. The danger is the insidious one that the long run upward trend of American wages and earnings will be weakened in the decades surrounding the year 2000 by a crowding out of American-owned capital formation as the already present weakness of private thriftiness at the family and corporation level is compounded by the public dissaving involved in high-employment structural budget deficits.

SENATOR SARBANES. Thank you very much, Professor Samuelson.
SENATOR SARBANES. Professor Tobin, please proceed.

STATEMENT OF JAMES TOBIN, PROFESSOR OF ECONOMICS, YALE UNIVERSITY

MR. TOBIN. Thank you, Senator.

I would like to assure the panel that they do not have to notify the Justice Department about any collusion among witnesses here, because if we agree on our recommendations, it is because we arrived at the truth independently and not by colluding. I have had that problem with Professor Samuelson for about 50 years. [Laughter.]

I too think that there is a recession problem; the problem of creating enough demand to bring the economy into recovery—a vigorous and complete recovery. There are also structural problems and they are very serious. The long-run problem of productivity slowdown is one, and the other I would identify is the increasing inequality of income and wealth in the last decade.

Now, from an economist's point of view, the cyclical problem—the recession and stagnation, whatever phase we are in right now—is easier to deal with. The difficulty is that we do not have enough demand for goods and services in the economy as a whole. Creation of demand is not technically a difficult thing to do.

The structural problem is much more difficult. It has to do not with demand but with supply—the supply side of the economy—the adequacy of savings and investment for capital formation, education, public capital, as well as private capital; the adequacy of other productivity increasing outlays in the economy, like research and development. Improving the distribution of income is also a structural problem concerning the earning power of the population and its distribution among our citizens.

Right now, of course, the demand stimulus is urgent to get the economy moving out of the doldrums. But I also would urge that we do recovery policy in a way that does not interfere with a solution of the other two problems and, if possible, advances their solution. For that reason, I am not anxious to see stimulus given through tax cuts or other concessions to affluent members of the society or even to the great middle class. I will come back to that.

I certainly agree with Paul Samuelson that the first line of defense—rather, the first line of offense—in getting the economy going is monetary policy. And it is the responsibility of the Federal Reserve. They have been too slow, too little, and too late since the second quarter of 1989, I would say. And we do need to get interest rates down. Short-term interest rates really ought to be below the ongoing rate of inflation. And that may mean that they need to be down at 2 percent or less. And we should try to get long-term rates going down at the same time.

So, I would want the Federal Reserve to do another full-point reduction of the discount rate in January or February—soon—on top of the one

that they did in December, and to also bring the federal funds rate down by a similar amount, a full percentage point.

There cannot be any harm in doing it, and it is likely to do a great deal of good. I think the answer to people who say, "Well, interest rate cuts have not solved the problem yet," is that they have been too little and too late. If there are structural changes in the banking and financial systems that dilute the effectiveness of any conventional dose of monetary medicine, the answer to that is just to give bigger doses. They are needed now.

The other thing I would do, along with Paul Samuelson, is to recommend that the Treasury stop for the time being issuing long-term bonds, bonds of maturity, let's say, beyond ten years. I believe you, Senator Sarbanes and Senator Sasser, have made a similar point in your recommendations.

I also would urge the Federal Reserve, when they need to provide additional bank reserves, to do so in part by buying medium-term and long-term securities. There is no law of God or nature or man that says the Federal Reserve must always engage in operations only at the extreme short end of the maturity spectrum. They can operate at any part of the spectrum that they want. It would be a very good idea to diminish the outstanding quantities of long-term bonds and notes, even of intermediate bonds, concentrating the new supply of federal debt in the short-term area.

It would also be good for the taxpayers because it would reduce future charges for debt interest for some time to come. Again, there may be doubt about how much more effective than the normal Fed operations this can be in reducing long-term rates. But it is worth a try and cannot do any harm.

Let me say something about the international aspects of monetary policy. It may be that the expansionary monetary measures that I propose would reduce money-market interest rates and, I hope, long-term interest rates also in the United States below those in Japan and Europe; in particular, in Germany. And that is not a bad thing, in my opinion. It would mean further pressure for depreciation of the dollar in the exchange markets. Depreciation of the dollar would be helpful to our exports. Exports are one likely candidate for being the driving force for recovery now in 1992 and 1993. A change in the exchange rate, such as has been going on, especially relative to the deutsche mark, is a good thing.

I think there is some misunderstanding on this point both in your memorandum, Senators, about your proposals and in the philosophy behind the Bush-Japan agreement in the paper this morning. From a worldwide point of view, it is a good idea that interest rates go down in those countries, as well as in ours. On the other hand, from the United States point of view, we might do better to have differentials below interest rates in those countries.

The Germans, for example, may think that their economy is overheating, and they want to oppose that. They do not apparently mind having some more unemployment while we have less, which would be

the result of our currency going down relative to theirs. So, it may be helpful to both countries, given their different objectives, to allow those interest differentials to occur.

As for the Japanese, we might prefer to have an expansion in the Japanese economy fueled by expansionary fiscal policy rather than expansionary monetary policy. That would mean their interest rates would not have to go down as much. The Japanese do not have as much of a fiscal deficit problem as we do. They have a much larger amount of saving. We should push for that in preference to monetary ease in Japan.

I, too, believe that in this country we should buy some fiscal insurance. Although I have more confidence than most people do that aggressive monetary expansion will do the job, we should take out insurance against the possibility that this time, for various reasons, it won't do it as fast or as completely as we would like. What I would like to see as a fiscal package is one that does the things that we want to do for solving the long-run problems, anyway. And those are to have more investment in the economy, more public investment, as well as more private investment. We want to have them in this economy for improvement of productivity and real wages after we have a recovery, as well as during a recovery.

The way to get the stimulus to demand that we need right now is to start doing those things, and at the same time, schedule for future years the revenues or savings from other federal defense expenditures that would be necessary.

For that reason, I would favor an investment tax credit for the next three years for investment above some threshold. The threshold would be the company's average expenditures for, let's say, a recent three-year base period for the taxpaying company, and 15 percent, let's say, in 1992, going down by five points in each of the next two years. It would be phased out. The investment tax credit gets more bang for the buck than most ways of getting additional expenditure in the economy. It is especially effective when it is known to be temporary.

The other thing I would do is to start an additional program of aid to state and local governments. Now, in 1992, we can't expect the state and local governments to propose public capital formation programs that would use additional assistance right at this time. They should do that for continuation of the program in 1993 and thereafter. But for 1992, we would just leave that aside. A rough formula for giving them assistance would be enough, let's say, in proportion to the assistance that they already get from the Federal Government. I would continue this program beyond 1992. I would provide in legislation for the way that it will be paid for. In 1992 it would be adding to the deficit. But in 1993 and subsequent years, it would be paid for by cuts in defense spending beyond those that are already scheduled or by increases in federal taxes. Those should be on the books now so that the bond markets know that these are outlays that will not increase federal deficits forever.

I am in favor of extending unemployment compensation. It is obviously a humane thing to do.

I am not in favor of middle-class personal income tax cuts. I am afraid that they would be extended even if they started out to be temporary. And I think that if there is any reform to be made in the Tax Act of 1986 to make it more equitable, it should not be done in an emergency situation, but rather with thorough and deliberate consideration.

I am in favor of making the personal income tax more progressive. I am particularly anxious to improve the income distribution for the lowest quintile of the income distribution, the one that lost the most relatively; in particular, relative to the highest quintile of income distribution.

Now, it is true that middle-income Americans have been suffering stagnation of real wages. That is nothing new. It has gone on for a long time. It may be that part of their malaise and disaffection with the economy and government policy right now is the cumulative impact of the stagnation of real wages, and then added to that, the unemployment and endangerment of their jobs right now. But we cannot solve the stagnation of real wages by antirecession legislation. That is a structural problem related to the productivity slowdown and also to the high-interest rates. Real wages in this country have not even kept up with productivity, low as the rate of productivity growth has been. I do not think we can make up for the stagnation of real wages by a succession of cuts in personal income taxes. We have to make up for it in the long run by having the means for Americans to earn progressively higher real wages. My proposal on the fiscal package would be about 1 percent of GNP, $60 billion; $50 billion for the state and local government program, and $10 billion for the investment tax credit, in that ballpark.

Let me say one further thing. I have not talked about the trade deficit and international difficulties of the United States in transactions with the rest of the world as a separate problem. I think of that mainly as manifestations of the other problems. Our lack of competitiveness is really a manifestation of our slow productivity growth.

That, however, does not mean that we can't be competitive if we depreciate the dollar sufficiently. But it does mean that we become competitive by offering more of our goods and labor for the same amount of imports from the rest of the world. It would be much nicer, much better for our standard of living, if we could earn our imports without concessions, in the terms of trade, without an exchange depreciation. But until we can, we have to become competitive by depreciation, as I already mentioned.

Competitiveness, in terms of real wages, is a subset of the productivity problem. Even if we did not have foreign trade at all, even if we were a closed economy, we would still have a productivity problem, essentially the same one that we have now. The same is true for the trade deficit. It is another aspect of our chronic low saving habits, exacerbated by the federal deficit itself.

Given that we are a low-saving country, it is probably fortunate that we have been able to borrow abroad to finance domestic investment. But

if we are going to get away from having to do that, we have to solve the structural problem of low saving, low investment, and low productivity.

Thank you very much.

[The prepared statement of Mr. Tobin follows:]

PREPARED STATEMENT OF JAMES TOBIN

America's Three Economic Maladies

The United States faces three painful economic maladies: unemployment, low productivity growth, and increasing inequality. From their conjunction have arisen extraordinary national discontents and anxieties over the economy's performance and government policies -- extraordinary because the malaise seems disproportionate to the shallowness of the cyclical recession and recent stagnation. After all, the unemployment rate is three to four percentage points lower than its peaks in the recessions of 1974-75 and 1979-82 and the GNP GAP is only half as large. Yet the national mood is more hopeless, frightened, and angry now than then. One important reason, I think, is that layoffs and unemployment over the last two years have reinforced and brought to the surface frustrations and disappointments due to the stagnation of real wages over the last two decades.

The failure of wages to grow in purchasing power is a stunning reversal of experience in the first quarter century after World War II. Here is where the other two maladies come in. The trend growth of labor productivity slowed down around 1973, and real wages cannot for long rise faster than productivity. Since 1980, real wages have actually lagged behind the modest gains in productivity that have occurred. Non-labor income has gained relative to wages, exacerbating income inequality. A major reason, I believe, is the ballooning of interest income associated with the unprecedented high real interest rates of the decade, in large part the result of the bizarre mixture of loose fiscal and tight monetary policies followed by the federal government.

The National Mood

Cyclical recovery, bringing the unemployment rate back down to 5.5 percent or lower and eliminating the 5 percent GNP GAP, is clearly the immediate priority of federal policy. Since potential output grows at 2-2.5 percent per year, it would take five years of 3-3.5 percent growth of actual real GNP to catch up, or two and a half years of 4-4.5 percent growth. Nevertheless, the cyclical bulge in unemployment should be the easiest of the three maladies to relieve. The problem is inadequate aggregate demand for goods and services and for the labor to produce them, and all it takes is for governments to spend more themselves or to enable and induce households, businesses, and foreigners to spend.

However, as welcome as cyclical recovery would be, I doubt that by itself it would cure the political-economic malaise of the American people. The disappointments related to real wages, productivity, and income distribution would remain. They were suppressed in the public mind during the recovery of the 1980s, which was a dramatic reversal of the deep recession of 1979-82 and of the previous disasters of the 1970s, the two oil shocks and the stagflation. A magnetic President succeeded in billing the 1980s recovery as "morning in America." That won't happen again.

I urge the Congress not to adopt recovery measures that will worsen either or both of the other two afflictions but rather to choose measures that will to some extent improve the long-run productivity trend or reduce economic inequality or both. I do not mean that the Congress should now try to solve all three problems. That would take too long, and a Presidential election year is not an auspicious time for thorough fundamental reforms. But at least try, as the Hippocratic oath commands physicians, to do no harm.

Unemployment

Unemployment has probably risen more since 1989 than indicated by the overall percentages of labor force reported by the Bureau of Labor Statistics. One reason

is that the fall in the labor force itself due to the decline in available jobs -- the "discouraged worker" phenomenon -- has been abnormally large. Another is that an unusually large number of workers counted as employed are partially unemployed in that they are involuntarily confined to part-time work. Unemployment has spread to skilled, managerial, and professional occupations, to white-collar as well as blue-collar workers, more than in previous cyclical recessions. This may be an additional reason why it is a more sensitive political issue.

In no business cycle does recovery mean the restoration of the status quo ante the recession. The industries, regions, and occupations that lead in a recovery are not necessarily those that lost the most in the preceding recession. Recently many "household-name" corporations have announced layoffs or plans for permanent downsizing of operations and employment. In many cases the new austerities of American managements reflect not only the recession but longer-run pressures from technological change, from disarmament, and from domestic and foreign competition. Cyclical recovery will not bring back the specific jobs lost. Indeed the "leaner and meaner" looks of these businesses indicate improvements of productivity. For the economy as a whole these are welcome—provided of course that jobs elsewhere replace the jobs lost and also absorb new workers. It's the task of stimulative demand policies to provide the climate and confident expectation of prosperity in which those jobs will be created—and in our economy, almost entirely by the private sector.

Low Productivity Growth

The causes of the post-1973 deceleration in productivity are not clear, even to economists expert in the subject. Whatever the causes, remedies are difficult. It is much harder for government policy to accelerate labor productivity than to stimulate demand. The simplistic "supply-side" view that all that was needed was to lower tax rates and eliminate burdensome regulations has been discredited by events. Indeed those policies were counter-productive, because the tax concessions stimulated consumption, mostly by the affluent, rather than saving and investment. The federal deficit ate up the private sector's saving. At the same time, anti-tax politics at all levels of government crippled civilian government.

Speeding up productivity growth will require equipping workers with more and better tools, technology, training, and education. On these counts our country's record in the last decade was abysmal. National saving and investment relative to GNP were lower than in previous decades, and lower than those of other major countries. Research and development expenditures by both private and public sectors likewise failed to keep up with the economy. Our educational system has failed to give our children and youth the skills they and the nation need. Public capital facilities have been recklessly neglected. These problems and their requirements for budgetary resources will still be with us after we have recovered from our current economic doldrums. Let us not do anything now, in the name of "jump-starting" the economy, that will make those problems worse or deprive productivity-enhancing activities the resources they will need.

That means avoiding permanent consumption-stimulating tax cuts, or temporary ones that are likely under political pressure to become permanent. It especially means avoiding such cuts for affluent consumers, like general reduction in capital gains tax rates or restoration of IRAs (which lose more in national saving by increasing the budget deficit than they gain by added private saving.)

It is a dangerous illusion to think that workers' disappointments with the static trend of real wages can be compensated by periodic tax cuts. If the country is going to consume more in the future, higher living standards have to be earned by productivity growth. Tax cuts that encourage consumption at the expense of private and public capital investments will doom the economy to continuation of the adverse trends of the last two decades. Although there is room in the economy now

for increased consumption, although the Federal Reserve would not be forced to raise interest rates by tax cuts in so slack an economy, although extra government deficits now need not crowd out private investment, these conditions will be reversed as recovery is achieved. Real wages would continue to suffer from slow productivity growth and from the claims of interest payments on national income.

Increasing Income Inequality

The economy and the federal budget can certainly afford to treat humanely both the victims of unemployment and the poor. We hear a great deal about the middle class these days. The striking increase in inequality, however, has been the contrast between the income gains of the upper quintile of families and the losses of the lowest quintile, rather than changes in the shares of the three middle quintiles. It is the poor who are bearing the brunt of the recession and of the government economies enforced by anti-government and anti-tax politics. I doubt that a wholesale revision of the 1986 tax act should be on the agenda this year. But if any new tax credits or exemptions are to be considered, for children or health insurance or whatever, I hope two conditions will apply. First, the costs should be met by higher taxes for affluent taxpayers. Those taxes could be enacted now but scheduled to come into force partly for tax year 1993 and fully for 1994. In this way, demand stimulus would come when it is needed. Second, the tax concessions should be "refundable", i.e. payable in cash to the extent that those eligible do not exhaust them in reductions of tax liabilities.

The Need for Further Monetary Stimulus

What demand stimulus should the federal government give to the economy right now? I begin with monetary policy. The Federal Reserve can act quickly and decisively. Despite the interest rate cuts the Fed has already made, they still have unused ammunition. They should take at least another full point off the discount rate and the Federal Funds rate this month.

Long-term interest rates, especially important for long-term business and residential investments, have fallen sluggishly in response to Fed cuts in short rates. There is no rational justification for the expectations of increases in future interest rates that seem to be embodied in the current maturity term structure. The federal Treasury should for the time being cease issuing securities of maturities exceeding ten years, and also diminish their intermediate term issues in favor of borrowing short-term. The Federal Reserve should buy securities of longer maturities when they need to add reserves to the banking system. There is no law of nature or of man that restricts Fed open market operations to the extreme short end of the maturity spectrum. Moves to limit the outstanding supply of long-term Treasury obligations will save the Treasury and the taxpayers money. They may lower the rates on corporate bonds and mortgages by removing Treasury securities from the competition for long-term funds. Even if these moves do not succeed in the latter objective, they will do no harm.

The good thing about monetary stimulus is that it promotes investment more than consumption, and it relieves the burden of existing debt on the balance sheets of businesses, households, and state and local governments. Moreover, it does all these things without increasing the federal budget deficit; indeed it reduces future deficits by lowering interest costs on outstanding debt.

In the longer run, after full recovery is achieved, it will not be possible to keep interest rates low without raising the national saving rate above what it was in the 1980s. That will require reduction of the federal deficit relative to GNP, by some combination of "peace dividends" and higher taxes.

One important way in which monetary policy can promote cyclical recovery is to depreciate the dollar, making American goods more competitive at home ad abroad. Depreciation occurs when interest rates on dollar assets are lower than

those on assets denominated in foreign currencies. The recent decline of the dollar against the Deutsche mark has been the result of the interest differential between American and German money markets, accentuated by recent interest cuts by the Fed and increases by the Bundesbank.

Senators Sarbanes and Sasser advocate reductions of interest rates in Germany, the rest of Europe, and Japan, in order to stimulate demand worldwide. They point out that expansion of demand overseas will increase demand for American exports. This is true, but the U.S. may do even better if there are interest differentials that cause the dollar to depreciate. Countries are not necessarily in synchronous cyclical situations. The Bundesbank is apparently more worried about inflation and overheating right now than about recession and unemployment. The existing interest differential and dollar depreciation may be in the best interests of both countries.

The case of Japan is different. The Japanese economy needs demand stimulus, it is true, but it would be better for the world as a whole and for the United States in particular if stimulus to Japanese internal demand came from expansionary fiscal policy than from lower interest rates on yen assets. Japan is a high-saving country with low government deficits and a large surplus in external trade. A higher value of the yen is appropriate and could be achieved without sacrificing internal expansion if fiscal stimulus were used. In contrast, the U.S. needs a policy mix that emphasizes monetary stimulus relative to fiscal expansion. It is the task of macroeconomic policy coordination among the Group of Seven to arrive at solutions that support world prosperity while allowing for the different circumstances of the several economies. Coordination does not mean that interest rates should go up and down together or that exchange rates among the major countries should be stable.

Fiscal Initiatives

In the United States, although aggressively expansionary monetary policy may by itself succeed in propelling a healthy recovery, no one can be sure. By waiting too long to take decisive measures, Chairman Greenspan and his colleagues let the economy flounder and let confidence in a turnaround slip away. Greenspan and company had hoped to discourage fiscal initiatives that might arouse fears in the bond market of higher future budget deficits and keep long-term interest rates from declining. Ironically, their own hesitations may have opened the door to those very fiscal policies.

Indeed, it is prudent to take some demand-increasing fiscal initiatives early in 1992, as insurance against the possibility that monetary ease will not succeed in bringing the economy out of its doldrums or even in averting a new downturn. What initiatives would be appropriate?

To stimulate private business investment in p]ant and equipment, I favor a temporary Investment Tax Credit, for example 15 percent of 1992 investment expenditures in excess of those in a base period (say the average of 1988-91). The credit could be phased out by reducing the percentage to 10, 5, and 0 in subsequent years. The ITC was effective, at modest budgetary cost, over its lifetime from 1962 to 1986. It gives a big bang per buck. Its effectiveness as a recovery measure is enhanced by limiting its duration.

Public investments in education, health care, public health, infrastructure, and environmental protection have been underfunded. They are as important for the future well-being of Americans as private business investments in plant and equipment. They are needed now, and they will still be needed after full employment has been restored. At present there is plenty of room in the economy for them, and an increase in the budget deficit to pay for them is in any case a desirable allocation of saving rather than a diversion of saving to private or public consumption. In future, after recovery, however, let us plan to finance these investments in social capital partly by allocating to them future cuts in defense

spending (beyond those already scheduled) and partly by higher taxes. These allocations could be phased in over the two years 1993 and 1994.

These public investments are in the domain of state and local governments, which are in desperate financial straits because of the soaring costs of Medicaid, the cutbacks of federal grants in the last ten years, the effects of the recession on their expenditures and revenues, and the anti-government, anti-taxation political moods of their electorates. A long-run program of federal aid, as suggested in the previous paragraph, will take time to design and get rolling. For the first year, 1992, a rough formula for allocation will have to do—for example, supplementing the total of existing grants by a uniform percentage without restricting the use of the funds otherwise than requiring states to pass customary shares of their grants on to local communities.

A total 1992 deficit-financed fiscal package of $60 billion, one percent of GNP, seems in the right ball park, $10 billion for the ITC and $50 billion for aid to state and local governments.

I would like to emphasize that there is little up-side risk in stimulative monetary and fiscal demand management for the next two years. That is, there is small likelihood that Chairman Greenspan is going to find the economy so exuberant and a step-up of inflation so threatening that the Fed will need to slam on the monetary brakes. The down-side risk—con- tinued sluggishness or further recession—is asymmetrically large.

Postscript on the Trade Deficit and American Competitiveness

I did not list the trade deficit and American uncompetitiveness in international markets as economic maladies distinct from the slowdown of productivity growth and its sources. Our deficit in external current account has been a particular manifestation of our chronically low rate of national saving. Had it not been possible to borrow from foreigners and import more than we export, this saving deficiency would have been concentrated wholly on domestic capital accumulation. The burden on the living standards of future Americans would have been no less, probably heavier.

Likewise our difficulties in competing with foreign products at home nd abroad are manifestations of the fundamental problem that our productivity has been growing too slowly. If we lived in a closed economy, that same productivity slow-down would be endangering our standards of living. It is not hard to be competitive, but it is hard to be productive. Depreciation of the dollar against foreign currencies will make us internationally competitive. More precisely, we can sell enough to foreigners to balance trade if we are willing to make our goods cheap and theirs expensive, i.e. if we offer more of our labor and its products for the products of their labor. What we really should aim to do is to increase our productivity enough so that we can trade with foreigners on favorable terms, i.e. earn the high real wages we aspire to. That requires the same efforts to raise productivity that we would need if we were insulated from the world.

There is one consequence of our trade deficit and foreign borrowing that is peculiar to international economic relations. It is the temptation to seek remedies from foreign competition by protectionist measures. These have been injurious to the national welfare in the recent past, and they are all too likely to visit further damage upon us in the future. Unfortunately the political appeal of false diagnoses and remedies of the country's economic maladies seems to be irresistible to both the executive and legislative branches of the federal government and to both political parties.

SENATOR SARBANES. Thank you very much, Professor Tobin.
Mr. Kudlow, please proceed.

STATEMENT OF LAWRENCE KUDLOW, CHIEF ECONOMIST, BEAR, STEARNS & CO.

MR. KUDLOW. Thank you.

Let me begin by making an odd statement for me. I was on vacation last week and watched the unveiling of the Sarbanes/Sasser economic plan, and in terms of the specifics of the plan, I wish that you had done more, particularly on the tax incentive side. But in terms of the general analysis behind the plan, I basically agree with you. We need more fiscal stimulus. We shouldn't be hamstrung by last year's budget deal in every element. We should be willing to be more flexible about shifting funds from the defense account—as the world has changed—into other tax cuts or into, where appropriate, domestic spending. And we should be willing to accept a moderate increase in the deficit estimate in order to achieve these goals, because the policy goals will lead to a stronger rate of economic growth in 1992 and the out years. I agree with that.

I do not agree with the specifics of your plan, but there is a lot of discussion around that. But I actually think that the analysis and direction of the plan is correct. I, myself, before this Committee and others, have urged a more stimulative fiscal program, going back more than a year. So, I am heartened by this.

I think there have been some other plans on the Republican side which are far more stimulative fiscally than the budget agreement, and I certainly can concur with that. And it may be that the Bush Administration is now beginning to get this message, however belatedly. So, I wanted to lead with that.

My second point is on the economy itself. I see perhaps not as pessimistic an outlook in the next 12 months as some people. I am not very optimistic, but I am not as pessimistic.

The one point I would make is that there has been a certain Fed-bashing going on, and I don't have a Nobel Prize, but I will defend the Fed, at least to some extent. I believe the Fed in recent years has done a pretty good job. Nothing in life is perfect, but the good should never be the enemy of the perfect. And I commend the Fed for bringing the rate of inflation down to practically zero. I think we have zero inflation, and it is certainly approximate to price stability.

Today's Producer Price Index, as you may know, fell as reported by the Labor Department, and this would be the first year in many for a long time, actually since the early 1960s, late 1960s, where we had a flat PPI, down slightly for the year. And the Consumer Price Index for 1991 is going to come in around 3 percent for the 12 months, and given certain distortions by government subsidies and the like, that is about as good as it is going to get. My hunch is the reported CPI probably will drop to 2 percent year-to-year next year.

These are 1950s, 1960s-style inflation rates, and I regard low inflation as a long-term stimulant to the economy. I think it improves the incentives for investment and saving. It bolsters real incomes for households and corporations. And, most importantly, perhaps, it reduces interest rates because inflation expectations decline.

Now, we are looking at interest rates of 20-to-30-year lows, and this is very good for the economy, in my judgment. Among its other benefits, low interest rates, both short and long, will probably provide upward of $50 billion in net interest relief for the private sector. In other words, mortgage owners, corporations, and other debtors will realize upward of $50 billion in interest savings, which, in effect, is the monetary equivalent of a tax cut.

In fact, on the mortgage side alone, we calculate that over 35-some-odd million mortgage-owning homeowners will save about $25 billion, which comes to about $700-$750 per household. So, it is a pretty good deal.

And as I agree with Mr. Samuelson and Mr. Tobin, low interest rates won't hurt. I think this is probably an unrecognized plus for next year's outlook.

I agree with these gentlemen on another area: I think the Treasury should change its debt management. They should announce to the market and clarify their position so that in an orderly way they will shorten the average maturity of the Treasury yield curve by curtailing the offerings of medium- and long-term bonds in the next year, or two, or three. That will save the taxpayers some money, and it will help to bring down long-term interest rates. So, I do agree with that point of view.

And judging from the performance of commodity prices and the bond market, which I regard as leading market indicators of inflation, I believe that the Fed has room to ease the federal funds rate. So, I do agree with the gentlemen on that and would like to see the Fed funds rate down to about 3.5 percent.

Whether we need to go beyond that, I think should be a response to the market. One thing the Fed recognizes, because it operates at least a little closer to the real world, bringing down short rates don't always cause long rates to fall. The issue of inflation expectations is something that has to be contended with.

In 1989 the Fed was easing very rapidly the second half of the year, and long rates shot up over a percentage point, and that really did a lot of damage to the economy. Now, my expectation is that long-term rates can come down in the next year. But the Fed has to be cautious in its approach.

My sense is that the big mistakes leading to this stagnant period—by which I would include 1989, 1990, and 1991, for sure; whether that is a three-year recession or a three-year stagnation doesn't really matter—I think the mistakes have been on the fiscal side. And this is not a new view, and you probably knew when you invited me here that I might

mention some of this. I felt that the 1986 tax bill had a lot of bad elements in it. I thought the 1990 tax bill had a lot of bad elements.

Having served in the Government briefly in the early part of the 1980s, I have always felt that you run these policies and, if the policies don't work in some measurable fashion over time, there is no harm in changing them.

I never understood this sacrosanct 1990 budget deal stuff. I remember Congressman Hamilton a year ago saying that he really didn't think this was the right medicine, and other Members of Congress said it. But they wound up doing it because the momentum of doing it seemed to engulf everybody.

We testified. The director of the CBO didn't have much of an argument in favor of it. I opposed it. I don't recall who else was on the panel, but there wasn't anyone gleefully saying, "What a neat deal this is. Let's all raise taxes now that we are in the fourth or fifth month of recession." So, if it needs to be changed, change it. If the 1986 bill needs to be changed, change it—no problem. Life goes on. Private-sector people change their game plan. No reason the government can't do the same.

Now, in particular, relating to the current economic weakness, I think the biggest problem in today's economy is jobs. There is no increase in nonfarm payrolls. In a shorthand sense, the unemployment claims are too high. Curiously enough, there is a recovery case to be made for other data. It is not a robust recovery; it is not the 6 percent recovery that Mr. Samuelson referred to, which is the normal recovery rate. But there is a recovery in housing; there is a recovery in business spending; there is a small recovery in consumer spending. But there is no recovery in jobs, and jobs do create incomes and, therefore, revenues and consumer confidence.

I have some pictures in my text of the extraordinary relationship between consumer confidence and unemployment claims, and a decent relationship between new businesses and employment. And it is on this point that I want to focus for a moment. I recognize that the front pages are headlining large restructurings from major companies—GM, Citicorp, IBM, etc. But I want to remind you that this restructuring is not really cyclical, it is really a longer run issue. It has been going on for 10 or 15 years in fits and starts, and it has to do with the global economy, new competitive pressures, and also a lack of long-run profitability and greater return for these companies that went on in the 1980s. But in the 1980s, we were able to generate a tremendous surge in new business formation.

Now, this is perhaps an obscure indicator, but I wish it would be less obscure. It is a good measure of entrepreneurship, and the relationship between new-business creation and jobs is a very good one. Statistically, it is a good one. It holds up. We have knocked it around; we have pushed it and shoved it. Statistically, it really holds up nicely.

Now, the 1980s was not the first decade of strong new-business creation. We had smatterings of it in the 1970s; we had an excellent

performance in the 1960s. But it is really the principal job creator for the American economy, not the Fortune 500 or even the Fortune 100.

So, I ask why is it that new-business starts have not rallied or recovered yet, and how are we going to get jobs created? This is really the crux of the issue. And I believe we should operate toward a more expansive fiscal policy in two key areas: One is taxes; two is regulation. And I am not going to dwell on the spending side. Others have talked about spending. I don't have any great opposition to infrastructure spending, if it is done in moderation and with the most efficient ways possible. There are a lot of big cost increases built into this public spending that could be reformed, by the way, to make them more efficient.

On taxes and regulation, I think we should provide relief on the capital gains tax. I am not here to argue new tax shelters. I do think that we think we have the highest capital gains tax in the G-7, and I think there are ways to structure a capital gains tax that would meet the test of fairness and economic growth. I am sympathetic to the fairness test. It has always been part of tax policy—the issue of fairness—as well as economic efficiency and income neutrality.

My recommendation is (1) index capital gains; if you do nothing more, index capital gains; (2) my preference is to bring the rate back to 20 percent, where it was before the 1986 bill, or even 15 percent; and (3) I believe that the lower income tax bracket—the 15 percent income tax bracket—should get a deeper capital gains differential. In other words, I would structure it so that the middle-income people, who generally would come under that threshold, would get a zero to 7.5 percent capital gains tax rate, perhaps depending on the length of the investment, while the people paying 28 to 31, at the top, would have a 15 to 20 percent capital gains tax rate. Both would be indexed; both depending on the length of the holding of the investment.

I think you will see a lot of money that is locked into investments over the past five years would be unlocked and rechanneled if the incentives are better, and I think it will help middle-income small businesses, minority businesses, and urban businesses that desperately need capital. So, there is a capital problem in the country right now. Banks aren't lending; savings-and-loans aren't lending. The junk bond market is not lending. The highest risk borrowers, the highest risk entrepreneurs who need capital are not getting it. We have to deal with that problem. It is a political issue, I understand that. But I am looking at it from the economic standpoint.

The second point I would make is that I think what would help new businesses and jobs is to lower the cost of labor. I have for many years—well, for all of two or three years—supported the Moynihan or Kasten-Moynihan social security approach. I recognize that it is politically controversial, but I want to put that aside. It is basically a straight-cost issue. As these tax rates go up, it becomes more expensive for the employers to hire them. And people look for ways not to make permanent hires.

There is an interesting development in the economy. There is an outfit in Chicago called Manpower, Inc. It is a very interesting operation, Manpower, Inc. They actually have published job data. A lot of companies nowadays call them in and say, "Give me a work force for three months. I don't want to hire them permanently. I don't want to have to pay the benefits packages, the payroll taxes, and all of the rest. I want to pay you as the contractor to give me 100, or 30, or 500 people for three months' work, and then we are going to end the contract, and you worry about the work force."

This is a growing business. I am not here to talk the company, I am just saying it is a growing business. And what you see is that it is a direct response to firms' unwillingness to make permanent hires, because it is too expensive to do so.

So, in all of the discussion about middle-class tax relief, I think the key point is to look carefully at improving or reducing the cost of labor. If you don't want to cut the payroll tax because it is controversial, or you need more time to study the long-run assumptions into the 21st century, then think in terms of earned income tax credit, which would really be the second-best proposal, where other things would dovetail with that, another point I will make on taxes.

Also, with respect to small and new-business creation, I think business should get a tax break. My preference, surprisingly, is not for the investment tax credit, and I do not agree about temporary investment tax credits. The ITC has been on again, off again, for more than 20 years. The data on its effectiveness are inconclusive. Government studies have done it; private studies have done it. Inconclusive. You may get a little quick spurt, but it has no long-term benefit. And I also think the investment tax credit fundamentally reeks of unfairness. It does not affect all businesses equally. It really is skewed to the larger, existing companies who undertake a lot of heavy-equipment purchases. The smaller and light businesses would vastly prefer speedier acceleration of depreciation; in fact, moving toward a neutral cost-expensing system, which, by the way, if structured properly, would index for inflation. This is a way to help all businesses across-the-board bring down their overall tax rates.

So, those are my three principal thrusts. There is a lot of other tax policy coming around. But time is running short. Let me close on this point. Following the budget deal of 1990, the Congressional Budget Office published a set of economic assumptions and budget estimates. I was startled. I used to run these numbers at OMB in the early 1980s, so I have a great interest in them. I was startled at how weak the CBO forecasted the response to the budget deal: roughly 2.5 percent real GNP for the next five-year planning horizon. And I made some calculations, as have others, and compared this to the long-run, post-World War II economic growth rate baseline. We have run about 3 percent real GNP since— I don't know—the late 1940s or early 1950s, certainly after the Korean War. If the CBO estimates prove to be correct and average growth is 2.5 percent between 1992 and 1996, that is going to leave us

$1.8 trillion below the long-run real GNP baseline. In other words, we are not even going to be close to 3 percent. Three percent is associated with a level of national income. This 2.5 percent rate would keep us well below that level, and the wedge really starts to grow in the outyears. Not only does that reflect long-run economic underperformance, if you make some simple calculations with respect to the relationships between national income, real output and employment, the cumulative loss of employment by 1996 would be six million jobs from what would otherwise have been the case if we generated Mr. Samuelson's type of recovery of 4 percent over the five years.

My view is that we should have a national policy of real GNP growth rate of 4 percent for the 1990s to get us back to the long-run baseline, to expand the economy's potential to grow, to improve capital investment, worker productivity, and so forth and so on. And what you find is, if you can generate this faster growth, you will have a significant deficit reduction over time. Including the defense cuts and significant interest savings, 1 percent added growth in real GNP over the next five years will save you between fiscal years 1996 and 1997 $80 billion to $100 billion on the deficit, at least. Those are conservative estimates; our most static estimates. If I run a more dynamic model, I can get even bigger numbers.

And then if you take that $100 billion in deficit savings from the growth element and add on the lower interest expense because the Fed has held down inflation and brought down interest rates, and then if we can deal with the nexus of defense spending and domestic needs in a way that is somehow deficit neutral over time, you have yourself a budget deficit outlook that is much more favorable than the one we are presently looking at, and you have a chance to move the U.S. economic potential in the 1990s into a world-class zone.

So, in conclusion, I praise the Fed because I think lower interest rates and lower inflation is itself a stimulant to the economy. But I agree with the thrust of the Sasser/Sarbanes thinking that we need more fiscal stimulus. We should not be afraid to make some legislative changes nor should we be afraid to take on the issue of the big, bad budget deficit in the short run. And I am hoping we can talk more about the deficit, because I think to some extent it is a very flawed number.

Basically, whether it is job creation, or new-business starts, or deficit reduction, or productivity or international competitiveness, we have to focus squarely on the issue of economic growth.

SENATOR SARBANES. Thank you very much.

[The prepared statement of Mr. Kudlow follows:]

PREPARED STATEMENT OF LAWRENCE KUDLOW

The most optimistic and significant point for the economic outlook is the Fed's 1950s Bretton Woods-style monetary policy, which has significantly reduced inflation and interest rates over the past 10 years, and has reintensified this effort over the past three years. The return to low inflation is important: there is no better foundation for economic growth than low inflation and its near cousin low interest rates. It is the monetary equivalent of a tax cut. Price stability and strong monetary purchasing power are the key to any successful long-run economy. This is a greatly underrated factor in the economic outlook.

Under Greenspan's stewardship the theme of zero-inflation, or price stability with a gold and commodity-backed dollar, is becoming more and more a reality. Despite three years of discount and fed funds rate cuts, both gold and the CRB futures index remain steady. As a result, a forecast of a 2% CPI and no change in the PPI over the next twelve months is not out of the question. Nor is a 30-year T-bond of 7%; nor are short-term rates of 3 1/2 to 4%; nor is a 10% to 15% rise in profits; nor is a 3400 Dow, which would imply even larger gains for mid- and small-cap stocks. We first predicted a 3400 Dow last October, and we are sticking with it.

This is the era of stable commodity and raw material prices; it is the era of rising financial asset prices. At bottom, this is the key investment strategy point: stocks and bonds will continue to outperform real assets. With the proper fiscal and monetary policies, the Dow could reach upwards of 5000 by 1996 and long-term rates could be reduced to 6% or even less. Think of it.

Zero Inflation

The Fed's zero inflation policy is forcing significant downsizing and cost-restructuring by all types of businesses and all levels of government. Since neither corporate revenues nor government tax revenues will be inflated by loose money, business and government will be

forced to control costs and continue their efforts toward greater efficiency and productivity. Business products and government programs of dubious merit or efficiency must either be reduced or eliminated. By stripping away the veil of inflation, all US corporate and government operations will have to stand on their own merits.

Under a policy regime of price stability, the transition period to profitability in the private sector or budget balance in the public sector does require some painful adjustments, most recently symbolized in the restructuring announcements of IBM, GM, and Citicorp, as well as downsizing in numerous state and local government entities.

But the real story is not the transitions, not the temporary recession, but the tremendous opportunities for long-term growth given very low financing rates, stronger purchasing power for incomes and lower break-even points for business profitability and global competitiveness. The multi-tiered decline of inflation and interest rates over the past decade is reflected in the performance of the stock market, which has carried the Dow from 750 in 1982 to 3200 last week. Broadly speaking, this market recovery symbolizes the improvement of long-term economic performance resulting from greater price stability.

Fiscal Maladies

Regrettably, in recent years the nation's fiscal policy has become highly restrictive and the economy has suffered. Ideally a sound monetary policy aimed at zero inflation should be accompanied by a more relaxed fiscal policy designed to enlarge after-tax incentives to work and invest, to reduce regulatory and trade barriers and to enhance business entry, credit access and entrepreneurial opportunity. In other words, as put by Columbia Professor Robert Mundell, the right fiscal-monetary mix is tax cuts and tight money.

Instead, since the late 1980s, fiscal policy has generated regulatory and tax *increases*, along with tight money, all of which created a tightening noose around the economy's neck, leading to stagnation and recession.

- Tax rates on personal income, capital investment, corporate income and real estate have increased in both nominal and real terms, accompanied by higher state, city and local tax burdens. On balance, the federal tax bills of 1986 and 1990 were significant economic depressants.

- At the same time, regulatory barriers for S&L's, commercial banks and the high-yield bond market have severely limited the normal flow and disintermediation of credit.

- Additionally, numerous environmental regulatory costs have similarly punished entrepreneurs and business operations.

The Right Policy Mix

But hope springs eternal, and just as the monetary side is advancing nicely, the outlook for a more stimulative and incentive-oriented fiscal policy is improving. Both Congress and the Bush Administration now appear to recognize the need for fiscal stimulus and economic growth as the proper antidote for large budget deficits.

- The Sasser/Sarbanes Democratic plan, though falling short on tax incentives, does explicitly propose a modestly larger short-run deficit and a reallocation of deeper defense cuts to domestic tax cuts and added spending, as crucial policy steps to recovery.

- The Administration will renew its commitment to capgains tax relief, which is essential to promote the risk-taking, innovation and new business creation necessary to raise the economy's long-run potential to grow. Full indexation to offset future inflation should be part of their proposal.

  Additionally, the Administration is expected to propose some combination of tax credits for health care and first-time homebuyers, as well as some sort of business tax credit, and a larger middle-class income-tax credit to offset social security tax increases, or enhanced family allowances and a child care tax credit.

  Hopefully, the Administration and Congress will use middle-income tax relief to reduce labor costs and increase labor rewards. This is crucial to achieve faster new job creation in the 'Nineties.

- Tax credits for health care coverage of the uninsured are exactly the right approach, since they will create pro-market consumer choice, foster competition and improve the efficiency of health care delivery at a lower cost. In effect, this is a partial privatization of national health care insurance.

- Significantly, the notion of punitive upper-income tax increases seems to effectively have been dropped by Congressional leaders. This is no time to be raising taxes. Indeed, optimal tax policy would roll back the income tax increase and the luxury tax increase of 1990.

All of this is very sensible tax policy which will reverse the fiscal mistakes of recent years.

- Properly-structured tax cuts will stimulate capital formation, new business starts, jobs, incomes and economic growth. No one should be satisfied with the lackluster 2.3% five-year growth estimates which were generated by the Congressional Budget Office (CBO) following passage of the 1990 tax bill. These estimates hold the 1990s economy well below -- perhaps a cumulative $1.8 trillion below -- the nation's long-run post-World War II 3% growth trend baseline. By my calculations, the loss of jobs implied by CBO's growth projections relative to the long-term trend baseline comes to a whopping 6 million. It is precisely this point which must be immediately addressed in order to prevent a protracted period of U.S. economic stagnation.

- However, if 1992 fiscal policy is redirected toward an expanding economy, then these new measures could raise real economic growth over the next five years, by an average of roughly 1% per year, from 3% in 1992 to 4% in 1993-96. Faster growth would lower the deficit in 1996-97 by at least $100 billion and cumulatively by more than $300 billion

- Importantly, if the tax cuts are announced as retroactive to January 1st, then 1992 growth may accelerate even faster. This is a key point. If the tax cuts are not retroactive, then numerous spending, investment and income decisions will be postponed or deferred until later in the year or into 1993. This would actually worsen the 1992 outlook. But a prompt and clear tax policy announcement, including specific proposals as well as a retroactive starting point, would greatly improve the 1992 outlook.

- Assuming a steady monetary policy, lower Federal budget interest expense would add at least another $50 billion to deficit reduction, bringing the total deficit savings to $350 billion over the five-year planning period.

- All told, the deficit level could fall to double-digits; certainly less that 1% of GDP by 1996.

- Since more output of goods and services would be matched against steady money supply growth, the zero-inflation strategy will not be compromised. In all likelihood, real interest rates would temporarily rise by 50 basis points at most. But the real exchange rate will also rise, thus attracting foreign capital inflows. On balance, a well-crafted supply-oriented tax policy will actually improve the long run potential for higher bond prices and lower yields.

1992 Economic Outlook

My current thinking on the economy anticipates real GDP, on a Q4/Q4 basis, of roughly 3%, with the first quarter showing the slowest percentage gain of just 1%, followed by 3.6% growth over the remaining three quarters. In inflation-adjusted terms, consumer spending will rise 2.6%; business fixed investment will increase 7.5%; residential construction will be up 5.7%; the trade deficit for goods and services will improve further, narrowing to $20.7 billion by the fourth quarter of 1992; production will rise 3%; the unemployment rate will end the year at 6.4%; operating earnings will improve 11.5%. In short, I expect a moderate economic recovery.

Along with renewed growth, the outlook for inflation is extremely optimistic. Gold and commodity prices are holding at recent rock bottom trading levels, which suggests extremely low inflation figures will be recorded throughout 1992. For the year, on a Q4/Q4

basis, the GDP deflator and the CPI will increase between 2% and 2 1/2%. As for the PPI, which excludes all service sector prices, it could rise by only 1%. The recent decline in energy prices could lead to an outright decline in overall producer prices for the first quarter of the year.

The outlook for continued low inflation points to low interest rates throughout 1992. Both short- and long-term rates will fall further in the first quarter, with the 30-year T-bond perhaps dropping below 7% for the first time since 1973. By mid-year, as economic growth accelerates, short-rates may begin to move slowly higher in response. Though improved capital returns could raise real rates somewhat, I nonetheless expect long-term interest rates to finish the year well below 8%.

Finally, low inflation and higher domestic capital returns will lead to dollar appreciation. The dollar's foreign exchange value is closely tied to relative economic real rates of return. The combination of rising US real returns and easing real returns in Europe and Japan points to a 10% to 15% rise in the dollar over the course of the year. Since the dollar is presently well below its purchasing power parity, a mild increase will not jeopardize U.S. competitiveness.

Recovery Thus Far

Media pessimism aside, the economy is recovering, albeit slowly. While there are areas of weakness, on balance the data do not reflect a double dip recession. Indeed a closer look at the data shows that a number of economic indicators in fact remain above their 1991 trough levels. A tepid recovery is underway, but the data are not yet decisive.

- *Housing*, an important leading sector of the economy, has posted sizeable across-the board-gains. Since the January 1991 trough, starts haven risen

31.8% at an annual rate; permits are up 30%; existing home sales have increased 18%; new homes are up 31.5%.

- Low mortgage rates are not only boosting housing activity, but also providing a substantial tax-cut effect that will increase personal disposable incomes. By our estimates, lower mortgage rates will result in interest payment savings of $26 billion per year for the household sector. This is the equivalent of an average tax cut of $750 per year for each household with a mortgage.

- On an annualized basis since March, *durable goods orders* are up 17.1% as are *shipments*, which have risen for eight consecutive months.

- Despite a recent softening, *industrial production* has risen by an annualized 4% rate since its trough last March.

- *Retail sales* have risen the last four months and since January 1991 have increased an annualized 4.3%; over the same period, *car sales* are up 14.3%; *department store sales* have risen 6.0% since December 1990. In real terms, total *consumer spending* has picked up 2.3% since January.

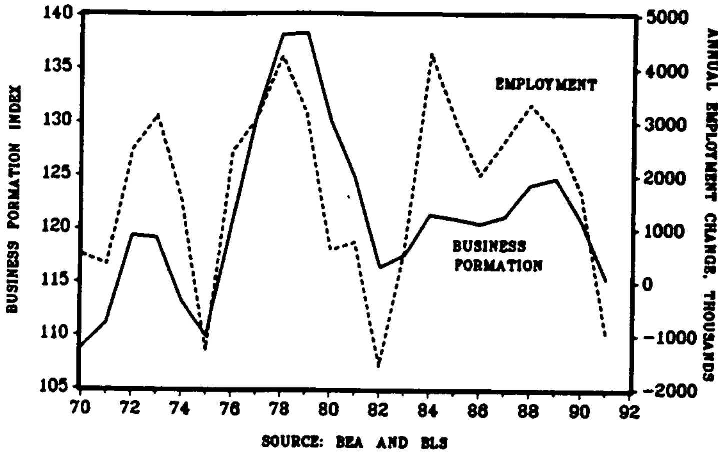
- Without a doubt, *employment* is the worst part of the recovery story. Nonfarm payrolls remain flat against their April trough level. In the most recent week, however, *initial unemployment claims*, a leading employment indicator, fell to 438,000, 19% below their peak level of 543,000 last March.

- Significantly, *real nonfarm proprietors' income* has risen eight of the last nine months and now stands 6.1% above its December trough level. This measure of self-employed, business operators is a entrepreneurial indicator.

- However, *new business incorporations*, one of the best measures of risk-taking animal spirits, has risen more slowly. Despite a mild 6.4% rebound between February and September, new business incorporations remain 20% below their December 1986 peak level.

The sluggishness of new business creation is a significant factor behind the weak employment figures and this my subpar recovery outlook. Throughout the 1980s, 90% of the 18 million new jobs created in the U.S. were generated from start-up companies and small businesses, the risk-taking entrepreneurial sector of the economy. As long as this sector remains dormant, new job creation will remain disappointing, and this in turn hurts sentiment. Consumer confidence levels are closely tied to the inverse of initial unemployment claims; not surprisingly, as claims rise, confidence falls.

This link, from business creation to jobs to consumer confidence is the key. This is why tax cuts, especially a capital gains tax cut and a payroll tax cut equivalent, are needed to reduce the cost of capital and labor. This will encourage new business creation which, in turn, will increase employment and raise confidence. As large existing corporations continue to restructure and downsize to remain globally competitive, new incentives for the new and small business sector become all the more important.


INDEX OF NET BUSINESS FORMATION & EMPLOYMENT
EMPLOYMENT = ANNUAL CHANGE IN PAYROLLS
BUSINESS FORMATION INDEX
ANNUAL EMPLOYMENT CHANGE, THOUSANDS
EMPLOYMENT
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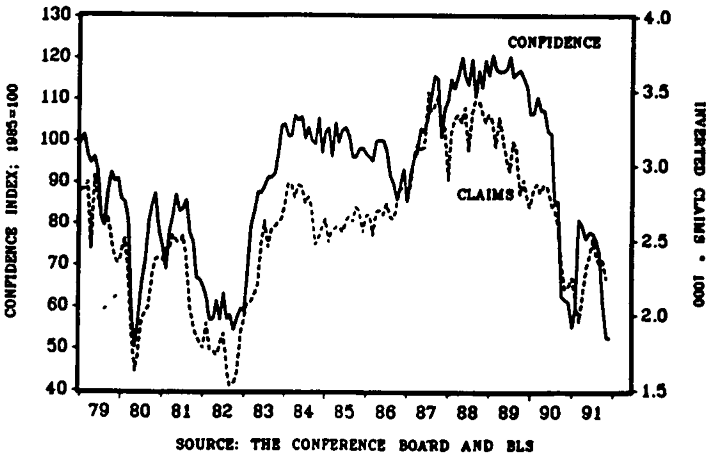
SOURCE: BEA AND BLS


CONSUMER CONFIDENCE & UNEMPLOYMENT CLAIMS
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4.0
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79 80 81 82 83 84 85 86 87 88 89 90 91
SOURCE: THE CONFERENCE BOARD AND BLS

Ruble Matters

Finally, in another important part of the world, if Russia and the new Commonwealth of Independent States (CIS) would reform its currency system -- as Argentina, Mexico, Czechoslovakia and Hungary have done -- then economic recovery in the former Soviet Union would come much faster. Russia should move to a fixed-exchange rate price rule, linking a "New Ruble" to the dollar or the German mark. This new currency could be backed by Russia's mineral resources, perhaps by selling commodity-backed bonds to raise foreign exchange reserves. During the transition, a G-7/IMF credit line should be made available to support the new currency.

The move to deregulate prices, privatize, develop private property rights and so forth are all important steps in the right direction, but they lack the backing of a sound currency. Without the benefit of a stable currency to act as a reliable medium of exchange and store of value, the end of price controls will spark a high inflation cycle.

In any event, the US and Western media are far too pessimistic about Russia's outlook. Free-market and free-election change in Russia will turn out to be a phenomenal plus for the world's economy and the cause of political and social advancement. China will be further isolated, as will be the remaining dictatorships in the Middle East, Africa, the Caribbean and South-East Asia. But these too will change for the better in the years ahead.

DATA SCORECARD

Economic Indicator	Percent Change at Annual Rate from Trough	Trough Month
Industrial Production	4.0% (Nov)	March
Purchasing Managers' Survey	8.8 percentage points (not annualized)	37.7% in January to 46.5% in December (6 of last 7 months above 50%)
Durable Goods Orders	17.1% (Nov)	March
Durable Goods Shipments	17.1% (Nov)	March
Nonfarm Payrolls	0.1% (Nov)	April
Initial Unemployment Claims	Peaked in March at 543,000; in latest week at 438,000 -- down 19%	
Unemployment Rate	6.8% in November	Perhaps peaked in June at 7%
Retail Sales	4.3% (Nov)	January
Department Store Sales	6.0% (Nov)	December
Automobile Sales	14.3% (Nov)	January
Real PCE	2.3% (Nov)	January
Real Disposable Income	1.0% (Nov)	February
Real Nonfarm Proprietors' Income	6.1% (Nov)	December
New Business Incorporations	6.4% (Sep)	February
Housing Starts	31.8% (Nov)	January
Building Permits	30.0% (Nov)	January
Existing Home Sales	18.0% (Nov)	January
New Home Sales	31.5% (Nov)	January
Leading Indicators Index	5.5% (Nov)	January

SENATOR SARBANES. Mr. Perry please proceed.

STATEMENT OF GEORGE L PERRY, SENIOR FELLOW, THE BROOKINGS INSTITUTION

MR. PERRY. Thank you, Mr. Chairman. I appreciate the opportunity to discuss what economic and budget policies are appropriate at this time when the economic news has been so disappointing and when there is a growing feeling that the government should be doing something about it.

For years now, the great majority of economists have emphasized the need to reduce the Nation's structural budget deficit. I am part of that majority. But long-range budget deficit reduction is not the only important dimension of economic policy. With the economy in recent months mired in low-level stagnation, if not in outright recession, the near term deserves attention as well. Monetary policy has been easing, and the recent sharp cut in the discount rate should lead to further cuts in the federal funds rate and market interest rates. But recoveries from past recessions have generally been aided by added fiscal stimulus as well. In five of the six past recoveries, the structural budget deficit was made meaningfully larger; 1980 was the exception when both fiscal and monetary policy were tightened in order to fight inflation and succeeded by aborting the recovery. In the other five cases, the structural budget deficit was increased by an average of 1.1 percent of GNP, which would be about $55 billion in today's economy. By contrast, the structural deficit is now narrowing slightly.

The case for short-run fiscal stimulus to help the economy is not that without it the economy would never recover properly. My own view of a likely range of economic outcomes is something like this: If we added fiscal stimulus at this time, it is unlikely we would regret having done too much a year from now, and it is quite possible we would have helped avoid a stagnant economy with persistent high unemployment. Now, that is enough to make it worth doing.

There is no conflict between the goals of near-term fiscal stimulus to aid recovery and those of long-term deficit reduction. The point of structural deficit reduction is to permit higher levels of national investment by increasing long-run national savings. But in today's underutilized economy, there is no need to free resources by saving more in order to produce more investment goods. Rather, stimulating activity, even by temporarily enlarging the budget deficit, will encourage private business investment, not crowd it out as it would in a high-employment economy.

Furthermore, some of the most damaging shortfalls in national investment have been in areas that are a public function and responsibility, such as education and infrastructure. These investments can be increased directly as part of a stimulus package.

The big risk is that the political process will enlarge the longer run deficit in the process of formulating a short-run stimulus package. If that is where opening up the budget discussion would lead, it might be better

to stick with the existing budget constraints, and let monetary policy try to promote recovery by itself.

To assure that the quest for short-run fiscal stimulus does not raise long-run deficits, only spending or tax changes that are explicitly temporary should be considered. To fit these objectives, the Budget Enforcement Act could be modified by temporarily lifting the overall budget constraints in fiscal years 1992 and 1993, but not for subsequent years. For now, spending or tax changes that affect budgets beyond fiscal year 1993 should have to be offset by other changes so that together they reduce or, at worst, do not add to long-run structural deficits. The constraints by individual categories should also be eliminated to allow for the prospects of lower defense spending.

A variety of tax or spending measures could help get the economy moving. Considerations of need and fairness, as well as avoiding adding to future deficits, should enter into the choice among them. On the tax side, changes could be chosen to impact either short-run consumption or investment.

First, if income tax breaks are used to boost consumption, a tax refund or credit that is paid out promptly would be better than a rate cut, because it avoids the risk of becoming permanent and because its impact comes sooner. I am not concerned that a one-time or temporary tax break is thought to have less effect on consumption than a permanent tax change. Today, many families are liquidity constrained and would spend added income. And if some part of a tax break went to reduce debt, that would not be such a bad thing either. And among incentives to boost investment rather than consumption, a temporary investment tax credit would have the strongest effect. A temporary credit not only leaves future deficits unchanged, but has the added advantage of providing a bigger, short-run impact than a permanent credit would. There would still be more bang for a buck if the credit applied only to investment above some fraction of previous investment. However, this would arbitrarily favor some firms over others. In contrasts to a temporary ITC, enhancing IRAs or reducing the capital gains tax would provide no near-term lift to investment or other spending. And despite the depression in nonresidential construction, Congress should not be tempted to bring back passive loss deductions or any related tax shelters that cost revenues and divert funds from where they are the most productive.

On the expenditure side, a standard problem is that new projects take too long to spend out and so have their impact too late. However, certain kinds of expenditure initiatives lend themselves to the present situation. Special one- or two-year grants to states and localities would help relieve the fiscal problems that are forcing many of them to raise taxes, lay off workers, and curtail or compromise important services. These should be on the top of your list of considerations. Accelerating expenditures on already-agreed-upon federal infrastructure projects would provide stimulus soon without creating new programs whose spending impact will be delayed and concentrated far into the future. Public construction programs

have the added benefit at this time of using labor and capital resources that have been idled by the great slump that is underway in private construction.

I have not addressed the question of what to do with the defense dividend, because it is relevant to future structural deficits rather than to the immediate economic outlook. But I would urge that you resist the temptation to pass permanent tax cuts for the stimulus they provide, while looking to future defense cuts to offset their effects on the structural deficit further down the road. For a decade, rational discussion of budget priorities and national needs has been constrained by the lack of revenues. Perhaps future defense cuts will be large enough to permit funding high-priority programs, deficit reduction, and tax cuts. But without convincing evidence that it would permit all three, it would be a mistake to perpetuate the problems of a decade by making any permanent tax cuts now.

Thank you, Mr. Chairman.

SENATOR SARBANES. Thank you very much, Mr. Perry.

[The prepared statement of Mr. Perry follows:]

PREPARED STATEMENT OF GEORGE PERRY

Dear Mr. Chairman and Members of the Committee:

I appreciate the opportunity to discuss what economic and budget policies are appropriate at this time when the economic news has been so disappointing and when there is a growing feeling that the government should be doing something about it.

For years now, the great majority of economists have emphasized the need to reduce the nation's structural budget deficit. I am part of that majority. But long-run deficit reduction is not the only important dimension of economic policy. With the economy in recent months mired in low level stagnation if not still in outright recession, the near term deserves attention too. Monetary policy has been easing and the recent sharp cut in the discount rate should lead to further cuts in the federal funds rate and in market interest rates. But recoveries from past recessions have generally been aided by added fiscal stimulus as well. In five of the past six recoveries, the structural budget deficit was made meaningfully larger. 1980 was the exception when both fiscal and monetary policy were tightening to fight inflation and succeeded by aborting the recovery. In the other five cases, the structural budget deficit was increased by an average of 1.1 percent of GNP, which would be about $55 billion in today's economy. By contrast, the structural deficit is now actually narrowing slightly.

The case for short-run fiscal stimulus to help the economy is not that without it the econmoy would never recover properly. My own view of the likely range of economic outcomes is something like this. If we added fiscal stimulus at this time, it is unlikely we would regret having done too much a year from now and quite possible we would have helped avoid a stagnant economy with persistent high unemployment. That is enough to make it worth doing.

There is no conflict between the goals of near-term fiscal stimulus to aid recovery and those of long-term deficit reduction. The point of structural deficit reduction is to permit higher levels of national investment by increasing long-run national saving. But in today's underutilized economy, there is no need to free resources by saving more in order to produce more investment goods. Rather, stimulating activity, even by temporarily enlarging the budget deficit, will encourage private business investment, not crowd it out as it would in a high-employment economy. Furthermore, some of the most damaging shortfalls in national investment have been in areas that are a public function and responsibility, such as education and infrastructure. These investments can be increased directly as part of a stimulus package.

The big risk is that the political process will enlarge the longer run deficit in the process of formulating a short-run stimulus package. If that is where opening up the budget discussion would lead, it might be better to stick with the existing budget constraints and let monetary policy try to promote recovery by itself. To assure that the quest for short-run fiscal stimulus does not raise long-run deficits, only spending or tax changes that are explicitly temporary should be considered. To fit these objectives, the Budget Enforcement Act could be modified by temporarily lifting the overall budget constraints for fiscal years 1992 and 1993 but not for subsequent years. For now, spending or tax changes that affect budgets beyond fiscal 1993 should have to be offset by other changes so that together they reduce or, at worst, do not add to, long-run structural deficits. The constraints by individual categories should also be eliminated to allow for the prospects of lower defense spending.

A variety of tax or spending measures could help get the economy moving. Considerations of need and fairness, as well as avoiding adding to future deficits, should enter into the choice among them.

On the tax side, changes could be chosen to impact either short-run consumption or investment:

- If income tax breaks are used to boost consumption, a tax refund or credit that is paid out promptly would be better than a rate cut because it avoids the risk of becoming permanent and because its impact comes sooner. I am not concerned that a one-time or temporary tax break is thought to have less effect on consumption than a permanent tax change. Today many families are liquidity constrained and would spend added income. And if some part of a tax break went to reduce debt, that would not be such a bad thing either.
- Among incentives to boost investment rather than consumption, a temporary investment tax credit would have the strongest effect. A temporary credit not only leaves future deficits unchanged but has the added advantage of providing a bigger short-run impact than a permanent credit would. There would be still more bang for a buck if the credit applied only to investment above some fraction of previous investment. However this would arbitrarily favor some firms over others. In contrast to a temporary ITC, enhancing IRAs or reducing the capital gains tax would provide no near-term lift to investment or other spending. And despite the depression in nonresidential construction, Congress should not be tempted to bring back passive loss deductions or any related subsidies to the construction industry. These would bring back the tax shelters that cost revenues and divert funds from where they are most productive.

On the expenditure side, a standard problem is that new projects take too long to spend out and so have their impact too late. However, certain kinds of expenditure initiatives lend themselves to the present situation.

- Special one or two year grants to states and localities would help relieve the fiscal problems that are forcing many of them to raise taxes, lay off workers, and curtail or compromise important services.
- Accelerating expenditures on already agreed upon federal infrastructure projects would provide stimulus soon without creating new programs whose spending impact will be delayed and concentrated far into the future. Public construction programs have the added benefit at this time of using labor and capital resources that have been idled by the great slump that is underway in private construction.

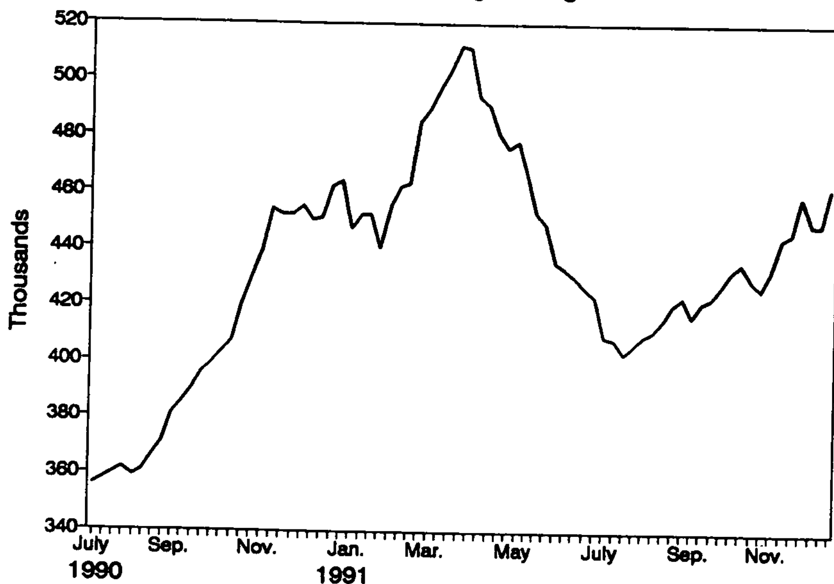
I have not addressed the question of what to do with the defense dividend because it is relevant to future structural deficits rather than to the immediate economic outlook. But I would urge that you resist the temptation to pass permanent tax cuts for the stimulus they provide while looking to future defense cuts to offset their effects on the structural deficit. For a decade, rational discussion of budget priorities and national needs has been constrained by the lack of revenues. Perhaps future defense cuts will be large enough to permit funding high-priority programs, deficit reduction and tax cuts. But without convincing evidence that it would permit all three, it would be a mistake to perpetuate the problems of a decade by making any permanent tax cuts now.

Thank you, Mr. Chairman.

SENATOR SARBANES. I want to thank all the members of the panel for your contributions.

We will now go into a question period.

First of all, let me say that, just to provide some context for the hearing, we have just received information that the new claims for unemployment insurance for the week of December 28, which came out this morning—so those are the latest figures—rose from 436,000 the previous week to 458,000. We know these numbers bounce up and down a bit. But if you take the four-week moving average, which is a more reliable figure, the trend line for unemployment insurance claims has been up. In fact, as this chart indicates, starting in March and April, which was regarded as the trough of the recession by many, the four-week moving average started coming down (see chart). Then, in August or September, it started back up again. So, while the weekly figures move much more erratically, the four-week moving average, as we can see, went up very sharply here. It came down, but now it has started back up again.



I think, Mr. Kudlow, you said that you established a correlation between the unemployment insurance claims and the consumer confidence figures, as I recall.

I want to ask, first, some questions about monetary policy. Senator Sasser and I, in the program we put forward, first of all recognize that the Fed now has lowered the discount rate to 3.5 percent, although we noted that the federal funds rate had not come down accordingly, and we urged

the Fed to move to lower the federal funds rate. I gather no one on the panel disagrees with that. You all think that that should be done. Is that correct?

MR. TOBIN. Yes.

SENATOR SARBANES. We had done a study that showed that up until the cut in the discount rate the Fed's easing of monetary policy in this recession was less than in previous recessions, making a comparison of the extent of the cuts.

Second, let me read from our statement:

> Effective immediately, the Treasury should shift toward shorter maturities in future auctions of Government securities, and the Federal Reserve should increase its holdings of long-term Treasury securities. This will reduce the supply of long-term Treasury bonds, raising their prices and lowering long-term interest rates.

Now, it is our perception that since you have this steep yield curve the Treasury and the Fed do have some power to affect long-term rates, at least through their management of the federal debt. And I take it from your testimony that the Treasury ought to be shifting toward auctioning shorter term securities rather than the longer term securities. Should the Fed also go into the market and purchase longer term securities to try to move longer term interest rates down?

What do you think, Professor Tobin?

MR. TOBIN. Yes, they should, not exclusively, but when they have a good opportunity to do so.

SENATOR SARBANES. Professor Samuelson?

MR. SAMUELSON. I think it would establish a good precedent. There was, in the 1950s, a dogma called "bills only," which prevailed in the Fed, even it did not have behind it the weight of economic history or the majority of academic analysts. There were also studies made in the 1960s—in the Kennedy era—in which Operation Nudge or Twist seemed from statistical studies not to have a great potency—some of them done at Yale, actually.

Now, I think that you have to keep doing economic studies as situations change. I remind myself that we were working desperately in the 1960s with an overvalued dollar, and Undersecretary Roosa was instructing himself and was being instructed not to let short-term rates go down below a stipulated level. So, under that constraint, any regression studies I think would be misleading. I think that the Treasury and Fed leaning toward support of long-term bonds would do some good. An experiment would be worthwhile. It would also get the market used to this worthwhile experiment.

And having said that, let me point out that the long-term rate has, in the last month or two, been coming down nicely. The curve is still steep, but the whole curve has been moving in a parallel way downward.

Second, a lot of the investment spending which we want to stimulate, like housing, is more geared to the 10-year part of the maturity span than

to the 30-year part. So, in my view, the Fed has been doing too little, but has been getting considerable results for what it has done.

I shudder to think what the situation would be like today, with the credit crunch and the FDIC situation, if President Hoskins of the Cleveland Federal Reserve or Board Governor Angell had prevailed. The Fed's genuine mistakes were not simply because of some stupidity on the part of Mr. Greenspan. Actually, Mr. Greenspan is a very savvy observer. A substantial element of his colleagues on the Open Market Committee, in season and out of season, insisted that it had a mandate to bring the price-level growth rate down to 0 percent or ½ percent—not 2 percent, not the 3 percent that we have now—by 1995. And this mono-mania is engraved in speech after speech as the overriding function, goal, and responsibility of the Federal Reserve. And it was those dogmatic pressures which led to too little too late.

SENATOR SARBANES. Professor Tobin?

MR. TOBIN. I want to say a bit about Operation Twist in the 1960s. To some extent, there was lack of true coordination between Federal Reserve operations and the Treasury's debt management policies. At the same time that the Federal Reserve did, in a begrudging way, buy some long-term securities in the open market, the Treasury—although it gave lip service to this policy—was doing advanced refunding operations that had the effect of lengthening the maturities of outstanding Treasury securities. So, the Treasury undermined the policy.

SENATOR SARBANES. Mr. Kudlow?

MR. KUDLOW. A couple of points. I am one of the people who agrees fully with the goal of price stability and zero inflation. I would not measure it in terms of the CPI, however. I would measure it in terms of commodity price movements. And commodity prices have been flat for the better part of the past couple of years.

So, I think the Fed has achieved its goal. It is because it has followed this goal that long-term interest rates are coming down to levels that we haven't seen since the early 1970s.

In other words, I would encourage my fellow panelists to study carefully why it is that what they characterize as "too little too late" has given us the largest long-term interest rate decline in many, many years. And I would suggest that it is because of the credibility of their counterinflation program which is operating, along with foreign central banks and the Group of 7, that market investors are now willing to buy these medium- and long-term bonds, bring rates down, which stimulates mortgages, housing, and corporate finance.

And let me add to this, neither the Federal Reserve nor any government agency will determine long-term rates. That is a market function. And we have tried many times in the past with these kinds of Operation Twist arguments, and they have never worked and mostly have backfired. Inflation expectations are the dominant force.

Now, withholding bonds from the new Treasury offerings— which I agree with—by itself is not a long-term solution, but if it occurs within

the framework of some sensible fiscal planning that would generate lower deficits through growth—some spending control and the like—it might work very nicely, because there is a burden at the long end. In technical terms, you are not only putting Treasury paper out there, you are also putting a lot of housing paper out there, securitizations in the housing mortgage market and now of late the RTC paper. So, there is a burden, and it might be helpful, but by itself it is probably just a small point.

SENATOR SARBANES. Mr. Perry, I will come to you, but before I do, let me make this observation, and maybe you can encompass it in your comments.

It is difficult for me to understand the Treasury's behavior, given this disparity between the short-term and long-term rate, given the low inflation, given the recession, given a reasonable anticipation about where we are going to be a year from now, that we are not going to have some kind of runaway economy—overheated and overstimulated.

In fact, the most optimistic prediction among the 50 Blue Chip forecasters is that even if we get positive growth it is going to be very anemic. There is a great tendency to see this issue in terms of whether growth is positive or negative. And that is a good benchmark. If growth is negative, it is bad. But even if it is positive, if it is only positive by a small margin, if it is very anemic, then we are still going to be left with a lot of economic problems. You do not immediately cross over into a pleasant situation when you go from negative to positive. It's better to be positive, but if the positive is a small figure, you still have a lot of economic problems on your hands. Those are the forecasts.

Now, why shouldn't the Treasury be borrowing money at the shorter maturities, with the lower interest rates, and save the federal budget what they would pick up by paying the lower interest rates rather than the higher interest rates that are associated with the longer-term maturities? That would help also to drive down the longer rates, broadly including the private sector, which of course then affects housing and other investment decisions.

What is the reason not to do that?

MR. PERRY. There is a normal cyclical pattern to the term structure of rates in that, when the Fed is very aggressively trying to fight a recession, it will push short-term rates well below intermediate and long-term rates. So, whether at this moment in time the rates are more out of line than they should be is a close call. I believe they are by a small margin. But recently the long rate has come down a lot. And one could argue that the relationship is now normal.

I do think that in the past the Treasury quite often issued long when they should have issued short. I think in particular in the 1980s—the period that Mr. Kudlow was speaking of—the issuance of long bonds at double-digit interest rates was strange for two reasons: One, it was bad because it was costing taxpayers an enormous amount of money, even today; but, two, it was perverse because every announcement the Government made at that time was that they were bringing inflation under

control, that they had policy in place that was going to give us a stable price level. If they believed that, the last thing they should have been doing was issuing bonds and paying 12 percent interest rates to do it, which is the point that you are making. Why issue a bond on which you pay so much more interest if you believe that interest rates are going to be substantially lower in the future?

I think the Treasury, making that kind of statement, can tell the market something. It can help guide the market by, in effect, saying, "We have policies in place that are going to produce no inflation. We are going to reduce the inflation from what it is, and therefore we refuse to issue any bonds that have implicit in them a very high inflation rate in the future, because that is not our policy, that is not our aim, and we don't want to pay the extra interest costs."

The Treasury is the party that, through its operations and what it issues, is making a statement about what it expects future interest rates to be.

MR. KUDLOW. We had this discussion just about ten years ago, and there was tremendous opposition inside the Reagan Administration in the early 1980s to issuing long bonds at 15 percent coupons. The Treasury Department opposed any changes in their debt management. And I think they did so, in part, on the advice of the Government Bond Dealers Association, of which my firm is a member, and partly because of a certain bureaucratic inertia which creeps into these things over time.

Frankly, you sit here with a very pointing yield curve, 300 basis points wide, some odd. Any deputy junior assistant corporate treasurer knows that you want to save the shareholders by staying short instead of borrowing long. And there are a lot of bright, high-IQ, multidegreed people in the Treasury Department who can probably figure that out. So, I think this is the right time to go after that issue. It is actually too late because we could have saved serious money if we had done it ten years ago. But it is never too late to start a better policy.

MR. SAMUELSON. Can I just register——

SENATOR SARBANES. My time is up, but I want to hear you.

MR. SAMUELSON. I think relying primarily on short-term debt is a very complicated question, not a simple question. The purpose of good policy overall should be the macrohealth of the economy, not what saves money for the Treasury. If you take the viewpoint of what in the end, during the steady state, will be the cheapest way for the Treasury to finance its deficits, operations, and surpluses, it is not clear that there is no room for long-term bonds—even though the yield curve does normally have a higher rate at the long end.

To be specific, I said that 4 percent real growth should be our goal for the first year ahead. I want to make clear that I did not express myself well. If anyone thought that I thought that over the whole of the next expansion 4 percent was a correct goal to aim for, that is a misunderstanding. I think that you slow down after the first year, and I will be very delighted if productivity so improves in the economy that I can

elevate my long-term figure. But my long-term figure is not now 4 percent. But suppose we do get 4 percent because of Congress's successful operations and the health of the economy, I think long-term interest rates will still go up from the trough to which they ought to be pushed in order to insure the recovery. And then it won't look to be such a smart thing for the Treasury to have not floated long term when their yields were low.

However, you can say, "Well, if we are pursuing lower costs, why do we pay any interest? Why don't we issue currency?" Just go south of the border and get a lot of lessons on why it is not a good idea to finance long-term—particularly structural—deficits that we now have by money or by near-money substitutes exclusively. Because in the long run, there is a solid germ of truth in the Quantity Theory of Money, and I include in that quantity theory of money near-monies. And so you do have a problem of the price level.

Yes, producers' prices are almost now constant. Still, you don't solve the inflation problem the way you solve the smallpox problem—get the last case of smallpox and then it goes into the history books. Rather, battling inflation is like keeping my weight down. Price stability is something which requires eternal vigilance and ever sacrifice.

But I don't have to decide these complicated problems in order to recommend Project Nudge. It is a good thing at this time to be shortening the average maturity. Later, you could have some hearings and get some studies as to what is the long-run optimal way of running the maturity structure.

SENATOR SARBANES. I do not think any of us is trying to set an absolute rule. We are really trying to focus on the current situation, where we are. In that context, I take it there is agreement at the table that the Treasury should shift its debt-management policy and that benefits would flow from that?

MR. PERRY. I did not interpret that to say that they should never issue long bonds.

SENATOR SARBANES. No, certainly not.

Congressman Armey?

REPRESENTATIVE ARMEY. Thank you, Mr. Chairman.

Gentlemen, it is always interesting and fascinating to talk about what the Treasury and Fed would do, but as William McChesney Martin told President Johnson in the 1960s, it is not our job, it is their job.

I would like to focus back on the question of the economy. From my point of view, Congress in 1986 and 1990 created a recession and told the Fed that now we are going to leave you holding the bag. So, let us talk about what Congress might do to pick up its share of the load.

We have all agreed, I think, Mr. Perry, with some reservation, that there ought to be some fiscal response to these circumstances. Mr. Perry, I think, is quite right to be reserved. Should that fiscal response result in some long-term structural increase in the deficit, we ought to try our best

to avoid it. I believe I am correct on this issue, and I think Professor Samuelson issued the same caveat.

Looking at the possibility of doing something on the fiscal policy side to help out what I think are the commendable efforts of the Treasury, let me just see if I can line some ducks up in a row and focus on something on the fiscal-policy side.

First, we are clearly concerned about consumer confidence. Certainly, the Chairman's table at the beginning of these hearings shows us how concerned we should be. Consumers' confidence, it seems to me, is derived largely from their employment circumstance; that is, do they have a job and are they optimistic and confident about their chances of retaining and, in fact, experiencing advancement in their job? Second, the extent to which they feel they have a position of wealth on which they can rely should something happen to their employment circumstance?

These two, I believe, and you can correct me if there is something that I have left out, would be the two things that we would look to in the household that would result in some consumer confidence resurgence. Obviously, then, we would think in terms of restoring some performance to the economy pursuant to increases on the demand side of the equation. In the old Keynesian framework, that could have happened by government spending in a healthy, more durable, more reliable, more satisfying way. It would happen if the consumers in fact had their own income with which to express that demand in the economy so that they could be more confident that their real needs would be met rather than those of politicians.

We also see that capital formation is essential to the creation of job opportunities and is most meaningful implemented in this country in new-business formation, small business. I think your statistics indicated that there seems to be general consensus here.

Now, let me get to the decision-making process. We are interested in capital formation so that people can have jobs, have expectations of getting jobs, and have expectations of thriving in those jobs. And incidentally, in that regard, let me suggest that if you read the *New York Times* today, you will find the real tragedy of our economic circumstances in a story there; the very poignant story of the young college graduates who are struggling, going haplessly in this job market to get started in the world of work. That is where the heartbreak is, in its most tragic terms.

Looking at capital formation, I want to focus on this. A businessman makes a business decision to purchase a piece of capital equipment, to purchase a plant for production, by using a method of decision-making called discounted present value, that sensational juxtaposition of expected earnings against current and expected costs of the enterprise.

You recall that. That is a very common process. But the decision is made now on the basis that—and remember the famous Keynesian observation that the economist looks at the future in light of the past for purposes of the present—a businessman is going to have expectations of future earnings; he is going to have the current cost of the capital equip-

ment. And would you agree with me that that businessman in making that decision is going to make it in real future dollar terms, real earnings flows, as opposed to nominal flows? That is, he will account for inflationary expectations in that decision-making process. So, that if we build down the rate of inflation and thereby build down inflationary expectations, he is more likely to make the investment. Furthermore, another important cost component is taxes, because the businessman will make this decision in terms of net earnings, not gross earnings, and he or she will obviously be well aware of the tax rate.

Now, you all agree that this is the process by which the decision is made. Mr. Greenspan says that if in fact we could lower the capital gains tax rate or, at least by basis, adjust capital gains in the tax code, setting the nominal rate equal to the actual rate, he would anticipate that there would be an immediate beneficial impact in the economy in capital formation and then, of course, subsequently, jobs.

I happen to believe that that is exactly what would happen. If in fact the whole world makes decisions about investment, in terms of the real capital gains earnings of that possible investment, is it rational or equitable or efficient for the government to have an official policy that ignores the differences between nominal and actual rates of return as a result of inflation, and shouldn't this fiscal policy alternative that we have at least begin with the government's dealing with investment activity and returns honestly, and in real terms by basis adjustment?

How many of you would accept that this would be a good first place to begin the process if, in fact, you want capital formation to result in job creation that would, in turn, result in increased consumer confidence and then, subsequently, recovery from the recession?

Would anybody like to comment on that?

MR. SAMUELSON. I have reservations, but I would like to hear the yea-sayers first.

MR. KUDLOW. I will be the yea-sayer. I think that is exactly right. I think it is fundamentally unfair to punish business returns and investments for inflation. I think that we should be indexing capital gains. I think we should be indexing depreciation and corporate tax rates. We index the income tax code essentially, and that has held up rather well.

The only way to promote long-term investment and savings is for people to have confidence in the steady real rate of return.

REPRESENTATIVE ARMEY. Let me make the observation that it is intellectually inaccurate for those who don't know any better and intellectually dishonest for those who do, to say that applying a real tax rate of 33 percent on investment income, as one would on wage income, while not making basis adjustment for inflation, is simply inaccurate or dishonest. The fact is that the actual tax rate is going to be, if there is any rate of inflation whatsoever, something higher than that imposed rate.

MR. SAMUELSON. I want to agree that long-run reform for purposes of equity calls for indexing capital gains taxation. That has nothing to do with the odd view that you now tell me that Mr. Greenspan has, that the

forecasts of the next six quarters that Wharton and DRI make for the economy will materially be affected by the rate at which this particular long-run capital gains reform is put in. It will not have that effect, in my judgment.

It will have on effect on the likes of me, I can tell you. For many years a good deal of middle-class recreational time was spent in converting ordinary income into low-tax capital gain. That did not create jobs. In recent years, affluent folks have desisted from that activity, because the same rates have prevailed for ordinary income and capital gains. You must factor in both the marginal increase in risk-taking and also the marginal increase in socially desirable risk-taking—the last of which is a different thing from what is taxwise for tax straddles and capital gains. However, with respect to indexing, I think you will get four people at this table to say that that is an overdue part in the capital gains picture.

REPRESENTATIVE ARMEY. Mr. Tobin?

MR. TOBIN. I am not disagreeing with that, but I do think that, if we index the cost basis for capital gains for the purpose of taxation, we have to index the whole tax system. For example, it is now possible to borrow money and charge off the full nominal interest as a cost deduction instead of just the indexed part of the interest rates; that is, instead of the real interest rate that you are paying on the debt. So, suppose you have inflation of 5 percent and a nominal interest rate of 10 percent, then you are able to deduct, as a cost, the full 10 percent and save paying income tax on that amount.

Now, if you index capital gains and don't index also the interest part of the tax law on both sides—the declaration of interest as income and the deduction of interest as cost—then it is possible for Mr. Samuelson to play games and he would. He would borrow money and charge the nominal rate as the cost on his tax bill, and yet pay tax only on his real gains. So, indexing is not a simple reform.

The second comment relates to lowering capital gains tax for assets acquired before the law went into effect. Now, that doesn't give any incentive at all. The behavior that they were engaged in when they acquired those assets and have held them these many years has already taken place. So, you are just giving them one-shot windfalls.

REPRESENTATIVE ARMEY. A belated equity. And the point remains.

MR. TOBIN. If I may add a third point. Under the present law, there is no capital gains tax levied at all on assets held until death, assets that go into estates for inheritance. None at all. So, to say that the capital gains tax is such a terrible burden ignores that essential fact.

REPRESENTATIVE ARMEY. With respect to that last observation, the fact is we all work on behalf of our children. There is very little consolation to me regarding the making of a decision about a long-term investment, when I believe that if I hold that instrument until my death, it will be my children from whom its value will be expropriated rather than me. I still lose.

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Mr. Tobin. Not from them either. It will not be. They will get a new basis at the time they acquire the assets, and they will not be stuck with yours.

Representative Armey. The assets minus the estate tax.

Mr. Samuelson. Since I am being caricatured as the legal tax avoider, let me say that I think of nothing so much as the date of my death. Unfortunately, it complicates my plan because I don't know what that date is.

Senator Sarbanes. I did not think you were being characterized that way. I thought the point being made is that a rational person with an ability to perceive one's rational interests, and if the system permitted the thing that Professor Tobin was outlining, that smart, rational people would proceed to do exactly that. If you could borrow money and deduct the nominal interest rate on it, and then invest it and pay taxes only on the real increase, then obviously you have an arrangement that you can develop to very good advantage. That is what I understood the point to be.

Does anybody else want to add anything before I turn to Congressman Hamilton?

Mr. Perry. Just very briefly, and I would echo what Professor Samuelson said. As a short-run impact measure to stimulate investment today, this would rank very low on the list as what everyone might think of as a long-run cleaning up of the tax bill measure. Professor John Shoven at Stanford is the only person I know who has tried to compare the effects on investment of introducing an investment tax credit with changing the capital gains rate. Comparing a drop from 28 percent to 20 percent with introducing a 7.5 percent credit, he found that the effect of the ITC on investment is about eight times as great.

So, as a short-run measure to stimulate investment, cutting the capital gains tax would rank very low. As a long-run measure for tax reform, I agree both with the thrust of the remarks that indexing is probably a good thing to do and with the caveat that it is a complicated thing to do, because one could, for tax purposes, deduct nominal interest rates against real capital gains. It is not that Professor Samuelson would stay up nights doing this. It is that an industry would probably crop up to do it. Mr. Kudlow's firm would invent instruments, the whole purpose of which would be to play with nominal interest rates on the one hand and real capital gains on the other. That is the kind of thing that the financial world has gotten very good at doing.

So, when you do get around to making this reform, I think you have to consider the fact that you can't deduct nominal interest expenses used in the course of earning real capital gains for your tax system. It is a complication.

Representative Armey. What we do have to understand, we don't look for job creation and the exchange of assets in the existing stock of wealth in the stock market. We are looking for where the investment

activity results in creation of new capital formation. If Professor Samuelson finds it to his personal tax advantage to hold his wealth in one instrument or another, that is really not the question here. That can be construed, as he says, as not creating jobs, unless he should elect to hold his savings by virtue of an instrument that results in immediate new capital formation. But just exchanging assets in the stock market, we understand that is just a game, in terms of its real economic effect. It is simply just the game of what is the form of the wealth today, much of which incidentally——

MR. KUDLOW. Can I comment on that?

SENATOR SARBANES. We have to move on. Mr. Kudlow, why don't you take ten seconds here?

MR. KUDLOW: I want to say that a properly crafted capital gains reform, which would include some rate relief for all of the brackets and indexation, would have a tremendous near-term impact. I do not agree with Mr. Perry, because we would get a lot of unlocking of assets that are frozen right now at a point where there is virtually no other liquidity coming out of the credit system. That is the key point. It would also help the revenue situation, but I don't care much about the revenue situation in the short run. People are having a hard time getting their hands on credit and capital, and this would really stimulate that process.

SENATOR SARBANES. Congressman Hamilton?

REPRESENTATIVE HAMILTON. Thank you, Mr. Chairman. And I want to thank the witnesses for a marvelous morning.

First, I want to get a couple of impressions. One impression I have is, and you don't need to give me an elaborate answer here, none of you is advocating a cut in the income tax rate. Is that correct?

[Witnesses nodding heads.]

REPRESENTATIVE HAMILTON. All of you agree that the wrong thing to do at this time is to cut income tax rates. Okay.

MR. KUDLOW. I know that you are developing momentum, but I just want to add, if the Congress in its wisdom decides not to reduce the payroll tax rate and not to raise the income tax credit, which is an offset to the payroll tax rate and therefore has no measures to change the cost of labor, then I would advocate dropping the 15 percent bracket down by two or three points.

REPRESENTATIVE HAMILTON. Okay.

Now, second, I am going back to Indiana next week, and I want to get a nice, clear answer to the question, are we in a recession or are we coming out of it now? Just give me a simple, easy answer. [Laughter.]

I am not talking to PhDs in economics. I am talking to nice, average folks. Are we out of the recession, or are we still in the recession?

MR. PERRY. With a gun to my head, I would say that we are still in it.

REPRESENTATIVE HAMILTON. Would you agree with that, Mr. Tobin?

MR. TOBIN. I would say that we are not out of it. [Laughter.]

REPRESENTATIVE HAMILTON. Mr. Samuelson?

MR. SAMUELSON. I think by the National Bureau definition of a recession, which is not what your Indiana country folk understand by recession, we are very near to having gone back into it after a short, abortive period of being out of it. And so, if that is so, the future Committee will decide that we didn't really get out of it.

REPRESENTATIVE HAMILTON. All right.

MR. KUDLOW. The 1992 economy is going to be much better than the 1991 economy.

REPRESENTATIVE HAMILTON. All right.

MR. TOBIN. Can I say one more thing on that?

REPRESENTATIVE HAMILTON. Sure.

MR. TOBIN. I would like to second what the Chairman said; namely, whether you have a plus above zero of a small amount or a minus below zero of a small amount, it doesn't really make that much difference. It feels like a recession either way.

REPRESENTATIVE HAMILTON. I understand that.

MR. TOBIN. In terms of the potential of the economy—low as it is, 2.0, 2.5 percent—we have been below that since the second quarter of 1989. And that is a long time of what sometimes is called a growth recession.

REPRESENTATIVE HAMILTON. The next thing I want you to help me on is the deficit. We have a $350 billion deficit, according to the CBO, for 1992. I am informed that in a few days they are going to increase that estimate substantially. I don't know what the increase is, but let's say to somewhere around $400 billion.

How can a federal budget deficit of $350 billion or $400 billion not be highly stimulative? I have been in the Congress long enough to know that we have gotten into a panic when a deficit approached a few billion dollars. I have been in long enough to remember a Secretary of the Treasury saying that, "it doesn't matter what the deficit is, just forget it." And I have been in long enough to see all kinds of arguments made in favor of cutting that budget deficit, many of them by you. Cutting the budget deficit is important because government borrowing crowds out money for private investment and drives up interest rates. That is something that we hear often. It swallows up the Nation's savings and balloons the interest payments that you have to make. Those interest payments are now or soon will surpass the defense budget in size. But as I listen to you this morning, none of you seems to be much concerned about that deficit. And if I heard correctly, some of you talked as if fiscal policy is moving toward restraint.

Now, I am having a difficult time figuring out why, with a $350 billion deficit, you distinguished economists come in here and tell me don't worry about it, spend more.

MR. PERRY. I tried to emphasize in my testimony—and I think I heard others make the same point—that you should not do anything in the process of dealing with the current economic crisis that would enlarge the deficit further down the road. Your concerns about the deficit are

valid—it would take too long to go through all of the ins and outs—but anything that is done today should be done with explicit care not to enlarge the structural deficit in the future where, for a variety of reasons——

REPRESENTATIVE HAMILTON. Are you talking about the 1993 fiscal year?

MR. PERRY. This year and next you still are dealing with recession problems, and after that you should get back on the deficit path.

REPRESENTATIVE HAMILTON. Your view is that you can increase the deficit in fiscal year 1993, and that's good?

MR. PERRY. Yes.

REPRESENTATIVE HAMILTON. Is that the view of all of you?

MR. SAMUELSON. Yes. But I would like to be more responsive to your immediate question.

SENATOR SASSER. When Dr. Perry said that it has been customary in the last five or six recessions, with the exception of 1980, for there to be reliance upon a increase in the deficit, what his text said was, "as measured by how large the deficit would be at full employment." And we need more of what is the current deficit in order to have a larger full-employment deficit if we are going to be fighting recession with the same strength in this recovery, as was typical in all of the previous recoveries except 1980.

I suppose you could tell your Indiana constituency that the system is already accustomed to this degree of deficit and needs, if it is going to tackle joblessness basically, more of that fuel. The fact is that the whole system has readjusted its spending to this basic structural-deficit legacy of the Reagan epoch, a tragedy for U.S. thriftiness.

REPRESENTATIVE HAMILTON. So, if we move to increase that deficit in fiscal year 1993 by $50 billion or $60 billion—the figure some of you have suggested—in the manner that you have suggested, then we ought not be worried about increasing the deficit in that way?

MR. SAMUELSON. You will then be doing what has typically been done in the past, and if you stick to that past, you would then typically make sure that that incremental Keynesian cyclical deficit is reduced when there is a healthy recovery. Now, this provides no judgment as to whether the average level, at which all of this anticyclical behavior is taking place, is right for long-term needs. And since you have two considerations, the short-run macrobehavior of the economy and the long-run, supply-side performance of the American economy, I have to tell you that in these last two recessions, when these corrections were being made, they were being made, in my judgment, around the wrong level of long-term deficits.

REPRESENTATIVE HAMILTON. Dr. Samuelson, one of the things that I have heard for a long, long time up here is that we can increase the deficit in the short run because the long run is going to be wonderful. We are always going to balance the budget five years out. I have never seen

a projection, I don't think, that hasn't balanced the budget five years out, and almost invariably it increases the deficit in the short term.

Now, maybe that's right. But I don't recall very much testimony telling me that we have to balance the budget "this year." Most of the testimony I recall hearing is, "Go ahead and increase the deficit in the short term, and in the long term, everything is going to be all right." The fact of the matter is when you get five years out, we have made the deficit bigger than ever. That has been the pattern.

Mr. Tobin. Congressman, I think the economists that are before you today did testify here and to other committees of the Congress that the deficits in the 1980s—the latter part of the 1980s, in particular—were too large, too big a percentage of national product. Those are what are being referred to as the structural deficits that occur even at full employment, even when we are in prosperity. They were taking too large amount of the people's saving. That was the majority opinion of economists, I think, and still is. And that is why we were careful today to say that as much as you may need additional deficit spending in calendar years 1992 and 1993, you do not want to do that in a way that will leave a higher permanent structural deficit.

Representative Hamilton. Would a majority of the economists today increase the deficit by $50 billion or $60 billion in fiscal year 1993?

Mr. Tobin. A majority of the ones here, anyway.

Representative Hamilton. Do you think you represent——

Mr. Tobin. A large number. I haven't made a poll.

Let me say one other thing about the $364 billion deficit. A part of that deficit is for the resolution of the disasters of the savings-and-loan associations and the banks. That was a terrible calamity, but it happened a long time ago, quite a while ago. And the draft on the United States resources took place when the bad loans were made and spent in the first place. Now, we are simply changing the form of the federal debt from the debt of the insurance corporation—the deposit insurance funds— to a debt of the Treasury. That has no macroeconomic significance; it is not counted in the deficit as computed for macroeconomic purposes.

Part of the current budget deficit is that. Part of the current budget deficit is a result of what economists have always called built-in stabilizers; namely, that the deficit automatically increases, passively increases, not because of acts of Congress—new tax and expenditure laws—but because of recessions, which bring in less revenue for the same tax code and cause more expenditures for the same entitlements legislation. That has happened in this recession, as well.

You can tell constituents that deficits that arise for that reason are not expansionary; they do not stimulate the economy; they result from the fact that the economy is not being stimulated. So, the correct measure of the deficit, from a point of view of economic analysis, is about $150 billion. That is the structural deficit at high employment and prosperity, omitting things that are counted in the unified budget deficit, but are merely reshufflings of the nature of the federal debt.

REPRESENTATIVE HAMILTON. I understand. I think I understand that argument, and I appreciate it, and I certainly appreciate your articulating it. I guess in the end my concerns are more political than economic. I can accept a $50 billion to $60 billion short-term increase in the deficit, targeted in such a way as to bring us out of the recession and help us in the long term, as well. But I think all of us are very much aware here of enormous pressures building up for additional spending, and most of it for worthy causes. And once you open it up, you have to consider an awful lot of other, very worthy claims on the federal budget.

Mr. Chairman, I thank you for that. I certainly thank the witnesses for their comments this morning.

SENATOR SARBANES. I might observe that if the economy goes into a double-dip recession because we fail to provide some stimulus to bring it out of the recession, that process of going deeper into the recession will itself add further to the deficit. So, that you will, in effect, suffer a higher deficit without having taken action to try to prevent it. So, the question is whether incurring a limited, temporary increase in the deficit provides sufficient stimulus to move the economy upward and avoid the downturn that would accumulate an even larger deficit over time.

Senator Sasser, we will turn to you. We are pleased you are able to join us.

SENATOR SASSER. Thank you very much, Mr. Chairman.

I think the question that was posed by Congressman Hamilton, and the statement at the beginning of this hearing made by Congressman Armey, indicates that this is a very complex matter, and there is considerable confusion abroad in the land about how increasing the debt in the short term, through stimulative spending, might be necessary at the present time to avoid a double-dip recession or a further economic decline.

Now, for the benefit of our viewers, or those who might be watching, when we are speaking of a structural deficit here, we are talking in terms of the difference between revenues and outlays of the government in a full- or relatively full-employment economy. Now, that number, as Dr. Tobin has indicated, is about $150 billion.

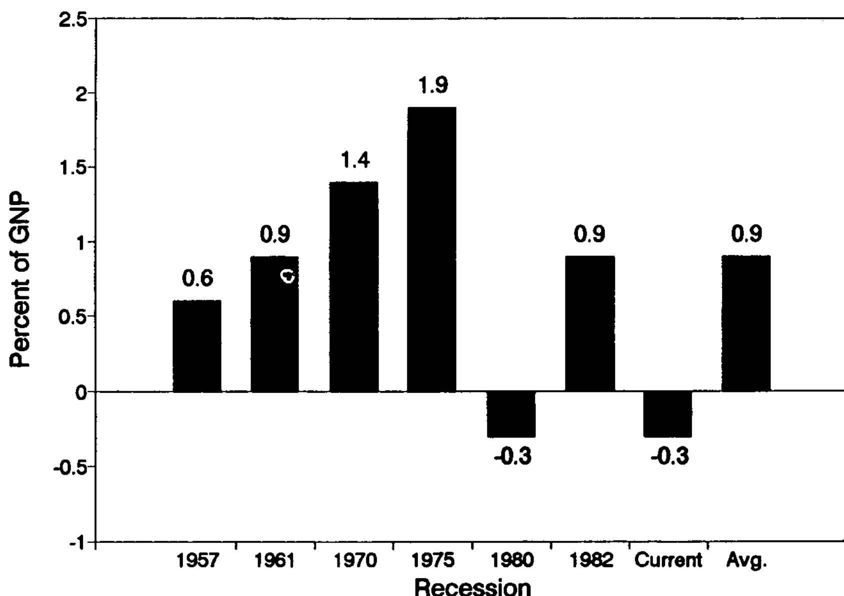
If I were guessing, Dr. Tobin, I would say that it is probably $20 billion or $30 billion higher, but we maybe counting it in a different way.

Now, when we got into the budget summit agreement, the driving force behind that was to reduce that structural deficit. Now, unfortunately, we got into that negotiation at a time when the country was either on the cusp of a recession or, as we know now, already in the recession by about two or three months. It is unfortunate that the Administration and Congress—and some of us tried to advise the Administration when they first took office—that was the time for the negotiation, that was the time to reduce the structural deficit, but the Administration was not ready to move at that particular juncture.

Now, if you add up the structural deficit and add to that the funds for the savings-and-loan problem, and the FDIC problem and the banks—which amounts to about $115 billion—and you add to that the problem

caused by lack of economic activity, the loss of revenues, as a result of a sluggish economy, adds up precisely to your deficit projected at about $360 billion, which will be revised upward shortly by CBO, which will be a result of the poor performance of the economy.

Now, if I could just direct the attention of this learned panel to a chart that I have here—which I think some of you may have been studying—in all pre-war recessions, we have engaged in a measure of short-term stimulative spending that would increase the debt in the short term in an effort to pull us out of the recession.



We see in 1958 that we increased it by about six-tenths of 1 percent of GNP; in 1961 by about nine-tenths of 1 percent of GNP; in 1970, by 1.4 percent of GNP; and in 1975, perhaps looking forward to the 1976 elections, it was increased by almost 2 percent of GNP, stimulative spending to try to pull us out of the recession.

Now, what has happened in our current situation, we find that, because of fiscal drag coming out of our budget summit agreement and out of state and local Government cuts in spending, we are actually decreasing spending by about three-tenths of 1 percent of GNP.

Now, I guess the question that I would ask this distinguished panel: Are we on the right track in the Sasser/Sarbanes plan in increasing spending in the short term, and what should be the measure of that stimulus in the short term to give us the tail wind to pull us out of this recession?

Mr. Perry, I would like to direct that question to you first because you are the first person I have seen from Brookings in recent times who has indicated that maybe we ought to get in the direction of increasing the deficit in the short term to try to do something about it in the long term.

MR. PERRY. I think any one number is going to be a number that you can disagree with a little bit to one side or the other. I think the typical experience of the postwar recessions is probably as good a guide as any at this time. And adding something like 1 percent of GNP to the fiscal stimulus is hardly extravagant, but isn't negligible either. It is an amount that should really make a difference. I think that combined with the recent interest of the Federal Reserve in being much more stimulative on the monetary side would make me feel reasonably comfortable that we can get a good expansion going. I think that is about the right order of magnitude.

SENATOR SASSER. Does anybody disagree with that. Who wishes to take a different course with regard to that?

MR. SAMUELSON. I would simply say that wherever you say spending, I would say spending and/or tax.

MR. KUDLOW. Right. I am sorry. I would focus——

SENATOR SASSER. And/or tax reduction?

MR. KUDLOW. Right. I was thinking about the deficit. I felt when I first heard of the Sasser/Sarbanes—your explanation of it—the analysis behind it was completely right and was probably the clearest that I have seen, at least from the majority side. And I thought that that was great progress. In terms of the policy mix, that remains to be discussed and debated. You could look at it the way that Mr. Tobin discussed it, too—the deficit not just the stimulative part, but the entire deficit in economic terms. It takes out the RTC and so forth. I think you will find the budget deficit in this recession is the lowest recessionary deficit in about 15 years.

SENATOR SASSER. As a matter of fact, in the budget summit agreement, which has been much maligned, and which I disagree with in many aspects myself, we actually did, I think, as a result of that, reduce the structural deficit in fiscal year 1991 by about $30 billion and by a larger amount in fiscal year 1992. Now, the problem is that we were getting this deficit reduction in the structural deficit just as we were going into recession.

Now, gentlemen, let me pose this question to you: We see here in my chart that we have a 0.3 percent reduction with regard to fiscal stimulus in GNP currently; that is, in federal spending. Now, we calculate that, superimposed on that, we have about a $35 billion fiscal drag as a result of spending cuts or tax increases that are occurring at the state and local level, which we calculate, at least, we think, will be an additional impediment to economic recovery.

Is there agreement on this panel that it would be an impediment to economic recovery? That is elementary. I would just like to get it on the record.

MR. KUDLOW. Yes. I would agree, yes, that it is a source of fiscal drag.

SENATOR SASSER. What is the panel's reaction to that portion of the Sasser/Sarbanes economic recovery program that calls for a mix of grants or loans to state and local governments to try to counteract the fiscal drag that is occurring at the local level?

MR. KUDLOW. I recognize the intent, but I am very uneasy about it because, if you go through the past revenue sharing and the like, I think almost everybody would agree that we did not have a good experience with all of that after we were able to study the flow of funds and the use of those funds. And it is a very complicated question that many cities in the 1970s and the early 1980s misspent federal appropriations that were not targeted. And that was the reason for the bipartisan support to eliminate revenue sharing over time and some other related-type programs. It was a misuse of funds.

And then at the same time, if the federal sector tried to dictate, if you will, the terms of trade to the states and localities, the states and localities didn't like that very much. They said, "Well you're just a bunch of guys in Washington, and you can't tell us how to spend and where to put the money." And I think that you are going to reopen that entire debate.

That is not to say that there isn't fiscal stringency right now at the state and local level, but I am very uneasy about going back to the very things that we essentially lived with in the 1970s and early 1980s and decided to terminate.

SENATOR SARBANES. But there is no reason to think that that is what we are going back to. We had local elected officials in here yesterday before the Budget Committee, and one of the questions that was put to them was, if this money became available, what do you say to the charge that, "Well, you are just using it to uphold expenditures that ought to be squeezed out in the name of greater efficiency?" And the response to that by some very able people was, "We did that a long ago. We have been under tremendous constraint for a sustained period of time, and we took the fat and water out a long time ago. We are now into the bone and muscle, and we are now cutting services that are desperately needed and impact on the future strength of the economy." And of course, you have the state and local governments doing this perverse thing of putting a drag, as Senator Sasser has pointed out, on the economy at the very time that it is going into recession.

MR. KUDLOW. I watched some of that. It was good testimony on this. My only comment is that not all mayors are as able as Mayor Flynn. That is really where I come out because the story on a city-by-city basis varies enormously, and the city where I am from would not in any way be able to make the statement that we have cut all of the fat out of the programs. It is being studied by people in both political parties, scholars, practitioners, and what have you. And I just think it is a very uneven study, an uneven story that they have all cut the fat out.

SENATOR SARBANES. That may be, but you have to make some judgments about where you are overall. I would like to hear from Professor Samuelson, because he said at the outset of the question period that he would like to address this.

Professor Samuelson, would you like to make some observation about what is happening at the state level?

MR. SAMUELSON. I advocated that, if we are to have some emergency fiscal expansionism, there are extremely important human needs which were being met under the previous macrosystem which are being squeezed. I think that multiple prisoners occupying the same bed is an obscenity. These are needs.

In the past, because the conservative myth is wrong that local government is responsive and efficient government—and coming from Massachusetts, I can tell you that there is another side to that picture—the Federal Government greatly improved the state administration of how they spent money in the previous grants-in-aid. And I would, if it was a matter of preference, not give carte blanche to Louisiana or any state just to spend the money the way they want to spend the money. These are important monies which are being used for this limited period, and there ought to be some responsible supervision of them.

All that I can say is that there are glaring human needs. If we were doing things right 12 years ago or even 5 years ago, we are doing them very wrong in a number of states that do have Gramm-Rudman legislation from way back, requiring very frequent and close balancing of the budgets in a recession. In the past, we could live with that because the Federal Government was in fact the court of last resort and took up the monetary slack in the recessions. That has been not the case recently, and certainly would not be the case under last year's budgetary agreement. The time for that budgetary agreement should have been 1986 and 1987, when the economy was strong and a little bit overstrong.

SENATOR SASSER. I agree.

SENATOR SARBANES. Mr. Tobin?

MR. TOBIN. Senator Sasser's question about whether we approved of that part of the Sarbanes/Sasser statement about helping state and local governments, I would say grants, not loans, should add to the debts of those governments that are already onerous. And I think my proposal was that we do the same thing and do it as a permanent thing, not just as an antirecession device, but that we not try to pay for it by taxes during the recovery from this recession, but now schedule additional defense cuts in the future or taxes to pay for the longer term continuation of such grants.

And I would like the emphasis in the continuing program of aid to state and local governments to be on public investment. I think public investment is a perfectly good use of national saving. So, when governments borrow to build schools, educate their children and youth, or maintain and improve their infrastructure, that is a use of savings that helps the future standard of living of the country, as does private investment.

Government expenditures for those purposes should not be regarded as if they were just current consumption.

You don't have to apologize so much for a deficit that adds to the Nation's capital—human, public, private, physical, whatever. You don't have to apologize if you are doing that with the Nation's saving anywhere near as much as when you are giving people tax concessions which they use for current consumption.

SENATOR SARBANES. One of the things that Senator Sasser and I talked about, looking ahead, is the short-run stimulus which Chairman Sasser has been outlining. But then, looking further ahead, we said:

> We believe it is possible to shift substantial resources from the military budget to fund the Marshall Plan for America. This public investment would be directed at programs that expand our country's capacity to produce and compete in the future, including infrastructure, education, research and development, and worker training. Potential savings from military spending reductions are anticipated to be large enough to fund not only new investments in America but also considerable reductions in the federal deficit."

So, in effect, with the reordering of priorities, with these changing circumstances, we would be able to draw from that part of the budget in order to carry out an investment strategy, as well as continue to lower the deficit figure.

SENATOR SASSER. Mr. Chairman, could I just follow up, if I may, on that particular point? Since we made our announcement of our plan, we have done some work in the Budget Committee, and we are calculating now that, in all likelihood, with some cooperation of the Administration, it is a ballpark figure to say that we can save between $120 billion and $150 billion between 1993 and 1997 out of the defense budget. I think those are fairly conservative figures. And I would be interested, Mr. Chairman, in where this panel thinks that money ought to be invested and how it ought to be used.

MR. PERRY. Those figures, are they annual savings or are they savings over the five-year period?

SENATOR SASSER. This is the cumulative savings. This is over and above the budget agreement.

MR. PERRY. From the current services?

SENATOR SASSER. And I say those are conservative figures.

MR. PERRY. I would hope so.

SENATOR SASSER. They are very conservative.

MR. PERRY. The question was what is the best use of that money?

SENATOR SASSER. Yes.

MR. PERRY. I think that the last should be tax reductions. We have been through a decade now when people from both parties would respond to the need for new initiatives by saying it would be wonderful to do this, but we just don't have the revenues. I think that is a simple starting point

for thinking about the future. We shouldn't be saying that five years from now, because we have given away the defense reductions in that form.

I think it is going to be a matter of political discussion and different people's different priorities as to just what you do with budgets in the future when you do get a little breathing room. But for starters, don't give away all of the breathing room, because, as I say, I think, on both sides of the aisle, that has been the reason for not even putting on the agenda things that badly need discussing.

MR. SAMUELSON. My answer cannot be given in scientific terms, free of value judgments. But I think the defense need has crowded out meeting the human, collective needs, and when the defense need lightens up, this provides an opportunity.

However, in terms of the simple mechanics of the business cycle and the simple mechanics of what influences private capital formation, you could do it by a variety of different recipes, including tax reduction and expenditure increase.

MR. TOBIN. I agree with George Perry about that. But I would suggest, with no basis whatsoever except for the way things are usually resolved, how about saying half of it for deficit reduction, half of it for civilian expenditures, such as the assistance for public investment by state and local governments, that we have just been talking about?

MR. KUDLOW. My view is different. I would make tax reduction the first priority. I feel, in contrast to Mr. Perry, that revenue growth in the 1980s was very strong. During the expansion period from 1982 to 1989, real receipts increased by more than a third, and we were unable to make more progress on the deficit because we were unable to control spending.

Now, we do have the opening on defense, and I am very much for reduction in the defense baseline. But I feel that we have a lot of tax relief needs, a lot of tax relief needs for capital, labor, and families. I am not opposed to all spending programs; that is not my position. I wouldn't make the blanket statement on the other side that was made on the tax side. I think that there is going to have to be a mix.

But I think what we found is that raising taxes in recent years, whether it is luxury taxes, or real estate taxes, or capital business taxes, it did not generate the revenue flow. The revenue flows have slowed markedly in recent years, following a series of tax hikes. So, I think that the evidence on that is not good on the tax side, and I think that we have to get back if we want to fund a certain level, or a certain rate of rise, of domestic spending for programs which the Congress deems meritorious and necessary. And I know that we have to create sufficiently steady revenue streams to do that, within reason.

And I feel the fiscal drag on higher tax and regulatory burdens, imposed at the federal level, needs to be rolled back. I am not talking about a 1981-type tax change after 10 or 15 years of inflationary tax-bracket creep and so forth. I am talking about modest tax changes that will reincentivize economic growth. And then I think you will find that as we

move through the 1990s you are going to have more resources than fewer resources.

MR. TOBIN. The increase in federal tax revenues referred to is due to the payroll taxes, social security taxes. And that raises a whole issue that we don't have time to get into now, I suspect. Those are, in principle, taxes that are supposed to be paying for a particular program. And we can argue about whether it is a good idea to have a surplus built up in the social security trust funds or not, but it is misleading to say that there has been an increase in tax revenues that are available for ordinary civilian programs.

MR. KUDLOW. Let me disagree with Mr. Tobin on that point, because I am prepared to argue factually that income tax revenue growth significantly accelerated in the 1980s, after the slump of 1980 to 1982, of course. But the rate of change was very strong, and in fact it has only been recently that income tax revenues have flattened out. They continued to rise even as the economy slumped.

MR. PERRY. We should have one rule of procedure: That we don't count what wonderful revenue growth we got when we started from the bottom of the worst recession in the postwar period, and then we went to the top of the expansion. Okay. That tells you nothing about how the economy works or whether you have a deficit problem. That is the only period over which you can make those statements.

MR. KUDLOW. I am prepared to say, if you compare trough to peak or if you compare average real revenue growth in the long expansion of the 1960s, two expansions in the 1970s, and the long expansion in the 1980s, that the 1980s compares favorably. It is not the best on record, but it still compares favorably.

MR. PERRY. Why not make an honest comparison——

SENATOR SARBANES. The trough in the 1981-82 recession was the worst trough since the 1930s. You are taking a recession, an earlier one, where the trough was here and the peak was there, and then you are comparing that on a trough-peak basis with a recession where the trough was way down here and the peak was up here. I mean you would have to adjust for the severity of the recession, the level of the trough, and the peak in order to be able to make that statement.

MR. KUDLOW. I agree with that, but there has been a lot of work done on this that comes out differently than what we have been told.

MR. TOBIN. I suggest that you make the following calculations: Go from 1978-79—the peak of the previous business cycle—to, let's say, 1988-89, and look at the percentages of GNP that are collected in ordinary income taxes by the Federal Government. You will find it has gone down.

If you make the further calculation and say how much revenue relative to GNP—prosperity GNP—was available to the Congress, the Federal Government for civilian programs to be financed without deficit, other than social security, debt interest, and defense—those three things—you

will find that that went down tremendously between 1978-79 and 1988-89. That is the relevant discussion. Remember that expenditures for interest are now around $200 billion, about 3 percent of GNP. And that is an extraordinary increase since 1980.

When people complain about what is wrong with the Federal Government that they cannot finance programs with the revenues that they are still getting, they are ignoring the fact that, because of the deficit spending policies of the 1980s, a large part of revenues are already dedicated to paying the interest on the debt burden added during those years.

SENATOR SARBANES. Senator Lott?

SENATOR LOTT. You have one question? I hope it is very brief.

REPRESENTATIVE ARMEY. A very quick, brief question. I am being called back to my office, but I cannot resist the opportunity since I have Professor Samuelson here.

Professor Samuelson, I will quickly pose my question. If you had a senior who brought to you an honors thesis in which he purported to predict a net revenue impact on the Treasury of the imposition of a surtax, or excise tax, or luxury tax on four luxury items in the United States, in which he acknowledged that there would be some reduction in demand as a result of the imposition of that tax, and projected on some basis of sales some tax revenues, but did not mitigate against those projected tax receipts from the imposition of the tax, a reduction in tax receipts and income tax, F.I.C.A. tax, sales and excise tax from the lost salaries from the reduced employment from the reduced sales, would you pass the student on his thesis? [Laughter.]

MR. SAMUELSON. I would investigate further on the basis of the evidence you have provided me.

SENATOR LOTT. Mr. Chairman, it is such a temptation to make speeches at events like this. But I am going to try to resist.

First, I want to thank you for allowing me to be here. I have found it very interesting. I regret that it is being held at a time when more of our colleagues are not here—House and Senate. And I do hope that in the future maybe we will have these gentlemen back and some other gentlemen. I would like to have a little bit more balanced panel in the future, and get some other, differing views.

Now, having said that, I thought there was a remarkable amount of agreement here today on monetary policy, and maybe changes that ought to be made at Treasury, and that something needs to be done for fiscal stimulus. So, in three areas, there is a lot of agreement. But the problem is we don't have a lot to do here in the Congress with the monetary policy or what the Treasury does. We have to focus on the fiscal stimulus side. So, that is the fundamental problem that we are trying to wrestle with in trying to decide what needs to be done.

I disagree with all of you on the priorities. I think we ought to reduce the deficit first. That should be our principal responsibility—and that is what I find from a lot of people out in the country—and then look toward tax reduction on the people because the people—let me assure you—don't

feel undertaxed, and then look at where we might and could do some additional spending.

I still don't understand the thinking—we went through this with revenue sharing—of how it is a good idea to take money from the people in the country, bring it to Washington, redistribute it back in the form of permanent grants, as has been suggested here today, to the state and local governments, which they—a different group of politicians—then decide how it is going to be spent.

I don't understand why it doesn't make more sense to leave that money in the first place at the state and local level, and let them take it and decide how to use it, rather than bringing it up here and refunneling it back down there, because we have, I think, as serious a problem with our budgets as they do at the state and local level.

Having said that, when I consider the Sarbanes/Sasser proposal here, I would want to know an awful lot about how is that going to be redistributed in the form of grants. Even CDBGs, which we now use to help states, I find the State Governors love it. They take it; they take credit for it and make a political decision on how to distribute it around the state. And, therefore, a program that could be pretty good, I have a lot of doubts about. So, I am afraid that we are going to have that in the future with these proposals. So, let me ask some basic questions rather than making speeches.

Mr. Kudlow, we touched on the credit crunch. As I travel around my own State of Mississippi, one of the biggest problems in trying to get economic growth and expansion and creating small businesses—doing anything—is credit is just almost nonexistent at a time when a lot of the banks in my own state had record profits last year. So, I guess one question that I would like to ask you is: How much impact is this credit crunch having on the stagnation in the economy?

MR. KUDLOW. I think initially that it had a tremendous impact and was one of the key factors behind the recession. I think the impact has waned in terms of magnitude, but I think it is lingering. Banks are flush now—and I will speak generally for the banking system—is flush with reserves that the Fed has provided, particularly in the last 12 months. But there is not a strong willingness by banks to make loans.

Now, it can be countered that the business demand for credit is weak, as normally is the case in a downturn, and that is true. But it is also true that banks are unwilling to make any loans with any degree of risk beyond the normal 91-day inventory financing kind of trade paper. There is no money around for construction. And I am not talking about see-through office buildings; I am talking about new homes, new-home starts. There is no money for that.

Second, there is no money for venture capital. There is a story in yesterday's *Investor's Business Daily*, right on the front page, how venture capital has dried up. The banks have pulled out of that business. There is no money available for high-risk corporate start-ups.

SENATOR LOTT. Let me interrupt you there. It is part of the problem. Maybe it has resided. What can be done to try to help relieve that problem? Maybe it is in the Administration. I don't think that there is anything particularly that Congress can do on that particular point, is there?

MR. KUDLOW. No. Congress and the Administration have started to make the point that bankers ought to take a longer run view and move toward more of a forbearance than a foreclosure policy. But that gets into very delicate matters of supervisory and regulatory policy.

My proposal this morning—repeating what I have said in the past—is one of the key reasons that I am for capital gains tax relief is because I think it will unlock credit flows in the very short run. Now, people may argue that that is not the case. My view is that we ought to take a risk and see.

SENATOR LOTT. I think it is the case.

Let me ask, Mr. Perry, trying to look at what we should do on the fiscal stimulus side, we kind of agree on monetary and Treasury actions, but I think the only thing that I heard you propose is a spending stimulus package that would add to the deficit of $50 billion or so. Is that all you proposed? And if it is, is that nearly enough? Or maybe you did have some other things in there, and I just didn't get them.

MR. PERRY. In answer to the question of what the right size should be, I suggested that 1 percent of GNP—$60 billion—sounded like a useful size. In terms of what to do, I suggested that there were several options, including some tax relief or some spending projects. And I would put at the top of my list, I think, aid to the states and localities, which I think are particularly hard-hit; and advancement of some federal infrastructure projects that are already in the pipeline, so you are not starting up and don't waste your start-up time. On the tax side, a temporary investment tax credit was one of the things I was suggesting.

SENATOR SARBANES. Anything else?

MR. PERRY. And a one-time relief to the income tax at the income tax level. Not a change in the rates; I think that would end up being permanent.

SENATOR LOTT. Say that again. A one-time shot at the income tax level? What do you mean?

MR. PERRY. A tax credit on the income tax, a tax rebate.

SENATOR LOTT. A $450 rebate, $50?

MR. PERRY. That would not be the top of my list. But if you want to do that, that would be a way to do it through the tax side, if you wanted to aid the consumer, the household.

SENATOR LOTT. Mr. Kudlow, on the issue of ITC, you disagreed that it should be temporary. Briefly, tell me why making it temporary would be counterproductive or not productive. Why should we make it so? I was surprised when I was at home during December, the number of unsolicited comments from people in places like Laurel, Mississippi, from busi-

ness people, "Hey, the investment tax credit would be helpful." And I really was surprised at that.

MR. KUDLOW. It's not that I oppose an investment tax credit. I think it is inferior to a properly neutral cost-expensing accelerated depreciation system. And also with respect to the temporary nature, we have had this so many times that businesses know how to outsmart this; so they go in, they buy off as much equipment as possible, cause the government to lose even more revenues, and they stop. It is not based on economics, it is based on outfoxing——

MR. PERRY. Mr. Kudlow gave the argument for why you want to do it temporarily in order to help you out of a recession. Business is smart enough to know that there is a sale on business equipment that ends a year from now. And so they go out and do a lot more spending than they otherwise would.

SENATOR LOTT. On accelerating the infrastructure spend-outs, I am inclined to agree with that. I want to make sure what you are talking about. Are you talking about in highway construction? Airport trust fund, airport construction? Are you talking about water and sewer projects? Give me two or three examples of what you might be talking about, any of you.

Mr. Perry, you talked about that.

MR. PERRY. Your examples sounded all right to me. I don't know the details of which projects are already in progress, so one could add 20 percent to the rate at which we are doing it, as opposed to which projects are supposed to start two years from now, in which case they would not be candidates. You have to do it case-by-case.

SENATOR LOTT. I like that idea. In the past, I think we have tried to do that, and the record generally shows that it takes a year for those things to start happening. In highway construction, if we really could accelerate that substantially and find a way to do it, I certainly would like to do it. But I don't think that our past record is very good in being able to accelerate these infrastructure projects to a great degree.

One other thing that I want to ask you people to comment on. Everybody says we can save more money in defense. I am on the Armed Services Committee, so I have been dragging my feet along on this all along. I had voted against the budget deal in 1990 because it cut defense, in my opinion, too much, too fast; it raised taxes; it also allowed the deficit to go up—all simultaneously. But having said that, I have supported keeping it in place because it has been the only thing keeping the Congress, in my opinion, from going crazy spending even more.

But there is a limit to how much we can cut in defense over a short period of time without it having an economic impact. I am convinced that our defense cuts are already having a negative impact on the economy. I saw a DOD study just yesterday that indicated between now and 1997, in my own poor State of Mississippi, there would be about a $700 million reduction in defense income to the State.

Now, what that means to me is that Air Force technicians and welders in the shipyard in my home town and others are going to be out of work. We are going to spend more money instead to pay for food stamps and unemployment benefits for them.

Now, what is the impact or should we weigh the impact of losing the defense jobs with the impact it will have on the economy?

MR. TOBIN. In the long run, the way defense cuts are going to help the economy is by having the resources, including the workers, doing things that are more useful to American people.

SENATOR LOTT. Like what?

MR. TOBIN. Than building weapons. But there is a reconversion problem, a transition problem. It might be a very good idea for including in the defense budget money for reconversion and adaptation to the blow over two or three years.

SENATOR LOTT. What are you talking about? You are talking about retraining funds?

MR. TOBIN. Retraining funds, reconversion of facilities where it is possible, helping communities where these facilities are located and where jobs are going to be lost on armaments, to bring in and generate other kinds of civilian business. If you took the amount you are cutting out and dedicated 10 percent of that amount within the defense budget itself for this problem for a period of years after the cut is made, that would be a good use of the money.

SENATOR LOTT. Anyone else want to comment on that?

MR. SAMUELSON. I don't think you gain jobs net if you cut down on the producing of swords and increase the producing of machine tools. That is a wash in the short run. But the increase in the stock of machine tools that will raise the future productivity of the rank-and-file of the American people is a better way of using that resource than to continue what may have been prudential in the Cold War period, but no longer has that justification and purpose.

SENATOR LOTT. You are talking long term. In the short term, we have to acknowledge that shutting down the bases and closing down plants has a negative economic impact.

MR. SAMUELSON. I acknowledge that, and I also point out that, just as there are ecological monstrosities that we now find in Poland and in the Soviet Union, the military basis of the United States have grave legacies: if the troops pull out, they do not leave the countryside the way it was 200 years ago. It is a responsibility to clean your own mess, and doing that is job creating, like any other useful purpose.

So, the transition can involve some nonsavings, but is a necessary part of meeting the responsibility of past military action that it has necessitated.

MR. KUDLOW. It is a regional issue, though. If you are talking about the macroeconomy, some parts of the country benefit enormously from the buildup and now are going to be hurt, but other parts of the country lost

resources because of the buildup and are now going to be helped. And I don't know anybody that has put out a strong study that suggests lower defense spending will hurt the overall macroeconomy. In fact, I would think, even in the reasonably medium run, it is going to be a help, not a hurt. It is going to free up resources.

SENATOR LOTT. Professor Samuelson, one last question here. I can't believe anybody really thinks giving grants to states and local Governments—and somebody suggested yesterday, just to local governments—is going to solve the stagnant economy. That is not going to be enough incentive to get the economy going again. So, other than giving grants to cities, what is it that you would propose that we do in addition to that that would have some economic stimulus?

MR. SAMUELSON. I think there are tremendous layoffs in the State of Michigan, the State of Massachusetts, and parts of the country that are hard-hit. Those layoffs are subtracting from the circular flow of income in the short run, and they could be revised in the short run by having finance which is not available to the present Governor of Massachusetts or Michigan. I simply take these examples as strong, strong cases. So, I see nothing inherently weak about this particular program.

Also, you ask whether a best case can be made for doing most things at the local level. I want to point out that if you confine meeting needs to the local level then you will encounter a run-out effect: the state that least meets those human needs will be the most competitive at the Chamber of Commerce level in attracting new business. That is the reason why the unit of government that meets common national needs has to get bigger rather than smaller. Otherwise, you have economic law working against meeting those needs.

SENATOR LOTT. Is there anything else other than grants to states and local governments that you think we should look at doing here in Congress this year?

MR. SAMUELSON. Yes. When I listed the four programs, state and local was only one of them. Now, Professor Tobin put five-sixths of his powder in that bin. I did not. But that is one glaring case where the recession is adding to the human woe.

SENATOR SARBANES. I might note, because the question was asked earlier about why would you bring the money up to the federal level and then send it back down to the state and local level, that the wealthy states in the country—Connecticut, California, New York, Maryland, and others—have complained for years that we send more money into Washington than we get out of Washington. Now, one of the reasons that we do that, as I understood it, is to at least bring up the floor to a national level with respect to important programs—education, infrastructure.

The State of Mississippi has the lowest per capita income in the country—67 percent of the national average. Now, I come from a state that has 118 percent of the national average. Now, the argument, "Look, you just ought to leave it all right there at the state level," in some way is fairly attractive to me, although, even within my state, we have difficult

problems. The City of Baltimore has a property tax rate double —double—the property tax rate of the surrounding jurisdictions, and yet it faces problems that it has to deal with far in excess of the problems of the surrounding districts. So, it is in a crunch. It faces tougher problems and has less of a revenue base.

Now, you try to deal with that at the state level by providing some reallocation of assistance in order to enable them to meet their problems. And what we have done traditionally in this country, with some sense that we are a Nation, that there is a Union—a United States of America—with the emphasis on "United," is to provide some reallocation of resources in order to help those areas that in themselves, within their own particular jurisdictions, are not able to reach that national standard, to try to do some things.

SENATOR SASSER. As a senator from one of the lower per capita income states of the 50 States, we often express our appreciation to the taxpayers of New York, California, Connecticut, etc., for the Tennessee Valley Authority. It has been a great economic help to us in our area, and we could not have built it with funds internally in the multistate area that it serves.

SENATOR SARBANES. Before we conclude, I want to put a couple of very quick questions.

Mr. Kudlow, do you recognize that there is an infrastructure investment deficit? Would you agree with those who assert that such a deficit does exist and that we are, as it were, behind the curve, for example, with the water sewage systems network?

MR. KUDLOW. I would not be prepared to agree yet. I would have to look at it more carefully. I am not sure what the definition and framework is.

SENATOR SARBANES. You don't think that part of our difficulty in competing internationally with, say, Japan and West Germany is, in part, at least, attributable to the fact that they are investing significantly more than us in worker training, education, research and development, and infrastructure?

MR. KUDLOW. I wouldn't generalize on that. I think each nation has a special set of data. Statistics have to be looked at carefully. The cross-national boundary analysis of data is very tricky business. As far as their own growth is concerned, I see slumping growth overseas, not rising growth. And I am concerned about that in both Japan and Europe.

I am not suggesting, Senator, that I am opposed to all public spending. I am not. I am just suggesting that there are some general assertions out there. I would like to carve them out and look at them carefully before I put a yes or no on it.

SENATOR SARBANES. Do you regard an important item in reducing the cost of labor, which you put forth, the need to develop a national health-care plan that would shift the burden of the cost from the individual employer—who must consequently factor it into his cost of product—to

a more generalized social insurance program, as is done in most of the other industrialized countries, so that the cost is factored as a social cost, but is not factored as a cost of production for the individual enterprise?

MR. KUDLOW. I am leery of going farther and farther down that road. I must confess my own biases right now tend to favor the idea of a tax credit for the uninsured parts, and perhaps even broadening that tax credit on a means-tested basis. I would like to see some market competition put in the health-care system wherever that is possible.

SENATOR SARBANES. How are you going to get some cost containment on that basis?

MR. KUDLOW. My worry is that, and studies have shown, enormous parts of the cost of health care at the federal, state and local level is consumed by the expenses of the administration and staffing levels.

SENATOR SARBANES. By the private insurers?

MR. KUDLOW. It may be true by the private insurers. I don't think there is enough competition in the system to make either the public or private side really become lean, mean competitors.

SENATOR SARBANES. Let me ask another question on capital gains. It is your view that it would churn a lot of activity, is that right? People would sell stocks and so forth and so on?

MR. KUDLOW. My view is that with considerable restructuring there would be rechanneling into new investments.

SENATOR SARBANES. More stock transactions would take place?

MR. KUDLOW. You would see it in the financial markets, but you would see it with direct business investments, as well.

SENATOR SARBANES. The investment houses get a commission off of stock transactions. So, if you intensify that activity, it has a business benefit.

What is your reaction to the suggestions that have been made that there should be some sort of a small transaction tax or fee on transactions, the money going into the public treasury to help us do any number of things? It could help us reduce the deficit. It could fund these programs, or it could even fund further changes in the tax code. But it would be a sensible way to raise revenues for these other purposes.

You have a notion on capital gains that will encourage a lot of activity and transactions. The investment houses will benefit from that because they take a commission on those transactions. So, their income will go up as a consequence.

Suppose we also enact a transaction fee that went into the public treasury on that activity. Do you have a reaction to that?

MR. KUDLOW. I have an uneasy reaction because I think you start moving into the whole process of intermediation. You talk about the public sector, you have large public pension funds—states, cities, counties, and so forth—which would then have to incur and bear the higher cost of that transaction, which in turn might reduce their overall rate of return.

And I think they would be unhappy with that or, at least, many of them would. So, there is a larger question here.

Let me just note that, while it is true that I favor capital gains relief, the fact of the matter is stock market volume on the exchanges in New York and elsewhere has been enormous in the past 12 or 15 months. There are lots of other factors behind the volume and brokerage commissions than just the capital gains tax.

I am interested in creating new business and job opportunities, and I would like us to see the unlocking of a certain amount of wealth and recycling and rechanneling, because I think that is what makes the system run. And at the proper incentive rate level, you are going to get people betting on the high-risk ventures—the 30-to-1, 50-to-1, 100-to-1 type shots that right now people are afraid to invest in.

SENATOR SARBANES. Leaving aside for the moment whether you do capital gains or something else, would you subscribe to the proposition that changes made in the tax code should be self-contained; in other words, easing revenues in some parts of the tax code should be compensated by raising the burden in other parts of the tax code? Do you agree with that proposition?

MR. KUDLOW. I would not subscribe to that.

SENATOR SARBANES. Professor Samuelson, would you agree with that proposition?

MR. SAMUELSON. Yes, for the reason that I believe that America, given its cumulating needs and propensity under its democracy to appropriate what it does appropriate, is an undertaxing nation. And I think that we need to raise general taxes. Under the guise of tax reform, to pass only those legislations that reduce tax obligation of somebody is going to make that situation not better, it's going to make that situation worse.

So, one defense against further emasculating the tax code is to make the reforms be under the constraint of revenue neutrality.

SENATOR SARBANES. Professor Tobin?

MR. TOBIN. I agree with that.

SENATOR SARBANES. So, any cuts made for some people in their taxes would have to be compensated for somewhere else in the tax code by raising the revenues to offset them?

MR. TOBIN. You are talking about the permanent tax code, not what you might do on a temporary basis?

SENATOR SARBANES. That's right. Permanently.

MR. TOBIN. Yes, I definitely agree with that. I also agree that the United States is undertaxed.

SENATOR SARBANES. Mr. Perry?

MR. PERRY. Yes, I would agree with that.

SENATOR SARBANES. Gentlemen, we want to thank you very much. It has been a very helpful hearing. We have been trying, obviously, to draw the difference between what to do short term to counter the recession and what to do as a longer term strategy for economic growth. I think your

explanation, in the exchange with Chairman Sasser, of why a large deficit is not necessarily providing a stimulus to the economy is very important to understand. In closing, I want to point out articles this week in two of the national news magazines. In *U.S. News & World Report*, their cover story is "Is Your Job Safe?" It says that one in five Americans was unemployed sometime last year. This year it could be even worse. And the other, *Time Magazine*—and I guess you can see that photo there, with someone selling, I can tell by the car that this is a photo out of the 1930s—the title is "The Recession: How Bad Is It, and What Gives on Wall Street?"

So, obviously you are here at a very critical time. We thank you very much for your contribution.

Tomorrow morning the Joint Economic Committee will hold a hearing at 9:30 a.m. to receive the latest unemployment figures. That is the monthly report from the Bureau of Labor Statistics on the unemployment rate. That will be followed immediately after we receive those figures by a hearing on the outlook, the 1992 outlook, for job terminations and mass layoffs. We will have expert witnesses who will be discussing what they perceive the prospects to be for this year, in terms of job terminations and mass layoffs.

The Committee stands adjourned.

[Whereupon, at 1:22 p.m., the Committee adjourned, subject to the call of the Chair, to reconvene at 9:30 a.m., Friday, January 10, 1992.]

[The following answer to a question by Senator Sasser to Mr. Tobin was subsequently supplied for the record:]

ANSWER TO SENATOR SASSER'S QUESTION

I do believe that the tightening of Federal Reserve policy in 1988-89 was not justified by the macroeconomic situation at the time and that it contributed substantially to the slowdown in 1988 and the actual recession in 1990. The Federal Reserve had done for the most part a good job in managing the 1983-88 recovery. They were appropriately concerned not to let the economy become overheated as the unemployment rate fell into the 5 to 6 percent range and excess capacity dwindled. But there were no signs of inflation that required such drastic tightening. In this respect, the slowdown and recession of 1989-91 differ radically from those of 1979-82, 174-75, 1968-70, and even earlier recessions. In those cases, there were surges of inflation that could reasonably be said to require monetary tightening.

In 1988-89, I think, Federal Reserve policy was influenced by the extreme views of some anti-inflation "hawks" within the System, in Congress, and in the financial and economic community. Their idea was to take advantage of the prosperity of 1988 to push the inflation rate toward zero, even though it had been stable between 4 and 5 percent for five or six years. Although there were plenty of problems during the 1980s' recovery—among them excessive public and private debt, overbuilding of office space and other commercial real estate, failure and threatened insolvencies in depository institutions—these did not doom the whole economy to the subsequent slowdown and recession. Nor were they problems that raising interest rates would solve, quite the contrary. In addition, of course, there were serious structural problems of under-investment and low productivity growth, which continue now and will still be with us after the economy recovers. But these too neither caused the recession nor will be ameliorated by it or by the tight money that brought it on.

1992 ECONOMIC REPORT OF THE PRESIDENT: OUTLOOK FOR JOB TERMINATIONS AND MASS LAYOFFS

FRIDAY, JANUARY 10, 1992

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

The Committee met, pursuant to notice, at 10:50 a.m., in room SD-608, Dirksen Senate Office Building, Honorable Paul S. Sarbanes (chairman of the Committee) presiding.

Present: Senators Sarbanes and Sasser, and Representative Armey

Also present: William Buechner, professional staff member.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

SENATOR SARBANES. The Committee will come to order.

In its first hearing this morning, the Committee received the very grim unemployment figures that were announced—a 7.1 percent unemployment rate—the highest in this recession. And if all elements of unemployment are factored in, the rate is actually up in the double figures, 10.4 percent. Or if you also take into account slow labor force growth, over 11 percent.

In our second hearing, we now want to turn to examine the job outlook for 1992 and the recent announcements of significant permanent job cuts by a number of large American firms.

As I understand it, of the job losers in this recession, only one out of four people who have lost their jobs during the recession are on a temporary layoff and can be expected to be called back. Three-quarters of the people who have lost their jobs during this recession, it appears, have lost them permanently. They have not been put on temporary layoff, where, if economic conditions picked up, they would be called back. They have actually been squeezed out of the company or firm, and there is no job for them to go back to. So, unlike previous recessions, when people would get laid off, it would be a temporary layoff, and they would say, "If economic conditions pick up, I am going to be hired back." In this instance, three-quarters of those who have lost their jobs are not in that

position, as I understand it. And I think we will be hearing from the witnesses about that.

All through the fall, major U.S. companies have announced new cuts in jobs to be carried out in 1992. These are job termination announcements. The list is led by General Motors at 74,000; IBM at 20,000, and on down. These are plans to cut jobs that have not been put into practice as yet. IBM, of course, is one of our most successful high-tech companies and yet it plans to cut 20,000 jobs.

These announced job cuts come on top of a significant increase in mass layoffs that have already occurred during 1991. The number of workers who lost their jobs during mass layoffs in the first half of 1991 was up 60 percent from 1990. And it looks like, on the basis of the report this morning—earlier this morning—that even more workers may be vulnerable this year.

Finally, job terminations and mass layoffs are only one facet of the changing nature of work in today's ravaged economy. Many firms are increasingly abandoning the traditional job contract, which includes fringe benefits as well as wages—most importantly under fringe benefits is health-care coverage. Firms are instead hiring workers on a part-time or contingent basis. Contingent workers are listed as employed; they don't show up as unemployed, but they have little job security and few fringe benefits. Therefore, the concept of being employed is changing in terms of what that encompasses.

Obviously, Americans would rather have some job than no job, but it is a sad comment on the functioning of the economy that a growing number of today's jobs do not provide the worker with the benefits that were once attached to full-time employment. As Senator Riegle earlier mentioned, these are people who have dropped from a highly skilled job to, say, a minimum wage job because that is all they can find.

In addition, you have people who may even be working at the same level, but having a job no longer means, in terms of their benefits, what having a job used to mean. It used to mean your health care would be covered; there would be a retirement system; there would be sick leave and vacation provisions. In many instances now, they are shifted into this contingent category, and none of that is available to them.

We are going to address some of these issues in this hearing. We are very pleased to have this distinguished panel of labor-market experts to discuss the job outlook for 1992 and the outlook for job termination and mass layoffs. The panel consists of Mr. Dan Lacey, the editor of the Workplace Trends Newsletter; Dr. Richard Belous, vice-president and senior economist of the National Planning Association; and Dr. Marvin Kosters, who is director of Economic Policy Studies at the American Enterprise Institute.

I would like to say that Dr. John Makin from the American Enterprise Institute was here yesterday afternoon as a witness before the Senate Budget Committee, and he made a very strong contribution.

Gentlemen, we are pleased to have you here.

Congressman Armey, do you have any statement?

REPRESENTATIVE ARMEY. Thank you, Mr. Chairman, I have no statement. I just want to thank you again for having these hearings, and I join you in welcoming Senator Sasser as well.

SENATOR SARBANES. Mr. Lacey, we would be happy to hear from you.

STATEMENT OF DAN LACEY
EDITOR, WORKPLACE TRENDS NEWSLETTER

MR. LACEY. Mr. Chairman and members of the Committee. In the year just ended, the typical middle-class American began to understand through personal experience that the unemployment rate compiled by the Bureau of Labor Statistics no longer suffices as a full and accurate gauge of the health of the U.S. workplace.

The best evidence of this new understanding is the fact that, although the national unemployment rate remained relatively low through the recession year of 1991, consumer confidence—which the Conference Board and other highly regarded business research institutions have found is prone to fall as employment-related worries increase—fell to very low levels.

Consequently, it has become obvious to me that the most important issue to be explored concerning the U.S. economy in 1992 is not the unemployment rate, which measures only the gross quantity of workers looking for jobs, but the development of a huge array of changes that are diminishing the quality of work opportunities in America and that are indirectly driving down the consumer activity that makes up about two-thirds of our economy.

I hope to accomplish three objectives in my testimony today:

- To point out to this Committee, through evidence other than the Labor Department's unemployment statistic, several of the most significant sources of turmoil and trauma in the U.S. workplace.
- To explain why the changes currently taking place in the U.S. employment relationship should not be regarded merely as temporary symptoms of a cyclical recession, but as parts of a permanent restructuring of work in America brought on by the pressures of the new global economy.
- And to suggest several actions that our Federal Government might take, in my opinion, to reduce some of the economic turmoil and human trauma being caused by upheavals in the nature of the employment relationship.

According to a database that we have been building at Workplace Trends since late 1988, publicly-held U.S. corporations announced a total of 556,092 permanent staff cuts during 1991, an average of about 2,100 positions permanently cut each business day during that year. That is the highest total we've ever recorded (please see attached Table 1 and Chart 1), and it is important to note that many of the cuts announced last year

won't be effected until this year or even until several years down the road.

During 1991, the number of companies announcing such cuts totaled 366, about one per calendar day. That pace has continued into 1992, so there is no evidence that the staff-cutting trend is abating.

It also is important to note that our database does not include temporary workforce layoffs to trim inventories or production, such as is traditional in the auto industry. We count only those cuts which are, by any reasonable standard, permanent. In many cases, the corporations announcing these cuts have publicly verified the permanency of their staff reductions by taking the cost of the reductions to the bottom line of their quarterly reports.

What's more, we are able to count only those permanent staff cuts that are publicly announced on a nationwide basis, typically by large corporations. So, I believe it is fair to assume that we are capturing no more than one-half of the permanent staff cuts occurring. For example, we know that we are not capturing most of the permanent staff cuts being generated by the collapse of the U.S. savings-and-loan industry.

This staff-cutting trend has been under way since the start of the 1980s. But as Table 1 shows, the trend began to intensify dramatically in the third quarter of 1989, and that is about a full year before the official start of the recession in 1990. Taking these statistics into consideration, it would be more logical to deduce that the staff-cutting spree helped bring on the recession than to continue to believe that the recession has been the primary cause of the staff cuts.

Clearly, to me, the academic axiom "correlation is not causation" should be applied when discussing the relationship between the current staff-cutting spree and the recession of 1990-91, and I assume 1992.

Although most of Corporate America is hesitant to admit it because of potential political liabilities, the hard truth is that it is becoming standard management practice in U.S. corporations to cut permanent staff to the absolute minimum number of persons required to continue profitable operations, while utilizing a variety of innovative, nonpermanent employment relationships to cope efficiently with fluctuating workloads. This strategy is most often referred to in management circles as the "core-staff concept".

The adoption of the core-staff concept affects employees at virtually all levels of the typical corporate structure. For example, both blue-collar and white-collar workers typically suffer income and benefit cuts when they move from employment in a big company to a small one, or to self-employment or another nontraditional work relationship. So, the public debates that have we have been experiencing over whether this is a "blue-collar" or a "white-collar" recession are moot, at best, and often downright silly.

The shift by large corporations to core staffing and its derivatives is putting to death the comfortable employment relationship that the typical, big, corporation employee—no matter what color the collar of the shirt,

blouse, or uniform they wear to work—enjoyed during the postwar boom decades.

Put most succinctly, the expectation of long-term steady employment at ever-rising wages, with full company-paid benefits has become obsolete in America. Yet, nearly all the components of contemporary middle-class living in America—such postwar consumer institutions as 30-year mortgages, five-year car loans, and revolving consumer credit—are based upon those obsolete boom-era workplace expectations.

Obviously, the process of moving from the boom-style employment standard to the post-boom model is a very traumatic one for middle-class Americans. Most members of this traumatized group still have jobs and are not represented in the unemployment statistic, but a rapidly growing numer are no longer employed in the secure, consistent, predictable fashion that middle-class living in the United States demands.

Is there really any wonder, then, why consumer confidence has been so low? Boom-style employment is dying a very painful death, and the entire U.S. economy is suffering as a result of that.

There is no quick and simple remedy for the pain that millions of middle-class Americans are experiencing in their worklives right now—no fast, fun, five-point quiz that working Americans can take to find their way back onto the road to economic comfort. But there are several steps that, I believe, the members of this Committee can initiate to help make our country's transition to the global workplace of the 1990s and beyond more methodical and much less traumatic.

Most urgent is the need to separate, once and for all, the financing of our out-of-control health-care system from the employment relationship. Although the two issues are rarely discussed in tandem, the crisis in health-care financing and the corporate staff-cutting trend are closely linked.

None of the leading industrialized countries with which we compete links health care to employment as we do, and none has a health-care system that devours money as outrageously as does ours. Consequently, many U.S. corporations have been cutting staff in a panicked, amateurish effort to control employee benefit costs and, thereby, remain internationally competitive. Yet, many of the health-care reform proposals put forth in the past year actually seek to increase the linkage between health-care financing and the employment relationship.

If we do, in fact, push more of the burden for health care onto the paycheck, we'll succeed only in accelerating the move to the core-staff strategy. That can only cause more staff cutting and more pain for working middle-class Americans.

So, first and foremost, we must separate health care from the paycheck. Only then we can begin a successful crusade to drive the U.S. health-care industry back into the realm of economic reality without putting working Americans directly into the line of fire.

Next, we need to launch a massive—I mean massive—workforce retraining program. We must immediately admit that many millions of

Americans still have nothing more to sell to the world economy than do citizens of the Third World who have had little or no access to formal education and often work for wages that barely support mere survival. Then, we must begin to remedy that tragedy of being undereducated by implementing a domestic, skills-specific, workforce retraining campaign greater than any that history has ever seen. This is a historic thing that is happening, and we need to take historic action.

Some people have questioned how we can afford to retrain a large percentage of the American work force. But I contend that we already have in place throughout most areas of this country a community college system that, although uniquely qualified and suited for this purpose, is profoundly underutilized.

In 1991, America proved that it can still muster world-shaking power once it decides to trounce its military enemies. So, I urge you to put 1992 into history as the year we proved that we can also muster as much, or more, power within our borders to conquer humankind's greatest enemy, ignorance.

Third, I believe we must reform U.S. employment law to fit the 21st century workplace. Virtually every aspect of U.S. workplace law presumes the 19th century factory style of work, and yet a shrinking number of us, as we have seen this morning from the figures presented by the BLS, earn our livings through work that requires a factory-like setting.

For example, although millions of Americans are turning to self-employment each year as big, boom-style-corporation employment fades, our government hasn't developed a simple, reliable standard for determining who is an employee and who is an independent contractor. A few attempts at reforming the independent contractor morass, such as House Bill 3813, have been put forth. But this area of workplace law begs for a quick and complete overhaul.

What's worse, our refusal to confront and reform the 19th century doctrine of at-will employment is generating a huge new body of litigation that—generally known as "wrongful discharge" lawsuits—is exacerbating the pain created by our transition to the global economy, while benefitting virtually no one except trial lawyers.

America is no longer a country dominated by factory workers, and our laws governing the employment relationship must recognize that fact if we hope to compete in the world economy of the 21st century.

And finally, I believe we must abort the U.S.-Mexico "free trade" pact and, instead, dramatically increase immigration. Allowing the sweat-shop labor of Mexican and Central American to flow into the U.S. economy without restriction, while the workers themselves remain trapped up against our southwest border—and I have been there, and it is disgusting—would repeat, tragically, the greatest workforce error America ever made—allowing the labor of enslaved African-Americans to flow northward and abroad, while the workers themselves remained trapped below the Mason-Dixon Line. It is the same thing, we are doing it over again.

Our traditional fear of unemployment and human beings with origins other than ours often blinds us to the fact that human beings don't consume economic activity, they create it. Instead of resisting immigrants, we need to welcome ever-growing hordes, waves of them into this country which—as a drive across a great state such as Texas will show you—is still relatively empty. The American work force is growing older and less mobile, on average, and only a massive infusion of eager-to-work, eager-to-adapt immigrants can reverse that trend quickly. And we can pump new money into Medicare and things like that.

Once they arrive, these new immigrants must be welcomed into the great workforce retraining campaign that we've launched. Working together, native and newcomer alike, we can create the most highly skilled, most energetic, and most prosperous work force on Earth.

Thank you for this opportunity to appear before this honorable Committee.

[The prepared statement of Mr. Lacey follows:]

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PREPARED STATEMENT OF DAN LACEY

Turmoil and Trauma Plague the U.S. Workplace

In the year just ended, the typical middle-class American began to understand through personal experience that the unemployment rate compiled by the Bureau of Labor Statistics no longer suffices as a full and accurate gauge of the health of the U.S. workplace.

The best evidence of this new understanding is the fact that, although the national unemployment rate remained relatively low through the recession year of 1991, consumer confidence -- which The Conference Board and other highly regarded business research institutions have found is prone to fall as employment-related worries increase -- fell to very low levels.

Consequently, it has become obvious to me that the most important issue to be explored concerning the U.S. economy in 1992 is not the unemployment rate, which measures only the gross quantity of workers looking for jobs, but the development of a huge array of changes that are diminishing the quality of work opportunities in America -- and that are, indirectly, driving down the consumer activity that makes up about two-thirds of our economy.

I hope to accomplish three objectives in my testimony today:

-- To point out to this committee, through evidence other than the Labor Department's unemployment statistic, several of the most significant sources of turmoil and trauma in the U.S. workplace.

-- To explain why the changes currently taking place in the U.S. employment relationship should not be regarded merely as temporary symptoms of a cyclical recession, but as parts of a permanent restructuring of work in America brought on by the pressures of the new global economy.

-- And to suggest several actions that our federal government might take to reduce some of the economic turmoil and human trauma being caused by upheavals in the nature of the employment relationship.

Permanent Staff Cuts Have Become Standard Practice

According to a database that we have been building at Workplace Trends since late 1988, publicly held U.S. corporations announced a total of 556,092 permanent staff cuts during 1991, an average of about 2,100 positions permanently cut each business day. That is the highest total we've ever recorded (please see attached Table 1 and Chart 1), and it is important to note that many of the cuts announced last year won't be effected until this year, or even several years from now.

During 1991, the number of companies announcing such cuts totaled 366, about one per calendar day. That pace has continued into 1992, so there is no evidence that the staff-cutting trend is abating.

It also is important to note that our database does not

include temporary workforce layoffs to trim inventories or production, such as is common in the auto industry. We count only those cuts which are, by any reasonable standard, permanent. In many cases, the corporations announcing these cuts have publicly verified the permanency of their staff reductions by taking the cost of cutting staff to the bottom line of their quarterly reports.

What's more, we are able to count only those permanent staff cuts that are publicly announced on a nationwide basis, typically by large corporations. So I believe it is fair to assume that we are capturing no more than one-half of the permanent staff cuts occurring. For example, we know that we are not capturing most of the permanent staff cuts being generated by the collapse of the U.S. savings-and-loan industry.

This staff-cutting trend has been under way since the start of the 1980s. But as Table 1 shows, the trend began to intensify dramatically in the third quarter of 1989 -- nearly a full year before the official start of the recession in 1990. Taking these statistics into consideration, it would be more logical to deduce that the staff-cutting spree helped bring on the recession, than to continue to believe that the recession has been the primary cause the staff cuts.

Clearly, the academic axiom "correlation is not causation" should be applied when discussing the relationship between the current corporate staff-cutting spree and the recession of 1990-91.

This contention that rampant corporate staff cutting predates the recession, and that the staff cutting may actually be a primary cause of the recession, certainly contradicts conventional economic and political wisdom. But to many specializing in the study of human resource management this idea is not so shocking, because we have been observing for more than a decade a profound and historic shift by corporate management away from the parent-child employment relationship invented during America's post-World War II boom decades.

Although most of Corporate America is hesitant to admit it because of potential political liabilities, the hard truth is that it is becoming standard management practice in U.S. corporations to cut permanent staff to the absolute minimum number of persons required to continue profitable operations -- while utilizing a variety of innovative, non-permanent employment relationships to cope efficiently with fluctuating workloads. This strategy is most often referred to in management circles as the "core-staff concept".1

Boom-Style Employment Is Dying a Painful Death

The adoption of the core-staff concept affects employees at virtually all levels of the typical corporate structure. For example, both blue-collar and white-collar workers typically suffer income and benefit cuts when they move from employment in a big company to a small one, or to self-employment or another non-traditional work relationship. So the public debates that have been conducted in recent months over whether the recession that we have been experiencing is a "blue-collar" or a

"white-collar" one are moot, at best.

The shift by large corporations to core staffing and its derivatives is putting to death the comfortable employment relationship that the typical big-corporation employee -- no matter what color the collar of the shirt, blouse or uniform they wear to work -- enjoyed during the post-war boom decades.

Put most succinctly, the expectation of long-term, steady employment at ever-rising wages, with full company-paid benefits has become obsolete. Yet nearly all the components of contemporary middle-class living in America -- such post-war consumer institutions as 30-year mortgages, five-year car loans and revolving consumer credit -- are based upon those obsolete, boom-era workplace expectations.

Obviously, the process of moving from the boom-style employment standard to the post-boom model is a very traumatic one for middle-class Americans. Most members of this traumatized group still have jobs and are not represented in the unemployment statistic. But a rapidly growing number are no longer employed in the secure, consistent, predictable fashion that middle-class living in the United States demands.

Is there really any wonder, then, why consumer confidence has been so low? Boom-style employment is dying a very painful death, and the entire U.S. economy is suffering as a result.3

How To Stop the Pain

There is no quick-and-simple remedy for the pain that millions of middle-class Americans are experiencing in their worklives right now -- no fast, fun, five-point quiz that working Americans can take to find their way back onto the road to economic comfort. But there are several steps that, I believe, the members of this committee can initiate to help make our country's transition to the global workplace of the 1990s and beyond more methodical, and less traumatic:

Separate healthcare from the paycheck. Most urgent is the need to separate, once and for all, the financing of our out-of-control healthcare system via the employment relationship. Although the two issues are rarely discussed in tandem, the crisis in healthcare financing and the corporate staff-cutting trend are closely linked.

None of the leading industrialized countries with which we compete links healthcare to employment as we do, and none has a healthcare system that devours money as outrageously as does ours. Consequently, many U.S. corporations have been cutting staff in a panicked, amateurish effort to control employee benefit costs and, thereby, remain internationally competitive. Yet many of the healthcare reform proposals put forth in the past year actually seek to increase the linkage between healthcare financing and the employment relationship.

If we push more of the burden for healthcare onto the paycheck, we'll succeed only in accelerating the move to the core-staff strategy. That can only cause more staff cutting, and more pain for working Americans.

So first and foremost, we must separate healthcare from

the paycheck. Only then we can begin a successful crusade to drive the U.S. healthcare industry back into the realm of economic reality without putting working Americans directly into the line of fire.

Launch a massive workforce retraining program. We must immediately admit that many millions of Americans still have nothing more to sell to the world economy than do citizens of the Third World who have had little or no access to formal education, and who often work for wages that barely support mere survival. Then we must begin to remedy that tragedy by implementing a domestic, skills-specific workforce retraining campaign greater than any that history has ever seen.

Some people have questioned how we can afford to retrain a large percentage of the American workforce. But I contend that we already have a in place throughout most areas of this country a community college system that, although uniquely suited for this purpose, is profoundly underutilized.

In 1991, America proved that it can still muster world-shaking power once it decides to trounce its military enemies. So I urge you to put 1992 into history as the year we proved that we can also muster as much or more power within our own borders to conquer humankind's greatest enemy, ignorance.

Reform U.S. employment law to fit the 21st century workplace. Virtually every aspect of U.S. workplace law presumes the 19th century factory style of work, and yet a shrinking number of us earn our livings through work that requires a factory-like setting.

For example, although millions of Americans are turning to self-employment each year as boom-style, big-corporation employment fades, our government still hasn't developed a simple, reliable standard for determining who is an employee and who is an independent contractor.4 A few attempts at reforming the independent contractor morass, such as House Bill 3813, have been put forth. But this area of workplace law begs for a quick and complete overhaul.

What's worse, our refusal to confront and reform the 19th century doctrine of at-will employment is generating a huge new body of litigation, generally known as "wrongful-discharge" lawsuits, that is exacerbating the pain created by our transition to the global economy, while benefitting virtually no one except trial lawyers.

America is no longer a country dominated by factory workers, and our laws governing the employment relationship must recognize that fact if we hope to compete in the world economy of the 21st century.

Abort the U.S. - Mexico "free trade" pact and, instead, dramatically increase immigration. Allowing the sweat-shop labor of Mexican and Central American to flow into the U.S. economy without restriction while the workers themselves remain trapped up against our southwest border would repeat, tragically, the greatest workforce error America ever made -- that of allowing the labor of enslaved African-Americans to flow northward and abroad, while the workers themselves remained trapped below the Mason-Dixon Line.

Our traditional fear of unemployment and of human beings

with origins other than ours often blinds us to the fact that human beings don't consume economic activity, they create it.5 Instead of resisting immigrants, we need to welcome ever-growing waves of them into this country which -- as a drive across a great state such a Texas will show you -- is still relatively empty. The American workforce is growing older and less mobile, on average, and only a massive infusion of eager-to-work, eager-to-adapt immigrants can reverse that trend quickly.

Once they arrive, these new immigrants must be welcomed into the great workforce retraining campaign that we've launched. Working together, native and newcomer alike, we can create the most highly skilled, most energetic and most prosperous workforce on Earth.

Thank you for this opportunity to appear before this honorable committee.

REFERENCES

1 For more on the core-staff concept, see Rethinking Employment Security by Kathryn Troy, published in 1990 by The Conference Board Inc., 845 Third Ave., New York, NY 10022 (Research Bulletin No. 244).

2 Alternative staff strategies are discussed in depth in Flexible Staffing and Scheduling in U.S. Corporations, by Kathleen Christensen, Ph.D., published in 1989 by The Conference Board (Research Bulletin No. 240).

3 For more on the effects of staff cutting on employee morale, see Downsizing: Creative Approaches to Corporate Change, published in 1991 by The Bureau of National Affairs Inc., 1231 25th St., N.W., Washington, D.C. 20037 (Cat. No. 14-6127).

4 Up-to-date statistics on the American shift to self-employment appear in Starting Over by Thomas McCarroll in Time magazine's issue of January 6, 1992, Page 62.

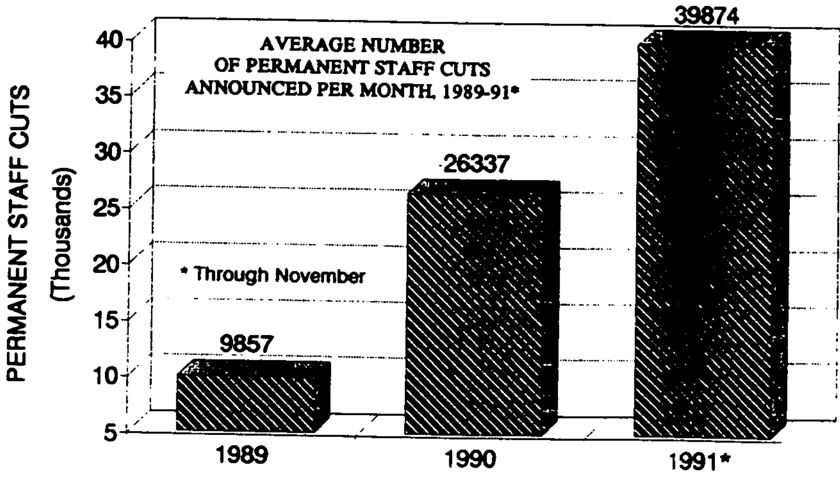
5 The positive effects of large-scale immigration on the U.S. workforce and the economy in general have been documented well in publications produced by the American Immigration Institute, 1625 K. St., N.W., Room 380, Washington, D.C. 20006

Table 1

SYNOPSIS OF PERMANENT STAFF CUTS
BY U.S. CORPORATIONS 1989-91

	Positions Cut	Companies Cutting	Dominant Industries
1989			
Q1	9,850	6	computers
Q2	10,100	3	aerospace
Q3	24,085	11	autos
Q4	67,250	35	computers, telecommunications
Year-end totals: 111,285 positions; 55 companies			
1990			
Q1	107,052	46	autos, telecommunications
Q2	87,686	44	aerospace, retailing
Q3	49,104	49	computers, aerospace
Q4	72,205	85	financial services, autos
Year-end totals: 316,047 positions; 224 companies			
1991			
Q1	110,856	91	retailing, transportation
Q2	76,622	60	defense, computers
Q3	147,507	104	financial services, computers
Q4	221,107	111	autos, computers
Year-end totals: 556,092 positions; 366 companies			

Chart 1



SENATOR SARBANES. Dr. Belous, please proceed.

STATEMENT OF DR. RICHARD S. BELOUS
VICE PRESIDENT AND SENIOR ECONOMIST
NATIONAL PLANNING ASSOCIATION

DR. BELOUS. Mr. Chairman, the harm which the American labor force has so far experienced in the current recession, and is going to experience in 1992, is far worse than the official statistics that you have been given today. We are all familiar in the financial world with the growth of junk bonds and the decrease of quality of many finanical instruments. We have experienced a similar process in the American labor market. It is true that the unemployment rate has only gone up around 40 percent of what it has been in the past two recessions, but there are a lot of other factors which one should take into consideration before one jumps for joy.

We have seen a tremendous growth of what I have called contingent workers. I think it makes sense to divide any work force, whether it is a work force for Congress, for an institute or a corporation, into what I call core and contingent workers. Core workers are full-time workers. There is a long-term commitment with the employer, and they are part of the corporate family. Contingent workers are part-timers, temporaries, life of project people, subcontractors, leased employees—just like you can lease a jet airplane or a building, now you can lease employees—and a good deal of self-employment. A conservative estimate would say that the contingent worker now represents around 25 percent of our work force. A liberal estimate is over 30 percent. I think reality is closer to the liberal estimate than the conservative. About ten years ago, the conservative estimate was around 20 percent and the liberal estimate was around 25 percent, so it has grown.

In the current recession, it still has been the blue-collar workers who have experienced the greatest rise in the unemployment rate. However, what we are seeing because of this growth of contingent work is that the harm, both in terms of unemployment and in other factors, has spread out through the labor force. The current recession has become much more of a white-collar experience than any recession since the Great Depression. White-collar workers have experienced more of the share of unemployment in this recession than they did in the 1981-82 and 1975 recessions.

For example, the jump on the white-collar unemployment rate was equal to only 34 percent of the increase of the unemployment rate for all workers in the 1981-82 recession. However, the jump in the white-collar unemployment rate has been equal to 69 percent of the increase in the unemployment rate for all workers in this recession.

But beyond this recession, middle-class workers are experiencing a difficult adjustment. My formal testimony includes estimates for displaced workers. You can see, for example, that the first time we looked at displaced workers—displaced workers are workers who have been on a job for at least 3 years or more, but have lost their position—in the late

1970s and early 1980s, under 14 percent of these people were managerial and professional workers. Now, over 20 percent are managerial, technical, and professional workers, so it has increased in the white-collar ranks. But there is another phenomenon which has grown that has held down the official unemployment rate, and I certainly think you would have to consider it a marginalization of the work force.

In my 1989 study of contingent workers, I found that corporations, such as the Manpowers and the Kellys, loved to talk on the record. The General Motors, the IBMs did not want to talk publicly on the record of what they were doing. So, I went to the case study approach and did over 50 case studies of leading employers from all sectors of the economy. What I am now in the process of doing—and it is work in progress—is going back to the same employers, seeing what they are doing in this recession.

First, what has been fascinating about this recession, as opposed to other recessions, is that firms are laying off white-collar workers, high-skilled workers, technical workers, and managerial professional workers at a much greater rate than they have ever done before. Some workers are offered so-called "windows of opportunity." The message is clear. You take this window of opportunity, which has some enhancement in terms of retirement benefits, and if you don't take it, there is a good chance that you are going to be pushed. So, many workers do opt for this. And it is difficult for a worker who is, let's say, 55 years old to find a different job with equal pay and benefits. What I have found, which is amazing, is that many of these corporations, once laying off their core workers, have started to rehire the same people in a matter of weeks, but in contingent forms as subcontractors, as consultants, in those ranges. For example, one major employer—a high-tech Fortune 500 corporation—has taken back roughly 50 percent of its professional and high-tech people as consultants. What is the difference? Well, this gets to your revenue estimates. They take them back at far less wages; they do not have fringe benefits, and obviously they have no job tenure.

SENATOR SASSER. If I could just interrupt there, Dr. Belous. You get a double whammy there. The Treasury gets a double whammy.

DR. BELOUS. Precisely.

SENATOR SASSER. Because the person that they push out or jumps, he or she is either retired or working at a much lower wage scale, and then they replace that person with someone that they pay less. So, the Treasury loses both ways.

DR. BELOUS. Yes, that's true.

The other area that I have looked at is part-time workers, and I think that the distinction sometimes between voluntary or involuntary part-time workers is meaningless. You can typically question a person who is working part-time, let's say a woman, and ask: Are you voluntarily or involuntarily working part-time? "It is my choice that I am working part-time," she might say. Then you list a whole host of countries that have

the good day-care arrangements. If you were offered that day-care arrangement, would you still want to be part-time? Often the woman will answer: "No, if I had that kind of day-care provision, I would want to would work full-time." So, I would say that a lot of people would say that they are voluntarily working part-time, given the difficulties in U.S. child care and other difficulties in our social welfare system. Yes, they are voluntary. But if we had a health-care system or a day-care system which matched, let's say, Canada or some of our other Western neighbors, the answer would definitely be no.

You have asked what do I feel is going to happen in the future? I hate to say this, but to borrow a phrase, as far as harm experienced by the white-collar and middle-class, "You ain't seen nothing yet." Essentially, in the 1980s, we raised manufacturing productivity by downsizing blue-collar workers. The productivity gains that we have seen in manufacturing have not come because of an extraordinary burst of capital formation. It has happened because of a fantastic downsizing of workers and the use of things like contingents. I think that what you saw in manufacturing in the 1980s you are going to start to see in the 1990s—and you are seeing it already in terms of financial services. You are going to see this in the service sector of the economy. Essentially, in the 1980s, the service sector threw people at problems. You're not going to see this in the 1990s. Similar to financial services, there will be a tremendous downsizing in the white-collar areas of service economy.

I was also taught when I went to graduate school that there was a difference between so-called traded goods and nontraded goods. In other words, there is an international trade for microphones and automobiles, but obviously in the service sector, there is not an international economy for barbers. Well, that may be the case for certain services, but more and more services are becoming internationally traded, and there is an international component. Many companies have found that they can move their back office from Manhattan to New Jersey, or Dallas, or somewhere in the South. And I submit to you, that if you can move your back office from Manhattan to New Jersey, there is no reason why you can't move it to Barbados. And I think that we are going to see a tremendous growth of that in the 1990s.

Senator Sarbanes. I want to just interrupt with one question. What is your definition of downsizing of workers? What do you mean by the phrase "downsizing"?

Dr. Belous. First of all, I would try to measure what is a core work force? What is normal full time? Then, I would try to compare what is that same number now, compared to three years ago. What is the size of their core work force before, compared to what it is now? And what we are seeing in many companies in the Fortune 500 is that there has been a tremendous downsizing and layoffs of core workers, plant closings, and such moves. That is what I would conclude in downsizing.

Senator Sarbanes. Do you have a term for the situation when you have people who have been trained and educated and have the skills to

do work at a certain level, who are doing work at a much lower level? For example, you have college graduates doing jobs that you would assume do not require a college education. The pressures of the workplace have led them to do that. Is that downsizing as well?

DR. BELOUS. In part, but simply that is a vast waste of human resources. It's interesting that Mr. Plewes in the last session did say—and he is right—that most people who go through this displacement, or 42 percent, almost half, do wind up at a lower skill level. So, I do feel that in the 1990s, coming out of this recession, we will see increases in productivity in the service sector, but it is going to be the same way that we increased productivity in the manufacturing sector.

I think the problems of the contingent work force are going to grow. This does impact on health care and other benefits. Even if you don't care about those things, it is going to have a tremendous impact on your job in trying to come up with what budget revenues are going to come into the federal treasury.

Let me end on one point—and I don't want to sound like Marie Antoinette, and let them eat statistics—but I do feel that statistics matter. The way in which we currently measure a recession is ridiculous, and it has led us to very false policy conclusions. Essentially, what we do now is look at GNP, or GDP, and if two quarters are down, then we call it a recession. If one quarter starts to come back up, we call it a recovery. It strikes me that if I were a medical doctor and had a patient who had a 105 temperature and all of a sudden I took his or her temperature and it was 104.9, I would trumpet to the press that my patient was now experiencing recovery. The truth of the matter is that at 104.9 my patient would still be as sick as a dog.

I think what happens when we start to say that we are in a recovery is that we get into a mindset where we feel that the economy can right itself, and we don't have to do anything. We don't have to make any adjustments, and we just have to keep our hands off of the economy. The tragedy in this recession has been that a lot of misery has been experienced that might have been avoided. One way of changing how we measure a recession might be to say that if the economy is not growing by at least the rate of the labor force, or at some socially minimal acceptable level, it is in a recession. Therefore, even if you see small levels of growth—or to use the medical analogy, a dip from 105 to 104.9—you wouldn't be trumpeting that recovery. You would still be saying that we are in a recession.

Again, I think statistics do matter because they color how we view the world. The way we measure recovery in this country has given us a tragic policy, since the problems were much more serious than many thought. Therefore, I would say that what white-collar workers are experiencing in this recession, they will experience in part even when the recovery comes. Many of them are going to continue to experience job loss. These are not just cyclical problems, but these problems are very serious long-term structural issues.

Thank you, Mr. Chairman.

SENATOR SARBANES. Thank you very much.

[The prepared statement of Dr. Belous follows:]

PREPARED STATEMENT OF RICHARD S. BELOUS

Mr. Chairman and Members of the Joint Economic Committee, since the 1930s the National Planning Association has been a unique network of top business, labor and academic leaders. Our research ranges from economic estimates, to studies on regional trading blocs, to the first U.S. study of the dramatic growth of contingent (i.e., part-time, subcontracted and temporary) workers.

You have asked for my observations concerning the differences in unemployment in this recession compared to previous recessions. While there are many differences in the size and nature of unemployment in this recession compared to previous recessions, I will keep my comments to 11 points.

1. The unemployment rate has not gone up as much in this recession compared to many previous recessions. But before one takes comfort in this fact, it should be noted that the growth of so-called contingent workers has hidden a good deal of the labor-related harm caused by this recession. As indicated in Table 1, unemployment has increased by roughly 1.3 percentage points in the current recession compared to 3.2 percentage points in the 1981-82 recession and 3.3 percentage points in the 1975 recession. Thus, relative unemployment has increased by roughly 40 percent of the average of the last two recessions. This is a smaller jump in reported unemployment, but there are other factors that should be noted before we take comfort in this condition.

2. In the current recession, as in previous recessions, it is blue collar workers who have experienced the greatest rise in their unemployment rates. As noted in Table 1, blue collar unemployment has increased by 2.0 percentage points, compared to 1.3 percentage points for all workers. Thus, the majority of the relative labor-related harm is still experienced by blue collar workers.

THE INCREASE IN UNEMPLOYMENT PERCENTAGE POINTS

	Current Recession	1981-82 Recession	1975 Recession
All Workers	1.3 percentage points	3.2 percentage points	3.3 percentage points
Blue Collar Workers	2.0	6.2	5.6
White Collar Workers	0.9	1.1	1.6
The Ratio of White Collar To All Workers	69	34	48

The way to read the above data is as follows: In this recession the unemployment rate for all workers climbed by 1.3 percentage points; and the ratio of the white collar increase to the increase for all workers is 69 (i.e. 69 = 0.9/1.3).

Source: NPA estimates based on U.S. Bureau of Labor Statistics data.

3. However, the current recession has become much more a white collar experience than any recession since the Great Depression. White collar workers have experienced more of the share of unemployment in this recession than they did in the 1981-82 and 1975 recesions. For example, the jump in the white collar unemployment rate was only equal to 34 percent of the increase in the unemployment rate for all workers in the 1981-82 recession. However the jump in the white collar unemployment rate has been equal to 69 percent of the increase in the unemployment rate for all workers in this recession.

4. Other data and estimates drive home that the white collar work force is feeling more of the relative pain caused by this recession than in previous recessions. For example, in past recessions the white collar work force has often experienced small or flat job growth. However, the current recession is the first time since the Great Depression that the white collar employment has declined by a statistically significant amount. Roughly 500,000 fewer white collar workers were employed in July 1991 compared to a year earlier.

5. Beyond the current business cycle, there is a good deal of evidence that the white collar work force is going through some serious structural changes. For example, my research has shown that while contingent workers at one time were almost only blue collar, service, and low level white collar workers, this picture has changed. The ranks of contingent workers now include many more managerial, professional and high level technical workers. Also, as Linda Levine of the Congressional Research Service of the Library of Congress, has shown, white collar workers now represent a much greater portion of the number of workers who are displaced than in the past (See Table 2). White collar workers represented almost 37 percent of the workers who were displaced between January 1979 and January 1984. However, white collar workers represented nearly half (48 percent) of the workers who were displaced between January 1985 and January 1990.

Displacement among White-Collar Workers (numbers in thousands)				
Occupational Group	Number of Displaced Workers 1/ between			
	1/79-1/84	1/81-1/86	1/83-1/88	1/85-1/90
Total (white-collar, blue-collar, & service occupations)	5,091	5,130	4,629	4,326
Managerial and professional specialties	703	782	815	869
Executive, admin., & managerial	444	487	524	563
Professional specialties	260	295	292	307
Technicians, sales, & admin. support	1,162	1,125	1,317	1,209
Techs. & related support wkrs.	122	174	165	129
Sales occupations	468	447	506	457
Admin. support, incl. clerical	572	504	645	623
Occupational Group	Percent Distribution			
Total (white-collar, blue-collar, & service occupations)	100.0	100.0	100.0	100.0
Managerial and professional specialties	13.8	15.2	17.6	20.1
Exec., admin., & managerial	8.7	9.5	11.3	13.0
Professional specialties	5.1	5.8	6.3	7.1
Technicians, sales, & admin. support	22.8	21.9	28.5	27.9
Techs. & related support wkrs.	2.4	3.4	3.6	3.0
Sales occupations	9.2	8.7	10.9	10.6
Admin. support, incl. clerical	11.2	9.8	13.9	14.4

1/ Displaced workers are persons 20 years or older with at least 3 years of job tenure who lost or left their jobs because of plant closings or moves, slack work, or the abolishment of their positions or shifts.
U.S. Bureau of Labor Statistics. Displaced Worker surveys.

Source: Linda Levine, "Job Security and White-Collar Workers: Structural and Cyclical Unemployment," (Washington: The Congressional Research Service of The Library of Congress) Report 91-846E, 1991, p. 3.

6. The use of contingent workers has grown in the United States. A conservative estimate would indicate that roughly 25 percent of the work force are now contingents. A liberal estimate would indicate that over 30 percent of the work force are now contingents. (I believe that reality is closer to the more liberal estimate.) Many of these workers do not have health care or other fringe benefits. They are also paid far lower wages than regular core workers on average. In 1989 when NPA published my study (The Contingent Economy) I said that the unemployment rate might rise faster in a recession than in the past because firms are now more willing to downsize their work force than in the past. What I did not realize was that many firms would be willing to fire workers and then hire them back as contingents. The net result of such transactions is to hold down the reported level of unemployment.

7. My 1989 study included many case studies with some of America's leading corporations. I am now in the process of going back to some of these corporations to see what they have done regarding contingent work in this recession. While this is still work in progress, I would like to share with you one case study. The corporation in question is one of America's leading high technology firms. In this recession — unlike previous recessions — it has downsized its white collar work force. Also, roughly half of the professional and high level technical workers who have left the company in this recession have entered into contingent work relationships with the company. Many have come back as consultants or other forms of subcontractors. As far as the official U.S. labor force data system is concerned, the net result has been to lower the reported unemployment rate.

8. One should also consider the number of people who must take part-time, temporary, or leased employment even though they want normal full time and steady work. Added to this has been the growth of discouraged workers. All of these factors have worked to lower the official unemployment rate and mask the real labor market hardship caused by this recession.

9. I believe that the world of white collar work will remain very tough for most of the 1990s even after this recession ends. While the 1980s was a era of blue collar downsizing in the manufacturing sector, I believe that the 1990s will be a time of major white collar downsizing in the service sector. Beyond the unemployment rate and the number of white collar jobs, I believe that many white collar jobs will become marginalized or made contingent. This has serious implications for the American social welfare system and economy.

10. The current recession has shown that the standard way that economists measure a recovery is foolish. The standard is to declare a recession if two back-to-back quarters show a decline in gnp or gdp. The first time gnp or gdp shows any — no matter how small — increases, a recovery is declared. Suppose a person had a temperature of 105 degrees, and then the person's temperature become 104.9 degrees. Using our current economic standards we would declare that the person has experienced a recovery. It makes more sense to look at the growth rate of the labor force. If gnp or gdp are not growing fast enough to keep up with the rate of growth of the labor force, then the nation is in a recession. Only if the growth rate of gdp or gnp is equal to or higher than the growth rate of the labor force does it make any sense to think of the nation in a recovery. If the nation's gdp increases by 1 percent while the labor force

is growing by 1.5 percent, then the nation is still sick and very much in a recession. I think that false statements about our being in a recovery in 1991 led us to make some very serious policy mistakes.

11. The current recession points out many of the weak points of our current official labor force data system. We are undercounting and not doing enough statistically in the service sector of our economy. I believe that if there were good counts in the service sector, official unemployment rates would have been higher. The official data system is doing next to nothing in the key area of contingent work. It is hard to form sound policies when the official data system is falling so far behind.

SENATOR SARBANES. I would observe that Professor Tobin made your last point yesterday in a very cogent way. He said that we tend to be mesmerized by whether GNP growth is positive or negative. He made the point that it could be positive by just a small margin and that you still would be beset by a whole range of economic problems associated with a sluggish economy. So, there is not some sort of magic to crossing the line from negative to positive, although it is obviously better to be positive than to be negative.

Dr. Kosters, we would be happy to hear from you, sir.

STATEMENT OF MARVIN H. KOSTERS
DIRECTOR OF ECONOMIC POLICY STUDIES
AMERICAN ENTERPRISE INSTITUTE

DR. KOSTERS. Thank you, Mr. Chairman. I too am pleased to be able to appear before this Committee this morning. What I would like to do is to summarize briefly my statement by touching on four areas.

Very briefly, the first area is the recession and measures of its severity. The recession that began in 1990, whatever its duration may turn out to be eventually, has so far at least been a less severe recession than the average, and certainly less severe than the last two. That is true if you look at the unemployment rate, at employment numbers, at unemployment because of job loss, at workers discouraged from the labor market participation, or at unemployment duration. Across the board, those numbers do not show a recession as deep as the average postwar recession.

We hear a great deal these days about the idea that labor market measures no longer mean what they once did. Mr. Belous mentioned that the recession is far worse than the official numbers. The Chairman mentioned earlier the *New York Times* article. You would think, based on this discussion, that we now have an entirely new and different set of measures of unemployment than we had before. I submit that is not the case. These are essentially the same kinds of data that we have gathered for many years during earlier recessions. The same kinds of critiques that we hear now were relevent then, as well as now. I think it is important to recognize this continuity, because we should not be misled by the numbers, one way or the other. It seems to me that if we claim that things are getting much worse than the numbers now suggest, then we should also claim that things were getting much better than the numbers suggested during the recovery. I think it is important to be realistic about what the numbers are really telling us about the economy.

Now, let me turn to the blue-collar/white-collar worker issue. White-collar unemployment hasn't increased as much as in earlier recessions. The rate is about half as high as for blue-collar workers. As it happens, at the present time, however, white-collar unemployment accounts for about as much of total unemployment as blue-collar unemployment. Now,

that is something new. This is something new, but it didn't happen suddenly. This is part of a longer term trend.

About 20 years ago, white-collar workers were about a third and blue-collars about half of the unemployed. Now, both have converged to about 40 percent. The main reason is that the white-collar work force has grown very much relative to the blue-collar work force, about a 10 percentage point difference in shares for both segments. As the actual numbers of unemployed blue- and white-collar workers have converged, in other words, the proportion of blue-collar workers has been shrinking in the economy. The number of white-collar workers has increased as a share of the total employment.

In summary, the main reason why white-collar workers are accounting for a larger share of unemployment nowadays is that we have much more of a white-collar economy.

SENATOR SARBANES. That is an interesting point. Could I just ask, is the percentage of blue-collar workers unemployed in this recession less than in previous recessions?

DR. KOSTERS. The percentage is less, yes.

SENATOR SARBANES. How about for white-collar workers?

DR. KOSTERS. The percentage is also less. Their unemployment rate is lower than in the last two recessions and, I think, also less than the average for postwar recessions.

SENATOR SARBANES. You were saying that the number of white-collar workers unemployed, as a percentage of the white-collar workers, is less in this recession?

DR. KOSTERS. I have a chart here that shows this, and the numbers show the same thing.

SENATOR SARBANES. Is the chart part of your submission?

DR. KOSTERS. I can make it part of the presentation.

SENATOR SARBANES. Can you present it so we can have the benefit of it?

DR. KOSTERS. Sure.

SENATOR SARBANES. Thank you very much, sir.

DR. KOSTERS. So, the main reason that white-collar unemployment has increased as a share of total unemployment is that white-collar workers are a growing share of the work force. This is a long-term matter, but there are a couple of short-term factors that I think are relevant too. In the past, the deeper the recession, the larger the share accounted for by blue-collar workers. One reason why we now have a smaller share accounted for by blue-collar workers is that the recession is somewhat shallower than the average recession. The other factor involves exports—export markets have been less weak than domestic markets.

SENATOR SASSER. Mr. Chairman, Dr. Kosters—I am confused here on a point. Did you say that the percentage of white-collar workers is lower than it has been than in previous recessions?

DR. KOSTERS. That is correct; their unemployment rate is lower.

SENATOR SASSER. I thought we were talking about the ratio of white collar to blue collar.

DR. KOSTERS. I talked about both actually, Senator.

SENATOR SASSER. Is the ratio of white-collar workers to blue-collar workers—those who are unemployed—higher than it has been in previous recessions?

DR. KOSTERS. Yes, that is correct.

SENATOR SASSER. I think that is the point that I understood was being made. The ratio is higher for white collars relative to blue collars than it had been in previous recessions.

DR. KOSTERS. Yes. Another way of saying it is that white-collar workers now account for a larger share of the unemployed, mainly, because they also account for a growing share of the employed. We have a white-collar recession because we are increasingly a white-collar economy.

To summarize this discussion about blue-collar and white-collar workers, changes in the relative numbers unemployed have occurred for reasons that are perfectly understandable and natural. We should recognize, of course, that in fact a larger share of unemployment is now accounted for by white-collar workers, and that may well make a difference in the way this recession is viewed. It is possible that concerns about job security for the average consumer or worker are higher, in part, because of more white-collar unemployment. It seems to me that it could also be the case that white-collar workers who lose their jobs think they are less likely to be recalled to the same jobs that they had before than blue-collar workers. I suspect that is correct, but judging from past experience, it is likely that they would get other jobs as readily as blue-collar workers are recalled to old jobs.

Another factor that I think is important to recognize about this recession—and this is something that is, in fact, unique to this recession—is that this is the first recession that we have experienced, under the 1988 Act, a requirement of advance notice of major layoffs—under WARN, as the act is called. Now, it is really not at all clear what effects, if any, this act may have had on layoffs, but it may have affected layoffs that occurred. It may produce a reluctance of firms to take on permanent employment in the very near future. If the outlook is somewhat uncertain, firms are reluctant to risk waiting for whatever period is required after a layoff announcement is made. It is also possible that firms now exercise somewhat more caution, and they make earlier announcements of layoffs that might take place in the future. It is not clear what effects legal requirements for advance notice are having, but it is a new element in the picture at this time.

There have recently been a number of major announcements of employment cutbacks. We can reasonably ask what we should infer from these about the employment outlook. I would say that there are two perspectives on this subject.

One perspective is that major layoffs certainly have adverse impacts on the people who are affected, on their communities, on the firms that are forced to downsize. On the other hand, I think it is also important to keep the numbers involved in perspective and to be clear on what we are talking about. Some numbers were mentioned here today; some 500,000 workers affected, for example. Some of these layoffs may or may not materialize. They are spread over a period of months, some of them even over years. And what we need to recognize, I think, is that the number of workers affected by major layoffs is very small compared to average job growth during all of the past 20 years through thick and thin, through recessions and recovery. We have added about two million workers a year on average. If we have a normal recovery, or even a modest recovery, the effects on employment of announced layoffs will be swamped by the job growth that we can expect. My inference is that we should focus mainly on programs that increase employment and create new jobs, not on protecting jobs of workers for whom layoffs have been announced.

Let me now turn briefly to the subject of contingent workers. I don't know how large a portion of the work force they may account for, partly because it has never been very clear exactly how contingent workers should be defined. But in any case, the notion is that these workers are less firmly attached to jobs than regular wage and salary employees are. I think it is important to understand a bit better the role of this kind of employment, because I think that we have sometimes been too critical of it.

One of the reasons for its emergence—it seems to me—is that with the growth of white-collar jobs and employment—generally more professional employment—getting a job is a somewhat different process than it was. In the past, a typical worker might apply at a local firm that might be hiring for a blue-collar production worker job, which had characteristics quite similar to jobs with other firms in the same industry and sometimes in other industries. White-collar employment involves jobs with a diverse range of specialized skills. Job matching is more complicated. As a consequence, people often find it in their interest to take some sort of temporary employment, get some job experience, and earn some income, while they search for a job that more precisely suits their interest and their abilities and their skill levels. So, it seems to me that temporary jobs for people in that situation are much better than a prolonged period of search and unemployment that might otherwise be necessary.

On the part of firms, there are also incentives that have grown over the years to move more toward the use of this type of temporary employment. Some of these incentives come from the legal and regulatory environment in which firms operate nowadays. Increasingly, taking on a full-time worker—a permanent wage and salary worker—means a pretty good size investment for a firm. The firm has become subject, in the last few years, to advance-notice requirements for layoffs, as I mentioned earlier. The firm is also subject to continuation of a health plan after a worker is terminated. The possibility of wrongful discharge suits in

various states has also already been mentioned as one of the conditions to which an employer is subject. Family-leave requirements have been enacted by several states. In fact, all sorts of mandated benefits—and this would be particularly true for mandated health-care benefits because they are so costly—would tend to make firms very reluctant to take on an employee and make a very substantial investment if they think it is possible that this person might not work very long for the firm, because of either a mismatch between the worker's skills and the job or because production requirements turn out to be somewhat lower than anticipated.

It seems to me that in view of the somewhat more complex job-search process that is typical nowadays, and in view of different circumstances that firms find themselves in with regard to permanent employment, it is natural that growth in contingent employment arrangements would occur. I think that it is a mistake, in other words, to think of the emergence of such arrangements as something that seriously displaces regular wage and salary employment. I think of it instead as a very important and useful supplement to that employment, and sometimes a route to longer-term employment. For many workers and for many firms, contingent jobs provide a period when both can try out the market, the job, and the person filling it.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Kosters, together with figures, follows:]

PREPARED STATEMENT OF MARVIN H. KOSTERS

I am pleased to appear before the Joint Economic Committee today to discuss recent labor-market trends. The letter of invitation referred specifically to the experience of white-collar and blue-collar workers during the recession that began in 1990, so I will discuss developments for workers in those broad occupational categories and then turn to some other related issues.

Although all recessions are characterized by somewhat similar movements in major economic data series, each recession also differs in a variety of ways from others with which it can be compared. Some of these differences seem to represent short-term, cyclical differences among recessions, while others seem to reflect longer-term trends.

How the duration of the recession that began in 1990 will be seen in comparison with others is at this point uncertain. Several indicators seemed to point to a recovery under way earlier in 1991. Some of these have since stabilized or declined, and this is a somewhat distinctive feature of this recession. Uncertainty about the immediate future has, of course, been heightened as a result.

The depth of the current recession so far appears to be relatively moderate in comparison with the average postwar recession. Most of the labor market indicators show a less severe recession, for example, than those of 1974-75 and 1980-82. The unemployment rate (at 6.8 percent in November) remains well below the levels it reached then, and the rise in the unemployment rate has been much smaller. This relatively moderate deterioration in labor market conditions is also shown by indicators such as the proportion of the labor force unemployed because of job loss and the number of workers (relative to the labor force) who decided not to seek work because they thought a job would not be available. Employment has also declined less than in the typical recession. The number of those working part-time for economic reasons, although still a significantly lower share of the work force than in 1982 and 1983, is somewhat higher than might be expected. Whatever the reasons, part-time workers who would prefer full-time work seem to show a longer-term upward trend.

Broad Occupational Characteristics

It has sometimes been suggested that, at least in comparison with earlier recessions, this has been a "white-collar recession". Whether this is so, or the sense in which it may be so, is not entirely clear. Certainly white-collar workers now account for a larger share of unemployed experienced workers than previously according to the broad occupational breakdowns available from household survey data. The proportion of unemployment accounted for by blue-collar workers is quite large, nearly 40 percent in 1991. But their share is more than 10 percentage points lower than it was in 1975 and 1980. White-collar workers, however, have also recently accounted for almost 40 percent of the unemployed compared with about 30 percent in 1982 and 1975 as shown in figure 1. To judge whether this should be viewed as an unusually large share of the unemployed, it is important to take into account the long-term trend toward a larger share of employment accounted for by white-collar workers.

White-collar workers have accounted for a growing share of employment over the years, with most of the offsetting decline accounted for by blue-collar workers. In 1970, for example, white-collar workers accounted for about 48 percent of employment compared with 57 percent in 1990. The blue collar proportion declined during that same time from over 35 percent of employment to 26.6 percent. (See figure 2. Most of the remaining share is accounted for by service workers, among whom a growing share is probably also accounted for by white-collar occupations).

We would, therefore, ordinarily expect a growing proportion of unemployment to be composed of white-collar workers.

The unemployment rate for white-collar workers has not increased as much as for blue-collar workers. It remains well below levels it reached in 1975 and 1982, and it has recently been less than half the rate for blue-collar workers. The white-collar unemployment rate has been about 4 percent in recent months compared with about 9 percent for blue-collar workers (see figure 3). Nevertheless, the unemployment rate for blue-collar workers has increased much less so far than in those two earlier, deeper recessions. Both in terms of the high levels of their unemployment and the proportion of unemployment they accounted for, those were certainly "blue-collar recessions" to a much greater extent than recent experience.

The data suggest to me that much of the larger current share of the unemployed accounted for by white-collar workers is attributable to their growing employment share. Some part, in addition, is accounted for by the somewhat shallower recession that we have so far experienced and by somewhat less weakening in export markets than in the domestic market. It should also be recognized, of course, that these sources of change do not alter the fact that a larger proportion of current unemployment is composed of white- collar workers--close to 40 percent of the unemployed--than in earlier recessions.

Job Security and Layoffs

It is possible that the increased proportion of unemployment accounted for by white-collar workers has heightened concerns about job security for the work force as a whole, even though the incidence of unemployment among white-collar workers is not unusually high for a recession. Their perceived vulnerability to unemployment may be higher because larger numbers are unemployed. It seems to me at least as likely, however, that perceived vulnerability to unemployment may be exacerbated by reports of future layoffs that have been announced as permanent reductions in employment instead of temporary layoffs, with workers likely to be recalled when a recovery is under way.

One distinctively different feature of the current recession is that it is the first in which employers are subject to federal advance notice requirements for layoffs under the Worker Adjustment and Retraining Notification Act of 1988. It is not clear what effects these requirements may have on the pattern of layoffs that have occurred so far, on caution by firms in recalling previously laid off workers, or on layoffs that have been announced for the future. Many large firms already provided general notice well in advance of planned employment cutbacks, but the new legal requirement for advance notice may affect the cyclical pattern of employment change.

White-collar employment has generally been regarded as providing more job security during recessions than blue-collar employment. But employment of both kinds in large firms has often been regarded as providing jobs with a great deal of long-term security. In many cases such jobs came to be viewed as permanent, often life-time, jobs. Recent developments, such as permanent employment reductions by major firms that had previously been able to avoid such changes, have emphasized that the adaptability and marketability of workers' skills is a more important underlying source of job security than the particular firms in which workers are employed. Characteristics of workers have often become more relevant for job security than those of firms.

A number of recent announcements of major reductions in jobs have raised questions about the implications of these plans for job creation and employment growth in the future. These announced changes, if cutbacks that are currently planned are actually carried out, will have a major impact on the individual workers affected, on communities where they are located, and on the firms making the adjustments. Their significance for job and employment trends as a whole,

however, should be kept in perspective. Some reductions in employment may not be carried out as announced, and many will be spread over a period of months or even years. Moreover, even the largest announced cutbacks are relatively small in relation to past employment growth that averaged 2 million additional jobs per year during the past twenty years. The effects of large employment cutbacks by particular firms will be swamped by job growth that we would normally expect in even a modest, healthy recovery.

Contingent Employment Arrangements

Changes in the characteristics of jobs and in the legal and regulatory environment have contributed to the emergence of new types of employment arrangements, sometimes called contingent employment. The trend toward white-collar employment has meant that the typical job-seeker is now more likely to prepare a resumé to facilitate matching a worker's skills with an employers needs than to go to a firm's employment office and fill out an application for a job that might be available. The process for matching workers' occupational skills with specific job requirements is probably more complex in professional and technical job markets than for traditional blue-collar production worker jobs.

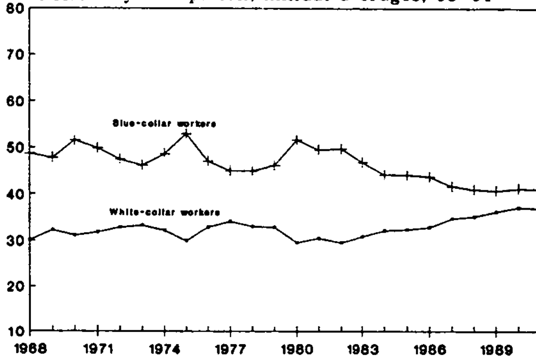
In addition, offering a worker a more-or-less permanent position entails a larger commitment, a bigger investment, than in the past. Mandates that employers now face--such as advance notice requirements before major layoffs and continuation of health plan coverage for workers who are terminated--and the prospect of possible additional benefit mandates, have increased the investment that firms need to make when taking on an employee. Changes in the legal status of workers' challenges to job termination and benefit mandates such as family leave requirements enacted by several states have also increased costs to employers of offering permanent jobs. Some type of temporary employment arrangement can help to avoid the possibility of the potentially costly mistake of bringing a worker directly on the payroll whose services might be needed only temporarily.

Employment arrangements, such as the widespread use of intermediary firms that supply temporary workers, have emerged in part in response to these conditions. For firms making use of such services, these arrangements provide some worker screening services and sometimes some training, flexibility to accommodate changing workloads, and a period of probationary employment without the need to make major commitments. For workers, they provide a job and current earnings during a period they can continue searching for a more permanent jobs that best suit their skills and interests.

Contingent employment is often criticized for the absence of job security it entails and because compensation is often paid primarily in wages, with few non-wage benefits. Avoiding the costs of some of these benefits, of course, particularly for workers who may not value them highly, is one of the reasons why these employment arrangements have become more prevalent. Although lack of health plan coverage is often associated with temporary employment arrangements, encouraging the purchase of health insurance by such workers by providing for them the same tax-advantaged terms as for workers covered by employer-paid health plans makes more sense than discouraging this type of employment.

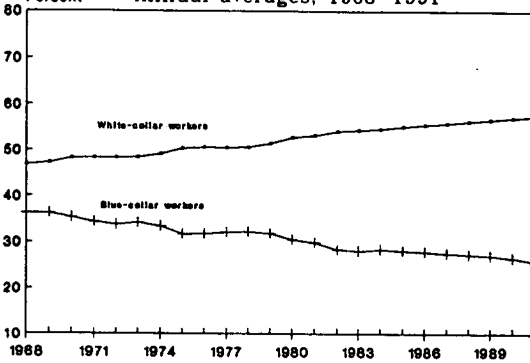
The growth of contingent employment arrangements has sometimes been viewed as an undesirable development because it is seen as supplanting traditional wage and salary employment. I believe that this is a seriously incomplete and misleading view. It seems to me much more appropriate to view at least some forms of contingent employment as a constructive supplement to traditional wage and salary jobs that sometimes help to facilitate entry into such jobs. Employment of this kind can be expected to result in more jobs than would otherwise be available, because it is in part a response to changes in the character of job-matching and to legal and regulatory aspects of the labor market.

Figure 1
Proportion of Unemployed Experienced Workers
by Occupation, Annual averages, 68–91



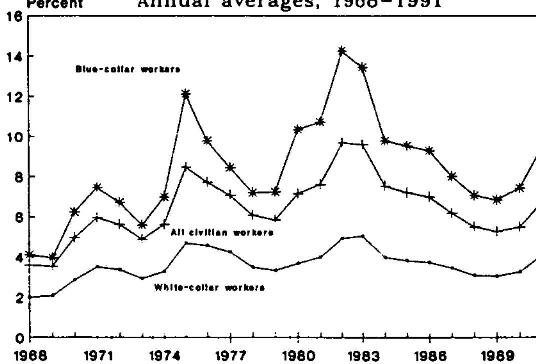
Source: Bureau of Labor Statistics.

Figure 2
Proportion of Employment by Occupation
Annual averages, 1968–1991



Source: Bureau of Labor Statistics.

Figure 3
Unemployment Rates by Occupation
Annual averages, 1968–1991



Source: Bureau of Labor Statistics.

SENATOR SARBANES. Thank you very much, Mr. Kosters.

Mr. Lacey, in your testimony, you say that the standard management practice, now on the part of U.S. corporations, is to change the nature of this employment relationship?

MR. LACEY. That is correct.

SENATOR SARBANES. They may in effect have a much more restricted group that is "the core staff concept," and then supplement or compliment it in other ways with people who are in a sense in a different category. They don't have tenure, they have less benefits and so forth.

MR. LACEY. That is correct.

SENATOR SARBANES. And you said that the notion of the corporate family is going by the board; is that correct?

MR. LACEY. That is correct, sir.

SENATOR SARBANES. What about in Japan and Germany, is that the standard practice there?

MR. LACEY. In my job, I get that question often. Frankly, it is a complex issue, because basically the European work relationship is socialism and the Japanese work relationship, other than for native Japanese executives, is radical capitalism. And these are words that we tend not to use in America, but I think we must use it to discuss this. We have radically different work relationships. The American work relationship in the last four decades has been sort of in the middle there. It has been capitalism dosed with socialism.

SENATOR SARBANES. Instead of using labels, because in each instance I'm not sure exactly what they mean, why don't you just tell me practically what is the relationship in the European corporation with the worker, and what is the relationship in the Japanese corporation with the worker, and how does that either correspond with or differ from the U.S. practice, particularly the U.S. practice that you perceive us moving toward?

MR. LACEY. As a generalization, the European work relationship includes a lot more of statutory job security. You have your job by law. You have a right to your job.

For example, the European version of our plant closing act requires two years advance notice of plant closings compared to our two months. Now, it gets complex as to whether that applies and where that applies, but it is a good example of how the Europeans have a legal statutory right to their job. In many cases—this is a generalization—but in many cases they have the legal framework. In the United States, the truth is that we have employment at will. The truth is we have no right to our job unless we are employees of government or have a union contract. This is one of the dark secrets of the American workplace. We don't want to talk about employment at will because it is leftover from the 19th century, and because of that dark secret, we are now battling each other in court trying to retroactively create a right to our jobs through wrongful discharge litigation.

SENATOR SARBANES. What about Japan?

MR. LACEY. The Japanese have practiced various forms of racism over the years. They have treated Koreans as a kind of subclass of workers. They have treated other nationalities as subclasses of workers. What they have——

SENATOR SARBANES. In Japan only, or in Japanese production facilities outside of Japan?

MR. LACEY. No, both; in and out.

SENATOR SARBANES. Within Japan, what is the status of the Japanese worker?

MR. LACEY. There is a mythical lifetime job security in Japan for certain Japanese workers. It is mythical because in America we have this legend that all Japanese have lifetime job security. The best way I can explain that is that in America in 1965, during our boom years, it was possible for a company to promise lifetime job security, and it looked like that promise was possible to keep, because growth covers up for a lot of things. In Japan, right now, they are making that same promise to certain employees, because Japan right now is in a boom as we used to be. And during those boom years, it is easy to make that promise. So, the best way that I can explain it is that the Japanese are following behind us by about 20 years in making that promise of job security to certain members of the work force, but it is not statutory, it is not legal.

SENATOR SARBANES. I understand, but the impression in this country is not that this is a new development in Japan. I want to leave aside whether there is a difference in how they treat Japanese workers, as opposed to immigrant workers. I just want to address the Japanese workers.

The impression in this country—the conventional wisdom—is that Japanese corporations operate very much on a family principle, so the Japanese workers with a company have a degree of security in terms of staying with that company and, in effect, not having to worry about being terminated by the company, and that that is not a new development stemming out of some boom idea now, but has been a general practice; is that not correct?

MR. LACEY. Frankly, it is only half correct. The first half was correct. But in truth that system is opposed to our system in Japan.

SENATOR SARBANES. I mean post-World War II. I am not talking about before World War II. I have to consider World War II as a transforming event on the international scene and, to some extent, on the economic scene.

MR. LACEY. In that sense, yes. The Japanese corporations do still provide a family-like relationship to certain Japanese workers, primarily the managerial people, and to some production workers who are willing to accept a kind of military style of employment, where they live in company housing, wear uniforms, and things like that.

SENATOR SARBANES. Are there a fair number of them?

MR. LACEY. I honestly cannot remember the statistics.

SENATOR SARBANES. Does anybody want to add anything on this question?

DR. KOSTERS. I don't claim to be an expert on Japanese employment practices, but I understand that many of the major firms in Japan have had, as a practice, a kind of family arrangement, in the sense that they pay a great deal of attention to employment stability. Now, there are two things that I think need to be kept in mind about that. One is that while this apparently is true of many of the major firms, it is much less true of their subcontractors who find that much less possible to maintain. For example, subcontractors who lose their contracts for one of the major auto firms inevitably need to shrink their employment very quickly. The other point is that some of the major firms in Japan—the automobile companies, for example—have not been in a short-term boom, but they have instead been in a period of substantial growth for a long time.

Now, during a period of sustained growth in our country, firms like IBM had a practice of not shrinking its work force. But I thought I saw IBM on the list of firms that has announced layoffs. This suggests that it may be that, if there were a significant downturn in demand for major Japanese firms, they might need to modify their practices, as well.

DR. BELOUS. I would add that lifetime employment ends at 55. It has never covered more than around 35 percent of the Japanese work force. My back-of-envelope calculations put it down as probably around 25 percent. In Japan, we have seen a tremendous increase in subcontracting. Also, a lot of its subcontracting is done offshore, and there has been an increase in the use of part-time workers, many of whom are female.

SENATOR SASSER. Is this attributable to the labor shortage in Japan?

DR. BELOUS. Only in part. It is one of their major responses to yen shock. When the price of the yen changed in relationship to the dollar, they tried to make up the shortfall in some ways. The basic difference that a lot of employers, both in the United States and around the world, have discovered is that labor is a variable cost. We labor economists have always considered labor a variable cost, but I think that many employers treated workers as if they were fixed costs in a good portion of the postwar period. Then in the 1980s—and it certainly has come home with a vengence in this decade—the green light has gone on, and many managers have said, "Look, we are in a squeeze; we have to pay our light bill; we have to pay our bondholders unless we go into Chapter 11; we have to pay for natural resources; and we have to pay stockholders. We may even have to raise dividends, even when the company is performing poorly. The one area in which we can adjust and have some control over in the short run is labor costs." They have discovered that labor costs can be adjusted. And I would like to disagree with Marv. It is true that we obviously live in much more of a service economy and in much more of a white-collar world. If you look back a few years ago, what we were told was that, perhaps, because we are becoming more of a service economy and more of a white-collar world, we would not experience these recessions or business dips. Some even talked about——

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Dr. Kosters. I never said that.

Dr. Belous. I know. But essentially the way that the white-collar workers were treated would remain the same, and that has not been the case. When you go look at company case studies, as I have, you ask them how many contingent workers do you have. You might come up with maybe 5 percent at this company 10 years ago. Now, you look at this company, and it is 30 percent or even higher. You have to say to yourself that something else is going on besides just the fact that we are becoming more of a service-oriented country and white-collar economy.

Senator Sarbanes. Let me ask you this question. I am puzzled and I'm trying to find an explanation for it. I think the German worker—and I am talking about West Germany now, and now of course they have this problem of integrating East Germany; the situation is changing, but let's assume that in time they will work through all of that—the German worker has all of these benefits. They have a lot of the laws that you were concerned about, Dr. Kosters; family leave, plant notice, all of the rest of it, which, as I understand it, people perceive as putting employers at a competitive disadvantage.

Now, how is it that the Germans can do all of these things and still compete so effectively in the international arena? We come up against the assertion that when you try to do these things it will make it harder for our employers to compete. Then, you look at the people we are competing with—and I am just taking the Germans as perhaps the clearest example—and you discover that they are doing all of these things and are very effective competitors. Now, why is that?

Dr. Kosters. I think that is really a very good question and an interesting one, and I certainly don't have all of the answers to it. But I think that it is important to look back and say, yes, the Germans have many policies to protect jobs, and many of the other European countries do too. If you look back over the 1980s, for example, European countries had very little job growth compared to the United States, and they were looking over here and asking what they might do to introduce more labor-market flexibility. So, I submit that these policies seem to come at a cost in terms of employment growth in those countries. Many people instead of mentioning Germany in the past would often mention Sweden, which is, as I understand it, now really having difficulties from which it is trying to extricate itself by reducing the extent of its commitments. So, I think that we need to recognize that some policies may look attractive in some ways, but they also often have costs that evidence themselves in one way or another.

Senator Sarbanes. But West Germany has had no serious unemployment problem for West Germans. Of course, they use guest workers as a kind of safety valve, bring them in and then . . . actually, they didn't let them out once they had them in. They tended to give them some permanent rights. But, nevertheless, if most American workers fully understood the worker position in Germany, they would start asking

questions about why is it they are able to have this package and we're not, and they can compete so effectively?

In other words, the American worker has always been told that we can't do that for you, we can't do this for you, because then we won't be able to compete. And yet, one of the most effective competitors in the international arena does a lot of these things that, in effect, are denied or not presented to American workers because of their competitive impact. I have been searching for an explanation to that.

DR. BELOUS. Mr. Chairman, I am just completing a study comparing European and American labor markets. I will make sure that you get a copy. It should be out early next month.

Essentially, what Germany has done—and it's just not German employers—it is about unions, governments and businesses, and work councils getting together. They have all said, "Look, what we need in Germany is a high-wage strategy to find ways where we can be highly productive and have high commensurate wages. And that is the strategy which we are essentially going to go for, and we are just going to assume that basically we are not going to be low man on the totem pole as far as wages in Europe." Having said that, they have adjusted policies to promote and support a high-wage strategy.

In the United States, essentially, we have taken the opposite. We are going the way of the low-wage strategy. The way we essentially are going to compete is to try to knock wages down as low as they can and go the contingent route. The problem with this strategy is that if we try to compete internationally on a low-wage strategy, we're not going to win. There is no way that we, on a low-wage strategy, can compete against a country like Mexico or any other Latin American country. So, I think, the German model has a lot to teach us. It is time that America—not just government, but business and labor—learn how to develop such a high-wage strategy, because if we try to continue to compete internationally on a low-wage strategy, it will be a game that I don't think we in America can win.

SENATOR SARBANES. I would be happy to hear from you.

DR. KOSTERS. Let me begin with the point you made whether Germany has an unemployment problem. We need to abstract from the present time as they integrate the two portions of what is now Germany.

If you look through most of the 1980s, their unemployment rate was, in fact, higher than ours now is. Whether they viewed that as an unemployment problem or not, I don't know. Now, with regard to strategies for wages, it seems to me that the most important determinant of wage levels for workers is not so much policy strategies as it is the training and competence and education of the workers. If you look at all of the data with which I am familiar, you find that wages are very importantly related to the schooling that workers have. So, it seems to me that the most effective high-wage strategy is trying to improve the training and education and skills of the work force. Now, the Germans do have

a method for doing that outside the college environment that maybe we ought to be more interested in than we are.

SENATOR SARBANES. They are reputed to have a very successful effort, as I understand it.

DR. KOSTERS. That is correct. We probably ought to be more interested in how that works. And we ought to ask ourselves perhaps, even if it is successful, does it to a great extent put people into a channel too early and not allow some to have the broader opportunities that they might otherwise have. That is a concern that is often expressed about the German system. But it is something interesting to look at.

SENATOR SARBANES. Do you want to add to that, Mr. Lacey?

MR. LACEY. Only to say that I agree with both of these gentlemen about the retraining. That is why I was advocating the massive retraining program. If we are going to proceed with a high-wage salary—and I agree that we must—we must figure out a way to make the average American worker internationally competitive in a high-wage environment. And education is the only answer to that.

SENATOR SARBANES. Thank you.

Congressman Armey.

REPRESENTATIVE ARMEY. Thank you.

Gentlemen, let me first compliment the three of you in tandem for presenting three very fascinating papers. And I was particularly pleased for the opportunity to read them together, since—as Alfred Marshall says—"the greatest creativity comes from synthesis." Let me also observe that as you know, and as is most perfectly illustrated in the homogeneous production model, ultimately in the end, wage cannot exceed value of marginal product. The value of marginal product depends upon the price the product can command and the physical productivity of the workers.

If, in fact, in Japan and Germany, they are producing high-quality products that command big prices on world markets, and they are doing so with very productive workers, then, of course, a high-wage-sell strategy is not only feasible, but is probably necessary.

Let's go to productivity because you, Mr. Belous, made an observation that I thought was really quite fascinating, which I think might help us to unravel some of these mysteries. You said that it had been your observation that over the recent years—say, the 1980s, as I recall—there had been increases in productivity extracted from the American workers, not by retooling the capital with which the workers were employed, but by reducing the number of workers. I find that quite fascinating. I think that Japan's and Germany's reconstructing process after World War II, and being very innovative in response to very nominal and zero capital tax rates, pursued productivity increases the other way, because, as we know, ultimately it is the technology imbeded in the capital that defines the capital labor issue and the productivity of both factors.

Now, if in fact your observation is correct that the productivity of the American worker has been increased by reducing——

DR. BELOUS. In the manufacturing sector.

REPRESENTATIVE ARMEY. It is much illusive in the service sector. But if you are correct, then what you are saying is that, given the necessary capital-labor ratio defined by the technology in the machinery and, of course, the technological requirements of the labor, being a compliment that is defined by that physical characteristic that heretofore they had not been operating their capital at these optimal levels with respect to the labor-capital ratio employed, there was in fact feather bedding. There is no other way that you can explain it. If you decrease the number of labor hours with the machine, you increase the productivity. You had to have had an excessive number of labor hours given to optimal capital labor ratio for the technology invited in the capital.

Feather bedding which you also . . . and I will say that we are living in a more competitive world because of the Japanese and the Germans, who have been producing such good quality products with high productivity that we can't afford, so we must change our employment practices and diminish the labor, adjust the capital labor ratio, and get the productivity up. And we found in that context that technology is what gives us increased productivity. So-so political, legal innovation is what decreases productivity. We have had these two forces working with the mandates that you referred to earlier, making it more and more costly to hire labor and certainly more costly to hire redundant labor. So, we make the adjustments. And I think that that is something we ought to look at. I think that productivity is a very, very sorely neglected subject.

Now, one of the things you're talking about in the adjustments, Mr. Lacey, you had some interesting phenomenon. The whole concept of the contingent worker—although I had been aware of it—had not really been brought up to me as it has been today. The employer wants to use this kind of addition to their permanent work force in order to take care of peak periods and so forth. It is very handy for them to go to the contingent market. The employee that would choose to participate in the labor market through this option would probably be an employee that says, I want to participate when it is convenient for me to do so, and I want to refrain from participation when it is inconvenient for me to do so.

MR. LACEY. If I may, in some cases, you're right. Many people like this new work relationship, but not all. Some are involuntary.

REPRESENTATIVE ARMEY. No doubt about it. I still believe with an abiding faith that most of us are fortunate enough in this country to seek employment within a mode we choose. What I think when you talk about additional research into this group, and I think it would be very enlightening for us to get demographic insight, for example, into how many of these people who participate in a contingent work force would self-identify as other than principal wage earners for the family that might take its benefits by way of a participant or a spouse's benefit package, which does happen.

DR. BELOUS. I have done that, and obviously, it decreases the number.

If you ask contingents, "Did you get your benefits from your employer?" Many of them will say obviously, "No." Then you have to ask yourselves, well, are they married to somebody who has benefits or are they in a household that has some benefits; are they in some government program where they get benefits, either pension or health care? Obviously, those factors reduce it somewhat. Nevertheless, the bottom line is that going toward contingents has vastly increased the number of people who do not have medical or pension coverage. And I will be glad to submit research.

REPRESENTATIVE ARMEY. I would love to see that data, because I think Dr. Kosters is probably correct in saying that this may not be significant, this phenomenon. Something that we bemoan, perhaps, maybe a cause for us to take hope.

Now, I want to move along, because I know I've a lot of ground to cover.

Mr. Lacey, you fascinated me with some of your recommendations. It happens that, by virtue of some of my own experience as an old college professor who got out of the state controlled retirement programs and into TIAA where I had some control over my own retirement destiny, what is good for me is something I naturally want for others: the freedom to control my own retirement program. The portable pension, because it tends to create a labor force with enormous mobility, seems to be something that we ought to encourage. It would certainly be helpful to know that you could own your contribution and the matching contribution from Day 1 and take it with you between jobs. You didn't mention that in your paper, but I would guess——

MR. LACEY. I would endorse that. That's what we need to do. We need to shift the whole framework onto the individual, but do it in a logical and understanding and humane way. The way we're doing it now, we're letting it bash its way into existence, and that's not healthy.

REPRESENTATIVE ARMEY. You do suggest something that seems a bit of a corollary in health-care insurance. We could make portable health care; let me buy my own policy, tailor-make it, and carry it with me. I remember when it was clear to me that I would not need the maternity benefit accepted in my group plan. What I really needed was braces for my kids to be covered. But the group made a different vote. It would be to my advantage if I had the freedom to tailor-make my own insurance and change it. The maternity benefits would be beneficial at one life stage, while retaining the freedom to alter it to my family's specific life cycle needs and carry it with me from place to place.

MR. LACEY. Yes, that would be another acknowledgement of the new work force to say that here is the ability to get health care without being someone's employee, per se. And that would be moving in the right direction.

REPRESENTATIVE ARMEY. This would have the salutory side effect of allowing a closer relationship between the person purchasing the policy and the coverage decisions that need to be made with respect to delivery

of health care under the policy, thereby, cutting out the third party. As you know, Armey's axiom is that nobody spends somebody else's money as wisely as their own. Third-party payment is a perfect formula for inflation.

MR. LACEY. That's right.

REPRESENTATIVE ARMEY. Indiscriminate use leads to excessive inflation. I want to thank the other members for their indulgence. This has been fascinating for me.

Dr. Kosters, you raise an interesting point on page 4 of your paper that gets us back to what has been a rather thematic concern throughout this series of hearings, the whole question of consumer confidence. And I have to ask myself, if the unemployment rates are as you have testified, if they have been so nominal compared to past statistics, why is consumer confidence plummeting so dramatically? This was a mystery to the President too. He said, "you know, we know the conditions were worse in the early 1980s, but people didn't seem to feel so pessimistic." We had earlier, at yesterday's work, pretty well found agreement, and I would hope that you gentlemen would agree that there is a great connection between consumer confidence, willingness to go out and buy in the workplace, and a sense of security about one's employment situation.

You pointed out that this is the first time in a recessionary experience that notification requirements were defined by the government. The Worker Adjustment and Retraining Notification Act not only requires the notification to be given to the employee—where it can be a very personal thing dealt with on a sober, serious personal basis, where in fact the notification requirement says that we're going to cut our labor force by 1,000 and we will do that through attrition—it is not the personal tragedy to the workers notified, but this Bill requires public officials to be elected. Public officials aren't generally elected officials. Elected officials are generally politicians, and when politicians get bad news, they make it a media event. And when it becomes a media event, then the word goes out throughout the community, we are suffering job loss, and I might be next. And if it can happen at General Motors, it might be able to happen at my plant, and therefore my sense of security and my job goes. Consumers' confidence is that great line that says this is not economic analysis, this is psychoanalysis. Consumer confidence is psychoanalysis, and it could very well be that you have given us a very good hint where to look for the culprit. The place where I ultimately always find the culprit is in the government.

Thank you, gentlemen.

SENATOR SARBANES. Let me just point out for the sake of the discussion, our witnesses yesterday, both Professor Samuelson and Professor Tobin, pointed out that there has been a stagnation of real income in the country. Last year, in fact, real income for middle-income people dropped. It was their view that that was also contributing to the consumer's view about the economy, because people who had jobs were, first, worried about losing them. But even if they weren't worried about losing them,

their position was slipping in real terms, and that affected their outlook about the economy. And this is another dimension that is present in this recession that was not present in the 1981-82 recession when unemployment rates went much higher. But the real incomes of those working did not actually deteriorate.

Senator Sasser.

SENATOR SASSER. Thank you, Mr. Chairman.

Two very brief questions. Mr. Lacey, you noted that there have been announcements of very large layoffs from General Motors, IBM, Xerox, and other companies that have been made. The announcements have been made, but the layoffs haven't occurred yet. And you suggest that this means that these layoffs are going to lead to an increase in unemployment claims being filed throughout this coming year, 1992, the year we are in. In light of these facts and considering the unemployment figures that we got this morning—which frankly were very unpleasant—what is your prognosis for unemployment, for the unemployment rate as we move through calendar 1992, particularly the first three quarters?

MR. LACEY. Well, sir, I tend to somewhat disregard the unemployment rate simply because there are so many people dropping out of the work force right now that it is difficult to predict that. I can't predict how many people will encounter structural unemployment. We don't know, for example, why women are dropping out of the workplace. We don't know these things. And so even though we know unemployment will rise in 1992, I can't say what the unemployment rate will do because the unemployment rate has, as I pointed out——

SENATOR SASSER. My question to you, what is your prognosis for unemployment then?

MR. LACEY. Unemployment will definitely get worse in 1992. Companies behind the scenes—and I work with companies behind the scenes—this is standard wisdom, everybody is cutting staff. Everyone intends to cut staff. There is about a ten-year gap between the corporate world's knowledge of this and the person in the street's knowledge of it.

I went to a Christmas party at an out-placement firm. That seems bizarre, I know, but I went to a Christmas party at an out-placement firm and everyone there, all of the corporate executives were saying things like, when are these people going to get the message, when are they going to understand?

SENATOR SASSER. Understand what? They're going to lose their jobs?

MR. LACEY. Yes, that these corporations fully intend to make the core staff concept an institution. They are going to continue to cut staff as much as they can and shift to the contingent work force, which Dr. Belous has so brilliantly identified.

SENATOR SASSER. Manpower Incorporated and firms like that, that has become a growth industry; has it not?

MR. LACEY. It is, and employee leasing which a lot of people are not aware of, but it is growing very rapidly and will continue to grow.

SENATOR SASSER. Dr. Belous, I look forward to getting your report on European workers. I read a statement made not long ago by a European industrialist, and he made the comment, "I don't know why American workers have any loyalty to their firms at all. It is amazing to me." He said, they have no job security, number one, and the American firms use them as if they are chattels or personal property, and it is amazing that American employees have any loyalty to their firms. And if what we are seeing is this phenomenon that you and Mr. Lacey are discussing, where they simply pare them off, give them the option of either jumping out the window or we're going to push you, then they move to the contract labor where they move in and out with no fringe benefits, you can certainly understand why the European industrialists might have that view.

Dr. Belous, Dr. Kosters has suggested that the higher fraction of white-collar unemployment is attributable to a higher fraction of white-collar workers in the work force. In other words, there are more of them than there used to be. Is this the only factor explaining the phenomenon of this increase in white-collar unemployment, vis-a-vis, what it has been in other recessions?

DR. BELOUS. No, I don't believe it is the only factor. Obviously, it is a factor, but I think other key factors have to go into the fact that many corporations are in a pinch. They cannot do too much in terms of their revenue and in terms of pricing because of competition. They are stuck on that end. If profitability is important, and it obviously is, then they have to look at costs. The only area which they can really move costs around in the short run are in human resources. And I think when push comes to shove in many corporations, what used to be unthinkable in terms of the white-collar work force, is now standard policy. So, it isn't just the fact that we are a more white-collar or more service-oriented economy, I think the climate has changed. As I say, what used to be unthinkable is now standard corporate procedure at many companies. So, more is going on than just becoming more white-collar in service.

And I would add another question that I am always asked, isn't it also a fact that more women are in the labor force despite the dropout recently? This may be wrong, but women have tended to be treated more in a marginal way. So, isn't what we are seeing really, as far as contingence, more the way women have always been treated? In part, yes, but much more is going on.

SENATOR SASSER. The reason I came to these hearings today, Mr. Chairman, was to get a handle on this business of why these revenue forecasts are going down. And what I have heard from Dr. Belous and Dr. Lacey—and you can correct me if I am in error here—but it appears to me that we are moving in the direction of a lower mass-wage economy.

DR. BELOUS. That is correct.

MR. LACEY. That is correct.

SENATOR SASSER. As we move in this direction, this means lower revenues flowing into the Treasury at the federal, state, and local levels. So, it appears to me that that goes a long way to explaining this rather substantial revenue forecast error that robbed us of about 30 percent of what we thought our savings were going to be under this budget summit agreement of 1990.

MR. LACEY. If I may, exactly that point has been explored very well by *Barron's*, but only relating to the State of California. An economist in California noticed the same phenomenon that you are noticing on the federal level, the revenue drop. And he correlated it to the true employment depreciation and found that it does correlate. So, your approach is correct. The turn in the workplace is logically connected to the reduced incomes of the government.

SENATOR SASSER. I want to ask Dr. Kosters this. In December, Dr. Kosters, you wrote a very excellent article in the *Washington Post*. You noted that when President Reagan took office our biggest worry was inflation. You said that because of that the American people were forgiving of the recession of 1982. You say now that the problem with this recession, as I recall, as was indicated to me—you say in your article that "the voters or the people see no reason for this recession that we are in now. So, people see no obvious purpose for the current recession."

My question to you is this, if they see no reason for this recession, doesn't this suggest that we had better get moving and get something done about it, those of us who are in a position to do something about it?

DR. KOSTERS. I am flattered, Senator, because this sounds like a pretty good article. I really don't recognize that article, but I am happy to comment on the substance in any case.

Let me combine my comment with something mentioned by the Chairman a minute ago, which I may have misunderstood. He said that real incomes last year declined, which I think is likely, and this might be reducing consumer confidence, and that that might be something different from the recession in the early 1980s.

Now, my recollection of that period is that between about 1979 and 1982 real incomes declined more rapidly than virtually any other period that I am aware of. So, I would be very surprised if the situation were more serious during the past year. I would also be very surprised if a movement to a lower wage economy was a major reason behind the forecasting errors in Treasury revenue estimates.

SENATOR SASSER. Part of the forecasting errors. I wouldn't attribute all of it to that.

DR. KOSTERS. I have never heard them say that, and I assume they are not misleading us. I would be very surprised if errors of that magnitude would come from a decline in average real wages. A decline in real wages is, of course, certainly a matter of concern.

Now, with regard to inflation, I think you made an excellent point. Certainly inflation was a very high priority concern of people in the late

1970s and early 1980s, and I think it may be the case that people now say, "We don't have a serious inflation problem, so why should we need to endure a recession?" This raises questions about whether we might in recent months have been overly concerned about the inflation side of things.

SENATOR SASSER. There is no question in my mind that the Federal Reserve has been overly concerned about that for two years, for three years. Go ahead, I didn't mean to interrupt you.

DR. KOSTERS. That's quite all right. I think that there may be something to the notion that the decline of people's concern about inflation has made them less willing to endure a recession now than they might have been in the past.

SENATOR SASSER. Thank you, Mr. Chairman.

SENATOR SARBANES. We want to thank the panel very much and——

REPRESENTATIVE ARMEY. Mr. Chairman, may I ask one quick question?

SENATOR SARBANES. Sure.

REPRESENTATIVE ARMEY. Are you all three by trade labor economists?

MR. LACEY. No, I am a journalist.

REPRESENTATIVE ARMEY. You are a journalist, okay. I was frankly surprised. I have to tell you again, I remember the 1970s. I remember them well. I remember my worry for my children's future in the 1970s. It was very oppressive. But I was quite frankly surprised by the assertion yesterday that throughout the 1980s there was a decline in real wage for the American worker. Have you all seen any empirical verification? I know that there's been a lot of political assertion, but has there been any factual verification of this?

DR. BELOUS. Yes, sir, there has.

MR. LACEY. I've seen charts from the National Alliance of Business demonstrating that individual wages peaked around 1973. The issue gets confused politically when you mix in family income. You have women coming into the workplace, but yes, there has been a lot of documentation. A book called *Dollars and Dreams* by Frank Levy, it documented that pretty well.

REPRESENTATIVE ARMEY. For money wages to increase, real wages to decrease, one must experience a rate of inflation that is greater than the rate of increase and the money.

DR. BELOUS. Or in certain periods of negative productivity growth, which lowers negative productivity growth.

REPRESENTATIVE ARMEY. We have established——

DR. BELOUS. And manufacturing. It represents around 20 percent.

REPRESENTATIVE ARMEY. Gentlemen—Dr. Kosters, do you agree that there has been a decline in real wages in America in the 1980s?

DR. KOSTERS. No, I disagree with that. I do agree that one can find data to show that as an average for some groups in the workforce, particularly relatively young, poorly skilled workers. But for the workforce as a whole, the data that I have looked at with some care suggests

that during the course of the 1980s real wages have been about even, perhaps up a little bit.

Now, these kinds of comparisons depend heavily on exactly when you start and when you quit. So, maybe it is better to ask about real compensation, people's total pay. Almost whenever you look, whenever you start, real compensation is up. So, I conclude that the average worker has been better off, and I find it rather surprising that people talk about a decline in American standard of living since 1973 and so on.

REPRESENTATIVE ARMEY. So, the substitute of benefits quite often mandated inflation in the cost of those benefits. We have been taking a real wage increase in our benefits package rather than our money wage. If you isolate it to money wage alone, then you probably would get the statistical numbers.

DR. BELOUS. But how do you estimate the dollar value of some of the fringe benefits? If I have my hand chopped off and it was sewed back on, would I be a multimillionaire. You mentioned graduate school, and I do remember from graduate school, we were always taught that if you torture data long enough it will testify to anything. As much as I respect Dr. Kosters, I think to say that they have not gone down is to torture data.

REPRESENTATIVE ARMEY. The answer was given to us by Ricardo. Price is your only objective measure of value. And that is still the best measure. If Dr. Kosters has a response, that's fine. I did want to question that because it didn't seem correct to me. I think you have helped me with it.

DR. KOSTERS. I have a brief response to the question of whether some of these nonwage benefits are valuable or not. Take health-care benefits, I know of no more sensitive issue that comes up in labor negotiations than efforts to cut back on employer payments to health plans. I take it, therefore, that this is a very highly valued benefit on the part of workers.

REPRESENTATIVE ARMEY. To a larger and larger extent, health-care payments in this country have been a transfer of income from the doctors and the patients to the lawyers. And that, of course, gives us some insight into the solution.

DR. BELOUS. There was a discussion a few years ago—and Marv and I were on different sides on that too—concerning growing inequality in the United States. Are we seeing an erosion of the middle class? And for a few years, there was some discussion about that. I think now the evidence is just overwhelming that income inequality has grown in the United States, and we have seen an erosion in the middle class.

REPRESENTATIVE ARMEY. As you study that in your academic pursuit of these things, do not trust any fixed tables that look as if we in America have lived in a caste society; especially, if they have been provided to you by the Congressional Budget office. They are 100 percent wrong. Conceptually and with respect to the data that they look at, this whole trumped up tale of income distribution and inequality in America is wrong. It is really quite embarrassing that they should do such shoddy

work. But it would be even more embarrassing if any of us were to fall for it, and please be careful about your source in that respect.

SENATOR SARBANES. If I could just interject to that point. It is interesting that the Federal Reserve itself has just come out with a study which substantiates the observation that Dr. Belous made in terms of income inequality and, even more, wealth inequality in this country. This is a chart from the figures of the Bureau of Labor Statistics on real compensation per hour, real compensation. So, it therefore includes not only wages but the benefits package. This is the course of movement of real compensation per hour, beginning in 1960 and going through to 1990. And as you can see, there was a fairly steady improvement up until about 1973, and from there it has moved up and down and with peaks and valleys, but it is essentially now at about where it was in 1973. There have been some years where real compensation has gone up and other years in which real compensation has gone down. But essentially there has been no substantial improvement since 1973.

Now, that is a chart that was prepared from figures provided by the Bureau of Labor Statistics.

MR. LACEY. That chart would be much more depressing if you took out the employer's contribution to health care. You see what happens there is that increasingly the total compensation includes these payments that are made that don't go in your paycheck, they go to someone else. That actually starts to curve down. If you take out the money that is going into the health-care system, I believe that is my understanding of how they calculate that.

SENATOR SARBANES. Thank you all very much. It has been a very helpful panel, and we appreciate your contribution. The Joint Economic Committee will hold a hearing on Monday at 11:00 a.m. in this room on the subject of a Marshall Plan for America.

We very much appreciate your testimony. The Committee stands adjourned.

[Whereupon, at 12:35 p.m., the Committee adjourned, subject to the call of the Chair.]

THE 1992 ECONOMIC REPORT OF THE PRESIDENT: A MARSHALL PLAN FOR AMERICA

MONDAY, JANUARY 13, 1992

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

The Committee met, pursuant to notice, at 11:12 a.m., in room SD–608, Dirksen Senate Office Building, Honorable Paul S. Sarbanes (chairman of the Committee) presiding.

Present: Senators Sarbanes, Riegle and Sasser; and Representatives Hamilton and Solarz.

Also present: William Buechner, professional staff member.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

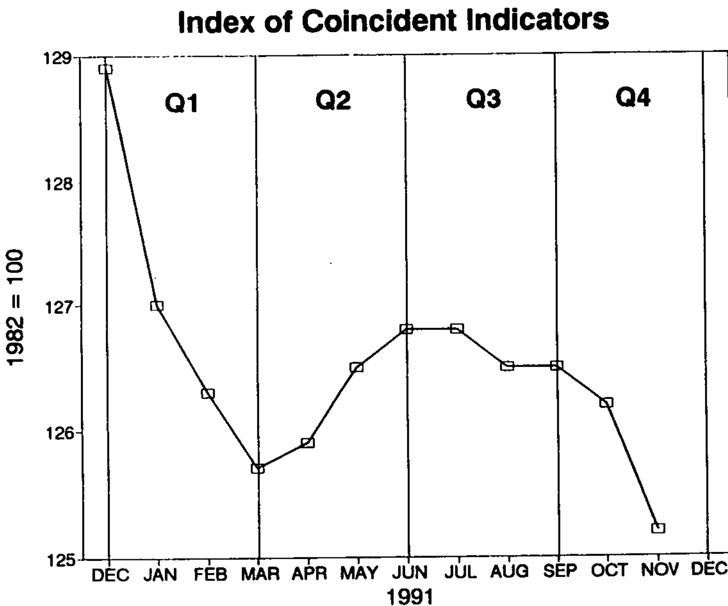
SENATOR SARBANES. The Committee will come to order.

This morning the Joint Economic Committee is holding the fourth in a series of hearings on the economy and the need for new economic policies to address both the short-term problems of recovery from the recession and the long-term challenge of increasing the growth rate of the American economy, improving our productivity, enhancing our competitiveness, and, in effect, laying the basis for a rising standard of living for all Americans.

The economic news is, of course, grim. On Friday the acting commissioner of Labor Statistics, William Barron, reported in this room to the Committee that the unemployment rate rose in December to 7.1 percent. That is the highest monthly unemployment rate that we have experienced during this recession. Almost nine million people are listed as officially unemployed, more than at any time since the recession of 1981-82. And that accounts for only part of the problem. There are over a million additional people who have become so discouraged that they have dropped out of the work force. There are over six million people working part-time who want to work full time; in other words, they want a full-time job, but the economic circumstances are such that they can only find part-time employment.

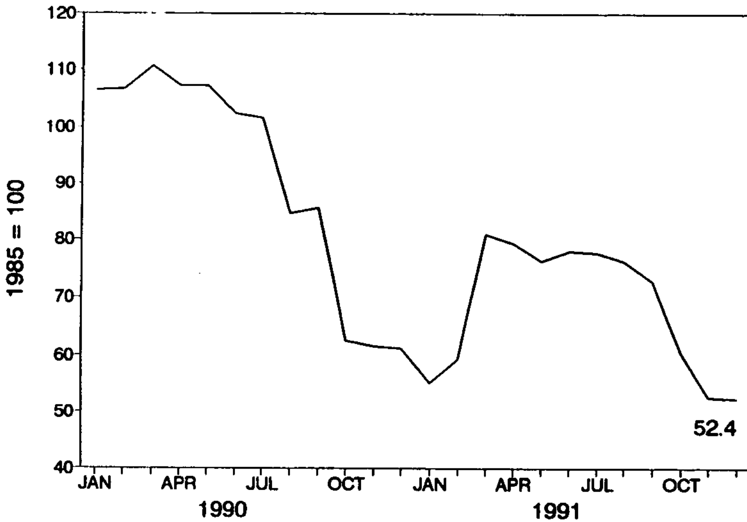
The recession is now 18 months long, the longest recession that we have experienced in the post-World War II period. The indicators for the future are not that encouraging.

The Index of Coincident Indicators fell eight-tenths of a percentage point in November. It is now the lowest it has been since any time since the recession. I think it is probably worth showing that on a chart. This is the indicator that shows sales, industrial production, new orders and income. Many people regard March of last year as the trough of the recession--in other words, the low point, and yet, as we can see, this indicator now is lower. The latest monthly indicator was lower than it was last March. (See chart below).



The number of people filing initial claims for unemployment insurance has been rising steadily for the past six months. It is now back where it was a year ago.

Consumer confidence has plummeted and is now lower than it was at any time during the 1981-82 recession. This is a very important indicator. It shows that there was a short drop in consumer confidence earlier during this recession period, it then started to rise again, it then dropped off the shelf over the last three months, and it is now lower than it was even during the 1981-82 recession. (See chart below).



This recession is made all the more difficult because for some time we have been following a set of economic policies which many of us believe have dug us deeper into the problem. For the past 20 years, productivity has grown only a little over 1 percent a year, compared with 3 percent a year before that. For most of this time, since about the mid-1970s, real compensation per hour for U.S. workers has been stagnant. In fact, it is no higher now than it was in 1973.

During the 1980s, government investment in civilian research, development and infrastructure has declined. Of the major industrial countries, the United States invests the lowest percentage of GNP in infrastructure, and we have the lowest productivity growth.

Senator Sasser and I have put forward proposals for a comprehensive rethinking of our economic policies. One set of proposals is directed toward trying to move us out of the recession and another set is for long-term growth, including a proposal to shift budget priorities away from military spending and toward public investments that would enhance future growth. We have proposed to take down the budget wall between military and domestic spending and to shift resources from the military budget toward deficit reduction and enhancing investment by the public sector.

Actually, even the Administration, in some of their reports—they don't put it out front as part of their program—have recognized the need for more public investment in infrastructure.

In the 1990 Economic Report of the President, sent to the Congress in February of 1990—and that is now almost two years ago—the Administration stated, and I quote:

> Roughly one-quarter of the capital stock of the United States is owned by federal, state and local governments. It is typical for discussions of investment behavior to focus on business investment, but government capital accumulation can also affect growth. Because the value of its product is not revealed through market transactions, the role of government capital in supporting the economy is sometimes under-appreciated.... Inadequate government infrastructure can impede improvements in productivity growth.

And in July of 1991, just this past summer, the Transportation Department released a report on the 1991 status of the Nation's highways and bridges, which documents how badly they have deteriorated in recent years.

They said, and I quote—and this is now from the Department of Transportation:

> By all systems performance measures of highway congestion and delays, performance is declining. Congestion now affects more areas, more often, for longer periods and with more impacts on highway users and the economy than at any time in our Nation's history. In the Nation's 39 largest metropolitan areas, the cost of congestion, including costs for delays and fuel consumption, was estimated to be over $34 billion.

Let me emphasize that: $34 billion in 1988.

Now, to this infrastructure deficit, we also need to add the cost of inadequate investment in education and worker training and in research and development—all important areas of government investment.

The focus of our hearing this morning is on America's long-term growth and the contribution which public investment can make to this long-term growth.

We have two panels of witnesses this morning. Our first panel consists of Congressman Ray Thornton, who has sponsored a resolution expressing the sense of the House of Representatives that we should develop a comprehensive, coordinated strategy to make the United States a stronger Nation economically. This resolution passed the House in the last session.

Congressman Thornton is joined by Congresswoman Barbara-Rose Collins and Congressman Tim Roemer, who are principal sponsors with him on the resolution. We are pleased to have the three of them here this morning.

Following this panel, we will have a panel of economists and businessmen: Jeff Faux, president of the Economic Policy Institute, which has taken a very keen interest in infrastructure questions; Michael Peevey, president of Southern California Edison Company; and James C. Miller, III, the former director of the Office of Management and Budget, and now chairman of Citizens for a Sound Economy.

So, we are very pleased to have this panel of our colleagues from the House side with us this morning. Before turning to them for their presentation, I will turn to Congressman Hamilton and then Congressman Solarz for any opening statements that they may have.

OPENING STATEMENT OF REPRESENTATIVE HAMILTON, VICE CHAIRMAN

REPRESENTATIVE HAMILTON. Thank you very much, Chairman Sarbanes.

I want to add a word of personal appreciation to my colleagues from the House of Representatives—Representatives Collins and Thornton and Roemer—all of whom are newer members. I might say to them that, when I came to the Congress, no freshman Congressman would dare have the temerity to step forward and testify and tell their seniors how to run the economy of the United States.

[Laughter.]

So, you are to be congratulated on not only the substance of what you have to say, but just your outright courage. I really think it is remarkable. We are delighted to have you here.

In all seriousness, I think the leadership of Congressman Thornton and his colleagues has been remarkable on this question, asking us to direct our attention to the rebuilding of America. We are very, very appreciative of your leadership, and we thank you for it, and we look forward to your testimony.

SENATOR SARBANES. Congressman Solarz, please proceed.

OPENING STATEMENT OF REPRESENTATIVE SOLARZ

REPRESENTATIVE SOLARZ. Thank you very much, Mr. Chairman.

I want to join Congressman Hamilton, first of all, in complimenting you for having this hearing, and our colleagues for coming. I can't help but be reminded of an observation Franklin Roosevelt made in the early days of the New Deal, at the height of the Great Depression. He said, in effect, that, given the economic crisis the country confronted, we had to try something and, if it didn't work, discard it and try something else, but above all, try something.

I have a feeling that we are afflicted with the same kind of political and policy paralysis now that we were afflicted with in 1931 and 1932, in the last years of the Hoover Administration.

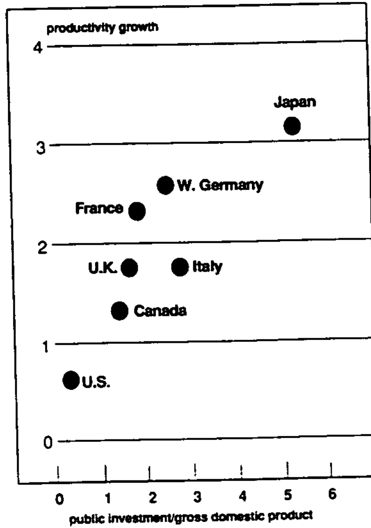
Meanwhile, the country sinks deeper and deeper into what you pointed out is the longest recession we have had since the beginning of the Second World War, and we need to try something. Maybe it will work and maybe it won't, but if it doesn't, then we will try something else. But one thing the American people will not accept, I think, is a continued paralysis from a policy point of view.

So, I am delighted our colleagues have come forward with an idea. God knows, this town is bereft of ideas, and whether it was wise for them to put their necks on the line, I suppose time and the voters of their constituencies will determine. But I, for one, am greatly appreciative for their having put in the effort to bring their proposal before us, and I very much hope that your proposal with Senator Sasser will also be given serious consideration. The time for talk is ending, the time for action has arrived, and, hopefully, these hearings will give it some impetus.

Thank you very much, Mr. Chairman.

SENATOR SARBANES. Congressman Thornton, before you begin, let me point out one other chart which I think is very relevant. This was prepared as part of a study at the Federal Reserve Bank of Chicago, and it shows the relationship between productivity growth and public investment, in other words, investment in infrastructure and training and education and so forth. (See chart below).

Productivity Growth & Public Investment
Average Annual Change, In Percent



Source: David Alan Aschauer, Federal Reserve Bank of Chicago.

Now, there are other factors that are also involved in productivity growth. I do not want to assert that this is just a single-factor correlation. But what this shows is that Japan, which has the highest productivity growth, also is the furthest along the scale in terms of its public investment, which is reflected by the fact that they are up here and over here. The United States, which is down here in productivity growth, is also very low on the public investment scale.

So, we are only up this far in public investment, and we are only this high on productivity. The Japanese are way over here on public investment, and they are also way up here on productivity growth.

And then we see that West Germany, France, the United Kingdom, Italy and Canada are all further along in terms of their public investment, the commitment they make, and higher up in terms of their productivity growth.

Now, it is not that simple. There are other factors, obviously, that enter into productivity growth, but I think this is a very important and interesting correlation.

We would be happy to hear your testimony.

STATEMENT OF REPRESENTATIVE THORNTON, THE STATE OF ARKANSAS

REPRESENTATIVE THORNTON. Thank you very much, Mr. Chairman.

Let me first comment that it does not take a Nobel Laureate to observe from that fine chart that you have just presented that there is a correlation between public investment and the rate of growth of productivity, and surely we can learn the lesson from our competitors.

With regard to Mr. Solarz's statement that we need to be willing to try something new, I would mention that Francis Bacon, some years ago, wrote in Novum Morganum, "It would be unsound and contradictory to suppose that that which has never been done can be done except by means which have not yet been tried." And today, in America, it is up to us who have the privilege of representing the people and who are concerned about our future to come forward with new ideas, new proposals which can move us away from the lethargy which you have mentioned.

I want to congratulate you, Mr. Chairman, Senator Sasser, Congressman Hamilton and other members of this Committee for scheduling this most important set of hearings. I truly appreciate your leadership in doing this, because we believe that there is a need for a Marshall Plan for America: comprehensive and coordinated strategies to educate and train our citizens and our work force, to rebuild our infrastructure and our manufacturing base, and to assure the long-term economic well-being of our Nation.

We must realize that the long-term economic success of the United States is as vital for our national security as military power. If we hope to achieve our national goals of affordable health care, well-paying jobs, opportunities for productive and fulfilling lives for Americans, we must develop strategies for sustainable economic growth.

If we hope to provide an alternative to the patterns of homelessness, poverty, crime and drug abuse which afflict all of America and which can even be found within blocks of this hearing room, we must develop strategies for sustainable economic growth.

To these ends, Mr. Chairman, I do congratulate all of you for your efforts to forge a course for both short-term economic recovery and long-term economic growth. As you have expressed in calling this series of hearings, our economy is in deep trouble, and I believe that that trouble is the result of years of neglect of the basic foundations for economic success. We have slipped badly from a secure position in which we were the only store in town, where all we had to do was to sit back and take orders from a world which could not produce goods and services.

My granddad used to tell me that there was nothing to pull a family or a nation together like the sound of a wolf at the door. They would link arms and hold themselves together in defense against a common adversary. But he said the thing that will test the character of a family is to put a pot of gold on the table, because the family will then begin to divide and fight among themselves as to who gets what share.

For the last decade, our Nation has acted as though we have a pot of gold on the table, fighting among ourselves for a share of our national resources, and not recognizing that the wolf is surely at the door.

Mr. Chairman, the American people now realize that we are threatened, and they are seeking vision and leadership to make America once again strong at home.

Last November, as you mentioned, we adopted a resolution in the House of Representatives expressing a sense of Congress for a Marshall Plan for America. Our distinguished colleague from your own state, Mr. Steny Hoyer, said, in placing this issue in historic context—and I am quoting him:

> After World War II, our Nation provided a plan, a blueprint to help Europe rebuild. Our Nation developed a coordinated, comprehensive strategy to address the needs of the times and to bring an entire region back to strength and prosperity. Surely a nation can do no less for itself. Surely our Nation can join together to meet the challenges of the day.

And the distinguished member of this Joint Economic Committee, Representative Hamilton Fish of New York, joined in support of the resolution, with these observations that I would like to share with you.

He said:

> The resolution before us is a sensible outline for public and private investment in our economic recovery. Its elements are: first, investment in education and training of our work force; second, stimulating investments in modern plants and equipment; and, third, increasing research and development in new products and processes, which historically has led to increased economic activity. For more than a decade, America has been unwilling to invest in the future and is consequently performing badly in each of these areas.

In urging his colleagues to support the resolution, Mr. Fish reminded us that, and I again quote: "It is a call for America to act, an America which today has the energies and resources necessary for its own recovery."

Mr. Chairman, in considering these very serious issues that we face in stimulating our stalled economy, you and Chairman Sasser have wisely made a distinction between short-term and long-term strategies. Certainly, we all know that the need for action is immediate, and we may need some short-term stimulus to prod our economy forward.

In particular, I agree that we should tear down the walls, the artificial walls which restrict us from using the resources that we are now able to save in the deployment of troops overseas, to address some of our domestic problems: the immediate relief of those who have depleted their unemployment benefits, accelerating the program of highway construction, a one-time shot in the arm for local governments.

And by the way, in that context, Senator Sarbanes, our colleague from the Judiciary Committee, now chairman of the House Government Operations Committee, John Conyers, has a very interesting proposal in committee, which would be Local Partnership Act, H.R. 3601, which

would establish means for carrying forward the goals that you and Senator Sasser are describing. I would hope that you would consider this legislation because it does provide, among other things, that the monies must be expended within one year of receipt.

The bottom line is that I think the American people are ready to exercise the same compassion for our own cities and for our own unemployed and for our own hungry people as that which we provide to other nations. These are important short-term objectives, and they need to be addressed, but they alone will not solve our problems. We must focus our efforts on assuring long-term economic well-being and growth, and that is the aim of what we have called the Marshall Plan for America, a comprehensive strategy that is as appropriate to our current circumstances as the original Marshall Plan was for rebuilding a physically and economically devastated Europe. We should be forging partnerships at all levels of the public and private sector to effectively educate and train our people, to rebuild and improve our transportation infrastructure and our communications networks, to strengthen our manufacturing base, to harness our inventive genius to the marketplace; in short, to secure and advance our dominant competitive position in the world.

For more than 40 years, this Nation pursued the Truman Doctrine of containment of the Soviet Union and provided a massive, continuing commitment and investment of resources to discourage any aggressor from seeking to dominate the world by force of arms. That Cold War has now ended, and the world is forever changed. While we were providing this umbrella of world security, both Europe and Japan became strong and effective competitors. They are eating our lunch for the world markets that developed from our inventive genius. They learned and applied the lesson that partnerships between the public and private sectors could be used to identify and capture marketplaces.

We know these lessons of history, Mr. Chairman, and what remains to be seen is how we will respond to the call that all of us are hearing from the people back home. People back home are telling us that it is time to rebuild America, that what we have done for other nations, we should now be doing for ourselves.

Let me make clear that a Marshall Plan for America is not a withdrawal from the world, but rather it is a symbol of a new beginning, new strategies for a changing world aimed at insuring that we enter the next century as a dominant economic power, providing the high-quality goods and services which fuel an economy, that provides the wealth for an ever-improving standard of living for all Americans.

Constructive and dynamic management of change will not be possible if we conduct business as usual and continue to build upon static and piecemeal responses to a world that no longer exists. New, comprehensive and continually updated strategies must be employed in which we reorder our priorities and redirect our resources in a manner that is appropriate for the environment in which we now live.

Mr. Chairman, our experiences in the just-completed Gulf War indicate that we can do just that. We met our military objectives through reliance on high technology and rapid airlift and sealift capabilities rather than on the large standing armies that we have stationed overseas to defend our allies against a nonexistent Warsaw Pact. Last year, this commitment, by the way, cost the American taxpayers over $130 billion.

Mr. Chairman, I am not content with the words "peace dividend," because they suggest a return on investment rather than the opportunity to develop new strategies to meet the challenges we now face. National security requires more than military strength; it also depends on well-educated and highly trained citizens who are capable of using advanced technologies, whether those technologies are applied in a battlefield or in a modern workplace. National security demands that the Nation be substantially energy- and resource-independent, not being held hostage to threats of interruptions of vital needs.

National security requires that our transportation, communication and service networks are capable of meeting current and future demands placed upon them. And national security requires strategies for education which provide access for all people, which establish achievement standards that meet and exceed the highest standards demanded by our competitors, which foster a learning environment that encourages and stimulates students and teachers to meet the challenges of global competition, and which provide the necessary resources to accomplish these objectives.

National security can be obtained only if our economy is strong and vibrant, harnessing the talents of our well-trained and well-paid work force to the abundant resources of our lands and to the inventive genius of our scientists and entrepreneurs.

Mr. Chairman, as you have suggested, too often some people consider an investment in infrastructure as being limited to roads, highways, bridges and buildings. But I would say that an investment in educated and well-trained human minds is part of the real competitive infrastructure which will determine our capacity to compete with Europe and Japan. A smart infrastructure is required if we are to keep pace with those who are passing us in field-after-field of critical technologies.

Of course, a Marshall Plan for America must also address problems of the physical infrastructure, and it must also provide a regulatory environment which facilitates rather than hinders domestic productivity and economic competitiveness. When we recognize the rapid pace of our global economy, we realize that we should encourage cooperative programs between domestic companies that are engaged in similar or complementary endeavors, and we should reassess some of the regulations which impede rapid market entry.

We should identify areas of emerging and critical technologies—high-definition television, high-performance computing, fiberoptics communications and superconductivity applications. And we should clear the path for American industries to become or remain the world leaders in these fields.

We should facilitate the application and commercialization of innovative technologies through emphasis on American technology preeminence and by rethinking some of our anachronistic intellectual property laws, which have impeded our efforts to harness the inventiveness of Americans to the marketplace.

This Committee has a great opportunity to lead the way by suggesting improvements in tax policies to stimulate savings and capital investment and to encourage manufacturing within our own borders rather than exporting our technologies and jobs abroad. But you also have a great opportunity to develop the concept of this comprehensive Marshall Plan for America.

It took eight months, Mr. Chairman, for a bipartisan effort of a Republican Congress and the Truman Administration to forge a comprehensive program for European recovery. At that time, we were head over heels in debt. We had mortgaged our future to win World War II, and yet we found the courage and leadership to devote 2 percent of our gross national product to rebuilding Europe. Today, we are head over heels in debt, having mortgaged our future, among other things, on the containment of forces of totalitarianism. Can we find today the courage and leadership to redirect our resources, reorder our priorities, and refocus 2 percent of our gross national product to stimulating action by federal, state and local governments, to forging partnerships between the public and private sectors to rebuild America?

As an observation, the National Security Council has been a vital mechanism for developing and implementing defense-oriented strategies. Perhaps, our economic strategies should entail the same sort of comprehensive, coordinated effort. Perhaps, we need a domestic equivalent of the National Security Council, made up of Cabinet officers, congressional leaders, industrialists, educators and workers, who could be established as an instrument for carrying forward our national economic goals and objectives. We could even call it a "Council on a Marshall Plan for American Security and Success." The acronym would be "COMPASS," something to point the way.

As my colleague from Ohio, Representative Dennis Eckart, put it at the hearings on the resolution, "This is a symbol of what America wishes and hopes for itself and its children. Reordering our priorities, reestablishing the need to reinvest in ourselves, and to redirect our resources is an important statement for this Congress to make."

Mr. Chairman, many of my colleagues have spent a great deal of time developing the concept of a Marshall Plan for America. My colleague from Florida, Representative Jim Bacchus, has focused on economic conversion of military spending to meet domestic needs. My colleague, Representative Barbara-Rose Collins of Michigan, has developed strategies for investing in human and material infrastructural needs. And my colleague from Indiana, Representative Tim Roemer, who, by the way, serves in the district that our colleague, John Brademus, once served in, has given much thought to the vital contribution that can be made to

this effort through education and training. And if it is agreeable, sir, I would like to yield such time as they may consume to each of my colleagues—five minutes has been a suggested amount of time—and ask that they have an opportunity to place their statements in the record.

Also, the statement Mr. Bacchus, if he submits his statement, I would like to get it in the record.

SENATOR SARBANES. That statement will be so included.

[The prepared statement of Representative Bacchus follows:]

PREPARED STATEMENT OF REPRESENTATIVE JIM BACCHUS

Mr. Chairman, I am grateful to you for holding this hearing on a Marshall Plan for America and grateful, too, for the opportunity to submit this testimony. This hearing is an example of the vision and leadership we need to improve our standard of living at home and to meet the challenges of a new and changing world.

I also want to commend my colleagues, Mr. Thornton of Arkansas, Mr. Roemer of Indiana, and Mrs. Collins of Michigan, for their leadership in winning House approval of a resolution calling for a comprehensive, coordinated strategy to meet our nation's challenges. I am proud to have been an original co-sponsor of this resolution.

To our everlasting credit as a nation, in the aftermath of World War II, we helped rebuild the devastated economies of Europe and Japan. Now we must rebuild the economy of the United States of America. We must rebuild our manufacturing and industrial base and enhance our nation's productivity and competitiveness. Above all, we must invest in our people -- by investing in children's programs, education, training, technology, and those other initiatives that will make us more productive and competitive as a nation.

I want to focus today on what I believe must also be an integral part of a Marshall Plan for America. For any such plan to work, it must include a strategy for economic conversion and diversification of our defense industries.

I am very proud to represent a district that has played such a key role in ensuring our national defense. I represent the people at Martin Marietta who helped build the Patriot missile, the people at McDonnell Douglas who helped build the Tomahawk cruise missile, the people at Grumman Corporation who helped build the J-Stars surveillance system, and the people at Harris Corporation who helped build the antennas and the communications satellites that provide us with our intelligence around the world.

These people helped make possible the very victory in the Cold War that now makes feasible a Marshall Plan for America. They helped us win the war in the Persian Gulf. They have some of the best technical minds and skills anywhere in the world.

Today, many of these people are one cut away from the unemployment lines. We cannot afford to let that happen. We need all their skills to rebuild America.

Our Marshall Plan must include a component, a strategy, for economic change, for economic transition, for economic conversion.

If we are going to cut defense intelligence, then why not take that money and invest it in developing advanced communications satellites or high definition television? If we are going to limit defense R&D, then why not take some of that money and give it to the National Science Foundation or invest in worker retraining? And if we are going to cut defense weaponry spending, then why not take that money and invest it in ways that will encourage those businesses that have been building weapons to convert so they can develop new rockets to take heavier payloads further into space, new magnetic levitation systems that can speed up our transportation, and alternative energy sources to help free us from our needless dependency on foreign oil?

I am preparing economic conversion legislation that will have three primary components: a permanent research and development tax credit; incentives for worker retraining and advanced education in technology-related fields; and tax-free treatment for funds set aside by defense companies for investing in new civilian manufacturing plants and equipment.

Mr. Chairman, our defense contractors and their highly-skilled employees have been critical to our success in ending the Cold War and thwarting aggression in the Persian Gulf. They are equally critical to the success of a Marshall Plan for America. I urge you to make economic conversion an integral part of such a plan.

REPRESENTATIVE THORNTON. Mr. Chairman, let me conclude by thanking you and the members of this Committee for your leadership in developing this two-fold approach, a short-term solution to our economic woes and a long-term Marshall Plan for America. I hope that, as a result of these hearings, you will be able to present suggestions to various committees of the Congress and to provide the leadership and the structure that this concept so greatly needs. It is a privilege to be here before you today on behalf of this idea.

[The prepared statement of Representative Thornton follows:]

PREPARED STATEMENT OF REPRESENTATIVE RAY THORNTON

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I TRULY APPRECIATE YOUR LEADERSHIP IN SCHEDULING TODAY'S HEARING ON THE NEED FOR A MARSHALL PLAN FOR AMERICA -- COMPREHENSIVE, COORDINATED STRATEGIES TO EDUCATE AND TRAIN OUR CITIZENS AND WORKFORCE, TO REBUILD OUR INFRASTRUCTURE AND MANUFACTURING BASE, AND TO ASSURE THE LONG-TERM ECONOMIC WELL-BEING OF OUR NATION.

WE MUST REALIZE THAT THE LONG-TERM ECONOMIC SUCCESS OF THIS NATION IS AS VITAL A FOUNDATION FOR OUR NATIONAL SECURITY AS IS OUR MILITARY STRENGTH.

IF WE HOPE TO ACHIEVE OUR NATIONAL GOALS OF AFFORDABLE HEALTH CARE, WELL-PAYING JOBS, AND OPPORTUNITIES FOR PRODUCTIVE AND FULFILLING LIVES FOR ALL AMERICANS, WE MUST DEVELOP STRATEGIES FOR SUSTAINABLE ECONOMIC GROWTH.

IF WE HOPE TO PROVIDE AN ALTERNATIVE TO THE PATTERNS OF HOPELESSNESS, POVERTY, CRIME AND DRUG-ABUSE WHICH WE SEE THROUGHOUT OUR NATION, AND EVEN WITHIN BLOCKS OF THIS COMMITTEE ROOM, WE MUST DEVELOP STRATEGIES FOR SUSTAINABLE ECONOMIC GROWTH.

TO THESE ENDS, MR. CHAIRMAN, I CONGRATULATE YOU AND SENATOR JIM SASSER, FOR YOUR EFFORTS TO FORGE A COURSE FOR SHORT-TERM ECONOMIC RECOVERY AND LONG-TERM ECONOMIC GROWTH. AS YOU HAVE EXPRESSED IN CALLING THIS SERIES OF HEARINGS, OUR ECONOMY IS IN DEEP TROUBLE. I BELIEVE THAT TROUBLE IS THE RESULT OF YEARS OF NEGLECT OF THE BASIC FOUNDATIONS FOR ECONOMIC SUCCESS.

WE HAVE SLIPPED BADLY FROM A SECURE POSITION IN WHICH WE WERE THE ONLY STORE IN TOWN. PEOPLE FROM ALL AROUND THE WORLD CAME TO US TO BUY THE PRODUCTS THEY NEEDED, AND WE ONLY HAD TO WAIT AND SERVICE THEIR ORDERS FOR GOODS AND EQUIPMENT.

MY GRANDFATHER USED TO TELL ME THAT NOTHING WOULD BIND A FAMILY, OR A NATION, TOGETHER LIKE A WOLF BAYING AT THE DOOR. BUT HE WOULD ADD THAT THE WAY TO TEST A FAMILY'S CHARACTER WAS TO PUT A POT OF GOLD IN THE CENTER OF THE TABLE.

FOR THE LAST DECADE, THIS NATION HAS BEEN FOCUSED ON THE POT OF GOLD ON OUR TABLE, FIGHTING AMONG OURSELVES FOR A SHARE OF THE WEALTH, AND NOT RECOGNIZING THAT THE WOLF IS SURELY AT THE DOOR. MR. CHAIRMAN, THE AMERICAN PEOPLE NOW REALIZE THAT WE ARE THREATENED, AND THEY ARE SEEKING VISION AND LEADERSHIP TO MAKE AMERICA ONCE AGAIN STRONG AT HOME.

ON NOVEMBER 25th LAST YEAR, H.Res. 284, A SENSE OF THE HOUSE RESOLUTION CALLING FOR A MARSHALL PLAN FOR AMERICA, WAS ADOPTED. AS OUR DISTINGUISHED COLLEAGUE FROM YOUR OWN STATE OF MARYLAND, REPRESENTATIVE STENY HOYER, SAID IN SUPPORT OF THIS RESOLUTION,

> "... WE MUST DIRECT OUR ATTENTION TO REBUILDING AMERICA, ITS RESOURCES, BOTH ITS PEOPLE AND ITS PHYSICAL INFRASTRUCTURE. ... THE UNITED STATES MUST REDIRECT ITS RESOURCES IN A COMPREHENSIVE AND COORDINATED MANNER."

MR. HOYER ALSO PLACED THE ISSUE IN HISTORICAL CONTEXT WHEN HE REMINDED US:

> "AFTER WORLD WAR II, OUR NATION PROVIDED A PLAN, A BLUE-PRINT, TO HELP EUROPE REBUILD. OUR NATION DEVELOPED A COORDINATED, COMPREHENSIVE STRATEGY TO ADDRESS THE NEEDS OF THE TIME AND TO BRING AN ENTIRE REGION BACK TO STRENGTH AND PROSPERITY. SURELY A NATION CAN DO NO LESS FOR ITSELF. SURELY OUR NATION CAN JOIN TOGETHER TO MEET THE CHALLENGES OF THE DAY."

A DISTINGUISHED MEMBER OF THE JOINT ECONOMIC COMMITTEE, REPRESENTATIVE HAMILTON FISH OF NEW YORK, JOINED IN SUPPORT OF THE RESOLUTION WITH THESE OBSERVATIONS:

> "THE RESOLUTION BEFORE US IS A SENSIBLE OUTLINE FOR PUBLIC AND PRIVATE INVESTMENT IN OUR ECONOMIC RECOVERY. ITS ELEMENTS ARE: FIRST, INVESTING IN EDUCATION AND TRAINING OF OUR WORKFORCE; SECOND, STIMULATING INVESTMENTS IN MODERN PLANTS AND EQUIPMENT; AND THIRD, INCREASING RESEARCH AND DEVELOPMENT IN NEW PRODUCTS AND PROCESSES, WHICH HISTORICALLY HAS LED

> TO INCREASED ECONOMIC ACTIVITY. FOR MORE THAN A DECADE, AMERICA HAS BEEN UNWILLING TO INVEST IN THE FUTURE, AND IS CONSEQUENTLY PERFORMING BADLY IN EACH OF THESE AREAS."

IN URGING HIS COLLEAGUES TO SUPPORT THE RESOLUTION, MR. FISH REMINDED US THAT: "IT IS A CALL FOR AMERICA TO ACT, AN AMERICA WHICH TODAY HAS THE ENERGIES AND RESOURCES NECESSARY FOR ITS OWN RECOVERY."

MR. CHAIRMAN, IN CONSIDERING THE SERIOUS ISSUES WE FACE IN STIMULATING OUR STALLED ECONOMY, YOU AND CHAIRMAN SASSER HAVE WISELY MADE A DISTINCTION BETWEEN SHORT-TERM AND LONG-TERM STRATEGIES. CERTAINLY THE NEED FOR ACTION IS IMMEDIATE, AND WE MAY NEED SOME SHORT-TERM STIMULUS TO PROD OUR ECONOMY FORWARD.

IN PARTICULAR, I AGREE THAT WE SHOULD REMOVE THE ARTIFICIAL WALLS WHICH NOW PREVENT THE RE-DEPLOYMENT OF RESOURCES FROM OVERSEAS MILITARY COMMITMENTS TO ADDRESSING CONCERNS WITHIN OUR OWN BORDER.

A REDIRECTION OF THESE RESOURCES TOWARD ACCELERATING THE PROGRAM OF HIGHWAY CONSTRUCTION, TOWARD IMMEDIATE RELIEF FOR THE THOUSANDS WHO HAVE DEPLETED THEIR UNEMPLOYMENT BENEFITS, AND TOWARD A ONE-TIME "SHOT-IN-THE-ARM" TO BELEAGUERED STATE AND LOCAL GOVERNMENTS, WOULD PROVIDE A SHORT-TERM BOOST TO THE ECONOMY.

INTERESTINGLY ENOUGH, UNDER THE LEADERSHIP OF CHAIRMAN JOHN CONYERS, THE HOUSE COMMITTEE ON GOVERNMENT OPERATIONS, ON WHICH I SERVE, IS DEVELOPING LEGISLATION WHICH I BELIEVE COULD BE AN APPROPRIATE VEHICLE FOR PROVIDING THE ASSISTANCE TO LOCAL GOVERNMENTS WHICH YOU AND CHAIRMAN SASSER HAVE BEEN ADVOCATING.

THE PROPOSED LOCAL PARTNERSHIP ACT, H.R. 3601 ESTABLISHES A FEDERAL TRUST FUND FOR FISCAL ASSISTANCE TO LOCAL GOVERNMENTS, SETS FORTH A FRAMEWORK FOR DISTRIBUTING GRANTS, INDEXED TO STATEWIDE RATES OF UNEMPLOYMENT, AND REQUIRES THAT THE FUNDS BE USED FOR THEIR STATED PURPOSE WITHIN ONE YEAR OF RECEIPT.

I THINK THE AMERICAN PEOPLE ARE READY TO EXERCISE THE SAME COMPASSION FOR OUR OWN CITIES AND OUR OWN UNEMPLOYED AND HUNGRY PEOPLE AS THAT WE PROVIDE TO OTHER NATIONS. THESE ARE IMPORTANT SHORT-TERM OBJECTIVES, BUT THEY, ALONE, WILL NOT SOLVE OUR PROBLEMS. WE MUST FOCUS OUR EFFORTS ON ASSURING **LONG-TERM** ECONOMIC WELL-BEING AND GROWTH. THAT IS THE AIM OF A MARSHALL PLAN FOR AMERICA.

WE NEED A COMPREHENSIVE STRATEGY AS APPROPRIATE TO OUR CURRENT CIRCUMSTANCES AS THE ORIGINAL MARSHALL PLAN WAS FOR REBUILDING A PHYSICALLY AND ECONOMICALLY DEVASTATED EUROPE.

WE SHOULD BE FORGING PARTNERSHIPS AT ALL LEVELS OF THE PUBLIC AND PRIVATE SECTORS TO EFFECTIVELY EDUCATE AND TRAIN OUR PEOPLE, TO REBUILD AND IMPROVE OUR TRANSPORTATION INFRASTRUCTURE AND COMMUNICATIONS NETWORKS, TO STRENGTHEN OUR MANUFACTURING BASE, TO HARNESS OUR INVENTIVE GENIUS TO THE MARKETPLACE -- IN SHORT, TO SECURE AND ADVANCE OUR DOMINANT COMPETITIVE POSITION IN THE WORLD.

FOR MORE THAN FORTY YEARS THIS NATION PURSUED THE TRUMAN DOCTRINE OF CONTAINMENT OF THE SOVIET UNION. WE PROVIDED A MASSIVE, CONTINUING COMMITMENT OF RESOURCES TO DISCOURAGE ANY AGGRESSOR FROM SEEKING TO DOMINATE THE WORLD BY FORCE OF ARMS. THE COLD WAR HAS NOW ENDED, AND THE WORLD HAS FOREVER CHANGED.

WHILE WE WERE PROVIDING THIS UMBRELLA OF WORLD SECURITY, BOTH EUROPE AND JAPAN BECAME STRONG AND EFFECTIVE COMPETITORS FOR THE WORLD MARKETS THAT DEVELOPED FROM OUR INVENTIVE GENIUS. THEY LEARNED THAT PARTNERSHIPS BETWEEN THE PUBLIC AND PRIVATE SECTORS COULD BE USED TO IDENTIFY AND CAPTURE A MARKETPLACE.

BUT MR. CHAIRMAN, WE ALL KNOW THESE LESSONS OF HISTORY. WHAT REMAINS TO BE SEEN IS HOW WE WILL RESPOND TO THE CALL THAT WE ARE HEARING FROM PEOPLE BACK HOME. OUR CONSTITUENTS ARE TELLING US THAT IT IS TIME TO REBUILD AMERICA, THAT WHAT WE HAVE DONE FOR OTHER NATIONS, WE SHOULD NOW DO FOR OURSELVES.

A MARSHALL PLAN FOR AMERICA IS NOT A WITHDRAWAL FROM THE WORLD, BUT RATHER IT IS A SYMBOL OF A NEW BEGINNING -- NEW STRATEGIES FOR A CHANGING WORLD, AIMED AT ENSURING THAT WE ENTER THE NEXT CENTURY AS A DOMINANT ECONOMIC POWER, PRODUCING THE HIGH-QUALITY GOODS AND SERVICES WHICH FUEL AN ECONOMY THAT PROVIDES THE WEALTH FOR AN EVER-IMPROVING STANDARD OF LIVING FOR ALL AMERICANS.

MR. CHAIRMAN, CONSTRUCTIVE AND DYNAMIC MANAGEMENT OF CHANGE WILL NOT BE POSSIBLE IF WE CONDUCT BUSINESS AS USUAL AND CONTINUE TO BUILD UPON STATIC AND PIECEMEAL RESPONSES TO A WORLD THAT NO LONGER EXISTS. NEW, COMPREHENSIVE, AND CONTINUALLY-UPDATED STRATEGIES MUST BE EMPLOYED, IN WHICH WE REORDER OUR PRIORITIES AND REDIRECT OUR RESOURCES IN A MANNER THAT IS APPROPRIATE FOR THE ENVIRONMENT IN WHICH WE NOW LIVE.

OUR EXPERIENCES IN THE PERSIAN GULF WAR SHOWED THAT WE CAN DO JUST THAT.

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WE MET OUR MILITARY OBJECTIVES THROUGH RELIANCE ON HIGH TECHNOLOGY AND RAPID AIR-LIFT AND SEA-LIFT CAPABILITIES RATHER THAN ON THE LARGE STANDING ARMIES WE HAVE STATIONED OVERSEAS TO DEFEND OUR ALLIES AGAINST A NON-EXISTENT WARSAW PACT -- A COMMITMENT WHICH LAST YEAR COST THE AMERICAN TAXPAYERS OVER 130 BILLION DOLLARS.

MR. CHAIRMAN, I AM NOT CONTENT WITH THE WORDS "PEACE DIVIDEND", BECAUSE THEY SUGGEST A RETURN ON INVESTMENT RATHER THAN THE OPPORTUNITY TO DEVELOP NEW STRATEGIES TO MEET THE CHALLENGES WE NOW FACE.

NATIONAL SECURITY REQUIRES MORE THAN MILITARY STRENGTH. NATIONAL SECURITY ALSO DEPENDS ON WELL-EDUCATED AND HIGHLY-TRAINED CITIZENS CAPABLE OF USING ADVANCED TECHNOLOGIES, WHETHER THOSE TECHNOLOGIES ARE IN A BATTLEFIELD OR IN A MODERN WORK-PLACE.

NATIONAL SECURITY DEMANDS THAT THE NATION BE SUBSTANTIALLY ENERGY AND RESOURCE INDEPENDENT, NOT BEING HELD HOSTAGE TO THREATS OF INTERRUPTIONS OF VITAL NEEDS.

NATIONAL SECURITY REQUIRES THAT OUR TRANSPORTATION, COMMUNICATION, AND SERVICES NETWORKS ARE CAPABLE OF MEETING THE CURRENT AND FUTURE DEMANDS PLACED UPON THEM.

NATIONAL SECURITY REQUIRES STRATEGIES FOR EDUCATION WHICH PROVIDE ACCESS FOR ALL PEOPLE, WHICH ESTABLISH ACHIEVEMENT STANDARDS THAT MEET AND EXCEED THE HIGHEST STANDARDS DEMANDED BY OUR ECONOMIC COMPETITORS, WHICH FOSTER A LEARNING ENVIRONMENT THAT ENCOURAGES AND STIMULATES STUDENTS AND TEACHERS TO MEET THE CHALLENGES OF GLOBAL COMPETITION, AND WHICH PROVIDE THE NECESSARY RESOURCES TO ACCOMPLISH THESE OBJECTIVES.

NATIONAL SECURITY CAN BE ATTAINED ONLY IF OUR ECONOMY IS STRONG AND VIBRANT, HARNESSING THE TALENTS OF OUR WELL-TRAINED AND WELL-PAID WORKFORCE TO THE ABUNDANT RESOURCES OF OUR LANDS AND TO THE INVENTIVE GENIUS OF OUR SCIENTISTS AND ENTREPRENEURS.

TOO OFTEN, SOME PEOPLE CONSIDER AN INVESTMENT IN INFRASTRUCTURE AS BEING LIMITED TO MATERIAL RESOURCES, ROADS, BRIDGES, AND BUILDINGS. INVESTMENT IN EDUCATED AND WELL-TRAINED HUMAN MINDS IS PART OF THE REAL COMPETITIVE INFRASTRUCTURE WHICH WILL DETERMINE OUR CAPACITY TO COMPETE WITH EUROPE AND JAPAN. A SMART INFRASTRUCTURE IS REQUIRED IF WE ARE TO KEEP PACE WITH THOSE WHO ARE PASSING US IN FIELD AFTER FIELD OF CRITICAL TECHNOLOGIES.

BUT A MARSHALL PLAN FOR AMERICA MUST ALSO ADDRESS IMPROVEMENTS IN OUR PHYSICAL INFRASTRUCTURE, AS WELL AS PROVIDE A REGULATORY ENVIRONMENT WHICH FACILITATES RATHER THAN HINDERS DOMESTIC PRODUCTIVITY AND ECONOMIC COMPETITIVENESS.

RECOGNIZING THE RAPID PACE OF OUR GLOBAL ECONOMY, WE SHOULD ENCOURAGE COOPERATIVE PROGRAMS BETWEEN DOMESTIC COMPANIES ENGAGED IN SIMILAR OR COMPLEMENTARY ENDEAVORS, AND WE SHOULD REASSESS SOME OF THE REGULATIONS WHICH IMPEDE RAPID MARKET ENTRY.

WE SHOULD IDENTIFY AREAS OF EMERGING AND CRITICAL TECHNOLOGIES -- SUCH AS HIGH-DEFINITION TELEVISION, HIGH-PERFORMANCE COMPUTING, FIBER OPTIC COMMUNICATIONS, AND SUPER CONDUCTIVITY APPLICATIONS -- AND "CLEAR THE PATH" FOR AMERICAN INDUSTRIES TO BECOME OR REMAIN THE WORLD LEADERS IN THESE FIELDS.

WE SHOULD FACILITATE THE APPLICATION AND COMMERCIALIZATION OF INNOVATIVE TECHNOLOGIES THROUGH EMPHASIS ON AMERICAN TECHNOLOGY PREEMINENCE AND BY RETHINKING SOME OF OUR ANACHRONISTIC INTELLECTUAL PROPERTY LAWS.

WE SHOULD RATIONALIZE OUR TAX POLICIES TO STIMULATE SAVING AND CAPITAL INVESTMENT AND TO ENCOURAGE MANUFACTURING WITHIN OUR OWN BORDERS RATHER THAN "EXPORTING" OUR TECHNOLOGIES AND JOBS ABROAD.

THIS COMMITTEE HAS A GREAT OPPORTUNITY TO DEVELOP THE CONCEPT OF A MARSHALL PLAN FOR AMERICA. IT TOOK EIGHT MONTHS FOR A BIPARTISAN EFFORT OF A REPUBLICAN CONGRESS AND THE TRUMAN ADMINISTRATION TO FORGE A COMPREHENSIVE PROGRAM FOR EUROPEAN RECOVERY.

WE WERE HEAD-OVER-HEELS IN DEBT, HAVING MORTGAGED OUR FUTURE TO WIN WORLD WAR II. YET WE FOUND THE COURAGE AND LEADERSHIP TO DEVOTE 2% OF OUR GROSS NATIONAL PRODUCT TO REBUILDING EUROPE.

TODAY WE ARE HEAD-OVER-HEELS IN DEBT, HAVING MORTGAGED OUR FUTURE ON THE CONTAINMENT OF FORCES OF TOTALITARIANISM. CAN WE TODAY FIND THE COURAGE AND LEADERSHIP TO REDIRECT OUR RESOURCES, REORDER OUR PRIORITIES, AND REFOCUS 2% OF OUR GNP TO STIMULATING ACTION BY FEDERAL, STATE, AND LOCAL GOVERNMENTS, TO FORGING PARTNERSHIPS BETWEEN THE PUBLIC AND PRIVATE SECTORS TO REBUILD AMERICA?

THE NATIONAL SECURITY COUNCIL HAS BEEN A VITAL MECHANISM FOR DEVELOPING AND IMPLEMENTING DEFENSE-ORIENTED STRATEGIES. OUR ECONOMIC STRATEGIES SHOULD ENTAIL THE SAME SORT OF COMPREHENSIVE, COORDINATED EFFORT.

WE SHOULD CONSIDER WHETHER A DOMESTIC EQUIVALENT OF THE NATIONAL SECURITY COUNCIL -- MADE UP OF CABINET OFFICERS, CONGRESSIONAL LEADERS, INDUSTRIALISTS, EDUCATORS, AND WORKERS -- SHOULD BE ESTABLISHED AS AN INSTRUMENT FOR CARRYING FORWARD OUR NATIONAL ECONOMIC GOALS AND OBJECTIVES. PERHAPS WHAT WE NEED IS A COUNCIL ON A MARSHALL PLAN FOR AMERICAN SECURITY AND SUCCESS -- OR RATHER, A "COMPASS"!

AS MY COLLEAGUE FROM OHIO, REPRESENTATIVE DENNIS ECKART PUT IT, THE CONCEPT OF A MARSHALL PLAN FOR AMERICA IS A SYMBOL:

> "IT IS A SYMBOL OF WHAT AMERICA WISHES AND HOPES FOR ITSELF AND FOR ITS CHILDREN. REORDERING OUR PRIORITIES, RE-ESTABLISHING THE NEED TO REINVEST IN OURSELVES, TO REDIRECT OUR RESOURCES, IS AN IMPORTANT STATEMENT FOR THIS CONGRESS TO MAKE."

MR. CHAIRMAN, MANY OF MY COLLEAGUES HAVE DEVOTED A GREAT DEAL OF TIME TO DEVELOPING THE CONCEPT OF A MARSHALL PLAN FOR AMERICA.

MY COLLEAGUE FROM FLORIDA, REPRESENTATIVE JIM BACCHUS HAS FOCUSED ON ECONOMIC CONVERSION OF MILITARY SPENDING TO MEET DOMESTIC NEEDS.

MY COLLEAGUE, REPRESENTATIVE BARBARA-ROSE COLLINS OF MICHIGAN HAS DEVELOPED STRATEGIES FOR INVESTING IN HUMAN AND MATERIAL INFRASTRUCTURE NEEDS.

AND MY COLLEAGUE FROM INDIANA, REPRESENTATIVE TIM ROEMER, WHO SERVES THE DISTRICT ONCE REPRESENTED BY DR. JOHN BRADEMUS, HAS GIVEN MUCH THOUGHT TO THE VITAL CONTRIBUTION WHICH MUST BE PROVIDED BY EDUCATION AND TRAINING.

I WOULD LIKE TO YIELD FIVE MINUTES TO MR. ROEMER AND FIVE MINUTES TO MS. COLLINS, AND WOULD LIKE TO SUBMIT A PREPARED STATEMENT FROM MR. BACCHUS WHO COULD NOT BE HERE TODAY, AND THEN ALL OF US WOULD BE PLEASED TO RESPOND TO YOUR QUESTIONS.

MR. CHAIRMAN, LET ME CONCLUDE BY ONCE AGAIN THANKING THIS COMMITTEE AND CHAIRMAN SASSER FOR YOUR LEADERSHIP IN DEVELOPING THE MARSHALL PLAN FOR AMERICA APPROACH.

I HOPE THAT AS A RESULT OF THESE HEARINGS YOU WILL BE ABLE TO PREPARE A REPORT TO BOTH BODIES OF THE CONGRESS IN WHICH NEEDS FOR SPECIFIC LEGISLATION AIMED AT LONG-TERM ACTION ARE CALLED TO THE ATTENTION OF COMMITTEES WITH APPROPRIATE JURISDICTION.

FURTHER, I HOPE YOU WILL BE ABLE TO SUGGEST A FRAMEWORK FOR THE IMPLEMENTATION OF SUCH PROPOSALS, TOGETHER WITH A TIME-FRAME FOR ACCOMPLISHMENT OF THESE GOALS.

SENATOR SARBANES. Thank you, Congressman Thornton, for an eloquent and powerful statement.

I also want to thank you for the leadership that you have taken on this concept of a Marshall Plan for America. I know that it is a matter on which you have been working for a sustained period of time, and I am very impressed by the substance of your statement and also by the effort that you have mounted in the House in this regard.

We are very pleased to have two of your colleagues who are with you. We would be happy to hear from them now. I don't know if you have worked out among yourselves an order to proceed.

We will hear from Representative Collins first, I gather, and then we will turn to Congressman Tim Roemer, who now represents the district that was represented by John Brademus. Congressman Brademus, of course, was one of our Nation's most effective members whom we were privileged to have in the Congress. He is now one of our Nation's most distinguished educators, the president of New York University.

We greatly admire the work that Congressman Roemer is doing in that district and the work that Congresswoman Collins is doing in Michigan, and we would be happy to hear from you.

STATEMENT OF REPRESENTATIVE COLLINS, THE STATE OF MICHIGAN

REPRESENTATIVE COLLINS. Thank you very much, Chairman Sarbanes. Mr. Chairman, members of the Joint Economic Committee, thank you for calling this hearing today on the Marshall Plan for rebuilding America. I would especially like to thank Congressman Ray Thornton, Congressman Tim Roemer and other participants on this panel for their outstanding leadership that has helped facilitate today's events.

Simply by looking around us in our everyday lives, we can see that this Nation is confronting a crisis that is, in many ways, equal in proportion to the devastation Europe faced following World War II. For example, in my own district in Detroit, in the great city of Detroit, many homes have been abandoned or burned, and school dropout rates are as high as 40 percent. The unemployment rate hovers around 30 percent. Crumbled physical structures, extremely high unemployment rates, and appalling dropout rates are merely signals that we have taken a wrong turn in our Nation's path to long-term prosperity and stability.

As the leaders of this great Nation, we must act now to put this Nation back on track. A comprehensive planning process took place during World War II that not only brought a devastated Europe back into the modern world, but also saved the United States billions of dollars in economic aid. The allied countries of Europe owe much of their current endemic strength to the Marshall Plan. Today, we must develop a plan of action of our own to promote our own domestic recovery.

At the end of the first session of this Congress, this body passed a $151 billion transportation bill that has since become law. This is a

tremendous sum of money, particularly for a country facing a multi-trillion-dollar debt.

However, the bill will accomplish several goals: by improving and modernizing the existing transportation system; by furnishing mass transit systems to areas that need them for both commuter and environmental reasons; and by providing tens of thousands of jobs for a work force that is losing its manufacturing base. As a member of the Public Works and Transportation Committee, I was gratified that we could pass this costly bill. In fact, $65 million in much-needed funds was included in the transportation bill for Detroit.

Despite this action, we have failed to make progress in our recovery because we have only provided a short-term fix for one problem, and ignored others. By not addressing infrastructure, business growth and education both simultaneously and comprehensively, chances for a long-term domestic recovery were minimalized. Once the work mandated by the surface transportation bill is completed, we will still need to address such problems such as finding jobs for unskilled workers entering a technologically advanced work force.

As a Nation, we need to invest not only in rebuilding our infrastructure, but we must provide assistance for the regrowth of American businesse, and for advancing education.

I would like to pass on just a few of my suggestions for creating an effective long-term recovery.

One, provide 2 percent of the gross national product, or about $110 billion, each year for the next ten years—depending on the rate of recovery—in the areas of education, business, and infrastructure. This money should primarily be distributed through a revenue-sharing program, with a formula that favors the hardest-hit areas of the country.

Two, any immediate savings from cutting the military budget should and must go to the domestic budget. This means breaking down the budgetary walls between the defense and domestic budgets. The money should be used for military conversion, job retraining and education for soldiers, job training and education for civilians, and general assistance.

Three, only a small percentage—5 percent or less—of any defense savings should initially go directly toward reducing the budget deficit. While deficit reduction must be a goal of the economic recovery plan, the primary reduction in the debt should come from taxes paid by new businesses created through federal assistance, not by direct payment from savings.

Four, tight local control on funding are necessary because of limited resources. One reason that the original Marshall Plan was so effective is because of the efficient use of funds.

And five, within the first few weeks of the second session of the 102nd Congress, we must enact a long-term strategy for reinvesting in this, our country. We can no longer afford to create piecemeal legislation.

Setting policy for reinvesting in America must be among our highest priorities. We must spend simultaneously in the areas of education,

business and infrastructure. Only by coordinating this effort will we ensure a long-term domestic recovery. The longer we wait to set policy in this area, the more "war-torn" this Nation will become in the immediate outlook. We must act quickly to safeguard the stability of our Nation's future.

I thank you very much for giving me this opportunity to testify before this distinguished panel.

SENATOR SARBANES. We thank you very much for a thoughtful statement.

[The prepared statement of Representative Collins follows:]

PREPARED STATEMENT OF REPRESENTATIVE BARBARA-ROSE COLLINS

Thank you Mr. Chairman, and members of the Joint Economic Committee for calling this hearing today on a "Marshall Plan for America."

Simply by looking around us in our everyday lives, we can see that this Nation is confronting a crisis that is in many ways equal in proportion to the devastation Europe faced following World War II. For example, in my own district in Detroit, many homes have been abandoned or burned, school dropout rates are as high as 40 percent, and the unemployment rate hovers around 30 percent. On the national level, crumbled physical structures, extremely high unemployment rates, and appalling dropout rates are merely signals that we have taken a wrong turn in our Nation's path to long-term prosperity and stability. As the leaders of this nation, we must act now to put this Nation back on track.

A comprehensive planning process took place following World War II that not only brought a devastated Europe back into the modern world, but also saved the United States billions of dollars in economic aid. The allied countries of Europe owe much of their current endemic strength to the Marshall Plan. Today, we must develop a plan of action of our own — to promote our own domestic recovery.

At the end of the first session of this Congress, this body passed a $151 billion transportation bill that has since become law. This is a tremendous sum of money, particularly for a country facing a multi-trillion dollar debt. However, the bill will accomplish several goals: By improving and modernizing the existing transportation system; by furnishing mass transit systems to areas that need them for both commuter and environmental reasons, and; by providing tens of thousands of jobs for a work force that is losing its manufacturing base. As a member of the Public Works and Transportation Committee, I was gratified that we could pass this costly bill. In fact, $65 million in much needed funds was included in the Transportation bill for Detroit.

Despite this action, we have failed to make progress in our recovery because we have only provided a short-term fix for one problem, and ignored others. By not addressing infrastructure, business growth, and education both simultaneously and comprehensively, chances for a long-term domestic recovery were minimalized. Once the work mandated by the Surface Transforation bill is completed, we will still need to address problems such as finding jobs for unskilled workers entering a technologically advanced work force.

As a Nation, we need to invest not only in rebuilding our infrastructure, but we must provide assistance for the regrowth of American businesses, and for advancing education.

I would like to pass on just a few of my suggestions for creating an effective long-term recovery:

1) Provide 2 percent of the gross national product, or about $110 billion each year for the next ten years — depending on the rate of recovery — in the areas of education, business, and infrastructure. This money should primarily be distributed through a revenue sharing program, with a formula that favors the hardest hit areas of the country.

2) Any immediate savings from cutting the military budget should and must go to the domestic budget. This means breaking down the budgetary walls between the defense and domestic budgets. The money should be used for military conversion, job retraining and education for soldiers, job training and education for civilians, and general assistance.

3) Only a small percentage, 5 percent or less, of any defense savings should initially go directly toward reducing the budget deficit. While deficit reduction must be a goal of the economic recovery plan, the primary reduction in the debt should come from taxes paid by new businesses created through federal assistance, not by direct payment from savings.

4) Tight local controls on funding are necessary because of limited resources. One reason the original Marshall Plan was so effective is because of the efficient use of funds.

5) Within the first few weeks of the second session of the 102d Congress, we must enact a long-term strategy for reinvesting in this our country. We can no longer afford to create piecemeal legislation.

Setting policy for reinvesting in America must be among our highest priority. We must spend simultaneously in the areas of education, business, and infrastructure. Only by coordinating this effort will we ensure a long-term domestic recovery. The longer we wait to set policy in this area, the more "war-torn" this National will become in the immediate outlook. We must act quickly to safeguard the stability of our Nation's future.

Senator Sarbanes. Congressman Roemer, please proceed.

STATEMENT OF REPRESENTATIVE ROEMER, THE STATE OF INDIANA

Representative Roemer. Thank you, Mr. Chairman.

I would like to take a couple of brief seconds to thank you for the opportunity to testify before your Committee today on an issue that I think rivets the country. When I talk about the Marshall Plan in the Third District of Indiana, business leaders, educators, small-business leaders, farmers and a host of people want to see this country address the long-term problems. The Marshall Plan does that, and I salute you on the Committee for recognizing the need and for holding hearings for something this important.

I would also like to thank particularly you and Senator Sasser, Mr. Chairman, also Lee Hamilton for his leadership and encouragement. It is people like you and Steve Solarz, who, as he opened up his comments, encourages us freshmen members of Congress to know that ideas, substance and initiation do matter. People will respond to creative ideas; they are ready for these challenges. And I know that Americans want to see something like the Marshall Plan passed.

I would also like to recognize, as you did, Mr. Chairman, John Brademus for his contributions in the field of education, which I will address a little bit in my comments. But also I want to turn to Ray Thornton, who is the brain-child of the Marshall Plan in so many ways. If George Marshall took the credit for the Marshall Plan in the 1940s, I think Ray Thornton, if we do pass one, with his leadership, and that of people like Barbara-Rose Collins and Jim Bacchus and the leadership of the House Speaker Foley, Congressmen Gephardt and Hoyer have been very helpful to us in seeing this brought to fruition on the House side.

Mr. Chairman, you probably have had a number of hearings or town meetings in your constituency. And we find that our constituents are anxious, they are upset. Some are angry, many are just plain disappointed that we are not showing the political courage and leadership here in Congress to deal with what I call "kitchen table" issues. Whether we talk about those kitchen table issues as economic ones, related to job creation and the preservation of jobs, whether we talk about children's issues, whether we talk about roads and bridges, or helping businesses with tax credits on the creation of new machinery and equipment that produces tangible goods, people are very, very frustrated out there. They want us as a Congress to deal with these issues that they talk about at their kitchen tables.

I do not think, Mr. Chairman, that we need a Pearl Harbor, that we need a Depression, that we need a Sputnik, or that we need an "Evil Empire," even, to deal with the challenges that we face as a people and a country going into a brand-new century. If we do, all we have to do is refer to the front page of the *Washington Post* this morning, talking about

the possibility of each and every child in this country not having a very good opportunity to succeed.

Let me read you a couple of quotes from the front page of the Washington Post: "Alarming erosion in the well-being of children. We need 'to put children first.' This country not doing right by its children."

In the interest of the children and even in the interest of what we talk about as being the American dream of, at least, providing the opportunity for each successive generation to do better than their parents did, we need to have a Marshall Plan. And I am not saying that you guarantee that each generation do better, Mr. Chairman, just that they have the opportunity to get a rung above their parents on this ladder of the American dream.

We need, we must have, we must pass a Marshall Plan for America. Specifically what does that translate into? The Marshall Plan for Europe did not talk a great deal about education. It involved agriculture, it involved investment, it involved a host of things because George Marshall and President Truman realized that we needed a strong and competitive Europe to compete and to succeed in a democratic country here in the United States.

The Marshall Plan that we need for the 1990s, going into the new century, needs and must include an education pillar. Four critical elements must be included in this education pillar: One is a connection with federal and state monies to reform to new ideas, not to doing things the old way, where we have been teaching school the same way for the past 100 years, based upon an agriculture calendar. We need to associate through incentives, through initiatives, reform and attach that federal money to that creativity.

Some of the things that we are talking about in the Education Committee include a new higher education bill to open up education to the middle class. It includes talking about such ideas as a business corps or a teacher corps. We talk about the state initiatives, as well. The State of Oregon is looking at a brand-new program that would give up to the tenth grade a certificate for excellence for a master of excellence degree, and then in the eleventh and twelfth grade, you would proceed on a dual track method or record going into either the track of vocational and technical education, or on a track of college preparatory coursework.

The Germans do that. I think the United States needs to experiment and look at creativity in our high schools to prepare our workers for the 1990s and the challenges of the 1990s.

Second, in addition to reform, we need early intervention. We have all agreed, Democrats and Republicans alike, that programs like Head Start work. Programs like Head Start are only serving roughly two out of five of my constituents in the Third District of Indiana. We need to see full funding for those programs.

Third, and one of the most important ingredients of these pillars, is worker preparedness. Right now, according to a study by Ray Marshal and Bill Brock on the Work Force 2000, we are seeing that our workers

in the transition from school to the workplace are in one of the worst shapes in America, in comparison to other industrialized countries. Those graduates of high schools have to be prepared for the business environment. Right now, the federal dollars serve about 1 in 20 of those people interested in job training.

Finally, we need full participation in educational endeavors, not just Congress talking about it, not just the President talking about goals for the year 2000, but we need our parents to be involved, we need businesses and entire communities, including the Chamber of Commerce, to get involved in educational endeavors. We, as members of Congress, cannot just talk a good game about educational reforms, we have to be involved in the initiation process of new ideas at the local, state and federal levels.

Finally, Mr. Chairman, we all have seen the rich, copious literature out there talking about the initiatives that we need. Robert Reich has written a new book, "How Nations Work," talking about the ideas that we have articulated in the Marshall Plan to make us more competitive. We have seen Stephen Schlosstein write a new book, "The Decline of the American Century," again talking about the importance of education, including businesses and rebuilding our infrastructure, to help get us competitive. We also see John Chancellor writing a new book, "Peril and Promise," talking about the challenges that the American people face and the sacrifices that they are willing to make to see their children succeed, or at least have that opportunity to succeed in the new century ahead of us.

We need to act on these relevant issues before the American people, both as a Congress and as a legislative body, but also as a people going into this brand-new century.

One final story, Mr. Chairman. Given the choices that we face as a Congress coming forth, talking about the budgetary choices as well as the educational choices, I was talking about nine months ago to the director of prisons in the State of Indiana, and I asked him, Mr. Chairman, what is the single biggest indicator of how many prison cells that we will need to build in the year 2015, because we are constantly spending more and more money on that end of things. He looked at me and said, "Tim, hold on to your seat, the single biggest indicator is the number of at-risk children in the second grade." So, if we continue to see our children's posture erode, their opportunity dissipate and the American dream denigrate, we will not have the competitive country or the compassionate country that we have been brought up in that we need to pass on to our children.

I am delighted to be here, and again salute the Committee for their leadership and foresight in having this hearing, and again thank Congressman Thornton for his leadership, as well.

SENATOR SARBANES. Thank you, Congressman Roemer, for a very strong statement. We know of the leadership that you are already playing in the educational field, and we appreciate that testimony.

REPRESENTATIVE ROEMER. Thank you, Mr. Chairman.

[The prepared statement of Representative Roemer follows:]

PREPARED STATEMENT OF REPRESENTATIVE TIM ROEMER

Mr. Chairman and distinguished Members of the Joint Economic Committee, there is a great deal of momentum in this country towards changing the way we do business in many ways. Health care, education, industry and government all need some kind of reform.

In my home, the 3rd District of Indiana, I am constantly approached by farmers, small business people, industry leaders, educators, health care providers and Hoosiers from all walks of life asking for, and sometimes demanding, change.

It has always been a tenet of our existence in this country that our children would have a better life than we did. This is no longer true. What happened? Why are we losing jobs? Why is our status quo crumbling? What happened to our growth? What happened to America being the number one economic power in the world?

Are our resources gone? No. Have our abilities disappeared? No. Rather, our focus is gone. Our priorities are loose. And we have neglected the institutions that support our quality of life, such as education, our health care system and the nation's infrastructure. But we do have the ability and the resources to rebuild them. What we need is the resolve to create a blueprint, and to follow through with it.

There are working men and women in Indiana, hard workers, who have found themselves out of work after many years of loyalty to their employers. The layoffs and downsizing do not make sense to these people in a country with the highest GNP in the world. With a trillion dollar economy, it is tragic that we are leaving these people out to dry, and they are angry. I don't blame them, and I am here today to try to prevent greater job loss, and to restore the jobs that have been lost, and help lead this country into the challenges of a new century.

How? By calling for a Marshall Plan for America.

Although the call is for a new plan, a "Marshall Plan for America," we are not trying to recreate the original Marshall Plan in its exact form. Rather, this is to be a creation that is similar in its goals, boldness, and foresight, and of course, its overwhelming success.

One very important "pillar" or foundation of the Marshall Plan is education. Education was not a significant part of the original Marshall Plan, which focused mainly on agricultural and industrial production, economic restoration, and stimulation of trade.

Our Marshall plan must include a rejuvenation of education, particularly early intervention programs and partnership between business and education. With the advent of such modern dilemmas as babies born with addictions and rampant drug abuse in our schools, our system is in danger of collapse in many places, particularly urban centers.

Childhood development and education of our youth are no longer a priority of our nation. In fact, education was taken for granted for so long that it became neglected. Two results are obvious. The first is that far too many students are unprepared to learn. The second is too many students graduating are not prepared to work, either in business or in college.

And the problems of children as a class of society are increasing. There is a direct correlation between this increase and the decrease in our country's ability to compete. David Kearns, Chairman and CEO of Xerox, is quoted as saying, "The basic skills in our workforce - particularly at the entry level - are simply not good enough for the United States to compete in a world economy."

Yet in the 1980's, according to MDC, Inc., in a report for The Charles Stewart Mott foundation, the federal commitment to education declined by 23 percent in real dollars. The federal share of the total education budget has declined from 8.95% in 1980 to 6.27% in 1987. The same report also states that the federal commitment:

- serves only 1 in 5 needing pre-school education;

- serves only 2 out of 5 needing remediation;

- serves only 1 our of 4 needing bilingual education; and

- serves only 1 out of 20 needing job training.

The study also emphasizes the fact that state spending has increased 26% beyond inflation since 1980, from about $46 billion to about $80 billion, and local spending has increased 29%, from $40 to $70 billion. The bulk of these increases, however, has gone to increasing teacher salaries and lengthening school days and years.

And, America's dropouts are also a drain on the economy. High school dropouts loose billions of dollars in potential income, and the country loses proportional billions in lost tax revenue. Many of these people also become clients of the welfare system, a further drain on the economy by individuals who should have had the opportunity to be contributors.

The Committee for Economic Development has found that the return on $1 invested in early intervention can save almost five times as much in later costs. This does not reflect the further savings in the form of increased economic contribution to society by those that avoid crime, drugs, teenage pregnancy and instead seek college or job training.

Head Start is a perfect example. The program is now over 25 years old, and Head Start children have proven that they are much more likely to seek advanced education, and much less likely to get arrested or involved in narcotics or become teenage parents. Yet, even though Congress has authorized full funding of Head Start by 1994, the appropriation schedule is far behind.

A Marshall Plan for America must address these inequities by pursuing full funding of proven programs, recognizing the benefits of early nutrition and preventive care, and providing remedial solutions for children who are at risk throughout their school careers.

Beyond the early years, our Marshall Plan needs to recognize and expand on the existing programs of partnership between our schools and American business. By using business to help interest and recruit older youth, we can insure that future labor pools are qualified to work, especially the important science, language and technical fields. The ability of the United States to continue to compete in a competitive global market is dependent on the quality of the pool of talented and trained workers.

Our Marshall Plan for America needs to include the educational needs of our children, first to make them learning ready, and later to make them working ready. Without these children, our country cannot succeed. Without these programs and training, our children cannot succeed. Marshall Plan invests longer-term, restores the dream of success for each new generation, and challenges the American people. I know Hoosiers, and all Americans, are ready -- the question of whether Congress can act to address these concerns is the key.

SENATOR SARBANES. I am going to be very brief and then yield to my colleagues.

First of all, I was struck, Congressman Thornton, by the statement you made that a Marshall Plan for America is not a withdrawal from the world. What some people say and what the Administration often says when you talk about a vision or some initiatives on the homefront, they immediately say, "Well, this is just isolationism. This is the reemergence of the ugly head of isolationism."

It is my strongly held view that America cannot play a role in the world if it is not strong at home. Upon what is our international role to be based, if it is not on our strength?

Let me ask you this question: As changes in the international arena seem to be making the importance of military strength less—it is still important, obviously, but we no longer are in a Cold War confrontation—therefore, I think it is reasonable to ask whether we are going to dominate the international scene simply because of the military dimension—there are many who think that the economic dimension will rise to the fore in determining a nation's ability to influence international events.

First of all, do you agree with that analysis? Do you think we are moving in that direction? And if you do agree with it, how relevant is this Marshall Plan to enhancing our ability to address the challenge of the Japanese and Germans, who have moved into a position where they have become the major actors internationally in economic terms?

REPRESENTATIVE THORNTON. I think it is important, as you describe, to recognize that the struggle is shifting to new battlegrounds. I think it is very important that we remain the mightiest nation on Earth militarily, because that is the secret of world peace, if the strongest nation is a peace-loving nation. But the modern demands and strategies are for fast airlift and sealift capability, flexibility of response. We can do that with the expenditure of much less money than we have expended to keep hundreds of thousands of foot soldiers guarding Europe against the nonexistent Warsaw Pact. So, there will be a great opportunity to keep our country strong, but to have a smart strength, which costs much less money.

The important thing, as you suggest, is that we must recognize that the new battleground is of economic competition, and if we want to participate in the world, then we had better set our house in order so that we can be effective competitors in international competition and trade.

The way to withdraw from the world is to do nothing and to let the competition for trade markets be focused upon Europe contesting with Japan, and the United States, as a weak economy, would get out of the game. We have the resources, we have the strength, but we need to exercise the vision and leadership to assure that we do not withdraw from the world, but that we be a dominant economic power in world trade and enterprise.

SENATOR SARBANES. Congresswoman Collins, do you want to add to that?

REPRESENTATIVE COLLINS. I concur. I think it is abominable for this country to go on, in light of the recent liberation movements in Europe toward democracy, in the many countries, it is abominable for us to continue putting our money in heavy defense budgets, especially the foot soldiers in Europe, when we see that our Nation is on the verge of collapse in many cities and states. Their budgets are going into bankruptcy, major cities, Mr. Chairman, and states.

It takes vision, it takes courage to dismantle those walls between the defense budget and the domestic budget. And truly the battle will now be in economics. In fact, it has been there for a long time, we just haven't been in that game.

SENATOR SARBANES. Congressman Roemer?

REPRESENTATIVE ROEMER. Yes, Mr. Chairman, I think that is a good question, and let me respond to it in a couple of different ways. It might be asked, "Are we a superpower? Are we the only superpower left in the world now, with the changes in what was the Soviet Union, now the Confederation of Independent States?" I think we are the only superpower left militarily.

Are we economically? We have competition economically with the Japanese, with trading blocs, with Europe, now emerging as a united entity, with the "little dragons," as they are called, in the Pacific Rim area. How do we address that situation? Do we do it by just saying that there is unfair trade out there with the Japanese? While there is unfair trade with the Japanese, it is also not just unfair trade, it is an unprepared United States for some of these challenges. We have to be able to meet the challenges by helping our businesses with a fair and consistent tax policy, helping our education system, rebuilding roads and bridges, as the Marshall Plan calls us to.

Second, as your question also points to, Mr. Chairman, we need to reevaluate a military budget that spends billions of dollars in Europe and Japan, given the new world. Also, the way we give out foreign aid, do we continue to give $600 million to Turkey, given the lack of a threat from the Soviet Union? And should most of that be in military assistance?

Do we need both a rail garrison and an MX? More money has shifted in MX. More money has shifted in SDI, with the threat from accidental launch given from the former Soviet Union. But there are adjustments that we need to make both in the way we calculate foreign assistance and who we give it to and in how we attach farm and business assistance and credits to that aid, as well as a reevaluation of what weapons systems in the military budget are important in these new times.

SENATOR SARBANES. Thank you very much.

I am now going to yield to Congressman Hamilton. Let me make the observation that we alternate the chairmanship of this Committee from Congress-to-Congress. He chaired it in the last Congress. I read over the weekend the record of hearings that he held in the last Congress on public investment in human and physical infrastructure, which addressed, at least, part of what we are talking about here today. So, I very much want to

acknowledge the leadership that Congressman Hamilton has been exercising on this issue over a sustained period of time.

REPRESENTATIVE HAMILTON. Thank you very much, Senator Sarbanes.

The thing that has impressed me most about your testimony is the fact that you are all new members of Congress. I have always had the theory—I am not sure it is valid—that new members of Congress are as close to their constituents as any members of this institution. I do not want to press that argument too far, because there are some of us here who have been here awhile, and I can see that being distorted in some ways.

But that leads to this question. I am sure all of you have talked about this in your constituencies. I think Congressman Roemer mentioned briefly the reaction in Indiana. I would like just to get a sense of how you think your advocacy of this has been received, not just in your own constituencies but in a broader constituency, as well.

And I want you to address just very briefly, if you will, this question of the deficit. How do you finance this plan? I do not mean to put you on the spot too much, but I am interested in how you, in your own mind, deal with that question. Are you prepared to see an increase in the deficit in order to finance the Marshall Plan, for example? How do you deal with it?

And, Senator Sarbanes, if I may, I just want to point out to my colleagues here that Congressman Thornton was in the House of Representatives at an earlier time for several years. He did so well in the House that he graduated and became the president of two universities. Most of us struggle in this institution to become chairman of a small committee, and he has been president of two universities, the University of Arkansas and Arkansas State University. After he straightened those institutions out, he came back to the Congress to straighten us out. We appreciate that. He has had a very distinguished career. He is a remarkable leader here.

Could you address the questions that I have raised?

REPRESENTATIVE THORNTON. Let me begin by saying that the reason I left the presidency of the University of Arkansas was because people in Arkansas were becoming deeply concerned about the decade of neglect of education, of infrastructure, of rebuilding, and of America's ability to be competitive in the world. As I began my campaign for Congress in October 1989, people had already told me that it was time for a new effort to forge partnerships between the public and the private sector in order to overcome the problems that are causing American economic competitiveness to falter.

So, rather than bringing to the people this concept that we needed to rebuild America, the people in Arkansas were telling me that we need to do something to redress the problems of rebuilding America's economic strength, and that's what I needed to focus on when I came to Congress. Those were people who thought I was going to go, and they were right. I am very happy that their forecasts were borne out.

A few months after that, the Berlin Wall fell, and some people said that we needed a Marshall Plan for Eastern Europe. I immediately said, "No, we need a Marshall Plan for America. We need to use the same kind of comprehensive redirection of resources that we have applied well in building every other nation in the world." And, Mr. Chairman, that has struck a chord that has reverberated throughout the district. Indeed, the people of this country are ahead of us on this issue.

With regard to the cost of the program, 2 percent of our gross national product is $110 billion. We spent $130 billion last year defending Western Europe against a nonexistent Warsaw Pact. Every 1 percent of unemployed people amounts to about $38 billion in cost to our Nation. Restoring employment will go a long way toward paying for the cost of a plan to rebuild our country.

At the end of World War II, we were head over heels in debt. We owed $260 billion and had a gross national product of $212 billion. Our debt was 120 percent of our total earnings as a Nation, and yet we found 2 percent of our GNP to rebuild Europe. Today, we have an overwhelming debt; it is measured in the $4 trillion range. But we have a gross national product of $5.5 trillion. So, on a percentage basis, we are not as deeply in debt today as we were then.

I do not think it is necessary to go into debt further to implement the Marshall Plan. I think we can redirect and refocus our resources and find the money within savings that can be made. But I also think that we need to distinguish the difference between an investment in the future and an expenditure for current needs.

A family that goes out to the ice cream parlor every day and buys and consumes gallons of ice cream has nothing except, maybe, a little fat to show for that expenditure. A family that buys a home and invests in the future by providing tuition savings plans for their children to go to college is not making a current expenditure, but is making an investment in the future. And that is what we are calling for.

Representative Hamilton. Representative Collins?

Representative Collins. Thank you, Mr. Hamilton.

As my Senator, Mr. Riegle, can attest, Detroit and Michigan are desperate for a Marshall Plan. I speak regularly in the churches and on radio and before any citizens group that will listen, and they are all very enthusiastic for a Marshall Plan for rebuilding America, not just in Detroit and in Michigan. I have also spoken with John Kenneth Galbraith, who will be testifying before your Committee at some future time. I think across the land that people are excited about the notion of reinvesting in America, rebuilding America.

As a matter of fact, the people from my grass-roots district, a working-class district, cannot understand the speed with which American wants to rebuild the newly democraticized nations in Europe, while turning a blind eye to what is happening here at home.

As for financing the Marshall Plan, we are not asking or advocating a tax increase. We are not saying, don't pay attention to the debt. It is just

that, when you are devastated, when you are hungry now, when you are thinking that this is an emergency, we need to turn our attention there.

I have a senior citizen in my district who is having a great deal of trouble surviving on her social security pension every month, and I asked her why, and she said, "I have to pay my bills." And it occurred to me, first, to take the money out so that you can eat for 30 days and then you pay your bills, but if you don't eat, you won't survive to pay your bills. And I think America is in that position now where we have to take care of the basic necessities of rebuilding this country, rebuilding our work force, rebuilding our competitiveness and our manufacturing capacity.

I think we have to prioritize where our dollar goes, and I think we have to have an organized method. I do not think that we can have this program, this program and that program, because we have already got that and it is not working. We need one program for rebuilding this country.

SENATOR SARBANES. Congressman Roemer?

REPRESENTATIVE ROEMER. Congressman Hamilton, being that both you and I are from the Hoosier State and that you and I like to have town meetings, you and I have also discussed what we often hear in these town meetings. Oftentimes, the case is people simply saying, "You people up on Capitol Hill are becoming irrelevant. You are not relevant to the things that we want and need."

Whether they talk about education, whether they talk about jobs, whether they talk about hope for their children's futures or health care, this Marshall Plan connects with people. Whether I am talking to a town meeting, whether I am talking to a group of farmers, whether I am talking to University of IU, Indiana University or Notre Dame, people feel that this idea could make a difference in their lives, that this is a kitchen table issue, something they talk about in their homes and on the front porches.

So, I think the business community, the education community and average citizens are willing to meet the challenges and make sacrifices to make the Marshall Plan work.

Now, your question is a tough one: How do we finance it; what do we do about the cost of a Marshall Plan?

You are legislators. That is why we are before you, very knowledgeable, senior members of Congress. It is for you to come up with some of the ideas to finance this, Congressman Hamilton.

Seriously, though, I think we have to make choices. I think the American people want to see us make some tough choices. I am trying to make some of those tough choices. I didn't vote for the space station. I would like to see some of that money devoted toward problems that we have here on Earth before we go into the next venture there. I think we need to make some tough, across-the-board cuts in many programs on appropriations bills. I know you voted for some of those cuts.

We need to look at a host of programs to come up with financing, maybe pare back on foreign aid; not cut foreign aid completely, but reevaluate the way we give foreign aid so that we help our farmers and

our businesses with credits, with a new way of giving foreign aid. These are just ideas.

I think that we need to look at the defense budget to some degree and reevaluate, as I said before to Chairman Sarbanes's questions about what programs are needed and vital to the new threats that we face in the world. And we can come up with some money there.

Secretary Cheney and General Powell are admitting that we can come up with cuts there.

Finally, though, Congressman, I do not think that we can afford not to do this. This growth, this investment in competition, making us competitive with the Japanese and the Germans and the world, will produce jobs, will produce revenue, will produce an added tax base for us as a country to grow and prosper. And I think that is a prudent investment for us to make.

REPRESENTATIVE HAMILTON. Thank you very much.

Thank you, Mr. Chairman.

SENATOR SARBANES. I want to mention that Congressman Armey, who is the ranking Republican member of the Committee, and who has been quite regular in his attendance at the Committee, very much wanted to be here today, but he had obligations back in Texas, back in his district, and it just wasn't possible for him to be here, and he wanted you to know that.

He has also submitted an opening statement, which of course will be included in the record.

[The written opening statement of Representative Armey follows:]

WRITTEN OPENING STATEMENT OF REPRESENTATIVE RICHARD K. ARMEY

I welcome all the witnesses today, but I am particularly pleased to see that James C. Miller, III, the former head of the Office of Management and Budget will appear. I'm concerned about the long-term budgetary impact of the Plan advanced by Senators Sarbanes and Sasser, and Dr. Miller is particularly qualified to discuss the federal budget, deficits and growth.

The Chairman of the JEC and the Chairman of the Senate Budget Committee are running a series of alternating hearings by each Committee about the U.S. economy and their "Marshall Plan for America." Their proposal will likely bust the federal budget in the future, and yet have no impact on the current level of unemployment.

When the facts are considered, it becomes clear that the so-called "Marshall Plan for America" lacks the key ingredient that brought economic prosperity to Europe after World War II, an emphasis on the market economy as the means to prosperity. Instead, we are offered un unspecified plan that relies almost solely on government largesse. The National Association of State Budget Officers estimates a decline in fiscal stimulus from the state budgets of about $25 billion netted against a federal budget deficit of $360 billion for fiscal year 1992. The additional $55 billion in deficit spending suggested in these hearings will virtually assure that there is no growth and no private-sector job creation in the future.

I'm anxious to hear what our witnesses have to say today about the Sasser/Sarbanes proposal.

Senator Sarbanes. We have been joined up here by two of our colleagues from the Senate, and we are very pleased by this. The Senate Banking, Housing, and Urban Affairs Committee has been holding hearings on the state of the economy and the Senate Budget Committee has been holding a series of hearings on the state of the economy, and the chairmen of those two committees are both with us this morning. They have a keen interest in this subject and, I think it is fair to say, a lot of respect for the panel that is here before us.

I am going to turn now to Chairman Riegle first, of the Senate Banking, Housing, and Urban Affairs Committee, and then Chairman Sasser of the Senate Budget Committee.

Chairman Riegle, please proceed.

STATEMENT OF SENATOR RIEGLE, JR., CHAIRMAN COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

Senator Riegle. Thank you very much, Chairman Sarbanes. I appreciate, as well, the leadership that you and this Committee are giving to get into the guts of these questions, and what is happening to America, and why is it we are losing our economic future, and how do we turn this around.

And I want to thank all of the witnesses this morning, those who have spoken and those that are to speak.

I particularly want to thank Congresswoman Collins. She and I together both represent the Thirteenth District of Detroit.

Representative Collins. That's right.

Senator Riegle. She has described in powerful and important terms what is happening in people's lives, the honest-to-goodness difficulties that people are confronting hour-by-hour, day-by-day, to try to survive and get by in a grinding kind of economic situation that is almost impossible for many of them.

I think that in the city of Detroit or in my home city of Flint that the urban areas are experiencing the problems in a certain way, but the problems are very severe in the rural areas as well. There was a story just last week that the rate of suicide among farmers in America last year was higher than it has been in anybody's recorded memory, in terms of just the sheer pressure of economic events throughout our society.

Also, I would say, coming from Michigan, as Congresswoman Collins does and I do, the other day, the announcement by General Motors, which is just one of many corporate announcements of cutbacks and job reductions and plant closings, General Motors announced that they are going to be eliminating 74,000 permanent jobs, and by the time they finish implementing that reduction, General Motors, in the vehicle business—cars and trucks—will have been cut in half since 1985. Now, this is the biggest single company in America.

But it is not a unique story. IBM is doing the same thing. AT&T is doing the same thing. You go right across the tier of big companies in

America, you can go right across the tier of medium-size businesses in the country, and the same thing in small businesses. In fact, small businesses are being snuffed out faster across the country than any other group. And most of our new-job creation comes from small business. So, we really have an extremely serious problem.

When there was a hearing in this Committee, as a matter of fact, just last week on the new unemployment numbers, unemployment, of course, had jumped back up again. It is now up to 7.1 percent. But I was so struck by the testimony of the people in our government that collect the unemployment data. This is what they said to us. They said there are now at least 16 million people in the United States that are either out of work and can't find any work to do, over ten million in that category; there are another six million that want to work full time and can't find full-time work, so they are only working part-time because that is all they can find. But if they work as little as one hour a week, they are counted as employed rather than unemployed.

So, we know in that group that there are very many that are not earning enough to eat properly or to feed their children if they have families and what have you.

I asked the question, "What happens to people who lose their jobs and are lucky enough to find another job? What is happening to them? Are they finding jobs at the same skill level and at the same income level of the job they left?"

He said, "No, by no means. Historically, in the recent history, 42 percent of the workers who lost their jobs found that when they were able to find a replacement job that it was at a lower skill level."

So, this is why you see teachers, in some cases, driving taxicabs and you see people with engineering degrees working at fast-food restaurants because they can't find work at their old job level and skill level, so they have to take a lower-level skill job in terms of what they otherwise could do, and obviously lower income with it, a lot of them at or near the minimum wage level.

So, we have got a massive unemployment problem in America right now today, this day, in this country, and we shouldn't have to beg and plead for an economic plan for America.

The thing that bothers me with our Administration is that they have an economic plan for every country in the world except this one. There is a plan for Kuwait, a plan for Mexico. There is a plan for what is left of the old Soviet Union, a plan for Australia, a plan for Singapore. No plan for America. All of these other countries have plans, because if nations are going to succeed today, they have to plan as to how they are going to do it.

Certainly, the Japanese are very good planners, as the President found out the other day when he went over on the little trip and asked for a little fairness in the trade relationship and got a few table crumbs in return.

They have a plan. They are executing their plan. In fact, their plan works so well that since 1980 Japan has taken $460 billion out of the United States. If you want to know why so much of our economy is struggling, whether it is in Arkansas or Indiana or whether it is in Michigan, or wherever it might be, it is the tremendous loss of capital.

Just in the auto industry alone, the three auto companies have lost $10 billion in the last five operating quarters. So, the General Motors announcement was not just on plant closings and permanent job reductions, but the chairman of General Motors also said that they are going to be selling assets to raise money to funnel into the business. They are going to cut down on their capital spending plans.

This is the wrong direction for us to be going as a Nation. We want our companies growing, we don't want them shrinking, and we can't afford this continued financial pinch.

I have tried to analyze why all of the resistance to a plan, to a thoughtful plan. You have come in today with a thoughtful plan of investing in this country, whether we call it a Marshall Plan, or an American plan, or a Team America plan.

The witness that is coming to speak from a California perspective, I was reading his statement from Southern California Edison, talking about the need for investment there, in our people, in our businesses, in our infrastructure, so that we can have a good, healthy future. Why all of the resistance? I keep asking myself the question, "Why is it that the Administration is willing to have a plan for everybody else around the world, but no plan for this country?"

And I have decided that there are two or three reasons why: One, I think after 11 years in power—and that is what it has been, Reagan-Bush for eight years, now Bush-Quayle for three years—they can't admit there is a problem. Because, if there is a big problem, where did it come from and how can you suddenly say right on the eve of a national election, after 11 years, "Well, by the way, here is a big problem that we just found," one that presumably they should have been on top of and working to correct over that time?

Another thing is that I am convinced that there is a disconnection from the realities of what is going on in the lives of everyday people. When I listen to some of the economic advisers today around the President and what they are putting forward in the way of their analysis and their suggestions, they are so disconnected from the realities of what is going on out across the country; it's as if they lived on a different planet. And I think, for many of them, they are living, if you will, on family trust fund income, and whoever is managing the trust, you know, is investing in foreign stocks and currencies and this and that, and the money rolls in each month and so forth. And so, you know, they are not experiencing a problem, so they don't know what the problem is that we are talking about.

That is why I suggested that some of these people go out and visit an unemployment office, because in the unemployment offices today, they

will find people with college degrees; they will find people with doctoral degrees; they will find working mothers that cannot support their families or feed their children, desperate for work. They will find people standing in Detroit with signs that say, "We will work for food," because they are desperate. It's not unique to that town, it's true all across the country. Our homeless shelters are packed to capacity. In many shelters, you will find a larger population of children, including even babies.

Now, what kind of a country is it that we don't care more about our people than that, that we are so incompetent that we can't manage our affairs to see to it that there is enough work to go around, and that we have a strong vibrant economy?

The Japanese, the other day, laughed at the President and are laughing at our country because they have a plan, a very aggressive plan, and they are pursuing it and are getting stronger, and we are getting weaker, in part, because of unfair trade that they are carrying out and in part because we don't have a plan here in America. And we need an American plan.

We need to pull business, government, labor and citizens together in this country and invest in this country, in our people, in our businesses, in our future. Otherwise, we are not going to have a future; we are going to continue to see the social order unravel, as it is unraveling; and we are going to see more broken homes and broken lives. And it is just not right, and it doesn't have to be that way.

And when I hear some of these economists talk about it, I call them "flat-earth economists," because they have this vision of the world that is so far removed from the realities of what is going on.

We have to have a plan that works for America and that works throughout the length and breadth of this country. Now, where can we get the money? I think Congressman Hamilton raises a good point. We have the money. The money is here. The problem is that it is not being invested. And I mean invested in the things that it needs to be invested in to make us stronger and wealthier in the future and to create assets, brainpower assets, physical plan assets, and new technology assets that America needs.

Some of it ought to come out of the pension money that is collected in this country each day. We are collecting billions and billions and billions of dollars of pension money day-by-day, week-by-week and month- by-month. Where is that money going? Is it staying here in America? Is it being reinvested in America in sound, long-term investments that will produce a real yield? Much of it isn't. Much of it is being sent out of America to build other countries in other places.

Let's create some incentives to keep more of that money home, invested here, because if we don't have a good strong economic future, we are not going to be able to pay pension benefits in the future. In fact, our Pension Benefit Guarantee program right now is in big trouble. I don't think that you will hear the Administration admit that before November, but the cold fact of the matter is that it is in trouble. So, that's one place where we can get the money.

Another place we can get the money, you have suggested today, is right out of the defense budget. We don't need any more of these long-range nuclear bombers that cost $1 billion apiece. We need to have our kids in school learning things that make them smarter and able to produce more. And we need more money in research and technology and development so that we can build better products and get them out there.

But you can't do that if you allow other countries to systematically target your industries and destroy them one-by-one, as Japan has done to consumer electronics, as they have done to computer chips, as they are doing in cars and trucks, as they plan to do in aviation. You can't let another nation or a set of nations come in and strip mine the economic strength of America and be a strong country. You just can't do that. And that is why other countries don't allow that to happen to them.

It's so interesting, here are the Europeans, the Europeans said to the Japanese, "Look, we are only going to let you sell cars in Europe up to a level of 16 percent of the market for the next ten years, partly because you won't let us sell in your market, and partly because we want to keep those industries large and strong and state-of-the-art and to keep those jobs and that income here in Europe." That's what the Europeans said. They have a plan.

Here in this country, some of the flat-earth economists, people who I think are living off the trust-fund income that comes in every week and every 30 days, they see no problem because there is no problem for them because they are disconnected from the problem. And that is why this country is in trouble.

This country is not going to get out of trouble until we put in place a sensible plan, like the one you have suggested today. We can finance it by cuts in the defense budget, by asking Europeans to pay for their own defense, for a change.

And, of course, the Japanese have taken a free ride on the defense spending. We have done tens of billions of dollars of free defense spending for the Japanese. At the same time, they have taken $460 billion out of the United States since 1980 in this trade deficit area. They took $42 billion out last year. They are going to take nearly $4 billion out this month. It's just incredible.

I thank you for what you have said here today. You have laid out a plan, and I think it is a sensible plan. I think we have to get all of the plans on the table.

I would just conclude by saying that we in the Congress now have a responsibility to enact a plan. If the President doesn't see the problem, isn't willing to move on it, we have an obligation to move on it. And I know that people will try to stymie it, they will try to block it. In the Senate, they will throw up all kinds of parliamentary devices to try to prevent us from getting votes and to try to stall us with filibusters and so forth and so on. I think we have to persevere right straight in the face of that, and if people are trying to prevent us from crafting an intelligent plan for America, then at least the American people will know about it,

and it won't be long until, in just a few months, they will be able to do something about it, because everybody in this country of voting age that registers to vote can do something about these problems because they can vote for a plan. They can vote against people who don't think there is a need for a plan, no matter where they happen to be.

There is an opportunity here to do something, and I hope that in the House of Representatives, as well, that there will be an aggressive effort to craft and enact a plan.

Now, we may send it down to the President, and he may do what he did to unemployment compensation benefits. We sent those down, and he said, "Well, we really don't need that," so he vetoed that package. So, we sent it down again. Well, he vetoed it again. And finally, the third time, after we enacted it, he allowed the unemployment benefits to go out there to try to help some people keep their lives together that otherwise were in desperate, desperate shape.

So, we may have to pass a plan two or three or four times, given the resistance that we are going to encounter, in all likelihood, down at the White House, who doesn't think there is a problem and doesn't think there is a need for a plan. There is a need for a plan, and you have given us some good ideas today, and I thank you for that.

SENATOR SARBANES. Thank you very much, Chairman Riegle.

Chairman Sasser, please proceed.

STATEMENT OF SENATOR SASSER, CHAIRMAN COMMITEE ON BUDGET

SENATOR SASSER. Thank you, Mr. Chairman.

I will be brief. I want to commend you, Mr. Chairman, for convening these hearings here this morning. And I must say that I am reenergized by listening to Congressman Thornton and Congressman Roemer and Congresswoman Collins.

You know, there are some historians who say that nations are like people and that they go through a period of infancy, growth, maturation, when they are robust, and then they decline. And some are saying that perhaps this Nation is on the verge of decline.

But listening to these new members of Congress and particularly Congressman Thornton, a distinguished man of public affairs, who left the academy to come back to the Congress to present his views and bring this plan, frankly, I have much greater confidence in the future of this country, and certainly we should when you look at the assets that this country has vis-a-vis our leading friendly competitors, and I emphasize "friendly," the Japanese, the Germans and others. Our natural resources and our other assets vastly outweigh theirs. And we in the United States have just come through a long, grim period called the Cold War and we have won that battle, and now it is time to refocus our energies on rebuilding our own country.

I was struck by something that Congressman Thornton said: "We need to distinguish between investment and expenditures." Well, we made an expenditure just in the past decade of $2.5 trillion in the national defense. Now, frankly, I thought that we overdid that during the decade and that we went too far. That amounted to almost 6.5 percent of our gross national product over those years.

What we are talking about doing here, as I understand the program that is being advanced by these distinguished congressmen, is to flow a percentage of that GNP that we have been utilizing for the defense of this country, and indeed the whole free world, against what we perceived to be a threat to our Nation and our lives, using a percentage of that GNP to rebuild the United States.

And I am enthusiastic to hear that their constituents are supporting this endeavor, because I find that my constituents in Tennessee feel the same way about it. And with the energy and enthusiasm of these new members of Congress, Mr. Chairman, I think that we can see a light at the end of the tunnel.

That is all I have to say, but thank you very much for appearing here this morning.

REPRESENTATIVE THORNTON. Thank you, Chairman Sasser.

REPRESENTATIVE COLLINS. Thank you.

SENATOR SARBANES. Thank you very much, Chairman Sasser.

I think we all share the sentiment that Jim has expressed. You have been a very powerful and helpful panel. We very much appreciate your testimony. We even more appreciate the tremendous work you are doing on the House side to marshal your colleagues in support of this plan for America. And we thank you very much for your testimony this morning.

REPRESENTATIVE COLLINS. Thank you.

REPRESENTATIVE THORNTON. Thank you, sir.

REPRESENTATIVE ROEMER. Thank you.

SENATOR SARBANES. We will now turn to our second panel, if they will come forward.

Our second panel this morning consists of: Jeff Faux, president of the Economic Policy Institute; James C. Miller, III, who is former director of the Office of Management and Budget, a frequent appearer before the Congress in those days, and now chairman of the private-sector group, Citizens for a Sound Economy; and Michael Peevey, who is the president of Southern California Edison Company.

Gentlemen, we are pleased to have you here.

We will start with you, Mr. Faux, and then we will go to Mr. Miller and wind up with Mr. Peevey. We will include your full statements in the record, and if you will proceed, we would be happy to hear from you.

STATEMENT OF JEFF FAUX, PRESIDENT ECONOMIC POLICY INSTITUTE

MR. FAUX. Thank you, Mr. Chairman and Senator Sasser, for having us here. I will submit my testimony and some backup material and just summarize it for the present purposes.

As a number of people have testified before this Committee in recent weeks, the economy has both short-term and long-term problems. The question that confronts us is: What do we do in the short term that also provides benefits for the long-term problems of slow growth and lagging productivity? It seems to me that the answer is to expand the rate of public investment in human capital, physical capital and civilian technology.

This is not the only answer. We need an expansionist monetary policy. We need to strengthen the safety net. In the longer term, we need more sensible trade and industrial policies. But public investment is the single most important thing that we can do now to solve the immediate issue of economic stimulation and to also provide some support for our long-term capital needs.

The deterioration in public capital in recent decades is now widely acknowledged. But although there is almost a consensus on this today, we are also told that we must first wait until we eliminate the fiscal deficit before we begin a serious program of public investment. In other words, we should forego public investment now in order to create more savings for private investment in the future.

I think that this is a self-defeating policy. It makes sense to be concerned about our savings rate. But under current conditions, we need more public investment in order to have more private investment. Private investment in today's economy is not primarily driven by the savings rate. It is primarily driven, first, by customers coming in the door with money in their pockets to buy goods; and, second, by improvements in productivity in both labor and capital.

Public investment pays off on both the supply side and the demand side. In the short term, it is clear that we need a fiscal stimulus. In this regard, I want to congratulate Senator Sarbanes and Senator Sasser for this morning's article in the *Washington Post*, which I thought helped clean up the widespread confusion about the issue of the deficit. In the short term, we need a fiscal stimulus to put money in the pockets of customers coming in the door to buy goods and services.

As a stimulant, public investment is clearly superior to a tax cut. More will be spent faster. And because it is more potent than a tax cut, it would require less of an increase in the deficit than would a tax cut to get an equivalent stimulus.

So, for those who are concerned about the deficit, and we all should be in the long run, you have less of a rise in the deficit if you put your stimulus into domestic spending.

Over the long term, there is a clear link between public investment and productivity growth. The chart that you have up there is also included in my testimony. David Aschauer, the economist who calculated those numbers for the Chicago Fed also did a study for the Economic Policy Institute, in which he analysed productivity growth and public investment among various countries. He found the following: Had we continued to invest in the public sector over the last 20 years at the rate that we were investing in 20 years ago, the impact on private investment, private profits and private productivity would have been dramatic. His analysis shows that private productivity would have gone up 50 percent; private profits would have gone up 22 percent; private investment, 19 percent. Because of this two decades of neglect, the returns on public investment are now very high. And for every one dollar that we put into public investment, we get an additional 45 cents going into private investment.

SENATOR SARBANES. Let me be graphic. I have talked to a trucking company executive, who said to me, "If my truck is sitting in a traffic jam for 2½ hours and can't get through to deliver the goods, that is coming right out of my productivity." He is absolutely correct.

MR. FAUX. You can see the same pattern in investment in human capital and certainly in technology. There are many studies, which I have outlined in my testimony, that show the direct connection between human capital investment and economic growth. Statisticians and flat-earth economists will quibble over the detail, but there is practically no one, I believe, who would quibble with the statement that today the connection between public investment and private investment is strong and it is positive. One of the reasons, of course, is that our public investment has been declining so much over the past 20 years.

In Figure 2 of my testimony—and I don't know if you have it there—I have a chart that shows the decline in federal spending in public investment, as a percentage of gross national product. It has been dramatic, and it will continue to decline under the conditions of the current budget agreement. If you look at that chart, you will see it declining out to 1996.

The states have not taken up the slack. They are now, as you know, cutting back dramatically. Last fall, the Economic Policy Institute did a survey of the neglected investment needs in the public sector. We went through a series of interviews with experts and concluded that the Federal Government would have to spend an additional $60 billion right now in order to avoid falling further behind our major competitors in the world. That is bare minimum.

If we don't spend that sum this year, it will add that much more to next year's budget needs because the problems are cumulative. If you don't repair that bridge this year, you have got a whole series of other bridges to repair next year, plus the one you didn't do this year.

The same is obviously true in the area of human investment. The dropout from our failure to invest in this year costs society even more next year. $60 billion is minimum. $125 billion would get us to the point

where we would begin to be competitive in this area. That still does not make us competitive with our major competitors.

We may be understating it. Economist Robert Heilbroner pointed out that it would take a quadrupling of public investment for us to get to the levels of Japan and West Germany.

Figure 3 of my testimony illustrates a strategy for raising public investment over a five-year period, starting with an increase in $60 billion for the first full year. The $60 billion estimate was quite independent, by the way, of any concern for fiscal stimulation, but it turns out, as testimony before this Committee has underscored, that $60 billion is just about the kind of stimulus that many economists think we need.

SENATOR SARBANES. Professors Samuelson, Tobin and George Perry all said about 1 percent of GNP, which would work out to about $55 billion to $60 billion.

MR. FAUX. That's right. And I just want to underscore that we came to the number last fall, building it up from the bottom rather than through macroeconomic concerns.

The strategy we suggest would begin with $60 billion, which is about 1 percent of GNP and about the average stimulus of about the last six recessions. It would reach $125 billion in the next five years, still trailing Germany and Japan.

The financing of such a strategy would shift over the period. In the next couple of years, it would make sense to borrow in order to get the stimulus, because the peace dividend will take a fair amount of time before it kicks in. No matter how you look at it, those savings from national defense do not occur in big numbers in the early years.

Later, when the economy is approaching capacity, when we are moving toward full employment, then it would make sense to finance more of it out of the increasing increment from the peace dividend and from taxes at that point. The peace dividend may be underestimated in our chart. It was designed around military savings that were estimated before the disappearance of the Soviet Union.

SENATOR SARBANES. Before?

MR. FAUX. Before. Yes. So, I think there is more there.

It also does not make any estimate of additional growth that would come because of the private investment, public investment spending. But even being very conservative about this, you get a sensible plan, an investment financing plan that is consistent with what Samuelson and Tobin talked about last week. Thus, we should borrow right now because we need a stimulus, but as we get the economy moving in toward full employment, we ought to be financing it out of current revenues.

In addition, right now, given the urgency for growth, it would seem to me that we want to put this money out there fast, at least in the remainder of this fiscal year. The best option is straightforward revenue-sharing. It comes out to about $35 billion for the rest of this fiscal year, few strings attached. This would give us an immediate impact on the economy,

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without the funds having to filter down through a lot of bureaucratic red tape. Starting in fiscal 1993, you would want this investment to be more restricted, I think, to make sure that it corresponds to long-term plans for the development of the public sector.

I would point out that this would add zero to the structural deficit, no new borrowing, at full employment.

We would also expect the composition of public investment spending to change. For example, increasing public investment does not mean that we have to redo the National Defense Highway Act. Just as in the past, we invested in the future in a transportation program that would make sense for the 1980s and 1990s, now we need to invest in a transportation program that makes sense for the 21st century.

A forward looking public investment program would emphasize the use of newer technologies that are more environmentally benign and which provide the potential for creating homegrown industries that then can become world leaders. I would direct your attention to the experience of Japan and France and now Germany over the last couple of decades. They built modern, efficient transportation systems to serve the transportation needs of their own countries, and on the basis of that strategy, they developed firms and industries that could sell the switching equipment, trains and similar technologies all over the world.

I think that is the kind of strategy that we ought to be pursuing. It generates public investment not merely to increase the services in the long run in this country, not merely to increase productivity, but also to develop international champions in important sectors of the world economy.

It is also consistent with the notion that we have to reform the way the public services are being delivered. Nothing here precludes that. As a matter of fact, I would argue that by increasing the total amount going into these areas that it gives the Federal Government more leverage to get reforms going in the provision of public services at all levels of government.

Again, I want to underscore that the concern with the deficit and the concern with the long-term savings rate is really no excuse for not investing today. Most people are concerned with the deficit over the long term because they believe that it will retard future investment and savings. But this concern is retarding investment now, and if we don't raise public investment today, we can expect private savings and investment to decline in the future. Thank you.

SENATOR SARBANES. Thank you very much.

[The prepared statement of Mr. Faux, together with attachments, follows:]

PREPARED STATEMENT OF JEFF FAUX

The U.S. economy faces major problems in both the short and long term. Currently, we have slid into the second trough of a double-dip recession. Over the longer term, we face a continuation of the unsatisfactory pre-recession trends of slow income growth, flagging productivity, and eroding international competitiveness.

The immediate question is this: what can we do to stimulate the economy in the short run that will also help solve our longer term structural problems, regardless of when the current recession ends?

The most sensible answer is a multiyear expansion of public investment in human capital, infrastructure, and civilian technology beginning now. Increased public investment is not the only answer to our economic maladies. In the short term, we need more stimulative monetary policy and an extension of our still too limited unemployment compensation safety net. In the longer term, industrial, trade and tax policies need to be improved. But under current circumstances, reversing the decline in the rate of public investment is the single most important step we can take toward restoring America's economic health, today and tomorrow.

The deterioration of America's human and physical capital is now widely acknowledged. Indeed, we are approaching a consensus across ideological lines that more investment should be a priority. But a serious

investment program has been blocked by the notion that we must first eliminate the federal deficit (or, as some would have it, wait for a budget surplus). Given the fact that we have no hope of doing so in the foreseeable future, this policy condemns us to continued disinvestment in the public sector for the rest of the decade. The result will be further erosion in living standards and competitiveness.

The economics of this policy are perverse. We are told that public investment must wait for deficit reduction because of the need to expand national savings, which at some unspecified time in the future the private sector will use for investment. But public investment is as crucial to the economy as is private investment. Moreover, as we shall see, unless we increase public investment, it is unlikely that our hopes for private investment will be realized, no matter what happens to the deficit.

Public Investment: Short Run Benefits

The current recession is the ideal time to begin a public sector reinvestment program. A fiscal stimulus is obviously needed. The overhang of debt and the financial disarray caused by the policies of the last two administrations have rendered monetary policy too weak to stimulate a healthy recovery by itself. Neither has the promised export-boom materialized.

In addition to the immediate pain and suffering of unemployment and

income loss, there are considerable long-term risks in permitting today's economy to remain stagnant or at low levels of growth. By shrinking the incomes of business, consumers, and governments, recessions deny business the prospect of sales, which is the most important stimulant to investment. Recessions also lower national savings, reducing the country's ability to finance investment. Bankruptcies and mass layoffs shatter the organization of people and skills that makes up the most important asset of a business firm. The longer a temporary recession lingers, the more permanent damage it does.

More money must be spent somewhere in order for the economy to recover. Consumers aren't spending because their incomes are stagnant, they fear for their jobs and they are deep in debt. Business isn't investing because consumers aren't spending. Foreigners aren't clamoring to buy our goods; indeed, when consumer buying recovers our trade balance will worsen. Financially strapped state and local governments are cutting spending and raising taxes. This leaves the federal government as the only potential source of significant new spending.

As a macroeconomic stimulus, increasing public spending is superior to cutting taxes for either business or middle class consumers.

Neither cuts in capital gains taxes or an investment tax credit is likely to have much of an energizing effect when demand is weak. In today's economy, firms are not generally inspired to invest because of changes in tax

rates, but when they see customers -- either business customers or consumers -- coming in the door to buy their goods or services.

But neither are middle class tax cuts the best way to restimulate immediate demand. Although most of a permanent tax cut will be spent in the long run, the evidence is strong that in the first year of either a permanent or temporary tax cut, most of the increase in disposable income (the economic models we work with suggest about 65 percent) would be used to pay off debts or saved, and therefore not enter the spending stream. Thus, the stimulant is muted when it is most needed. Moreover, a substantial share of the induced spending that does occur would be siphoned off in the purchase of imports.

Compared with tax cuts, increased public domestic spending -- primarily through some form of emergency revenue-sharing for state and local governments --would provide a faster, more potent stimulant. It would directly reemploy more people now out of work -- not just in the public sector but in hard-hit sectors such as construction as well. It would also have the added effect of helping out financially crippled states and localities. Because public domestic spending works more powerfully on the economy, it would require a smaller increase in the deficit to achieve a given stimulus than would a tax cut.

The conventional objection to public spending as an anti-cyclical measure is that it takes too much time for the actual spending to materialize

(projects must be designed, contracts awarded, etc.). But today state and local governments have substantial numbers of ready-to-go projects that have been put on hold because of the recession-induced decline in tax receipts (construction projects abandoned, schools and training centers shut down, infrastructure repairs planned but not completed). The fiscal squeeze has left states and cities with a capacity to absorb and disburse funds quickly.

A middle class tax cut is certainly justified on distributional grounds, given the upward redistribution of income and wealth that occurred in the 1980s. But this can be done in a revenue-neutral fashion. The question of tax fairness should not be confused with the question of economic stimulus.

Likewise, a shift in business taxes to encourage a better allocation of capital toward longer term productive investment and to discourage short-term horizons makes sense. But this too should more properly be done on a revenue-neutral basis.

Public Investment; Long Run Benefits

The fundamental income problems of this nation's working people are not rooted in tax policy. For example, only one-sixth of the 1977-90 redistribution of income from the bottom 80 percent of families to the top 20 percent was the result of tax changes. The bulk of the problem of declining real wages and stagnant incomes lies in the fact that the economy is creating lower paying jobs. This in turn is a function of the slowdown in our

productivity and the decline in our competitiveness. We cannot solve these more deep-seated problems without increasing investment in both the public and private sector.

Today, the rate of public investment is clearly inadequate. Between 1950 and 1970, the civilian public physical capital stock grew at an annual rate of four percent. Since 1970 it has averaged 1.6 percent, reflecting substantially lower rates of growth at federal, state, and local government levels. While the U.S. was cutting back on its public capital investment, our major competitors were adding to theirs at a higher rate. Japan, for example, invested 5.1 percent of its GNP in public capital between 1973 and 1985, while the corresponding figure for the U.S. was 0.3 percent.

Figure 1 shows the association between productivity and infrastructure investment among the group of seven advanced industrial countries.

Recent research suggests that in the U.S. economy each additional dollar of public infrastructure investment raises private investment by 45 cents. If, since 1970, the U.S. had maintained the 1950s and 1960s share of GNP for core infrastructure (roads, bridges, airports, water and sewer systems, etc.), productivity growth would have been 50 percent higher; the average profit rate would have been 22 percent higher; and the rate of private investment would have increased by 19 percent.

Returns to the nation from human capital investment are also high. For example, we have solid evidence that:

-- job performance rises with education and training;

-- in the first two years after a worker is trained, his or her productivity rises four or five times faster than compensation;

-- investing in lower class sizes substantially increases reading and math scores;

-- $1 invested in HeadStart saves $4 to $6 in special education, public assistance, and crime costs;

-- $1 invested in prenatal care saves $3.38 in care for low birth weight babies.

The list of such benefits is long and the evidence is clear. Statisticians may quibble with the precise estimates, but we know the relationship between public investment and long-term growth is positive and strong.

In 1989, the Economic Policy Institute presented to this Committee a statement signed by over 325 economists, including six Nobel Prize winners. It described growing Public Investment Deficit that "will have a crippling effect on America's future competitiveness." According to the economists:

> Just as business must continually reinvest in order to prosper, so must a nation. Higher productivity -- the key to higher living standards -- is a function of public, as well as private, investment. If America is to succeed in an increasingly competitive world, we must expand efforts to equip our children with better education and our workers with more advanced skills. We must assure that disadvantaged children arrive at school age healthy and alert. We must prevent drug abuse and dropping out among teen-agers. We must fix our bridges and expand our airports. We must accelerate the diffusion of technology to small and medium sized business.

Since then the situation has gotten worse.

Public Investment Needs

Figure 2 shows the recent decline in Federal spending for domestic investment and projects the coming investment declines implied by the current budget agreement. The definition of investment used is narrow; it does not include spending on health, housing, environmental cleanup, and other areas of social need which add to the nation's economic strength. (For more detail see the EPI Briefing Paper, "Increasing Public Investment.")

States and localities have not been able to pick up the slack. Education spending by states rose somewhat during the 1980s, but was less targeted on the disadvantaged, whose needs for resources are greatest. And, at any rate, the U.S. ended the decade spending proportionally less on grades K - 12 than its major international competitors. State and local spending for infrastructure actually declined over the period, and there was virtually no effort to raise state and local spending for training and civilian R & D, which have tradditionally been Federal functions.

A survey by EPI of sector-by-sector needs last fall concluded that it would take a minimum of $60 billion additional spending this year just to keep basic human and physical infrastructure from deteriorating further. A serious program to begin to repair the damage from a decade of neglect and to make significant additions to the nation's public capital would cost $125

billion annually -- roughly double our present spending level.

These numbers may well be conservative. Economist Robert Heilbroner points out that a quadrupling of public investment would be required to put the U.S. on a par with the performance of Germany and Japan. This would roughly equal the share of GNP devoted to such investment in the 1950s.

Any long-term public investment program would not and should not be directed at the investment projects of the past. In fact, the point of an investment strategy is to support the economy of the future. Thus, a transportation infrastructure program should be aimed at the technology of the 21st century, such as high speed rail transportation, electric cars, automated highways, vertical lift aircraft, etc. Not only would this provide the nation with a more efficient way of moving people and merchandise, it would generate enormous private investment opportunities to develop technologically advanced American firms who can compete in world markets.

Financing Public Investment

There are three possible sources of financing:

Borrowing. Borrowing for capital investment -- either directly or through government guarantees -- is as sensible for governments as it is for business or individuals. States, localities, and other nations typically operate with capital budgets which are separated out from operating budgets.

But the last decade's increase in the federal deficit did not reflect recent

borrowing for investment, as evidenced by a deficit three times as large as the investment budget. Instead, it reflected borrowing to finance tax cuts for upper income taxpayers and increased military consumption.

The current budget agreement between Congress and the White House further violates common sense budget policy. By putting a cap on discretionary domestic spending (the budget category containing public investment) but permitting "off-budget" increases in spending for such purposes as the bail-out of the savings and loan insurance fund, the U.S. government is essentially borrowing to pay off past economic losses and forcing capital investment to conform to inadequate current revenues.

Although the U.S. government lacks a capital budget, it certainly could apply capital budget principles to the spending choices that it faces over the next few years.

Sensible rules of both accounting and economics would suggest that the government should borrow for its investment programs in a time like the present when unemployment is high and the economy needs a net stimulus. But as the economy moves toward full capacity and inflationary pressures develop, more of the investment budget should be supported by taxes.

Taxes. As suggested, raising taxes is not appropriate when the economy is suffering from weak demand. But the U.S. as a whole is undertaxed. If the U.S. tax share were equal to the average share of OECD nations, we would be raising more than $400 billion in additional public

revenues. Under current proportions, 60 percent would be federal. Over the long run, higher taxes are needed in order to support a sustained reinvestment program.

The Peace Dividend. It is now obvious to almost all that a sizeable peace dividend can be had over this decade. A bare minimum of military savings is reflected in the analysis of William Kaufmann and John Steinbruner of the Brookings Institution. Their plan, calculated before the disappearance of the Soviet Union, would cut the defense budget by a total of $175 billion in budget authority and $130 billion in actual outlays (both in 1992 dollars) over five years, once the cuts begin. Given the events of recent months, this is clearly an underestimate of the potential savings. For the purposes of this discussion, the problem with the peace dividend is that it will take some time for the savings to be realized. But as the attached Briefing Paper, Investment-led Stimulus, shows, the projected Peace Dividend can be used as collateral for borrowing without raising the longer term deficit.

Illustrative Five-Year Public Investment Plan

Figure 3 illustrates a path to raising public investment by an accumulated total of $460 billion in 1992 dollars over the next five years in a way that contributes to solving both macroeconomic and structural problems.

New outlays would begin at the rate of $60 billion a year -- the minimum needed to keep the nation from adding to its investment gap. This

is also approximately the average fiscal stimulus (1 percent of GNP) provided by the federal government in the last six recessions. This would imply an outlay of about $35 billion in the remainder of fiscal year 1992. New investment outlays would reach $125 billion by 1997. It is a measure of how far the U.S. public investment rate has fallen that this plan would still leave the U.S. trailing the public investment rates of Japan and Germany.

In order to accommodate the urgency for stimulus now, the $35 billion for the reminder of this fiscal year would be spent in the form of emergency general revenue-sharing to replace the fiscal drag resulting from state and local cutbacks and tax increases. To avoid bureaucratic slowdown, there should be minimal restrictions of how the money could be spent. There is some risk that not all the money would be spent and not all that is spent would go for investment-type programs. But we can have some confidence that the bulk of the spending would go to bring back teachers to school, reopen training centers, complete transportation and other public works projects that would raise the nation's longer term productivity and competitiveness. Any dollars spent for other programs would still effectively counteract the current contractionary actions of the states and localities.

The investment budget for Fiscal 1993 would be more restricted and targeted by Congress and the Administration to assure that it is being spent for investment purposes. Requirements for local contributions would be strengthened.

Financing of the program would shift over time. In the initial phase, most of the money would come from borrowing to assure a stimulus when unemployment is high and inflation dormant. A small amount would come from the early proceeds of a peace dividend, as defined by Kaufmann and Steinbruner. In the later years -- when the economy was approaching full employment -- all of the program should be paid for with taxes and military budget savings. To the extent that the Kaufmann/Steinbruner analysis understates the potential peace dividend, the amount that would have to be paid for by taxes would be reduced.

Note that the proposal adds zero dollars to the structural deficit. As shown in Figure 3, this plan is grafted onto the spending projections assumed in the current budget agreement. Other than in the first two years (when the program is intentionally deficit-funded as a fiscal stimulus), it preserves the the budget agreement's long term objective of fiscal responsibility. The defense savings included in the agreement, i.e., the Cheney "peace dividend," are preserved for their original purpose -- deficit reduction. Only the additional defense savings, i.e., the "peace dividend," along with increased tax revenue, are redirected for domestic investment purposes. This would conform to the principles of a capital budget that the deficit should be reduced to no more than the level of investment spending.

Question: Won't Such A Plan Be Inflationary?

Fears of inflation are exaggerated; the economy is currently operating at a minimum of $250 billion below capacity. An injection of $60 billion into the spending stream should have no more inflationary effect than if consumers decided themselves to spend an equivalent amount. In fact, as indicated above, government spending will be less inflationary because it will tend to directly reemploy the unemployed rather than simply increasing the after-tax income of those who are already earning a paycheck. Moreover, over the longer run, public investments add to supply capacity which helps resist inflation.

Question: Won't Such A Plan "Spook" the Financial Markets?

Accepted wisdom among some policymakers and economists is that any fiscal stimulation of the economy will add to the deficit, thereby reducing savings available for future investment. The theory is that private investment depends on the availability of national savings, which determines the interest rate and therefore the cost of capital to business. Increased government spending -- whether financed through taxes or borrowing -- supposedly reduces the supply of private savings and raises interest rates, which in turn lowers investment and economic growth. According to the theory, financial markets, anticipating this sequence, will "spook" -- that is raise interest rates now, and thus negate the effect of the fiscal stimulus.

Among the flaws in this line of reasoning are:

1. Attempting to raise investment by reducing national consumption is counterproductive. In the real world, investment is not primarily driven by the savings rate, but by expectations of profit from expanding sales. Lower interest rates simply reduce the price of borrowing money for an investor who wants to invest. But if consumption is constrained, markets will not expand and investors will not invest, despite lower interest rates. As the recent recession has shown, when consumers reduce spending, saving does not rise, it falls because the growth in incomes is reduced.

2. History shows little evidence of private investment in the United States is being "crowded out" by the U.S. government deficit. For example, interest rates have declined substantially over the last year in spite of a $100 billion rise in the federal deficit. Moreover, the globalization of finance gives America access to a world pool of savings, increasingly freeing them from dependence on the U.S. savings rate.

As economist Herb Stein, chairman of Richard Nixon's Council of Economic Advisers, recently wrote in the Wall Street Journal, "No one really knows what affects the confidence of investors, or by how much. [If a $50 billion deficit stimulus results in increased sales, worked off inventories, and rising profits] are investors going to bang their foreheads and say: 'Egad, the deficit is rising. We better hunker down, sell bonds, and stop investing'?"

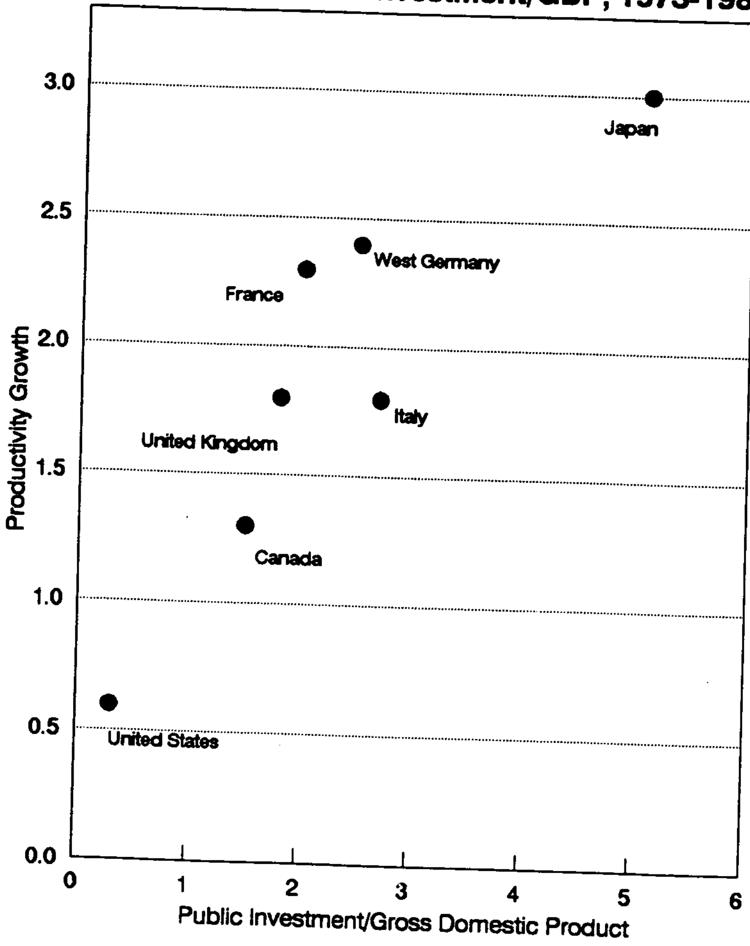
3. Without the prospect of rising sales, capital is often diverted into asset speculation, rather than into productive plant and equipment. This

occurred in the 1980s when the corporate sector borrowed $1.3 trillion to "invest" in leverage buyouts, junk bonds, and other forms of paper entrepreneurship which left them weakened by a huge debt burden with no increase in productivity to show for it.

4. Finally, the presumed effect of a higher deficit on financial markets is primarily a guess as to what the Federal Reserve will do. Since the Fed has consistently overcompensated for inflation fears by keeping interest rates high, market anxieties are understandable. But these anxieties are a function of Federal Reserve policies. If economic policy is paralyzed because Congress and the President are afraid of what the Fed will do, then the answer is not to prolong the recession, it is for both Congress and the White House to have a long talk with Alan Greenspan.

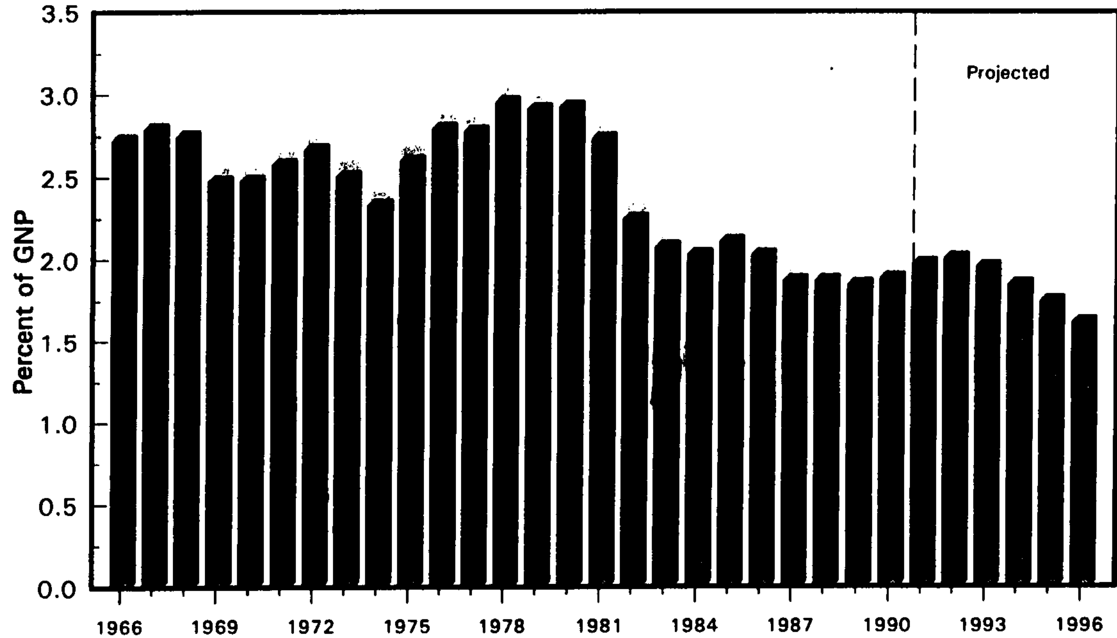
This is not to deny that savings is an important long-term factor in sustaining high levels of investment. Under conditions of rising demand and sustained full employment, efforts to raise the savings rate and to retard consumption are appropriate. But under the conditions the nation faces today, attempting to raise the savings rate is likely to result in less, not more investment. And less, not more, savings.

Figure 1
International Comparison of Productivity Growth and Public Infrastructure Investment/GDP, 1973-1985



Source: Aschauer, "Public Investment and Private Sector Growth," EPI, 1990.

Figure 2
Federal Investment Spending as Percent of GNP, Fiscal Years 1966-1996



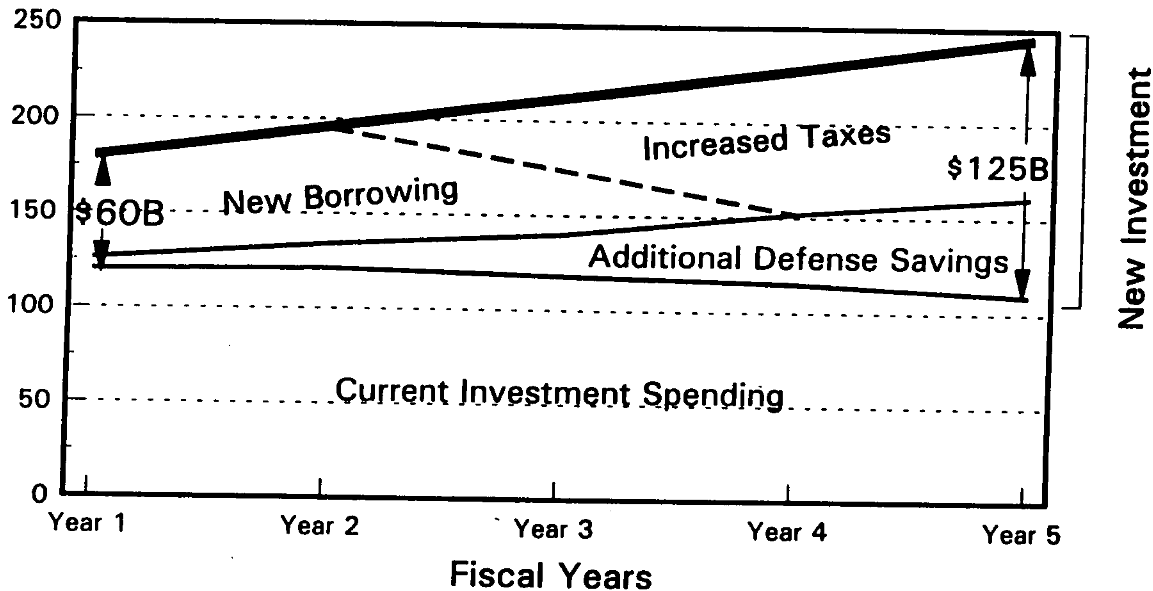
Source: "Increasing Public Investment," EPI, 1991.

Figure 3

FIVE-YEAR PUBLIC INVESTMENT PLAN

(Outlays, Billions of 1992 Dollars)

Billions of Dollars



Source: EPI

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INVESTMENT-LED STIMULUS

A PLAN FOR SHORT-TERM RECOVERY AND LONG-TERM ECONOMIC GROWTH

by Jeff Faux

The U.S. economy faces major problems in both the short and long term. Currently, it totters between an anemic recovery and a double-dip recession. Over the longer term we face a continuation of the unsatisfactory pre-recession trends of slow income growth, flagging productivity, and eroding international competitiveness.

This paper outlines the case for a modest, politically reasonable, fiscal strategy which will stimulate employment and production growth in the short run and expand public and private investment in the longer term.

1. DEFICIT PARALYSIS

The current federal deficit has trapped policymakers into believing that any effort to stimulate growth through expansive fiscal policy will do more harm than good because it will burden the economy with more debt in the long run and, thereby, raise interest rates. Indeed, some have been so mesmerized by the deficit that they advocate a deflationary policy of budget-cutting even though we are still in recession and in spite of the virtual consensus among economic forecasters that the next few years will see continued slow economic growth. As history shows, the result of attempting to slash the deficit at this point would be higher levels of unemployment, lower government revenues, and, in all probability, higher deficits.

In effect, recent economic policy reflects an implicit acceptance of pain, suffering, and loss of production *today* in exchange for a hope that unnamed

benefits will somehow automatically appear in some unspecified *tomorrow*. The scenario of hope goes like this: 1) eventually short-term interest rates or inventories will be low enough to spark a recovery; 2) this recovery will be strong enough and last long enough to eliminate the fiscal deficit at some point in the future; 3) at some even more remote point in the future, we may begin to address the longer term economic problems by investing in human, physical, and technological resources.

This policy -- based on hoping for the future, rather than planning for the future -- is fatally flawed. First, any realistic projection of budget and growth capacity in the 1990s suggests that *such a scenario precludes a meaningful investment program before the 21st century*. This will inevitably mean a further deterioration of U.S. competitiveness and living standards.

Secondly, rigid distinctions between short-term and long-term growth are artificial. The long-term risks of permitting today's economy to remain stagnant or at low levels of growth are considerable. By shrinking the incomes of business, consumers, and governments, recessions deny business the prospect of sales, which is the most important stimulant to investment. Recessions also lower national savings, reducing the country's ability to finance investment. And bankruptcies and mass layoffs shatter the organization of people and skills that makes up the most important asset of a business firm. The longer a temporary recession lingers, the more permanent damage it does.

The idea that nothing can be done to stimulate growth today without hurting the economy tomorrow is an error. The large fiscal deficit does limit our room for fiscal maneuver. Nevertheless, as the following argument suggests, there is still some room for action, and it makes economic and political sense to take advantage of it.

2. INVESTMENT-LED GROWTH

A fiscal stimulus requires the creation of net additional spending, i.e., an increase in the fiscal deficit. Without an increase in the deficit there is no economic juice to "jump start" the economy. Certainly, any effort to *reduce* the deficit right now would be dangerously misguided; it would reduce demand in the economy and slow growth further.

The question is whether we can design a stimulus for the short term that would do more *good* than *harm*, i.e., would provide long-term benefits for the economy *regardless of whether or not the economy picks up later in the first or second quarter.*

Attempting to stimulate the economy through tax cuts does not meet this criterion. Despite claims to the contrary, there is no evidence that cuts in capital gains taxes or an expansion of IRA benefits to all taxpayers will stimulate investment.

The case against a capital gains tax cut is well established. The experience with the 1986 tax reform when venture capital investment rose to record heights after the capital gains tax benefit was eliminated is but one of many pieces of evidence. When pressed, even the most fervid advocates of a capital gains tax cut admit the effect will be minuscule at best. In testimony before the Joint Economic Committee, Michael Boskin, Chairman of the Council of Economic Advisers, conceded that, even under his optimistic assumptions, the Administration's proposal would have an effect on investment equivalent to a drop in interest rates of "probably 10 basis points, or something like that, [perhaps] 15." (Thus, for example, a drop from 7 percent to 6.85 percent.) To put this into perspective, a drop in the prime rate between October 1990 and October 1991 of almost 250 basis points (7.81 percent to 5.34 percent) was not sufficient to induce a halt in the slide of business investment.

Proposals to stimulate the economy with cuts in middle class taxes repeat the error of the early 1980s when, in effect, the public sector went into debt in order to finance private consumption, leaving us with both a fiscal and a trade deficit. Proposals to cut *both* taxes on capital gains and on the middle class are contradictory; they attempt to increase savings and consumption at the same time.

On the other hand, public spending on areas that clearly represent investment in the future has a clear advantage to the economy over a tax cut in terms of both a short-run stimulus and long-run investment, both public *and* private.

In the short run, when the objective is to stimulate domestic spending, consumer-oriented tax cuts are inferior to public investments. Roughly 5 percent of tax cuts would be immediately saved, and thus never enter the spending stream.

Moreover, a larger share of the tax cut-induced new spending would be siphoned off in the purchase of imports. And, unlike public spending, tax cuts cannot be easily targeted to sectors and geographic areas where unemployment is highest.

One point that is often overlooked in the debate is that the stimulative effect of consumer tax cuts will be diluted if they are spread out over a year. For example, a net stimulus of $20 billion in cuts in payroll or income taxes will directly increase disposable income only about $400 million per week, with the last installment twelve months away. The first dollars of an equivalent public spending stimulus will hit the economy a little later than the first dollar of a tax cut, but the *total* $20 billion could be spent faster than with a tax cut. Of course, a lump-sum tax cut is always possible, but it would be seen as an unprecedented quick-fix election year giveaway.

The conventional objection to public spending as an anti-cyclical measure is that it takes too much time for the actual spending to materialize (projects must be designed, contracts awarded, etc.). But today state and local governments have substantial numbers of ready-to-go projects that have been put on hold because of the recession-induced decline in tax receipts (construction projects abandoned, schools and training centers shut down, infrastructure repairs planned but not completed). The fiscal squeeze has left states and cities with a capacity to absorb and disburse funds quickly.

But it is the longer-term value of public investments that make them the better instrument of fiscal stimulus. Even if growth should suddenly rebound, making stimulus superfluous, *the direct benefit of public investments and their stimulative effect on private investment would still yield economic dividends.*

It has now become clear to most people that the neglect of public investment -- human capital, physical infrastructure, civilian technology -- in recent years is a significant drag on the nation's productivity and competitiveness. Whether compared with our own more prosperous past or with the investment performance of our major competitors, the rate at which we are investing in the future is inadequate. And each year that we postpone a serious expansion of public spending in these areas, the burden on the economy becomes heavier and more expensive to solve.

Recent research by economists David Aschauer, Alicia Munnell, and others has confirmed that there are direct links between spending on public infrastructure and the growth of private investment, productivity, and profits. Aschauer, for example, found that in the long run each additional dollar of public infrastructure investment raises private investment by 45 cents. And evidence continues to accumulate that there are substantial returns to the nation from spending on education, training, early childhood programs, and civilian research and development (R&D). Statisticians may quibble over the precise numbers, but we know they are now positive and large -- in part due to the decades of neglect of public investment. Thus, *as a stimulant to private investment, public spending on human and physical infrastructure is superior to a capital gains tax cut.*

Moreover, given the depletion of public capital over the past decade and the strategic role it plays in stimulating private investment, at this point in our economic history, directly increasing domestic public investment is a quicker and more reliable path to the goal of raising both public and private investment in the U.S. than is radical deficit reduction. The primary economic case for giving priority to deficit reduction is that it will raise the national savings rate so as to permit more private investment. But, although savings facilitates investment, it does not stimulate it. When an economy is operating well below capacity, *as we have been operating for the last three years*, private investment will respond quickest to the new direct demand for goods and services generated by a public investment program.

Projections of public investment needs vary. EPI economists estimate that just to keep the gap from widening between needs and current spending for a narrowly defined list of public investments (education, training, physical infrastructure, civilian R&D) would require *a bare minimum* of $60 billion in additional federal spending this fiscal year. Others estimate that the shortfall is much larger.

Could we justify increases in the deficit at this time? Almost everyone would agree that it is perfectly appropriate for government to borrow in order to invest in the future. To the extent that an investment makes the nation more productive, increased tax revenues will be available to pay off the loan. Indeed, if the federal government's budget were kept in a more orderly, business-like manner, it would

separate its operating accounts (current spending) from its capital accounts (investment in the future). Thus, up to a point, the size of the deficit is not as important as the uses to which it is put. Especially at a time of high unemployment and low rates of capacity utilization in the business sector, raising the deficit by making investments that would increase national productivity in the long run is clearly justified.

Yet, it is said that expanding the deficit will "spook" the financial markets, undermining investors' confidence in stable prices over the long term, which in turn will lead to higher interest rates. A key assumption is that, in response to a higher deficit, the Federal Reserve will raise interest rates in order to choke off future inflation generated by faster growth. These higher interest rates will discourage future investment.

It is important to understand that such anxieties about the long-term consequences of an anti-cyclical deficit increase are rooted in conjecture, not in convincing evidence.

As economist Herb Stein, chairman of Richard Nixon's Council of Economic Advisers, recently wrote in the *Wall Street Journal*, "No one really knows what affects the confidence of investors, or by how much." Stein wonders if a $50 billion deficit stimulus results in increased sales, worked off inventories, and rising profits: "Are investors going to bang their foreheads and say: 'Egad, the deficit is rising. We better hunker down, sell bonds, and stop investing'?" It is unlikely for a number of reasons. *First*, inflationary pressures are presently absent from the economy and, following most economic forecasts, will be for at least the next 18 - 24 months even if we assume that a recovery has already started. *Second*, there is no clear historical connection between federal deficits and long-term interest rates. For example, federal deficits as a percent of GNP doubled between fiscal 1989 and 1992 while both short- and long-term interest rates declined. Over the last decade interest rates and the deficit as a percent of GNP have gone in opposite directions more often than not. *Third*, over the long run, public investments add to supply capacity which helps resist inflation. *Finally*, the presumed effect of a higher deficit on the market is primarily a guess as to what the Federal Reserve will do. Since the Fed has consistently overcompensated for inflation fears by keeping interest rates high, the market's anxieties are understandable. But these anxieties are a function

of Federal Reserve policies set by a group of people appointed by the President and confirmed by Congress. If economic policy is paralyzed because Congress and the President are afraid of what the Fed will do, then the answer is not to prolong the recession, it is for both Congress and the White House to have a talk with Alan Greenspan.

Still, whatever the fear is based on, the fear of deficits is widespread. Not having been exposed to a serious national debate over the *uses*, as well as the misuses, of government borrowing, the public is distrustful of deficit spending in principle. Should we dip back again into a recession, the political calculation may change. But in the face of a $365 billion deficit, there will have to be a much more drastic deterioration of the economy before a majority in Congress will vote for more spending if the consequence is a *permanent* increase in the fiscal deficit.

3. THE SPECIAL INVESTMENT FUND

However, we need not add to the long-term debt burden in order to get the stimulative benefits of at least an immediate modest increase in the rate of public investment. The prospect of reduced military spending permits us to borrow from the Peace Dividend and pay it back over the next five years. This would create a temporary deficit now, when it can help stimulate the economy, matched by a surplus later in the recovery, when some dampening of inflationary pressures may be needed.

The first step is to identify savings from the military budget over the next five years.

Based on analysis by the Congressional Budget Office (CBO) and the work of defense experts William Kaufmann of Harvard and John Steinbruner of the Brookings Institution, a cumulative reduction of $135 billion in budget authority over five years is a feasible and credible target. This amount should be isolated from the rest of the budget in a Special Investment Fund (SIF), with a legislative life of five years.

Because of the pattern of contracting in the military sector, spending cuts will lag behind reductions in budget authority. Therefore, a Peace Dividend of $135 in budget authority works out to an actual cut in military spending of about $100 billion over the same period. (Although over a longer term, the spending cuts will

approximate the budget authority reductions.) Moreover, the cuts will be back-loaded, i.e., most of the spending reductions will come in the later years. CBO estimates a pattern of "build-down" which begins in the first year with only $3 billion in savings.

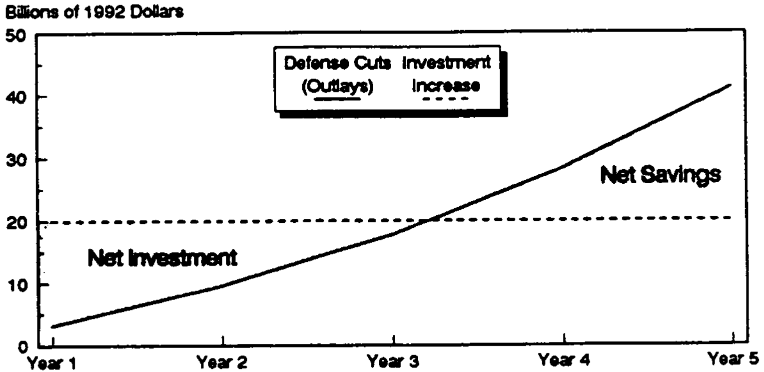
Both for long-term development and short-term stimulus reasons, the equivalent domestic investment spending should start at a quicker pace -- let us say an annual rate of $20 billion for the five-year period. If we immediately spend out the Peace Dividend at the rate of $20 billion a year the gap between the increase in domestic investment and the decrease in military spending will provide a maximum stimulus to the economy in the first year. The stimulus will then diminish until it becomes negative in the fourth and fifth year, when the military cuts would be greater than the domestic investment. This "surplus" would be used to pay off the deficit stimulus of the first two years.

The Special Investment Fund
(in billions of 1992 dollars)

Year	military cut	domestic investment	net stimulus
1	$3	$20	$17
2	10	20	10
3	18	20	2
4	28	20	-8
5	41	20	-21
	-------	-------	-------
Totals (Over five-year period)	$100	$100	0

As the table and figure (on p. 9) show, the SIF deficit would stimulate now when we need it. The suppressive effect of the SIF surplus would occur later in the recovery when the economy was stronger and when inflationary pressures would make it sensible to slow down demand. Over the five-year period the effect on the budget deficit would be neutral.

"Forward-Funding" $100 Billion from Defense to Domestic Investment



Note: The Defense Budget Authority cut necessary to achieve this level of Outlay savings is roughly $135 billion over the five years.

The years do not have to correspond to either fiscal or calendar years. Indeed, the whole point would be to get the stimulus out quickly. Certainly, it would make no sense to wait until the beginning of the next fiscal year in October 1992.

Because it does not increase debt in the long run, this modest *temporary* increase in the deficit cannot have any effect on long-term interest rates. A seventeen billion dollar stimulus in the first year represents less than a 5 percent increase in the 1992 deficit. It adds less than 1 percent -- roughly 0.6 percent -- to the national debt and only on a temporary basis. A ten billion dollar deficit in the second year is even less of a short-term burden. If anything, this proposal can be criticized for not providing enough stimulus.

Some may object that we cannot be sure that the surplus in years four or five will in fact be dedicated to paying back the deficit of 1992 and 1993. But this is precisely the virtue of isolating the SIF from other revenues. Congress and the

President would be signing a political IOU that would require that defense cuts not be used for other purposes. And if there is suddenly some new and extraordinary crisis which requires a reversal of the military cuts? In that case, the President and the Congress would be forced to do what they should have done in the 1980s -- raise taxes to pay for an expansion in the military budget.

In effect, the Special Investment Fund acts like a capital budget. Government, like any business or homebuyer or student, is justified in borrowing if the proceeds go to productive investment. The problem with the increased government borrowing of the last decade was that it was dedicated to financing military spending and tax cuts, which increased private consumption for largely upper income taxpayers. The SIF assures that the proceeds of the Peace Dividend will not be so recklessly wasted.

The same principle, of course, could be applied to other investment-type spending based upon secured future income. Highway and other trust funds, for example, could be "forward funded," i.e., spending accelerated now and decelerated later.

Finally, nothing in this anti-recession strategy precludes a middle class tax cut that is "revenue neutral" -- such as the Gore-Downey proposal. Nor does it preclude a revenue-neutral shift in business taxes, which would lessen the burden on long-term investments and raise taxes on income from short-term speculation. Neither does it preclude an overdue effort by Democrats to support a more stimulative monetary policy.

It is a sensible step that provides net benefits for the economy, much more so than tax cuts or deficit reduction, no matter what happens to growth over the next few months.

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INCREASING PUBLIC INVESTMENT

NEW BUDGET PRIORITIES FOR ECONOMIC GROWTH IN THE POST-COLD WAR WORLD

by Jeff Faux and Todd Schafer

INTRODUCTION

Serious economists have always understood the critical contribution government investment makes to healthy economic growth. Adam Smith -- who over 200 years ago made the fundamental case for private markets -- held that spending for public works and education was as important a function of government as national defense and the provision of justice. The history of market economies since then proves the point. The United States, for example, could not have successfully developed a powerful private economy without large and sustained government outlays on transportation, education, and the generation of new technologies. Yet, while governments in competitor nations have been investing more in the future, the U.S. has been investing less, setting the stage for further declines in living standards and competitiveness.

In 1989 a group of over 300 American economists -- including six Nobel Prize winners -- described a growing Public Investment Deficit that "will have a crippling effect on America's future competitiveness." According to the economists:

> Just as business must continually reinvest in order to prosper, so must a nation. Higher productivity -- the key to higher living standards -- is a function of public, as well as private, investment. If America is to succeed in an increasingly competitive world, we must expand efforts to equip our children with better education and our workers with more advanced skills. We must assure that disadvantaged children arrive at school age healthy and alert. We must prevent drug abuse and dropping out among teen-agers. We must fix our bridges and expand our airports. We must accelerate the diffusion of technology to small and medium sized business. (EPI, 1989)

Recent research by economists David Aschauer, Alicia Munnell, and others has confirmed that there are direct links between spending on public infrastructure and the growth of private investment, productivity, and profits. And evidence continues to accumulate that there are substantial returns to the nation from spending on education, training, early childhood programs, and civilian research and development (R&D). Statisticians may quibble over the precise numbers, but we know they are positive and large.

This briefing paper concludes that the federal government must increase domestic spending by a minimum of roughly $60 billion (more than one percent of the gross national product) this year just to keep from widening the investment deficit further. This estimate reflects the bottom of a range of needs estimates made over recent years. The high point of the range totals more than $125 billion. There is reason to believe that even these estimates have been constrained by perceptions of what is politically credible rather than what investments are needed to support a prosperous economy. Moreover, this is a narrow definition of investment; it does not include spending on public safety, health, housing, environmental clean-up, and other areas of social need which add to a nation's economic strength. The estimates contained in this paper therefore can represent at best only a part of the cost of an adequate domestic agenda.

Of course, more money alone cannot motivate the potential drop-out, teach complex skills to the disadvantaged, design and build modern transportation systems or discover new technologies. We also need to revitalize the institutions and techniques that deliver public investment goods and services. But in the market economy we live in, none of these goals -- including institutional reform -- can be accomplished without putting more funds into the effort.

Current economic and political developments suggest that an opportunity exists now to find the money. The economic opportunity results from the collapse of the Soviet military threat and the dramatic reduction in the need for U.S. military spending. The political opportunity is the growing awareness that laissez-faire policies have failed to deliver; a dozen years of disinvestment, deregulation and undermining of the public sector has produced a less prosperous America. More

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and more Americans now realize that there is a synergy between public and private investment. Thus, if our country is to regain its economic health, we have no choice but to raise the rate of domestic public sector investment. Each year that we wait, the problems accumulate and become more expensive to solve.

In our federal system, state and local governments make the bulk of domestic investments, both from funds raised by themselves and from funds received from the federal government. But today state and local governments have limited room to raise revenues to pay for the increases in public investment the nation needs. The federal government has already off-loaded much of the domestic investment burden onto state and local governments while simultaneously undermining their taxing capacity. Thus, in order to raise the national share of resources devoted to domestic investment, the federal government must raise its contribution.

Unfortunately, our current budget trajectory is leading us to further cuts in domestic investment in order to accommodate the Pentagon. The current defense budget implies higher military spending in fiscal 1994 and 1995 than was assumed by Congress in the Fall 1990 budget deal. Now, according to the Congressional Budget Office, the President's current plan will require $41 billion in cuts in non-defense discretionary budget authority to meet the overall budget caps for those years. This will translate into a further decline in the rate of public investment over the next five years. Thus, the present priorities of the United States government fail to reflect the realities of today's changed world -- in which economic strength is as important as military strength in the maintenance of national security.

WHAT COUNTS AS INVESTMENT?

In economic terms, public investment programs are those that increase the nation's future capacity to produce goods and services -- in either the public or private sector. Like private investments, public investments create human and physical assets which generate new income streams and ultimately additional revenue to justify the initial outlay.

There is room for debate over what should or should not be included in a public investment menu. This report employs a narrow, conservative, economic

definition. "Investment" is limited to spending for: (1) human resources -- education, training, and selected children's programs; (2) non-defense physical capital -- highways, bridges, water systems, pollution control, airports, schools, etc.; and (3) non-defense R&D.

The absence of other investment-type programs from our analysis is no comment on their value to the nation. For example, a sound economic argument can be made for housing assistance -- it is cheaper to keep people housed than to re-house them once homeless. Similarly, energy and resource conservation programs represent investment -- more efficient use of resources creates new net income. Moreover, spending for any children's program -- from Medicaid to foster care -- could logically be defined as investment. But we have chosen an austere standard in order to minimize debate over whether the investment gap described is exaggerated.

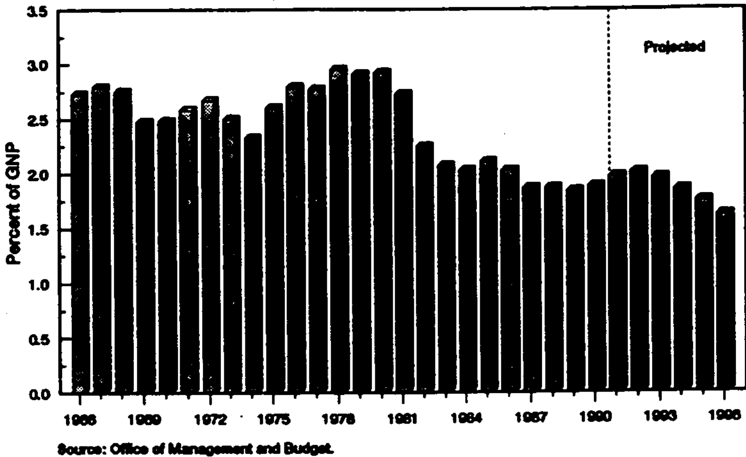
Because investment needs are a function of the economy's size, each category of investment spending is expressed as a percentage of gross national product (GNP). Real dollar investment trends are also useful, but this study is primarily interested in the connection between investment and economic growth. For the historical analysis that follows, therefore, unless indicated otherwise, all spending estimates are expressed in these terms.

FEDERAL INVESTMENT 1966-1996

Federal investment spending[1] in the past quarter century has ranged from 1.8 percent of GNP (1989) to nearly 3.0 percent (1978). These seemingly small percentages reflect large amounts of money invested (or not) in our nation's roads, schools, children, and new technologies. For example, in 1990 an increase in investment spending of 1.2 percentage points would have represented 65 billion dollars -- roughly the total federal expenditure for physical capital, education, and training combined.

Historical investment trends are dramatic. Fueled by the War on Poverty, the Space Race, and the construction of much of the federal highway system, public investment spending in the 1960s rose to over 2.7 percent by 1966. In 1969, with

Figure 1
Federal Investment Spending as Percent of GNP, Fiscal Years 1966-1996



the moon conquered and nearly 8.9 percent of GNP devoted to Vietnam-era military spending, investment spending shrank to under 2.5 percent, a level around which it would stay through 1975. Investment spending then rose, holding steady around 2.8 percent from FY76 - FY81, before again dropping dramatically -- to its lowest level in 19 years. The FY82 level of 2.2 percent would prove to be the first step in a relatively steady decline through 1990, when the investment share of GNP dipped below 1.9 percent.

During the 1980s, state and local governments were not able to pick up the overall slack produced by the federal cuts. Education spending by state and local governments rose, but the new spending was less targeted on the disadvantaged than was the federal spending it replaced. Moreover, this new state and local education spending meant fewer dollars for public infrastructure, which actually declined in the face of federal cuts. R&D and training programs, finally, are federal investment concerns only.

Table 1

FEDERAL INVESTMENT SPENDING, SELECTED PERIODS
(Annual Average as % of GNP)

	Total Investment
1966 - 1975	2.6%
1976 - 1981	2.8%
1982 - 1993	2.0%
1994 - 1996	1.7%

Source: Authors' calculations using OMB data.

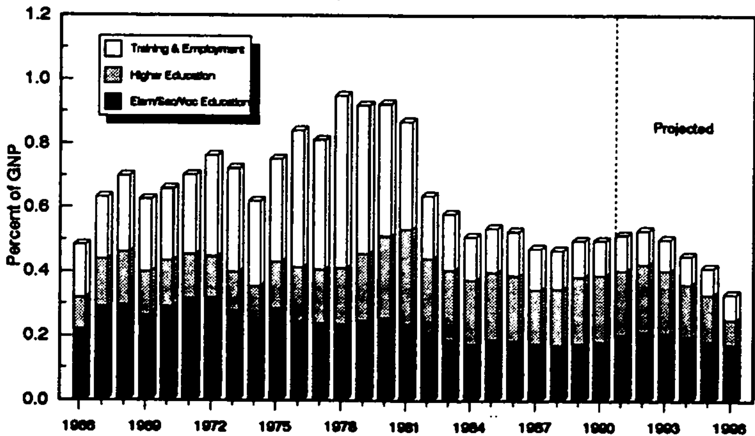
OMB estimates of projected investment spending in the FY92 budget foresee a very slight improvement through FY93. This increase coincides with the first phase of the current budget deal, during which levels for domestic, international, and defense spending are capped. After FY94, however, OMB projects investment spending falling to a new low -- 1.6 percent in FY96.

Human Resources

Education and Training

As the world market has become more competitive in the 1980s, the U.S. has responded with a less prepared workforce. A 1990 EPI study revealed that the U.S. ranks 14th out of 16 industrialized nations in expenditures for grades K-12. 'When

Figure 2
Federal Education and Training Investment as Percent of GNP, Fiscal Years 1966-1996



limited to federal spending, but expanded to include higher education and job training outlays, the national investment in the workforce looks no better. As Figure 2 illustrates, such investment has clearly been in retreat since 1981.

Table 2

FEDERAL INVESTMENT IN EDUCATION & TRAINING
(Annual Average as % of GNP)

	Total Investment
1966 - 1975	0.7%
1976 - 1981	0.9%
1982 - 1993	0.5%
1994 - 1996	0.4%

Source: Authors' calculations using OMB data.

Federal investments going into elementary, secondary, and vocational education have trended downward since the early 1970s to a 1990 level of under 0.2 percent. Spending for higher education peaked somewhat later (FY81), but also declined in the 1980s. Again, education spending is projected to be hit hard in the FY93-FY96 period.

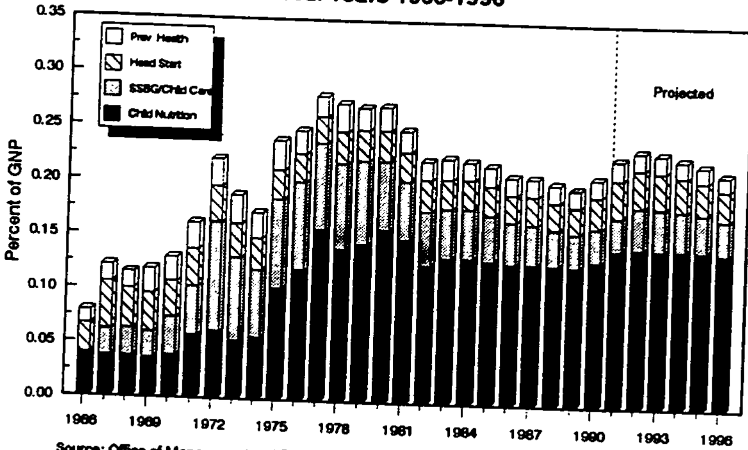
There is widespread recognition that the flexible workforce needed to compete in the global economy requires continuous training, retraining, and skill upgrading. Despite this knowledge, federal investment in training and employment was slashed by over 60 percent between FY78 and FY82. In the decade to follow, outlays will average about 0.13 percent, and are projected to fall to their lowest share in over 30 years (0.08 percent) in 1996.

Children

Investment in children, exclusive of education funding, has fared somewhat better than other investment categories over the past quarter century. While spending in the late 1980s averaged roughly 0.05 percentage points lower than in the late 1970s, it was considerably higher than in earlier years.

Much of the general increase in children's investment is attributable to increases in child nutrition programs through the 1970s and their relative stability through the 1980s. During this period, cuts in the special milk programs were

Figure 3
Federal Investment in Children as Percent of GNP, Fiscal Years 1966-1996



nearly offset by increases in the Special Supplemental Food Program for Women, Infants, and Children (WIC). Other losers during the 1980s were the children's programs (most notably childcare) funded under the Social Services Block Grant which fell from around 0.08 percent during much of the 1970s to 0.03 percent by 1989. Spending in this area should begin to grow again in FY92 with the introduction of the Child Care and Development Block Grants, though this upward trend is projected to be short-lived, turning downward again in FY94.

Table 3

FEDERAL INVESTMENT IN SELECTED CHILDREN'S PROGRAMS
(Annual Average as % of GNP)

	Total Investment
1966 - 1974	0.14%
1975 - 1981	0.26%
1982 - 1990	0.21%
1991 - 1993	0.23%
1994 - 1996	0.22%

Source: Authors' calculations using OMB data.

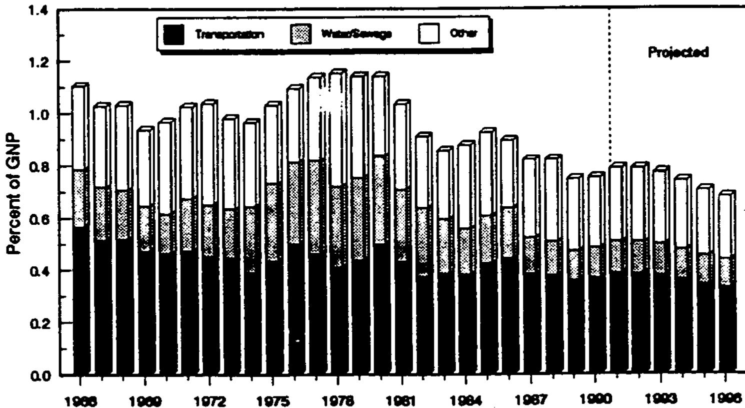
Despite the program's proven effectiveness, the rate of investment in Head Start has not risen since its introduction in FY65, shrinking slightly from FY73 to FY89. Head Start spending now is projected to return to its 1960s level, at least through Phase I of the Budget Agreement. Still, the program in 1992 will be able to support less than half of eligible children.

Physical Capital

The pattern of overall spending for physical capital breaks out into two basic periods: pre- and post-1981. Though there is some variation in the earlier period (the high of nearly 1.2 percent was reached in FY78), there is no point at which outlays for physical capital drop below 0.95 percent. However, in the post-1981 period, spending never rises above this level, trending generally downward, with each new low adding to the cumulative investment deficit. A new low of under 0.7 percent is projected for 1996.

Changes in spending for federal highways, mass transit, and sewage treatment account for the majority of the shifts in overall infrastructure investment. Though highway spending declined rather steadily after 1965 (from 0.6 percent to a 1990 level of below 0.3 percent), spending on transit and sewage treatment rose

Figure 4
Federal Investment in Physical Capital as Percent of GNP, Fiscal Years 1966-1996



from almost zero to a combined share of 0.3 percent in 1980, propping up total infrastructure investment in the process. Subsequent cuts in these areas during the 1980s, however, resulted in a decline in overall infrastructure investment.

Table 4

FEDERAL INVESTMENT IN PHYSICAL CAPITAL
(Annual Average as % of GNP)

	Infrastructure Only	All Physical Capital
1966 - 1975	0.7%	1.0%
1976 - 1981	0.8%	1.1%
1982 - 1993	0.5%	0.8%
1994 - 1996	0.5%	0.7%

Source: Authors' calculations using OMB data.

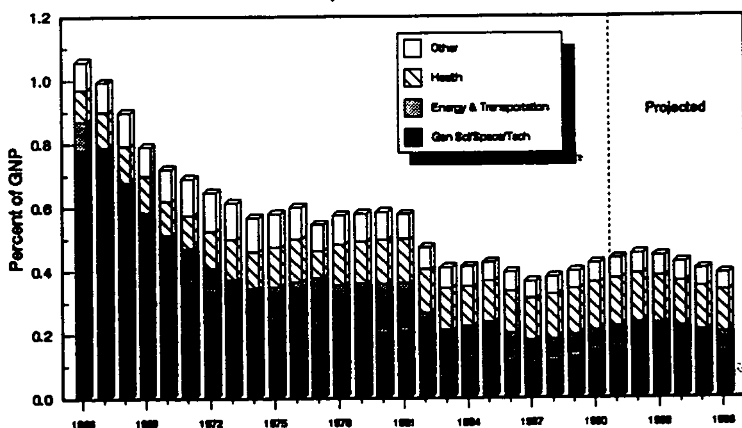
It should be noted that this analysis refers to gross physical investment. This understates the real shrinkage in investment in recent years because it ignores the need to replace worn-out capital. During periods of relative decline in gross investment -- such as the last decade -- the share of each additional investment dollar used to replace or maintain old capital rises, leaving a smaller portion available for new public capital to support a growing private sector.

Civilian Research and Development

U.S. investment (public and private) in civilian research and development has long trailed that of our major competitors. In 1978, national expenditures for nondefense R&D as a share of GNP were: Japan 2.0 percent, West Germany 2.1 percent, and the U.S. 1.6 percent. By 1988, the gap had widened: Japan 2.9 percent, West Germany 2.7 percent, and the U.S. 1.9 percent. Federal civilian R&D spending contributed to this deficit (see Figure 5), shrinking from 0.6 percent in FY78 to 0.4 percent in FY88. Not coincidentally, federal R&D spending for defense nearly doubled during the same period.

Much of the story of federally financed civilian R&D reflects the relative decline of NASA spending after the mid-1960's. Space support dropped to 0.2 percent of GNP by 1974. At this point, nondefense R&D spending as a whole held

Figure 5
Federal Investment in Research & Development as Percent of GNP, Fiscal Years 1966-1996



Source: Office of Management and Budget.

relatively steady at just under 0.6 percent through FY81. From FY82 - FY87, R&D spending again declined, with (1) general science, space, and technology, and (2) energy, the categories most affected. Finally, fueled by a renewed interest in NASA and increased health research spending, R&D investment began to grow again through the first two years of the 1990 Budget Deal. Beyond FY92, however, R&D spending is projected to follow the path of domestic discretionary spending as a whole, declining through FY96.

Table 5

FEDERAL NON-DEFENSE R&D SPENDING
(Annual Average as % of GNP)

	Total Investment
1966 - 1968	1.0%
1969 - 1972	0.7%
1973 - 1981	0.6%
1982 - 1993	0.4%
1994 - 1996	0.4%

Source: Authors' calculations using OMB data.

THE INVESTMENT GAP

One way to measure the existing gap between our present level of public investment and the level needed to support a more prosperous economy is through historical reference. As Table 6 shows, federal investment as a share of GNP was cut by a third between FY76 and FY90. Restoring the 1976 share to the 1990 budget would have required nearly $50 billion in additional investment.

The 1976 investment share of GNP is a relatively modest standard. It was not a peak year for federal investment as a whole or for any particular investment category, and was below the average for 1975 - 1981. But it does represent an investment level that the nation once found the means to support, even in the midst of the Cold War. It was also a time when the United States faced a much less competitive world economy, and therefore had less reason to be concerned about reinvesting to maintain its international economic position.

Table 6

FEDERAL INVESTMENT GAP -- FY76 BASIS
(Outlays in Billions of Dollars)

	1976	1990	Needed $ Increase To Reach '76 GNP Share
GNP	1,698.2	5,405.6	
Human Resources			
Education & Training	14.3	27.0	18.5
As a % of GNP	0.8%	0.5%	
Children	4.2	11.3	2.0
As a % of GNP	0.2%	0.2%	
Physical Capital	18.7	40.8	18.7
As a % of GNP	1.1%	0.8%	
R&D	10.2	22.7	9.6
As a % of GNP	0.6%	0.4%	
Total Investment	47.3	101.7	48.9
As a % of GNP	2.8%	1.9%	

Source: Authors' calculations using OMB data.
Note: Totals may not add due to rounding.
Physical Capital and R&D figures are non-defense only.

A more up-to-date estimate can be calculated from the range of recent expert analyses of unmet needs in specific sectors. In addition to providing insight into actual needs, these estimates capture some of the cumulative effects of neglect of investment in previous years. For example, roads neglected since 1976 cannot be returned to their 1976 standard merely by returning highway investment to its earlier level. Instead, sustained spending well above the FY76 level will be required until the backlog is eliminated. The reader should keep in mind, however, that only in the physical capital category can the backlog of needs be fully addressed. The backlogs in the R&D and human resources categories, by contrast, represent lost opportunities and wasted lives that can never fully be recaptured. In general, the estimates of need in these categories do not include any effort to make up for past neglect.

As Table 7 shows, the investment gap, measured by adding up the expert assessments, ranges from $63 billion to $126 billion, or from 1.1 to 2.2 percent of GNP. The sums of the experts' estimates presented here are obviously rough approximations of the investment gap. They are probably conservative, as they often seek to achieve a standard less lofty than that of 1976. Indeed, many of the estimates of specific program needs are biased downward by the estimators' perception of what is politically realistic in an era of fiscal constraint and resistance

Table 7

FEDERAL INVESTMENT GAP -- EXPERT ESTIMATES
(Outlays in Billions of Dollars)

	Needed $ Increase for "Full Funding"
HUMAN RESOURCES	
Education & Training	23.3 - 45.0
Children	6.1 - 12.5
PHYSICAL CAPITAL	22.7 - 54.8
R&D	10.8 - 13.5
TOTAL INVESTMENT	62.9 - 125.8

Sources: See Tables 8, 9, and 10.

to public spending, rather than a full assessment of need. For example, public investments involving new technologies -- i.e. high-speed trains, automated highways, high-definition television -- that might be on a European or Japanese list are often absent from ours. Finally, the aggregated estimates presented may understate needs as many of the smaller programs are not included.

Human Resources

Due to the deep cuts in this category since 1980, experts estimate that sizeable spending increases (75-150 percent) are required to meet currently unmet needs. The lower figure ($29.4B) represents a share of GNP only slightly higher (5 percent) than the amount cut since the peak year FY78.

Table 8

FEDERAL HUMAN RESOURCE INVESTMENT NEEDS, EXPERT ESTIMATES
(Outlays in Billions of Dollars)

	Needed $ Increase for "Full Funding"
EDUCATION & TRAINING	
Elem/Sec/Voc Ed.	8.5 - 16.9
Higher Education	2.5 - 7.6
Training & Emp.	12.3 - 20.5
CHILDREN	
Child Nutrition	1.6 - 2.6
Child Care/SSBG	2.8
Head Start	1.0 - 6.4
Preventive Health	0.7
TOTAL	29.4 - 57.5

Sources: CCC, CDF, CED, CEF, GAO, NCC, NEA, OECD

Shortfalls in education and training programs account for about four-fifths of the human resources investment gap, with training needs the largest. The substantial gap in training reflects the fact that the primary federally-supported

training system (JTPA) serves only 6 percent of a narrowly-defined eligible population. The range of spending increases presented represents the additional amounts necessary to match spending in (1) OECD countries on average, and (2) West Germany. Spending to either level would require that a different training system be put in place. Raising education spending, by contrast, does not imply such a dramatic overhaul, reflecting instead the funding shortfalls in the variety of current programs.

Though the FY76/FY90 investment gap (see Table 6) for the children's programs included here is rather small ($2 billion) and nearly eliminated due to increases in FY91 and FY92, experts' estimates suggest that much more is still needed. Stimulated in part by a growing consensus that spending on children makes good economic sense -- $1 invested in prenatal care saves $3.38 in care for low birthweight babies; $1 invested in immunization saves $10 in treatment costs; $1 invested in Head Start saves $6 of special education, reliance on public assistance, and crime costs -- experts place "full funding" for the limited array of children's programs presented here at an additional $6.1 - $12.5 billion.

Physical Capital

Primarily driven by the needs of a neglected transportation sector, the physical capital investment gap is estimated at roughly $55 billion annually. Even at the lower end of the range ($22.7 billion), annual needs far surpass the

Table 9

FEDERAL INVESTMENT NEEDS IN PHYSICAL CAPITAL, EXPERT ESTIMATES
(Outlays in Billions of Dollars)

	Needed $ Increase for "Full Funding"
Highways	5.7 - 27.9
Transit	3.4 - 8.9
Aviation	3.9 - 6.9
Water/Sewage	4.9 - 5.8
Rail	1.5 - 2.0
Other	3.3
TOTAL	22.7 - 54.8

Sources: AASHTO, APTA, CCC, CWC, DOT, EPA, GAO, UMTA

FY76/FY90 gap, calling for nearly a 60 percent increase in physical capital investment over the FY90 level.

The estimates for the nation's highways, roads, and bridges offer an example of what the range of numbers mean. The Department of Transportation estimates that $45.7 billion is needed annually to maintain the nation's highways, roads, and bridges at their 1989 level. To improve conditions to a standard that eliminates all backlog and accruing deficiencies, however, cost is estimated at $74.9 billion per year for the next twenty years. The federal share of highway, road, and bridge spending was 56 percent in 1980 and 43 percent in 1990. Applying the low federal share to the more modest goal and the high federal share to the more ambitious goal generates a range of $19.7 - $41.9 billion. Subtracting the 1990 spending level of $14 billion leaves an investment gap of $5.7 - $27.9 billion.

Another major contributor to the infrastructure investment gap is funding for aviation programs. Unlike highway spending, however, outlays for aviation have been on the rise. The gap here ($3.9 - $6.9 billion) is due to dramatically increased air traffic and ridership.

Civilian Research and Development

Recommended funding levels for R&D are difficult to determine, as the R&D "budget" is the composite of thousands of individual projects. Therefore, our estimate of need is based on international comparisons. According to National Science Foundation estimates of nondefense R&D spending, the U.S. invests 30-35 percent less than its major competitors, West Germany and Japan. This converts to a $43 - $54 billion investment shortfall in FY90. Maintaining the current U.S. federal share of nondefense R&D (25 percent), the annual federal R&D investment gap is estimated at $10.8 - $13.5 billion. This needed additional investment represents a 50-60 percent increase over the FY90 level.

Table 10

FEDERAL R&D INVESTMENT NEEDS
(Outlays in Billions of Dollars)

	Needed $ Increase for "Full Funding"
TOTAL	10.8 - 13.5

Source: Authors' calculations using NSF data.

WHERE WILL THE MONEY COME FROM?

The damage done to the economy by the investment deficit of the past decade has been compounded by the damage done to our financial condition by the fiscal policies of the past decade. But as much of a problem as the fiscal deficit may be, it does not justify continued neglect of the nation's investment needs.

The estimates examined here are inexact, but the rough magnitudes suggest that we should be investing, at a bare minimum, another $60 billion in America's future, now. And that number should be rising throughout the 1990s as the economy expands.

The good news is that responsible public investment more than pays for itself over the long term. The bad news is that in the short term, the money must be paid up front.

Given that other domestic discretionary spending has been cut to the bone and there is little support for major cuts in entitlements such as social security, there are three main sources of funds to eliminate the public investment deficit: borrowing, taxes, and transfers from the military budget (the peace dividend). In theory, all three sources are available, and in order to meet our investment needs in this decade all three will have to be used. But political and economic realities will continue to make it difficult to raise significant sums from either new borrowing or taxes for the next several years. Fortunately, the recent dramatic meltdown of the Cold War provides us with a new opportunity to reorder federal priorities and raise the rate of domestic public investment.

New Borrowing. It is proper for governments to borrow in order to invest in the future. To the extent that an investment makes the nation more productive, increased tax revenues will be available to pay off the loan. But, as we have seen, the last decade's increase in the federal deficit does not reflect recent borrowing for investment. Instead, it reflects borrowing to finance tax cuts for upper income taxpayers and increased military consumption.

The current budget agreement between Congress and the White House (reflected in the Budget Enforcement Act) further violates common sense budget policy. By putting a cap on the discretionary domestic spending (the budget category containing public investment) but permitting "off-budget" increases in

spending for such purposes as the bail-out of the savings and loan industry, the U.S. government is essentially borrowing to pay off past economic losses and forcing capital investments gains to conform to current revenues.

Although the U.S. government lacks a capital budget, it certainly could apply capital budget principles to the spending choices that it faces over the next few years. This would permit it to borrow for investments and gradually force its operating budget to conform to its revenues.

Clearly this is the direction in which sensible budget policy should be headed. But it is unlikely to solve our problem in the near term as the federal budget deficit for this fiscal year is now expected to be over $360 billion -- 6.1 percent of GNP. As this share drops later in the decade, it will make sense to expand borrowing for investment purposes.

Taxes. The U.S. as a whole is undertaxed. Taxes as a share of GNP are lower in the U.S. than in any other advanced industrial nation. If the U.S. tax share were equal to the average share for the OECD nations, we would be raising more than $400 billion in additional public revenues -- of which nearly 60 percent would be federal. Unfortunately, the combination of the last decade's irresponsible anti-tax politics and irresponsible tax policies -- which shifted the tax burden from the rich to the lower and middle income classes -- has limited our ability to raise substantial new general tax revenues. There is certainly room for raising tax rates on high income, but in today's political climate the proceeds are most likely to be used for tax relief for middle income families.

Specific taxes dedicated to specific investment purposes may be somewhat more politically acceptable -- e.g., an energy tax earmarked for conservation or energy-efficient technologies or a payroll tax earmarked for training. But if the recent rejection of a proposed 5 cent per gallon increase in the gas tax is any guide, we can expect only modest results. Moreover, many such taxes are regressive; raising them would further compound the inequitable upward redistribution of incomes of the last 15 years. Some increased user fees, which would reflect the real social cost of certain public goods, may be in order. But the benefits of most public investments, by definition, spill over to a large number of people who cannot be easily charged, so there is a practical limit to the amount of funds that can be

fairly raised this way. Gathering political support for a value-added tax, even if it could be fashioned to eliminate its regressive effect -- will take years.

The Peace Dividend. No matter how one looks at it, we are now spending, and plan to spend, much more than is necessary for our national security. If we use 1976 as a benchmark for military consumption, as we have for domestic investment, the numbers are dramatic. In that year, under a Republican president, when the Soviet Union was run by hard-line communists and the Warsaw Pact was fully armed with its guns pointed West, the U.S. defense outlays were $215 billion (in 1992 dollars). In fiscal year 1992 -- in the aftermath of the military and economic collapse of the Soviet Union, indeed its dismemberment -- we will spend $295 billion! Thus, today, we are already spending a minimum of $80 billion more on defense than historic common sense suggests we have to.

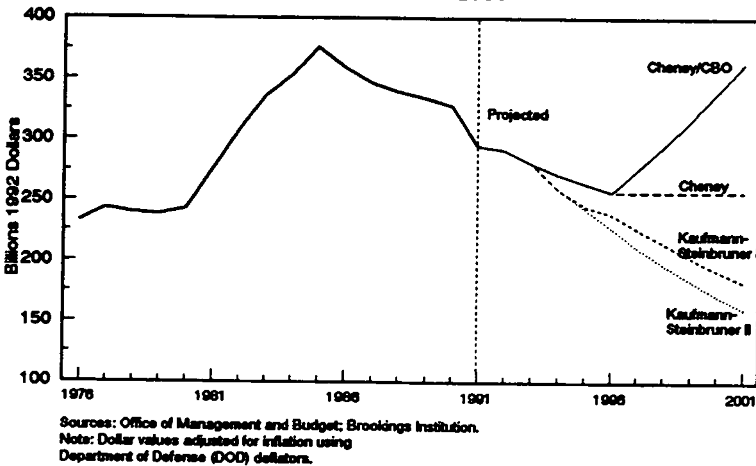
The answers of military experts vary as to how much and how fast the defense budget can be cut. The Administration tells us that the failure of the coup in the Soviet Union will have a negligible effect on current defense spending levels. This would leave us with a current dollar defense budget of $298 billion in 1996, and as indicated earlier, will require a $41 billion domestic investment spending cut in 1994 and 1995.

Figure 6 shows two Administration military budget projections. One is the projection presented by Defense Secretary Cheney last Winter, which is the Administration's estimate of the cost of the present Pentagon five-year defense plan. After 1996, this projection levels out above the real-dollar 1976 level of defense spending. But according to the CBO and other budget experts, this seriously underestimates the real costs of the program. CBO's estimates of the cost of the Administration's current military plans are shown as Cheney/CBO and imply sharply rising costs of defense after 1996.

An alternative set of budgets has been proposed by former Pentagon official Henry Kaufmann and Brookings Institution defense scholar John Steinbruner. These were also calculated before the recent break up of the Soviet Union. Kaufmann and Steinbruner propose a ten-year budget based upon their various assumptions of the evolution of international cooperation. These are shown on Figure 6 as Kaufmann/Steinbruner I and Kaufmann/Steinbruner II. (The

Kaufmann/Steinbruner estimates have been adjusted by adding national defense costs assigned to the Department of Energy -- including the cost of cleaning up hazardous waste from the nuclear weapons program.) Kaufmann/Steinbruner II, the lowest projection, which reflects the most optimistic assumptions, reaches the 1976 real dollar level in 1995 and drops to $160 billion in real terms by 2001.

Figure 6
National Defense Budget Authority,
Fiscal Years 1976-2001



Because of the current budget restrictions, neither the Cheney nor the Kaufmann/Steinbruner budgets provide any savings that might be reallocated to domestic investment through the life of the current budget deal; that is, through 1995. In fact, each of their options would require additional domestic <u>cuts</u> to meet the discretionary spending caps in FY94 and FY95. Table 11 displays the cuts (from the "baseline" reflecting the maintenance of existing programs) that would be required under each budget scenario.

Table 11

DISCRETIONARY SPENDING IMPLIED UNDER CHENEY & KAUFMANN/STEINBRUNER PLANS
(Budget Authority in Billions of Dollars)

	Assume Cheney		*Assume Kaufmann/Steinbruner*	
	FY94	FY95	FY94	FY95
Defense Cuts	-8.4	-18.4	-21.1	-41.8
Non-Defense Cuts	-16.5	-24.3	-3.8	-1.0

Sources: Authors' calculations using CBO, OMB, Brookings data.
Notes: The Kaufmann/Steinbruner plan refers to their "Cooperative Security Option."
International spending accounts for under 10 percent of the non-defense discretionary budget.

It should be kept in mind that the perspective of all of these proposed budgets reflects the Pentagon planning process and concern for a deliberate, orderly pace of reductions. There is nothing magical about a ten-year horizon (history and international affairs do not evolve in such neat time frames.) It is used by defense experts because the Pentagon plans are developed in five-year intervals. The more immediate urgency of increasing domestic spending and the costs of failing to do so are not central considerations in these projections.

The urgency arises not only from the human and economic cost of further delaying domestic investment, but also from the lag time between budget authority and actual spending on defense procurement, which makes up about 30 percent of the defense budget. Because of these lags, over 80 percent of procurement spending in any given year is a function of previous years' commitments, which means that action must be taken now to reduce spending in future years. The recent Administration proposal to significantly reduce the nation's tactical nuclear arsenal offers an example. Though projected savings in the long term are estimated at $12.8 billion, the FY92 budget will be largely unaffected.

Any transfer of spending from military to civilian budget categories must involve planning to conserve assets and minimize the human cost of the transition. Paralleling the reduction in military spending therefore should be a national conversion effort to assure the transition of people and communities to the civilian economy, and to preserve high capabilities in industrial technology, both to support U.S. competitiveness and to be available if the need for remobilization occurs in the future. The key to both economic and military security in the future is an economy with the flexibility and capacity to deploy its industrial technology wherever and whenever it is needed.

CONCLUSION

There is now obviously a serious mismatch between investment needs vital to America's future and the present budget agreement. Something has to give. Borrowing is not an option in the short term, and a massive increase in taxes is not politically acceptable. The only alternative is to cut the military budget fast and deep. The present agreement protects the President and the Congress from having to make hard decisions until after the next election. In doing so, it puts America at risk. Failure to scrap the Budget Enforcement Act and to renegotiate a budget which permits the reordering of priorities is, in effect, a decision to dramatically reduce American competitiveness and living standards in the 1990s.

October 1991

ENDNOTES

1. Minor double counting is included between the human resources and physical capital categories. However, as grants for physical capital investment in education, training, employment, and social services combined was only $58 million in FY90 (out of the category's total of $38.5 billion), the effect of double counting is assumed to be minimal.

TABLE NOTES

Table 1

-- **Total Investment** represents the combined average annual expenditure for human resources, physical capital, and non-defense R&D, as a percent of GNP. Time periods are selected to highlight the trends depicted in Figure 1.

Table 2

-- **Total Investment** represents the average annual expenditure for education and training, as defined for Figure 2. Time periods are selected to highlight the trends depicted in this graphic.

Table 3

-- **Total Investment** represents the average annual expenditure for the selected menu of children's programs included in Figure 3. Time periods are selected to highlight the trends depicted in this graphic.

Table 4

-- **Infrastructure Only** represents the average annual expenditure for transportation, water, and sewage treatment programs. **All Physical Capital** represents the average annual expenditure for all physical capital, including infrastructure. Time periods are selected to highlight the trends depicted in Figure 4.

Table 5

-- **Total Investment** represents the average annual expenditure for the conduct of all non-defense R&D. Time periods are selected to highlight the trends depicted in Figure 5.

Table 6

-- **Needed $ Increase To Reach '76 GNP Share** represents the additional expenditure needed in each category in 1990 to place investment spending (as a percent of GNP) at its 1976 level.

Table 7

-- Sum of data in tables 8, 9, and 10.

Table 8

-- **Elementary, Secondary, and Vocational Education** estimates represent the sums of recommended funding increases for various programs included in budget subfunction 501: adult education, bilingual education, Chapter 1, Chapter 2, impact aid, special education, math & science, and vocational education.

-- **Higher Education** estimates represent the sums of recommended funding increases for various programs included in budget subfunction 502: Pell grants, Supplemental Educational Opportunity grants, and Work-Study.

-- **Training and Employment** estimates represent the increases necessary for U.S. public investment in job training to equal the levels in OECD countries on average (low) and Germany (high).

-- **Child Nutrition** estimates represent the sums of recommended funding increases for School Lunch and WIC.

-- **Child Care/SSBG** estimate represents the increase recommended by the Committee for Economic Development.

-- **Head Start** estimates represent the increase needed to serve all eligible 4- and 5-year olds (low) and the increase needed to serve all eligible 3- to 5-year olds (high).
-- **Preventive Health** estimate represents the sums of recommended funding increases for prenatal care, immunization, and family planning.

Table 9
-- **Highways** estimates represent the federal share of the average annual increase necessary to maintain 1989 conditions (low) and to improve conditions to a standard that eliminates all backlog deficiencies (high). (USDOT)
-- **Transit** estimates represent the increase needed to return to the 1981 funding level (low), and to address $90.8 billion in current capital needs (high) over a five-year period, with federal share at 80%. (APTA)
-- **Water/Sewage** estimates represent the average annual increase needed to comply with federal drinking water and sewage treatment laws and rebuild aging systems 1993 - 2000 (CWC) and to eliminate the backlog of capital needs ($83.5 billion) over five years, with federal share at 50%. (EPA)
-- **Aviation** estimates represent the needed funding levels in 1990 and 1995, based on projected air traffic. (AASHTO)
-- **Rail** estimates represent average annual increases necessary to address capital needs. (UMTA)
-- **Other** estimate represents the needed increase in the Community Development Block Grant program to restore its 1980 level. (CCC)

Table 10
-- **Total** estimates represent the federal share (25%) of the average annual increase necessary to match civilian R&D investment in W. Germany and Japan.

Table 11
-- **Defense Cuts** represents the reductions contained in the Cheney and Kaufmann/Steinbruner plans for budget function 050.
-- **Non-Defense Cuts** represents the reductions necessary in non-defense discretionary spending in order to satisfy the Budget Enforcement Act caps.

FIGURE NOTES

Figure 1
-- Sum of data for figures 2, 3, 4, and 5.

Figure 2
-- **Elementary, Secondary, and Vocational Education** spending represents outlays for budget subfunction 501;
-- **Higher Education** spending represents outlays for budget subfunction 502;
-- **Training and Employment** spending represents outlays for budget subfunctions 504 and 553.

Figure 3
-- **Child Nutrition** spending represents outlays for child nutrition and special milk programs, plus outlays for supplemental feeding programs (e.g., WIC);
-- **SSBG/Child Care** spending represents outlays for the 60% portion (Sugarman 1991) of Social Services Block Grants devoted to children's programs, plus, beginning in FY91, outlays for payments to states for daycare assistance;
-- **Head Start** spending represents the Congressional appropriation for the program (FY93 - FY96 estimates are based on OMB's projection for human development services spending as a whole);
-- **Preventive Health** spending represents outlays for maternal and child health, child immunization, family planning, and infant mortality (FY66 - FY92 program funding levels are from federal budgets of the same years; FY93 - FY96 estimates are based on OMB's projection for domestic discretionary spending as a whole).

Figure 4
-- **Transportation** spending represents outlays for highways, public transit, aviation, and railroads;
-- **Water/Sewage** spending represents outlays for water programs, plus spending for sewage treatment programs;
-- **Other** represents outlays for all physical capital not included above.

Figure 5
-- Spending for **General Science, Space, and Technology; Energy & Transportation;** and **Health,** represent outlays for the conduct of R&D in these areas (FY93 - FY96 estimates are based on OMB's projections for domestic discretionary spending as a whole);
-- **Other** represents outlays for the conduct of research in agriculture, natural resources, environment, and all other non-defense areas not included above (FY93 - FY96 estimates are based on OMB's projections for domestic discretionary spending as a whole).

Figure 6
-- **Cheney** represents budget authority for national defense (budget function 050) assuming that the FY96 level will be maintained through 2001;
-- **Cheney/CBO** represents budget authority for function 050 following CBO's estimates after FY96;
-- **Kaufmann-Steinbruner I** represents budget authority for subfunction 051 following their "Low Option", plus Cheney estimates for subfunctions 053 and 054;
-- **Kaufmann-Steinbruner II** represents budget authority for subfunction 051 following their "Cooperative Security Option", plus Cheney estimates for subfunctions 053 and 054.

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Public Investment and Private Sector Growth

The Economic Benefits of Reducing America's "Third Deficit"

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Executive Summary

This report demonstrates the importance of *public* investment in physical infrastructure (roads, bridges, mass transit, electric power, sewers, etc.) to the stimulation of *private* sector productivity, profitability, and investment. Specifically, the report argues that the slow-down in spending for infrastructure over the past 25 years has been a major cause of the U.S. economy's poor performance since 1970.

More than half of the decline in our productivity growth over the past two decades can be explained by lower public infrastructure spending, which has dropped to less than one-half of one percent of total output. The shortfall between our present stock of public capital and our public capital needs is often described as "America's Third Deficit."

More than half of the decline in our productivity growth over the past two decades can be explained by lower public infrastructure spending.

The report presents an economic model showing that if the average level of public infrastructure investment (relative to GNP) between 1950 and 1970 had been maintained for the succeeding twenty years:

- the rate of return to private capital would have averaged 9.6 percent instead of its actual value of 7.9 percent;
- private investment would have averaged 3.7 percent of the private capital stock rather than 3.1 percent;
- the average annual rate of private sector productivity growth would have been 2.1 percent instead of 1.4 percent—a 50 percent increase in the average rate of expansion of our productive capacity.

The model is based on statistical studies of the effects of public investment on the economy using historical data for the aggregate U.S. economy, state-led economies, and comparisons among major industrialized countries.

From these studies, it is estimated that a one percent increase in the level of core infrastructure will increase GNP by as much as 0.24 percent. Moreover, after four years or so, each additional dollar of public investment in infrastructure will *raise* private investment by 45 cents, contradicting the notion that a dollar of public investment merely "crowds-out," and therefore reduces, private investment.

The basic reason why public capital improves private sector efficiency, profits, and investment is that public facilities provide productive services to firms, such as an effective transportation system of airports, highways, and mass transit. These public facilities are as necessary to the production process as a firm's own capital equipment.

Moreover, because public capital comprises over a third of our total physical capital, the services it generates can be expected to have an important effect on macroeconomic, or aggregate, economic performance. For every dollar of private capital in place there is 56 cents of public capital.

The report shows that today public infrastructure investment is a higher economic priority than private investment; the pay-off in GNP growth from an extra dollar of public capital is estimated to exceed that of private investment by a factor of between two and five.

The pay-off in GNP growth from an extra dollar of public capital is estimated to exceed that of private investment.

Public investment in infrastructure has dramatically declined. Over the last two decades, non-military public investment, as a fraction of GNP, was only 65 percent of its average level during the preceding two decades, falling from 3.7 percent to 2.4 percent. When depreciation is taken into account, the rate of non-military public investment in the 1980s was only half that of the 1970s and just one-fourth that of the 1950s and 1960s.

Public investment is critical to general economic growth, but because we live in a dynamic economy which changes constantly in response to technological progress, foreign competition, and changes in the labor force, infrastructure needs in the future may not necessarily be the same as they were in the past. As we move toward the 21st Century, the definition of infrastructure may have to be broadened to include such investments as communications networks or energy development.

This report encourages a reconsideration of federal budget policy so as to facilitate the growth of the public capital stock. Current policies entail severe, untimely constraints on public investment for the foreseeable future. The U.S. economy needs to be prepared for the challenges of the future, and public investment should be a tool of first resort.

Introduction

In the past few years, a number of tragic incidents have focussed attention on the disrepair of the nation's public infrastructure. Examples include:

- a bridge collapses on the NY State Thruway, taking the lives of ten motorists;
- a dam bursts in Georgia, flooding a bible school and drowning a number of school-aged children;
- medical debris washes up on the shores of Long Island, posing a health risk to millions of people.

To what extent has the decline of investment in public infrastructure affected the performance of the U.S. economy as a whole?

Concern has also grown over the less dramatic but pervasive congestion of our streets, highways, and air routes: mounting delays in a transportation network that is apparently insufficient to meet the needs of a growing economy. Indicators of the congestion problem include:

- The U.S. Department of Transportation has estimated that in 1985 total vehicle delays on the highways exceeded 722 million hours; it is projected that this alarming number will skyrocket to 3.9 billion hours by the year 2005 if improvements to the nation's freeway system are not forthcoming.
- As these cars and trucks were stuck in traffic, nearly 3 billion gallons of gasoline were wasted, almost 4 percent of annual consumption in the United States. The total cost of this congestion was estimated at $9 billion.
- Within Los Angeles County alone, traffic congestion is estimated to result in $507 million worth of lost time and 72 million gallons of wasted fuel each year.
- According to the Federal Aviation Administration, air travel delays in 1986 resulted in $1.8 billion in additional airline operating expenses and $3.2 billion in time lost by travellers.

Underlying these headlines, anecdotes, and cost estimates is a larger question: to what extent has the decline of investment in public infrastructure affected the performance of the U.S. economy as a whole?

In recent research, I and other economists have been attempting to get a broad picture of the importance of the public infrastructure to our economic prospects, to our ability to produce profitably and efficiently, and to our international competitiveness.

In this paper I survey the results of that research. I conclude that the reduction of public investment spending in the U.S. over the past 25 years played a central role in a number of our long-term economic ills. My study suggests that if the U.S. had continued to invest in public capital after 1970 at the rate maintained for the previous two decades, we could have benefitted in the following ways:

The reduction of public investment spending in the U.S. over the past 25 years played a central role in a number of our long-term economic ills.

- Our chronically low rate of productivity growth could have been up to 50 percent higher—2.1 percent per year rather than the actual rate of 1.4 percent;
- Our depressed rate of profit on nonfinancial corporate capital could have averaged 9.6 percent instead of 7.9 percent;
- Private investment in plants and equipment could have increased from the sluggish historical rate of 3.1 percent to 3.7 percent of the private capital stock.

These results indicate that close attention should be paid to the critical role played by public infrastructure in augmenting overall economic performance.

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Infrastructure and the Economy: Trends

As is well-known, a number of signs indicate that the United States' economy has not performed as well in recent years as in the so-called "golden-age" of the 1950s and 1960s.

We have seen a *continuing slump in the growth rate of economic productivity*, measured either conventionally as output per labor hour (labor productivity) or alternatively as output per unit of combined private labor and private capital services (called total factor or multifactor productivity). Beginning sometime in the early 1970s—the specific date is much debated—productivity growth fell by some 1.4 percent per year. In the case of labor productivity, the drop was from 2.8 percent to a much lower 1.4 percent. This was clearly an important development. It meant that labor productivity would no longer double every 26 years; under the new trend we could only expect labor productivity to double once every 51 years. This implies that on a per capita basis, our future income must rise much more slowly, thereby generating a wide variety of concerns on issues such as the viability of our national social insurance programs & our national security.

We have seen a continuing slump in the growth rate of economic productivity.

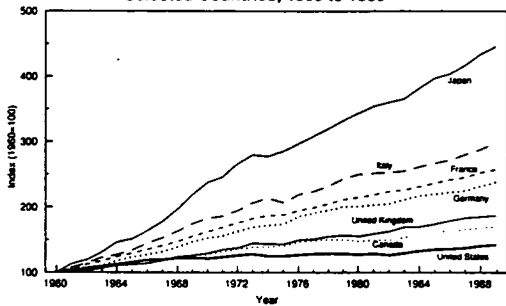
Low productivity growth was reflected in a 3.3 percent decrease in the real average hourly wage between 1979 and 1987. Annual average wages and salaries only held up in this period because people were working 5.8 percent more hours per year. The typical worker in the factory, on the construction site, and behind the check-out counter increasingly feels the bite as wages fail to keep up with inflation.

Not only has productivity growth fallen over time in the United States, it has been low for the past three decades relative to our major international competitors. For example, from 1965 to 1985, Japan and West Germany achieved labor productivity growth rates in excess of 3 and 2 percent per year, respectively (see Figure 1). One reflection of our low productivity growth, when coupled with persistently high consumption growth, is the yawning trade deficit and the switch, during the 1980s, from our nation's position as the world's largest creditor to the world's largest debtor.

A second dimension of poor economic performance which is related to low productivity growth is a *low profit rate*. During the 1970s and 1980s the profit rate was depressed to a considerable amount below its level in the 1950s and 1960s—from about 11 percent to about 8 percent.[1]

A third indicator of poor economic performance which is closely linked to the fall-off in the profit rate is a *low rate of net private investment*. For instance, the growth rate of the private capital stock (the value of capital assets) has been about 3 percent per year in recent years, down from about 4 percent in the 1950s and 1960s.[2]

Figure 1
Trends in Real GDP per Employed Person, Selected Countries, 1960 to 1989



(Sources: Alicia Munnell, Federal Reserve Bank of Boston; Bureau of Labor Statistics.)

Although the United States still leads in the level of output per worker, we have been far outpaced in the rate of growth of that measure of productivity since 1960.

INDICATORS OF SAGGING U.S. ECONOMIC HEALTH IN THE 1970s and 1980s

☑ Productivity growth rates are lower by a yearly average of 1.4 percentage points.

☑ Productivity growth has been much lower than that of Japan and West Germany.

☑ Private profit rates have dropped by three percentage points.

☑ Net private investment, as a fraction of output, has declined by three percentage points.

☑ Average hourly wages, adjusted for inflation, were 3.3 percent lower in 1987 than in 1979, and real average weekly earnings were lower in 1989 than in 1967.

Solving the Mystery

The reasons for our low productivity growth, our low profit rate, and our low net investment rate—in general, our state of economic "malaise"—have so far resisted explanation by economists. Many obvious culprits have been brought to trial in the economics literature and, for one reason or another, all have been found largely innocent.

The reasons for our low productivity growth . . . have so far resisted explanation by economists.

For example, the Bureau of Labor Statistics came to the conclusion that at most one-half of the total fall-off in productivity growth can be explained by obvious suspects such as oil price hikes during the 1970s, a decline in research and development spending after the mid-1960s, and mismeasurement of labor input (U.S. Department of Labor, 1983; Fischer, 1988; Griliches, 1986, 1987; Olson, 1988; Romer, 1987).

In this paper, I bring another suspect before the bench by asking: what role might movements in the amount of public infrastructure capital have played in the evolution of the macroeconomy over the past forty years?

To be potentially important for explaining shifts in the performance of the aggregate economy, the public capital stock must be large relative to the private capital stock, and it must display variable trends over time. Table 1 provides 1987 data on the levels of total, private, and public stocks of fixed reproducible capital. It can be seen that of the total physical capital stock of 6.5 trillion dollars, 2.3 trillion dollars—36 percent—is held by the public sector. For every $2 of private capital, there is $1 of public capital.

TABLE 1

Private and Public Capital Stock, 1987

Capital Stock	Billions of Dollars	Percent of Total
Total	$6,487.3	100%
Total Private	4,142.8	64%
Nonfarm Business	3,974.6	61
Farm	168.2	3
Total Public	2,344.5	36%
Military	457.7	7
Nonmilitary	1,886.8	29
Core Infrastructure	1,195.7	18
Education, Hospital, & Other Buildings	535.9	8
Conservation & Development	155.2	2

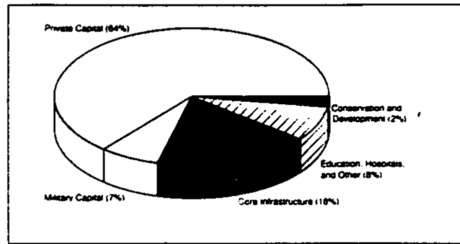
Source: Bureau of Economic Analysis.

While military capital makes up the bulk of the federal capital stock, it only amounts to 7 percent of the nation's total (public and private) stock of capital. Nonmilitary capital accounts for 29 percent of the national stock of tangible capital. Finally, the stock of "core infrastructure capital" (streets and highways, water and sewer systems, mass transit, airports, and electrical and gas facilities) comprises nearly 20 percent of the nation's stock of physical capital (see Figure 2). Moreover, it could be expected that because the elements of core infrastructure are intrinsic to most every sector of private production, they are especially influential in the determination of total national economic output. Clearly, the public capital stock has sufficient magnitude to influence the behavior of the private economy in a meaningful way.

Elements of core infrastructure are intrinsic to most every sector of private production.

It may not be fully appreciated that, setting military spending to one side, the bulk of the public capital stock resides in the state and local government sector. For instance, in 1985 the total federal net stock of public capital, excluding military equipment and facilities, was $247,125 million in 1985 dollars. But the state and local counterpart to this amount was $1,518,736 million. Thus, the state-local component of total civilian public capital was roughly 86 percent (Bureau of Economic Analysis, 1987).

Figure 2
Private and Public Capital as Percent of Total U.S. Capital in 1987



(Source: Bureau of Economic Analysis)

In 1987, publicly-owned structures and equipment providing services in the areas of national defense, transportation, education, health care, conservation, and development constituted 36 percent of the total U.S. capital stock.

Not only is the public capital stock large, but it also has evolved in a marked pattern over the post-World War II period. As Table 2 reveals, the level of nonmilitary public investment generally rose during the 1950s and 1960s—reaching some 3.9 percent of GNP in the latter decade—and then fell during the 1970s and the early 1980s (see Figure 3). While in recent years public investment has rebounded slightly, it remains far below levels attained during the mid-1960s. This striking pattern prevails for nearly all

Public investment . . . remains far below levels attained during the mid-1960s.

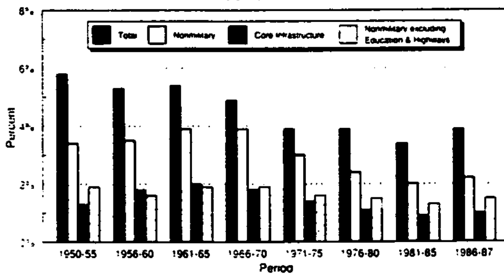
TABLE 2

Trends in Public Investment Relative to GNP

	Total	Nonmilitary	Core Infrastructure	Nonmilitary Minus Education and Highways
1950–55	5.8	3.4	1.3	1.9
1956–60	5.3	3.5	1.8	1.6
1961–65	5.4	3.9	2.0	1.9
1966–70	4.9	3.9	1.8	1.9
1971–75	3.9	3.0	1.4	1.6
1976–80	3.4	2.4	1.1	1.5
1981–85	3.4	2.0	0.9	1.3
1986–87	3.9	2.2	1.0	1.5

Source: Bureau of Economic Analysis, U.S. Department of Commerce.

Figure 3
Trends in Public Investment Relative to GNP
1950 to 1987



(Source: Bureau of Economic Analysis)

Measured as a share of GNP, civilian public investment and its components have all declined since the late 1960s.

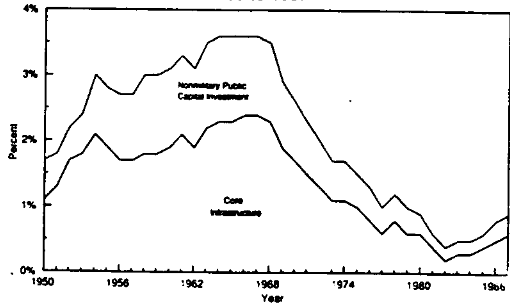
functional categories of public capital investment. Relative to output, the level of investment in core infrastructure peaked within a year of the peak in nonmilitary public capital spending, and it has risen only modestly in the last half decade.

As indicated in the last column of Table 2, nonmilitary public investment minus spending on educational structures and highways displays similar trend behavior.

By 1982 net public investment in core infrastructure had nearly ground to a halt in the United States.

It should also be noted that these figures pertain to gross investment in nonmilitary capital; no deduction has been made for the physical wear and tear on the nation's total stock of public capital, so the figures cited in Table 2 understate the problem. Once the public stock is adjusted for depreciation, the negative trend becomes even more disturbing. As shown in Figure 4, by 1982 *net* public investment in core infrastructure had nearly ground to a halt in the United States, coming in at less than 0.5 percent of total output. This means that the U.S. was not doing much more than replacing the existing public capital stock: very little was being added, the needs of the growing private economy notwithstanding.

Figure 4
Net Public Investment Relative to GNP
1950 to 1987



(Source: Bureau of Economic Analysis)

Public investment in core infrastructure, relative to GNP, has dwindled to less than 0.5%; other types of public investment have barely exceeded that level. The precipitous drop since 1968 is well below average performance during the 1950s.

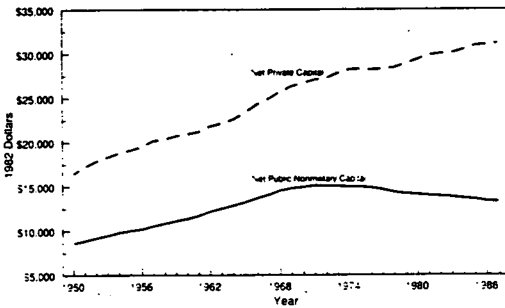
Figure 5 shows that this fall-off in public investment is reflected in a similar fall-off in the amount of infrastructure capital available to each worker in the economy. After climbing from around $8,500 per worker in 1950 to $15,000 per worker in the early 1970s, the public capital stock tumbled to some $13,000 per worker by the end of 1987.

At the same time, the dollar value of private plants and equipment per worker has continued to climb throughout the post-World War II period, from about $16,000 in 1950 to roughly $34,000 by the end of 1987. Thus, while the *private* sector has largely—though not completely—been doing its job in equipping workers with adequate tools and work environments, the public sector has been negligent in providing the appropriate amount of infrastructure, the necessary foundation to the private economy.

The last decade has also witnessed a third deficit: a lack of spending on vitally needed public works.

It is common for economists to talk about the "twin deficits" of the 1980s: the federal government budget deficit and the trade or current account deficit. But in a sense, the last decade has also witnessed a third deficit: a deficit in spending on vitally needed public works. Indeed, the fundamental thesis of this paper is that this third deficit is central to some of our most important long-term economic difficulties: our declining private profit rate on machinery and structures; our overall failure to invest adequately in our future; and our sluggish growth in productive efficiency.

Figure 5
Private & Public Nonmilitary Capital Per Worker
1950 to 1987



(Source: Bureau of Economic Analysis)

Net public nonmilitary capital per worker has clearly fallen off since 1970. The rate of increase for net private capital has changed little in forty years, which is remarkable in light of changes in the US economy and the strenuous efforts to stimulate private investment.

Infrastructure and the Economy: Concepts

Economists describe goods and services used to produce other goods and services as "factors of production." These consist of land (and associated natural resources), labor (considered in terms of time expended and skill level, among other things), and capital (chiefly equipment and structures).

Without a good infrastructure, private production would be much more costly, in certain cases prohibitively so.

If a private company builds a road from one of its buildings to another, or digs a well to obtain water, we would classify these items as private capital investments. If that same company were to move goods or obtain water as part of the production process by means of public roads and water supply, we would be remiss in not acknowledging the effect of the services of public capital on private production.

The delivery of an overnight package by Federal Express, for example, requires labor (truck drivers, airline pilots, mail sorters) and physical capital (the associated trucks, airplanes, and the "Octopus"—Federal Express's mechanical mail sorting machine). Oddly, standard procedure for economists is to limit the physical capital concept to *private* capital and to neglect public capital such as roads, airports, and other public infrastructure facilities. As the chosen example should make clear, however, this is an unfounded omission. For what kind of product would Federal Express have were it not for the streets on which it drives its trucks, or the airports where its planes land? What profits would Federal Express generate without such things as public highways and airports?

So the basic connection between infrastructure and the economy is simple. The stock of public highways, bridges, and other infrastructure capital is essential to the profitable and efficient production and distribution of private sector goods and services. While the choice of Federal Express as an example is admittedly not fortuitous, a moment's reflection should convince the reader that infrastructure capital directly or indirectly affects nearly every productive unit in the economy. Consider, for example, the variety of ways that infrastructure might be important to a clothing producer in a major city. Mass transit provides the firm with access to an extensive pool of inexpensive and productive labor. The washing and dyeing of fabrics requires a steady source of water and a reliable sewer system. Good streets and highways serve the dual purposes of just-in-time inventory management and easy shipment to national and international markets. Without a good infrastructure, private production would be much more costly, in certain cases prohibitively so.

The potential importance to the macroeconomy of trends in infrastructure spending can be discussed by utilizing the theoretical framework in Arrow and Kurz (1970) and Aschauer and Greenwood (1985). These authors expand on the standard neoclassical production function, expressed in labor-intensive form, to show that private sector output is a function of both private capital and the public infrastructure capital:

$$y = f(k, k^g) \qquad (1)$$

Here y = private sector output, k = private capital, and k^g = public infrastructure capital (all expressed per unit of labor employed).

This type of analysis has a number of important implications. First, an increase in the stock of public capital would be expected to directly raise the level of private sector output of goods and services. In the example given above, Federal Express would be able to make more deliveries per year (produce more output) with a given number of workers, planes, and trucks if the nation's stock of airport and highway facilities was expanded or improved. In this sense, public capital directly abets private sector production. Second, under certain circumstances, public capital and private factors of production—labor and private capital—may be "complementary inputs" so that an increase in the stock of public capital increases the productivity of private factors of production and thereby generates increased demand for labor and private capital investment goods. The decision by the government to improve the nation's transportation network might well encourage Federal Express to buy more planes and trucks, to hire more pilots and delivery personnel, and perhaps to make better use of their own capital.

An increase in the stock of public capital would be expected to directly raise the level of private sector output of goods and services.

Thus, one obvious implication of including public capital in our depiction of the process of private production is that it may play a direct role in promoting private sector productivity.

Evidence for the Hypothesis

A one percent increase in the stock of infrastructure capital will raise productivity by 0.24 of one percent.

Recent empirical evidence indicates that the public capital stock is an important factor of production: the slowdown in public investment can help explain a significant portion of the slump in productivity growth in the past two decades. For example, in Aschauer (1989a) I present historical statistical (i.e., time series) evidence for the post-World War II period in the United States which indicates that a "core infrastructure" of streets and highways, mass transit, airports, water and sewer systems, and electrical and gas facilities bears a substantially positive and statistically significant relationship to both labor productivity and multifactor productivity. Table 3 contains estimated output elasticities for various categories of public capital.[3] As can be seen in this table, the core infrastructure category has the largest output effect (i.e., the largest elasticity estimate) and is the most statistically significant of the various categories of public capital. A one percent increase in the stock of infrastructure capital, by this estimate, will raise productivity by 0.24 of one percent.

Figure 6 illustrates the close relationship estimated between total factor productivity and the nonmilitary public capital stock. To highlight the link between longer-term movements in productivity and the public capital stock, the measures of total factor productivity and the public capital stock have been adjusted for business cycle effects.[4]

TABLE 3

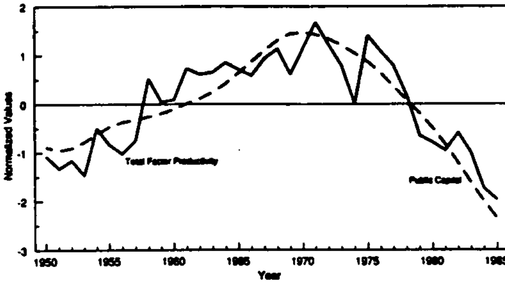
Public Capital by Type and Productivity (1949-1985)

Type	Coefficient Estimate*	T-statistic	Percent of Total	F
Core Infrastructure (highways, mass transit, airports, electrical and gas facilities, water and sewers)	0.24	(5.07)	55%	0.16
Other Buildings (office buildings, police and fire stations, courthouses, garages, and passenger terminals)	0.04	(1.57)	7	0.01
Hospitals	0.06	(1.62)	3	0.33
.nservation & Development	0.02	(0.92)	4	0.01
Educational buildings	0.01	(−0.18)	16	0.99

* The coefficient is the percentage change in total national output given a one percent change in the particular type of public capital.

Source: Author's calculations.

Figure 6
Public Capital and Productivity
1950 to 1985



(Source: Author's calculations.)

Changes in total factor productivity are closely associated with movements in the size of the public capital stock, after accounting for short-term fluctuation in productivity attributable to the business cycle.

The graph shows how that portion of total factor productivity which *cannot be* explained by technological progress[5] (proxied by time) or by the state of the business cycle (proxied by the capacity utilization rate) *can be* explained by movements in the public capital stock. One can see the close association between changes in productivity and public capital; indeed, the empirical estimates in my 1989 paper suggest that of the total 1.4 percent annual fall-off in productivity growth during the 1970s and 1980s, fully 57 percent—or 0.8 percent per year—can be attributed to the downturn in public investment spending. The levels of productivity and public capital stock peaked in the late 1960s to the early 1970s and during the mid-1960s, respectively.

One can see the close association between changes in productivity and public capital.

Certain refinements of my 1989 paper by Munnell (1990a) entailed adjusting the standard Bureau of Labor Statistics measure of labor input to account for changes in the age/sex composition of the labor force and updating the sample period to 1987. Munnell obtained strong parallel results on the importance of public capital in private sector production.

Munnell also computed adjusted measures of multifactor productivity growth and found that after accounting for changes in the quality of the labor force and for changes in the growth rate of the core infrastructure capital stock, the fall-off in multifactor productivity growth during the 1970s and 1980s relative to the 1950s and 1960s was "much more in line with expectations" and that "[much] of the drop in published multifactor productivity numbers may reflect the omission of public capital from the calculations of inputs rather than a decline in technological innovation" (Munnell, 1990; p. 19).

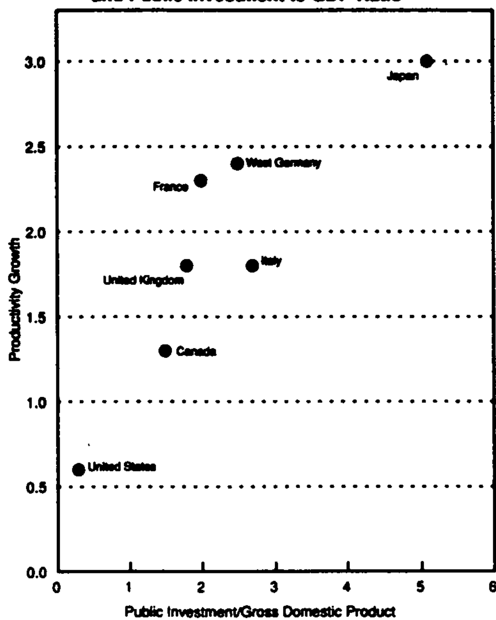
A shift from private to public investment would increase GNP substantially.

Of course, from a policy standpoint it would not be prudent to rest such strong conclusions solely on the basis of aggregate historical data from one country. It should be very instructive to examine cross-sectional evidence by comparing either states, industries, or countries. In fact, additional empirical results buttressing the case for expanded public spending on infrastructure are available.[6]

In Aschauer (1990d), I present evidence that public investment in streets, highways, and water and sewer systems is an important factor in explaining the variation in levels of productivity across states, and that the level of such public spending is lower than would be chosen by optimizing governmental bodies. Indeed, the inefficiency of our existing allocation of investment resources is underlined by the finding that increases in GNP resulting from increased public infrastructure spending are estimated to exceed those from private investment by a factor of between two and five. This means a shift from private to public investment would increase GNP substantially; it reflects the dearth of resources presently committed to infrastructure. Munnell (1990b) estimates the sizes of state-area public capital stocks and finds that public infrastructure capital is an important factor of production determining the level of state-area productivity. The categories of public capital bearing the most importance for private productivity turn out to be streets and highways and water and sewer systems; other public capital facilities have little or no explanatory power in private sector output regressions.

In Aschauer (1989c) I employed comparative historical data (i.e., pooled time series data) using evidence from national comparisons for the Group of Seven nations (Canada, France, Germany, Italy, Japan, Great Britain, and the U.S.) over the period 1965 to 1985. I found that upon controlling for private investment and employment growth, public nonmilitary investment bears a significantly positive relationship to growth in gross domestic product per employed person (see Figure 7).

Figure 7
Cross-Country Comparison of Productivity Growth and Public Investment to GDP Ratio



(Source: Author's calculations.)

A cross-country comparison of average annual growth rates of labor productivity with the ratio of public investment to gross domestic product indicates that over the period 1973–1985, nations which invested more in their public capital stocks saw productivity gains as well.

This is a noteworthy result because a number of researchers have pointed out that the productivity slump was not a disease unique to the United States; to the contrary, it had epidemic-like proportions, affecting nearly all industrialized economies. In the words of Stanley Fischer, the explanation for the productivity slowdown "is unlikely to lie in the special circumstances of a single country" (Fischer, 1988; p. 3). In that regard, it is interesting to note that public investment spending as a share of gross domestic product fell during the late 1960s and early 1970s in five of the seven counties in the sample. Furthermore, the ratio of public investment to total government spending declined during this period in all the Group of Seven countries.

The rate of return to private capital in the nonfinancial corporate sector is positively affected by changes in the stock of public capital per worker.

Summing up the evidence for the first major finding highlighted at the outset of this paper, the size of the public capital stock is an inescapable feature of the explanation for national productivity trends. This conclusion holds when considering the evolution over time of productivity in the U.S.; it holds when comparing disparate productivity levels in the states; and it holds when comparing the productivity performance of major industrial nations.

As stated above, a second implication of including public capital in the production technology is that changes in the *public* capital stock may influence the marginal productivity of *private* factors of production. For example, a better transportation network would allow Federal Express to make better use of additional trucks and airplanes which, in turn, would raise profit rates on such private capital goods. In Aschauer (1988), I present an historical statistical analysis (i.e., aggregate time series) which suggests that the rate of return to private capital in the nonfinancial corporate sector is positively affected by changes in the stock of public capital per worker. Employing data on manufacturing firms over the period 1970 to 1978, Deno (1988) finds similarly strong effects from public capital—highways, sewers, water facilities—as well as the total of these. In particular, he finds evidence of a complementary relationship between public and private capital. In short, public capital is "profitable" because it boosts the returns to private capital. While Eberts (1986) also finds that the public capital stock makes a positive and significant contribution to manufacturing output, the magnitude of his effect is considerably smaller than that indicated by Deno's results. Deno (1988) reconciles the difference by arguing that his own approach is more flexible, as it allows for responses to changes in public capital by firm output supply and by factor demands.

The evidence appears overwhelmingly in support of the proposal that public infrastructure directly augments private sector production. Therefore, a valid case can be made for a significant increase in public investment spending. But a crucial question must then be asked: what impact would an increase in public capital spending have on private investment? If the public investments were merely to displace private investments in plant and machinery—economists call this a complete "crowding out" of private capital accumulation—then national investment (private plus public) would be left unchanged and relatively minor productivity gains could be expected.

An increase in the public capital stock can be expected to have a positive effect on the profitability or the rate of return to private capital.

There are two basic effects operating on private investment activity when public investment is increased. As discussed above, an increase in the public capital stock can be expected to have a positive effect on the profitability or the rate of return to private capital. The theory of the firm suggests that firms will respond to heightened profit rates by expanding the pace of capital investment. But if we assume that the private sector profit rate remains constant, then greater public capital investment can also be expected to reduce private investment as national investment (private plus public) is pushed beyond the level which optimizing agents would choose. Historical data for the United States suggest that both types of effects of public investment on private investment may well be operative (Aschauer, 1989b). More specifically, I present results which indicate a nearly one-to-one "crowding out" of private by public investment (holding fixed the rate of return to private capital) as well as a "crowding in" of private investment by public investment—as the rate of return to capital responds over time to the increases in the public capital stock which are brought about by higher public investment. In the long run—in this case four or five years—the "crowding in" effect dominates and overall private investment is stimulated: *indeed, for every dollar increase in public investment, private investment rises by approximately 45 cents.*

What If We Had Invested More in Public Infrastructure?

The simulation exercise depicts an increase in the level of public nonmilitary investment by one percent of the private capital stock during the period from 1970 to 1986.

It is instructive to bring together some of these empirical results to consider how large an effect public investment has on crucial dimensions of economic performance: investment, profits, and productivity. This is accomplished by utilizing the aforementioned empirical estimates to construct a minimal model capable of simulating the effect of higher public investment on the aggregate economy. The increase in public investment hypothesized for the purpose of the simulation is consistent with what the U.S. would have experienced if the actual historical rate of public investment from roughly 1950 to 1970 (as shown in Figures 3, 4, and 5) had he[illegible] for the following two decades, rather than falling off as it did.

More specifically, the simulation exercise conducted below depicts an increase in the level of public nonmilitary investment by one percent of the private capital stock during the period from 1970 to 1986, an amount *125* percent greater than the actual level of public investment in this time period, so that the rate of public investment since 1970 is comparable to that of the 1950s and 1960s. By incorporating the effects of the greater public investment, Table 4 provides data on actual and simulated levels of the rate of return to private nonfinancial corporate capital, on net private investment in nonresidential structures and equipment, and on private business sector productivity growth.

TABLE 4

Simulated Impact of Public Investment on Private Economy

	Return to Private Capital (%)		Private Investment (% of Private Capital Stock)		Productivity Growth (% Per Annum)	
	Actual	Simulated	Actual	Simulated	Actual	Simulated
1953–69	10.7	—	3.8	—	2.8	—
1970–74	8.7	10.7	3.9	3.9	1.5	1.9
1975–79	8.5	9.9	3.2	4.2	1.3	2.2
1980–84	6.7	8.4	2.7	3.0	1.1	1.9
1985–88	7.8	9.6	2.8	3.8	1.8	2.7
1970–88	7.9	9.6	3.1	3.7	1.4	2.1

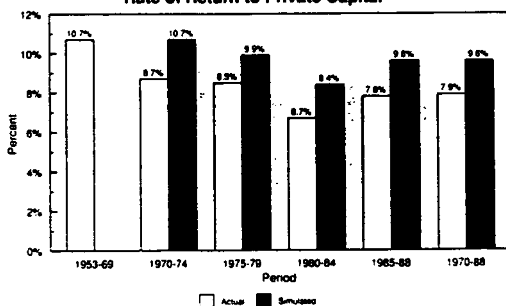
Source: See Appendix and Aschauer (1989a, 1989b) for details of simulation methodology.

The actual data document that between 1970 and 1988, inferior economic performance was experienced relative to the 1953-1969 period, along with a lower rate of return to private capital (7.9 percent as opposed to 10.7 percent), lower private investment (3.1 percent of the private capital stock rather than 3.8 percent), and lower labor productivity growth (1.4 percent per annum as opposed to 2.8 percent).

The simulation data also reveal relationships between public nonmilitary investment, private profitability, private investment, and private sector productivity growth. In the first five years of the hypothetical expansion in public investment, the rate of return to capital rises by 2 percentage points over its actual level, remaining at its 1953 to 1969 level of 10.7 percent instead of falling to 8.7 percent (see Figure 8). This is due to the cumulative positive effect of the rising public capital stock on the productivity of private capital.

In the first five years of the hypothetical expansion in public investment, the rate of return to capital rises by 2 percentage points over its actual level.

Figure 8
Actual and Simulated Impact of Rate of Return to Private Capital



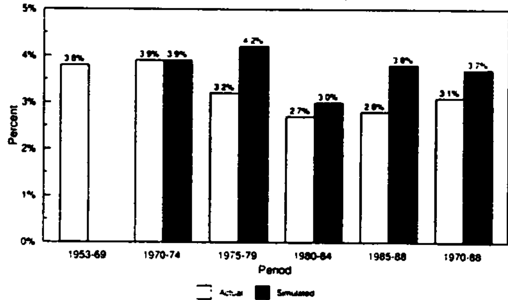
(Source: Author's calculations.)

The light bars reflect actual historical levels of the return to private capital in the U.S. The dark bars reflect the rates of return that could have been achieved if the commitment to public investment had not lagged after 1970

During the same period, the private investment rate averages 3.9 percent of the private capital stock, the same as in the actual data (see Figure 9). This reflects two offsetting forces: in the first three years of the higher public investment, private investment is pushed lower due to the direct crowding out effect of higher public investment, while in the next two years private investment is brought above its historical level by the higher rate of return to private capital. In the same period, private sector productivity growth is enhanced by 1.5 to 1.9 percent per year (see Figure 10). As the private investment rate (as a percent of the capital stock) is seen to remain steady, this enhancement of productivity growth reflects the direct, positive effect of a growing public capital stock on the productivity of labor.

Private sector productivity growth is enhanced by 1.5 to 1.9 percent per year.

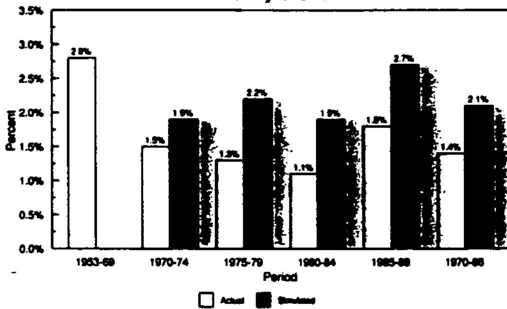
Figure 9
Actual and Simulated Impact on Net Private Investment



(Source: Author's calculations.)

The simulation suggests that net private investment could also have been augmented after 1975 if public investment rates had not decreased after 1970.

Figure 10
Actual and Simulated Impact on Productivity Growth



(Source: Author's calculations.)

Productivity growth could have been significantly higher than actual performance after 1970 under a regime of increasing public investment.

In the later years of increased public investment, the simulation results show that the rate of return to private capital could have held up to between one and two percentage points more than the historical levels. This issue arises because the private investment rate climbed to one percentage point higher than the historical level, and the consequent negative effect on the rate of return to private capital of the growing private capital stock roughly offset the positive effect of the expanding public capital stock. Productivity growth would then rise by a more substantial amount (nearly one percent per year above historical values) because the direct effect of growth in the public capital stock is augmented by the indirect effect of a higher return to capital, raising private investment which, in turn, stimulates productivity growth.

The rate of return to private capital could have held up to between one and two percentage points more than the historical levels.

On the whole, the simulation exercise suggests the possibility that the performance of the economy might have been greatly improved by an increased investment in public facilities. Comparing the 1970-1988 period to the 1953-1969 period, the rate of return to private capital could have been only 1.1 percentage points lower (instead of 2.8 percentage points); private investment could have been only 0.1 percentage points lower (rather than 0.7 percentage points lower); and annual productivity growth could have been 0.7 percent per year lower (instead of 1.4 percent lower).

Criticisms and Rebuttal

As was mentioned above, there are a number of reasons why these results might be interpreted with some caution. One reason for guarded optimism about the ability of public investment to improve private sector economic outcomes is that a logical case can be made that rather than being exogenous, public investment may well be responding to changes in the private economy instead of initiating them. In other words, one could argue that slower growth in productivity, per capita income, and tax revenue induced the government to reduce spending on public capital projects. Pushed to its logical extreme, this suggests that the fall-off in public investment in the 1970s and 19[illegible] was a result, not a cause, of the slump in productivity growth during the same period.

> ***Those functional categories of public capital which one would expect, on an a priori basis, to be the most productive—turn out to have the strongest statistical significance in estimated productivity relations.***

This argument can be answered by reference to the simple facts mentioned above: public nonmilitary investment expenditure, relative to output, reached a peak in the period between 1965 and 1968, and the usual dating of the onset of the productivity decline is around 1973. While some argue that the productivity slump began as early as 1965, and others deny its very existence (Darby, 1984), such economists are in a decided minority.

As demonstrated in Aschauer (1989a), those functional categories of public capital which one would expect, on an *a priori* basis, to be the most productive—in particular, a core infrastructure of surface and air transportation facilities, water and sewer systems, and electrical and gas facilities—turn out to have the strongest statistical significance in estimated productivity relations. Holtz-Eakin (1988) looked in some detail at the statistical association between public capital accumulation and private productivity growth and found that a substantial portion of the correlation reflects a causal role for the public capital stock and a passive role for productivity, rather than the converse. This means that public investment is the active causal factor in stimulating GNP growth and refutes the suspicion that GNP growth merely finances public spending of questionable value.

A second objection could be made that the estimated impact of public capital on productivity—one key parameter in the simulations above—is unreasonably large. Montgomery (1989) asserts that "the importance ascribe[d] to government investment ... simply strains credulity" (Montgomery, 1989; p. 2). Also, in a contribution to *Setting National Priorities: Policy for the Nineties*, Schultze (1990) writes that the regression results in Aschauer (1989a) "imply ... that a $1 increase in the stock of public infrastructure adds about as much to productivity as a $4 increase in the stock of private business capital" which, in his eyes, implies "grossly inflated estimates of the returns to infrastructure investment" (Schultze, 1990; p. 63).

My own judgement is that public infrastructure capital—which is valuable precisely because of the myriad ways in which it simultaneously raises productivity jointly across industries—may well be *four times* as potent in affecting the macroeconomy as private investment. More importantly, however, the plausibility of such large impacts of public capital has been estimated by Baxter and King (1990), who used theoretical simulation techniques to generate output paths resulting from changes in public investment. The authors conclude that "our analysis of the effects of public investment supports Aschauer's [1989a] view that variations in publicly provided capital have important macroeconomic effects. In particular, the decline in public investment . . . could potentially account for the recent decline in private factor productivity" (Baxter and King, 1990: p. 29).

My own judgement is that public infrastructure capital may well be four times as potent in affecting the macroeconomy as private investment.

It is true, however, that the elasticity estimates contained in Aschauer (1989a) yield an estimate of the rate of return to public capital in the range of 50 to 60 percent. And while rates of return to public investment in the 50 percent range are high relative to those estimated by conventional cost-benefit techniques, this could conceivably be due to deficiencies in cost-benefit methods which tend to understate the true return to public capital investments. Such defects in cost-benefit analysis could include:

(A) The use of an inappropriate rate of discount for public projects. Ogura and Yohe (1977) demonstrate that in a setting with a distortionary tax on private capital, if public capital and private capital are complementary inputs to the private production function, then the correct discount rate for public projects lies below the rate of time preference. This is because the completed public investment project will raise the marginal productivity of private capital and induce more aggregate savings and private investment than would arise without the complementarity. As we have seen, empirical evidence of such complementarities has been found in Aschauer (1988, 1989b), Deno (1988), and Eberts (1986).

(B) The inherent difficulties involved in capturing general equilibrium effects in partial-equilibrium cost-benefit analysis. In the words of the authors of a research project currently being funded by the Transportation Research Board, the spur which public investment provides

> . . . to labor productivity and growth is not fully captured in Benefit-Cost analysis, either because of limitations in the theoretical framework or because of benefit estimation methodologies. The growing suspicion among transportation policymakers and engineers is that either one or both is indeed the case; and that as a result even the most proficient use of Benefit-Cost analysis creates the risk that 'the sum of all infrastructure decisions taken according to the strict rules of net present value maximization will fail to achieve the level and mix of transportation investments that maximize productivity, national economic growth, and welfare . . . (Hickling, 1990: p. 72).

A clear example of the validity of such reasoning can be found in Quarmby (1989), which considers a detailed example of the possible cost reductions to a food retailer resulting from a road improvement. The cost savings arise as time savings to the retailer's vehicles (traditional user's benefits) and as "restructuring benefits" as the retailer is able to capture economies of scale by reducing the number of food depots. The quantitative significance of the restructuring benefits leads Quarmby to the conclusion that "[i]t is doubtful whether current methods of cost-benefit assessment fully account for the benefits of network improvements, which may include structural changes in distribution logistics" (Quarmby, 1989; p. 84). This is merely one example of the way in which infrastructure investment may help improve the productive "atmosphere" (Meade, 1952), thereby allowing the capture of increasing returns to scale and productivity gains. It seems plausible that in the aggregate such spill-overs could have significant effects on private sector production; indeed, they would seem to offer as much potential for explaining the stylized facts of economic growth as do the knowledge spill-overs discussed by Romer (1986, 1987).

Traditional disequilibrium macroeconomic models stipulate a direct, demand-side effect of government spending on output and capacity utilization.

(C) The actual process of project selection. In many cases, cost-benefit analysis is not even undertaken. To cite one example, it is stated that "methods of assessing the costs and benefits of pollution control have not generally been applied by the states on any regular, continuing basis" (Environmental Protection Agency, 1985; p. 27). When cost-benefit studies are undertaken, in actual practice the analysis is often performed with the use of relatively high real discount rates. The Office of Management and Budget, for instance, requires the use of a 10 percent discount rate for evaluating federal projects.[8] Also, rather than separate projects being evaluated individually and being funded if they pass the cost-benefit test, it is often the case that the parties responsible for choosing projects have a fixed amount of resources to allocate, leading to the possibility that a number of projects which are justifiable on cost-benefit grounds are left unfunded.

A third concern about the simulation exercise is that the model is simplistic. It assumes, for instance, that movements in employment and capacity utilization are independent of changes in public investment spending. It might be expected that public spending increases the general employment level through some kind of Keynesian "demand-side" effect.

In response to this I would reiterate that the focus of this exercise is on forces operating on the supply side of the economy, not the demand side. Traditional disequilibrium macroeconomic models stipulate a direct, demand-side effect of government spending on output and capacity utilization. Even equilibrium macroeconomic models can allow for significant positive output effects of public investment, at least in the long run. Baxter and King (1990) show that a unit increase in public investment spending may result in sizeable output multipliers, substantially in excess of unity.

Aschauer (1990b) provides evidence that public nonmilitary investment has a much more stimulative impact on output than do either public consumption or military investment; the output multipliers attached to the former type of expenditure lie in the range of four while those associated with the latter two types lie well below unity.

The upshot is that these theories may posit an alternative transmission mechanism for the effect of public investment on GNP, but they do not contradict the basic direction or magnitude of the effect underlying the simulation exercise, the immediate purpose of which, after all, is simply to estimate potential GNP which the U.S. has lost for lack of an adequate commitment to the public capital stock.

These theories may posit an alternative transmission mechanism for the effect of public investment on GNP, but they do not contradict the basic direction or magnitude of the effect underlying the simulation.

While a variety of objections could be made to these exercises, it is striking how closely the simulation results match those obtained by other researchers in simulations of purely theoretical representative agent growth models (Baxter and King, 1990).[9]

Conclusion

The Administration's proposed level of spending on nonmilitary equipment and structures, relative to total output, is 26 percent below the 1960 level and 24 percent below the 1980 level.

President George Bush, Secretary of Transportation Samuel Skinner, Budget Director Richard Darman, and Council of Economic Advisors Chairman Michael Boskin are all well aware of these arguments for the importance of a sound infrastructure to our economic vitality. In his introduction to Secretary Skinner's recent report on the nation's transportation needs, President Bush said that "our competitive success in the global economy depends [on preparing] our transportation system to meet the needs of the 21st Century" (U.S. Department of Transportation, 1990). Similarly, in the President's proposed Fiscal 1991 Budget, Richard Darman wrote that "it is intuitively apparent that some public investn[illegible]—particularly those of infrastructure such as streets, highways, airpor[illegible] water and sewer systems—provide direct productive services and are complementary with private capital. Comparisons over time and across countries seem to indicate that some relationship may exist between additions to such capital and growth." (Office of Management and Budget, 1990: p. 36). In the most recent *Economic Report of the President*, Michael Boskin asserted that "inadequate government infrastructure can impede improvements in productivity growth" and that "taking advantage of productive opportunities to maintain and improve the infrastructure is an important part of federal, state, and local government policies to raise economic growth." (Council of Economic Advisers, 1990: p. 123).

These sentiments notwithstanding, the Administration's proposed level of spending on nonmilitary equipment and structures, relative to total output, is 26 percent below the 1960 level and 24 percent below the 1980 level. Grants to state and local governments for physical investment purposes, relative to total output, will be left 40 percent under the 1960 level and 43 percent below the level in 1980. Likewise, the proposed level of total federal investment—in physical capital as well as in research and development and education—will lie 33 percent below its 1960 level and 10 percent under its 1980 level.

Of course, it is highly unlikely that the mix and level of public investment spending which was chosen over the past forty years will be preferred in the future. Even if, for instance, it were established beyond a shadow of doubt that the Interstate Highway System was a key determinant of productivity growth in the 1960s and 1970s, such a discovery would not necessarily imply that a similar effect on productivity would be obtained from the construction of another 40,000 miles of controlled access highways. We live in a dynamic economy which changes constantly in response to technological progress, foreign competitive pressures, and alterations in the demographic characteristics of the domestic workforce. In the future, infrastructure needs may well shift from surface to air transportation, from the transport of goods to that of ideas, and from a national to an international focus. Potentially large efficiency gains are to be expected, therefore, from improved air and seaport facilities and from telecommunications networking, among other things.

The evidence surveyed in this paper, along with the related simulation results, suggest that the benign neglect of the quality and quantity of our nation's infrastructure facilities will act as a severe drag on our overall economic performance. Unless we address our public capital needs immediately, we can expect a continuation of lackluster productivity growth, low profit rates on the existing private capital stock, stagnant real wages, and sluggish private net investment.

The collapse of Communism and the associated reduction in Cold War tensions now offers an unanticipated opportunity to rechannel some of the nation's resources from military spending into more productive areas. Many would argue that reductions in military spending should be utilized to reduce the budget deficit, in the hope that lower government borrowing would push down interest rates and, indirectly, stimulate private investment. I claim, however, that at the present time the best use of the extra resources is to directly augment the nation's public capital stock through a surge in infrastructure investment. Following this course will help equip the nation to compete effectively in the international arena and, at minimum, it offers some hope for a partial reversal of our sliding economic fortunes.

The benign neglect of the quality and quantity of our nation's infrastructure facilities will act as a severe drag on our overall economic performance.

Appendix: Simulation Methodology

The simulation results reported in the text were obtained using the following methodology. The empirical results from Aschauer (1989a, 1989b) were used to parameterize the following simple model:

(A.1) $\Delta k/k = -.04 + .60 * \Delta k(-1)/k(-1) + .79 * r - .99 * \Delta kg/k$

(A.2) $r = 2.52 + .006 * time - .27 * \log(k/n) + .09 * \log(kg/n) + .19 * cu$

(A.3) $\Delta y/y - \Delta n/n = .008 + .26 * (\Delta k/k - \Delta n/n) + .39 * (\Delta kg/kg - \Delta n/n)$
$+ .43 * \Delta cu/cu$

where: k = net fixed private capital stock
r = net rate of return to private capital stock
kg = net fixed public nonmilitary capital stock
n = labor force
y = private business sector output
cu = capacity utilization rate
Δx = absolute growth in variable x.

The first equation shows the growth rate of the net private capital stock as dependent upon its own lagged value (due to increasing costs of adjusting the capital stock), the rate of return to capital, and investment in public nonmilitary capital. The second equation shows that the rate of return to private capital is dependent upon time (due to neutral technological progress), the private capital to labor ratio (negatively due to a diminishing marginal product of private capital), the public nonmilitary capital to private labor ratio (positively due to the services of public capital in private production), and the capacity utilization rate (positively due to shocks to supply or demand). The model also contains two identities to convert investment rates into growth rates of capital stocks.

The parameterized model was used to obtain simulated values for $\Delta k/k$, r, and $\Delta y/y - \Delta n/n$ during the period 1970 to 1988 taking levels and growth rates of the labor force and capacity utilization as given exogenously.

Endnotes

[1] These data refer to the profit rate on nonfinancial corporate capital structures and equipment.

[2] Darby (1984). Of course, there is much controversy about the validity of these facts as well as about their appropriate interpretation. For instance, there are some, like Michael Darby, who argue that there has been no true productivity slowdown: instead, what we have chosen to see in this regard is "a case of statistical myopia." Others, such as Martin Feldstein and Lawrence Summers, would argue that there is really no long-term downtrend in the corporate profit rate. And there is much controversy about whether investment really has been depressed during the 1980s. Individuals like Paul Craig Roberts choose to emphasize gross, as opposed to net, investment rates, and gross investment has been relatively stable during recent years. Finally, it is necessary to be careful about interpreting movements in productivity, profit rates, and investment—or, for that matter, other variables such as the current account deficit—as indicators of economic malaise. The appropriate, or optimal, rates of national savings, investment, and productivity growth are inherently unobservable and may well be changing over time. It seems clear, nevertheless, that the economy has not been performing well as of late and that the typical person in the street is rightly concerned about our long-term economic prospects.

[3] An output elasticity of public capital is defined as the percentage change in total national output given a one percent change in the stock of public capital.

[4] "Total factor productivity" or "multi-factor productivity" is a statistical measure of the "joint" productivity of all inputs in the production process: labor, private capital, and public capital. Munnell's findings (1990a, b) emphatically support the conclusion that the shortfall in public investment spending played a large role in diminishing the productivity of the private economy, over and above the separate influence of the changing labor force. The dependence of productivity on the level of utilization of the private capital stock has also been estimated and subtracted from the measure of total factor productivity. Productivity is commonly believed to move in conjunction with the business cycle: when unemployment is low, productivity is high, and vice versa. This has been attributed to the tendency of business firms to refrain from some layoffs when business is slow in order to ensure the retention of experienced workers, with the result that firms are somewhat overmanned in such circumstances and output per worker declines.

[5] This refers to technological progress in the sense known by economists as "neutral."

[6] Munnell (1990b) and Aschauer (1990d).

[7] The rate of return to private nonfinancial corporate capital is defined here as the ratio of corporate profits net of depreciation plus net interest received to the total value of the net capital stock. The rate of return to net private investment in non-residential structures and equipment is defined as the ratio of net profits and net interest to the stock of non-residential structures and equipment. The rate of return to capital in terms of productivity is defined in terms of the growth in output per labor hour.

[8] This represents a high discount rate because in the present value calculations the future benefits are expressed in real, inflation-adjusted terms. Consequently the ten percent discount is best interpreted as a ten percent real discount rate.

[9] The model employed by Baxter and King (1990) is a representative agent model with a production structure similar to equation (1) in the "Infrastructure and the Economy: Concepts" section of this report. The model imposes the discipline of general equilibrium; that is, there are no involuntarily unemployed resources at any time. Still, public investment policy has important effects on the economy by altering productivity as well as factor returns (wages, profits) which, in turn, change the pace of employment and capital stock growth.

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SENATOR SARBANES. Mr. Miller, please proceed.

STATEMENT OF JAMES C. MILLER, III, CHAIRMAN, CITIZENS FOR A SOUND ECONOMY

MR. MILLER. I would like to find out where your chart came from. Certainly, there is an error. During the decade of the 1980s, the productivity rate of growth for the United States was between 3 and 4 percent. I am just interested in where the data came from.

SENATOR SARBANES. This came from a Federal Reserve Bank of Chicago study.

MR. MILLER. What years is it based on? Recently? The last couple of years?

SENATOR SARBANES. The study was from the decade 1975 to 1985.

MR. MILLER. I think if you chose a different timeframe, you would probably get a different number. If you chose the last decade or even the last 12 or 15 years, you would get a much higher number for the United States.

SENATOR SARBANES. What the chart is seeking to show is that there appears to be a correlation between a nation's level of public investment and its productivity growth. Now, it may be that for a more recent period—and this was a very carefully done study, and that is why we are relying upon it—we may be farther along the public investment line, hopefully higher up on productivity.

But this chart illustrates the correlation. It shows that Japan, which has productivity growth up above 3 percent, had public investment out here in the range of 5 to 6 percent of gross domestic product. (See chart on p. 142).

MR. MILLER. I agree that there is a correlation. Most of the literature comes to that conclusion. My suspicion, though, is that the United States number is an artifact of the choice of the time period in which the analysis was done, because the numbers for productivity growth during the 1980s, for example, were quite high, much higher than is indicated there, on a par or even above that of West Germany, in terms of the point that is indicated there.

Nevertheless, if I could go into my testimony now, Mr. Chairman.

SENATOR SARBANES. Surely.

MR. MILLER. Thank you for that clarification.

I appear as an academic economist affiliated with George Mason University's Center for Study of Public Choice, where I am the John M. Olin Distinguished Fellow in the Center there. But I also appear on behalf of 250,000 members and supporters of Citizens for a Sound Economy, an organization of which I serve as Chairman of the Board.

Now, if I were an economic doctor, I would say that the patient's vital signs are not particularly good. We have had three straight quarters of decline in the gross national product, corporate profits are generally down,

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investment has been contracting, though it has picked up thanks to increased inventories.

The unemployment rate is up, but stubbornly remains higher than usual. The capacity utilization rate ticked up after substantial decline, but has turned down again. More worrisome, the money aggregates are still growing at very low rates. We look at M1, it has been growing at slightly higher than the rate of inflation, but M2 and M3 have been growing at lower than the rate of inflation, and, in fact, M3 has actually contracted for four straight months. And, of course, this portends a very sluggish economy in the future.

In fact, of the major vital signs, only inflation is giving us a positive signal. Coming on the heels of a record economic expansion, the present economic situation has led to calls from political leaders to do something, to jump start the economy.

This is due, in part, to widespread anxiety of a type not experienced at the conclusion of previous recessions. And the reason is easy to explain. In previous recessions when they have ended, the economy has rebounded quite dramatically. Here, we have had no rebound, we have just been constant.

Moreover, as Labor Secretary Lynn Martin has noted, the structure of unemployment this time is different. It is more vertical, with less assurance that the jobs lost will eventually be filled or replaced.

Okay. Now, the question is: Should the government intervene? In general, finetuning the economy is a bad idea because it seldom works. Even good economists don't always know what to do, and the decision-makers don't always do what they say or follow sound advice from whatever source.

The best economic policy is to establish a set of institutions within which the economy can flourish without constant attention from government. At present, however, our institutions are so at variance from the ideal that some sort of intervention is called for to shock the system and begin the process of setting it right.

So, I believe the appropriate metaphor is not a car with a dead battery that needs jump-started—I remember as a teenager jump-starting many a car—rather, the appropriate metaphor here is a car that is chugging along the road but not gaining speed. The reason it is not gaining speed is that it is loaded down with excessive baggage.

Moreover, the excess weight makes it hard for the car to negotiate the twists and turns of an internationally competitive marketplace. We need to dispose of the excess baggage and make the car faster and more maneuverable.

Now, specifically, the following steps should be taken:

First, Congress should lower—preferably to zero—the tax rate on capital gains from whatever their source, and reduce tax rates to where they were before the 1990 budget accord, and should lower the marginal tax rates across the board.

Second, Congress should freeze total spending, in nominal terms. An increase for entitlements, such as social security or Medicare, can be financed by automatic revenue increases from a modicum of economic growth, from reductions in outlays for defense, although these will be modest, as Mr. Faux is pointing out, and from savings from postponing or eliminating low-priority programs, including well-publicized pork.

Third, Congress and the Administration should establish a moratorium on new regulations. We have had an enormous flood of regulations in the last several years. Things have changed. There is a problem now. It is not a problem that has been in the making over the past ten years; we have a problem that has developed in the last several years. Any look at the numbers on output will tell you this.

To have a moratorium on regulations, and to do it right would require congressional action to delay some of the judicial, some of the statutory deadlines for regulations that are in the legislation.

Fourth, Congress and the Administration should grant the financial institutions some breathing room.

I am sorry Chairman Riegle left, because I had hoped to have a colloquy. He came and made a speech, made a lot of accusations about things and about people, including me, I guess, since I am one of those flat-earth economists. But I can assure him that I work for a living; I don't live off of somebody's largess.

Over the longer run, Congress and the Administration must simplify the tax code, reform the budget process, institute a regulatory budget and revamp, preferably replace, the current system of government deposit insurance.

But the four initiatives I just described are things that I think have to be done now.

Should there be a Marshall Plan for America? I am aware, of course, that the focus of this hearing is the Marshall Plan for America that has been introduced by you, Chairman Sarbanes, and Senator Sasser. I agree with some of the tenets of the plan. The economy is in distress. The government can profitably invest in R&D, education, infrastructure and so on.

But I most emphatically disagree with the notion of a Marshall Plan of the type put forward, with its reliance on fiscal policy—and here I differ dramatically with Mr. Faux—I most emphatically emphasize that this type of Marshall Plan is not what we need right now. First, for the reasons stated above, we do not need more finetuning or even gross tuning, but deliberate action to restore the set of institutions conducive to long-term economic growth.

Second, as Santayana said, "Those who do not remember the past are condemned to relive it," and the Marshall Plan, while a magnanimous and effective gesture, was not what revived the European economy after World War II. It helped, but it was not decisive. What was decisive was the liberalization of European economies. As economist Wilhelm Rielke wrote in late 1947, "Where a poor and war-devastated country like Italy

allowed sufficient elbow room to the economy, there was momentum, reconstruction, speedy recovery, and hope."

In HUD's Secretary Jack Kemp's recent open letter to Boris Yeltsin, published in the Policy Review, he notes the extraordinary revival of the German economy and credits the free-market policies of what he calls the "wily old professor," Ludwig Erhardt.

Third, fiscal policy is a notoriously clumsy, imprecise and inefficient way of dealing with insufficient aggregate demand. It is prone to make matters as worse as to make them better. Witness the 1990 budget deal, which increased taxes and stifled growth at a time when the economy was entering a recession. Even when in the right direction, the timing is just as likely to be off as to be on, further exacerbating our economic problems. No, as incapacitated as monetary policy might be right now—with terrible disruptions in our monetary institutions—I believe that monetary policy is still a much preferred course, if stimulating aggregate demand is the goal.

Fourth, activist fiscal policy constitutes a slippery slope, the end of which is national economic planning. I have just returned from the old Soviet Union, and I have seen with my own eyes the devastation that centralized economic planning has wreaked on the citizens of that mighty nation.

Fifth, frankly, I find it incomprehensible that the authors of the Marshall Plan for America would characterize the current fiscal situation as "fiscal contraction." While state and local governments are running a modest surplus, the U.S. Government is running a deficit ten times as great—exceeding $300 billion per year. This constitutes an expansionary fiscal policy, not a contractionary one.

And I know, Chairman Sarbanes, you worked for Walter Heller at the Council of Economic Advisers. We are both alumni of that distinguished organization. I would think that he, if he were still alive, would agree that a $300-plus billion deficit is an expansionary fiscal policy, not a contractionary one.

SENATOR SARBANES. Let me just interject there. I don't think Walter would agree with you, because he would distinguish a deficit that is resulting from a slow, recessionary economy and which has a heavy component from the bailout of the savings-and-loans and the banks. Walter defined a fiscal policy according to the full-employment level of the deficit.

MR. MILLER. Okay.

SENATOR SARBANES. Now, we are running a structural deficit at full employment. This year we are running a smaller structural deficit than we were running last year. So, to that extent, federal fiscal policy is contractionary at this time period. In the very downturn, fiscal policy, which is contractionary, is helping to contribute to the downturn.

MR. MILLER. The rate of change of the expansionary policy is negative, but the expansionary policy is there nonetheless. The deficit is very large. The structural deficit still is very large.

SENATOR SARBANES. And we are trying to get that down. But to try to get a structural deficit down in a recessionary period, in fact, helps contribute to the downward momentum. That is the problem. Now, the large number you talk about for the deficit—I mean the structural deficit is large enough as it is—but it has been greatly increased by the impact of the recession and by the large amounts that are going into the bailout of the financial institutions.

MR. MILLER. I thought you just defined structural deficit as the full-employment deficit.

SENATOR SARBANES. Yes, but I am going to your $300 billion figure here, which obviously embraces the impact of the recession.

MR. MILLER. Yes. The impact. Right.

SENATOR SARBANES. Let me ask you this question: Does it not embrace the impact of the recession and the money being used for the financings?

MR. MILLER. Sure, it does.

SENATOR SARBANES. Yes.

MR. MILLER. That's right. But even considering your full-employment deficit, you probably are looking at a minimum of $200 billion structural deficit—many times the surplus being run by state and local governments. I am just saying that it is inaccurate to characterize the present situation as a contractionary fiscal situation. It is an expansionary fiscal situation, though, perhaps, not as expansionary as last year.

SENATOR SARBANES. But it is contractionary compared to last year's policy. It is happening at a time of recession, not at a time of economic expansion, and is therefore contributing to the economic contraction.

SENATOR SASSER. Mr. Chairman, if I could make one statement here. First, the structural deficit has been reduced. It was reduced as a result of the budget agreement last year. It now stands at about $190 billion, a reduction from about $210 billion, I think, prior to the budget agreement.

And Dr. Miller, in his own statement here, indicates that the 1990 budget deal—quoting from it—"which increased the taxes and stifled growth at a time when the economy was entering a recession," that it appears that Dr. Miller himself is saying that the fiscal drag of reducing the structural deficit coming out of the budget agreement is a drag on the economy and helped induce the recession.

MR. MILLER. Well, thank you, Senator, for bringing that to my attention. There are supply-side and demand-side effects. If we are talking about stimulating aggregate demand, I think we need to look at the size of the deficit; not the rate of change in the deficit, but the size of the deficit. I meant by that, and as I will explain a little bit later in my testimony, the effects were on the supply-side of the tax cut.

But even using the fiscal contraction numbers that you talked about in the release, $20 billion at the federal level and $35 billion at the state and local level, this amounts to less than 1 percent of our $6 trillion gross national product. Eliminating this so-called fiscal drag, if it could be done

effectively and immediately, would be only a partial solution to our economic ills.

And by the way, you can make the same argument about the trade deficit with Japan. Even if the Japanese were to buy all of the $40 billion, we still wouldn't be out of the recession. We wouldn't be back to normal rates of growth; we would be at 1 percent or something like that.

It is the supply-side, not the demand-side, that is presently giving us fits, and with the possible exception of the tax cut, I see little in this Marshall Plan's fiscal provisions to help the problems on the supply-side.

Mr. Chairman, members of the Committee, our economy is in the doldrums. Congress and the Administration need to act boldly, but with forethought. Our problems stem primarily from the deterioration of our economic institutions, from ill-considered and ill-timed tax increases, from spending increases in the public sector that crowded out more productive expenditures in the private sector, from the imposition of extraordinarily burdensome and ineffective regulations, and from the disruption of our financial institutions. The Marshall Plan for America does virtually nothing to address these problems, and could well make matters worse. Thank you, sir.

[The prepared statement of Mr. Miller, together with a response for the record, follows:]

PREPARED STATEMENT OF JAMES C. MILLER, III

Mr. Chairman and Members of the Committee, thank you for inviting me here today.

I appear as an academic economist affiliated with George Mason University's Center for Study of Public Choice, where I am the John M. Olin Distinguished Fellow. But I also appear on behalf of the 250 thousand members and supporters of Citizens for a Sound Economy, where I serve as Chairman of the Board.

The Economy and What Needs to Be Done

If I were an "economic doctor", I would say the patient's vital signs are not particularly good.[1] We've had three straight quarters of decline in the gross national product. Corporate profits are generally down. Investment has been contracting, though it has ticked up -- thanks to increased inventories. The unemployment rate is up and stubbornly remains higher than usual. The capacity utilization rate ticked up after a substantial decline, but has turned down again. More worrisome, the money aggregates are still growing at very low rates. While M1 has risen substantially since the beginning of the year, M2 and M3 -- the broader definitions of money -- are not even keeping up with the rate of inflation. M3 actually has contracted for four straight months. This, of course, portends a very sluggish economy for the coming year.

In fact, of the major vital signs, only inflation is sending out a good signal. Thus, the outlook for the economy is not

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[1]Reference: Economic Indicators, December, 1991 (Washington: U.S. Government Printing Office, 1992).

good.

Coming on the heels of a record economic expansion, the present economic situation has led to calls for political leaders to "do something" to "jump-start" the economy. This is driven in part by wide-spread anxiety of a type not experienced at the conclusion of recent economic downturns. In the past, when recessions have ended things have gotten much better; this time, there is no rebound. Moreover, as Labor Secretary Lynn Martin has noted, the structure of unemployment this time is different -- more vertical, with less assurance that lost jobs eventually will be replaced.

OK, the question is, should the government intervene? In general, fine tuning the economy is a bad idea, because it seldom works. Even good economists don't always know what to do, and decisionmakers don't always follow sound advice. The best economic policy is to establish a set of institutions within which the economy can flourish without constant attention from government. At present, however, our institutions are so at variance with the ideal that some "intervention" is called for -- to "shock" the system and begin the process of setting it right.

So, ladies and gentlemen, I believe the appropriate metaphor is <u>not</u> a car with a dead battery that needs to be "jump-started". Rather, it is a car chugging along the road but not gaining speed. The reason it is not gaining speed is that it is loaded down with unnecessary baggage. Moreover, the excess weight makes it hard for the car to negotiate the twists and turns of an internationally competitive marketplace. We need to dispose of the excess baggage and make this car faster and more maneuverable.

Specifically, the following steps should be taken. First, Congress should lower, preferably to zero, the tax rate on capital gains, should reduce tax rates to where they were before last year's budget accord, and should lower marginal tax rates across the board.

Second, Congress should freeze total spending in nominal terms; any increases for entitlements (such as social security and medicare) should be "financed" by automatic revenue increases (from a modicum of economic growth), from reductions in outlays for defense (though, realistically, these must be modest), and from savings from postponing or eliminating lower priority programs, including well-publicized pork.

Third, Congress and the Administration should establish a moratorium on new regulations; to be complete, this would require congressional action to delay statutory deadlines.

Fourth, Congress and the Administration should grant the

financial institutions some breathing room.

Of course, over the longer run Congress and the Administration must simplify the tax code, reform the budget process, institute a regulatory budget, and revamp, or preferably replace, the current system of government deposit insurance. But the four initiatives just described are things I believe should be done now.

A Marshall Plan for America?

I am aware, of course, that the focus of this hearing is the proposal by Senators Sarbanes and Sasser to establish a so-called Marshall Plan for America.[2] I agree with some tenets of the plan. The economy is in distress. There are areas where government can profitably invest in infrastructure, education, R&D, and so on. But I most emphatically disagree with the notion that a "Marshall Plan" of the type put forward -- with its reliance on fiscal policy -- is what we need right now.

First, for the reasons stated above, what we need is not more fine-tuning, or even gross-tuning, but deliberate action to restore a set of institutions conducive to long-term economic growth.

Second, as Santayana said, those who do not remember the past are condemned to relive it. The Marshall Plan, while a magnanimous and effective gesture, is not what revived the European economy after World War II. It helped, but was not decisive.[3] What was decisive was the liberalization of European economies. As German economist Wilhelm Ropke wrote in late 1947, "Where a poor and war-devastated country, like Italy, allowed sufficient elbow room to the market economy, there was momentum, reconstruction, speedy recovery, and hope."[4] In HUD Secretary Jack Kemp's recent "Open Letter to Boris Yeltsin," he notes the extraordinary revival of the German economy and credits the free-market policies of that "wily old professor," Ludwig Erhard.[5]

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[2]Senator Paul S. Sarbanes, Chairman, Joint Economic Committee, and Senator Jim Sasser, Chairman, Senate Budget Committee, "A Program for Recovery and Growth", n.d.

[3]See, for example, Henry C. Wallich, Mainsprings of the German Revival (New Haven: Yale University Press, 1955).

[4]Wilhelm Ropke, "Marshall Plan and Economic Policy," Against the Tide (translated by Elizabeth Henderson; Chicago: Henry Regnery Company, 1969), p. 124.

[5]Jack Kemp, "Houses to the People!: An Open Letter to Boris Yeltsin," Policy Review (Winter 1992), p. 2-7.

Third, fiscal policy is a notoriously clumsy, imprecise, and inefficient way of dealing with insufficient aggregate demand. It is as prone to make matters worse as to make them better -- witness the 1990 budget deal, which increased taxes and stifled growth at a time when the economy was entering a recession. Even when in the right direction, the timing of fiscal initiatives is as likely to be "off" as "on", further exacerbating our economic problems. No, as incapacitated as monetary policy might be right now -- with terrible disruptions in our monetary institutions -- I believe that monetary policy is still a much preferred course, if stimulating aggregate demand is the goal.

Fourth, activist fiscal policy constitutes a slippery slope, the end of which is national economic planning. I've just returned from the old Soviet Union, and I have seen with my own eyes the devastation centralized economic planning has wreaked on the citizens of that mighty nation.

Fifth, frankly I find it incomprehensible that the authors of the Marshall Plan for America would characterize the current fiscal situation as "fiscal contraction". While state and local governments are running a modest surplus, the U.S. government is running a deficit 10 times as great -- exceeding $300 billion per year. This constitutes an _expansionary_ fiscal policy, not a contractionary one.

But take the "fiscal contraction" the authors talk about -- $20 billion at the federal level and $35 billion at the state and local levels -- amounts to less than 1 percent of our $6 trillion gross national product. Eliminating this so-called fiscal drag -- if it could be done effectively and immediately -- would be only a _partial_ solution for our economic ills.[6] It is the _supply_ side, not the demand side, that is presently giving us fits. And, with the possible exception of the tax cut, I see little in this "Marshall Plan's" fiscal provisions that go to problems on the supply side.

Concluding Remarks

Mr. Chairman and Members of the Committee: our economy is in the doldrums. Congress and the Administration need to act boldly, but with forethought. Our problems stem primarily from the deterioration of our economic institutions -- from ill-

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[6]A similar point could be made in response to the charge that the Japanese are responsible for our economic maladies. First, of course, we ran a trade deficit with Japan all through the high-growth period of the 1980s. But take the present $40 billion trade deficit with Japan: _even if_ the Japanese were to increase imports from the U.S. by this amount, U.S. output would go up by less than 1 percent.

considered and ill-timed tax increases, from spending increases in the public sector that crowd out more productive expenditures in the private sector, from the imposition of extraordinarily burdensome and ineffective regulations, and from the disruption of our financial institutions. The Marshall Plan for America does virtually nothing to address these problems -- and could well make matters worse.

Thank you.

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James C. Miller III
Chairman of the Board

January 18, 1992

The Honorable Paul S. Sarbanes
Chairman
Joint Economic Committee
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

Thank you again for inviting me to testify last Monday on a "Marshall Plan for the United States." I wanted to follow up on our colloquy concerning productivity and investment.

The chart which appeared behind you led to my questions concerning productivity growth in the United States. As best I could tell, the chart was unmarked as to time frame and as to the definition of "productivity". As indicated by the enclosed page (16) from the latest (December 1991) issue of Economic Indicators, labor productivity (output per hour of all persons) grew during the 1980s at a rate considerably higher than the roughly 0.3 indicated for the period 1973-1985 as shown on your chart. In addition to time frame, this difference may be due in part to lower productivity growth during the late 1970s and also to the increasing labor force participation rate (specifically, more women entering the work force) that occurred during the 1980s -- which, everything else equal, reduced the ratio of capital to labor and therefore reduced measured productivity.

Now, concerning Professor Aschauer's piece, from which the chart was taken (David Alan Aschauer, Public Investment and Private Sector Growth: the Economic Benefits of Reducing America's "Third Deficit" [Economic Policy Institute, 1990]), I have reviewed it briefly, but more importantly I have had a chance to check with other economists who have looked at it in more detail. While I agree with others that Professor Aschauer is to be congratulated for bringing to our attention the possibility that public investment not only generates a positive return, but promotes private investment as well, I think it important to understand that the "Aschauer thesis" simply does not stand up to scrutiny.

Senator Sarbanes
Page 2

Let me quote portions of Dr. Henry Aaron's (director of economic studies at the Brookings Institution) discussion of Professor Aschauer's presentation at the Boston Federal Reserve Board:

> Aschauer has had a valuable insight but has generally exaggerated its quantitative importance; this paper does little to advance the thesis he propounded elsewhere.

After examining Aschauer's model, utilizing variations in its specifications, he concludes:

> If the results are not robust -- and Aschauer's are not -- then the hypothesis under examination cannot be regarded as even provisionally confirmed and no policy recommendations of any sort can rest on the results.

As I indicated during the testimony, I do not in any way contest the notion that there are public investments that generate substantial returns (citing Head Start as an example). But I believe to base a massive federal spending program to support infrastructure and other public investments on such a flawed study would constitute a policy mistake of enormous proportions.

Finally, I recall someone on the dias noting that the public debt as a proportion of GNP is smaller today than at the end of World War II -- as a way of justifying a program which would increase the deficit (and add to the debt). It is worth noting, however, that as indicated in the enclosed chart, the <u>interest</u> on the debt is a higher proportion of GNP today than it was at the end of World War II.

I respectfully request that this letter be placed in the record following my testimony.

Sincerely yours,

James C. Miller III

PRODUCTIVITY AND RELATED DATA, BUSINESS SECTOR

Period	Output per hour of all persons		Output [1]		Hours of all persons [2]		Compensation per hour [3]		Real compensation per hour [4]		Unit labor costs		Implicit price deflator [5]	
	Business sector	Nonfarm business sector	Business sector	Nonfarm business sector	Business sector	Nonfarm business sector	Business sector	Nonfarm business sector	Business sector	Nonfarm business sector	Business sector	Nonfarm business sector	Business sector	Nonfarm business sector
	1982=100; quarterly data seasonally adjusted													
1980 r	98.6	99.0	100.5	100.8	101.9	101.8	85.0	84.9	99.5	99.4	86.2	85.7	85.9	85.6
1981 r	99.9	99.9	102.4	102.4	102.5	102.5	93.0	93.0	98.7	98.8	93.1	93.1	94.5	94.2
1982 r	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
1983 r	102.2	102.4	104.1	104.4	101.8	102.0	103.7	103.9	100.5	100.7	101.5	101.5	103.4	104.0
1984 r	104.6	104.5	112.6	113.0	107.6	108.1	108.1	108.1	100.4	100.4	103.3	103.4	107.7	107.6
1985 r	106.1	106.4	116.7	116.8	109.9	110.8	113.0	112.6	101.3	101.0	106.5	106.8	111.2	111.6
1986 r	108.3	107.5	119.9	120.1	110.7	111.8	118.6	118.1	104.4	104.0	109.5	109.9	113.6	114.2
1987 r	109.4	108.3	124.8	125.0	114.1	115.4	122.7	122.1	104.3	103.7	112.2	112.8	116.6	117.2
1988 r	110.4	109.2	130.1	130.6	117.9	119.5	128.0	127.2	104.4	103.8	116.0	116.4	120.8	121.4
1989 r	109.5	108.2	132.4	132.8	120.9	122.7	132.5	131.5	103.1	102.3	121.0	121.5	126.0	126.4
1990 r	109.7	108.1	132.9	133.2	121.2	123.1	139.6	138.3	103.1	102.1	127.3	127.9	130.8	131.3
1982: IV r	101.1	101.0	100.0	100.0	98.9	98.9	102.1	102.1	100.6	100.6	101.0	101.1	101.1	101.4
1983: IV r	103.0	103.2	107.5	108.1	104.3	104.7	105.2	105.1	100.4	100.3	102.1	101.8	104.8	105.2
1984: IV r	105.2	105.1	114.4	114.8	108.7	109.2	109.7	109.7	100.6	100.5	104.3	104.4	109.0	109.0
1985: IV r	106.9	105.8	118.0	118.2	110.4	111.7	115.4	114.8	102.2	101.6	108.0	108.4	112.4	112.9
1986: IV r	108.0	107.1	120.6	120.8	111.6	112.8	120.6	120.1	105.3	104.9	111.6	112.1	114.6	115.2
1987: IV r	110.3	109.1	127.4	127.6	115.5	117.0	125.3	124.6	104.8	104.2	113.7	114.3	117.9	118.5
1988: IV r	110.4	109.6	131.7	132.5	119.3	121.0	130.1	129.3	104.3	103.6	117.8	118.0	122.8	123.4
1989: I r	110.0	108.8	132.6	133.0	120.5	122.2	131.3	130.4	103.9	103.2	119.3	119.8	124.2	124.5
II r	109.7	108.2	132.5	132.8	120.7	122.7	131.9	130.7	102.9	102.0	120.2	120.8	125.6	126.0
III r	109.2	107.9	132.4	132.8	121.3	123.1	132.6	131.5	102.7	101.8	121.5	121.9	126.4	126.9
IV r	109.1	107.8	132.2	132.6	121.2	123.0	134.1	133.0	102.8	101.9	122.8	123.4	127.6	128.0
1990: I r	109.6	108.1	133.2	133.5	121.6	123.5	136.2	134.9	102.8	101.6	124.3	124.9	128.8	129.2
II r	110.3	108.6	133.9	134.1	121.4	123.4	139.0	137.6	103.6	102.6	126.1	126.7	130.2	130.6
III r	109.6	107.9	132.9	133.1	121.2	123.3	140.9	139.5	103.3	102.3	128.5	129.2	131.6	132.2
IV r	109.4	107.9	131.8	132.0	120.5	122.4	142.3	141.0	102.6	101.7	130.1	130.7	132.5	133.3
1991: I r	109.4	107.9	130.2	130.4	119.1	120.9	143.2	142.0	102.4	101.5	131.0	131.6	134.0	134.9
II r	109.9	108.4	130.7	130.9	119.0	120.8	144.8	143.6	103.0	102.1	131.8	132.5	135.0	135.7
III r	110.2	108.6	131.3	131.4	119.2	121.0	145.8	144.5	103.0	102.1	132.4	133.1	135.6	136.4
	Percent change; quarterly data at seasonally adjusted annual rates													
1980 r	−0.7	−0.9	−1.6	−1.7	−0.9	−0.8	10.7	10.7	−2.4	−2.4	11.5	11.7	9.7	10.4
1981 r	1.3	.9	1.9	1.6	.6	.7	9.4	9.6	−.8	−.7	8.0	8.6	10.1	10.1
1982 r	.1	.1	−2.3	−2.4	−2.5	−2.4	7.6	7.5	1.3	1.2	7.4	7.4	5.8	6.1
1983 r	2.2	2.4	4.1	4.4	1.8	2.0	3.7	3.9	.5	.7	1.5	1.5	3.4	4.0
1984 r	2.3	2.1	8.2	8.2	5.7	6.0	4.2	4.0	−.1	−.3	1.9	1.9	4.1	3.5
1985 r	1.4	.8	3.6	3.4	2.1	2.5	4.5	4.2	.9	.6	3.0	3.3	3.3	3.7
1986 r	2.0	1.9	2.8	2.8	.7	.9	4.9	4.9	3.0	3.0	2.8	2.9	2.2	2.4
1987 r	1.0	.8	4.1	4.1	3.1	3.3	3.5	3.4	−.1	−.2	2.5	2.6	2.6	2.6
1988 r	.9	.9	4.3	4.4	3.3	3.5	4.3	4.1	.1	0	3.3	3.2	3.6	3.6
1989 r	−.7	−.9	1.8	1.7	2.6	2.7	3.5	3.4	−1.2	−1.4	4.3	4.3	4.3	4.1
1990 r	.2	−.1	.4	.3	.2	.3	5.4	5.2	−.0	−.2	5.2	5.3	3.8	3.9
1989: I r	−1.5	−2.8	2.6	1.4	4.2	4.3	3.5	3.4	−1.3	−1.5	5.1	6.4	4.7	3.9
II r	−1.0	−2.0	−.3	−.6	.7	1.4	2.0	1.1	−3.9	−4.7	3.1	3.2	4.4	4.7
III r	−2.0	−1.3	−.1	.1	2.0	1.4	2.1	2.5	−1.0	−.7	4.2	3.8	2.7	3.0
IV r	−.2	−.3	−.6	−.7	−.4	−.4	4.4	4.5	.4	.5	4.6	4.8	3.7	3.5
1990: I r	1.7	1.0	3.0	2.7	1.2	1.8	6.6	6.0	−.7	−1.3	4.8	5.0	4.0	3.8
II r	2.4	2.1	2.0	1.8	−.5	−.3	8.4	8.1	4.3	4.1	5.8	5.9	4.3	4.5
III r	−2.2	−2.5	−3.0	−3.0	−.8	−.5	5.7	5.6	−1.1	−1.2	8.1	8.4	4.4	4.8
IV r	−.9	−.3	−3.0	−3.1	−2.2	−2.8	4.1	4.4	−2.7	−2.4	5.0	4.7	2.8	3.4
1991: I r	−.1	.1	−4.9	−4.9	−4.7	−4.9	2.6	2.7	−.9	−.8	2.7	2.7	4.5	4.8
II r	1.9	1.9	1.7	1.6	−.3	−.3	4.6	4.8	2.4	2.5	2.6	2.6	2.9	2.5
III r	1.1	.9	1.8	1.6	.7	.7	2.8	2.7	−.2	−.2	1.7	1.9	1.8	2.1

[1] Output refers to gross domestic product originating in the sector in 1987 dollars.
[2] Hours of all persons engaged in the sector, including hours of proprietors and unpaid family workers. Estimates based primarily on establishment data.
[3] Wages and salaries of employees plus employers' contributions for social insurance and private benefit plans. Also includes an estimate of wages, salaries, and supplemental payments for the self-employed.
[4] Hourly compensation divided by the consumer price index for all urban consumers.
[5] Current dollar gross domestic product divided by constant dollar gross domestic product.

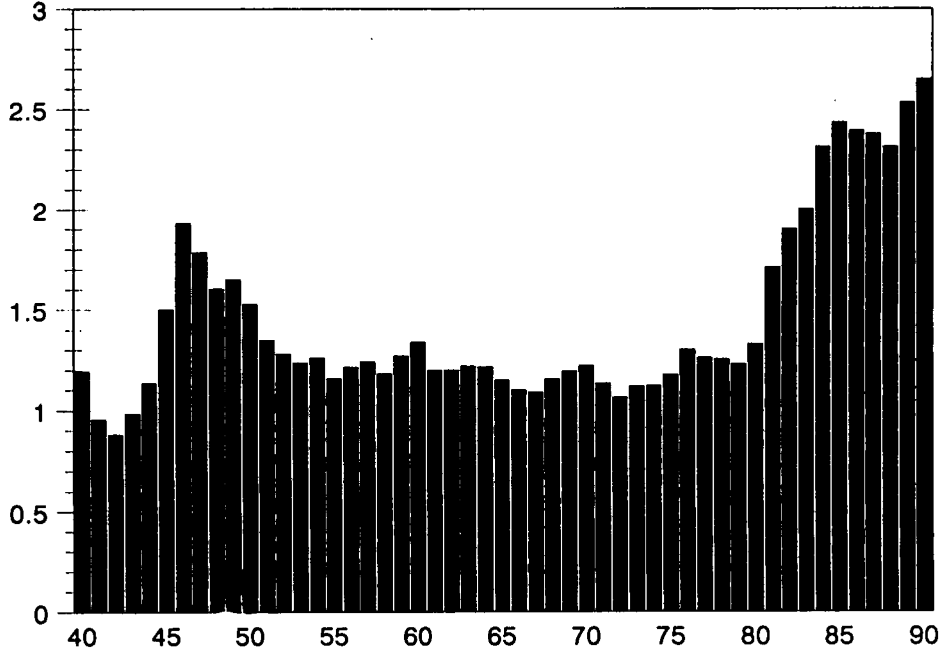
Note.—Data relate to all persons engaged in the sector.

Percent changes are from preceding period and are based on original data; they therefore may differ slightly from percent changes based on indexes shown here.

Data reflect the recent comprehensive (benchmark) revision of the national income and product accounts by the Department of Commerce, Bureau of Economic Analysis (BEA). BEA data for output and compensation for the first three quarters of 1991 incorporate benchmarking to unemployment insurance (UI) records. However, the detailed UI information needed by the Bureau of Labor Statistics to measure employment and hours for 1990 and 1991 is not yet available. Therefore, movements in measures based on hours of labor input should be interpreted with caution for 1990 and 1991.

Source: Department of Labor, Bureau of Labor Statistics.

Interest on the National Debt as a Percent of GNP



Source: Economic Report of the President 1991 (pp. 286 and 380).

SENATOR SARBANES. Thank you very much, sir.

Mr. Peevey, before you begin your testimony, I just want to address one point that Mr. Miller raised at the outset of his statement.

The Economic Report of the President that was transmitted to the Congress in February 1991, which is just this last *Economic Report*, indicates that productivity, in terms of output per hour for nonfarm business between the third quarter of 1981 and the third quarter of 1990—because you raised this point—increased at 1 percent per year. Now, the 3 to 4 percent figure that you cited, I think, applies to manufacturing. We had a good improvement in productivity in the manufacturing sector over that period, compared to earlier periods. And in all fairness, I think that is what your figure applies to. But productivity growth for the entire economy, nonfarm business, was 1 percent.

MR. MILLER. I would be more than happy to look at those figures. But the representation on the chart suggests that it is far lower than what is recorded. It looks like it is 0.3 percent.

SENATOR SARBANES. No, it is about 0.7 percent, I think. You are up the scale, and, of course, as I said, this was a 1975 to 1985 figure. You then raised the point that it should be 3 to 4 percent. I am giving you the figures out of last year's *Economic Report*, page 74, that the productivity increase for the decade of the 1980s in the entire economy was 1 percent per year.

Now, the figure you use may in fact be accurate for the manufacturing sector. I don't have that here. I know that the performance there was better, but for the overall economy, it was 1 percent.

MR. FAUX. Mr. Chairman, if I could make one point about that. It is very important to look at these relationships over time, because, obviously, a one-year increase in investment is not going to instantaneously give you an increase in productivity. That is why you need this longer term timeframe.

SENATOR SARBANES. Mr. Peevey, we would be happy to hear from you. We can come back to the subject in the question period. Thank you very much for being here today, sir.

STATEMENT OF MICHAEL PEEVEY, PRESIDENT, SOUTHERN CALIFORNIA EDISON COMPANY

MR. PEEVEY. Thank you, Mr. Chairman and Senator Sasser.

My name is Michael Peevey, chairman of Southern California Edison Company. We are an electric utility, the second biggest in the Nation. We provide service to about ten million people in Southern California. Today, I would like to express some thoughts on the public capital investment issue and how it affects California's economic well-being. By so doing, I perhaps would be less global than either Mr. Faux or Mr. Miller have been in their trek over the landscape.

SENATOR SARBANES. That is a very modest statement for a Californian. Usually they equate California with the global perspective. We appreciate that.

MR. PEEVEY. You may want to hold your judgment until I finish my remarks.

[Laughter.]

California has been the land of seemingly endless growth and economic opportunity throughout most of this century. That growth has been fueled by several things, including a steady stream of immigrants from other states and nations, a history of carefully planned and future-oriented infrastructure development.

In the late 1940s, 1950s and 1960s, California made massive investments in public education, transportation, the state water plan and other basic systems. California has benefitted enormously from that investment. Its higher education system—the community colleges, state universities and the University of California—were viewed nationally as the model to be followed by others. This tripartite system provided everyone with a high school diploma, the opportunity for a higher education and, hence, greater economic opportunity.

Today, this is changing. California's primary and secondary educational system ranks among the lowest in the Nation in per-pupil expenditures. This translates into overcrowded classrooms and inadequate material support. At the higher educational level, high school graduates no longer are assured that they can enter a community college or public university and often, if they do, they cannot take the classes they wish.

Also, today, the physical infrastructure of California is either cracked or breaking. Regular media reports note a deteriorating quality of life, pollution, water shortages, unaffordable housing, traffic congestion and freeway gridlock, and beleaguered industries.

The very qualities of life that brought millions upon millions of people to California over the past 50 years are disappearing. Yet, the State's rapid population growth will continue.

California contains about one-eighth of the U.S. population, but it is projected to absorb nearly three-eighths of the Nation's population growth over the next 15 years. These new residents will need more streets and freeways, more mass transit, more medical care, more schools, more utility connections; in short, more of everything, public and private.

The economic growth needed to finance such expansion must flow from the productivity of California's workers. Thus, investing in the future is critical, because the quality and productivity of California's future work force will determine the state's economic vitality.

California's business leaders are deeply concerned about the education and skills of the State's young people. Today's jobs are more demanding, yet, the schools do not produce enough workers with basic skills or proficiencies. California's companies and industries simply are not getting the kinds of entry-level employees needed to assure long-term productivity and competitive well-being.

I would add that at Southern California Edison that only about 20 percent of the people who apply for entry-level jobs are able to pass our tests. That is somewhat of an indictment of our educational system, perhaps, as well as suggesting that maybe we can do more ourselves. And perhaps it reflects a bit on the tests.

SENATOR SARBANES. Twenty percent pass or 20 percent fail?

MR. PEEVEY. Twenty percent pass, 80 percent fail, of those who seek entry-level jobs at California Edison. Admittedly, it is a company, a utility. It pays well. It is an attractive place to work for people out of high school.

SENATOR SARBANES. Do you have an historical comparison?

MR. PEEVEY. I can certainly get something. It is lower now than it was 20 years ago.

As the world's sixth largest economy, California leads the Nation in total employment, manufacturing employment and export-related manufacturing employment. By the year 2000, California's economy will be expected to create more than four million new jobs—more than half of which will require post-high school training. Given high dropout rates, illiteracy and the influx of immigrants with language barriers, the demands on the educational system to provide competent workers will be daunting.

These days, some claim that California's growing immigrant population is a prime source of the state's problems. While it is true that immigrants have increased the state's social service costs, they also provide a large pool of ambitious, hardworking people who often take service-sector jobs at the bottom of the economic ladder. Their efforts spur more investment and they pay plenty of taxes.

History suggests that population growth and immigration themselves are not the problem. During the 1950s and 1960s, before the rash of tax cuts of the last two decades—such as Proposition 13 in 1978—California was able to absorb, without major stress, a much higher rate of immigration than today. In fact, the state's population grew much faster from 1950 to 1970, up 86 percent, than it did from 1970 to 1990, up 50 percent.

But in the 1950s and 1960s, the State did a much better job of planning for growth. Now, California has curtailed public-sector investment and has cut outlays for roads, bridges, schools and other essential community investment. In earlier years, the State planned for population growth and accommodated it. Now, it seems, California prefers to complain about it.

The economic price that the State is paying for its failure to make needed public infrastructure investments is substantial. Southern California's reliance on the automobile for job-related transportation has numerous costs, including the Nation's worst smog and massive freeway congestion. How bad is the congestion? Many employees at Edison typically spend three to four hours a day in an automobile getting to and from work. Congestion is so bad that serious consideration is being given

to banning commercial vehicles from freeways during rush hours—a step that would impose huge costs on industry and commerce.

The problems compound each other. More autos mean more smog. This leads to more expensive pollution controls mandated upon manufacturers, which leads to job losses from business migration, which depresses the tax base, which makes it harder to finance any needed government activity.

The problems at the interface between California's economic woes and transportation problems are illustrative. To combat traffic congestion and pollution, Los Angeles County has embarked on one of history's most ambitious public works projects—a $150 billion effort to build from scratch the Nation's second largest rail transit system, its largest carpool lane network, and its biggest bus fleet—all in a decade. The heart of this plan is a new commuter rail system.

Until recently, no U.S. company made new rail cars. Now, the only one that does competes with foreign companies with proven track records. Controversy swirls in Los Angeles today around the recent selection of a Japanese manufacturer to supply automated rail cars for one segment of the planned rail transit system. Setting aside the specific issues surrounding the selection, it is clear that the Southern California economy would be better off if the State had the manufacturing capability to produce mass-transit rail cars. A public policy that would stimulate such manufacturing capability would make sense.

Similarly, California is looking increasingly to the use of nonpolluting automobiles to help solve its air quality problems. Edison is deeply involved in efforts to develop better batteries in order to make electric cars attractive in the marketplace. The State has mandated that 2 percent of all new vehicles sold in California be zero-emission vehicles by 1998, and 10 percent by 2003. Only electric vehicles currently meet this test.

Thus, California will soon become the world's largest market for electric vehicles. Yet, the State today has no manufacturing capability, either for batteries or for electric autos. Nor does it have the electric transportation infrastructure of R&D, components manufacturing and the like that could employ some of the highly skilled scientists, engineers and technicians who will experience job losses due to defense cutbacks. At the same time, Southern California's only auto production plant will close later this year. Might not judicious and creative application of public funding work effectively at this nexus of economic and infrastructure problems?

Public-private partnerships in infrastructure investments can pay many rewards. In the late 1970s and early 1980s, Edison, working with the U.S. Department of Energy and others, developed the Coolwater Coal Gasification Project to help demonstrate how coal could be burned without major environmental consequences. A similar partnership invested in the Nation's first solar generating facility—Solar One. Both of these projects were infrastructure investments that point the way to how the

Nation can meet future energy needs in an environmentally acceptable manner.

Excessive dependence on foreign suppliers now is an increasing problem for businesses—including the electric utility business. At Edison, the number of U.S. firms manufacturing electric utility equipment has diminished in recent years. We had four U.S. and one foreign supplier of large power transformers ten years ago; now, all are foreign but one. Today, our sole source of hydroelectric turbines and 500-kilovolt power circuit breakers is from abroad. Unfortunately, the same story holds true for many other types of power-plant equipment.

This loss of domestic suppliers, particularly in the manufacturing sector, is detrimental to the economic well-being of the Nation. It not only means that the Nation must purchase more equipment offshore—which hurts the trade balance—but it also costs U.S. jobs. We must recognize that the Nation's manufacturing capability and infrastructure development are closely linked.

Public policy needs to focus on the support of domestic manufacturing capacity as a means of enhancing the Nation's economic potential. Every major economic power with which the U.S. competes provides some form of public support to key industries. Indeed, the technology and manufacturing capability which allows Japanese companies to win mass-transit rail-car contracts today in California arose from public investment in rail transportation in Japan.

In closing, the future of Southern California Edison, as a utility, is inextricably tied to California. We cannot get up and leave. We are a provider of essential infrastructure, and we recognize the need for greater public investment in infrastructure of all types—from schools to highways to mass transit. Recognizing the need to enhance private sector productivity and competitiveness, we, as a Nation, need to focus much more clearly on greater public-sector development. The beneficiary will be our Nation now and in the future. Thank you.

Senator Sarbanes. Mr. Peevey, thank you very much for a very thoughtful statement.

[The prepared statement of Mr. Peevey follows:]

PREPARED STATEMENT OF MICHAEL R. PEEVY

Thank you. I'm Michael Peevey, president of Southern California Edison Company. We provide electricity to over 10 million people in Southern California. Today I will express some thoughts on public capital investment and how it affects California's economic well-being.

California has been the land of seemingly endless growth and economic opportunity throughout most of this century. That growth has been fueled by several things, including:

- a steady stream of immigrants from other states and nations, and
- a history of carefully planned and future-oriented infrastructure development.

In the 1940s, '50s and '60s, California made massive investments in public education, transportation, the state water plan and other basic systems. California has benefitted enormously from that investment. Its higher education system -- the community colleges, state universities and the University of California -- were viewed nationally as the model to be followed by others. This tripartite system provided everyone with a high school diploma the opportunity for a higher education and, hence, greater economic opportunity.

Today this is changing. California's primary and secondary education system ranks among the lowest in the nation in per-pupil expenditures. This translates into overcrowded classrooms and inadequate material support. At the higher educational level, high school graduates no longer are assured they can enter a community college or public university and often, if they do, they cannot take the classes they wish.

Also, today the physical infrastructure of California is either cracked or breaking. Regular media reports note a deteriorating quality of life, pollution, water shortages, unaffordable housing, traffic congestion and freeway gridlock, and beleaguered industries.

The very qualities of life that brought millions upon millions of people to California over the past 50 years are disappearing. Yet the state's rapid population growth will continue.

California contains about one-eighth of the U.S population, but it is projected to absorb nearly three-eighths of the nation's population growth over the next 15 years. These new residents will need more streets and freeways, more mass transit, more medical care, more schools, more utility connections -- in short, more of everything, public and private.

The economic growth needed to finance such expansion must flow from the productivity of California workers. Thus, investing in the future is critical because the quality and productivity of California's future work force will determine the state's economic vitality.

California's business leaders are deeply concerned about the education and skills of the state's young people. Today's jobs are more demanding, yet the schools do not produce enough workers with basic skills or proficiencies. California's companies and industries simply are not getting the kinds of entry-level employees needed to assure long-term productivity and competitive well-being.

As the world's sixth-largest economy, California leads the nation in total employment, manufacturing employment and export-related manufacturing employment. By the year 2000, California's economy will be expected to create more than 4 million new jobs -- more than half of which will require post-high school training. Given high drop-out rates, illiteracy, and the influx of immigrants with language barriers, the demands on the educational system to provide competent workers will be daunting.

These days some claim that California's growing immigrant population is a prime source of the state's problems. While it is true that immigrants have increased the state's social service costs, they also provide a large pool of ambitious, hard-working people who often take service-sector jobs at the bottom of the economic ladder. Their efforts spur more investment and they pay plenty of taxes.

History suggests that population growth and immigration themselves are not the problem. During the 1950s and 1960s, before the rash of tax cuts of the last two decades -- such as Proposition 13 in 1978 -- California was able to absorb without major stress a much higher rate of immigration than today. In fact, the state's population grew much faster from 1950 to 1970 -- up 86% -- than it did from 1970 to 1990 -- up 50%.

But in the 1950s and 1960s the state did a much better job of planning for growth. Now California has curtailed public sector investment and has cut outlays for roads, bridges, schools, and other essential community investment. In earlier years, the state planned for population growth and accommodated it. Now, it seems, California prefers to complain about it.

The economic price the state is paying for its failure to make needed public infrastructure investments is substantial. Southern California's reliance on the automobile for job-related transportation has numerous costs, including the nation's worst smog and massive freeway congestion. How bad is the congestion? Many employees at Edison typically spend three to four hours a day in an automobile getting to and from work. Congestion is so bad that serious consideration is being given to banning commercial vehicles from freeways during rush hours -- a step that would impose huge costs on industry and commerce.

The problems compound each other. More autos mean more smog. This leads to more expensive pollution controls mandated upon manufacturers, which leads to job losses from business migration, which depresses the tax base, which makes it harder to finance any needed government activity.

The problems at the interface between California's economic woes and transportation problems are illustrative. To combat traffic congestion and pollution, Los Angeles County has embarked on one of history's most ambitious public works projects, a $150 billion effort to build from scratch the nation's second-largest rail transit system, its largest carpool lane network and its biggest bus fleet -- all in a decade. The heart of this plan is a new commuter rail system.

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Similarly, California is looking increasingly to the use of non-polluting automobiles to help solve its air quality problems. Edison is deeply involved in efforts to develop better batteries in order to make electric cars attractive in the marketplace. The state has mandated that 2 percent of all new vehicles sold in California be zero-emission vehicles by 1998 -- and 10 percent by 2003. Only electric vehicles currently meet this test.

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Public policy needs to focus on the support of domestic manufacturing capacity as a means of enhancing the nation's economic potential. Every major economic power with which the U.S. competes provides some form of public support to key industries. Indeed, the technology and manufacturing capability which allows Japanese companies to win mass transit rail car contracts today in California arose from public investment in rail transportation in Japan.

In closing, the future of Southern California Edison as a utility is inextricably tied to California. We cannot get up and leave. We are a provider of essential infrastructure and we recognize the need for greater public investment in infrastructure of all types -- from schools to highways to mass transit. Recognizing the need to enhance private sector productivity and competitiveness, we, as a nation, need to focus much more clearly on greater public sector development. The beneficiary will be our nation, now and in the future.

Thank you.

SENATOR SARBANES. I want to now put into the record a statement by 327 prominent economists that was released in the summer of 1989, "A warning to the Congress and the President." And I am going to read just part of the statement, a letter to the Congress and to the President from 327 American economists, headed "America Needs Increased Public Investment Now":

> In addition to our trade and fiscal deficits, America faces a third deficit: the deficiency of public investment in our people and in our economic infrastructure. This deficit will have a crippling effect on America's future competitiveness. Just as business must continually reinvest in order to prosper, so must a nation. Higher productivity, the key to higher living standards, is a function of public as well as private investment.
>
> If America is to succeed in an increasingly competitive world, we must expand efforts to equip our children with better education and new workers with more-advanced skills. We must assure that disadvantaged children arrive at school age healthy and alert. We must prevent drug abuse and dropping out among teenagers. We must fix our bridges and expand our airports. We must accelerate the diffusion of technology to small or medium-size business.
>
> Yet, these needs have been neglected throughout the past decade. In real dollar terms, Federal spending in the 1980s on science and civilian technology has been significantly below the levels of the 1960s and 1970s. Compared to the late 1970s, the Federal Government is now spending less per person on education and less per worker on training. We are devoting less of our national spending to federal investments in highways, mass transit, airports and other transportation infrastructures. State and local governments have not been able to pick up the slack. We fully understand the problem that the current U.S. fiscal deficit poses for efforts to expand public investment in these areas.
>
> Many of the undersigned have been in the forefront of those arguing that the fiscal deficit must be reduced. But in economic terms, budget deficit reduction and an expansion in public civilian investment are compatible. Indeed, over the long run, we cannot eliminate the twin deficits and maintain our living standards unless we expand our public investments.

[A letter to the Congress and to the President from 327 American economists submitted in its entirety for the record follows:]

A Warning About America's *Third* Deficit From 327 Prominent Economists

America Needs Increased Public Investment, Now.

In addition to our trade and fiscal deficits, America faces a "third deficit"—the deficiency of public investment in our people and our economic infrastructure. This deficit will have a crippling effect on America's future competitiveness.

Just as business must continually reinvest in order to prosper, so must a nation. Higher productivity—the key to higher living standards—is a function of public, as well as private, investment. If America is to succeed in an increasingly competitive world, we must expand efforts to equip our children with better education and our workers with more advanced skills. We must assure that disadvantaged children arrive at school age healthy and alert. We must prevent drug abuse and dropping out among teen-agers. We must fix our bridges and expand our airports. We must accelerate the diffusion of technology to small and medium sized business.

Yet these needs have been neglected throughout the past decade. In real dollar terms, federal spending in the 1980s on science and civilian technology has been significantly below the levels in the 1960s and 1970s. Compared to the late 1970s, the federal government is now spending less per person on education and less per worker on training. We are devoting less of our national spending to federal investments in highways, mass transit, airports and other transportation infrastructure.

State and local governments have not been able to pick up the slack. In the 1980s, state and local spending on both education and transportation as a percent of GNP has been below the level of the 1970s.

We fully understand the problem that the current US fiscal deficit poses for efforts to expand public investment in these areas. Many of the undersigned have been in the forefront of those arguing that the fiscal deficit must be reduced. But, in economic terms, budget deficit reduction and an expansion in public civilian investment are compatible. Indeed, over the long run we cannot eliminate the twin deficits and maintain our living standards unless we expand our public investments.

Clearly, this will require adjustments in other parts of the Federal budget. Substantial savings are obviously possible in the military and agriculture sectors. And there is no escaping the need for more revenue.

Raising taxes is never popular. Neither is reducing spending on programs which benefit powerful economic or ideological interests. But there is strong evidence that the people know that there is no free lunch. Polls have shown that majorities support a change in priorities and that people are willing to pay for public services that are vital to the nation's future.

Thus, while there is no easy answer, there is an answer: it is to devote a portion of new revenues raised, and/or savings made from reducing areas of excess spending, to critical public investments. We can afford it. For example, $30 billion in net new public investment would come to approximately one-half of one percent of our GNP in fiscal year 1990. Such an investment, if properly administered, would be a bargain for today's working population. The present generation of workers will have to depend on a much smaller working population to support their retirement. Without adequate training and an efficient economic infrastructure, tomorrow's workers will not be able to maintain tomorrow's retirees in a comfortable and dignified standard of living.

The future will not wait. Each year of delay means another million dropouts and an increase in the number of American workers whose skills are inferior to those against whom they have to compete. It means more deterioration in our roads, bridges and airports. It means falling behind another step in the race for the technologies that will support tomorrow's higher incomes. It means compounding the already massive debt we are leaving to the next generation of workers by denying them the tools they will need to pay off that debt.

We therefore urge you to resist the temptation to deal only with today's crises, as important as it is to solve them. For the sake of our nation's future, we urge you to raise the monies needed to regain America's competitive edge—before it is too late.

ECONOMISTS' STATEMENT
c/o
Economic Policy Institute
1730 Rhode Island Ave., NW, Suite 812
Washington, DC 20036

SENATOR SARBANES. One of the things that Senator Sasser and I called for in our plan was actually consistent with this statement, "But in economic terms, budget deficit reduction and expansion in public civilian investment are compatible." Because what we suggested, looking ahead, is that we try to realize a major shift in the allocation of resources from the defense budget, to be used for two purposes: for the investment in infrastructure and other items that have been mentioned that should be made, and also for continuing a deficit reduction.

I would like each of you to comment on the statement or on any portion of the statement that I read from. Do you share the view that there is a third deficit in addition to the trade and fiscal deficits; namely, the deficiency of public investment in both human capital and economic infrastructure?

MR. FAUX. If I can start, as one of the signatories to that statement, I think it is as relevant today, if not more so, than it was two years ago. There is just no question that the relationships—and again, we can quibble about the details—but there is no question about the relationship between public and private investment and growth.

The problem with the debate over the budget is that this dimension has been left out. And, perhaps, part of the problem is that, in the national economic accounts and in the data that economists work with, we have this funny language problem. That is, we don't call what the government does "investment."

Now, if you were to ask an economis or almost anyone in the country whether or not he or she personally believes that putting money into schools and training and infrastructure is an important investment, they would say "yes." Yet, in the economic models that they work with and in the national income account terminology, "investment" is just applied to those activities in the private sector. That is a distortion of what goes on in the real world, and it may partially account for this odd implicit assumption that investment is only a function of the sector, which completely neglects the role of public investment. I think the point of that statement is that, unless we address that third deficit, we are not going to be able to resolve the first two deficits.

SENATOR SARBANES. Mr. Miller?

MR. MILLER. You asked if there is a third deficit. I am concerned about over-using the word deficit. There is a trade deficit and a budget deficit. I even used the trade deficit term in my testimony. Infrastructure deficit, education deficit, you can call a lot of things deficit.

I think the real question is whether the Federal Government could productively employ resources in public works and the public sector. And I think the answer is "yes."

The real tragedy of our budget process, though, is that we waste such incredible sums of money. Some of the sprinkling out of the funds go to the things that matter, things where productive investment makes sense or where investment would be productive. But so much money goes to where it doesn't make sense. I dealt year after year after year with

members of Congress, squirreling in appropriations, some demonstration project here or there, some overpass or something to carry back home and tell the folks back home, "I brought home the bacon." And it was terribly wasteful, while there were other things that went crying.

The President and I increased allocations to programs like Head Start in every budget that we sent the Congress. There are things that make sense, but so many things that don't make sense.

SENATOR SARBANES. Even with the increase in allocation, I think we are now serving only 20 to 25 percent of the young children who qualify for Head Start, who, in fact, have a Head Start program. I am not even sure it is that high. But I think it is about 20 percent.

SENATOR SASSER. Twenty percent, I am told.

SENATOR SARBANES. So, 80 percent of the children who meet the criteria for a Head Start program don't have it.

MR. MILLER. There are degrees of gradation. Hopefully, we are hitting the ones who need it the most, where the increase in output or the payoff, where the bang for the buck is the greatest. It may be that there are a lot of other folks that should be helped as well. But that is what the data showed when I reviewed it as budget director, and it made sense to go forward, and we put money in the budget despite the fact that we had very strong deficits, although the deficits, as you know, at the time I was there, were only about half what they are now.

Let me mention, though, that we ought to be looking at more cost-effective ways of doing any specific thing. One example is infrastructure. We ought to look at privatization as a better alternative in many dimensions. Many times a private road would be much more efficient, and put in place much more quickly than a public road. We ought to look at that.

SENATOR SARBANES. What do you mean by a private road?

MR. MILLER. A toll road. There is a proposal close by to extend the Dulles Access Road and to do it privately. The State of Virginia has approved that. That is an infrastructure investment that would be done privately and quickly, and it makes a lot of sense, and the market mechanism is being used to test whether it would be a productive expenditure of resources.

Let's talk about education.

SENATOR SARBANES. Do they use the public power of eminent domain to do this private enterprise?

MR. MILLER. Yes. I understand they had to use it in certain instances.

SENATOR SARBANES. So, they use a public power to take people's property and then build a private road on which they collect tolls and, I assume, earn a profit?

MR. MILLER. They earn a profit. The tolls are contracted for way in advance. There is a lot of conditions on their ability to do that. But here is an example of using private mechanisms much more efficiently, and

having a market test that is not frequently available when we do public infrastructure investments.

SENATOR SARBANES. Is it your view that we could generally build roads on that principle or that only certain, specific projects, like a road to an airport, could be financed like that? Can you build the Nation's transportation infrastructure that way?

MR. MILLER. Let me try to answer that. Given where we are starting from and given current technology, it makes sense to look at things on an individual basis. And the number of opportunities are relatively limited.

We are changing technology at a very rapid rate. You will be able to have on your car window—there are experiments going on, if you are not familiar with them, you might have somebody look into it—you have a little sticker in your car and automatically, as you go through a toll booth at 60 miles an hour, and it takes the fee off of your credit card. There are ways of pricing roads to increase the efficiency with which existing roads are used. We need to do that at the federal level as well, rather than simply presuming that the answer is to go out and do more paving.

Could I just mention education? I want to say that I personally have invested a lot in education. My kids went to private schools and are off in college. My wife has just finished the requirements for a PhD. I have one. We spend a lot of money for education, and we think it is all worthwhile. So, I don't want to step back from a need to look closely at education as an investment.

But I think there are ways that we can, as a public, invest in education more productively. We need to think of school choice, alternatives to simply spending more money.

I did an analysis of over 100 Virginia school districts, and tried to explain performance of students on standardized tests with a number of variables. Do you realize that expenditure per pupil explained only 6 percent of the variation in scores on standardized tests?

So, there are more issues than just increasing the amount spent per pupil. It has to do with the home environment. It has to do with the freedom that teachers and principals have to tailor their programs. It has to do with the degree to which parents feel they have control over the system, over their children's education. There is a lot more to it than just going and spending more money.

SENATOR SARBANES. How did you determine the 6 percent figure? Is that telling us that if you took the poorest spending school district and the wealthiest spending school district, that there is only a gap of 6 percent in student performance?

MR. MILLER. No,sir. I did a standard statistical multivariate analysis.

MR. PEEVEY. If I could answer your question, yes, I think there is a third deficit. I will be brief on that.

I find things that both Mr. Faux and Mr. Miller say have attractiveness to me. What Mr. Faux says about looking at capital budgeting, these major physical infrastructure needs we have, finding another way of budgeting for that so that we don't get into this rhetoric about all it does

is enhance the budget deficit. I think it is very important because they are long-term investments.

I have to agree with Mr. Miller that no one wants waste wherever waste exists. That is a tautology, I would say. There is something to be said, in selected instances, for privatization. In California, the State legislature a couple of years ago did pass legislation, the Governor signed it, to allow for privately built toll roads in the State of California. A couple will be constructed in the State of California. The reason for this was the absolute frustration over the inability to have adequate funding to do it under the public mantle. Those roads—one will be in Orange County, one in Contra Costa County—after a period of time will revert to state ownership. Eminent domain is used.

There are things that can be done that make sense, but one has to approach these things with some care and caution. You don't want to throw the baby out with the bathwater.

Airports are another example. If you fly from here to London, you fly to Heathrow. Heathrow is privatized. So, is Glasgow, so is Gatwick, so is Stansfield, so is Edinboro. There are things that can be done. It frees up money, which can be invested in public infrastructure, needed elsewhere. A judicious application of reason in these things is in everybody's interest.

SENATOR SARBANES. I want to put one question to you, Mr. Peevey. I thought you made an important point about our lack of capacity to produce mass-transit rail cars at a time when it is clear that mass transit is going to have to become a more important part of our transportation network in the major metropolitan areas of the country. You can't solve the transportation problem by roads. They just continue to get clogged up. You have significant environmental consequences, especially in Southern California.

It seems to me that this is a classic instance of an interaction between the public and the private sector. As you point out, Japan, in effect, through the support of its mass-transit system, helped to create manufacturers who not only met the Japanese needs, but are now meeting worldwide needs and are causing a political problem in California about where to get your transit cars.

It occurred to me that, if you have an appropriate economic conversion program to shift from defense to the civilian sector, the transportation network may offer a lot of productive possibilities for plants and workers who were formerly building major defense weapons systems that may now be no longer needed in a changed international environment.

Of course, you have to make a judgment on its own of what your security needs are and how you have to respond to them. But I have heard no one argue that the international situation has been transformed sufficiently that it doesn't require a major rethinking in defense expenditures.

Now, people may differ on how much of a rethinking is needed, but I don't know anyone who says that we don't need to do any rethinking, or who says that the rethinking should only be trivial or at the margins.

So, if you shift those resources, you could move them into the kinds of production that look ahead to the long-run needs that have to be met. And I take it that you would be amenable to that kind of approach. Is that right?

MR. PEEVEY. Yes, that is correct. And let me throw out to you something even broader than rail cars. That is, electric vehicles. Electric vehicles are going to come because they are more environmentally compatible, frankly, and the society needs them. There is a huge market potentially, and research is going on here in the United States and in Europe and in Japan and elsewhere. At the present time, the United States is in the lead in this technology, this evolving technology.

SENATOR SASSER. A leader?

MR. PEEVEY. The leader. We are ahead of the Japanese in this. We are ahead of the Europeans in this. And it will be a great tragedy nationally if we squander that lead.

Now, things are going on that I think that at the interface of public and private cooperation that make an awful lot of sense here. There is now the creation of the U.S. advanced battery consortium; utilities are involved, the automakers are involved. DOE is putting up half of the funds to get to another generation of batteries because that is the constraining factor in electric vehicle use.

But that is the kind of thing that we, the society here, can do that is most constructive, and I am sure that the two gentlemen on my left would agree with entirely, and pass things like the legislation as part of the national energy strategy.

At the current time, one of the titles on the national electric vehicle demonstration—Research and Demonstration Act that Rockefeller sponsored—is in a Senate bill and it will be in the House bill. If it founders for other reasons, it will be stripped out, and I think George Brown would move it on its own. But it is a way of concentrating efforts on the private and public side in a combination way to enhance our capability and our capacity. And it can, as I said in my statement, help in a place like Southern California to employ people who are high-tech people—scientists, engineers and technicians—who have worked in the defense industry and so forth.

I think there are many opportunities if we think creatively, if we are not scared of public investment per se. I am not here to endorse every form of public investment across the board willy-nilly. As we said earlier, that it is, in many cases, wasteful and inefficient. But there are a lot of very targeted things that can be done that can move that dot there up to the right and north.

SENATOR SARBANES. Senator Sasser?

SENATOR SASSER. Thank you very much, Mr. Chairman.

Mr. Peevey, I thought your statement was particularly interesting because you give us almost a case study in what happens in an area where there is a decreased investment in what I would call public institutions.

Now, I was really shocked and stunned to read on page 2 of your statement that California's primary and secondary educational system ranks among the lowest in the Nation in per-pupil expenditures. I guess I am still stuck back in the 1950s and 1960s, when we all looked to California as leading the way in education, both in the K through 12 level and with the very excellent college and university system that the State of California put in place.

Now, you go ahead to say that California is going to create four million new jobs in the next few years and that two million of them are going to require education beyond high school. How are you going to provide the skills and the brainpower for these jobs that require education beyond high school if California is cutting back so dramatically in education?

MR. PEEVEY. I do not have an answer for that. Perhaps, if I did, I would be advising your former colleague rather than appearing before you today. It is a very, very difficult situation.

In 1959, the State made a commitment in its master plan that the top 12.5 percent of all high school students—the top one-eighth—could matriculate to the University of California, the top one-third could go to the California State college and university system, and anyone with a high school degree could go to the community colleges. That is not going to be able to continue, frankly, because of budgetary constraints.

In part, the economy is down in California for the same reason that it is down in Maryland, or in Tennessee, or in any place else, because of the national economic malaise. But we also have some other problems that perhaps are unique to California. We are going to have to reform the way we deliver educational resources.

SENATOR SASSER. Let me ask you this. I am going to focus on Mr. Peevey. We have economists here all the time. It is interesting to hear the observations of a businessman. Someone said, "Mr. Chairman, if you laid all of the economists end-to-end, no one would miss them." Now, I don't agree with that.

MR. FAUX. Thank you, Senator.

MR. PEEVEY. Having an advanced degree in economics, I am not sure that you wouldn't miss me either.

SENATOR SASSER. I gather that you attribute this lack of investment now in education and what I would characterize—and you disagree if this characterization is inaccurate—as a deterioration of the education system in California, is this attributable to the Proposition 13s and all of the tax-cutting initiatives that took place in California? What is the reason for this lack of investment?

MR. PEEVEY. That is part of the cause. It is not the exclusive cause. I have to agree with Mr. Miller that there is not a one-to-one ratio between class size and expenditures and all those kinds of things. There are lots of other factors that go into it.

But certainly the relative role of the public sector in California is less today than it was in the 1960s, the 1950s, and in the 1940s, or even in the 1970s, prior to 1978. I think most people who have given a lot of thought to this and realized the need for public sector investment would wish that Prop 13 had never occurred. And I might add that a good portion of the business community in California was opposed to it at the time it did pass. It passed for a lot of other reasons that you gentlemen would understand better than myself, in terms of the popular dynamic of rapidly rising property taxes.

But it then ushered in several other things—constitutional amendments to limit the sheer size of the state's budget compared to the state's gross domestic product and so forth, abolishment of all inheritance taxes. All of these things, the consequence of them in total, has been to diminish significantly the public-sector contribution at a time when population growth remains very rapid and the nature of that population growth is altering. Immigration has always been a big factor in California, but the relative places from which the immigrant population comes has changed. It was mostly domestic United States until the last 15 years; now, it is not exclusively but largely abroad—South and Asia. That brings in a whole series of challenges, frankly.

SENATOR SASSER. You indicated in your statement, and I thought this was quite interesting, you say that it is true that immigrants have increased the state's social service costs, but they "also provide a large pool of ambitious, hardworking people who often take private-sector jobs at the bottom of the economic ladder. Their efforts spur more investment and they pay plenty of taxes."

We heard testimony here in this Committee, I believe, Mr. Chairman, from Mr. Lacey.

SENATOR SARBANES. He is the journalist who does an economic newsletter.

SENATOR SASSER. Mr. Lacey was making the point, and it kind of rocked me back, but he made the point that we ought to allow for free immigration up from Mexico and from countries below Mexico because, as these people come in, at least they are doing their labor here and are paying taxes and that sort of thing. But when the labor is done in Mexico and the goods are brought across the border, they simply compete with their low wages in Mexico against American workers. And I couldn't buy that. Frankly, I still don't agree with it.

But the point I am coming around to on the question of immigration into California, at this juncture, would that be a net positive for the economy, in your judgment, or a net negative or a neutral factor?

MR. PEEVEY. When you say now, do you mean 1992?

SENATOR SASSER. Yes.

MR. PEEVEY. I think over the past several years that it is probably a net positive. I would say that in any one year in which there is tremendous stress on the economy and unemployment is increasing that it could be a negative. But we should take a longer term view.

SENATOR SASSER. Over the long term in California, do you anticipate that the Canadian immigration would be a positive, a negative, or neutral?

MR. PEEVEY. I think it is positive. That is a personal view, not shared universally. If one looks at the history of this Nation, the greatest relative increase in our population, in terms of immigration, was the decade from 1900 to 1910. If we could go back into an earlier life, there was tremendous decrying of the immigration at that time as ruinous to the fabric of society and the economic well-being, and so on and so forth. In the end, I think you find that immigrants who come here by their choice—in some cases pushed, no doubt, but in most cases, by their choice—had much to contribute to the well-being of the economy of California and of this Nation.

SENATOR SASSER. Very interesting.

One final observation. I have had the opportunity to be in a helicopter over the city of Los Angeles, just before rush hour begins, and watch the automobiles coming out of the parking lots into the streets and onto the freeways and seeing the gridlock that takes place.

The person in charge of public transportation in the city of Los Angeles was a former Tennesseean who learned his trade, I think, in Chattanooga, Tennessee, and then went on to be head of the Public Transit Authority in Los Angeles. I am not sure if he is still there. He treated me to this view about four or five years ago when, in the whole question of public transportation and the rail system, they were working in that direction.

Have you seen any figures that would indicate the loss of productivity that is caused by the traffic congestion in Los Angeles and, perhaps, the gain in productivity that might occur when and if the mass transit is put in place?

MR. PEEVEY. There are estimates of that. I don't have them. I am sure we could find them. There certainly are estimates in the productivity, that it would be significantly enhanced for the reasons I said.

The mayor of Los Angeles has seriously proposed banning trucks during the morning and evening rush hours from the freeways, and that would have other consequences, obviously, economically. But that is just symptomatic of the problem and what can be enhanced by rail systems and other things that would increase the fluidity or motion or movement of people in a very difficult situation, which is what it is today.

As a company, I will give you an example. We are considering each day that we have 6,000 or so employees that go into the customer service department, go in various locations. They come in, they check in, they punch a time card before 8:00 a.m. And from that spot, they get in trucks

and go throughout the 50-square-mile service territory, and that, in many cases, it takes them an hour once they get into the truck to get to where they are going to be working.

So, we are thinking about ways of allowing people—and this has a lot of other implications and people worry about making sure that people are doing the right thing—to go directly to the job site just to get around the congestion problem. It has implications for the management and control system, command and control system, as a company. But it also enhances the productivity; it would get them to work sooner.

What we care about is not when they check in and punch a time clock, but what time they start at an underground culvert or up in a utility pole, or something like that. And if it is 9:15 one way and we can get it done at 8:15 the other way, my God—but that is because of this kind of gridlock and congestion.

People will adapt. That is one of the strengths of the private sector. But it's not what we would choose.

SENATOR SASSER. One final comment, Mr. Chairman.

I am drawn to the concept that Mr. Peevey was talking about, about cooperation between the public and private sector. Now, I am delighted to hear that we are ahead in the technology, battery technology for electrical automobiles. But we must not—we must not—allow someone else to move in, grab this, and commercialize it ahead of us. We all know that color television was born here in the United State, but the color television sets are made in Japan or in Taiwan now. And robots, robotics, that is something that was born here in the United States, but the Japanese have done so much more to commercialize it.

So, I would hope that we would take Mr. Peevey's advice here and move forward to try to have some symbiotic relationship between the public and private sector in such a way that we can commercialize this technology of the electric automobile before someone else does it, and we start buying Toyotas or Hyundais or Mercedes-Benz that are driven with battery technology that was developed here in the United States.

MR. PEEVEY. I think you put your finger on a fundamental, and I think everyone here would agree. That is, that this country still is the dominant economic power by a big margin in basic R&D, basic lab R&D, that type of thing. Something goes terribly awry before it becomes commercial. We lose a step. It's what they used to say about the British all the time.

I was told, I don't know it as a fact, in Japanese universities, there is not one Nobel Prize winner for research. There are many, many, many in the United States, obviously, on both coasts and throughout the Midwest and every place else. It tells you something is terribly amiss. We can be such a leader in basic research and development, and so far behind in the commercialization; the example you just gave us, that's one.

The worry I would have in the electric vehicle area is that when it comes time for consumer acceptance that the Japanese will do a better job than us. That is the problem we have internal to the United States. Going to Japan is not going to solve that problem. Trying to sell more vehicles

is not going to solve that problem. The problem is here, domestically, and we have to get with it here as Americans.

SENATOR SASSER. Thank you very much, Mr. Peevey.

I want to thank all members of the panel for appearing here this morning.

Thank you, Mr. Chairman.

SENATOR SARBANES. Mr. Peevey, I would mention that we did some hearings in the Joint Economic Committee on the very question of basic R&D and applied science. What we found was, as you say, that we were way ahead on the basics, but then others would take our discoveries and translate them into applied economic terms in a much more effective way. So, I think it is a very important point. There is a complicated set of factors to deal with, but it can be addressed, I think, if we put our minds to it.

Gentlemen, we want to thank you.

Mr. Peevey, I particularly want to thank you for a very pragmatic and practical approach to these problems. My own view is that one of the reasons we are having such difficulties is that, unfortunately, a high ideological content has been introduced into the debate about what to do, on the part of some who say, "Well, those things are just ruled out." It's all this way or all that way. Most of these problems are not that way.

My own view is that they require a great degree, an increasing degree, of public-private interaction or partnership. As you look at our competitors, that is certainly what they are doing. That is one aspect of what they are doing that seems to be working well.

And then we get the argument that, if you start down that path, you are going to go to its logical extreme. I have never bought that. Part of making good policy, it seems to me, is to make decisions that don't carry to extremes. Any decision, if carried to its logical extreme, is probably not going to be a very sensible or a common-sense decision, almost by definition. If you posit as a counter argument the logical extreme, then you never make any effort to find a solution.

The real question is, on many of these things, whether there is a way to develop a more pragmatic approach. It's interesting that the United States has, for much of its history, compared with the Europeans, been seen as a very practical, common-sense country. There wasn't a lot of dogma; there wasn't a lot of ideology. Americans figured out what would work, what the problem was, how to address it. They figured out how to deal with it, and then they went at it.

The Europeans were always caught up in highly developed ideological systems that would clash and incapacitate their ability to deal practically with problems. Now, things seemed to have changed somewhat. They have become practical and pragmatic, and we seem to have this high ideological content. Hopefully, we can work through that and, in practical terms, come face to face in dealing with some of the problems you have outlined.

We thank you all very much, and the Committee stands adjourned.

[Whereupon, at 2:05 p.m., the Committee adjourned, subject to the call of the Chair.]

1992 ECONOMIC REPORT OF THE PRESIDENT: THE ECONOMIC OUTLOOK

FRIDAY, JANUARY 31, 1992

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

The Committee met, pursuant to notice, at 10:00 a.m., in room SD–628, Dirksen Senate Office Building, Honorable Paul S. Sarbanes (chairman of the Committee) presiding.

Present: Senator Sarbanes.

Also present: William Buechner, professional staff member.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

SENATOR SARBANES. This morning, the Joint Economic Committee meets to examine the economic outlook for 1992.

On next Thursday, the Chairman of the Council of Economic Advisors, Michael Boskin, and his two colleagues will be presenting the Economic Report of the President and will appear before the Committee for that presentation.

And then on next Friday, we will receive the employment and unemployment figures for the month of January.

The focus of the hearing this morning is the economic forecast. A year ago, most economists were projecting that the recession would come to an end in the spring of 1991. The Administration was saying it would be short and shallow. As it turns out, that's obviously not been the case. The recession has now gone on for 18 months, which makes it the longest in the postwar period.

While the decline in GNP has been smaller than in some previous recessions, I think the hurt being felt by the American people has been extensive, not only because the unemployed have suffered, but also because the employed are feeling a compression in their standard of living because their real incomes have not been rising.

The last report of the Bureau of Labor Statistics estimates that we now have 7.1 percent unemployment. That's the highest during this recession. In addition, there are 1.1 million who've become so discouraged that

they've given up looking for work, and another 6.3 million people who are working part-time but want to work full time.

If you factor those in, according to the BLS's usual formula, you get a comprehensive unemployment rate of 10.4 percent, rather than the 7.1 percent.

We're interested this morning, obviously, in the forecasts that our four distinguished witnesses will bring to us. The Administration, even if you accept their outlook, would not get the unemployment rate back to where it was before this recession started until 1997. That's by the Administration's own forecast.

We're very pleased to have four leading economic forecasters with us this morning to discuss the economic outlook and the factors that will affect that outlook. It will obviously be of help to the Committee in evaluating the Administration's economic forecast.

So, we're pleased to have this panel.

I think I'll start with Dr. Larry Chimerine, and we'll just move right across the panel: Mr. Ratajzcak, Mr. Silvia and Mr. Straszheim.

Larry, we'd be happy to hear from you.

Gentlemen, we'll include the full statements in the record, and if you wish to summarize, we would appreciate that, but we will be happy now to hear from you.

STATEMENT OF LAWRENCE CHIMERINE, SENIOR ECONOMIC COUNSELOR, DRI/MCGRAW-HILL, AND FELLOW, ECONOMIC STRATEGY INSTITUTE

MR. CHIMERINE. Thank you, Mr. Chairman, it's good to be back. I feel as if I've lived through this recession with you. I think it is the third or fourth time I've been here since the recession started. I don't know when your tenure of Chairman of this Committee ends, but I hope we come out of it before it does.

SENATOR SARBANES. So do I.

I want to make the point that we were already in this recession before I became the Chairman, just to make sure there's no cause and effect connection.

MR. CHIMERINE. No, quite the opposite, Mr. Chairman. I think you ought to be commended for recognizing it rather early, compared with some others, and showing far more concern about it and offering more solutions to it than many others.

SENATOR SARBANES. Thank you.

MR. CHIMERINE. And I won't name who those might be.

SENATOR SARBANES. Thank you very much.

MR. CHIMERINE. Let me just quickly outline what I hope to cover in my ten minutes or so. First, to give you some idea where I see the economy right now. Second, what are the current driving forces? Third, some brief comments about the forecast.

And then I'd like to conclude by making some comments about the Administration's forecast and, in particular, the budget that I still haven't fully digested, but, at least, based on an early assessment, some of my observations on that budget.

Where are we right now? I think everybody here knows that the economy did pick up a little bit in the spring of 1991, mostly in retailing and housing, and of course many people heralded that as the start of a recovery, particularly the Administration. But as we now know, the economy flattened out by mid-summer and, in fact, over the last two or three months, if anything, the momentum has been slightly on the downside, not traumatically; let's say anywhere from flat to down.

The one bright spot in the last three or four weeks is that there's clearly been a pickup in housing, especially in existing home sales. Even new home sales have picked up a little bit. And we did get a pick up in retailing, right after Christmas, for the first week or two of January. I'm told that that has now fizzled out and that the last ten days to two weeks have been weaker again. It's obvious that the earlier pickup was due to heavy discounting right after Christmas.

Orders are weak in most industries. I can't name more than a handful of manufacturers who are telling me that their orders are up. Most say their orders are either flat or down. And, in fact, the weakness has spread regionally. This is no longer a Northeast or New England recession, as you know. If anything, in the last six months, we've seen a deterioration in Southern California and even some weakening in parts of the Midwest that, until then, had been doing better than most other parts of the country.

This has been a national recession, and no matter how you slice it, or what word you want to use to describe it, as of right now, there is no recovery underway. Any recovery is still a forecast. The best we can say is that, despite the sharp decline in confidence, we don't seem to be falling off a cliff again. But there's no meaningful evidence of any broad-based sustained economic recovery at the present time.

Why not? Why didn't we get this recovery that everyone predicted? What caused the false start last summer? I think there are several reasons for it. Some of these I've discussed in previous testimonies, so I'll summarize them very quickly.

Number one, the recession has been misunderstood from day one. This was not an oil-shock recession. Those people who thought that it was predicted a quick and fairly vigorous rebound when the war ended, and that was not the case because it wasn't oil-induced in the first place.

Clearly, events in the Middle East did make the downturn worse than it would have been, but other factors were primarily responsible for it. As a result, all we should have expected when the war ended was a little up blip, reflecting a temporary return to confidence, and some postwar pent-up demand. And that's what we had, a little upward blip after the war ended. But the ongoing fundamental forces are still in place.

Nor was it a Fed-induced recession, nor was it caused by the budget accord, including the tax increases in the fall and early winter of 1990. As you pointed out, the recession was underway well before that.

This recession is part of an economic slowdown that began three years ago, primarily reflecting long-lasting factors, such as overbuilding, high debt, weakness in the state and local budget position, banking problems, and a whole slew of ongoing, long-lasting factors, many of which were created during the 1980s. That's why the economy began to slow down in early 1989.

We were probably already sliding into recession in 1990. The right way to look at this period is not as a typical, normal recession. The recession has not been an isolated event, but is really part of a process of economic slowdown or stagnation that began three years ago reflecting these long-lasting factors.

A second reason why the optimists were wrong is that they counted on the easing by the Fed, which began two and a half years ago, to turn things up, in addition to the postwar pickup in confidence. And, unfortunately, in the environment that we're in right now and have been in, monetary policy has provided less kick to the economy than people predicted.

First of all, we are in the midst of a deleveraging of the United States's economy. I hate that phrase. I've been using it consistently, but I can't think of a better term. But the fundamental trend in this country now is toward reducing debt. We are terribly overbuilt. Banks have enormous amounts of credit-quality problems. In this kind of environment, pushing interest rates down does not generate the same bang-for-the-buck on the economy that it otherwise might.

Furthermore, until recently, the declines in rates by the Fed were very gradual, very minimal, and interest rates were still at relatively high levels.

So, for all of these reasons, those people who expected a surge in economic activity as a result of Fed policy have turned out to be wrong.

Third, there is another trend not widely understood underway in this country that I think is, at the moment, preventing a meaningful recovery from developing. And that's the process of disinflation. Yes, I said disinflation. I know what the CPI numbers are and I know all the concern at the Fed and in much of the economic profession about inflation. But the fundamental trend in this country now for the broad mass of this economy is toward disinflation.

Wage increases are being cut back. Property values have weakened everywhere in this country. Commodity prices are, and have been, in the tank for months and months, years now. And hardly any companies can raise prices. The pockets of inflation are very special, are very selective, and very limited. Health-care costs, college tuitions, and a few things like that. But in the bulk of the economy, there are no inflation pressures and, in my judgment, it's constraining the economy in the short term because,

coupled with the recession, we are seeing weak revenues in almost every single industry.

I cannot ever remember a time when so many companies are reporting declining revenues, let alone profits, as is the case right now. And we economists focus a lot on real GNP, but companies run their businesses off revenues, and with the absence of revenue growth and the absence of an economic recovery, coming at a time when most industries have already experienced a sharp squeeze on profits, this is producing the most widespread, dramatic, cost cutting that I have ever seen since I've been in this profession. Companies are taking more steps to cut inventories, cutting benefits, trying to make cuts in wages again, and, mostly, are implementing enormous layoffs in most of these industries which, in the short term, is a further constraint on any economic recovery.

It might be healthy in the long term. Some of this will show up in better productivity, and some of these companies may be better off as a result, but you have to wonder when one company does it, it might be good; when everybody's doing it, who's going to be around to buy their products.

And this has, to some extent, become another constraining factor on the economy.

A fourth factor in what is happening is at the state and local government level, partly for the same reason. Their tax base is not growing because there's no inflation in the system, and because of the recession, of course, they're not benefitting much from lower inflation on the spending side. I don't know a lot of state governments that buy lots of copper, or aluminum, or whatever.

Their expenses are primarily in wages for their employees and in medical costs, both of which have been rising fairly rapidly. And, as a result, we've seen an enormous gap between their income and their expenditures, leading to large tax increases, big spending cuts, including layoffs for many state and local government workers, which again has become a restraining factor on the economy.

On top of that, confidence is weak for obvious reasons—people are scared about their jobs.

These are the forces now that are preventing the start of any meaningful economic recovery, on top of the ongoing structural problems that are still in place—overbuilding, and so forth.

There are a few hopeful signs right now. Quite frankly, I feel a little bit more gratitude for the first time in three years. This is a personal observation. The one positive effect that easing by the Fed is now causing is all the refinancing, because we've finally begun to see a little bit of the decline in short-term rates show up in the long end of the market. As a result, we're seeing variable rate loan monthly payments go down. Corporations are refinancing some of their debt. Many families are refinancing their mortgages. All of this will free up a sizable amount of purchasing power this year.

And this is the only way the Fed, in my judgment, can produce any economic stimulus, because very few people are going to be going out to borrow more, in view of the deleveraging trend.

Second, oil prices are down, which will further bolster purchasing power. Third, we will get a fiscal package. I'll get back to that in a moment. It will have some stimulus at the margin.

For all of these reasons, there are more hopeful signs now than at any time in the last couple of years. And I think, if you put the pluses and minuses together, it's possible to support the forecast that we will get a slow, gradual recovery, starting sometime in the next three or four months, reflecting the factors I just listed. When it starts and how strong it will be will depend upon three or four factors.

Number one, are more layoffs coming? Second, how will the layoffs already announced, as well as any new ones, show up in the flow of income? Many of these jobs have not yet been cut, even though they've been announced, so we can't be sure, yet, about what the income flows will be.

Third, how much of any increase in income coming from mortgage refinancing and so forth will be spent? These, to me, are the three big questions.

My best judgment is that we will have a recovery starting in the spring, but the ongoing structural factors will limit the speed of that recovery. The risks are still significantly on the downside. If we do get more layoffs, we could see further erosion of confidence, further reducing spending. If the economy remains stagnant for three or four months, it's not inconceivable that corporations will make strong efforts to cut their capital spending which, if they do, will make it very difficult to see any recovery in the second half of the year.

We also could get a financial accident. Lots of companies and lots of financial institutions are not that far away from going under. So, there are lots of risks which could prevent or delay the recovery. So, I think the best we can hope for is a slow recovery starting some time in the spring or early summer.

SENATOR SARBANES. Let me interrupt a second—when you use the word "recovery," what's your definition of that?

MR. CHIMERINE. The economy moving upward. And it's probably a poor word because it's going to take a long time, as you indicated, to get back to where we started from.

But what I should really say is, the economy moving in an upward, sustainable positive direction. And that's what I'm saying.

Now, what should we do on the policy front?

By the way, I think the Administration's forecast for 1992 is reasonable. They have a fourth-quarter-to-fourth-quarter growth of, I think, 2.2 percent and it could even be a little higher than that, so that isn't what concerns me.

What concerns me most about the Administration's forecast is, they are claiming that, as a result of their proposals, we will increase average

economic growth by approximately one-half of 1 percent per year for the next six years.

I haven't the foggiest idea of what the President has announced that could possibly increase economic growth to that extent. It cannot come from the capital gains tax cut, in my judgment. There is nothing in there, in my view, that will significantly address our long-term problems or accelerate long-term economic growth in this country. So, my big concern with the Administration's economic projections is not 1992, it's the approximate 3 percent a year average in the next six or seven years, some of which, they say, comes from their proposals. I don't understand how they reach that conclusion.

On the policy side, the Administration is making a number of proposals, but I think they're probably over-stating the amount of short-term stimulus that they will provide. The withholding shift is one example. Most people deliberately overwithhold because they like to get a big refund. This is a forced savings. So, it's not clear how many of them are going to take the cut in withholding in the short term.

And second, the record is clear. Every temporary tax cut on the personal side that we've had in the past has been largely saved. And this isn't even a temporary tax cut. I mean, this is a temporary shift in taxes. So, I'm skeptical about how much stimulus we'll get from that.

I think we'll get some added housing from the housing tax credit, although it affects a limited part of the market. People who are worried about their jobs are not going to be buying houses. Housing is already a lot more affordable, so, you know, much of this would have happened any way.

The Administration talked about doing some things about the credit crunch, but the regulators are not responsible for the credit crunch. The President telling the regulators to ease up is not going to change the credit crunch in this country, at least at the moment.

I would have preferred the incremental investment tax credit that I've advocated to this Committee before. But what they've done on depreciation, I think, is a reasonable substitute for that. And, of course, the tax credit, tax exemption, doesn't even start until next October.

So, my best judgment is that this will provide a small amount of stimulus at the margin and contribute a tenth or two-tenths percent economic growth later this year. And really, what it does is to offset some of the restraint that was previously embodied within the budget. It's certainly still not a very stimulative budget in the short term.

What bothers me most about the budget, though, and the President's speech—I mean, we have serious economic problems in this country. We are essentially slowly destroying the United States's economy. In my judgment, it is unconscionable what we've done in the last ten years. And there is nothing in this budget, in my view, that addresses our serious long-term problems of productivity and competitiveness.

It's also loaded with gimmicks. As it is, their projections are for $200 billion deficits every year. It's really going to be much worse, as is

normally the case. There's no reasonable program to deal with these budget deficits, let alone any kind of national economic plan to rebuild this economy, to improve productivity, and to improve our competitiveness in world markets.

We fooled ourselves in the 1980s with a recovery built mostly on Patriot missiles, empty office buildings, and putting lawyers and financial people to work doing leverage buyouts. At the same time, the underlying fundamentals deteriorated.

We saved less, we invested less, we spent less than our foreign competitors on R&D. Health-care costs are out of control, and there's nothing in the budget to deal with that. The quality of education has deteriorated and so forth.

We need a national economic strategy aimed at improving productivity through generating much higher levels of investment in human capital, in fixed investment, and in infrastructure. And in my judgment, there's little or nothing in this budget that deals with that. I find it very disappointing.

When we dominated world markets in the 1950s, 1960s and 1970s, we did it because we were more productive; we led in technology, and we produced better quality products. We used that growth in productivity and those advantages in productivity to raise wages and living standards for our workers, and to create millions of high-paying corporate jobs. Those trends are being reversed because we've lost our competitive advantages.

And until we recognize that and until we start facing up to that with appropriate policies, I think the long-run outlook is very iffy, despite whether we get an uptick in the economy during 1992.

One last comment, Mr. Chairman, and that's with some of the specific proposals. I want to address capital gains, which is the centerpiece of the Administration's proposal.

All the evidence that I've seen suggests the reductions in capital gains taxes have a very small impact on the cost of capital, a very small impact on fixed investment, and therefore on economic growth. And I support the concern on the fairness side, as well, but the real issue with capital gains is that, by itself, the President's proposal will not significantly increase capital formation in this country, in my judgment.

What we really need is a substantial difference between the tax rate on short-term gains and the tax rate on long-term gains, and also a substantial difference between the tax rate on long-term gains and the tax rate on ordinary income.

I would propose two things: first, a sliding scale capital gains tax. Let's raise the rate on short-term gains, scale it down gradually the longer the asset is held, and maybe even wipe it out completely for assets held six, seven or eight years. That way, you have a big difference between the rate on short-term gains and long-term gains, encouraging the kind of long-term investments that we need.

And second, raising the top marginal tax rate makes sense, not only on fairness grounds. Because, again, the lower that rate is, the less risk-taking we get in this country. Why would anyone take the risk of investing in

something for the long-term when they keep most of the income they get in the short-term because the tax rate is so low, and because they don't get any benefit on the tax side from a long-term investment.

I think increasing the top rate and widening the spread between the top rate and the capital gains tax rate for long-term investments makes some sense. If you look at increasing the top rate, you ought to do it on those grounds, not just on an equity argument.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Chimerine follows:]

PREPARED STATEMENT OF LAWRENCE CHIMERINE

My name is Lawrence Chimerine. I am currently a Senior Economic Counselor to Data Resources-McGraw Hill, Inc., and a Fellow at the Economic Strategy Institute. I appreciate the opportunity to testify before the Joint Economic Committee on the current economic situation, the near term outlook, and on my policy recommendations.

In sum, my views are as follows:

1. The recession which began in early summer 1990 is still in place. Furthermore, it not only is already one of the longest on record, but it has been a more serious downturn than convention wisdom, and some of the economic statistics, now indicate. The still weak state of the economy also makes it clear that this was not an oil-shock recession. In my view, it cannot be blamed on the Federal Reserve either.

2. The 1990-91 recession is different than most others in (a) that it was preceded by a long period of transition (18 months of growth averaging only about one percent), instead of following quickly on the heels of rapid growth; (b) that the job losses during this recession have been spread across far more industries and occupations, and included more terminations rather than layoffs, than in previous recessions; and (c) that it has been caused primarily by long-lasting structural factors, rather than the temporary factors that have caused most previous recessions.

3. These long-lasting structural factors include high levels of private debt, massive overbuilding in commercial construction, restrictive fiscal policies, tighter lending standards, widespread state and local government fiscal imbalances, weak real income growth, poor international competitiveness, etc. This recession has thus been more of a balance sheet, financial recession than an inventory, tight money, or inflation caused recession. Furthermore, the recession should not be considered as an isolated event but rather as part of the sharp slowdown which began about three years ago.

4. The economy did experience a small uptick in the spring of 1991, suggesting to many that the recession had ended. However, the small improvements in retailing and housing that took place at that time primarily reflected temporary post-war euphoria, and the early arrival of summer in the eastern half of the United States, rather than the start of a any lasting recovery. In fact, the economy flattened out in mid-summer, and the momentum over the past few months has actually been slightly downward.

5. The absence of a strong, sustained recovery, despite numerous optimistic forecasts, can be explained by a misunderstanding of the economic forces at work. First, many counted on the

post-war rebound in consumer confidence to trigger a surge in spending--however, the real constraint on consumer spending has been weak income growth and high debt levels. Secondly, the optimists also counted on the easing by the Fed to trigger stronger economic activity--however, in part because the Fed eased too slowly, and in part because of the high levels of debt, high vacancy rates, and the strained financial system, lower interest rates have had a very limited impact.

6. The long-lasting structural factors discussed above continue to constrain the economy. Two factors in particular seem to be most significant at the present time. First, the deleveraging process that has been underway for several years in the private sector remains in place--not only are households and corporations uninterested in accumulating more debt, but many appear determined to reduce their indebtedness in order to improve their balance sheets. This acts as a constraint on spending, particularly for high price tag, debt sensitive, items. Secondly, the corporate sector is experiencing an almost unprecedented slowdown in revenue growth-- many large companies in fact are reporting year over year declines in revenue, in many cases for the first time in many decades. This reflects not only the weakness in volumes resulting from the recession and other factors, but also the widespread disinflation that exists in much of the economy. Most companies are finding it extremely difficult to raise prices in view of the highly competitive nature of their industries--in many cases, prices are falling. This weakness in revenues is creating more downward pressure on already depressed profit margins, forcing many companies to cut costs more aggressively in order to prevent additional profit erosion. This cost cutting is primarily in the form of layoffs and wage restraint, but also includes new efforts to cut inventories, and in some cases, cutbacks in capital spending. The high layoff rate, coupled with declining real estate values, has caused confidence to plunge again, further limiting consumer spending.

7. There are some factors which are more favorable than at any time since the recession began. First, long-term interest rates have finally begun to decline--while this is not likely to reverse the deleveraging trend, it will free up billions of dollars in purchasing power as payments on variable rate mortgages decline, and from widespread re-financing of fixed rate loans. This will at least partly offset the adverse effect of weak employment, higher taxes, etc., on income. Secondly, the decline in oil prices in recent months will also bolster purchasing power. Thirdly, declining mortgage rates has triggered some increase in existing home sales in recent weeks. Finally, inventories are so low in many industries that current efforts to reduce them further are likely to be very modest, thus producing little or no additional downward

pressure on production.

8. On balance, when the pluses and minuses are weighed, my best judgement is that a modest recovery is likely to begin by late spring. The ongoing structural factors, coupled with the likelihood that much of the added purchasing power will be saved because of widespread job fears, will keep the recovery very slow, uneven, and erratic. Furthermore, I continue to believe that the downward risks are sizeable.

9. I believe the most serious economic problems in the United States are the sluggish trend growth in productivity, and the decline in the international competitiveness of the United States economy. It is vital that we implement a multi-dimensional national economic program designed to accelerate productivity and improve our competitiveness. This must be a government led effort and should focus on increasing investment. It is also essential that we no longer permit some of our major industries to continue to decline or disappear--the notion that we can make up for these declines elsewhere is a myth.

10. In view of this high probability of only a slow recovery or no recovery in the near-term, and because of the relative ineffectiveness of monetary policy, I believe that budgetary measures should be considered. Any such measures should be directed toward reducing hardships from the recession and to improve long-term economic prospects, rather than just creating a temporary recovery. Furthermore, given the size of current budget deficits, it is essential that any new measures be designed to generate maximum bang for the buck, or they may prove to be counterproductive by raising deficits even more. I thus suggest a program which includes an extension of unemployment benefits, either a large investment tax credit or dramatically accelerated depreciation on incremental investment, and a tax credit on spending for durable goods in 1992.

CURRENT ECONOMIC SITUATION

Retail activity, auto sales, and housing did pick up somewhat in the spring of 1991, but at a relatively modest rate; furthermore, most other sectors of the economy remained stagnant or continued to decline. Thus, the pickup last spring was very slow and uneven. We now know it was also temporary, reflecting post-war euphoria and pent-up demand, and an early summer in the eastern half of the United States (which pulled some summer-related spending forward). The upward momentum ended by mid-summer when the economy began to flatten out--in the last two or three months, the momentum appears to have been slightly downward. Thus, it is now clear that the situation in the Far East aggravated the

downturn causing additional downward pressure when war was about to break out, and that that activity was made up in the late spring and early summer of 1991. Now that those temporary forces have faded out, the ongoing structural factors continue to hold back the economy.

It appears that the recession is still in place. Virtually all manufacturing companies continue to report flat, or declining, orders. Retailing did improve somewhat in the first week or so after Christmas, but retail activity has slowed again since. Auto sales remain at rock bottom levels. The only area of improvement appears to be a modest upturn in housing activity, particularly for existing homes.

On a regional basis, there is no region currently experiencing any sizable rate of increase in economic activity. Some, in particular California and much of the Midwest, appear to be sliding more sharply than they did even earlier in the recession. Any economic recovery at this point is thus still a forecast--there is virtually no evidence that the economy is on a rising trend at present.

There are three factors in particular that are most responsible for preventing a meaningful sustainable upturn at the present time. First, the private sector is in the midst of a trend toward deleveraging that began several years ago, at least partially reversing the enormous buildup of private debt during the 1980's. Put simply, many corporations and individuals were having increasing difficulty servicing the debt that had already been accumulated. Many have balance sheets that are lopsided with debt, increasing the risks in their businesses or personal lives. Furthermore, the decline in the value of many assets, especially real estate, has aggravated these balance sheet problems. Finally, some of that debt was incurred by stretching out the maturity of loans (auto loans are a prime example)--this too has caused many people to experience a decline in the value of their assets over time at a much more rapid rate than they were able to pay down debt. This ongoing deleveraging is an obvious limiting factor on economic growth, especially in comparison to the 1980's when the increased willingness to borrow contributed as much as a half to one percent per year to the growth rate. It shows up particularly in reduced demand for debt sensitive products, like autos, other consumer durables, housing, capital goods, and inventories.

Secondly, a significant trend toward disinflation is occurring in the United States. This is most evident in declining property values, in extremely weak commodity prices, in slower growth in wage rates, and most important, in the difficulty that most companies in most industries are having in raising prices (many have been forced to cut prices). This trend toward disinflation is the result of many factors, including widespread excess capacity, intense domestic and foreign competition, efforts to improve

productivity, and buyers resistance. The latter is particularly apparent in the corporate sector, where the weakness in profits is forcing many companies to increasingly resist price increases from their suppliers, pushing the disinflation process throughout the system. The effect of price restraint and weak volumes in most industries has been to cause revenues in a large number of companies to be extraordinarily weak--many are reporting revenue declines for the first time in many decades. While economists focus extensively on real GNP and other such measures of economic activity, most companies run their businesses off revenues--the weakness in revenues, coupled with the absence of any meaningful recovery, is causing the most widespread cost-cutting in the corporate sector that has been experienced in many years. This is taking many forms, including additional efforts to cut inventories, cutbacks in capital spending, wage freezes, benefit cutbacks, and mostly, an extraordinarily high rate of layoffs. All of these are further restraining economic activity--the layoffs are doing so in two ways, by reducing household income, and by causing widespread anxiety regarding job security (which has caused consumer confidence to plummet again).

Thirdly, the income imbalance at state and local governments has also become a major constraint on the economy. In particular, disinflation and poor income growth are restraining state and local government tax receipts at a time when rising medical costs, higher wages for government employees, federally mandated program increases, etc. are causing expenditures to continue to rise. The result has been the largest fiscal imbalance at the state and local government level since the depression--this in turn is causing widespread expense reductions (including layoffs) and increasing taxes.

There are some favorable elements in the near-term outlook, perhaps more so than at any time since the recession began. First, inventories are so low in may industries that additional cuts are likely to be very limited. Secondly, while the deleveraging trend remains in place, continued Fed easing can help the economy by lowering the cost of debt servicing. In particular, the declines in long-term rates that have finally started to occur are not only reducing monthly payments on many variable rate loans, but are causing a wave of refinancing which will also reduce such payments on many fixed rate loans. Thirdly, real incomes will be further bolstered by the sizable decline in oil prices over the past several months. Finally, lower mortgage rates have already begun to strengthen the existing home market over the past month or so.

The outlook for the near-term depends upon whether the increase in purchasing power from lower mortgage payments and lower oil prices is enough to offset the declines in purchasing power caused by higher taxes and job losses, and in how much of such added purchasing power will be spent in view of the low level of confidence. My best guess is that we will begin to see a slow

upturn in consumer spending, and in new housing, sometime in the next several months, which will ultimately lead to a gradual overall economic recovery beginning by late spring. However, because structural factors will continue to hold down demand for the foreseeable future, the recovery is likely to be very slow and uneven. It will take a number of years for debt to be brought down to levels that it is no longer a constraint on new spending; for banking problems to be worked out so that normal credit standards can re-emerge; for vacancy rates to move toward more normal levels, so that new commercial building can increase; and for many state and local governments to eliminate their fiscal imbalances.

The strength of the recovery will also be held back by the fact that, even with recent declines, long-term rates remain extraordinarily high, particularly in relation to current short-term rates. These high long-term rates primarily reflect the massive Federal budget deficit still in place, combined with our low saving rate and a reduced flow of foreign capital.

The recovery will also be held back by a slowdown in export growth, reflecting the weakness in economic conditions in many European countries, in Japan, and in Canada.

Thus, after a flat first quarter and a small uptick in the second quarter, I would expect to see GNP growth in the 2.5% range during the second half of this year and into 1993.

I continue to believe, however, that there are major downward risks which could delay the recovery even further, or cause it to be even weaker when it does begin. First, as mentioned earlier, it is not clear whether the added disposable income that will result from lower mortgage rates and lower oil prices will be spent in view of the weak state of confidence and the high debt position of many consumers. This is also true in the corporate sector--with the trend toward cutting costs, lower debt servicing costs for many corporations will not necessarily translate into more capital spending or hiring. Secondly, announcements of additional job cutbacks over the next few months cannot be ruled out--if such were to occur, the adverse effect on incomes, coupled with the possibility of even weaker consumer confidence, may adversely affect spending. Finally, the longer the economy remains stagnant, the more likely that capital spending plans will be scaled back--this could become a problem later this year.

NATIONAL ECONOMIC STRATEGY

The long recession still in place finally has brought home to a majority of Americans what has been obvious to many of us for a number of years, namely that the U.S. economy has stagnated. And without significant changes, prospects remain very poor.

The underlying weaknesses of the economy were hidden during the 1980's by the long expansion which began at the end of 1982, and continued unbroken until very late in the decade. However, that expansion was by no means the result of a supply-side miracle or other magical transformation of the economy, or of favorable fundamentals. Quite the opposite, it was simply a cyclical rebound from the two severe back-to-back recessions early in the decade, which left the economy operating far below capacity--in fact, even with the long expansion, average growth for the decade as a whole was the lowest since the 1940's. Even worse, that growth took place as a result of tax cuts we couldn't afford; of enormous military and construction booms; of massive borrowing from overseas; and of the biggest leveraging of our system since the 1920's. Unfortunately, the fundamentals were at the same time getting worse--our rates of saving and investment were declining from already low levels; economy-wide productivity growth barely picked up from the anemic rates of the 1970's; little was done to address the quality of education, the cost of health care, the crumbling infrastructure; our international competitiveness continued to decline; etc.

As a result, now that the driving forces of the 1980's expansion have faded out and in fact are being reversed, there is nothing to take their place. In effect, we not only didn't build for the future, but we mortgaged our future at a time when our competitiveness in world markets continued to deteriorate. It was thus inevitable that the U.S. economy would stagnate--a temporary surge in exports reflecting the sharp decline in the dollar, and the continued inflow of foreign capital, delayed the day of reckoning somewhat in the late 1980's, but now the day has arrived. It already has been a very long day, with the likelihood that it will be even far longer.

The warning signs are numerous. They include:

- The virtual elimination of U.S. advantages in productivity in a growing number of industries (we've actually fallen behind in many), due largely to productivity stagnation in this country.

- The shrinking technological leadership that once characterized the U.S. economy.

- Massive trade deficits, reflecting declining shares of U. S. production in a large number of industries, in response to these changes.

- The dismantling of many important companies and industries, with many others headed in that direction.

- Widening gaps between the United States and other

countries in the quality of eduction.

- Stagnate real wages for the majority of Americans during the last fifteen years or more.

- A distribution of income which is becoming more unequal.

- A banking system which is in shambles.

- An increase in resources devoted to essentially non-productive uses.

Very clearly, we have been going in the wrong direction as a country, at a time when our economic performance is more influenced by global factors, and when our advantages in natural resources which were instrumental in our economic domination during the past are no longer as important. Put very simply, the world has changed--almost everyone has caught up to us and even surpassed us, at a time when the world economy is far more integrated than ever before. But, despite the assertions of some economists who point to the recent pick-up in exports as an indication that we are becoming more competitive in world markets, quite the opposite is the case. Witness, for example, the fact that the 1991 trade deficit probably exceeded $70 billion despite relatively low oil prices, despite the severe consumer-led economic decline, and despite an exchange rate for the dollar that was more that fifty percent below the peak in the mid-1980's. And witness the fact that we continue to lose share in many manufacturing industries, especially in high-technology.

What is most disturbing is that it is difficult to expect productivity growth to accelerate, and our relative competitiveness to improve, in light of the following:

- Our net investment rate is half of Japan's, and far below that of other major competitors.

- Our national saving rate is at a record low level, despite the so-called supply-side savings incentives.

- Our business sector is highly leveraged, which is causing additional downward pressure on non-defense R and D (which has already fallen below the rates in Japan and Germany).

- Declining SAT scores and other measures show that the quality of education at the elementary and secondary school levels continues to deteriorate, falling further below our major competitors.

- Our infrastructure continues to decay, reflecting

the neglect of the 1980's.

- No systemized effort is underway to improve job training and provide the needed skills for the 1990's.

It was fashionable in the 1980's to brand anyone who made these observations a doom and gloomer or a pessimist. But you can't grow an economy forever by building empty office buildings and Patriot missiles, and by doing leveraged buyouts and stock buy-backs. The lessons are clear: the factors that were largely responsible for the highly prosperous 50's, 60's, and early 70's, namely our enormous competitive advantages in world markets and our strong growth in productivity, no longer exist. And it should be obvious that the economic policies, and indifference and neglect, of the 1980's are not the solution--if anything, they made things worse.

Key Objectives Of A National Economic Strategy

The ultimate goal of any effort to restore economic health is to raise living standards for the vast majority of the population, and in so doing, significantly improve prospects for the next generation. This can only be accomplished by achieving a much higher rate of productivity growth than the less than one percent average between 1973 and 1991.

An acceleration in productivity growth is also vital for a number of other reasons. First, it is clear that the major factor in the loss of international competitiveness of the United States has been an erosion of the productivity advantages that most U. S. industries previously enjoyed. This has resulted not only in the loss of U.S. market share in an increasing number of global industries, and enormous trade deficits, but has created downward pressure on the number of high-paying manufacturing jobs, on average wages, and on the U.S. dollar, all of which have reduced real wages and living standards for many Americans. Secondly, the lack of significant productivity growth in non-tradable sectors has also prevented any meaningful improvement in living standards for workers in those industries--only if productivity picks up can this trend be changed. Finally, only a meaningful improvement in productivity growth can produce the necessary economic growth to enable us to address the serious social problems which exist in this country, including drug abuse, illiteracy, crime, social decay, etc.

It is important to note that what is required is not merely a one-time increase in productivity, such as has occurred in many companies as a result of staff cutbacks or closure of relatively inefficient plants. What is needed is an acceleration in the trend in productivity growth, or repetitive year-after-year gains in productivity, such as this county experienced in the first thirty years after World War II, and such as is now occurring in Japan and

many other countries. And it must be economy-wide--improvements in productivity in some industries which take place primarily as a result of outsourcing and other measures which shift the problem elsewhere will not effectively solve most of our problems. Finally, it is also important that acceptable gains in productivity take place in a relatively fully employed economy--improvements in efficiency, or downsizing, which reduce employment in some industries is only acceptable in an environment where the demand for labor is rising sufficiently in other industries to keep the economy fully employed.

Basic Principles

I strongly believe that a national economic plan to restore productivity growth, competitiveness, and improving living standards is absolutely essential; these will not materialize without such a plan. I believe that the national economic strategy must be consistent with the following basic principles:

1). As mentioned earlier, there has been a dramatic change in the global economy, and the United States position in that economy, during the last fifteen years. In particular, the United States no longer has the vast advantages in productivity, product quality, and technological innovation and implementation that it did in earlier years. These declining advantages have come at a time when world trade represents a larger share of the U.S. and world economies, so that declining competitiveness has a more adverse effect on economic performance now than it did in earlier periods.

    Most significantly, these changes suggest that economic and trade considerations can no longer be secondary to political, national security, and other factors in setting policy in the United States. Thus, we can no longer "give away the store" by providing unlimited access to U.S. markets to other countries (who do not reciprocate) for State Department considerations, or to buy their support on other global issues, because we no longer have the competitive advantages to offset the differential in market access and other such factors. Similarly, we can no longer afford to spend six percent of our GNP to defend the free world when our major foreign competitors are spending only a fraction of that--again, when we were dominant in productivity and technology, we could defend the free world and still be competitive in world markets but that is no longer the case.

2). The guiding principle of domestic policies in the past in the U.S. has been "what's good for the consumer is good

for the economy". This, in addition to political factors, has underlined our trade policy--it also lies at the heart of our domestic anti-trust and tax policies. But the jobless, or those earning lower real wages, cannot maintain their standard of living no matter how favorable these policies are. The key to consumption is real wages and employment--I believe that our economic and other policies have to be shifted to better balance between consumption and production.

3). The national economic strategy must be multi-dimensional. Any simply-minded, narrowly focused solution, whether it be in macro economics (such as simply cutting marginal tax rates, or a capital gains tax cut), or in education, or any other policy area should be rejected. I strongly believe that the decline of the United States has been caused by a combination of factors, none of them devastating individually, but all of which have added up to the economic malaise which characterizes the U. S. economy at present. In my view, each of these areas must be addressed in order to turn the situation around: this includes effective macro policies that will increase our investment in productive assets; reversing the decline in the quality of education; stabilizing health care costs; preventing the continued disappearance of major industries, particularly those that have important linkages to others; restoring our leadership in technology; etc.

4). I believe that each of these areas must be addressed simultaneously, in a coordinated fashion. This is particularly true in view of the massive budget imbalance--these enormous deficits pre-empt the possibility of just adding more money in one place or another without considering offsets elsewhere. Quite the opposite, it is clear that developing a budget for the next five years or longer first requires a determination of our important priorities, and how much funding will be necessary to address these areas, rather than looking at each one in isolation of the others. Furthermore, various linkages must be considered--solutions to improve the quality of education cannot be made independently of our needed efforts to increase the resources devoted to science and engineering.

5). I strongly believe that the development of a national economic strategy, and to some extent its implementation, must be led by the Federal government. The Federal government has always had a major role in the U.S. economy, starting with the industrial revolution which resulted in U.S. economic leadership in the world for almost a century.

6). I believe that the focus of the national economic strategy should be as follows:

a). To significantly increase the amount of productivity-enhancing investment, so that the capital stock per employee, in both quality and quantity, will begin to approach our major foreign competitors;

b). To bring about a dramatic improvement in the skills of our work force, both by improving the quality of public education, and increasing public and private job training;

c). To reverse the slide in United States technological superiority by beefing up basic research, and by speeding up the process by which new technological breakthroughs are translated into new products and into higher productivity.

7). Finally, the economic strategy should be based on the principle that what we make as a country is important. In particular, I strongly reject the notion that all goods and services are alike--that there is no difference between wood chips, potato chips, and semiconductor chips. Quite the opposite, it is extremely important to make certain that the United States has a major presence in those industries which represent the growth markets of the future, if in fact we want to experience strong economic growth; in those industries and products which have high multiplier impacts on the rest of the economy; in those industries and products which generate high value-added and thus produce high paying jobs; and in those industries and products which are leaders and drivers of new innovation, and without which the process of new technological development will be set back. Thus, we cannot accept another period of economic growth accounted for by the construction of empty office buildings, Patriot missiles, and the like, while more and more of our key industries are permitted to deteriorate.

This does not mean significantly greater economic management of the economy, or that the Federal government should consistently pick winners and losers. But, some industries are important for the well being of the country as a whole, so that if they are not permitted to develop, or if certain existing industries are permitted to go under, the entire economy will lose. Thus, permitting the development of some key strategic industries will be a win-win situation for the economy, rather than coming at the expense of other industries, because they will help create a higher employment, higher wage, more vibrant economy, thus increasing the

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demand for other goods and services as well.

Role of the National Government

The Federal government should have the following role in bringing about a better economic environment in the years ahead:

a). To set targets for various measures of economic performance. Included should be desired rates of saving, investment, and non-military R&D; average SAT scores; health care costs and health care inflation; and productivity growth and overall economic growth, for the next ten years. These measures include both ends in themselves as well as means to achieving those ends--thus, the ultimate objectives are productivity and economic growth, but it is necessary to specify goals for savings, investment, R&D, etc., in order to achieve desired growth in economic activity.

These goals should be monitored on a year-by-year basis, and if the trends are unfavorable, policy changes should be considered to increase the chance of achieving them. It is not only important for the Federal government to develop these quantitative targets, but it is also important for them to be presented to the country at large, so that individuals, corporations, etc., have some understanding of where we want to be.

b). The Federal government should act as an example for the private sector by channeling as much of its own funds into productivity-enhancing expenditures as possible, by eliminating waste and inefficiency, etc.

c). It is important for the Federal government to recreate the concept of the national interest. Thus, we can no longer tolerate behavior that might enrich some selected individuals but which damages the national economy. When situations such as this arise, it is legitimate for the Federal government to make some effort to reverse them by jawboning or by other means.

d). It seems clear that one additional role of the Federal government will be to act as a catalyst in achieving our economic objectives. Thus, there will be times when the Federal government should bring various segments of the economy together in order to help them reach some agreement which might

be in the national interest, or might facilitate some event or direction that might be helpful to the national economy.

e). It may be necessary for Federal funding to be increased for various activities if it is determined that reliance on the private sector alone will not be sufficient. For example, increased funding for pre-competitive research may be one area where the Federal government's role may need to increase in the years ahead.

f). Perhaps the most basic function of the Federal government is to create the proper business environment. This includes effective macro policies to increase saving and investment to bolster productivity and competitiveness, and taking prudent steps to reduce the budget deficit in order to cut the cost of capital to the private sector. Other policy measures, such as those which will encourage more private R&D, which might slow the growth in health care costs, etc., also need to be implemented.

g). A significant change in its own priorities seems in order. Any realistic strategy will require increased Federal funding for research, for improving the quality of education, etc. An increase in public investment, both to repair the existing infrastructure as well as to build the infrastructure for the future, must also be part of any successful economic strategy.

h). Finally, micro policy changes will also be necessary, such as relaxing anti-trust laws to permit more industry consortiums (both on the research as well as the production side), providing assistance to key emerging or existing industries, more vigorous enforcement of existing trade laws, developing a trade policy more in tune with today's economic realities, etc.

It is my view that some significant changes in the basic structure of the economy and its major entities will also be necessary to facilitate a healthier economy in the years ahead. In particular, I believe that the current structure discourages patient capital--that is, investments with a long-term payoff--thus promoting a short-term orientation which limits our ability to compete in long lead-time industries. Some of this is due, of course, to macro policy, which in previous years has produced a high cost of capital in the United States compared with other countries. While the cost of capital is less unequal now, this

comes at a time when many of our major foreign competitors have built up enormous internal funds which they are now using to finance their future development, and thus, are not as sensitive to the relative cost of capital as may have been the case in the past.

It is vital that we begin to make the long term investments which are needed to improve productivity and increase capacity, rather than the short-term, speculative, financial-type investments that were so prevalent in the 1980's. It is thus essential that we find ways to stretch out the investment horizon in the United States.

SHORT-TERM POLICY RECOMMENDATIONS

In my view, a proactive program to stimulate the economy is badly needed to insure a stronger sustainable recovery, and simultaneously to bolster our long-term growth prospects. The way to meet both of these needs is with an investment-oriented, countercyclical program that will dramatically increase our rate of investment in new, productive assets, thus helping raise our abysmal productivity growth and improving our competitiveness in world markets, while at the same time increasing short-term economic activity. Thus it is vital that any short-term program address long-term needs, or very little will be accomplished--in effect therefore, I am suggesting that the short-term stimulative program that we put in place be the first step in developing and implementing an economic plan to rebuild the U.S. economy on a long-term basis.

In my view, any stimulative package to address our short and long-term needs should adhere to the following guidelines: First, we should address our problems without widening our mind-boggling structural deficits (which will already be much higher than OMB is now estimating). These deficits are the major reason why long term interest rates are still at least 2 percentage points higher than they otherwise would be, given the weak state of the economy and current levels of short term rates and inflation, and thus are another drag on economic growth. They are also increasing our dependence on foreign capital, squeezing out productive investment, and placing an unconscionable burden on future generations. Widening the deficit could cause long rates to go even higher, as recent nervousness in the bond market suggests. Deficit-neutrality would of course require creativity--it means that any actions that are put in place will have to produce a "big bang for the buck" by being targeted and focussed, and/or, be temporary. Second, we should accept the fact that most of the income growth and tax benefits which occurred during the 1980's accrued to people in the upper income groups. Any proposals to stimulate the economy must be fair by not making the tax structure even more regressive--in fact, some of the regressivity now in place should be reversed if

possible.

How can all of this be accomplished? Well, it is clear that what the economy needs is jobs and investment--jobs to provide income and improve confidence, and investment to improve long term productivity and competitiveness. Our public and private investment needs are enormous--they include modernizing our capital stock, reducing our dependence on foreign oil, upgrading our infrastructure, and building communications and data-handling systems for the future. We thus need an investment-led recovery, but weak profits, poor sales and the overleveraged condition of many companies are now, if anything, further depressing capital spending plans. However, many large corporations do have substantial cash and other assets that can be turned into new capital spending. The objective essentially is to encourage them to do so in order to prime the pump in the short term and improve productivity in the long term.

Some are suggesting that this can be accomplished by cutting the capital gains tax rate. However, capital gains tax changes by themselves simply do not impact fixed investment significantly. And its fixed investment that what's needed to help the economy off its back, and begin the process of boosting productivity and competitiveness. A straight reduction in capital gains tax rates will simply provide a windfall on investments already made (and thus raise the budget deficit in the long run), and perhaps generate some more trading on Wall Street. The estimate that such a cut will generate more than a million jobs is thus ridiculously optimistic.

A better approach is to combine a restructuring of the capital gains tax with enactment of more effective investment incentives. In particular, the investment tax credit , which has had an excellent track record in stimulating new investment in the past, should be restored.

I suggest that a large credit (i.e. 20-25%) be implemented, but only on incremental investment, in productivity-enhancing equipment, over and above a base period. For any company, the base can be calculated as the average of investment during the last several years. Dramatically accelerated depreciation, or total expensing, on incremental investment would work just as well. All would not only provide a big incentive at the margin, but revenues would not be lost for investments that were previously planned. Thus, if they do not stimulate new investment, there would be virtually no revenue loss to the Treasury; if they do, the increase in economic activity will generate enough added revenues to basically pay for the credit or accelerated depreciation.

Changing capital gains taxes can help shift the pattern away from the short-term, financially-oriented, speculative type

investments that characterized the 1980's to badly needed longer term investment. However, to accomplish even that, a much larger difference between the rates on short-term and those on long term gains would be necessary. This can best be accomplished by enacting a sliding scale capital gains tax structure, incorporating an increase in the rate on short-term gains, with the rate declining the longer the asset is held (to perhaps near-zero for five years or longer). Furthermore, the relatively low long-term rate should apply only to investments in productive assets, and not to vacation homes, old buildings, etc. And it should also apply only to new investment--it is unnecessary to reward those that have been made in the past. In fact, limiting it to new investment would likely result in a larger turnover of old investments, since investors would not otherwise get the benefit of the new lower long-term rate, and thus would produce a bigger short term revenue windfall. And this structure would come close to being revenue neutral in the long-term.

The other arguments being used to support a simple cut in capital gains taxes are also flawed. For example, the assertion that cutting capital gains tax rates will help real estate is misleading at best. Commerical property prices and rents are falling because of the overbuilding of the 1980's, aggravated by declining service sector employment resulting from the current recession. And housing prices are declining in many areas because the speculative binge in the 1980's carried them too high, and because near record low consumer confidence, reflecting anxiety regarding job security, is short circuiting the normal moving-up process. In the long term, the only way to stabilize real estate values is to reverse the current weakness in the job market and in confidence.

Advocates of the capital gains tax cut also argue that it is needed to bolster the stock market. However, the market seems to be doing extremely well despite the increase in the capital gains tax rate enacted in 1986. In fact, the market is making new highs despite the extremely weak economy, and most measures of market valuation are close to all time high levels. Clearly, a strong stock market does not guarantee a strong economy--if anything, the relationship between the two seems weaker now than at any time in our history. And of course, the benefits would go largely to those who have already had large tax cuts in the 1980's.

I also suggest an increase in the top marginal tax rate, or implementing a third marginal tax rate (perhaps at about 35%) on relatively high incomes. While many advocate doing this on the grounds of restoring some fairness to the tax system, there is an even stronger reason to do so. In my view, such an increase would be pro-investment--it, coupled with a decline in the capital gains tax rate on long-term, productive investments, will encourage relatively high-income individuals to shift some of their safe investments into the riskier, long-term investments that the

country needs. In addition, it would encourage more employees to enter the world of entrepreneurship. Both effects will come about because the changes suggested above will produce a large difference between the tax rate on long-term capital gains and that on short-term income (and short-term capital gains)--it is this difference, rather than just the level of the capital gains tax rate, that is important for venture capital, business start-ups, and other risky long-term investments. While a higher marginal rate might reduce new savings (this in fact is debatable, because if personal savings do fall, it will at least partly be offset by a reduced Federal deficit), the key is to make more effective use of the savings already in place. The current low marginal tax rate and the relatively high capital gains tax rate discourage risk-taking and long-term investments. As a further inducement, the low rate on long-term capital gains should be available only on new investments, further encouraging those now holding securities to shift to new start-ups, since they would not be eligible for the lower rate unless they do so. This would also have the advantage of unlocking a lot of existing investments, thus creating a short-term tax windfall.

To help improve the investment climate, some stimulus for consumer spending should be provided, as long as it does not widen the deficit, and is not offset by other restrictive measures. This can be accomplished by adjusting the Social Security wage ceiling and tax rate in a revenue neutral manner. Such a change would reduce taxes for a large majority of American families (and those which need it the most), would make the tax structure less regressive, and would provide a modest amount of stimulus by shifting income to those who would spend more of it. I also suggest that we further extend and widen unemployment benefits, and other safety net programs that were cutback during the 1980's, not only as a humane measure, but because the marginal propensity to spend out of these benefits is relatively high. Finally, I suggest enacting a refundable income tax credit on purchases of autos, other durable goods, and other discretionary items, for 1992 only. The size of the credit can be made to vary with income. It could also vary with domestic content in order to provide maximum stimulus for the U.S. economy. This is likely to be more effective than a straight income tax cut in stimulating spending in the short-term because, at the margin, it will make it more attractive to spend because temporary tax cuts are usually saved, and because it will pull some spending forward. If in fact it does not result in any increase in spending over and above what would have happened anyway, it would be like an ordinary income tax cut that's saved--if it does result in more spending, it will help stimulate the economy.

The country also desperately needs more public investment. A much-needed rebuilding and upgrading of our infrastructure is essential if productivity growth is to be accelerated. This can be

financed without enlarging the deficit by privatizing a modest amount of government-owned energy facilities, such as the Tennessee Valley Authority and the Bonneville Power Authority. And over time, we should commit to using any additional cuts in defense spending to fund more public investment.

Combined public-private investment initiatives could also provide an immediate boost to the economy. For instance, new high-speed rail links developed by Federal and State public entities could be linked to new private investments in fiber optic communications. New highway construction could also be coupled with building new fiber optic communications alongside highways. The gains from such infrastructure development efforts could have an important long term impact on the economy.

Because the decline in real estate values is having a depressing effect on the economy, any measures that would stem that decline, and allow banks to resume lending, but without encouraging more new building, would be desirable. I thus support the partial restoration of changes in the passive tax rules that were rescinded in 1986, but only for those involved in the management of real estate properties (and not for investors who use real estate write-offs to offset other income). In addition, an extension of the period over which banks can realize real estate losses, or reserve against them, might be helpful by enabling them to recognize such losses without curtailing other lending.

In order to carry out this program, and to pay for it, some changes will be needed in the current budget law. First, measures that are truly self-financing ought to be adopted without the required offsets (this would include the incremental ITC referred to earlier). Secondly, temporary budget-widening measures should also be permitted without offsets, which would otherwise dilute their stimulative impact. Thirdly, the firewalls from the 1990 budget law should also be eliminated, so that over the long-term, additional cuts in defense or other programs can be used to pay for some of the measures outlined above, especially more public investment.

Finally, I would encourage the Federal Reserve to continue to ease monetary policy. They probably will have to wait until the bond market begins to rally again, but additional easing could be helpful by bolstering real estate prices and confidence, both of which are added drags on the economy, and by further reducing the cost of servicing existing debt.

Given our limited resources, the program outlined above is far more sensible and cost effective than any of the others now being discussed. It will provide short term stimulus and thus improve the job situation, and do so in a manner consistent with our long term needs--it also addresses the fairness issue more effectively

than many of the proposals now on the table, and would avoid an increase in the budget deficit over the long-term.

I believe the country cannot afford a large broad-based income tax cut at the present time, especially if it is on a permanent basis. Even a short-term tax cut would probably do little good in that a relatively large fraction is likely to be saved. And, many of the proposals regarding expansion of IRA's would neither increase savings nor spending, and would probably widen the budget deficit. Finally, as indicated earlier, a straight reduction in the capital gains tax rate would do more for Wall Street trading than for fixed investment and real economic activity. Studies by Professor Shoven at Stanford University, and by my colleague Roger Brinner, show that a reduction in the capital gains tax rate by itself has a relatively small impact on the cost of capital relative to, for example, changes in accelerated depreciation or an investment tax credit.

I believe the proposals above are far superior than the program outlined by the President in the State of the Union address, based on the early information on his proposals. In particular, I have the following concerns with the President's program.

1). The amount of near-term stimulus is very limited, especially since the increase in the per child exemption does not take effect until October 1. The shift in withholding will have very limited impact because most people deliberately over-withhold as a means of forced savings, and because at best, it will be considered a temporary tax cut to be offset by a tax increase (lack of a refund) next year. The marginal propensity to spend from temporary tax cuts has been very small in the past. Finally, the tax credit for first time home buyers affects only a small portion of the marketplace--furthermore, housing is already far more affordable than it has been in many years, but uncertain job prospects is limiting the willingness to buy new homes.

2). My biggest concern is that the program does virtually nothing to improve our long-term productivity and competitiveness. I view the investment incentives as inadequate, especially since the cut in the capital gains tax rate that is the centerpiece of the Administration's program, as discussed earlier, will only have a small impact on investment and economic growth.

3). While the tax credit for health care costs might help some people (the degree to which it will help will depend upon whether it's refundable), it does absolutely nothing to address the big issue of health care costs.

4). The President's proposals to permit penalty-free withdrawals from IRA's for various purposes will also be of limited value because many of the people who are considering buying their first home or need to use their savings to cover medical costs, don't have IRA's to begin with.

5). Finally, while I have not seen the budget in detail at this point, I have a real concern that the sum total of these proposals will in fact significantly increase the structural budget deficit.

SENATOR SARBANES. Thank you very much for a very helpful statement.
Dr. Ratajzcak, please proceed.

STATEMENT OF DONALD RATAJZCAK, DIRECTOR, ECONOMIC FORECASTING CENTER, GEORGIA STATE UNIVERSITY

MR. RATAJZCAK. Well, I don't want to repeat most of the issues that Larry Chimerine talked about.

I do agree that what we are seeing here is a prolonged adjustment to the excesses of the 1980s. And those excesses, of course, included the heavy debt burdens that we have accumulated. They included the excessive investment in real estate and other real properties partially generated by the lax review of thrift institutions. They also reflect an excessive expectation of future benefits that most people in the 1980s felt that they would be able to somehow continue to progress, either because they were getting their marginal tax rates reduced or they were working more hours. And contrary to what the Japanese individuals said, Americans, in the last 10 years, have increased their hours worked, and it is the only major industrial country that's done that.

Also we have sent spouses to work to increase the household income, even if individual incomes fell. Obviously, increasing hours worked and increasing spousal work is limiting and can't be done indefinitely. We are finally running into those limits. And, as a result, the household sector is realizing that they cannot continue to generate household gains in the 1990s if they continue to have economic conditions such as those of the 1980s.

I would submit that our greatest problem right now is a significant downsizing of consumer expectations of future economic well-being. The downsizing is based partially upon this new realization and upon the fact that, in this recession, people who previously felt that they were not recession-prone have discovered that they can lose their jobs. And so, as a result, we are seeing a significant shift in consumer behavior.

And that, unfortunately, is an uncertainty that is continuing. I see no evidence at this time that the shift in consumer behavior has ended. Therefore, anyone forecasting for 1992 is really making a guess as to when that shift will finally end and when consumers will have set a lower sight for the future that they are comfortable with and can act upon.

We may very well be seeing consumer reluctance to spend well into 1992. And, as a result, everyone's forecasts of a rebound early in the year will have to be put off.

Concerning other excesses, there is the overhang of construction product, which is being intensified by the accumulation of construction product by the Resolution Trust Corporation and is exerting downward pressures on market values. The decline in market values has, in turn, reduced the capital held in financial institutions, both commercial and insurance institutions.

That reduction in capital has restrained lending activity, and so, the excesses of the 1980s permeate throughout all of the forces that are causing economic weakness now.

We did have one other event, which was the war, that obviously had an adverse effect when it created uncertainty. When that uncertainty was removed, it did create a bubble of activity. But since that was only one of several forces slowing down the economy, once that bubble of activity was exhausted, there was no further stimulus to the economy. And, indeed, this economy right now is in trouble of slipping back.

I've appended to my remarks a monthly estimate of GDP that we run out. It is not revised for the release on Wednesday because I submitted it to the Committee in time for reproduction. But there's no question that according to our figures that the weakest month of the fourth quarter was December. Therefore, we are moving into 1992 not on an up-note, but on a continuing downnote, with every possibility that, if we do not turn the economy around in the next month or so, the first quarter will be a negative quarter for GDP.

I also have to say, unfortunately, that the last year's budgetary policies, while not creating the recession, certainly didn't ease the recession. We should not have raised excise taxes in the middle of a recession. It was a faulty policy, motivated by the high deficits that we have had.

Indeed, that's one of the dangers of continuing to have high government deficits. Periodically, whenever interest rates move up, and they usually move up near the end of the cycle, we will get a policy response that, in its delayed action, will have its economic effects after the cycle has already turned down, and therefore will accentuate the downturn of the cycle.

And I do believe that that happened last year.

Now, we have had declining interest rates. That decline in interest rates is creating a refinance windfall. One-third of all homeowner households will probably refinance in the next 12 months, and this will add something on the order of $100 to $150 of purchasing power a month, significantly greater, I should add, than the cut in withholding taxes. That will obviously have some positive influences on the economy. However, we can't overstate that, because, in fact, where is the windfall coming from? It's coming from bank depositors who are seeing their CD rates and their other savings rates yielding much less than they previously anticipated. It is realistic to assume that the borrowers are more prone to spend than the savers. And so, as a result, this income redistribution created by the refinancing toward the borrowers will, in fact, stimulate the economy, but certainly not by the magnitude of the size of the refinancing. So, we will have some increase in consumer activity.

The refinancings at the corporate level have reduced interest charges by $30 billion over the last two years. And that reduction in interest charges is having an impact upon corporate well-being, although, at the present time, many are still worried about their heavily leveraged position

and are not dramatically increasing borrowing for investment activity or to retain workers.

Anyway, that's the change that we've been seeing as a result of the 1980s excesses.

I'll talk a minute about inflation. This is an area that I do considerable work on. And, again, I agree mostly with Dr. Chimerine on this. If you take a look, there isn't any significant commodity inflation at the present time.

There are pockets of inflation; tobacco products, tuitions, medical, and these are pockets that are difficult to dislodge. The tobacco inflation is the result of strong demand abroad, and the medical, because that's the one sector of the economy that hasn't seen a recession. Tuitions are still a puzzle to me, I must admit.

But if you withdraw those numbers, you would find that inflation, less food and energy, increased only about 3 percent this year. It's still an increase, but a relatively modest increase.

And in 1992, there's every reason to believe that the inflation rate should not increase and could even decrease. It is correct that we will not have as large a decline in fuel prices. It is also correct that we cannot hope to have another 30-year restraint in grocery store prices. Last year, we had the lowest grocery store price increases in 30 years.

We certainly can't expect those areas to keep restraining inflation. But in other areas, the incredible amount of excess capacity and the continuing moderation of wage pressures certainly have every reason to restrain inflation here.

In addition to which, oil prices could collapse further in the spring. There is significant amounts of production around the world, and, although there is confusion about what's happening in the Russian area, it appears that domestic demand in Russia is falling quicker than production, with the result that they may have more oil to sell on the world market.

If that proves to be correct, we could very easily see significant weakness in oil prices in the spring, which, of course, would then stimulate consumer activity.

I think that inflation is not now a concern and should not be a concern in policies through 1993. After that, we will have to watch as labor markets start to tighten and some industries increase their capacity.

I think this fear is overdone. When people say recovery is coming and therefore inflation will rise, the recovery after 1960 showed no increase in inflation until 1964. The recovery after 1982 showed no increase in inflation until 1987.

Therefore, the presumption that recovery and inflation go hand-in-hand simply are not correct. Inflation is the result of economic friction, not economic growth. Friction comes by too-rapid growth or reaching economic bottlenecks. At this point in time, we are not looking at either of those problems. So, I would say inflation is not an issue.

As far as critique of policies is concerned, although Mr. Greenspan has gotten a lot of criticism during the last few days, on balance, we would have to say that the current policy steered by the Federal Reserve is appropriate. Indeed, it is the reduced financing charges that give us optimism for an economic recovery.

There's no question that the Federal Reserve was slow in realizing the dimensions of the capital constraints in the banking system, and therefore was slow to react to economic conditions. But at this time, their policies are very appropriate and should be applauded.

There are problems with what we are doing on the budgetary side. First, since the Department of Commerce has decided to make us similar to other industrialized nations by emphasizing gross domestic product, perhaps we should ask them to also make us similar to other industrialized nations by separating the government budget into consumer and investment goods. Then we would have a better picture of what we are in fact doing in our Federal Government.

Restraining highway building and bridge repairs because you're worried about a government deficit at a time when you're approaching a recession is inappropriate. The Federal Government has the lowest financing charges. It should be spending more on its capital account during recessions. That just stands to reason.

Private corporations that have strong balance sheets, strong credit conditions, will do that. Unfortunately, without knowing what our capital account is, we fail to recognize how we spend on that. So, I think that's something that should be reviewed very closely.

I should also point out that, as far as the Federal Reserve is concerned, they are using interest rate movements and Federal Reserve liability infusions at the exclusion of their other activities a little bit too heavily. Indeed, when they recognized that we had a capital constraint in the banking system, they should have moved aggressively on reserve requirements. That would have been the quick solution and would have avoided some of the pain that we are currently having.

At this point, however, with significant amounts of Federal Reserve liquidity already pumped into the system, it's probably too late in this cycle to consider a reserve requirement shift. But certainly that kind of policy should be more aggressively used.

At the end, I should point out that one of the things I was very disappointed about, in looking at the budget, is not that we are trying to stimulate the economy out of recession—I think that is appropriate—but I am very disturbed by the form of some of the stimuli.

The homeowner tax credit from February 1, 1992 to January 1, 1993—what makes the people who purchased this time so special to economic policy? In addition, we probably would have had over 800,000 first-time homebuyers without a tax credit. This will probably bring the number to about a million. Of that, following the normal pattern, three out of four homes that they buy will be previously-owned homes. So, in point of fact,

you're talking about giving away $5 billion in taxes for the potential of building 100,000 new homes, a subsidy of $50,000 for each new home.

The Federal Government probably could have built them and done a better job at a lower cost.

Similar criticism could be made on the proposed tax credit for insurance policies. When you already have a large body of people who are engaging in an activity and you cannot exclude them, once you let anyone who engages in that activity get the credit, you're paying a very large amount for an incremental change. We are paying a lot, losing a lot of tax revenues in 1992, for relatively small returns for the economy.

I understand what's so special about 1992, with the withholding taxes for 1992, with the investment tax credit for 1992, with the 15 percent investment tax allowance for 1992. But quite frankly, it's special to people in Washington. It's not special to people on Main Street. We should have a proposal that is more consistent with what the public thinks needs to be done than what the people in Washington feel will make their comfort level higher when the election approaches.

I make my last comment because I am concerned about some of the things that are being developed here in an effort to jump start the economy for 1992. The Hippocratic Oath tells physicians first, do no harm. I think the Administration and the Congress should think about that when they look at the stimulus package.

[The prepared statement of Mr. Ratajzcak follows:]

PREPARED STATEMENT OF DONALD RATAJZCAK

Economic recovery should slowly build up momentum in 1992 as the forces causing the recession are gradually reversed and as more stimulative monetary policies begin to take hold. However, the overhang of excess construction inventories, heavy debt burdens of the corporate and household sectors, continued aversion to risk by financial institutions, and the downsizing of expectations of future earnings by consumers all will continue to restrain the rate of recovery. For all of 1992, inflation adjusted GDP should increase only 1.4%. A stronger gain of 3.5% is projected for 1993.

FACTORS CAUSING RECESSION

The collapse of more than a third of the savings and loan associations in this country clearly contributed to the current recession. First, capital was misdirected to marginal construction projects, aiding in the excess accumulation of real estate inventory. Because capital requirements were relaxed, the normal market constraints upon such lending activity were not operational. Second, the overhang of real estate accumulated by the Resolution Trust Corporation from failed institutions has undermined the market values of privately held real estate. When property can be bought from the RTC and refurbished for a lower combined cost than current construction, few new projects will be built.

Reduced market values for real estate, in turn, have lowered the market value of investments held by financial institutions. As those loans fail, capital supporting the remaining investments becomes inadequate. Regulators have reminded banks that either more capital must be raised or risky assets must be reduced. According to the latest FDIC reports, commercial banks have reduced loans by $47 billion while adding $27 billion of government bonds in the past fiscal year.

Although many of the loan problems were real estate based, the shrinking capital reduced the capacity by some institutions to lend to other borrowers. This "credit crunch" clearly restrained economic activity. (Both commercial banks and insurance institutions have tightened their lending criteria during the past year.)

Falling interest rates have allowed financial institutions to widen the spread between borrowers and lenders. These additional earnings have begun to rebuild capital at financial institutions. Also, declining rates allow more loans to qualify even with higher lending standards. Therefore, the financial constraints that contributed to the downturn are slowly being lifted.

By hindsight, I would have reduced the reserve requirements at commercial banks to more rapidly provide an infusion of capital. However, interest rate declines have now been sufficient to begin reversing bank lending constraints. Clearly, more attention should be given to reserve requirement changes to manage capital adequacy questions at commercial banks and to slow excessive lending if such problems arise.

Collapsing real estate values also have contributed to the spending reluctance of consumers. In the Northeast and the West, recent market declines in housing have reduced access to home equity loans and reduced the "wealth cushion" that many home owners normally have. Not surprisingly, retail trade has weakened more in those regions than in other areas, where housing depreciation has been less intense.

More significantly, consumers are lowering their expectations of future promotions, raises, or even employment experiences. In addition to the traditional factory workers, recession has hit the consulting activities at law and accounting firms. Middle managers have been terminated during corporate restructuring. As sales slow, advertising budgets are reduced, causing weakness in the media. Many who thought their jobs were recession proof are now seeking new employers or even new careers.

After eight years of expansion, expectations of future earnings normally become excessive. However, the current adjustment to lowered anticipations is more substantial than in other downturns. Indeed, the adjustment is not completed. Therefore, the magnitude of this shift in consumer spending cannot yet fully be gauged. This remains the largest uncertainty facing the 1992 economy.

Mortgage refinancing will inject new spending into home owner households. Under prevailing conditions, about a third of all mortgages will be refinanced at lower interest rates, reducing monthly payments. However, this refinancing "windfall" can be overstated; for the gains to mortgage borrowers are at the expense of lenders, including depositors at financial institutions. The spending desires of borrowers probably are higher than for lenders who are losing interest income, but claims that the refinancing surge will "jump-start" the economy are overdone.

Also burdening the economy is the heavy debt load accumulated by all sectors of the economy. Last year's misguided budgetary policies which included raising taxes and reducing the medical assistance and other support for governmental programs at state and local levels during a recession certainly were dictated by the heavy debt load accumulated by the federal government. Unless the budget deficit will be vigorously reduced during the next economic upturn, more misguided policy is likely. Of course, an upturn needs to be in place before further deficit reducing programs can be pursued.

The debt burden similarly has become excessive for corporations and households. Personal bankruptcies may rise 20 percent this year. In many cases, debt has become overwhelming. Clearly, for these nearly million households and many more wishing to avoid their fate, spending must be constrained.

Also, corporate restructuring has been aggressive partially because debt burdens have alerted managers to the dangers of high cost operations. Falling interest rates will relieve some of this burden. Bond restructuring and falling short term rates have reduced corporate interest payments by nearly $30 billion in the past two years. This addition to earnings will help restructure corporate finances, but more aggressive cost management also is expected.

Falling real estate values and reduced earnings expectations by consumers can still undermine any recovery, but the risk aversion at financial institutions, excessive debt at households and corporations and the inappropriate budgetary policies of a year ago are diminishing their adverse impact upon the economy. Of course, much of the relief is from sharply reduced finance charges. Therefore, if interest rates rise, the recovery again may be in jeopardy.

A NONINFLATIONARY RECOVERY IS EXPECTED

Despite recent fears by bond investors that economic recovery will re-ignite inflation, no strengthening of inflation is in sight. I have attached my latest projections of commodity and consumer inflation by sector for the next two years. A return to normal oil prices in 1991 following the Kuwait invasion contributed to declining prices for fuels, chemicals, and plastics. The recession reduced metals prices while strong meat production reduced leather prices. Other price increases also eased. Grocery store prices showed their smallest gain in 30 years.

Oil prices are expected to fall below trend in 1992 because of strong production in the Persian Gulf and reduced demand in Eastern Europe that more than offsets rising demand in North America, Western Europe and Asia. However, the economic recovery will reduce price concessions in other sectors. Furthermore, the food and fuel price weakness will be less intense.

Therefore, consumer prices should rise 3.3% on a December to December basis as opposed to 2.9% in 1991. Excluding food and fuel, however, inflation will continue to moderate to a gain of 3.9% compared to 4.3% in 1991. Lower wage

pressures and reduced excise and sales tax increases assure this for consumers while moderation in transportation equipment and machinery prices will aid a decline to 2.2% price gains for finished goods less food and energy in 1992 and only a mild increase in 1993 for producers' prices. Some strengthening of price increases is likely in 1993, but inflation will not be a significant risk.

Inflation is the result of economic friction. Too rapid growth or capacity limitations spawn price pressures. With economic growth expected at only 1.4% for 1992 and 3.5% in 1993, only in the latter year can any friction be expected, and that will be small. Indeed, the lagged wage adjustments to recessionary pressures may prevent any inflationary increase that year as well.

Also enclosed is my monthly analysis of economic trends. My quarterly forecast has not been changed in light of fourth quarter conditions and administration proposals and is not yet available. However, a copy of that forecast can be made available to the committee when it is prepared.

Falling consumer spending on durables contributed to the fourth quarter weakness in GDP. Our estimates suggest that GDP was lower in December than during the quarter, despite gains in construction from favorable weather. As mortgage refinancing "windfalls" take hold, spending should slowly rise during the winter and reach modest rates of growth during the spring. Housing should continue its orderly rebound (although apartments are not recovering at this time), while trade balances should gradually improve with gains in export growth. Inventory accumulation also should be gradual but supportive of economic growth.

On the other hand, imports will rebound as consumer spending does, nonresidential construction probably will decline until the middle of 1992 and government spending also will be lower with defense cutbacks and continued stress at the state and local levels.

Producers' durables currently are projected to rise slightly more than 4% in 1992 following unusually strong activity late in 1991. Anticipations surveys suggest that a stronger gain is possible there.

On balance, GDP should increase in all quarters of 1992, but gains during the winter will be less than 1%. Spring gains of less than 2% should be followed by 3% gains during the second half of the year. Stronger gains of 3.5% currently are projected for 1993, as the consumer finally replaces the aging consumer durables they currently own.

Of course, the timing of consumer response may change. Stronger gains during the spring are possible if refinancing has a bigger net impact than envisioned. Weaker gains are possible if consumer downsizing persists into the spring. Also, a spring collapse in oil prices, a distinct possibility, would add an additional percent gain in consumer spending and cause economic activity to grow more than 2% for the year. All these are possible but have not been included in my best guess for current activity.

Short-term interest rates may fall slightly further before the economy fully responds to current Federal Reserve policy. No further discount rate cut is expected, but the federal funds rate (currently expected to average 4% for the year) could be lowered to 3.5%. Such a reduction would further lower the prime rate to 6%, but that is not my most likely outcome. More probably, little change will occur in short-term interest rates until after the elections. Then a gradual reduction in Federal Reserve support to prevent inflationary forces could increase rates by half a percentage point by year-end. Rising short-term rates, with a prime averaging 8%, are likely in 1993.

Long-term rates have risen sharply in recent weeks in anticipation of a stimulation package. Of course, such increasing rates blunt the impact of any fiscal stimulus. If government is not paid through taxes, debt must be issued. Despite some economic theory purporting to indicate that government financing does not matter, additional debt financing of government will add to the savings-investment

imbalance that has created historically high inflation adjusted long-term interest rates. That high cost of capital, in turn, has reduced the competitiveness of American industry in the global economy. Tax cuts without increased government efficiencies to finance them will not have the economic stimulus currently expected of them. There is no such thing as a free lunch. Neither is there a tax cut that has no economic costs associated with it.

Despite higher inflation adjusted long-term rates, market rates still are expected to decline toward 7% early in the spring because of reduced inflationary pressures. As the economy rebounds later in the year, however, renewed upward pressures are expected, with long-term rates approaching 8% by year-end. Rates are then expected to average slightly above 8% in 1993.

CRITIQUE OF ECONOMIC POLICIES

I teach my students that a recession is like a fever. The disease already has spread before the fever appears. Indeed, the fever is the body's attempt to fight the disease. Sometimes the fever is so high that it must be treated. Most of the time, however, the disease should be attacked. This recession was caused by previous excesses. The time to prevent rising unemployment was when the excesses were developing. To encourage consumer borrowing when their debt burdens are too high, or to stimulate commercial construction when too many buildings already are empty will create jobs today, but will not remove the risk of another downturn tomorrow. Building pyramids will create jobs, but we must aspire to more than that.

Whether or not excise taxes should have been increased or medical assistance growth curtailed to state and local governments for long-term policy objectives, they should not have occurred in the middle of the 1990 recession. Tax policy and the increasing burdens placed upon other governments by the federal government in its attempt to restrain deficit gains added to the recession. Will we now give away our gains in inflation restraint by adding to growth once recovery begins in earnest?

Despite attempts in the Carter stimulus package of 1977 to get the economy moving again quickly, studies indicate that the package provided its maximum stimulus in 1979, when an overheated economy was the problem. Even with rapid changes in withholding, most of the change in taxes will not alter spending until 1993 and beyond.

On the expenditures side of government, a new accounting framework is needed to consolidate the impact of federal policies upon state and local governments as well as upon its own budget deficit. Also, our government should begin to separate government expenditures on investment goods from those on consumption, as many other countries do. Restraining the growth of borrowing by restricting the repair of bridges or the improvement of ports may not be sound policy. Indeed, government should be encouraged to spend on its investment account in times of economic weakness, when construction costs are low and financing charges are moderate. Thus, much of the recent transportation bill makes economic sense despite possible additions to the deficit.

Improving the human capital of Americans, through education, and fostering additional domestic research and development also would be included in that investment account. Other expenditures of government need to be balanced with revenues over time. Our non-educational assistance programs, retirement programs, governmental insurance activity, accumulated interest burdens, and government operations should no longer be financed through issuance of debt.

Our tax codes continue to suffer from discouraging production more than consumption, by discouraging risk taking, by overstating taxable returns from capital in an inflationary environment, and by encouraging debt formation over equity

accumulation. Some reduction in economic distortions from a decade ago have been achieved, but more needs to be done.

Any tax reductions should be financed through reduced government, such as larger declines in military spending needs, or alternative new revenue sources. Higher tax exemptions may be justified on the grounds of raising the progressiveness of the income tax. However, relief is needed more on payroll taxes. A program that eliminates the income tax on employee payroll contributions would lower the marginal tax rate paid by workers, but an alternative source of financing should be found.

An investment tax credit could stimulate investment almost immediately while a capital gains exclusion increases venture capital over time. If investment losses continue to be limited to $3000 while gains are fully taxed, a capital gains exclusion could be justified. However, a preferred approach would be to index the capital charge-off for inflation and allow a full write-off for losses. That would redress some of the distortions in our tax codes.

In general, tax policy should be aimed at long-term objectives. Capital spending by government could be timed to meet short-term needs as well as acquire long-lived investment goods at reasonable costs. A stimulus package probably will have limited impact upon behavior in 1992. Therefore, the size of the package should be severely constrained. Otherwise, the reduced finance charges that will gradually support a rebound will be undermined by the rush to please voters through tax action.

Now that the Federal Reserve has become more aggressive, can more be expected there? Lower interest rates may be justified if lending activity remains weak and consumer spending does not respond to the refinancing "windfall." A key will be the response of loan activity and growth in the monetary aggregates. Some stirring in lending is apparent, but monetary growth remains anemic. Further rate reductions may be necessary, but only if the political overseers allow the Federal Reserve to restrain activity if money growth becomes excessive. Too often, the Federal Reserve has overdone policy once they have joined the effort to stimulate or restrain activity. After a late start, the Federal Reserve appears to be aggressive in its efforts to stimulate and should be praised for its current policy. At least they did not raise the discount rate during a recession.

In the Hippocratic oath, physicians are admonished to "do no harm." The same pledge should be taken by the administration and the Congress as they debate the stimulus package for 1992.

EMPLOYMENT

	Payroll Employment Proj	Payroll Employment AR%	Index of Hours Worked Proj	Index of Hours Worked AR%	Household Civilian Employment Proj	Household Civilian Employment AR%
July 1991	108859		120.7		116729	
August	108971	0.5	121.5	1.3	116484	-0.8
September	109066		122.3		117089	
October	109073		121.3		116867	
November	108808	-0.2	121.4	-0.1	116772	0.1
December	108839		121.7		116728	
January 1992	108878 *		121.4 *		116705 *	
February	108865	-0.1	121.5	0.2	116736	-0.2
March	108927		121.7		116794	
April	108956		121.6		116853	
May	109021	0.5	121.8	0.8	116911	0.6
June	109073		121.9		116962	
July	109126		122.1		117009	
August	109158	0.6	122.3	1.8	117053	0.6
September	109221		122.5		117152	
October	109283		122.8		117227	
November	109327	0.6	123.0	2.3	117225	0.6
December	109396		123.2		117269	
Chng Dec(92)/Dec(91)		0.5		1.2		0.5
Chng Dec(91)/Dec(90)		-0.7		-1.3		-0.6

	Civilian Unemployment Rate Proj	Hourly Earnings Proj	Hourly Earnings AR%
July 1991	6.8	10.36	
August	6.8	10.40	2.6
September	6.8	10.41	
October	6.9	10.40	
November	6.9	10.43	2.1
December	7.1	10.50	
January 1992	7.1 *	10.51 *	
February	7.2	10.53	3.4
March	7.1	10.55	
April	7.1	10.58	
May	7.0	10.60	2.7
June	7.0	10.62	
July	7.1	10.65	
August	7.1	10.68	2.9
September	7.0	10.70	
October	6.9	10.73	
November	7.0	10.76	3.2
December	7.0	10.79	
Chng Dec(92)/Dec(91)	0.4 #		2.8
Chng Dec(91)/Dec(90)	0.4 #		3.2

PROJ includes current information until the * and then projections by month thereafter
AR% is the annualized percentage change from the previous quarter.
is the percentage change in the labor force

PERSONAL INCOME

	Personal Income		Wage & Salary		Personal Savings	
	Proj	AR%	Proj	AR%	Proj	AR%
July 1991	4.833		2.808		204.4	
August	4.854	3.4	2.824	3.2	219.7	-25.4
September	4.873		2.836		216.0	
October	4.886		2.831		232.6	
November	4.879	3.0	2.830	2.0	200.1	10.8
December	4.904 *		2.849 *		224.0 *	
January 1992	4.921		2.860		224.8	
February	4.941	4.2	2.868	4.6	230.8	21.7
March	4.958		2.878		234.1	
April	4.973		2.884		233.2	
May	4.992	4.2	2.894	3.5	232.4	5.0
June	5.009		2.902		232.5	
July	5.032		2.916		235.1	
August	5.055	5.1	2.929	4.9	238.7	10.3
September	5.075		2.940		241.8	
October	5.100		2.956		245.5	
November	5.123	5.6	2.970	5.7	246.6	15.4
December	5.146		2.983		249.5	
Chng Dec(92)/Dec(91)		4.9		4.7		11.4
Chng Dec(91)/Dec(90)		2.4		1.9		-4.3

	Disposable Income		Personal Outlays	
	Proj	AR%	Proj	AR%
July 1991	4.221		4.017	
August	4.239	3.0	4.019	5.1
September	4.255		4.039	
October	4.267		4.034	
November	4.260	3.1	4.060	2.7
December	4.284 *		4.060 *	
January 1992	4.302		4.077	
February	4.322	4.8	4.091	3.9
March	4.338		4.103	
April	4.353		4.119	
May	4.372	4.7	4.139	4.7
June	4.387		4.154	
July	4.407		4.172	
August	4.428	5.3	4.190	5.0
September	4.446		4.204	
October	4.467		4.222	
November	4.487	5.6	4.241	5.0
December	4.507		4.258	
Chng Dec(92)/Dec(91)		5.2		4.9
Chng Dec(91)/Dec(90)		3.0		3.4

PROJ includes current information until the * and then projections by month thereafter
AR% is the annualized percentage change from the previous quarter.

CONSUMPTION

	Personal Consumption		Durables		Nondurables	
	Proj	AR%	Proj	AR%	Proj	AR%
July 1991	3908.0		453.8		1262.0	
August	3910.7	5.3	449.0	12.3	1258.5	1.4
September	3930.6		456.0		1251.7	
October	3926.0		449.2		1249.4	
November	3951.9	2.8	451.4	-2.6	1253.8	-2.2
December	3952.7 *		449.2 *		1247.9 *	
January 1992	3970.0		451.0		1251.3	
February	3983.7	4.1	452.2	2.1	1253.1	0.6
March	3996.6		453.8		1252.4	
April	4012.7		453.9		1256.3	
May	4032.8	4.9	458.3	3.9	1259.8	2.4
June	4047.5		457.9		1263.5	
July	4065.6		460.6		1266.8	
August	4083.1	5.2	462.3	5.1	1270.1	3.0
September	4097.4		464.1		1270.8	
October	4115.5		466.3		1274.5	
November	4134.4	5.2	468.9	5.4	1278.6	2.9
December	4151.1		470.3		1281.7	
Chng Dec(92)/Dec(91)		5.0		4.7		2.7
Chng Dec(91)/Dec(90)		3.6		0.7		0.2

	Services		Consumption Real	
	Proj	AR%	Proj	AR%
July 1991	2192.2		3273.3	
August	2203.3	5.7	3267.1	2.3
September	2222.8		3273.2	
October	2227.5		3264.7	
November	2246.7	6.9	3276.5	-0.1
December	2255.6 *		3268.7 *	
January 1992	2267.7		3278.2	
February	2278.4	6.5	3281.0	1.4
March	2290.5		3284.6	
April	2302.5		3292.0	
May	2314.7	6.4	3301.7	2.3
June	2326.1		3306.6	
July	2338.2		3313.1	
August	2350.7	6.4	3319.5	2.3
September	2362.5		3324.2	
October	2374.7		3330.8	
November	2386.9	6.4	3338.0	2.3
December	2399.2		3343.6	
Chng Dec(92)/Dec(91)		6.4		2.3
Chng Dec(91)/Dec(90)		6.2		0.5

PROJ includes current information until the * and then projections by month thereafter

AR% is the annualized percentage change from the previous quarter.

RETAIL SALES

	Retail Sales		Non-Auto Durables		Auto (Million Units)	
	Proj	AR%	Proj	AR%	Proj	AR%
July 1991	153.20		22.88		9.1	
August	152.16	1.8	22.70	1.3	8.4	12.7
September	153.03		22.70		8.7	
October	152.48		22.53		8.2	
November	151.73	-2.6	22.28	-6.3	8.3	-23.5
December	151.15		22.38		8.0	
January 1992	151.63 *		22.44 *		8.1 *	
February	151.91	0.2	22.54	1.8	8.1	-1.6
March	152.04		22.51		8.2	
April	152.37		22.58		8.2	
May	153.16	3.0	22.67	3.1	8.4	8.5
June	153.40		22.76		8.3	
July	153.99		22.84		8.4	
August	154.45	3.7	22.83	3.3	8.5	10.0
September	154.72		22.89		8.6	
October	155.27		22.96		8.7	
November	155.90	3.8	23.05	2.7	8.8	14.9
December	156.30		23.01		8.9	
Chng Dec(92)/Dec(91)		3.4		2.8		11.3
Chng Dec(91)/Dec(90)		0.7		2.2		-10.3

	Nondurable Sales		Auto Sales	
	Proj	AR%	Proj	AR%
July 1991	99.08		31.24	
August	98.77	2.5	30.69	0.2
September	98.50		31.83	
October	97.83		32.13	
November	97.81	-4.3	31.64	5.6
December	97.49		31.28	
January 1992	97.76 *		31.43 *	
February	97.90	0.5	31.47	-1.9
March	97.84		31.69	
April	98.15		31.64	
May	98.42	2.4	32.07	4.5
June	98.71		31.93	
July	98.97		32.18	
August	99.23	3.0	32.39	6.3
September	99.28		32.55	
October	99.57		32.74	
November	99.89	2.9	32.96	7.4
December	100.13		33.16	
Chng Dec(92)/Dec(91)		2.7		6.0
Chng Dec(91)/Dec(90)		0.0		1.8

PROJ includes current information until the * and then projections by month thereafter

AR% is the annualized percentage change from the previous quarter.

CONSTRUCTION

	Housing Starts		Single Family Starts	
	Proj	AR%	Proj	AR%
July 1991	1.049		0.879	
August	1.056	18.8	0.883	21.0
September	1.017		0.861	
October	1.089		0.891	
November	1.066	18.0	0.892	10.1
December	1.099 *		0.904 *	
January 1992	1.104		0.906	
February	1.127	15.5	0.924	12.1
March	1.142		0.935	
April	1.152		0.931	
May	1.173	17.8	0.953	11.9
June	1.189		0.960	
July	1.205		0.964	
August	1.209	13.7	0.961	7.7
September	1.215		0.972	
October	1.230		0.978	
November	1.244	11.4	0.985	8.0
December	1.254		0.990	
Chng Dec(92)/Dec(91)		14.1		9.5
Chng Dec(91)/Dec(90)		13.2		20.4

	Multi-Family Starts		Housing Permits	
	Proj	AR%	Proj	AR%
July 1991	0.170		1.005	
August	0.173	5.8	0.953	8.9
September	0.156		0.982	
October	0.198		1.028	
November	0.174	66.7	0.998	12.7
December	0.195 *		1.003 *	
January 1992	0.198		1.009	
February	0.203	32.2	1.027	4.2
March	0.207		1.024	
April	0.221		1.036	
May	0.220	47.5	1.053	14.7
June	0.229		1.078	
July	0.241		1.089	
August	0.248	42.5	1.085	14.5
September	0.243		1.102	
October	0.252		1.111	
November	0.259	25.6	1.114	8.2
December	0.264		1.116	
Chng Dec(92)/Dec(91)		35.4		11.3
Chng Dec(91)/Dec(90)		-11.4		17.4

PROJ includes current information until the * and then projections by month thereafter

AR% is the annualized percentage change from the previous quarter.

	Non-Residential Proj	Non-Residential AR%	Public Construction Proj	Public Construction AR%
July 1991	132.3		108.1	
August	130.6	-22.9	109.7	11.4
September	130.0		110.4	
October	129.2		112.8	
November	126.3	-10.0	112.8	13.7
December	127.2 *		113.3 *	
January 1992	126.3		113.1	
February	125.9	-5.1	113.7	2.6
March	125.5		114.3	
April	125.1		114.6	
May	125.2	-2.4	114.5	3.4
June	125.1		114.9	
July	125.4		115.3	
August	125.6	1.1	115.9	4.3
September	125.4		116.4	
October	125.6		116.8	
November	125.8	1.4	117.3	5.0
December	126.3		117.8	
Chng Dec(92)/Dec(91)		-0.7		4.0
Chng Dec(91)/Dec(90)		-21.2		-1.2

	Residential Construction Proj	Residential Construction AR%	Construction Expenditures Proj	Construction Expenditures AR%	Real Construction Expenditures Proj	Real Construction Expenditures AR%
July 1991	158.0		398.4		356.4	
August	162.8	20.9	403.2	1.8	360.2	-2.7
September	166.6		407.0		363.0	
October	167.5		409.4		365.4	
November	167.3	16.2	406.3	6.4	363.1	6.3
December	171.3 *		411.8 *		367.7 *	
January 1992	172.2		411.6		367.2	
February	175.2	15.6	414.8	5.3	369.7	4.5
March	177.3		417.1		371.4	
April	179.7		419.4		372.8	
May	181.5	16.9	421.2	7.1	374.1	5.4
June	184.3		424.3		376.2	
July	186.6		427.3		378.2	
August	188.4	15.0	429.9	7.8	379.8	5.5
September	189.9		431.7		380.3	
October	191.1		433.5		381.3	
November	193.0	10.1	436.1	6.1	382.6	3.4
December	194.6		438.7		384.1	
Chng Dec(92)/Dec(91)		13.6		6.5		4.5
Chng Dec(91)/Dec(90)		-0.4		-5.8		-6.6

PROJ includes current information until the * and then projections by month thereafter

AR% is the annualized percentage change from the previous quarter.

BUSINESS ACTIVITY

	Manufacturers Inventories		Durable Goods Orders	
	Proj	AR%	Proj	AR%
July 1991	378.0		130.83	
August	377.4	-4.4	125.48	31.3
September	378.8		120.09	
October	378.1		123.33	
November	378.0	0.1	124.53	-3.2
December	378.3 *		125.53 *	
January 1992	378.6		124.97	
February	379.4	1.5	124.41	2.0
March	380.5		125.83	
April	381.8		126.11	
May	383.0	3.7	125.57	2.0
June	384.1		125.43	
July	384.9		127.05	
August	386.2	3.4	127.83	5.3
September	387.4		127.11	
October	388.9		127.42	
November	390.1	4.3	127.71	1.0
December	391.8		127.78	
Chng Dec(92)/Dec(91)		3.6		1.8
Chng Dec(91)/Dec(90)		-2.7		6.4

	Non-Defense Capital Goods Orders		Non-Defense Capital Shipments	
	Proj	AR%	Proj	AR%
July 1991	36.69		31.73	
August	30.99	66.8	32.26	-0.7
September	30.08		32.55	
October	31.10		33.32	
November	35.15	11.6	33.76	19.0
December	34.23 *		33.75 *	
January 1992	34.26		33.89	
February	33.95	8.9	33.95	4.5
March	34.43		34.11	
April	34.61		34.28	
May	34.57	5.6	34.25	3.1
June	34.88		34.21	
July	35.46		34.43	
August	35.91	11.5	34.36	2.4
September	35.57		34.55	
October	35.83		34.69	
November	36.04	2.8	34.75	4.1
December	35.82		34.95	
Chng Dec(92)/Dec(91)		4.6		3.6
Chng Dec(91)/Dec(90)		14.2		5.3

PROJ includes current information until the * and then projections by month thereafter

AR% is the annualized percentage change from the previous quarter.

BUSINESS ACTIVITY (CONT)

	Business Inventories		Defense Shipments	
	Proj	AR%	Proj	AR%
July 1991	806.8		8.25	
August	806.6	-1.7	9.14	9.6
September	811.7		9.03	
October	813.0		8.85	
November	814.3	3.0	8.72	-3.1
December	815.8 *		8.64 *	
January 1992	816.9		8.69	
February	818.4	2.1	8.52	-6.4
March	820.6		8.57	
April	821.9		8.69	
May	823.7	2.6	8.63	1.2
June	826.4		8.54	
July	830.1		8.36	
August	831.7	4.0	8.35	-12.4
September	834.3		8.31	
October	837.8		8.38	
November	840.2	4.1	8.43	2.3
December	843.5		8.35	
Chng Dec(92)/Dec(91)		3.4		-3.4
Chng Dec(91)/Dec(90)		-1.3		4.1

	Industrial Production		Capacity Utilization	
	Proj	AR%	Proj	AR%
July 1991	108.1		80.0	
August	108.0	6.8	79.8	4.2
September	108.4		79.9	
October	108.2		79.6	
November	108.0	-0.6	79.3	-3.0
December	107.8		79.0	
January 1992	107.8 *		78.8 *	
February	107.9	-0.4	78.7	-3.0
March	108.0		78.6	
April	108.2		78.6	
May	108.4	2.0	78.6	-0.5
June	108.7		78.6	
July	108.8		78.5	
August	109.0	2.2	78.5	-0.3
September	109.3		78.6	
October	109.5		78.5	
November	109.7	2.6	78.5	0.0
December	110.0		78.6	
Chng Dec(92)/Dec(91		2.0		-0.5)
Chng Dec(91)/Dec(90		0.6		-2.0)

PROJ includes current information until the * and then projections by month thereafter

AR% is the annualized percentage change from the previous quarter.

PRICES

	CPI-U (seasonally adjusted) Proj	AR%	PPI Finished Goods (seasonally adjusted) Proj	AR%
July 1991	136.3		121.1	
August	136.6	3.0	121.4	-0.7
September	137.1		121.5	
October	137.2		122.3	
November	137.8	3.2	123.0	4.4
December	138.2		122.6	
January 1992	138.5 *		122.2 *	
February	138.8	3.1	122.1	-1.4
March	139.1		122.3	
April	139.5		122.6	
May	139.7	2.8	122.8	2.1
June	140.0		123.1	
July	140.5		123.5	
August	140.8	3.1	123.7	2.9
September	141.1		124.0	
October	141.6		124.3	
November	141.9	3.1	124.6	3.0
December	142.2		124.9	
Chng Dec(92)/Dec(91)		2.9		1.9
Chng Dec(91)/Dec(90)		3.1		-0.1

	PPI-Industrial Commodities (unadjusted) Proj	AR%	Estimated GDP Deflator Proj	AR%
July 1991	116.0		117.1	
August	116.3	0.9	117.4	2.1
September	116.2		117.7	
October	116.6		117.9	
November	116.7	1.0	118.2	2.6
December	116.1		118.5	
January 1992	115.8 *		118.6	
February	115.9	-2.0	118.9	2.5
March	115.9		119.2	
April	116.0		119.4	
May	116.2	0.1	119.6	2.5
June	115.5		119.9	
July	116.8		120.2	
August	117.0	4.0	120.5	2.9
September	117.3		120.8	
October	117.5		121.2	
November	117.8	2.5	121.4	3.1
December	118.0		121.7	
Chng Dec(92)/Dec(91)		1.6		2.8
Chng Dec(91)/Dec(90)P		-1.9		3.2

PROJ includes current information until the * and then projections by month thereafter

AR% is the annualized percentage change from the previous quarter.

PRICES (CONT)

	Consumption Deflator		Consumer Durables		Consumer Nondurables	
	Proj	AR%	Proj	AR%	Proj	AR%
July 1991	119.4		108.2		119.9	
August	119.7	1.9	108.2	2.6	120.3	1.4
September	120.1		108.5		120.4	
October	120.3		108.6		120.2	
November	120.6	3.0	108.7	1.6	120.9	1.7
December	120.9 *		108.9 *		121.0 *	
January 1992	121.1		109.0		121.0	
February	121.4	2.7	109.2	1.7	121.2	1.7
March	121.7		109.4		121.4	
April	121.9		109.5		121.5	
May	122.1	2.5	109.7	1.8	121.7	1.7
June	122.4		109.9		121.9	
July	122.7		110.1		122.1	
August	123.0	2.8	110.3	2.2	122.4	2.2
September	123.3		110.5		122.6	
October	123.6		110.6		122.8	
November	123.9	2.8	110.9	2.1	123.1	2.4
December	124.2		111.1		123.4	
Chng Dec(92)/Dec(91)		2.7		2.0		2.0
Chng Dec(91)/Dec(90)		3.0		2.3		1.2

	Consumer Services		Implicit Construction Deflator	
	Proj	AR%	Proj	AR%
July 1991	121.7		111.8	
August	122.0	3.5	111.9	2.7
September	122.6		112.1	
October	123.0		112.0	
November	123.2	3.9	111.9	0.1
December	123.6 *		112.0 *	
January 1992	123.9		112.1	
February	124.3	3.3	112.2	0.8
March	124.6		112.3	
April	124.9		112.5	
May	125.2	3.0	112.6	1.6
June	125.5		112.8	
July	125.9		113.0	
August	126.2	3.2	113.2	2.1
September	126.5		113.5	
October	126.9		113.7	
November	127.2	3.2	114.0	2.6
December	127.5		114.2	
Chng Dec(92)/Dec(91)		3.2		2.0
Chng Dec(91)/Dec(90)		4.2		1.3

PROJ includes current information until the * and then projections by month thereafter

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MISCELLANEOUS

	Merchandise Trade Balance		Leading Indicators		Estimated GDP	
	Proj	AR%	Proj	AR%	Proj	AR%
July 1991	-5.95		145.6		5703	
August	-6.53	64.5	145.6	7.4	5698	4.1
September	-6.93		145.3		5728	
October	-6.73		145.5		5730	
November	-3.57	-67.3	145.0	-0.7	5737	2.1
December	-4.38 *		145.2		5752	
January 1992	-5.98		146.0		5759	
February	-5.73	91.5	145.6 *	2.4	5785	3.1
March	-5.56		146.7		5805	
April	-5.64		146.9		5819	
May	-5.89	10.3	147.6	4.1	5844	4.2
June	-6.17		148.2		5866	
July	-6.01		149.3		5909	
August	-5.88	11.3	149.6	6.2	5929	6.2
September	-6.29		150.5		5955	
October	-6.05		151.7		5993	
November	-5.88	-11.0	152.6	7.2	6015	6.1
December	-5.73		153.1		6049	
Chng Dec(92)/Dec(91)		-30.8		5.5		5.2
Chng Dec(91)/Dec(90)		0.5		4.1		3.2

	Estimated GDP (1987 $)		IVA (annual rate)
	Proj	AR%	Proj
July 1991	4864		3.1
August	4854	1.8	-4.8
September	4865		-14.3
October	4861		-10.5
November	4854	-0.4	-7.3
December	4856		-2.7
January 1992	4855		1.7
February	4865	0.6	2.5
March	4872		2.1
April	4875		3.6
May	4887	1.7	1.4
June	4891		-1.8
July	4914		-2.7
August	4920	3.1	-5.6
September	4931		-8.2
October	4947		-8.5
November	4953	2.9	-9.3
December	4970		-9.2
Chng Dec(92)/Dec(91)		2.4	
Chng Dec(91)/Dec(90)		-0.1	

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MISCELLANEOUS (CONT)

	Currency Index		Adjusted Profits	
	Proj	AR%	Proj	AR%
July 1991	95.19		180.5	
August	93.47	1.4	176.2	-5.4
September	91.18		175.5	
October	90.69		174.9	
November	87.98	-20.4	176.8	-1.4
December	85.65		178.6	
January 1992	89.93 *		178.2	
February	87.46	-0.5	179.4	6.3
March	86.57		180.9	
April	86.89		181.9	
May	87.46	-0.6	182.9	6.6
June	89.23		182.4	
July	90.27		184.8	
August	89.54	10.5	185.1	6.6
September	90.46		186.0	
October	91.12		188.3	
November	91.87	8.1	189.5	9.5
December	92.62		190.8	
Chng Dec(92)/Dec(91)		8.1		6.8
Chng Dec(91)/Dec(90)		2.8		4.4

	30 - Year Government Bonds		New York Composite	
	Proj	AR%	Proj	AR%
July 1991	8.45		208.29	
August	8.14	-6.4	213.33	8.1
September	7.95		212.55	
October	7.93		213.84	
November	7.92	-15.2	213.45	6.8
December	7.70		217.43	
January 1992	7.50 *		237.79 *	
February	7.52	-19.7	232.28	43.7
March	7.27		235.77	
April	7.35		235.32	
May	7.38	-0.9	237.21	2.2
June	7.51		237.18	
July	7.58		240.93	
August	7.64	11.8	237.42	5.4
September	7.65		240.71	
October	7.71		243.55	
November	7.70	6.1	247.47	11.6
December	7.80		248.04	
Chng Dec(92)/Dec(91)		1.3		14.1
Chng Dec(91)/Dec(90)		0.4		22.4

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AR% is the annualized percentage change from the previous quarter.

FINANCIAL MARKETS

	Monetary Base		M1		M2	
	Proj	AR%	Proj	AR%	Proj	AR%
July 1991	337.2		859.5		3389.2	
August	340.0	5.7	866.1	7.0	3389.0	-0.5
September	342.0		870.0		3389.0	
October	344.5		879.1		3395.7	
November	347.1	8.4	890.0	11.5	3408.1	2.2
December	348.4		898.4		3419.3	
January 1992	350.3 *		903.4 *		3423.7 *	
February	352.5	6.8	907.7	8.9	3440.2	3.7
March	354.5		913.5		3451.3	
April	356.0		916.0		3463.2	
May	357.8	6.2	919.5	5.3	3475.8	4.4
June	359.5		924.6		3488.2	
July	361.4		928.8		3502.1	
August	363.0	6.1	932.2	5.6	3513.4	4.4
September	364.8		937.2		3525.8	
October	366.1		938.7		3541.2	
November	368.2	5.8	944.8	5.2	3553.1	4.6
December	370.4		950.1		3566.7	
Chng Dec(92)/Dec(91)		6.3		5.7		4.3
Chng Dec(91)/Dec(90)		8.2		8.8		2.9

	Federal Funds		T-Bills (6 Mos.)	
	Proj	AR%	Proj	AR%
July 1991	5.82		5.70	
August	5.66	-14.2	5.39	-15.2
September	5.45		5.29	
October	5.21		5.04	
November	4.81	-46.9	4.61	-50.3
December	4.43		4.10	
January 1992	3.92 *		3.83 *	
February	3.87	-59.3	3.74	-55.0
March	3.75		3.69	
April	3.64		3.61	
May	3.67	-17.7	3.66	-11.5
June	3.68		3.65	
July	3.69		3.69	
August	3.75	8.6	3.74	11.5
September	3.78		3.79	
October	3.75		3.85	
November	4.09	35.7	4.09	42.1
December	4.27		4.31	
Chng Dec(92)/Dec(91)		-3.6		5.1
Chng Dec(91)/Dec(90)		-22.2		-38.8

PROJ includes current information until the * and then projections by month thereafter

AR% is the annualized percentage change from the previous quarter.

	AAA (Seasoned)		Municipals (Bond Buyer)		(3 Month) Commercial Papers	
	Proj	AR%	Proj	AR%	Proj	AR%
July 1991	9.00		7.05		6.05	
August	8.75	-5.4	6.90	-6.5	5.72	-15.8
September	8.61		6.80		5.57	
October	8.55		6.68		5.35	
November	8.48	-14.6	6.73	-12.0	4.98	-44.9
December	8.31		6.69		4.61	
January 1992	8.17 *		6.42 *		4.05 *	
February	8.25	-10.7	6.40	-16.9	3.96	-60.0
March	8.21		6.37		3.87	
April	8.05		6.26		3.81	
May	8.15	-3.2	6.31	-4.9	3.74	-18.7
June	8.23		6.38		3.73	
July	8.31		6.40		3.75	
August	8.39	12.7	6.47	10.3	3.84	7.3
September	8.47		6.55		3.89	
October	8.56		6.69		3.98	
November	8.61	10.7	6.74	18.0	4.15	39.2
December	8.65		6.81		4.34	
Chng Dec(92)/Dec(91)		4.1		1.8		-5.9
Chng Dec(91)/Dec(90)		-8.2		-5.6		-40.9

	90 Day CD's		Prime Rate	
	Proj	AR%	Proj	AR%
July 1991	5.98		8.50	
August	5.65	-19.3	8.50	-11.8
September	5.47		8.20	
October	5.33		8.00	
November	4.94	-44.8	7.58	-33.1
December	4.47		7.21	
January 1992	4.00 *		6.50 *	
February	3.95	-58.2	6.50	-46.4
March	3.90		6.50	
April	3.84		6.50	
May	3.75	-16.1	6.50	0.0
June	3.75		6.50	
July	3.78		6.50	
August	3.85	8.7	6.50	0.0
September	3.95		6.50	
October	4.06		6.50	
November	4.21	43.8	6.85	18.6
December	4.41		7.00	
Chng Dec(92)/Dec(91)		-1.3		-2.9
Chng Dec(91)/Dec(90)		-42.8		-27.9

PROJ includes current information until the * and then projections by month thereafter

AR% is the annualized percentage change from the previous quarter.

EXTENDED PPI PROJECTIONS
SECTOR PRICES
(Not Seasonally Adjusted)

Cumulative Changes (Not Annual Rates)	12/90 1/91	12/91 1/92	12/89 12/90	12/90 12/91	12/91 12/92	12/92 12/93
Index of All Commodities	0.3	-1.1	5.0	-2.3	0.8	2.8
Farm Prices	0.0	0.1	0.3	-2.1	1.2	3.1
Farm Product	-0.7	1.2	-5.2	-6.4	1.5	4.6
Processed Foods	0.3	-0.4	-0.6	-0.2	1.0	2.4
Industrial Commodities	0.3	-1.3	5.9	-2.4	0.7	2.7
Textiles	0.5	0.2	1.3	1.6	1.8	2.2
Leather	-0.3	-0.2	0.8	-2.1	0.5	3.8
Fuels	-0.1	-5.2	22.4	-12.3	-2.7	4.3
Chemicals	0.4	-0.4	5.6	-2.3	0.6	2.7
Rubber & Plastics	0.7	-0.1	2.0	-0.4	0.5	1.3
Lumber	0.7	-2.9	-1.4	6.0	2.1	2.9
Pulp & Paper	0.8	0.0	2.3	0.2	1.5	2.7
Metals	0.1	-0.1	0.5	-2.9	0.2	2.4
Machinery	0.7	0.0	2.4	1.1	1.0	1.5
Furniture	0.8	-0.1	1.5	1.4	1.5	2.0
Nonmetallic Materials	0.9	-0.2	2.4	1.1	0.7	2.0
Transportation	0.6	0.2	3.8	3.6	2.8	3.0
Miscellaneous Product	0.5	0.1	6.5	3.7	3.5	3.8

STAGE OF PROCESSING
(Not Seasonally Adjusted)

	12/90 1/91	12/91 1/92	12/89 12/90	12/90 12/91	12/91 12/92	12/92 12/93
Finished Goods	0.3	-0.3	5.6	-0.1	1.3	2.2
Consumer Finished Goods	0.2	-0.2	6.4	-0.9	1.0	2.1
Consumer Foods	0.6	-0.1	2.5	-1.6	0.9	2.3
Consumer Nonfoods	0.0	-0.3	8.5	-0.6	1.0	2.0
Capital Equipment	0.8	0.1	3.4	2.5	2.3	2.6
Intermediate Goods	-0.3	-0.8	4.3	-2.6	0.8	2.7
Intermediate Foods	-1.1	-0.9	-1.2	-0.1	2.2	4.5
Intermediate Industrial	-0.2	-0.8	4.6	-2.7	0.8	2.6
Crude Materials	2.1	-2.6	6.0	-11.6	0.7	4.4
Crude Foodstuffs	-1.2	1.6	-3.6	-5.6	3.4	5.9
Crude Nonfoods	3.8	-4.9	13.1	-14.8	-1.3	3.4
Other Crude Nonenergy	0.8	-0.5	0.4	-8.0	2.7	5.3
Finished Goods Less Food and Energy	0.9	0.1	3.5	3.1	2.2	2.6

EXTENDED CPI PROJECTIONS
(NOT SEASONALLY ADJUSTED)

Cumulative Changes (not Annual Rates)	12/90-1/91	12/91-1/92	12/89-12/90	12/90-12/91	12/91-12/92	12/92-12/93
Index of All Items	0.6	3.1	6.1	2.9	3.3	4.2
Food & Beverages	1.5	2.6	5.3	2.2	2.7	3.9
(Food at Home)	(1.9)	(1.4)	(5.8)	(0.6)	(2.4)	(4.0)
Cereals	1.3	4.0	4.6	3.9	4.0	3.8
Meats	0.8	1.3	7.9	1.4	1.0	3.9
Dairy	1.2	0.1	3.1	0.3	1.5	3.6
Fruits & Vegetables	7.1	3.5	7.2	0.6	4.3	5.5
Sugar	0.7	3.6	4.4	3.2	2.6	3.8
Fats & Oils	1.1	0.6	7.7	1.1	2.8	4.4
Nonalcoholic Beverage	2.3	1.3	1.9	0.7	1.5	2.3
Other	1.0	2.9	5.2	2.7	3.1	3.9
(Food Away From Home)	(0.1)	(2.8)	(4.5)	(2.9)	(2.8)	(3.5)
(Alcoholic)	(4.9)	(10.2)	(4.2)	(10.1)	(4.6)	(5.1)
Other Commodities	1.0	0.5	7.5	0.5	2.0	3.7
Apparel	1.4	5.6	5.0	6.0	3.2	4.1
Energy (commodities)	6.9	17.5	35.4	16.6	3.6	4.5
Tobacco	2.8	10.1	10.8	10.2	9.7	9.4
Medical	0.8	7.8	8.4	7.7	8.0	8.3
Furnishings	0.4	1.5	0.6	1.5	1.8	2.2
New Cars	0.9	2.8	1.4	2.8	3.0	3.2
Used Cars	0.9	3.1	2.2	3.0	2.1	3.4
Entertainment	0.8	4.0	3.0	4.0	3.5	3.5
Services	1.1	4.5	5.7	4.3	4.1	4.6
Residential Rent	0.1	3.2	4.1	3.1	3.4	3.9
Homeowners' Cost	0.3	3.5	4.7	3.9	3.5	3.8
Energy	2.7	2.8	1.5	2.3	2.0	2.8
Other Household	1.1	2.1	2.6	6.7	3.6	4.0
Transportation	0.5	2.4	8.2	2.2	3.7	6.1
Medical	1.1	7.2	9.9	8.1	8.0	8.3
Other	0.7	7.1	6.5	6.5	6.3	6.0
Less: Food and Energy	0.8	4.4	5.2	4.3	3.9	4.4

SENATOR SARBANES. Okay, thank you very much.
Mr. Silvia, please proceed.

STATEMENT OF JOHN SILVIA, CHIEF ECONOMIST, KEMPER FINANCIAL SERVICES, INC.

MR. SILVIA. Thank you, Mr. Chairman, for this opportunity to present my outlook for the 1992 economy.

Certainly, this year truly represents a turning point for both the economy and economic policy. Long-term structural change has been a major influence on economic performance in recent years, and in a similar way, long-term fiscal policy change will influence economic performance for several years to come.

For 1992, I think recovery will become clearer by the second quarter. I would agree with Larry on that.

Four factors support the economic recovery case.

First, a reduction in interest rates have simply reduced the financing costs for new housing starts, home improvements and business spending.

In addition, lower interest rates reduce the financing burden of outstanding home mortgages and corporate debt.

I agree again with Don that, indeed, the financing burden reduction for home mortgages means better disposable income for borrowers, and, in general, those borrowers are more likely to spend than save. So, some increase in consumption is due in that regard.

Looking at corporate debt, certainly the decline in interest charges, I think, is very important and that will lead to some stimulus in terms of employment and health care.

Second, lower inflation will increase real income and wealth for households. My forecast is fairly consistent with Don's, I think, on inflation. The year-over-year inflation in 1992, relative to 1991, comes down to the 3 percent area, as opposed to 4 percent in 1991, and that's a significant shift in inflation and also the burden of inflation on discretionary and disposable incomes.

And I would also agree with Don that inflation does indeed lag the cycle, as I argued and presented some evidence in the longer background piece that you have, Mr. Chairman.

Third, another element favoring recovery is the low-oil prices that reduce energy expenses and thereby raise discretionary income for both households and businesses.

And finally, gradual improvement in corporate profits will help businesses restructure their balance sheets, as well as prompt employment gains and capital spending.

Two factors that really have led to the poor performance in the past few years are also two factors that are likely reversing costs ahead, either through private economic change or active fiscal policy.

First, the private-sector economy has indeed undergone significant structural change in household formation, inventory controls and inflation

expectations. On the public-sector side, the growth in municipal government spending will also be reduced due to demographic change in budget constraints.

I refer to one of the tables in my longer piece—the background piece—in which I tried to present to you how really different this recovery has been prior to earlier periods.

Notice, for example, in the average recession——

SENATOR SARBANES. What page?

MR. SILVIA. This is page 27 in the longer document.

If you notice, there are some real big shifts there going on. And I attribute most of this to structural adjustment.

Notice that in a typical recession that consumption actually rose 0.4 percent. This time, it's down 0.3 percent.

For structures, structures typically declined 4 percent. They're down 17.4 percent. State and local government typically rises, spending 2.7 percent, and now it's 0.3 percent.

Exports, surprisingly, usually gain just 0.3 percent. Now, they're up 8.5 percent. And housing starts usually go up 6.4 percent, and now they're down 8 percent.

Picking up on something that Larry had mentioned—on the next page—if you'll look at money growth, you'll see one real difference. And I think Don is quite right in looking at the Fed; the Fed has decided that they're going to look for less inflation. They want less inflation.

So, money growth, M2 growth, in the average downturn, it was up 7.1 percent. Now, it's up just 2.4 percent.

Alan Greenspan has made it clear, at least to the financial markets, that he will not repeat the mistakes of the 1950s, 1960s and 1970s. And it doesn't look like he's doing it.

And on the final page——

SENATOR SARBANES. He's just going to make new mistakes which will give us a different kind of recession. But I'll save my commentary until later.

MR. SILVIA. And on page 29, what I think is very interesting, and picking up on something that was mentioned earlier, again, in the average downturn, debt growth in the United States was up 7.3 percent. In this period, debt growth is up only 2.3 percent. That's a significant change.

And I'll talk a little bit about that because, basically, a lot of that debt was undertaken with the expectations that whatever the economy was doing and whatever inflation was doing at that time would continue.

But what happens when inflation's less than expected? We have something, what we term the law of unintended consequences. No one believes that the Fed's really serious about lowering inflation or that inflation will come down. But when inflation is less than expected, it means that the real burden of that debt goes up.

And when you have a whole society developing ever since World War II an increasing personal household corporate debt, and all of a sudden

you get surprised, and then the real burden of that debt rises fairly dramatically.

On top of that, we put the demographic changes that have gone on—the changes in household formation, particularly inventory controls, and then global competitiveness. We can see that there are significant structural changes going on here.

I agree, and I have said it before in other forums, but I will agree with Larry and others, including Don, who I am sure has made this point before in his comments that I have benefitted from, that there really is a significant structural change going on, and that is very important in underlying much of what we are talking about.

SENATOR SARBANES. If I could interject—on page 29—you were looking at total domestic nonfinancial debt. But if you go down to the next column, I take it that the Federal Government debt in the 1981 recession——

MR. SILVIA. The next row?

SENATOR SARBANES. The next row, yes. Sorry.

MR. SILVIA. Okay.

SENATOR SARBANES. —went up 23.6 percent? Is that right?

MR. SILVIA. That is correct; from that period, 1981 third quarter, to 1982 fourth quarter.

SENATOR SARBANES. And the states's debt went up 16.5 percent?

MR. SILVIA. Yes.

SENATOR SARBANES. Which is really completely contrary to any previous experience in the postwar period. Is that correct?

MR. SILVIA. It is much stronger than previous experiences. But certainly they do rise, you see.

SENATOR SARBANES. Yes. Okay, thank you.

MR. SILVIA. Just to continue, just to let me work on this thought a little bit, the second factor again that really made this recovery different, or this recession different, excuse me, is the increased burdens of the 1990 tax levies that were certainly ill-timed in their economic impact.

I agree again with Don who made the point that you do not increase taxes in the middle of a recession. Tax increases of $160 billion over five years were just too much for an economy already undergoing significant structural change. Plain and simple.

This year's tax initiatives, looking at fiscal policy going forward, offer again an opportunity to refocus our tax policy toward long-run objectives of improving U.S. growth.

I would argue, or I would agree with Larry Chimerine in his argument, if you have a serious long-run problem like competitiveness and productivity, then you need long-run policy changes—permanent changes in taxes, not temporary.

In light of this, with Don I would agree that this talk about what makes this group of first-time homebuyers so important in 1992 relative to those in 1993, I think is a real question that we have to deal with.

But if we look at tax initiatives in terms of our growth and our U.S. competitiveness, we really have to look at the three factors of production: technology, capital and labor.

I believe technology would benefit from a permanent R&D tax credit. R&D spending is an investment in future productivity and technological breakthroughs.

I was encouraged in this by reading today's *Washington Post* that indicated that some R&D spending was being shifted from military to civilian uses. I think that was very important, and I would applaud the Administration on that.

A credit, again, would lower the cost of investment and better the risk/reward tradeoff for American firms. I think that is important.

As far as capital spending and capital investment go, I do believe it would be enhanced by accelerated depreciation and a reduction in the capital gains tax. Accelerated depreciation, unlike the investment tax credit, would not bias the tax code between different types of investments or different industries. In addition, an increase in depreciation allowances would be easier to administer, I believe.

Reduced capital gains taxation, either by reduced rates or indexation, would reduce the cost of capital. A lower cost for capital—a lower capital gains tax would also lessen the double taxation of capital which heavily discourages new investment, since you tax both the capital and the returns from that capital.

With respect to, I think, Larry's earlier comments, he was particularly interested in increasing the spread between income and capital returns, or the spread between short-term and long-term capital gains.

I think you can increase that spread without raising the marginal tax rates, or without raising the capital gains tax on the short term. I think what you want to do really is lower the capital gains tax long-term.

I certainly would agree with Larry that going to zero after six years would be very positive.

I think raising the short-run capital gains tax would be very negative. I think what you want to do is to increase the spread by just getting the long-term capital gains tax to zero.

SENATOR SARBANES. Why? Would you elaborate why raising the short rate would be very negative?

MR. SILVIA. Well, it would discourage people. It would have a tremendous lock-in effect. You would not want to be turning over the asset at all. They would look and say, well, I cannot do anything for the next six months to a year or two years, and they would be very concerned about doing anything. It would have a tremendous lock-in effect.

Also, you are raising the cost of capital in the short term. You would have a situation——

SENATOR SARBANES. Why is that very negative, given the economic problems we face?

MR. SILVIA. My impression is that what we are talking about is trying to get activity going in 1992. If you start raising taxes, you are going to

end up doing the same thing you did in 1990. You are going to stop activity this year. I think that is exactly the opposite of what I thought was the intention.

So, I would not do that. I think you can accomplish Larry's objective of increasing that spread, or increasing basically what we say is the reward for long-term investing by getting the long-term tax rates even lower.

Then, finally——

SENATOR SARBANES. And then how would that encourage short-term activity?

MR. SILVIA. That would encourage people to invest right now for returns later. They would say, hey, if I put my money in now, I can get the returns two years, three years, five years or six years down the road with a lower return.

In other words, their expected rate of return is enhanced by lowering taxes, and that is what you really want to do.

SENATOR SARBANES. Yes, but how is——

MR. SILVIA. See, nobody is going to invest if their expected rate of return goes down.

SENATOR SARBANES. So, if you——

MR. SILVIA. But if their expected rate of return goes up by lowering the taxes, that is what you really want.

SENATOR SARBANES. All right. But what difference would it make on that issue if you left the short-term rate where it is, or if you raised the short-term rate and increased the gap; thereby, providing some encouragement to go long term?

MR. SILVIA. But again, you are raising the tax short-term, and you do not want to do that, especially, again, in a recession. Otherwise, it is just like in 1990, you are increasing short-term taxes.

You can achieve the wider gap, or let us say the reward, you can achieve that reward for going long term, which I think is what really Larry was aiming at, by simply lowering the taxes longer term.

I think that is the real strength of that proposal, to increase the spread by lowering the taxes longer term rather than raising them short term.

And certainly the same thing with income. To increase the margin on tax rate on income right now, I think would just be a very, very bad signal.

The other point we need to do, again with respect to productivity, capital and labor, is to reduce the taxation on labor.

I would again favor reducing the payroll tax to reduce the cost of labor and/or an enhanced IRA or family savings plan which would increase the reward for labor.

In recent years, payroll taxes have raised the wedge between the employer's cost of labor and the employee's reward for labor supplied. This wedge has raised the cost of hiring workers and has led to reduced employment gains relative to what they otherwise would be.

My outlook, Mr. Chairman, then is that the economic recovery will take place this year, but the recovery still suffers from the burden of financial restructuring in the 1990 tax increases.

Fiscal policy today can help by increasing the pace of recovery by reducing the tax burden on technology, capital and labor.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Silvia, together with attachment, follows:]

PREPARED STATEMENT OF JOHN SILVIA

Economic Outlook

Thank you for the opportunity to present my outlook for the 1992 economy. This year truly represents a turning point for both the economy and economic policy. Long term structural change has been a major influence on economic performance in recent years. In a similar way, long term fiscal policy change will influence economic performance for several years to come.

For 1992, recovery will become clearer by the second quarter. Four factors support the economic recovery case. First, reductions in interest rates have reduced the financing cost for new housing starts, home improvements and business spending. In addition, lower interest rates reduce the financing burden of outstanding home mortgages and corporate debt. Second, lower inflation will increase real income and wealth for households. Third, lower oil prices will reduce energy expenses and thereby raise discretionary income for both households and businesses. Finally, gradual improvement in corporate profits will help businesses restructure their balance sheets as well as prompt employment gains and capital spending.

Outlook Highlights

	1991	1992
GDP (1982 $)	-0.7	1.8
Final Sales	-0.2	1.5
Consumption	-0.3	1.7
Investment		
Non-Residential	-3.4	-3.3
Residential	-13.7	-13.1
Exports	4.1	4.9
Imports	-0.2	4.5
CPI	4.2	3.3
Housing Starts	1.0	1.23
Federal Funds	5.7	4.2
Ten-Year Treasury	7.8	7.0
U.S. Dollar Exchange Rate	0.86	0.81
Unemployment Rate	6.8	6.9

Two factors that led to the poor economic performance of the past few years are also two factors that are likely to reverse course ahead - either through private economic change or active fiscal policy.

First, the private sector of the economy has undergone significant structural change in household formation, inventory controls and inflation expectations. On the public sector side, growth in municipal government spending will also be reduced due to demographic change and budget constraints. Looking ahead, these changes will continue, but for various reasons, much of this adjustment is already behind us.

Second, the increased burdens of the 1990 tax levies were ill-timed in their economic impact. Tax increases of $160B over five years were too much for an economy already undergoing significant structural change.

This year's tax initiatives offer an opportunity to refocus tax policy toward longer run objectives of improving US growth. In turn, growth and US competitiveness reflects the enhanced contributions of three factors of production: technology, capital and labor.

Technology would benefit from an R&D tax credit. R&D spending is an investment in future productivity and technological breakthroughs. A credit would lower the cost of such investment and better the risk/reward tradeoff for American firms.

Capital investment would be enhanced by accelerated depreciation and a reduction in the capital gains tax. Accelerated depreciation, unlike the investment tax credit, would not bias the tax code between different types of investments or different industries. In addition, an increase in depreciation allowances would be easier to administer.

Reduced capital gains taxation either by reduced rates or indexation would reduce the cost to capital. A lower capital gains tax would also lessen the double taxation on capital which heavily discourages new investment.

Reduced taxation on labor is favored through either a payroll tax cut to reduce the cost of labor and/or an enhanced IRA or Family Savings Plan which would increase the reward for labor. In recent years, payroll tax increases have raised the wedge between the employer's cost of labor and the employee's reward for labor supplied. This wedge has raised the cost of hiring workers and has led to reduced employment gains relative to what they otherwise would be.

Economic recovery is the outlook. But the recovery still suffers some of the burden of financial restructuring and the 1990 tax increases. Fiscal policy today can help increase the pace of the recovery by reducing the tax burden on technology, capital and labor.

Economic Outlook

Dr. John E. Silvia
First Vice President & Chief Economist
Kemper Financial Services

Supporting Documentation for Testimony Before the Joint Economic Committee
January 31, 1992

I. 1992: Year of the turnaround (Is this the story behind the stock market rise?)

On a year-over-year basis

What's Up
Real GDP
Final Sales
including Consumption and Business Equipment Spending

What's Down

CPI Inflation

But a turnaround situation burdened with remaining problems and below historical gains
Expected Economic Growth remains below historical norms

Problem areas remain for

Investment in Nonresidential Structures
State and Local Government Spending

Final Sales grow 2 percent in the first half of 1992 due primarily to gains in Consumption.
Producer durable equipment spending responds to the investment tax credit,
Residential investment rises due to tax cuts and low interest rates.

But after the late 1992 growth kick from policy initiatives the economy returns to a slower growth path as long term demographic and financial changes reassert themselves to reduce quarterly growth rates back to the 2.5 percent range by the second half of 1993.

Need for long term fiscal policies to
promote saving and investment.

Inflation Benefit

CPI inflation remains moderate as the Fed's long run anti-inflation policy remains in place.
Fiscal policy initiatives do not reignite inflation.

Outlook Highlights

	1991	1992
GDP (1982 $)	-0.7	1.8
Final Sales	-0.2	1.5
Consumption	-0.3	1.7
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Non-Residential	-3.4	-3.3
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Housing Starts	1.0	1.23
Federal Funds	5.7	4.2
Ten-Year Treasury	7.8	7.0
U.S. Dollar Exchange Rate	0.86	0.81
Unemployment Rate	6.8	6.9

II. Forecast Inputs

Quality in any economic forcast depends upon the inputs to that forecast.

Philosophy

Be forewarned. **This outlook explicitly is making a bet that the economic future will be different than the past.** This recovery will be less cyclical than historical due to significant structural, long term, changes that we believe are important in the economy.

At the margin, compared to prior cycles
Consumers will spend less, particularly on durable goods

Business will
- build less structures
- hire fewer workers
- buy more equipment

Municipal government spending will be severely constrained by large deficits for the first year of this recovery.

Pricing flexibility for suppliers will be limited thereby reducing both producer and consumer inflation

Inputs

Consumer Auto Purchases

Historically, consumer purchases of durables has been very cyclical. But, looking ahead, the outlook is for a less-than-cyclical pickup in auto purchases due to consumer uncertainty, slow employment growth and a general sense of consumer preference to forgo additional spending on durables in favor of debt reduction.

We are betting that consumer behavior this cycle will favor more saving and less consumption than past cycles. Therefore, policy makers will be surprised that less consumption, more saving will be a result of the 1992 tax cuts than would otherwise take place.

Inventories

Inventory gains in the third quarter were believed to be mostly unintended. Therefore, inventory reduction would be fairly aggressive in the fourth quarter and will continue, at a more moderate pace, in the first quarter. Weakness in commodity price indices, such as the JOC, also do not support a case for inventory rebuilding yet.

Once again the forecast takes the position that businesses permanently have changed their inventory controls so that less inventory building than usual will be the story throughout the 1992-1993 forecast period.

State and Local Spending

State and local budgets headed back towards steeper deficits in recent months. As a result, spending restraint is expected for the next two quarters.

Beginning with the next fiscal year (1992:3Q) spending constraints will continue although on a more modest scale.

Business Structure Spending

Business will continue to reduce spending on structures much more than they have in the typical historical recovery period and provides real income for discretionary consumer purchases.

Oil Prices

Oil prices are expected to remain soft with Brent set at $20/barrel. This helps limit the rise in the CPI during a period of economic recovery and provides real income for descretionary consumer purchases.

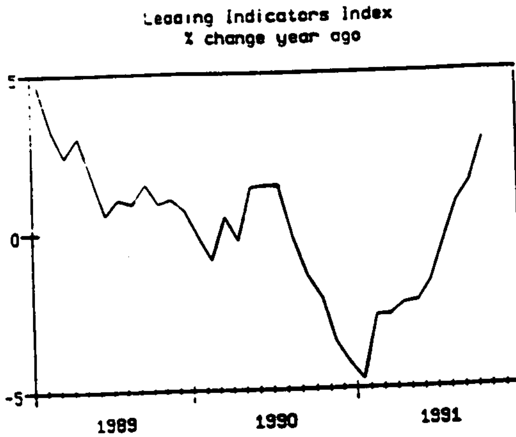
GDP - Rest of World

	1991	1992
Germany	3.0	1.5
France	1.3	1.5
Mexico	5.0	5.0
Japan	3.5	4.0
Canada	-0.7	3.0
United Kingdom	-2.4	1.0
Rest of World Composite	2.2	2.8

III. Review of the Outlook

Leading Indicators: Moving On Up

Leading indicators continue to move upward suggesting a carry through of economic recovery. Remember that leading indicators suggest direction not magnitude. So while the leading indicators continue to suggest recovery, the strength of that recovery remains an open issue.



Consumer Spending This Recovery is Different - Why?

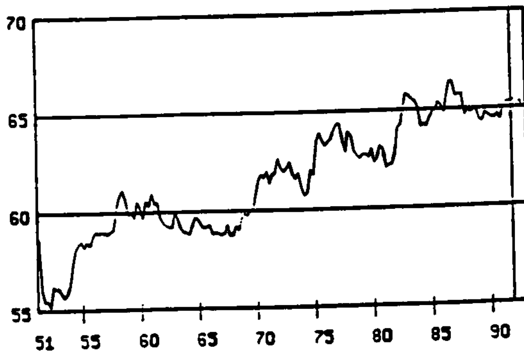
Why is this recovery different from past recoveries? How will different sectors behave?

Consumer Spending: Falls As a Percent of GNP

Slower population growth
19% 1950s
13% 1960s
11% 1970s
10% 1980s
8% 1990s

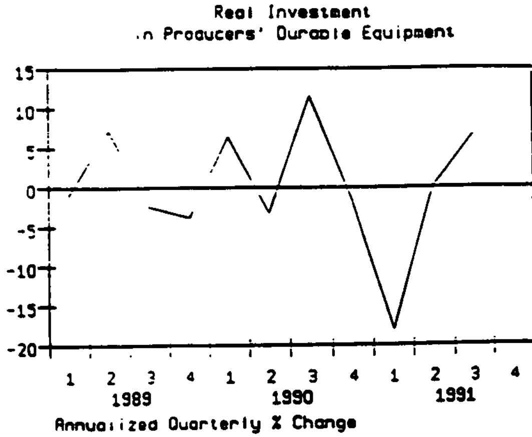
Slower Real Per Capita Income Growth
slower productivity (1.4% per year) due to
low savings and investment of the 1980s

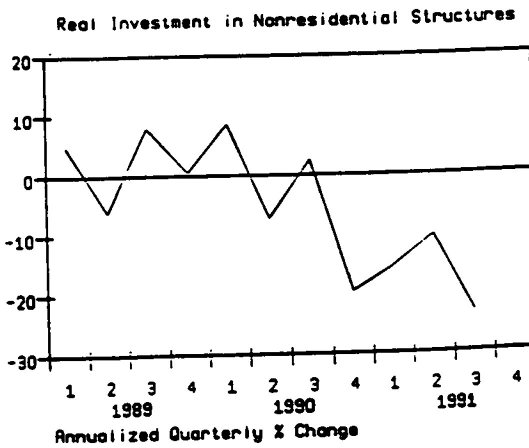
State and Local Tax Increases to Close Spending Gaps



Business Investment: We Live in Two Different Worlds

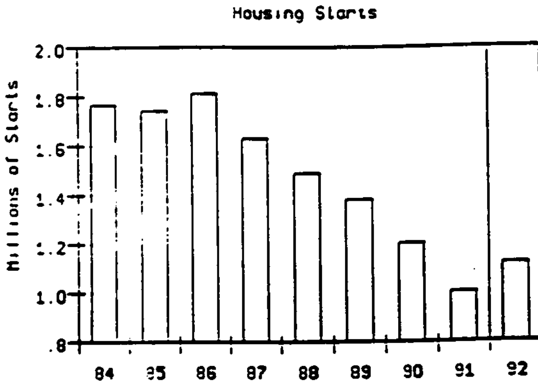
Equipment spending and structures are acting as if they are in two different worlds. **In 1992, equipment spending** is expected to rise 6 percent **but spending on structures** continues to decline (down 13 percent). Moderate economic recovery and lower bond rates are positive factors supporting gains in equipment spending. Expectations for a rebound in capital spending are also supported by the rise in spending plans reported in the latest Department of Commerce Capital Spending survey.





Housing Starts: Modest Recovery

There has been a modest recovery in housing but the level of housing starts remains far below the pace of the mid-1980s. Existing home sales and building permits are up due to lower mortgage rates and rising real disposable income but the slower pace of household formation has put a damper on the typical recovery burst of housing starts. For 1992, the high level of housing affordability supports the case for a housing recovery.



Housing Starts
(millions)

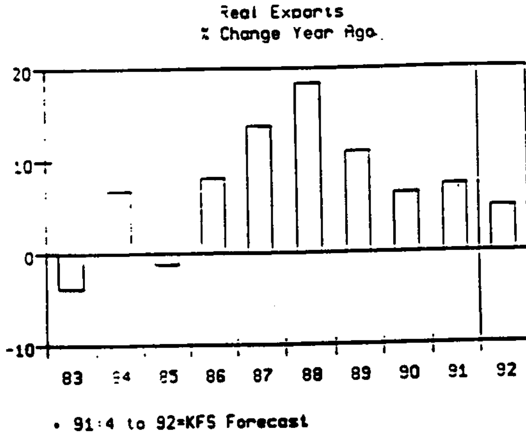
1H91	2H91	1H92	2H92
0.96	1.05	1.14	1.32

Household Formation: The Long Term Damper on Housing Starts
(In Percentage Growth For Selected Years)

1976	1.70	1991	1.21
1981	1.41	1996	1.05
1986	1.33	2001	1.09

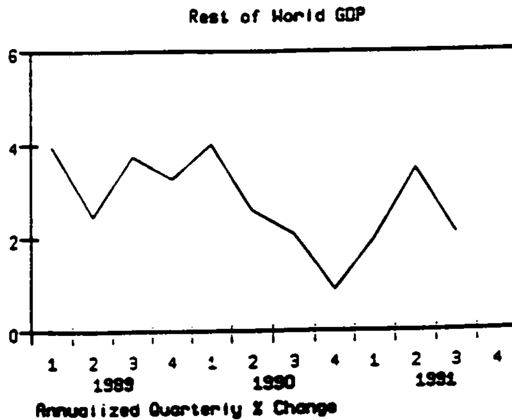
Exports: US Remains Competitive

Slower foreign GDP will slow US export growth but this will be at least partly offset by the impact of dollar depreciation during both 1990 and 1991. Reduced foreign capital spending does appear to be reducing export growth of capital goods but U.S. exports of industrial materials and supplies continue strong. Higher US price inflation relative to our trading partners remains a long-term negative for improving US export performance.

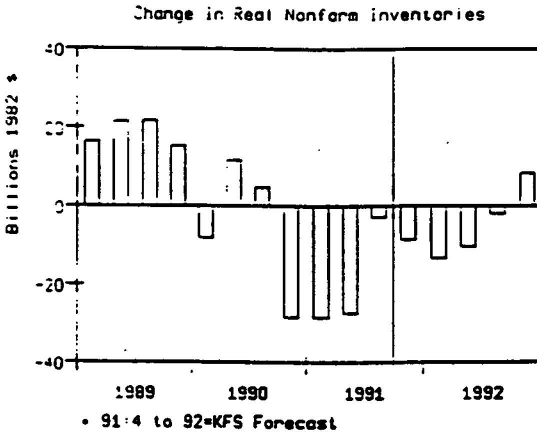


World GDP: Is There a Rebound in 1992?

World GDP growth is expected to steadily rise from 2 percent in 1991 to 3.5 - 4 percent by the second half of 1992. This would be a give boost to US exports but it remains a very controversial assumption.



Inventories: Early Recession Correction a Plus For Recovery - But More to Come



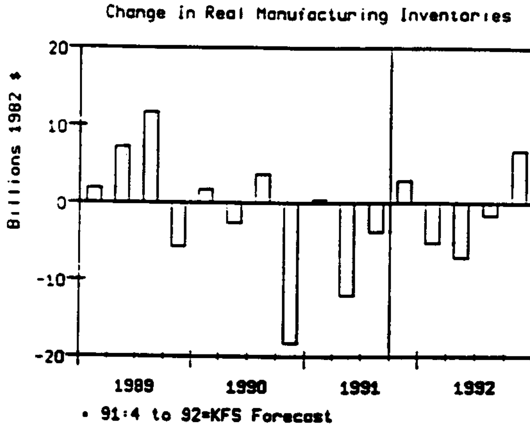
Cautious inventory policies produced a shallow recession. Corporate adjustment of inventories reflects three factors; the difference between expected and actual final sales, utilization rates, and real short term financing costs. For the past year actual final sales have fallen short of expectations and yet inventories have been reduced despite lower financing costs. But going forward, actual sales should pick up and the size of the declines in real nonfarm inventory are expected to diminish. Smaller inventory declines (smaller negatives) effectively increase GNP.

Nonfarm Inventory Change
($B)

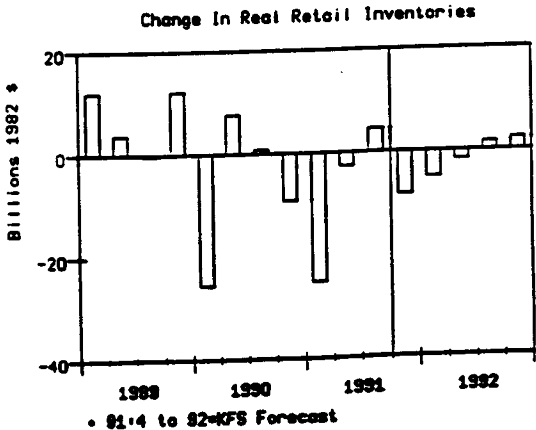
1H91	2H91	1H92	2H92
-31.0	-6.0	-12.0	+6.0

Inventories (By Sector) - Are Inventories in Good Shape in All Sectors?

Not all inventories are alike. Manufacturer's inventory/sales ratios are indeed down year over year.



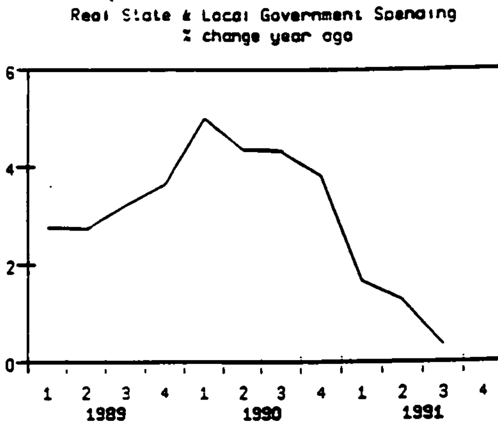
But retail inventories are up relative to sales. The retail sector experienced a major upward trend in the 1980s recovery as consumption rose as a percent of GNP. But, today, consumers are adjusting to the recession, slower income growth and, perhaps some shifting in demographic trends. Therefore, it is very likely that a significant cutback in retail inventories will continue through 1991. The heavier burden of inventory cutbacks is more likely to take the form of reduced imports rather than diminished domestic production.



Real State and Local Government Spending

Spending will slow as rising operating deficits and taxpayer resistance have led to increased restraint on municipal spending. Operating deficits are expected to widen in 1991 relative to 1990 due to spending on unemployment assistance and the backlog of previously planned construction spending. On the revenue side, slower growth in personal income, retail sales and gasoline sales will slow revenue growth.

Budget deficits led to a sharp downshift in municipal spending in late 1990. The correction does not appear over. Real spending is not expected to return to the 3 percent area until late 1993.



Fiscal Policy Assumption

According to the model, changes in fiscal policy in 1992 include:

1. **Personal Income tax cuts of $23B** in 1992 due to
   a) "temporary" cut in personal tax rates for middle income tax payers

   along with

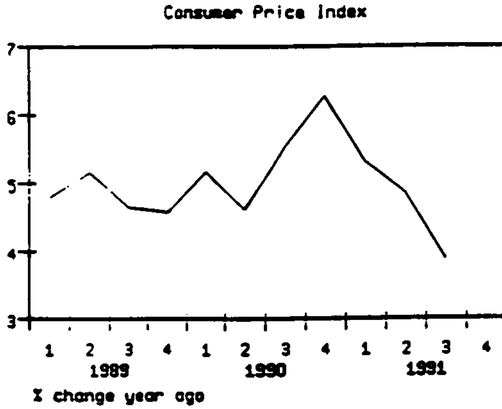
   b) a permanent cut in the capital gains tax rate.

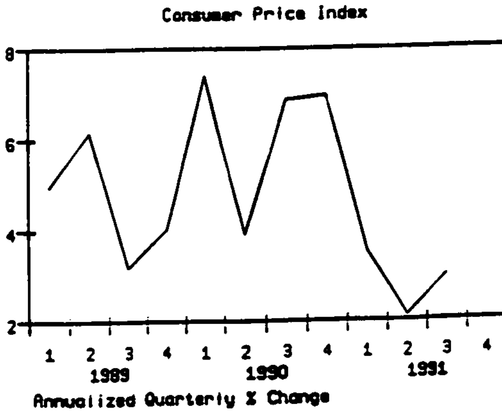
2. **Business Capital Tax Credit ($10B): Either Accelerated Depreciation or ITC**
   applies only to non-auto equipment purchases
   rate 10% in '92, 5% in '93

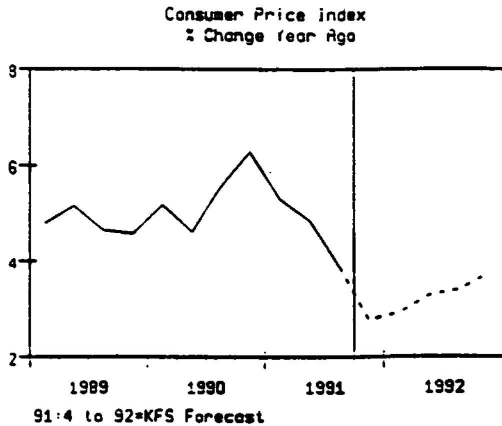
3. **Grants-in-aid to state and local governments in line with the authorized transportation spending.**

Inflation: Peaked - A Big Economic Positive

Inflation, as measured by the consumer price index, peaked on both a year-over-year and quarterly rate. This is a very significant development. But does the bond market believe it? A stronger dollar and higher unemployment rate work toward reducing inflation pressures.







- **Inflation** typically declines in the first year of recovery compared to the prior recession.

- **Weak economic growth** creates excess capacity in production and pressure on businesses to reduce or eliminate price increases in a weak final demand environment. The excess of potential over actual GNP opened up to 6 percent in the second half of 1992 from just 3.1 percent a year ago and 1.6 percent in 1989.

- **Second, recession also tends to raise unemployment rates** which reduce the aggressiveness of labor to seek large wage increases and thereby reduces unit labor costs.

- Third, the modest decline of the **dollar** going forward will not provide much of a inflation boost in 1992.

- **Finally, monetary** policy, as measured by money growth, drives long-run inflation. As long as the recent rebound in money growth moderates to rates (3-5 percent) more consistent with long run economic growth then the long run outlook for lower inflation remains intact.

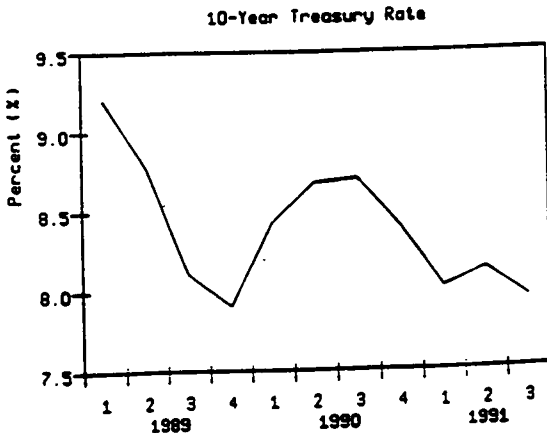
Interest Rate Outlook: Lower Yields

On balance, lower inflation, expectations of a modest economic recovery, lower oil prices and reduced RTC financing should put downward pressure on rates.

- o **first, inflation fears appear overly pessimistic** in the bond market.
- o **Second, economic growth will remain moderate ahead.**
- o **Third, the Fed is likely to pursue any additional ease very cautiously** given the recent sensitivity of bond yields to inflation/recovery expectations.
- o **Fourth, foreign interest rates will continue to decline**, on average, as Japan reduces its interest rates and weak economic growth continues in France, Italy, and the UK. The global capital shortage argument appears overplayed.
- o Finally, **the dollar, while it is expected to decline, is not expected to drop so sharply as to drive foreign investors away.** This will be good news to both the Fed and the bond market. Dollar stability will also help draw in foreign capital which will keep US rates from moving upward in 1992.

A steeper yield curve has been characteristic of the credit markets for the last two years now. The ratio of ten year to three month Treasury rates have risen from 1.08 (1989:1) to 1.58 in 1991 fourth quarter. **This steeper yield curve is a result of continued Treasury long term supply in the face of Fed easing of short rates.**

Growth in domestic nonfinancial debt has slowed steadily since 1986 from a peak of 13.8 percent in 1986:1 to 9.0 percent in 1989:1 to 6.0 percent in 1991. This steadily decline has **been a symbol of the changing nature of finance in the late 1980s.**



Corporate Profits: Positive Outlook After Second Quarter Bottom

Profits bottomed in the second quarter of 1991 and are expected to rise in 1992. Four factors support a positive outlook for profits.

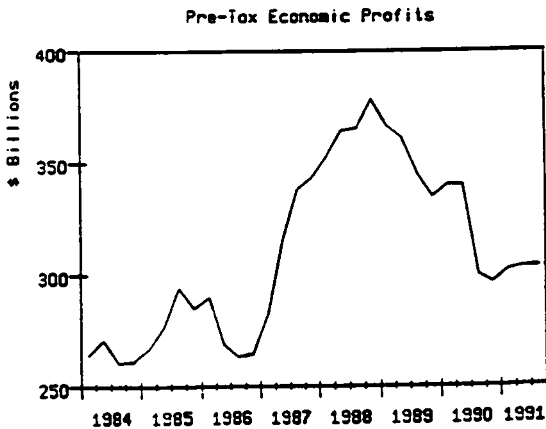
- **First, unit labor costs are slowing** on a year-over-year basis and these reductions in labor inflation open up an opportunity for higher returns to capital.

- Second, **profit margins,** as proxied by the spread between producer prices and labor costs, have bottomed and are expected to rise.

- Third, **capacity utilization** rates are expected to bottom in the second quarter. Utilization rates serve as a measure of the intensity of capital goods usage. The greater the intensity the more the cost of that good can be spread over more and more units of production thereby reducing the cost per unit of output.

- **Fourth, corporate profits should recover along with the recovery in the real GNP** in the second half of 1991.

Inflation-adjusted pre-tax corporate profits bottomed in the second quarter of 1991. That's to be expected since capacity utilization bottomed in April.



IV. The Economic Twilight Zone

Just how has this recession been different? We'll review the entire recession/slow growth period from 1990:3 to 1991:3 as if it were one economically - functional period. There is a reason to believe it is so since the financial corrections continued throughout this period even as the Iraqi war became a distant memory. Many sectors that were weaker than average in the recession remain weaker than average in the slow growth period of 1991 recovery. There is no real cyclical correction. Rather, the entire period appears to be one dominated by longer term structural changes that reduce (or raise) the relative growth of different economic sectors over the entire business cycle.

Is It Just One Long Structural Adjusment?

A common thread in many of the "Twilight Zone" episodes was that of altered reality. The protagonit faces a world where reality is somehow altered yet he (or she) alone perceives the change while everyone else about sees nothing (until much later). Remember William Shatner and the airplane ride with that woolly airplane-wing mechanic? Now think of yourself as that protagonist who hears soothing economic messages from the stewardess while facing a bumpy airplane ride in a vasting altered economic sky. Welcome to the "Economic Twilight Zone."

A. The Iraqi Recession Phase: 1990:3 to 1991:1

Outlined in Table one is a comparison of the recent recession to the average of prior recent downturns. In particular, by comparing the last two columns we can note the following developments.

Recession was less severe than average overall (GDP fell 1.6 percent just slightly less than the average decline of 1.8 percent).

Consumption is the big news. Consumption declined 1.2 percent during the recsssion compared to an average gain of 0.4 percent in prior recessions. The big hits were to non-durables and (surprise, surprise) services. The huge difference in services is a key structural change to the U.S. economy. Services are no longer recession proof in the economy and, therefore, neither is service sector employment.

This downturn in overall consumption is a major disappointment to Americans and is no doubt viewed as a threat to the American dream of a steady rise in our standard of living. Moreover, this is probably a major factor underlying the deterioration in consumer sentiment.

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Other Major Disappointments

Business Structure Spending
State and Local Government Spending
This slowdown is a major change from the average recession and is a surprise to municipal employees and local contractors who have considered their economic status as secure.

Real Disposable Income (Real DPI)
Real Income fallen this recession more than average.

Housing Starts down more than average.

Major Positive Surprises

Business equipment spending has fallen less than usual.

Exports are up sharply relative to the average.

Nonfarm invnetories have been slashed sharper (down 1.6 percent) than usual and this would, under normal circumstances, help to shorten the economic recession

Major Policy Success: Lower Inflation

Lower inflation (CPI, GNP deflator, GDP deflator) is the major success.

Clearly the Fed has been successful in achieving its top priority goal.

Why Fed Success Against Inflation?

As seen below in Table 1b, the Fed's success must be clearly related to much less than average M2 growth along with a much less than average decline in interest rates during the recession.

B. Weak Recovery Phase: 1991:2 - 1991:3

Weaker Than Usual: It's a Long List

GDP
Consumption
  non-durables and services again
Business Structures
Residential Investment
State and Local Government
Non-farm invnetories (decline greater than average)
Real Disposable Personal Income
Housing Starts
Inflation

Stronger than Average: A Short List

Business Equipment Spending
Exports

C. Why is This One Long Structural Adjustment?

Structural change comes to America

Yuppie Consumption Ends
Consumption continues much weaker
In fact, consumption has fallen since 1990:3 and
this weakness is in all three categories: durables, non-durables and services.

Buildings are Out
Expenditures on structures by business and housing starts for
households are both weaker than usual.

State and Local Government Retrenchment
Spending (up 0.3 percent) at the municipal
local remains much weaker compared to historical averages
(up 2.7 percent).

Inventories are not being Rebuilt
Inventories stop declining in the early phase of a traditional recovery.

Forget it--inventories continue to be slashed (down 2.5 percent since 1990:3).

Disinflation Rides Heard on Historical Extrapolation
Inflation stays low. The Fed's policy success continues as inflation
continues to remain below average and below any period of recession/recovery (?)
since 1960.

D. Altered States: Restructuring Persists in both Recession and Recovery

What is it that persists despite the ups and downs of GDP? Why does recovery feel like recession? Haven't we corrected our recession excesses yet? Let's return to those brave old days of late 1990 and early 1991 to recall that daring cry (with apologies to the Lone Ranger).

"This recession is not a garden variety, borne of excess inventory of goods, but rather a financial recession, borne of an excess inventory of debt." **John E. Silvia - The Nightly Business Report, January 21, 1991.**

A Recession in debt growth is the distinguishing factor between this period and prior periods and the tying factor between both the recession and "recovery" phases of the 1990 - 1991 period.

As show in Tables 4 and 4b, debt growth was far weaker than in the average prior downturn and totally contrary to the double digit gains of the 1982 - 1983 period. The drastic slowdown in debt growth occurred in all three sectors: federal, state and local, and private.

"Recovery" experience during 1991:2 and 3 (table 4b) shows a very similar pattern where all three sectors recorded debt growth below the average of past recoveries and, once again, far below the outsized gains of the 1982-83 period.

For a generation of private decision - makers and public officials bent on replaying their 1982-81 experience the warning is out. This time it is different. You have entered the economic twilight zone.

2/10/91

Table 1

COMPONENTS OF GNP
(1987 $)

ECONOMIC CYCLES
Peak to Trough Percent Change
(Simple Rate of Change For Period)

	60:2 TO 61:1	69:4 TO 70:4	73:4 TO 75:1	80:1 TO 80:3	81:3 TO 82:4	Avg. of Downturns	Current Cycle 90:3 TO 91:1
Real GNP	0.4	-0.2	-4.6	-2.7	-2.9	-1.9	-1.3
Real GDP	0.3	-0.2	-4.1	-2.5	-2.7	-1.8	-1.6
Final Sales of Domestic Product	1.1	0.6	-1.6	-1.4	-0.6	-0.4	-0.7
Domestic Final Sales	0.6	0.5	-3.0	-2.3	0.4	-0.8	-1.6
Private Domestic Final Sales	-0.5	1.4	-4.4	-2.8	-0.3	-1.3	-2.4
Consumption	0.1	1.7	-0.8	-1.0	2.1	0.4	-1.2
Durable	-9.3	-0.2	-10.2	-7.6	0.4	-7.0	-6.7
Non-Durable	0.5	2.0	-3.2	-1.6	1.5	-0.2	-0.9
Services	1.8	3.6	3.2	0.0	2.0	2.4	-0.1
Business Fixed Investment	-4.0	-3.0	-12.1	-6.4	-9.6	-7.2	-6.6
Equipment	-11.0	-4.3	-12.6	-8.3	-11.8	-9.6	-5.2
Structures	4.4	-3.1	-11.3	-3.6	-6.4	-4.0	-9.3
Residential Investment	-2.5	9.1	-30.4	-17.3	-10.9	-10.4	-10.6
Federal Government	2.7	-9.7	1.7	1.6	6.2	0.5	3.5
Defense			-0.5	1.0	9.0		4.1
State & Local Government	6.2	4.4	3.4	-1.8	1.6	2.7	0.7
Exports	2.7	5.3	6.0	0.2	-13.3	0.3	2.2
Imports	-7.2	2.5	-13.3	-11.5	-1.0	-6.1	-6.4
Level of Nonfarm Inventories	-1.2	1.3	4.0	-1.0	-2.5	0.1	-1.6
Real DPI	1.0	3.0	-4.2	-0.7	0.6	-0.1	-0.9
Savings Rate	0.2	18.6	-18.9	2.9	-19.1	-1.7	0.0
Industrial Production	-5.5	-5.6	-12.8	-4.3	-8.0	-7.2	-4.3
Housing Starts	-2.3	30.0	-40.6	11.7	33.1	6.4	-19.0
Inflation: CPI	0.8	5.6	14.4	9.3	6.1	6.5	2.6
Inflation: GNP Deflator	0.0	5.0	12.7	4.8	6.6	5.0	2.0
GDP Deflator	0.0	5.0	12.7	4.8	6.6	5.0	2.0

Shallower recession overall

But

Big surprise

steeper income decline

/19/91

Table 1B

MONETARY INDICATORS

ECONOMIC CYCLES
Peak to Trough Percent Change
(Simple Rate of Change For Period)

	60:2 TO 61:1	69:4 TO 70:4	73:4 TO 75:1	80:1 TO 80:3	81:3 TO 82:4	Avg. of Downturns	Current Cycle 90:3 TO 91:1
Money Supply: M2	5.1	6.1	7.8	4.6	11.9	7.1	1.4
Federal Funds Rate	-45.8	-37.7	-36.9	-34.6	-47.2	-40.5	-21.2
Real Fed Funds Rate	-65.4	-101.1	-406.1	-470.4	-28.0	-214.2	-57.3
Prime Rate	-10.0	-14.9	-8.5	-29.2	-41.2	-20.8	-8.1
Real Prime Rate	-0.7	-38.8	-254.5	-160.6	-20.7	-95.1	-13.0
Inflation: CPI	0.8	5.6	14.4	5.3	6.1	6.5	2.6
PPI-Finished Goods	0.7	2.6	20.0	5.9	4.6	6.8	2.0
CRB Commodity Price Index	-1.3	-4.6	2.7	-0.5	-15.4	-3.8	-6.4

In Recession

← less M2 growth

Small declines in rates

result? better inflation numbers

/18/91

Table 2

COMPONENTS OF GNP
(1987 $)

ECONOMIC CYCLES
Percent Change in First 2 Qtrs. of Recovery
(Average Annual Rate of Change for Period)

	61:1 and 61:2	71:1 and 71:2	75:2 and 75:3	80:3 and 80:4	82:4 and 83:1	Average of Past Cycles	Current Cycle 91:2 and 91:3
Real GNP	4.5	5.8	6.3	3.4	1.4	4.3	1.2
Real GDP	4.5	5.5	6.2	4.1	1.6	4.4	1.5
Final Sales of Domestic Product	2.6	3.6	4.4	3.9	3.4	3.6	0.2
Domestic Final Sales	3.1	4.4	4.8	4.8	3.9	4.0	0.7
Private Domestic Final Sales	3.0	6.4	5.6	5.3	4.2	4.9	1.4
Consumption	3.6	4.7	6.2	4.6	4.4	4.7	1.8
Durable	-10.3	28.9	18.2	17.2	11.3	13.1	3.6
Non-Durable	3.7	0.7	5.8	0.6	2.9	2.7	0.8
Services	6.3	3.5	4.2	5.0	4.0	4.6	2.0
Business Fixed Investment	-0.5	4.4	-3.2	1.9	-10.0	-1.5	-3.4
Equipment	2.5	8.6	-1.1	2.1	-6.9	1.0	3.2
Structures	-3.6	-1.1	-6.5	1.7	-14.1	-4.7	-17.1
Residential Investment	1.7	34.5	10.4	27.8	57.0	26.0	7.4
Federal Government	2.1	-7.7	0.5	-2.6	5.6	-0.4	-3.8
Defense			-0.1	2.3	3.6		-6.4
State & Local Government	4.9	2.1	2.9	-0.9	1.1	2.0	-0.6
Exports	-8.0	-0.6	-3.6	-2.2	-7.6	-4.4	12.7
Imports	2.6	12.3	0.7	-1.4	-0.6	2.7	17.8
Level of Nonfarm Inventories	-1.3	4.5	-2.3	-1.0	-5.3	-1.2	-1.8
Real DPI	5.2	5.2	6.9	6.4	1.1	5.0	1.4
Savings Rate	31.0	12.1	12.2	12.6	-23.2	8.9	
Industrial Production	4.9	5.7	4.7	5.6	-1.5	3.9	4.5
Housing Starts	12.8	40.1	63.9	102.3	112.4	66.3	29.3
Inflation: CPI	0.0	3.6	6.6	9.7	0.8	4.1	2.5
Inflation: GNP Deflator	1.5	6.3	7.2	10.6	4.1	5.9	2.6
GDP Deflator	1.5	6.3	6.8	10.4	4.1	5.8	2.6

If this is recovery much less than average growth

contrast

12/18/91

Table 2B

ECONOMIC INDICATORS

ECONOMIC CYCLES
Percent Change in First 2 Qtrs. of Recovery
(Average Annual Rate of Change for Period)

	61:1 and 61:2	71:1 and 71:2	75:2 and 75:3	80:3 and 80:4	82:4 and 83:1	Average of Past Cycles	Current Cycle 91:2 and 91:3
Money Supply: M2	7.3	15.2	15.4	12.0	16.1	13.2	2.1
Federal Funds Rate	-42.8	-32.0	-6.5	56.2	-30.2	-12.4	-22.9
Real Fed Funds Rate	2.4		72.0		-5.8		148.4
Prime Rate	0.0	-44.5	-29.1	5.1	-45.3	-22.0	-16.5
Real Prime Rate	39.7	-56.6	73.2	300.7	-33.0	82.4	35.6
Inflation: CPI	0.0	3.6	6.6	9.7	0.8	4.1	2.5
PPI-Finished Goods	-2.0	3.7	8.8	11.0	1.1	4.4	-0.6
CRB Commodity Price Index	7.6	-0.2	1.1	22.0	-0.7	6.0	-9.7

same story

less money

less inflation

·19/91

Table 3
COMPONENTS OF GNP
(1987 $)

ECONOMIC CYCLES
Peak to Trough Percent Change
(Simple Rate of Change For Period)

	60:2 TO 61:1	69:4 TO 70:4	73:4 TO 75:1	80:1 TO 80:3	81:3 TO 82:4	Avg. of Downturns	Current Cycle 90:3 TO 91:3
Real GNP	0.4	-0.2	-4.4	-2.7	-2.9	-1.9	-0.8
Real GDP	0.3	-0.2	-4.1	-2.5	-2.7	-1.8	-0.9
Final Sales of Domestic Product	1.1	0.6	-1.6	-1.4	-0.6	-0.4	-0.6
Domestic Final Sales	0.6	0.5	-3.0	-2.3	0.4	-0.8	-1.3
Private Domestic Final Sales	-0.5	1.4	-4.4	-2.8	-0.3	-1.3	-1.7
Consumption	0.1	1.7	-0.8	-1.0	2.1	0.4	-0.3
Durable	-9.3	-8.2	-10.2	-7.6	0.4	-7.0	-5.0
Non-Durable	0.5	2.0	-3.2	-1.6	1.5	-0.2	-0.5
Services	1.8	3.6	3.2	0.8	2.8	2.4	1.0
Business Fixed Investment	-4.0	-3.8	-12.1	-6.4	-9.6	-7.2	-8.2
Equipment	-11.0	-4.3	-12.6	-8.3	-11.8	-9.6	-3.7
Structures	4.4	-3.1	-11.3	-3.6	-6.4	-4.0	-17.4
Residential Investment	-2.5	9.1	-30.4	-17.3	-10.9	-10.4	-7.3
Federal Government	2.7	-9.7	1.7	1.6	6.2	0.5	1.5
Defense			-0.5	1.0	9.8		0.7
State & Local Government	6.2	4.4	3.6	-1.8	1.6	2.7	0.3
Exports	2.7	5.3	6.8	0.2	-13.3	0.3	8.5
Imports	-7.2	2.5	-13.3	-11.5	-1.0	-6.1	1.6
Level of Nonfarm Inventories	-1.2	1.3	4.0	-1.0	-2.5	0.1	-2.5
Real DPI	1.0	3.0	-4.2	-0.7	0.6	-0.1	-0.2
Savings Rate	0.2	18.6	-18.9	2.9	-19.1	-1.7	
Industrial Production	-5.5	-5.4	-12.8	-4.3	-8.0	-7.2	-2.2
Housing Starts	-2.3	30.8	-40.6	11.7	33.1	6.4	-8.0
Inflation: CPI	0.8	5.6	14.4	5.3	6.1	6.5	3.9
Inflation: GNP Deflator	0.0	5.0	12.7	4.8	6.6	5.8	3.3
GDP Deflator	0.0	5.0	12.7	4.8	6.6	5.8	3.3

One Long Structural Adjustment

Big Shift

19/91

Table 3H

MONETARY INDICATORS

ECONOMIC CYCLES
Peak to Trough Percent Change
(Simple Rate of Change For Period)

	60:2 TO 61:1	69:4 TO 70:4	73:4 TO 75:1	80:1 TO 80:3	81:3 TO 82:4	Avg. of Downturns	Current Cycle 90:3 TO 91:3
oney Supply: M2	5.1	6.1	7.8	4.6	11.9	7.1	2.4
ederal Funds Rate	-45.8	-37.7	-36.9	-34.6	-47.2	-40.5	-30.8
eal Fed Funds Rate	-65.4	-101.1	-406.1	-470.4	-28.0	-214.2	-32.7
rime Rate	-10.0	-14.9	-8.5	-29.2	-41.2	-20.8	-16.0
eal Prime Rate	-0.7	-38.8	-254.5	-160.6	-20.7	-95.1	1.3
nflation: CPI	0.8	5.6	14.6	5.3	6.1	6.5	3.9
PI-Finished Goods	0.7	2.6	20.0	5.9	4.6	6.8	1.6
RB Commodity Price Index	-1.3	-4.6	2.7	-0.5	-15.4	-3.8	-11.1

less money

smaller interest rate declines

mean less inflation

Long term positive for bonds

12/18/91

Table 4

ECONOMIC INDICATORS

ECONOMIC CYCLES
Peak to Trough Percent Change
(Simple Rate of Change for Period)

	60:2 TO 61:1	69:4 TO 70:4	73:4 TO 75:1	80:1 TO 80:3	81:3 TO 82:4	Avg. of Downturns	Current Cycle 90:3 TO 91:1
C & I Loans			19.8	1.2	12.5		0.0
Industrial Production	-5.5	-5.4	-12.0	-4.3	-8.0	-7.2	-4.3
Total Domestic Nonfinancial Debt	3.2	6.9	10.9	4.0	11.5	7.3	2.3
Federal Government Debt	0.0	4.1	7.8	6.9	23.6	8.5	5.4
State & Local Debt	5.7	9.0	9.6	3.0	16.5	8.9	1.0
Private Debt	4.8	7.4	11.9	3.2	7.6	7.0	1.5

Debt slowdown in recession

12/10/91

Table 4B
ECONOMIC INDICATORS

ECONOMIC CYCLES
Percent Change in First 2 Qtrs. of Recovery
(Average Annual Rate of Change for Period)

	61:1 and 61:2	71:1 and 71:2	75:2 and 75:3	80:3 and 80:4	82:4 and 83:1	Average of Past Cycles	Current Cycle 91:2 and 91:3
C & I Loans			-7.5	13.1	3.9		-6.4
Industrial Production	6.9	5.7	6.7	5.6	-1.5	3.9	4.5
Total Domestic Nonfinancial Debt	4.7	9.2	8.7	9.9	9.7	8.4	5.1
Federal Government Debt	1.4	7.1	27.3	12.5	24.0	14.5	12.5
State & Local Debt	6.6	12.0	5.4	7.6	11.2	8.6	5.6
Private Debt	6.3	9.5	4.8	9.5	5.6	7.1	2.5

and recovery

VI. An Investors Guide to Election - Year Fiscal Policy Initiatives

On January 28 President Bush will announce a "growth package" of fiscal policy initiatives, primarily tax options. To help you prepare for that announcement, the following text is a "teaser", **a brief highlight film of the wonderful world of tax policy.** For each potential initiative I have tried to explain the initiative and it's likely economic impact. Any comments or questions would be appreciated.

A. Temporary or Permanent Tax Change: A Question of Timing

A temporary tax change will alter the timing of economic events but is unlikely to significantly alter the long term path of economic activity.

Today there is considerable discussion of a "temporary" tax cut for investment spending, personal income and first time home buyers. These temporary options should be viewed as a "shot in the arm" to the economy in 1992 but as a drag to 1993. In economics, temporary tax reductions act just like temporary auto rebates. They change the timing of economic activity but do not alter the basic trend of activity.

If passed, a "temporary" investment tax credit or first time home buyer credit would boost economic activity in 1992 relative to 1993. This is clearly **countercyclical fiscal fine tuning** - not a long run growth incentive.

These "temporary" tax reductions are advocated by those who favor a short run stimulus/no significant out-year, deficit impact. Of course, there is some out-year incremental deficit financing cost due to the short run revenue lost as a result of the tax cut.

1. Investment Tax Credit (ITC): The Incremental Approach or Accelerated Depreciation

- **Lower Cost of Capital**

This tax credit reduces the user cost of investment and thereby increases its expected, after-tax, rate of return. Combined with accelerated depreciation, the tax credit has a significant impact on business spending.

One critique of the ITC is that it biases the tax code between different types of investments (equipment v. buildings, intangibles) and between industries (high v. low capital intensity). Today, an "incremental" ITC is being discussed. This would give a credit to investment spending by a firm that was incremental or above its average investment spending (or a national average ratio of investment/sales) for some prior period. A national threshold would reduce the revenue loss and, additionally, not penalize already high investment spending companies. The incremental approach targets extra investment, not what would happen anyway.

Accelerated depreciation would not be as biased against certain types of investment as would the ITC. In addition, a temporary increase in depreciation allowances may be easier to administer.

Both the ITC and accelerated depreciation has been used before in countercyclical fiscal policy. In the past, the investment credit has been suspended (1966, 1969) to reduce aggregate demand and thereby inflation pressures while in 1975 the credit was raised to stimulate recovery. The current ITC proposal may exclude transportation investments (autos and trucks) so it is not a "quick fix" for the auto sector.

2. First Time Home Buyers Credit ($5,000 over two years): A Problem Child for The Deficit

- **Lower after tax costs of Home Purchase**

Clearly this would increase the federal deficit. If each of 200,000 potential buyers (National Association of Home Builders) gets the credit of $5,000 the cost is $10B. This problem child is growing daily.

This would lower the upfront cost of a home for a first time home buyer. At the margin, this proposal, especially if it were temporary, would boost home sales. Some estimates are for 200,000 additional sales. Existing home sales would probably benefit more than new home sales since average prices on existing home tends to be lower. Firms in carpeting, furniture and appliance sectors would also benefit. Low to middle price range housing starts may also benefit since first time buyers are more likely to qualify.

3. Increase in Personal Exemption or a Tax Credit for Middle Income Taxpayers

- **Exemption increase of $1,000 per child for adjusted gross income below $100,000**
- **Increase After-tax Disposable Income**

Unlike the tax credit for home buyers, this personal exemption increase or tax credit is not targeted to benefit a particular activity. Therefore, the economic benefit will be diffused among all taxpayers. Most of the savings from lower taxes will be spent but, it is likely a portion will be saved.

This tax credit will likely be temporary since a permanent tax credit would suggest higher future deficits which would be difficult for the bond market to accept in the face of a "budget agreement."

4. Passive Loss on Real Estate

- **Attempt to Stabilize Real Estate Values**
- **Limit revenue loss by limiting repeal to existing structures only**

Although this tax break was eliminated in the 1986 tax reform package, it is likely to reemerge, but with some restrictions. **Passive - loss restrictions will be repealed only for taxpayers who spend a majority of their time in real estate.** This proposal targets assistance toward the real estate industry in an attempt to stabilize real estate values and, indirectly, commercial banks with loans on such real estate.

However, the provision is also clearly a revenue loser with a bill of about $5B over five years. Moreover, the difficulty politically with passive losses is to limit them to active managers/investors in real estate and not broaden it out to cattle raising or equipment leasing.

5. Capital Gains Tax

- **Reduce Cost of Capital**

It is likely a capital gains tax cut proposal will be put forth. **The cut maybe to 19 percent with a one year holding period.** In economics, a capital gains tax reduction increases the after-tax return to capital. Therefore, it is likely that more capital will be supplied to the market and long run economic growth improved.

6. Family Savings Plan

- Increase Long Run Savings

Higher savings are clearly the goal here. In addition, a long run improvement to human capital is also possible to the extent the savings are targeted toward educational purposes.

In the short run, however these plans cost revenue. However, it is also possible that a rollover from existing IRAs will be allowed but this rollover will be taxed. Thereby this proposal could raise revenue in the short run.

7. Health Insurance Initiative

- Expand Health Insurance Coverage

A maximum $3,000 credit for health insurance payments offered for low income taxpayers (below $60,000 AGI) to be funded by a new tax on health insurance benefits of higher income individuals.

If health insurance coverage is expanded then the overall demand for health care will rise and so will health care inflation. To what extent "health" is actually improved remains an open issue.

8. Payroll Tax Cut - One of My Favorite Means to Reduce Labor Costs

- **Reduce Cost of Labor**
- **Immediate Tax Benefit**

Payroll taxes create a wedge between the employers wage bill and the employees take home pay. With lower payroll taxes, both employer and employee are better off at the expense of the government. Lower payroll taxes reduce employer costs and therefore will likely increase the demand for labor and thereby reduce unemployment.

Implementation of the payroll tax is also very easily done on an employers computerized payroll system. A payroll tax cut can also be put into effect immediately - you don't need to wait until 1993.

Distributionally, a payroll tax cut would benefit the lower income workers proportionately more. Therefore, it may be more acceptable politically than other tax cuts that are perceived to favor high or middle income groups.

V. **Equity Markets: How Has This Recession Been Different?**

With all the talk about how the economy is so different this recession than last recession. let's turn the tables and see **if the equity market views this recession as different than the last.**

It does. The equity market, for many sectors, is telling us that this recession is different - but not for the usual reasons.

The current recession/weak recovery period since 1990:3 is compared in the table attached to the average of five prior downturns (1960, 1970, 1973, 1980, 1981) and to the 1981-1982 downturn separately. Performance of the S&P index is shown as well as many subcomponents. Finally, the behavior of pre-tax economic profits and interest rates is also shown in the table.

First, the Economic Fundamentals

Surprise #1 - Profits are Up

Corporate profits are up 2.1 percent this cycle compared to average declines of 14.4 percent in prior downturns. (Even if the "recession" phase ended in 1991:1 this difference in profit behavior remains.

Surprise #2 - Interest Rate Decline About Average

Ten Year Treasury yielded and 1 year Treasury yields have both declined about average. Despite all the talk about how sticky long term interest rates are this cycle, in fact, their decline is about average.

Result: Equities Up Better Than Average

Corporate profits are up and interest rates have declined about average. Therefore, you would expect stocks to do better than average. They have.

Overall S&P: Up 15 Percent: Usually Flat

Clearly the overall S&P index is up much greater than usual. Could the market be wrong? If the economy is so terrible why are stock prices up so much compared to the past? If the long term growth prospects of the US are so bad why the stock market rally? Moreover, the greater than average overall gain in the S&P is reflected in both its capital/consumer goods components.

If the consumer is dead, then the S&P index of consumer goods stocks does not reflect it.

So Why all the Bad Press?

Probably because the big name companies are being hit hard. Sectors with worse than average performance include:

Autos (GM)
Broadcasting (The Press is Broadcasting their own story ?)
Office Equipment (Problems at IBM)

These are the glamour, big headline industries and their equity performance is worse than average and, in fact, down absolutely since the beginning of the recession.

Commodities are also weak - but this reflects the Fed's success in reducing inflation. Note the performance declines for such commodity cyclicals as oil and aluminum. The unusual out of character behavior, however, of paper stocks is a thought challenge.

A Cheer for Dull: Railroads and Truckers, Chemicals and Paper

Nothing glamorous here except for the performance. This recent performance probably reflects nothing less than the hard won gains of years of cutbacks and restructuring in the 1980s.

Are Equities Up Too Much? Is the Fed Finally Credible?

Inflation maybe the key. Money growth and inflation have behaved quite differently (seen in the table) this economic cycle compared to prior cycles. It appears that these symbols of anti-inflation policy are credible to the market. Why else would the market vote against commodity cyclicals yet buy production-sensitive transportation issues such as truckers or railroads?

/3/92

S & P EQUITY INDICES

ECONOMIC CYCLES
Peak to Trough Percent Change
(Simple Rate of Change For Period)

	60:2 TO 61:1	69:4 TO 70:4	73:4 TO 75:1	80:1 TO 80:3	81:3 TO 82:4	Avg. of Downturn	Current Cycle 90:3 TO 91:3
S & P 500 COMPOSITE	10.6	-8.5	-22.9	11.8	8.8	-8.1	15.0
CAPITAL GOODS	4.8	-13.7	-25.2	9.0	1.4	-4.7	7.5
CONSUMER GOODS	7.8	-3.4	-23.0	14.1	29.2	4.9	26.9
NEW YORK BANKS	12.6	-2.0	-24.8	9.9	25.5	4.2	18.1
REGIONAL BANKS	16.7	-7.2	-29.5	10.3	-7.1	-3.4	37.1
LIFE INSURANCE	25.1	-28.5	-24.6	8.7	45.9	5.3	8.0
PROPERTY/CASUALTY INS.	20.4	-7.1	-27.6	12.1	16.9	4.6	13.5
BROKERAGE HOUSES				36.7	72.2		63.2
HOME BUILDING		-33.9	-35.7	23.4	21.0		20.2
AUTOMOBILE	-3.0	3.2	-30.7	0.8	26.2	-0.7	-11.2
DRUGS	7.3	-4.7	-19.3	15.0	21.5	3.9	34.6
FOODS	35.4	-5.8	-8.9	11.8	37.9	14.1	29.5
TOBACCO	40.8	17.5	-0.7	29.8	20.1	21.5	48.5
DEPARTMENT STORES	4.6	-5.6	-21.0	21.1	63.0	12.4	30.5
HOTEL-MOTEL		-23.5	-42.0	32.6	13.8		-1.6
BROADCASTING	-3.4	-33.2	-0.4	12.0	43.3	3.7	-3.7
INDUSTRIAL MACHINERY				24.1	-25.0		4.1
OFFICE EQUIP. (COMPUTERS)	32.5	-19.2	-31.1	1.0	33.9	3.6	-5.4
ELECTRONICS: SEMICONDUCTORS			-30.4	18.4	29.6		4.0
CHEMICALS	-2.9	-1.2	-12.6	8.9	-5.2	-2.6	26.5
CONTAINER:PAPER	1.3	-20.8	-17.4	-0.9	20.4	-3.5	33.8
ALUMINUM	-11.2	-21.3	-31.1	10.6	-6.6	-11.9	-4.0
PAPER	7.1	-17.5	-19.7	5.9	-2.7	-5.4	19.4

weak

note difference in these 3 cyclicals

	60:2 TO 61:1	69:4 TO 70:4	73:4 TO 75:1	80:1 TO 80:3	81:3 TO 82:4	Avg. of Downturns	Current Cycle 90:3 TO 91:3
DOMESTIC INTEGRATED OIL	26.7	-6.2	-18.6	9.2	-19.8	-1.7	-8.6
POLLUTION CONTROL		-1.2	-60.0	30.2	29.4		-12.2
AIRLINES	16.5	-24.9	-28.3	10.1	23.4	-0.4	6.9
RAILROADS	5.4	-19.8	-5.0	17.6	-0.8	-0.5	24.9
TRUCKERS	-29.5	-3.5	-12.7	22.7	28.0	1.0	35.4
TELEPHONE (NEW)							1.5
PRE-TAX ECONOMIC PROFITS	-8.9	-11.3	-15.2	-14.8	-21.6	-14.4	2.1
1-YR. TREASURY YIELD	-25.8	-28.5	-14.9	-27.2	-44.1	-28.1	-24.8
10-YR. TREASURY YIELD	-11.1	-6.1	11.6	-8.6	-28.2	-8.5	-8.8
30-YR. TREASURY YIELD				-7.1	-24.8		-7.0

— weak

> strength

— surprise for profits

/92

MONETARY INDICATORS

ECONOMIC CYCLES
Peak to Trough Percent Change
(Simple Rate of Change For Period)

	60:2 TO 61:1	69:4 TO 70:4	73:4 TO 75:1	80:1 TO 80:3	81:3 TO 82:4	Avg. of Downturns	Current Cycle 90:3 TO 91:3
oney Supply: M2	5.1	6.1	7.8	4.6	11.9	7.1	2.4
ederal Funds Rate	-45.8	-37.7	-36.9	-34.6	-47.2	-40.5	-30.8
eal Fed Funds Rate	-65.4	-101.1	-606.1	-470.6	-28.0	-214.2	-32.7
rime Rate	-10.0	-14.9	-8.5	-29.2	-41.2	-20.8	-16.0
eal Prime Rate	-0.7	-30.8	-254.5	-160.6	-20.7	-95.1	1.3
nflation: CPI	0.8	5.6	14.4	5.3	6.1	6.5	3.9
PI-Finished Goods	0.7	2.6	20.0	5.9	4.6	6.8	1.6
RB Commodity Price Index	-1.3	-4.6	2.7	-0.3	-15.4	-3.8	-11.1

slow money

much lower inflation

SENATOR SARBANES. Thank you, very much.
Mr. Straszheim, please proceed.

STATEMENT OF DONALD H. STRASZHEIM, CHIEF ECONOMIST, MERRILL LYNCH & COMPANY

MR. STRASZHEIM. Thank you, Mr. Chairman, for the chance to come back again.

I testify on my own behalf. My views are mine and not necessarily those of my employer.

I want to split these remarks into two pieces. First, some quick comments about the economic situation, which has been covered fairly well already. I do not have major differences with the other witnesses. Then, I want to spend most of my time on some policy thoughts.

On the economy, I think we are near, but not at, the end of the longest recession in the postwar period, which began in July 1990. It is now 19 months old.

I think the difference between this and earlier recessions is, as has already been mentioned, on the employment side. In most past recessions, a large share of the employment loss was blue-collar manufacturing jobs—layoffs.

Employees would say: "Inventories are too high, so we are going to lay you off for a couple of months. We have your phone number. When inventories are back at reasonable levels, we will call you back."

What is being said now is something quite different: "We are restructuring the company. We are no longer competitive. We are getting out of this line of business, out of that line of business. You are excess management. You are overhead. You are out, never to come back. Clear out your desk."

When that happens to a person, their view is, "The company across the street is probably in the same situation as my own company. I have to look for a new career in a new industry," and that is tough.

That is why I think the confidence levels are as bad as they are now, even though the overall unemployment rate is not so high.

Always, at this time in cycles, people say lower interest rates will not help, and they are always wrong; I think they will be wrong again.

I believe Federal Reserve Chairman Greenspan told us with the December 20th easing in the discount rate, "We think we have done enough."

He reiterated these points here just two days ago: "We think we have done enough. But if the economy does not begin to recover, we will do more."

In that sense, I think the recovery will be spurred by the decline in interest rates, but it will be slow and sluggish.

SENATOR SARBANES. Could I just interrupt you because I want to put a question on the very point you are covering and not save it.

What is the downside to the Fed doing more to lower interest rates now?

If Greenspan says, "we think we are going to make it with what we have done, but we do not know that we are going to make it, and if after a few months it proves out or shows that we have not made it, then we are prepared to do more," that means, of course, we are likely to experience another few months of the downturn and just prolong this period.

Now, what is the downside of going ahead and doing more now?

MR. STRASZHEIM. I think the only downside is that, and I believe it is a modest downside, people would regard this easing as being excessive and sending a signal that the Fed has given up on its longer run anti-inflation targets which would ultimately give you higher rates because of a higher inflation premium.

To me, that is not a major risk, but I think that is the risk at-hand.

I thought, from Greenspan's testimony of two days ago, that the financial markets viewed his remarks in the wrong way.

To me, there is really precious little risk that we are going to have any major inflation increase.

I am quite convinced that if, in fact, the economy does not recover in the next few months, we will see further Fed easing.

A 3 percent discount rate, I think, is not at all unlikely in that scenario.

The slow recovery: The normal recovery rate is 6.4 percent during the first six quarters of recoveries.

This time, I think the recovery rate will be about half as fast as normal for all of the usual reasons that you have heard: the consumer is highly leveraged; consumers remain worried about the value of their houses; the business sector is highly leveraged.

We do not have the fiscal lever in Washington to pull like we normally do.

State and local budgets are a mess. And lastly, the banks do not have the wherewithal to provide the kind of lift that is also common.

Inflation, I just mentioned, is not a major risk, and the interest rate profile, I suspect, will remain really quite subdued for the foreseeable future as well.

Now, let me say something about policy.

All of my other three compatriots here agree, as I do, that there will be a recovery later in 1992 with no additional fiscal stimulus. By the time Washington gets something done on the fiscal side, the economy will already be recovering. In that sense, I think it is too late.

Basically the view, I believe, ought to be: Think long term. No quick fixes. They do not work.

The public knows it. And I believe that good, long-term economic policy would be good politics.

The disaffection among the general public with Washington and the way we have handled our economic affairs in the last decade or two has increased enormously.

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We need to address the long-term problems, not the short-run wiggles and jiggles in the economy.

Leave most of the countercyclical burden to the Fed. They have done a great deal and, if needed, I think they would do more.

Do not get into a bidding war on tax stimulus. If we end up with an election-year compromise—which is of the form that the Republicans want X, the Democrats want Y, and the compromise is, "Fine, we will do both"—this is not fruitful for the economy long run.

We should twist the tax code, encouraging savings and investment relative to consumption. Individual Retirement Accounts and other savings incentives, I think, are a plus.

We ought to go further.

I would point out also that the middle name in the initials IRA is "retirement." I think it is a mistake to use Individual Retirement Account monies for house purchase, medical bills, education and the like.

I think we ought to increase our investment incentives in a variety of ways, whether it is the investment tax credit, whether it is some kind of a new depreciation scheme—the details are not so important as is the general message that we ought to be encouraging investment for our long-run growth rather than consumption.

We have to reduce the budget deficits over the long run.

We do not have a crisis, but we have a chronic condition that just gets worse and worse over time. We have overpromised at all levels of government—federal, state and local—and the public knows it.

In that sense, we ought to stop the budget gimmicks, creative accounting and unrealistic economic assumptions.

Now, the first line in the budget underneath the actual deficit is the deficit "excluding interest." What is going on here? This just does not contribute to anything.

SENATOR SARBANES. That is the budget that Mr. Darman sends to us that you are talking about.

MR. STRASZHEIM. Yes, Senator.

[Laughter.]

We ought to realize that all government spending is not equal, insofar as economic growth is concerned. The $50 billion of defense spending, or $50 billion of transfer payments, or $50 billion of net interest is not in any way the same in terms of its economic effect as $50 billion of spending on education, or infrastructure, or the like.

In that sense, I strongly endorse the proposition that we ought to do more in terms of the budget accounting with capital budgets and the like.

I think we ought to dramatically increase our investment in infrastructure.

It reminds me of the children's picture book game, "What's Wrong With this Picture?": A 16 percent unemployment rate in the construction trades, and the roads have pot holes?

There is a natural match out there that we ought to be able to reach—education spending, Head Start, the drug problem.

There is an increasing population that is a drag on the economy, and these folks have no chance of ever becoming mainstream contributors to our economic growth unless they are somehow lifted out of the downward spiral that they are in.

Do not confuse tax stimulus with income redistribution and tax equity up and down the income ladder.

If you think that one income level is paying too much or too little on tax fairness grounds, change it up or down as appropriate in the daylight, but tax redistribution and tax stimulus are really quite different propositions.

For a decade, people have been saying $100 billion deficits? What is the problem? We are doing fine.

Now, we are learning what the problem is.

The cost of this decade of deficits is a situation right now in which we would love to have a $100 billion fiscal level to pull to stimulate the economy. That level is not available to us because we pulled it a decade ago, and we left it pulled.

There is no reason to do tax stimulus in the commercial real estate area. While you might get, if you reduced the tax sufficiently, some more construction, we do not need it. There is more than enough capacity there to last us throughout the next decade, in any case.

We ought to support more research and development spending. It is important for our long-run competitiveness.

I would not send a lot of money to the state and local governments. They are bleeding. We all know they are bleeding. But the grants-in-aid process over the last 20 years, or whatever, I think has been a major mistake.

The states and the localities are simply going to have to make a variety of hard choices, as Washington must as well, in terms of spending and also receipts.

On the consumer: No big tax giveaway. The public knows better. They know that borrowing a whole bunch of money and sending checks to people is not good, long-run economic policy.

I do not like the idea of this $500-per-child increase in the exemption. I do not like the idea of changing the withholding taxes right now so that you end up with something less come next April 15.

This is not long-run economic growth stimulus; this is election-year politics that has no business in a thoughtful consideration of long-run economic growth.

I would cut the capital gains tax on new investment. To spur entrepreneurial activity would be a plus.

I would not get bogged down into this endless argument about the direct beneficiaries of the capital gains tax cut. We know that it is only the wealthy that receive those direct benefits.

But to the extent that you spur entrepreneurial activity, the employed in those firms, who benefit from these reduced capital costs, are in fact people employed at all levels of the income distribution.

I would take the peace dividend and spend it. I would not give it back in income tax cuts so that people can buy VCRs and new cars, or whatever. I would spend it on infrastructure. I would spend it on education, on drugs, on Head Start and the like.

I suspect, because of the series of bad policy decisions that we have made over the last 25 years, the 1990s will be the slowest growth decade since the 1930s. I think there are a variety of reasons for that that we can surely go into later if you would like.

That brings me to reiterate the first point I made: Think long term.

I know that the public votes its pocketbook. I know that this is an election year, but the public also realizes that some of these short-run programs do not have any lasting effect on the economy.

What we ought to be trying to do is to lift our long-run productivity rate and our long-run economic growth rate.

It has been 19 years since the first OPEC embargo, and we still do not have an energy policy.

I guess the question arises: What is the hurry?

It has been 15 years since Jimmy Carter was inaugurated. If we had established some long-run programs at that time, we would be 15 years into lifting this economy.

It has been 11 years since Ronald Reagan was inaugurated, and if we had started something at that time we would be well on the way as well.

Let us start right now.

[The prepared statement of Mr. Straszheim follows:]

PREPARED STATEMENT OF DONALD H. STRASZHEIM

I. INTRODUCTION AND SUMMARY

The views expressed here are mine and mine alone, and do not necessarily represent those of my employer.

The U.S. economy is weak and still suffering the longest recession in the postwar era—a recession which is not yet over. And with the joint occurrence of a recession and a presidential election year, all eyes are, understandably, on Washington and the government's policy response to our economic problems. The chronic federal budget deficit is a major constraint on our policy making options. Most of the counter-cyclical burden must, as a result, be left to the Federal Reserve and its conduct of monetary policy. Fiscal policy changes should primarily be geared to enhancing our long-run growth prospects rather than to a short-run fix to the present cyclical downturn.

On the tax side, a major middle income tax cut would be a mistake. We need to encourage savings over consumption. In particular, re-instituting the investment tax credit or accelerated depreciation rules, liberalizing the individual retirement account rules and a reduction in capital gains taxes all deserve consideration. We need to dramatically increase our public investment in physical capital (infrastructure) and in human capital (education) if we are to reverse the downhill slide in our economy of the last quarter century. The drug problem, especially in our center cities, is creating a cycle of drugs, crime, joblessness, poverty, and hopelessness for a rapidly growing portion of our population.

We must further work to reduce government spending in other less essential areas, and must avoid an election-year bidding war on tax reduction. The federal budget deficit is too large and the public sector must get out of the capital markets in order to leave more

room for the funding of private sector capital projects. Honesty in our budget processes and projections is essential to the public taking Washington seriously. And far more important than the details of any short-run counter cyclical measures is the necessity to focus more on our long term prospects. We need a long-run program, not a short-run reaction. Our budget making machinery is broken, and everyone knows it.

II. CURRENT CONDITIONS AND PROSPECTS

The U.S. economy is near—but not at—the end of the longest recession in the postwar era. 1991 ended and 1992 began on a weak note. The recession started in July 1990 and is now 19 months old. An upturn is not expected for a few more months. More depressing economic statistics are on the horizon.

During the summer months of 1991, after the Persian Gulf War, a pick-up in inventory building and a modest resurgence in consumer spending after the Persian Gulf war lifted the economy temporarily, but the economy is clearly sinking again. Economic activity should turn up in the spring, in response to the sharp drop in interest rates. Typically in recessions, skepticism is voiced about the future benefits of lower interest rates—and that skepticism is finally proven wrong. This past pattern will again be repeated, but the upturn will be delayed and sluggish.

The employment situation is very troubling despite the fact that the unemployment rate has risen much less than in many prior cycles. Typically, the majority of layoffs are temporary, associated with inventory excesses. As a consequence, those unemployed can look forward to returning to work in their prior job. But presently, the majority of layoffs appear to be permanent as companies restructure, exit various businesses and generally pare management layers and other non-essential employees.

This presents an entirely different prospect to the dismissed employee—the challenge of, perhaps, a new career with a new employer in a new industry. This chilling prospect is largely responsible for the seriously depressed state of consumer confidence. Job conditions will need to improve for several months before consumer spending—two-thirds of the economy—can be counted on as a source of cyclical strength.

The recovery, when it does occur, is expected to be about half as fast as normal. During the postwar era, the average real growth rate in the first six quarters of recoveries has been 6.4%. There are many reasons why the future recovery is expected to be slow and sluggish, not rapid and robust.

Consumers are highly leveraged. Consumers are worried about the value of their most important asset—their house. Businesses are highly leveraged. A major lift from inventory building is unlikely. Capital spending is expected to recover only very slowly. Our trade sector is likely to be a drag on the economy. The degree of fiscal stimulus available will be restricted by past fiscal actions. The problems of the state and local government are going to be a drag on the economy for years. And finally, the commercial banks do not have the wherewithal to provide their usual amount of cyclical lift.

While recessions come and go, and this one will to, the aforementioned problems will not be quickly reversed. Many of them have a structured as well as a cyclical component—hence the imperative of a major structural focus in Washington's repair actions.

The particular circumstances in a few sectors deserve mention because they suggest what might or might not be fruitful policy. The consumer leveraging of the 1980s was extreme—and is well known.

Health care costs will continue to escalate with the aging population and the ongoing advances in technology, further reducing consumer spending on all other items. Health care is the least discretionary of consumer spending—or in some sense one hopes that would be the case. Even a broad across-the-board income tax cut is unlikely to ignite a major consumer spending splurge.

The commercial real estate excesses of the 1980s will take a decade or more to absorb. And the state and local budgets are further out of balance now than at any time in the last 50 years. Tax hikes and spending cuts will be the rule rather than the exception at the state and local governments for years.

Housing is the most promising sector in the economy. A 33-to-50% pickup in housing activity over the next 18 months is a reasonable expectation. House prices are once again rising in most parts of the nation, so that housing is no longer viewed as potentially a depreciating asset to be avoided. Mortgage refinancing applications are up sharply, and the average homeowner can enjoy greatly reduced monthly mortgage payments from refinancing at the current prevailing rates. Some of these mortgage-payment savings will likely find their way into a broad range of consumer purchases. The economic-recovery benefits of these reduced mortgage payments will swamp any conceivable consumer tax stimulus now being considered.

The Federal Reserve's reduction in the discount rate from 4.5% to 3.5% on December 20, 1991 was decisive. Additionally, in speech after speech since then, a variety of Federal Reserve officials have specifically noted that they would be prepared to ease monetary policy even further should the economy continue to tumble. Both short-term and long-term interest rates are down to levels that should begin to lift the economy. A modest further decline in short-term rates is expected in the next few months before they stablilize in the second half of the year.

Long-term interest rates are expected to stay in a relatively narrow trading range throughout 1992. Unless the fiscal stimulus measures now contemplated in Washington become excessive, no major movement in long-term interest rates should occur. In addition, the spread between short-term and long-term interest rates should remain relatively wide for the next year or two as well.

The current debate about reducing the size of the 30-year Treasury bond auctions is a small item, not a large one. The rationale is that long-term interest rates would fall, helping the economy. Long-term interest rates might fall slightly, further yielding a reduction in net interest costs to the government. This would be a small plus to our economy and to the markets. But later, if long-term borrowing would need to be increased, as would almost certainly be the case, the reversal in policy would be perceived very negatively.

And with many short-term interest rates at their lowest level in 20 years or more, it should be remembered that this decline in interest rates is a minus to lenders (CD holders for example) just as it is a plus to borrowers. But, make no mistake about it. The decline in interest rates in 1991 is a major net positive to the economy.

Corporate profits have been severely squeezed in recent years, and have contributed to the poor job picture and reduced the level of capital spending. As measured by the S&P 500 earnings per share series, 1989-to-1991 was the first decline in three consecutive years since 1956-to-1958. On the positive side, the interest expense decline will amount to perhaps one-third of the increase in corporate profits in 1992, thus improving the climate for productivity growth and investment in plant and equipment.

Inflation is not a worry. The so-called core CPI (the consumer price index excluding food and energy) is expected to rise in the vicinity of 3.5% in 1992. Labor markets are weak, excess supply characterizes most product and commodity markets, and the economy is not strong enough to support a resurgence of inflation. The risk of a troublesome rise in inflation is minimal. In general, fiscal measures contemplated at present should not be constrained by the fear of higher inflation.

III. POLICY CONSIDERATIONS

A weak economy and an election year is an incendiary combination in Washington. While there certainly are a variety of fiscal "dos and don'ts," most important is that whatever fiscal package is enacted must be one which enhances our long-run economic prospects and, accordingly, is one that will build people's confidence about our future.

It has been 15 years since Jimmy Carter was inaugurated, and 11 years since Ronald Reagan was inaugurated. If we had adopted truly creative and bold long-term growth-enchancing policies then, they would be bearing fruit now. But instead, we continue to stagger. Our long-run growth prospects are diminishing. And while our present cycle is painful, what we have is not really a crisis, but a chronic condition. Unless repairs are made, some painful in the short-run, things will get worse. The public understands this. And the public would be heartened and encouraged, not angry and dismayed with policies that have a truly positive long-run component. The American public is disillusioned with our economic decision making in Washington. Every year we make economic assumptions which are too optimistic. Every year, our budget estimates prove too optimistic. We have a fiscal result not a fiscal policy. The current recession is likely to end during 1992 even without any discretionary new fiscal measures. Monetary stimulus will take care of that. In addition, by the time any presently contemplated fiscal

measures take hold, the recovery already will have begun. As a result, the present is a perfect opportunity to convert the current pressure to do something in order to give the economy a short-run lift, into an opportunity to make changes that would yield long-run benefits. For too long there has been a fundamental asymmetry in the type of policy choices we made in Washington. We tend, as a society, to choose policies that have short-run benefits but long-run costs. And we tend to avoid policies that have long-run benefits but short-run costs. The reason is clear—the time horizon is the next election. I am encouraged that for the first time in my memory, at least some consideration is being given to the long-run consequence of the various fiscal changes now on the table.

Perhaps the most destructive event for the economy at present would be for a bidding war on tax policy to erupt in Washington. Very damaging would be a typical election-year compromise, in which the Republicans want X, the Democrats want Y, and the "compromise" is to do both. The public knows that these short-run fiscal stimulants whereby the government borrows in the capital markets in order to grant people tax relief are of no lasting value. They do not contribute to our long-run economic health in any way, and do not contribute to our productive capacity or international competitiveness. While we economists often speak with decimal-point precision about the economic consequences of various fiscal measures, such precision is simply not attainable. Any short-run stimulus measures which raise the budget deficit materially in an election-year effort to lift the economy would be viewed very negatively in the capital markets. The attendant increase in long term interest rates might offset any direct benefit to the economy from the fiscal stimulus applied.

A broad middle class income tax rate cut is to be avoided. It would be an ineffective short-run fix, and would send the wrong signal. The signal would be that the government can "fix it." With the huge, recurring federal deficits, the public knows better.

The proper fix is structural, not a check in the mail or reduced withholding. As a corollary, it is important not to confuse tax stimulus with issues of tax equity and fairness.

While it can be argued that the tax code is unfair, income redistribution is a matter quite different from the issue of tax stimulus. If you wish to redistribute income, take that issue up on its own merits.

Our saving rate is among the lowest in the world—inappropriate for a society that is aging as fast as is ours, and that has such a deeply embedded transfer payment structure. We should encourage increased savings relative to consumption in a further liberalization of the IRA rules. Indeed, encouraging savings targeted to education, health care, long term care or other objectives deemed worthwhile deserve consideration. Remember that the middle initial in IRA is retirement and allowing the use of the earmarked funds for other purposes would be a mistake. Also, to reinstate the tax deductability of consumer interest expenses would be a step back, perhaps supported by some as an election-year measure, but unattractive to all in the long-run.

Encouraging greater direct business investment through the tax code should be considered, perhaps via the reinstatement of the investment tax credit or through a well thought out accelerated depreciation plan. Either would lower the after-tax cost of capital thus encouraging investment which would have long-run benefits by providing a newer and more efficient capital stock.

A reduction in the capital gains tax rate on new investment also deserves to be part of any new fiscal stimulus package. Do not get bogged down in largely philosophical, fruitless and endless debates about the estimated revenue impacts associated with a capital gains tax cut—these arguments are not about to be resolved. Recognize up front that the direct benefits do go disproportionately to the high income earners because they are the ones

with savings and capital to invest. But also recognize that the individual benefits of the greater entrepreneurial activity will accrue to all in the labor force—at all income levels.

Do not commit to a major new round of grants-in-aid to the state and localities. The public knows that Uncle Sam doesn't have the money to do that. And as the budgetary problems mount at the state and local governments, as they inevitably will, hard choices will be required. That is what governing in an environment of finite resources and infinite needs is all about. The states and localities, I suspect, will do a better job of exercising some discipline than has Washington. And we all are the victims of our increasing inclination to promise more than we can deliver in the postwar years.

The corollary to this point is that mandates do have costs although perhaps not in the federal budget accounts. This tendency for Uncle Sam to send the programs and the responsibilities—but not the money—to the governors and mayors is not fooling anyone.

The world is a vastly different place from when the budget deal of October 1990 was struck. While I am not an expert on defense, with the cold war over, major cuts in defense would seem feasible. The basic point on defense is to spend what defense considerations demand. And while we might argue about the size of the so-called peace dividend, do not give it away in a one-year consumer tax cutting frenzy. Rather, spend it (invest it if you prefer that terminology) on those programs that provide long-run benefits to the economy—education, Head Start, infrastructure, the drug problem, etc.

IV. CONCLUSION

Every recession brings pain to people's attention because it grows—and is both concentrated and diffused at the same time.

But far more important is the day-to-day erosion in our economic performance associated with decades of incoherent fiscal policy which focus on the short-run, not on the long-run. Unless there is a metamorphosis in Washington, and I am skeptical, the 1990's promise to be the slowest decade of economic growth since the 1930's. We will suffer, but far more important, future generations will suffer even more.

If you really want to give the voters an election year gift from Washington, don't try to devise a fool proof quick fix. Rather, go for the long-run wealth creating steps of increasing our savings and investment, rebuilding our capital stock both physical and human, both public and private. Only in that way will we enhance our competitiveness worldwide and permanently lift our standard of living.

And my own view is that the public is tired of these quick-fixes. I think you would find that good economic policy in the long-run would be even better politics.

SENATOR SARBANES. Thank you very much.

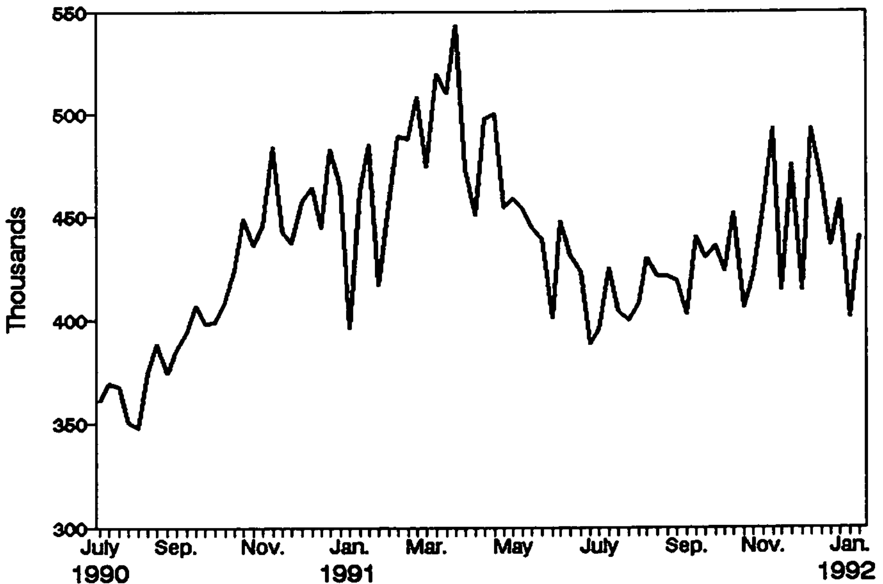
Gentlemen, I want to try to run through a series of questions and get the view of each of you—hopefully, briefly—so that we will be able to get a range of opinion here.

Before I begin that, though, Dr. Straszheim, I would like to ask you: You said, do not pay attention to these short-run wiggles and jiggles in the economy. Is that right?

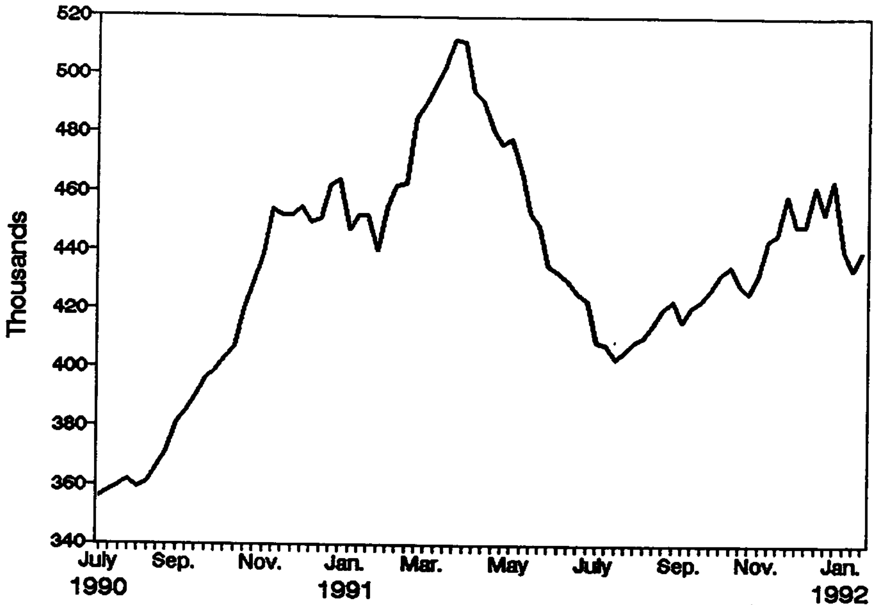
MR. STRASZHEIM. Yes.

SENATOR SARBANES. I want to ask you, first of all, there is a lot of wiggling and jiggling in this chart. These are initial claims for unemployment insurance. Of course, the point I am trying to make is that for some people what you call a short-run wiggle or jiggle in the economy is survival. (See chart below).

This is what has been happening to unemployment insurance claims. This is 1990. It went up and came back down, and now it is obviously moving back up again. The latest weekly figure moved back up.



We have also done a moving average which shows this same sort of thing, although it does not have all the wiggling and jiggling in it. (See chart below).



Let me ask each of you: Should we extend unemployment insurance benefits?

MR. STRASZHEIM. Yes. I would do that. But let me just say more about the term "short-run wiggles and jiggles."

We are not going to outlaw recessions and business cycles in this economy, I do not think. The economy goes up and down. Recessions come and go, and this one will, too.

It is fine to have some short-run view about alleviating the short-run pain. But far more important to relieving the pain of the American workers and the American family would be to have a coherent fiscal policy in place which had a long-run focus.

Twenty-five years ago, the view on our GNP potential in this Committee was 4.3 percent. Now, we are down to about 2.5 percent. That 1.8 percentage point difference is about half productivity and half demographics. We can ignore the demographics. But to slow down, productivity is a self-inflicted wound.

If we were to create policy that has a long-run focus, we would have dramatically reduce the overall suffering a lot more than focusing on relieving some short-run pain whenever we have one of these cycles.

SENATOR SARBANES. The fact of the matter is that we ought to do both, and our international competitors in fact do both.

Now, all the European countries have a much more developed safety net to handle the unemployed in the downturn, and they also have an investment strategy that is a better—at least, as I perceive it—than we have.

For the life of me, I do not see why these two things have to be put in something of an either/or framework.

MR. STRASZHEIM. You can certainly do some of each.

My own view is that over the past 25 years, whenever we have gotten into recessions, all we have thought about is relieving the short-run pain. Then, when we are not in a recession, we never think about putting in place these long-run programs that are going to be beneficial to our economy over the longer period of time.

SENATOR SARBANES. Obviously, you should think of those. But once you are into a recession, you have to think of the short-run pain because these people are getting thrown out of their homes, and they cannot put food on the table, etc.

MR. STRASZHEIM. Certainly. But we need——

SENATOR SARBANES. Dr. Silvia, do we need to extend the Unemployment benefits?

MR. SILVIA. My answer would be "yes," and we need to look at long-term fiscal policy change, including, again——

SENATOR SARBANES. All right. Mr. Ratajzcak?

MR. SILVIA. ——looking at Europe and Japan, in terms of their capital gains and their investments.

MR. RATAJZCAK. Yes, I mean the Unemployment——

SENATOR SARBANES. And their public investments, too.

MR. RATAJZCAK. Yes. The Unemployment Compensation is designed——

SENATOR SARBANES. Wait a minute. I want to make sure on this point from Dr. Silvia.

And their public investments?

MR. SILVIA. And their public infrastructure, sure.

SENATOR SARBANES. What we see when we look at that is that they are investing in public infrastructure at a significantly higher percentage of their GDP than we are.

Is that correct?

MR. SILVIA. It takes me almost an hour to get from Midtown Manhattan down to Don's office.

SENATOR SARBANES. There it is. It is right out of your productivity.

MR. SILVIA. And that is a long time.

SENATOR SARBANES. It is right out of your productivity.

Mr. Ratajzcak?

MR. RATAJZCAK. I think the Unemployment Compensation Program is designed to relieve short-run burdens. Let me say one thing, though——

SENATOR SARBANES. It is also countercyclical.

MR. RATAJZCAK. Oh, yes. And indeed that is what it was designed for, and it should be extended until its fundamental need is no longer apparent, meaning that the unemployment problem is starting to go away.

But let me say one thing about it.

The Congress right now, I think, in terms of trying to deal with equity, establishes the extension of the unemployment benefits based upon unemployment rates in particular areas.

I come from a state right now where the unemployment rate, as reported by the BLS, fell over a percentage point in the last year, but the number-of-jobs-declined is about sixth in the total number of states outstanding.

We do think that, perhaps, the BLS does not have an appropriate sample.

To limit our state to less extension than other states because there is a statistical measure that says there are fewer people seeking work in our state, I think, is inappropriate.

I think, if the burden is there, extend the unemployment claims the same throughout the country.

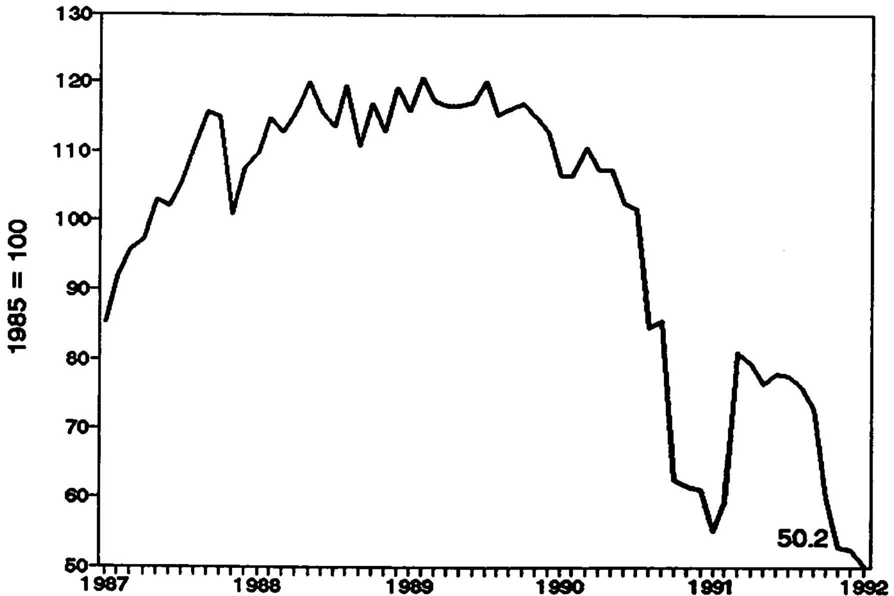
SENATOR SARBANES. Okay. Dr. Chimerine?

MR. CHIMERINE. Absolutely. And, in fact, on a short-term basis, I would consider increasing funding for the other safety net programs that were ravaged in the 1980s.

That it is probably a better stimulus package because the marginal propensity to spend out of these programs is very high. But from humane grounds, absolutely.

SENATOR SARBANES. Now, let me ask another question.

This is the Consumer Confidence Index from the Conference Board. (See chart below). As we can see, it literally fell off the shelf over here. Then, it started back up. Now, it has fallen off the shelf again.



In fact, I think it is at the lowest—I was going to say the lowest it has ever been, but I think there was one other time since they began keeping this index when it was lower than where it is right now.

The question I want to put to you is: What is behind this? Why is consumer confidence so far down?

Now, Mr. Straszheim, you touched on it and laid out one factor. I am inclined to think that there is more than one factor, and I want to hear from each of you.

You laid out, I think, a very important point, which was that there is a restructuring of industry going on. People are not being laid off and being told, when conditions pick up, we are going to call you back in. They are being told: You are finished; there is no more job here; out; clean your stuff out.

In fact, we have some figures that show that the percentage of people who are on layoff in this recession is significantly less than in previous recessions by very substantial margins.

So, people are not being laid off with the expectation of being called back. They are being terminated.

Mr. Chimerine. Right.

Senator Sarbanes. So, I agree with you. I think that is one factor. But I would like to hear, and, in fact, I am asking: Why is consumer confidence down like this?

Why do we not run right through the panel.

MR. CHIMERINE. I think, Mr. Chairman, there are three or four reasons.

First and foremost is job anxiety. As everyone here has pointed out, job losses have spread across industries and occupations that have never had them before and, as a result, a large segment of the population is worried about their jobs.

I think a second factor is the decline in housing prices which, for most people, represents the largest portion of their net worth.

I think third and quite frankly, the finger-pointing, gridlock, lack of a coherent plan and so on in Washington certainly does not make people in this country feel good. If anything, it is adding to the other concerns.

Then, I think there is a fourth factor. I think the public is way ahead of Washington on the curve right now, and particularly ahead of the Administration.

I think the overwhelming majority of Americans right now think that this economy is off the track and that there are some very serious, fundamental, long-term problems.

They are not living as well, in many cases. They are concerned their kids will not live as well.

I think that is also reflected in the current weakness in confidence.

MR. RATAJZCAK. I think the answer is the same thing. Until this recession, I actually had an equation that could estimate consumer confidence based upon the change in employment, interest rates and inflation.

It is clear. It started with the War, with your first dip, where clearly consumer confidence collapsed more than economic conditions would warrant. And as I say, we had the postwar euphoria.

This second collapse, I think, is fundamental. Consumers are not looking at current economic conditions and formulating their assumptions. They are looking at longer term conditions.

They feel major problems that they had overlooked and were not as concerned about in the past, they feel those problems now and that is why, in fact, they are downsizing their expectations and lowering their feelings of where they are going to be in the future. And that is what is undermining confidence.

I also agree with the leadership issue. The consumer is recognizing that there are structural problems in this economy that we have not been addressing. They are concerned that they do not see any movement toward addressing them.

SENATOR SARBANES. Dr. Silvia?

MR. SILVIA. Sure. Part of the issue, I think, has already been addressed by Larry and Don. But primarily when we talk about the consumer confidence issue, we are talking about jobs.

We have one difficulty because many companies announce layoffs, but they do not identify who is getting laid off. That is a real issue.

When you tell 10,000 people that we are going to lay off 1,000 of you, but we are not going to tell you who until two months from now, I think that is a real problem with respect to consumer confidence.

SENATOR SARBANES. You freeze everybody, do you not?

MR. SILVIA. You freeze everybody in place, and nobody is willing to spend any money because they are quite unsure about what is going on.

In terms of longer term conditions, certainly we have had the surprises in inflation expectations. With respect to the debt burden that people have to carry and the certainty with which they expected their house price to go up, those two premises of much of our activity in the 1970s and 1980s is gone.

I agree with Larry on that, because when you say that your house is no longer as certain a valuable asset as it was, or it is no longer as certain a bet as it was to make money 5, 10, 15 years ago, you have really changed the fundamentals.

Then finally, the last biggest bet that did not turn out right was all the college educated people who wanted to get service jobs and all of a sudden found out in the last two or three years that white-collar people get unemployed, as well.

In fact, I think it was even commented on earlier this morning that past recessions tended to be blue-collar recessions, but white-collar people never got unemployed.

This time, a whole generation has found out that their college education was not a ticket to permanent employment. And, in fact, that whole generation has been very surprised.

When we talk about lawyers or accountants, certainly those types of individuals with their professions and the high esteem of their professions never expected to be unemployed in the way they were in the last two or three years.

So, I would agree with the panel, in general, about jobs being key. But also, changes in debt burdens and housing prices; the type of unemployment is quite different; I think that is what it all goes into.

That is why it makes it different now than what it was in prior recoveries or recession periods.

SENATOR SARBANES. Don?

MR. STRASZHEIM. Mr. Chairman, you have gotten some explanations of why it went down.

The question now is: What would make it go up? Would $500 per child make it go up? I do not think so.

Changing withholding? No. Families know what saving is. Families save now. They endure pain by not going out to dinner now so that they can have their vacation next year, or buy the new car then, or whatever.

What I think would make this consumer confidence rise is if people had confidence in Washington that we were on the right track. Larry said we were on the wrong track. I quite agree.

If people had confidence that we were on the right track, that policy was turning in such a way that would lift our long-run growth rate, and

lift their prospects from two, three, five and ten years ago, I think that would be an enormous plus to long-run confidence.

SENATOR SARBANES. Okay. Now, let me try out some ideas on the four of you.

Even into late November, the President was publicly saying there was no recession—just this November.

Now, it is my view that the country knew there was a problem, and it was upsetting to the country to have the President saying "no problem."

Does anyone disagree with that view?

I mean, it goes with this policymaking problem, although you all are thinking in broader terms of the gridlock, which, hopefully, we may be able to avoid now. But clearly, we had a situation in which many in the Congress were saying there is a problem, and the President was saying "no problem."

The country was saying: What is he talking about? There is a problem. We feel there is a problem.

Does anyone disagree with that?

MR. CHIMERINE. I not only agree with that, Mr. Chairman, but I think it is even more serious than that, because I think it created the widespread impression that the Administration really does not know what is going on—which I think has been true.

I think the President has consistently been getting bad advice. They certainly have not recognized the seriousness of the decline.

Then, when they did recognize it, he started blaming economists for bad forecasts; then the Fed for acting too slowly. Then, it was Saddam Hussein.

The whining and the finger-pointing, I think, has become very counterproductive and has worsened confidence, because people feel he is either sweeping the problems under the rug and ignoring our problems; or, second, when they do emerge, we do not have constructive solutions.

SENATOR SARBANES. Well, even on a very simple thing—and I agree with your point that unemployment insurance benefits are the palliative that you use in a crisis—nevertheless, three times we had a try last year, in August, September, and finally at Thanksgiving.

Meanwhile, a lot of people fell off the cliff because of the delay. You did not get an earlier counter-cyclical impact, for whatever that would have been worth.

Dr. Silvia?

MR. SILVIA. Mr. Chairman, thank you.

I think many of the comments have tried to identify problems that really existed long before last November.

SENATOR SARBANES. Right.

MR. SILVIA. We have been talking about issues like productivity, capital formation, Head Start spending, infrastructure that have been going on for two or three years.

I think, when we look at that and we say, well, there is no recession, that is really not the issue. The issue is why did we get where we are now?

It has been a longer term process than just a short-term change in any particular activity. I think we need to focus again on a long-term type fiscal policy.

What do we really want to change to make the United States more competitive and make our workers more productive?

SENATOR SARBANES. Well, you have to have a short-run and a long-run strategy, and you have to integrate them to the extent possible so that what you do in the short run is not counterproductive with what you want to do in the long run, unless you are absolutely compelled by circumstances.

I do not think we have reached that point yet.

MR. SILVIA. But if you set up——

SENATOR SARBANES. You know, Senator Sasser and I put out a program that has both short-run and long-run components to it, and we recognize the need to link the two. But we are in a recession. If we do not get out of it, we are going to drag down even further our ability to move this economy.

We have a deficit problem, and the deficit is going up because of the recession.

MR. SILVIA. I certainly wish you good luck in linking the two in order to make sure that the long-run program, in terms of capital formation and productivity, really gets done.

SENATOR SARBANES. Let me ask you this question: Do you think that the stagnation of incomes has contributed to this drop in consumer confidence?

Last year, real incomes went down.

In 1981-82, that did not happen. The unemployment rate went way up—actually, it was the highest since the depression, much higher than it is now—but the people who were still working, in effect, were still improving their living situation.

Yesterday, the Commerce Department released figures on disposable personal income per capital for the fourth quarter 1991. It shows two troubling precedents.

For only the second time in the postwar period, personal income after tax fell from one calendar year to the next. And for the first time in the postwar period, per capita income after tax fell over a three-year period.

You mentioned that, to the extent people were sustaining their incomes, it was because they were working longer hours. There has been a study done that supports that.

Do you think that that has contributed to the drop in consumer confidence?

MR. RATAJZCAK. I think there is no question that what the consumer is seeing is that they are not getting the promotions, the raises, the

employment opportunities, and a lot of these are the promotions and raises that they had had in the past. That is why they are, in fact, deciding that they will not be able to grow out, in terms of job increases, of their current debt structure, and, therefore, they have to cut back now to get that debt back under control.

There is no question that the consumer has a good basis for the reduction in confidence. They are seeing their current earning power as not increasing, and they do not see prospects for it increasing in the future.

MR. CHIMERINE. Mr. Chairman, could I quickly comment on that?

SENATOR SARBANES. Certainly.

MR. CHIMERINE. I think you have to add another element into the 1980s.

In addition to sending another member of the family to generate income and working more hours, one of the vehicles that many families used to maintain or raise their living standards was borrowing more.

I do not think——

SENATOR SARBANES. Was what?

MR. CHIMERINE. Borrowing more.

SENATOR SARBANES. Yes.

MR. CHIMERINE. I do not think that the big debt buildup was simply based on inflation expectations. I think it was an effort on the part of many families to continue to maintain their living standards while their income was being squeezed.

For a large segment of this population, real incomes have not been rising for a long time. It has probably even worsened in the last couple of years.

So, I think this, to some extent, does reflect a worsening feeling. People do not feel they are getting ahead anymore. It is a long-term problem that has been building. Now that they have used up all the options—they have already borrowed as much as they could, they have sent everybody in the family out to work—there is nothing else.

SENATOR SARBANES. They have "hit the wall," so to speak.

MR. CHIMERINE. They have hit the wall.

SENATOR SARBANES. Now, there is one other idea that I want to test on you concerning consumer confidence.

Here I differ, to some extent, with Dr. Straszheim on the question of grants-in-aid to states and localities. It is my view that the intense fiscal squeeze is being felt at the state and local level. This means local papers are dominated every day by stories of cutting back on police when safety is a major problem; furloughing teachers; closing the schools down for a week; shelving infrastructure projects when, you know, the bridge is about to collapse—they were going to repair it, and now they are not going to repair it. So, now they may even have to have a detour or something to close it down, but there is no prospect of rebuilding it.

In the *Baltimore Sun* this morning, the whole front page is filled with the budget that the Governor has sent to the legislature, which is just such a doomsday budget and so forth.

It is my view that that causes people to think that there is something really going wrong here; this thing is not working right. Many are now beginning to perceive that the cuts are well below the level of water and fat; they are into muscle and bone.

This helps to bring about a turndown in consumer confidence because it creates a general sense that they are being hit with it all the time on their local television, local radio, local newspapers, that things just are not working right.

So, they pull back. The reaction to that is to become even more cautious and play it safe.

What is your view of that?

MR. STRASZHEIM. Senator, I think that is exactly right. The state and local budget situation is farther out of balance now than in the 1974-75 recession; farther out of balance than in 1981-82——

SENATOR SARBANES. We have had testimony that this is the first downturn in which state and local fiscal policy has been contractionary in a major way; therefore, helping to contribute to the downturn in a macro sense, let alone hurt the quality of life, in terms of the particular services that are being cut.

MR. STRASZHEIM. I understand. And in every state in the country, virtually, there are these headlines about the budget problems, and the Mayor does not have the money, and so forth.

The question, I think, is, would Uncle Sam borrowing some money and giving it to the states and localities be regarded as a step forward in our broad economic performance?

SENATOR SARBANES. Well, let us talk about——

MR. STRASZHEIM. And would that contribute to confidence?

SENATOR SARBANES. All right. Let's talk about "limited and temporary."

You say "major new round," which implies a permanent increase, but you support one that is limited and temporary. The mayors and governors have both assured us that they have a lot of projects sitting on the shelf that they could move tomorrow morning, which would create jobs and build infrastructure, and that clearly needs to be done. It is not make-believe infrastructure. It is projects that have been planned and programmed, and now they have had to shelve them. They are going to have to be done some day.

A lot of mayors would like to do them now because they are getting terrific bids. I mean, if they can find the money to put these bids out, they are getting a terrific response. They are really getting, they feel, real value for money. They are getting a value for their money—all these bids are coming in well below estimates.

So, what would be wrong with that?

MR. STRASZHEIM. I said earlier that I thought we ought to be spending more on infrastructure, and I meant it. It would be a long-run plus.

If you used the tax stimulus, whatever amount that you think you have available for that kind of measure, as opposed to $500-per-child measure, I think that would distinctly be a positive.

It ought to definitely be temporary. There is this mismatch between the fact that the roads have pot holes, the bridges are closed, and there are all these unemployed workers.

Something of that sort I think would be fine.

MR. SILVIA. Again, Mr. Chairman, spending is not really the issue. It is what kind of spending are you talking about. An infrastructure is a quite different animal.

SENATOR SARBANES. Right.

MR. CHIMERINE. Can I comment?

SENATOR SARBANES. Yes. Certainly.

MR. CHIMERINE. I would make two or three very quick comments, Mr. Chairman.

First, to some extent—not completely—but to some extent, the problems at the state and local level right now are another reflection of the incredible irresponsibility in Washington in the last ten years, because we have cut grants-in-aid sharply; otherwise, we would have even bigger federal deficits.

What we have done is, to some extent, just shift the problem down to the state and local level.

Second, I don't see how anyone can disagree with the notion that we, again, partly because of our deficits, have been neglecting infrastructure. Not only repairing the existing infrastructure, but making too limited investments in the infrastructure of the future, whether it be fiber optics networks, and whether it be smart highways, and the kinds of things that our foreign competitors are doing, which are very likely to give them a productivity and competitive advantage over us in the future if we do not catch up.

I strongly favor significantly increasing infrastructure spending on a permanent basis. That does not mean 50 years, but 5 years, whatever, putting money into this.

The mechanism by which we do it—by putting money into the grants-in-aid programs or in other ways—I am not sure about, but I think you have to start with the notion that this ought to be one of the areas of investment that is desperately needed in this country.

If we do it right, hopefully, it can add some short-term stimulus, as well. Whether we do it by giving money directly to the mayors, or whatever, I think is a secondary issue. But it seems to me that this ought to be a significant part of both a short- and a long-term program for this country.

SENATOR SARBANES. Yes.

MR. SILVIA. But it is a permanent change.

SENATOR SARBANES. Pardon?

MR. SILVIA. It is not, one year, let us take from fiscal 1993 and put it in 1992. It is a permanent change.

MR. CHIMERINE. Oh, yes; a permanent change, yes.

MR. RATAJZCAK. Well, but you can do both.

MR. CHIMERINE. But the sooner you can do it, the more benefit you get in the short term.

MR. RATAJZCAK. I mean, why not——

SENATOR SARBANES. I think, to address the recession, we need to frontload a lot of existing programs. We passed the Surface Transportation bill last year. There is not much argument that the purposes of the bill are highly desirable.

And, yet, the Administration's budget, which we have just received, actually proposes to cut back on the levels of commitment to transportation from last year.

On the one hand, you have this bill that is moving in the right direction, then, you get a budget which moves in the opposite direction.

Jim Tobin said in testimony earlier this month—and I want to get your reaction to this—that he is prepared to use fiscal policy as well as monetary policy. You may want to separate out the two, but just let me read you his comment:

> I would like to emphasize that there is little up-side risk in stimulative monetary and fiscal demand management for the next two years. That is, there is small likelihood that Chairman Greenspan is going to find the economy so exuberant and a step-up of inflation so threatening that the Fed will need to slam on the monetary brakes.
>
> The down-side risk, continued sluggishness or further recession, is asymmetrically large.

Now, on monetary policy first, do you agree with that?

MR. CHIMERINE. I agree, with one slight caveat. I agree that we need stimulus in the short term. It should be designed to help achieve our long-term objectives, and the risks in the economy now are really on the downside.

My only concern about monetary policy is, I am wondering if we are creating a problem for ourselves with the level of short-term rates that we already have.

I mean, when I see people taking money out of CDs and putting them into biotechnology stocks at 80 times earnings, I am not sure that is so healthy either.

The question I am asking is: If we keep pushing short rates down so dramatically, at what point are we going to trigger a massive outflow of money from the banks that will hurt banking and lending?

I do not know where that threshold is, but other than that, I agree completely with the statement that there is very little to risk in terms of more inflation, or over-stimulating the economy.

MR. RATAJZCAK. Well, I think your problem with the Fed, and why some of us would probably be hesitant to go as far as Jim Tobin, is the

evidence that they always overreact. They overreact on the upside, and they overreact on the downside. They wait too late.

So, our concern is not when should the Fed stop stimulating, but will we be willing to have them stop stimulating when it is clear that the economic growth of the economy is moving above trend rates of growth.

If, at that point, we are perfectly willing to say that that is it, Fed, slow it down, there is absolutely nothing wrong with the Jim Tobin approach. But in the past, the evidence has been political pressures, hey, we have a good thing going, keep it rolling. As a result, we set up our conditions for the next downturn.

SENATOR SARBANES. Okay. That is a reasonable point. The pressure is about ten months here.

MR. CHIMERINE. There is no question that this year there is no problem.

SENATOR SARBANES. The political pressure is about ten months, and it might get you out of the recession. I want to get out of this recession because, otherwise, I think it is just going to drag us further down.

It is the recession that is killing revenues at the state and local level and causing this problem, and it is the recession that is driving the federal deficit up.

Both Samuelson and Tobin were also in favor now of some fiscal stimulus. What is your view on that?

MR. RATAJCZAK. I think that is the issue of whether we are dealing with a capital account or a consumption account. It makes imminent sense to do our bridge building, and do our highway development, and do whatever our infrastructure development—and I include all of the development of human capital in that—the educational programs and some of the health programs—it makes a lot of sense to do that when the cost of doing it is low. And the cost of doing it is low now.

So, corporations, if they have good financial capabilities, would in fact be doing it at this point. The Government of the United States certainly has the financial capacity to do the short-term borrowings to get benefits of the low cost generated with these programs.

But I think the point is, do not just spend and have government programs spend. It should be programs that have a long-term use to them that are on the capital side of the budget and will make long-term differences.

SENATOR SARBANES. Do you all feel that the Treasury should, through debt management, contribute to bringing long-term rates down by shifting to issuing short-term securities rather than long-term securities? And that, maybe, the Fed ought to be buying longer term securities when they want to add to reserves, in an effort to move the long-term rates down?

MR. CHIMERINE. I do not——

SENATOR SARBANES. Is there any problem with doing that? Some say, "well, it may not work, but it might work." It might have some beneficial effect, and I do not see what the harm of it would be.

MR. CHIMERINE. I agree with that, Mr. Chairman, as I implied earlier.

I would prefer that. Short-term rates might be wonderful for the stock market, but it is long-term interest rates that drive the economy. The focus ought to be on getting long-term rates lower.

We have already done an enormous amount on the short end of the market.

SENATOR SARBANES. The refinancing rate on mortgages in Baltimore, according to the morning paper, has just gone back up from 8 percent to 9 percent on the basis of supposedly—I mean, who knows—of Greenspan's testimony of the other day.

Long-term marketers think the economy is going to come out of it, so all of a sudden, just as we are coming up out of the water, we get pushed back down again.

MR. CHIMERINE. Mr. Chairman, can I answer your question about fiscal policy because I have to leave——

SENATOR SARBANES. Yes, do it very quickly. We have a vote on, and I am going to have to leave here in two minutes. We are going to finish the hearing. So, very quickly.

MR. RATAJZCAK. Let me answer that one——

SENATOR SARBANES. Let me get Dr. Straszheim.

MR. STRASZHEIM. Let me make two points. On the housing refinancing, the banks are just swamped. Why not raise mortgage rates right now to get the crowd out of the lobby? I think that is what is going on with this little blip-up in mortgage refinancing.

The second thing is, on reducing the long-term borrowing of Treasury, the one downside of that is that, at some point in the future, unknown exactly when, you would have to go the other direction. And when you did that and started to increase the long-term borrowing again, relative to short term, that would be a bad signal that you would be sending to the markets at precisely the time that you do not want to do that.

SENATOR SARBANES. It is wonderful. In this business, though, you know, if people drove a car the way you put it, as soon as you turn the wheel a little bit this way, you would just stay with it and you would do a 360-degree turn.

[Laughter.]

I mean, no one drives a car that way. They move it a little bit this way when the road bends, and they move it a little bit that way when the road bends.

I know that there is a political problem, but that does not happen. Greenspan is ready. He would sit still for a fiscal stimulus if he could be assured it would be temporary and limited. His fear is that, once you start it, there you go.

A number of you made the point that we might get into a bidding war on this proposed tax cut, which I think is a reasonable concern.

I have to leave.

I want to put one very quick question.

We are going to have CEA Chairman Michael Boskin in here on Thursday. What question would you put to him if you could be there to put a question to him. Very quickly.

MR. SILVIA. Where are your long-term savings incentives?

SENATOR SARBANES. Excuse me?

MR. SILVIA. Where are your long-term savings incentives?

SENATOR SARBANES. Okay.

MR. RATAJZCAK. I want to see a long-term strategy for this government, not a one-year quick fix.

SENATOR SARBANES. What is the economic strategy?

MR. RATAJZCAK. That is correct.

SENATOR SARBANES. I mean, I think we a lot of tactics the other night, but no strategy, frankly.

MR. CHIMERINE. That is question number one. Question number two is: Where is the evidence to support the conclusion that cutting the capital gains tax by 5 or 6 percentage points is going to produce the kind of long-term growth that they have suggested.

SENATOR SARBANES. Well, we have Boskin on the record in a previous hearing on that, comparing what would come out of that versus somewhat lower interest rates.

MR. STRASZHEIM. I would simply ask him to focus more on the long term.

SENATOR SARBANES. You do not think they have done that in their——

MR. STRASZHEIM. I do not think they have done that.

SENATOR SARBANES. Well, they have never done that all along.

I will just end with this comment, which is a very partisan one, in a sense—but the President said in his speech that he was going to talk about big things at the outset.

In my perception, he subsequently did not lay out a large vision.

I think we are at a turning point, in terms of what is happening in the cold war.

That opens up an opportunity to deal with some of these challenges which, perhaps, heretofore, we have not addressed. We really need an overall economic strategy for the country, and I do not think we have that yet.

Thank you all, very much. Your testimony has been very helpful.

The Committee stands adjourned.

[Whereupon, at 11:45 a.m., the Committee adjourned, subject to the call of the Chair.]

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