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HEARINGS

BEFORE THE

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THE 1992 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 6, 1992

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

The Committee met, pursuant to notice, at 11:10 a.m., in room SD–628, Dirksen Senate Office Building, Honorable Paul S. Sarbanes (chairman of the Committee) presiding.

Present: Senators Sarbanes, Bingaman, Mack, Roth and Smith; and Representatives Hamilton, Armey, Fish, Obey and Wylie.

Also present: William Buechner, Paul Taylor, Chris Frenze and Charla Worsham, professional staff members.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

Senator SARBANES. The Committee will come to order.

This morning the Joint Economic Committee is meeting to receive the 1992 Economic Report of the President. Our witnesses are the members of the Council of Economic Advisers—the President's chief economic adviser, Michael Boskin, and his colleagues on the Council, David Bradford and Paul Wonnacott.

Other members of the Administration may argue about whether we should label you the President's chief economic adviser, but we want to add some stature to the Council of Economic Advisers. So I am prepared to accord you that title here this morning, and if the Secretary of the Treasury or the Secretary of Housing and Urban Development is upset, for instance, why we'll just have to accept that.

Our hearing this morning comes at a difficult time for the economy. We are in the 19th month of recession. That makes it the longest recession since the Depression. Despite the siren songs last year that it would be short and shallow, it has not been short and not really shallow.

The forecast, as I understand it, is that the economy will recover by spring or summer. If I am not mistaken, I think this is what we were told last year, and if I am mistaken about that, I hope the Chairman will correct me in his testimony.

I frankly very much hope that this forecast proves to be correct, but I'm concerned by the evidence that I see. This morning the Labor Department reported 450,000 new claims for unemployment compensation in the week ending January 25, indicating that unemployment remains at a high level this month. In fact, the number of people filing initial claims for unemployment insurance has risen for the past 6 months and is now back to what it was a year ago when the economy was in a steep decline.

The unemployment rate in December rose to 7.1 percent, its highest level in the recession. That represents just under nine million people. If discouraged workers—people who have stopped looking for work because they

think they cannot find it, counted at 1.1 million—and people who are working part-time but want full-time work—in other words, they are looking for full-time work but only can find part-time work—are considered, then the unemployment rate according to the Bureau of Labor Statistics would be 10.4 percent.

The number of people unemployed long-term—27 weeks or more—has risen from 600,000 at the start of the recession to almost 1.5 million in December.

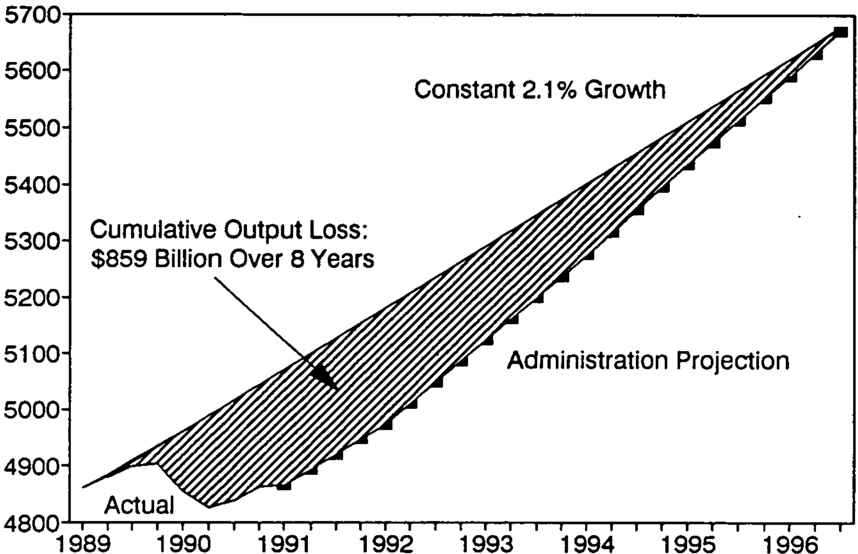
The most recent economic indicators for November and December show a continuing critical situation. The Index of Leading Indicators fell three-tenths of a percent in December. The Index of Coincident Indicators, which tracks the current state of the economy, rose slightly in December, but it is almost at its lowest level for this recession, and, of course, we are all aware of the plunge in consumer confidence, 35 percent during the last 7 months, which is now at a record low.

Throughout last year as the recession kept getting longer and longer, we were urged to simply stay the course and everything would come out all right. We were told that it was over and the recovery has begun. We tried to ease the human misery of the problem by extending unemployment benefits. The President twice rejected the congressional initiative and finally accepted it at Thanksgiving. He did propose another extension in his State of the Union Message, and the Congress has already acted upon that.

The final point I want to make is that even accepting your forecast, Chairman Boskin—and I've indicated that there is reason for some skepticism, although most of the forecasters are about where you are, give or take a bit—but even accepting it, it is a forecast for a very weak recovery; in fact, the weakest in postwar history. So, we will still be confronting the serious economic problems that have, in part, resulted from this downturn.

As I understand it, your forecast is for 2.2 percent growth from the last quarter of 1991 to the last quarter of 1992.

We took your premises which, as I have indicated, I am not certain that one necessarily ought to do, but even if you do that, this shows the percent change of real GDP that you forecast from the trough; in other words, coming out of this recession compared to recoveries from previous recessions (see chart below).



The red line is your projection. The blue lines are what actually happened in other recessions in the postwar period. I can go through each of them later, if you wish. But the chart shows how we came out of the previous recessions, in terms of growth, compared to your projections of how we will come out of this recession. The chart makes the point that the growth you are projecting is less than in any of those previous recoveries.

Unemployment, according to your projections, will barely improve in 1992. From the current rate of 7.1, it is expected to average 6.9 percent for 1992. And, as I understand it, it will be 1997 under your projections before the unemployment rate will get back to 5.3 percent, which is where it was before the recession began.

Now, that is 6 years before we return to the pre-recession level, and, of course, what that means is that there will be a significant loss in output as a consequence. We project the potential growth rate in your projection that, by the time we return to it, we get a loss of $859 billion over that period (see chart below).

We hope you will address these issues and, of course, a range of other issues in the course of your testimony. We are pleased to welcome you again and your two colleagues, David Bradford and Paul Wonnacott.

I'll now turn to members of the Committee who may wish to make an opening statement. First, Congressman Armey.

Representative ARMEY. Thank you, Mr. Chairman.

I have a formal opening statement and, with your leave, I'll put it in the record.

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

OPENING STATEMENT OF REPRESENTATIVE ARMEY

Representative ARMEY. With that then, let me just take a moment to welcome you, Chairman Boskin, Mr. Wonnacott and Mr. Bradford before the Committee. I look forward to your testimony.

As you might know or guess, I am and have been for some time a big fan of the concept of the Council of Economic Advisers and, in more personal terms, this particular Council of Economic Advisers.

So, I look forward to hearing from you today.

Thank you.

[The written opening statement of Representative Armey follows:]

WRITTEN OPENING STATEMENT OF REPRESENTATIVE ARMEY

I am pleased to welcome the members of the President's Council of Economic Advisors to this hearing of the Joint Economic Committee for the release of the 1992 Economic Report of the President. Chairman Michael J. Boskin, David F. Bradford and Paul Wonnacott have the distinguished research careers, the type of scholar that I sought as the chairman of a university economics department in Texas. They have further taken the plunge into the arena of policy-making in Washington, a contribution to public service that many tentured professors pass up.

I am especially pleased to welcome Dr. Boskin, Dr. Bradford and Dr. Wonnacott at a time when freedom to trade in open markets has been extended nearly universally around the world. The West has won, and the issue of United States security shifts decisively to our economic competitiveness around the globe. Economics now ascends to the top of our strategic concerns, and our primary enemies include the impediments to increased American productivity. This is a truly historic time for practitioners of economics.

The economic victories that we should be celebrating are currently mired in modest growth. The longer peacetime expansion experienced by the United States was brought down by equally large tax hikes and credit difficulties. Our real estate markets have been devastated by these difficulties. Much of the boat industry and the small airplane industry has been devastated by piling taxes upon slow growth. I applaud the Administration's call for repeal of the excise tax on boats and airplanes, a tax that has destroyed many blue collar jobs. We should not waste time before passing a strong growth package.

The Congress is ready to act on the tax proposals of the administration. I applaud the Chairman of the House Ways and Means Committee for indicating his willingness to act in less than a month, but one more problem stands in way of a victory of jobs and growth over partisan politics: the shameful tax scoring process of the Congress.

The mis-practice of the revenue and baseline estimating business has helped delay sensible tax changes that would have accelerated the current slow growth months ago. The Congressional Budget Office has just informed me that their 1990 capital gains realization projection was overestimated by a whopping 117 percent! It's no surprise that capital gains tax reform proposals had difficulty hurdling this falsely high baseline estimate that CBO passed on to Congress's Joint Tax Committee. Partisan numbers for partisan purposes. And of course, the JCT is the group that is still projecting that the misguided exercise tax on airplanes and boats would net $6 million each in Fiscal Year 1991. They will likely cause the loss of over $20 million in Federal income receipts alone, for a net loss of $17.3 million and over 9,000 jobs in FY 1991. If you punitively tax something, you get less of it. The growth debate over the next month must not be mislead by discredited static revenue analysis.

We in Congress must regain the confidence of all Americans over the coming month. I look forward to the economic debate today and results from Congress in the next month.

Senator SARBANES. Senator Bingaman.

Senator BINGAMAN. Mr. Chairman, I'll just wait for the question period. Thank you.

Senator SARBANES. Senator Roth.

Senator ROTH. Mr. Chairman, I'll do the same. It's a pleasure to have the three distinguished members of the Council before us.

Senator SARBANES. Congressman Obey.

Mr. OBEY. No statement.

Senator SARBANES. Congressman Fish.

Mr. FISH. Thank you, Mr. Chairman.

I welcome our witnesses, and I do not have an opening statement.

Senator SARBANES. Senator Smith.

Senator SMITH. No opening statement, Mr. Chairman.

Senator SARBANES. Congressman Wylie.

OPENING STATEMENT OF REPRESENTATIVE WYLIE

Representative WYLIE. Mr. Chairman, I am pleased to welcome the Administration's chief economic advisers here today and congratulate you on completing the 1992 Economic Report of the President.

I think that under your leadership, Dr. Boskin, the Council of Economic Advisors has assumed an influential role in policymaking over the past few years, and I believe that your sound advice, along with that of Dr. Wonnacott and Dr. Bradford, has served the Nation well.

The purpose of today's hearing is to discuss this year's Economic Report, and I know that all members are anxious to get on with that, but I think that under your leadership there will be positive economic growth and that we can reap much from the benefit of your advice.

Thank you very much, Mr. Chairman.

Senator SARBANES. Senator Mack.

Senator MACK. Mr. Chairman, sensing that there is the possibility for a record to be set here this morning for the shortest period of time consumed by opening statements, I certainly would not want to make one at this point. I will just welcome the witnesses.

Senator SARBANES. When I referred to Chairman Boskin as the President's chief economic adviser, and then in an abundance of caution, said that I hoped Secretary Brady or Secretary Kemp would not take umbrage with that, I probably should have mentioned Budget Director Darman, as well, since I understand he also competes for that title. We want to get all your competitors out on the playing field, as it were.

We would be happy to hear from you now.

STATEMENT OF THE HONORABLE MICHAEL BOSKIN, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS; ACCOMPANIED BY DAVID BRADFORD, MEMBER, COUNCIL OF ECONOMIC ADVISERS, AND PAUL WONNACOTT, MEMBER, COUNCIL OF ECONOMIC ADVISERS

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

I would like to do two things very briefly. You raised issues of the current state and prospective state of the economy and how we got here. I want to address them both. Before doing that, I would like to give a very brief overview of the Report. As you know, the——

Senator SARBANES. We have your detailed full statement before us, and, of course, we will include that in the record.

Mr. BOSKIN. I'll summarize that.

Senator SARBANES. Very good.

Mr. BOSKIN. My statement addresses primarily the current situation in the economy and is a summary of what is in the first couple of chapters in the Report. I'll mention a word or two about the Report, very briefly summarizing chapters 3 through 7, and then return to the current state of the economy. I suspect that that is what most people want to hear.

As you know, by tradition, the Report presents the Administration's interpretation of economic events, its economic outlook and policies. It's probably not widely known that about 45,000 copies of the Report are distributed, and almost all are sold. It is commonly used as a teaching device in college economic courses, as well as a data resource by professionals in many fields.

Again, I'll come back to the current state of the economy, recent problems, and the President's proposals in a moment. What I would like to do is just quickly summarize Chapters 3 through 7, which don't deal with the short term, but rather take a longer term perspective on things.

Chapter 3 deals with the longer term evolution of the American labor market, some of its remarkable achievements, and some of its great difficulties. It looks beyond the discussion of the recent economic problems in the labor market, such as the rise in unemployment and so on, that are discussed in Chapter 2.

In that sense, it takes a look at the last couple of decades and, individually, the last two decades relative to what came before. They were periods of some remarkable achievements and some difficulties as anybody might have guessed.

There was a 53 percent increase in employment, which far surpassed that of any other industrialized economy. For most there was hardly any growth at all. The earning power of workers increased in the last two decades, but it did so at a slower pace than during the first quarter century after World War II. The slower rate of productivity growth that started in the late 1960's is the primary cause of the slower rate of real wage growth.

Put in an historical perspective, the post-World War II growth in productivity was unusually high. Growth from the 1973 to 1981 period was abysmally low, but there has been a partial rebound since then.

In addition to factors found in labor markets, a key contributor to the low productivity growth rate can be found in capital markets, as the growth rate of capital per worker slowed after the early 1970's.

Investment and productivity growth rates have been low in the United States compared to other major industrialized countries. We're going to have to raise the rate of investment in the United States to achieve a higher rate of growth in our living standards.

Among the most notable features of the labor market in recent years has been the increase in earnings of college educated workers relative to those without college educations. At the same time, the work force has become progressively better educated overall, as evidenced by the increasing percentage of black, white, Hispanic, and women workers who have completed college.

The increase in the demand for better-educated workers has been associated with some technological changes in our economy, as well as shifts in demand to sectors that employ more skilled workers. A concomitant effect has been a widening in the earnings gap between those with more education and those with less.

Women entered the labor force in increasing numbers and benefitted from developments in the labor market. Their earnings steadily improved absolutely and relative to those of men. They moved into traditionally male-

dominated occupations, and their unemployment rates, while worse than men's in the past, became virtually indistinguishable from those of men.

Additional training and formal education have been associated with higher earnings and a lower risk of unemployment over the last two decades. The Administration has developed various school reform and job training programs that I would be happy to discuss later on. But we feel very strongly that a major long-run structural issue is getting the fullest potential from those with less education, thereby raising their productivity so that their earnings can increase more rapidly.

Chapter 4 deals with government and the level and distribution of income. While the median income of households and families has grown since the mid–1960's, the distribution of income has become gradually more dispersed over the same period. Most of that is due to demographic factors, such as the increasing fraction of families headed by a single parent.

Income growth occurred in all income quintiles. Substantial numbers of households and families have moved into higher income brackets. The standard measure of income understates the growth since the mid–1960's by almost half for lower income households, because noncash government transfers such as Medicaid are not considered. But sustained growth has been the surest way to raise the incomes of families and households.

The primary source of income for most families is labor earnings. The increase in the number of two-earner families, often alleged to be the major reason why family income has grown, accounted for less than 20 percent of income growth in the 1970's and 1980's. Actually, it was slightly less in the 1980's than in the 1970's.

There are many federal, State and local government tax and transfer payment programs that redistribute a substantial amount of income in our society. In 1990, according to estimates by the Census Bureau, the net effects of federal and State taxes and transfers raised the income of households in the bottom fifth of the pre-tax, pre-transfer income distribution by about $8,800. Their average income went from a quite paltry $2,100 to almost $11,000.

Households in the top fifth of that distribution paid, on average, $22,000 more in taxes than they received in transfers, reducing their average income from about $94,000 to $72,000.

Most of the redistribution that goes on in our federal tax transfer system obviously occurs through the transfer payment system. Federal transfers have increased significantly starting in the mid–1960's and continuing through the 1980's. Means-tested transfers have shifted strongly toward assistance in noncash forms, which again are not generally recorded in the money income measures.

The overall federal tax system and the individual income tax separately also redistribute funds from higher income to lower income individuals. But by various measures, the amount of redistribution within the federal tax system has not changed significantly since the mid–1970's.

The Social Security system, of course, redistributes funds across and within generations. In each case, the program redistributes income, on average, from higher income households to lower income households.

Despite long-term increases in income and government spending on means-tested transfers, poverty remains a serious problem in the United States. Since the early 1970's, demographic changes, through their effects on earnings and income and family structure, have been major contributors to an increase in poverty rates.

Although sustained economic growth remains the best way to improve general economic welfare, not all families can benefit from such growth. Special attention must be given to programs which help these families.

Chapter 5 deals with competitive forces and regulation. It lays out why it is important to have competition in the economy as a vehicle for innovation, efficiency, and growth. It discusses when regulation may be necessary in the case of a natural monopoly, or to correct a perceived or real externality, like pollution. It also explains how to do so in a way that minimizes the cost in terms of job dislocation.

Each chapter also outlines various Administration initiatives in these areas.

Chapter 6 discusses the relation between having an open international trading system and prosperity. I think anybody looking at the broad sweep of history knows that an open international trading system promotes growth. On the other hand, protectionism has led to a great contraction in the world economy.

Chapter 7, Mr. Chairman and members of the Committee, deals with a more arcane subject, economic statistics. Statistics which measure economic performance are in their most fundamental sense the way that our citizens gather information about how our economy is doing, how it's progressing over time, and how we compare to other nations. They are also used by many people in the private sector as a basis for investment, spending, or other important economic decisions.

Chapter 7 is meant to serve as an introduction to the statistical tables that follow it, to point out some of the problems in our very fine statistical system, and to clear up some confusion surrounding alternative sources of data. For example, there are three sets of federal data on employment and unemployment, and each has different strengths and weaknesses. Various issues in the statistical system such as this are discussed, as are the inherent tensions between speed and accuracy and things of that sort.

Each of those chapters is important, if not immensely topical on a one-day basis. Over time they are all-important in talking about and understanding the evolution of the American economy. I would like to summarize where we are now, what comprises the President's economic program, and why we think the economy is likely to grow, even if only modestly.

It's important to understand that we start as the most prosperous and productive nation on earth. With less than 5 percent of the population of the world, we produce a quarter of the world's output. But even a well functioning market economy like the United States is not immune to disruptions, and we've had several of them recently.

We went into recession in the third quarter of 1990. Output fell in the fourth quarter of 1990 and the first quarter of 1991. A recovery began, and it lasted by some measures only a few months. Others would say that it has been continuing at an anemic pace. In any event, from spring through the mid-summer, industrial production increased at about a 9 percent rate, consumer spending rose at about a 4 percent rate, and employment improved. I think the simplest generalization is that from late summer to the end of the year that the economy went as flat as a board. Some sectors improved a little, and others deteriorated a little.

There are many reasons why this occurred. Economists may differ, but in my opinion, the sluggish growth and the recession reflect an economy struggling to correct several structural imbalances while adjusting to a monetary tightening in 1988 and 1989, designed to head off an incipient increase in inflation—a credit crunch—which especially affected the availability of cred-

it for small- and medium-sized businesses, and, of course, the oil shock, and the war.

Obviously, some structural imbalances have developed in financial and real estate markets, in household and corporate debt positions relative to household income and corporate profits, and in federal, State and local fiscal positions. And, importantly, I think an underappreciated structural change involves a major reallocation of resources from defense to other sectors, reversing the trend of the 1980's.

We've also had to adjust to changing demographics as the baby boomers mature and the baby bust generation follows. This places strains first on the school system, then on the labor market, and now on the changing composition of demand.

Also, Mr. Chairman, let me just mention the major long-run problem we face, in addition to the serious problems of ensuring, speeding, and strengthening the recovery: the productivity slowdown that is over two decades old.

In my testimony, I go into these things in more detail, but I do want to emphasize that it was a combination of all of these forces that has led to the unsatisfactory performance of the economy in generating output and employment for the last 2 years. I would be happy to take questions on any of these issues and discuss them in more detail. But rather than go into the points that are elaborated on in both the Report and in the written testimony, I will just say that all of those factors played an important role.

You did ask one particular question, Mr. Chairman, and maybe I could respond to it now. You indicated being told last year that things would improve. In the Report, we have our 1992 economic outlook, which is roughly about what the Blue Chip consensus is predicting. The CBO, like last year, is more optimistic than we are.

And I should say that, when we prepared our economic forecast for the budget last year around December of 1990, we were still in Operation Desert Shield. Desert Storm hadn't begun. We were in the middle of an oil shock, and at that time, we became the first Administration to ever—Republican or Democrat—correctly forecast two negative quarters of output growth before data on even one had been released. That obviously raised various issues with respect to the budget law and so on. But I think we were on top of that.

We also predicted the economy would begin to turn around in the spring. We did expect the economy to continue to improve at a modest pace late in the year. That was also the forecast of almost every single private Blue Chip forecaster, the Federal Reserve, and the Congressional Budget Office. Indeed, we were probably somewhat more cautious. We always go back and ex-post look at how we did for the year, relative to the Blue Chip consensus. People are paid a lot for their advice—and we know economic forecasting is an imprecise science—but, in fact, only 8 of the 52 forecasters' Blue Chip surveys were more accurate than the Administration.

The problem was obviously that none of us, or actually only 1 out of the 52, predicted the flattening at the end of the year. We were taken by surprise by that. Obviously, it would be much better to be surprised by the economy doing much better than we had forecast rather than flattening out, but I thought I would just clarify that.

Thank you very much.

[The prepared statement of Michael Boskin follows:]

PREPARED STATEMENT OF THE HONORABLE MICHAEL J. BOSKIN

Mr. Chairman and other distinguished Members of this Committee, I appreciate this opportunity to appear before you today to discuss the 1992 Economic Report of the President. The Report's analysis of economic events, the economic outlook and economic policies reflects the Council's best attempt to incorporate available economic research as well as historical experience.

The United States is the most prosperous and productive Nation on earth. With less than 5 percent of the world's population, America produces a quarter of the world's total output. However, no economic system is immune to disruption. Even well-functioning market economies face the risk of temporary setbacks from external shocks, policy mistakes, or other disturbances. This was starkly demonstrated in the first 2 years of the 1990's. The American economy, which already was experiencing slow growth, fell into recession in the second half of 1990. Between the third quarter of 1990 and the first quarter of 1991, output fell 1.6 percent and 1.7 million jobs were lost. Growth resumed in the second and third quarter of 1991, but at a sluggish pace. Real GDP was essentially flat in the fourth quarter. The recession and very sluggish growth reflect the serious difficulties that the U.S. economy has faced in correcting structural imbalances while adjusting to previous monetary tightening, the credit crunch, and the August 1990-January 1991 oil shock.

Structural imbalances had developed in the financial and real estate sectors, in household and corporate debt positions, and in governments' fiscal positions. A major reallocation of resources from defense to other sectors is under way, reversing the trend of the 1980's. The economy also has had to deal with changing national demographics, and a productivity growth slowdown that began two decades ago.

The monetary policy initiated in the late 1980's to ease incipient inflationary pressure slowed growth beginning in 1989. The anticipated increase in demand for world capital resulting from the historic changes in the former Soviet bloc, especially the unification of Germany, increased interest rates substantially in early 1990. Problems in financial markets have limited the availability of credit.

The other industrial countries also were buffeted by many of the same problems that hit the United States—the oil shock, sinking consumer and business confidence, and high interest rates. Several of these countries also were experiencing structural problems related to government budget positions and serious difficulties in their financial and real estate markets. Recessions began in Canada and the United Kingdom earlier in 1990, and with jobless rates at or exceeding 10 percent in late 1991, the recessions have been deeper than in the United States. Growth in other industrial countries, including France and Italy, slowed in 1991, and the unemployment rate for the European Community as a whole was about 9 percent in 1991. Growth in Japan and Germany slowed considerably in the second half of 1991.

The current economic difficulties in the United States and other industrial countries should not obscure the fundamental strengths of market economies. The United States is the world's best example of the interrelated strengths of democratic pluralism and market-oriented economies. Americans have the highest standard of living in the world. U.S. gross domestic product (GDP) per capita of $22,056 in 1990, the latest year for which comparable data are available, places the United States more than 35 percent above Germany and more than 25 percent above Japan, when calculated using purchasing power equivalents. The United States has the highest level of productivity of any country in the world, with output per worker about 20 percent above the average of the other major industrial countries. As of 1990, the last year for which comparable data are available, the United States produced a larger share of the industrial output of the Organization for Economic Cooperation and Development—24 of the largest industrial economies—than it did in 1970.

Modern market economies such as the United States are constantly restructuring in response to changes in the goods and services that consumers desire, innovations in productive technologies, and external events that affect the ability of the economy to produce goods and services. In the last decade, for example, computer technology has transformed the workplace and greatly increased the demand for skilled workers.

In responding to structural change, however, even a fundamentally sound market economy can occasionally develop imbalances. Or external shocks or policy mistakes can knock it off track. A flexible and productive economy generally can adapt to such events with a minimal amount of disruption to the economy as a whole, although the costs of adjustment usually are concentrated in specific groups of the population or regions of the country. But if an unusual confluence of imbalances, mistakes, and shocks occurs, then the self-adjusting mechanisms may be inadequate to sustain overall economic growth. And if productivity growth is slow, the economy has less of a cushion to absorb the adjustment that markets undertake naturally without sliding into recession. The American economy is struggling today with such a confluence of events.

For the year and a half prior to the recession that began in the third quarter of 1990, the U.S. economy was growing at only a 1¼ percent annual rate as it adjusted to policies and worked to correct its imbalances. When the recession began, the Administration and most pri-

vate analysts believed that it would not be as severe as the last recession, or even the average of postwar recessions. Partly as a consequence of expecting a less severe recession, the subsequent recovery also was expected to be more moderate than those following other postwar recessions. Moreover, many, including the Administration, believed that the continuing resolution of structural imbalances would lead to a slower than average recovery.

The recession appeared to end in the spring of 1991, and signs of a moderate recovery began to emerge. The index of leading indicators, industrial production, real income, and retail sales all bottomed out in the first quarter and showed upward trends into the second quarter. Other key data also pointed to a recovery. Housing starts, new orders for durable goods manufactured in the United States, and manufacturers' shipments reached their recession troughs in the first quarter and then climbed through midsummer. Real GDP grew modestly in the second and third quarters of 1991.

Rather than continuing its modest rebound, the economy flattened from the late summer to the end of 1991. Payroll employment, industrial production, and retail sales all turned down. Real GDP was essentially flat in the fourth quarter. On the positive side, exports continued to rise and housing starts continued their slow upward progress. The Administration, along with most private analysts, expect the economy to be sluggish early in 1992 but then to pick up in the second half of the year. Some indicators of future economic activity reinforce this view.

Fundamentals that promote growth are beginning to fall into place. Declining real and nominal interest rates should help boost interest-sensitive spending. Inflation, too, is expected to remain near its current, relatively low levels. Imbalances in international accounts have been substantially reduced, and exports should continue to grow as the Nation's international competitive position strengthens. Some structural imbalances are being righted: Households and corporations are reducing their credit burdens, and banks are improving their capital positions. It will take time to correct all the imbalances, but a start has been made.

With the exception of a few industries, there does not appear to be a widespread inventory imbalance that would foreshadow further cuts in production. Increases in domestic and foreign demand will therefore be met mainly from new production and not from drawing down existing stocks. New production will generate income, increase consumption, and lead to further gains in production, employment, and income.

The international competitive position of the United States has improved. After adjusting for exchange rates, the pattern of unit labor costs in manufacturing has been favorable relative to that of the Nation's major trading partners. As foreign economic growth rebounds, U.S. exports should increase.

A particularly positive factor is the reduced inflation rate. Although special factors in agriculture, energy, and excise taxes may cause an occasional temporary blip in, for example, the consumer price index, underlying inflation is widely believed to be down. The economy currently is operating well below full capacity. Thus, during a moderate recovery, resource constraints that could rekindle inflationary pressures are unlikely to emerge. Furthermore, a credible and systematic monetary policy that is designed to reduce inflation gradually has ample room to accommodate a healthy expansion.

Nominal interest rates generally are at their lowest levels in two decades. Real rates may not be as low as they have been around the trough in some other cycles. But the lagged effects of lower interest rates already in the pipeline should help the economy in 1992. The lowest mortgage rates in almost 20 years should spur housing starts and sales. Low rates also allow households to refinance mortgages, improving their balance sheets and providing a foundation for consumption growth. For many businesses, lower interest rates reduce the cost of borrowing to finance new investment. They also increase corporate cash-flow. Some corporations are using the strong stock market to issue equity and repay debt, thus improving their financial position and freeing funds for investment. There is some offset to the expansionary effect of these factors because lower interest rates reduce interest income and the consumption based on it.

Because their capital positions have improved greatly, banks should be in a better position to lend than they have been for some time. Furthermore, the Administration, under the leadership of the Treasury Department and in conjunction with banking and thrift regulators, has been working to ensure that lenders make prudent loans and that examiners perform their reviews in a balanced, sensible manner. Still, bank lending remains tight; many banks are investing in Treasury securities rather than making loans. A combination of slack demand, due to the soft economy and the need to rebuild balance sheets still further, and skittishness, in response to regulatory overreaction, is preventing the banking system from playing its normal role in financing economic expansion.

The Administration forecasts real GDP to grow 2.2 percent in 1992 and 3 percent in 1993 if the President's policies are adopted. The unemployment rate may rise slightly early in the year, but if the President's policies are enacted, should start to decline thereafter. Inflation and interest rates should remain relatively low. If the President's proposals are not enacted, the economy is less likely to improve and the improvement is likely to be slower and weaker.

Table 1 compares the Administration forecast to that of the CBO and the so-called Blue Chip consensus—actually the average of the 52 private Blue Chip forecasters.

FORECAST COMPARISONS

	1992	1993
Percent change, 4th quarter to 4th quarter		
Real GDP (1987 dollars).		
Administration	2.2	3.0
Blue Chip	2.4	3.0
CBO	2.8	3.3
CPI-U.		
Administration	3.1	3.3
Blue Chip	3.5	3.8
CBO	3.4	3.6
Calendar year average, percent		
Civilian Unemployment Rate.		
Administration	6.9	6.5
Blue Chip	6.8	6.3
CBO	4.4	5.1
3-month Treasury bill rate.		
Administration	4.1	4.9
Blue Chip	4.2	5.0
CBO	4.4	5.1
10-year Treasury note rate.		
Administration	7.0	6.9
Blue Chip	7.3	7.7
CBO	7.1	7.1

Note: Blue Chip values are survey averages from the January 1991 Blue Chip survey; 10-year Treasury note rates for Blue Chip are converted from the reported Aaa bond rates.

As was the case last year, the CBO is somewhat more optimistic about real growth than the Administration. The Administration outlook is slightly below the Blue Chip average real GDP forecast. By way of comparison, summing the forecast errors for 1991 over real growth, unemployment, inflation and interest rates, only 8 of the 49 Blue Chip private forecasters (3 did not forecast all variables) were more accurate than the Administration. The Administration also was more accurate than the CBO. But the differences were modest. Virtually none of the private forecasters predicted the flattening out in the latter part of the year. CBO had real growth of about 3 percent for the second half; the Administration 2.4 percent; the Blue Chip average was 2.2 percent.

These developments serve to remind us all of something I say each time I deliver the economic outlook and that is well to bear in mind. Economic forecasting is an imprecise science. Unexpected events and policy changes can cause actual events to be substantially different from the forecast, and forecasts are based largely on predictions about human behavior, usually taking previous patterns of behavior as a guide. But human behavior is complex, difficult to predict, and subject to change. People do not always respond the same way, or with the same speed, in what appear to be similar circumstances. Hence, there remains some uncertainty about the outlook for the economy.

If the problems the economy has been facing are resolved relatively quickly and confidence is restored, growth could rise faster—and to a higher rate—than is expected. The relatively low rate of inflation combined with the large degree of slack in the economy is particularly noteworthy, as it could allow the Federal Reserve to keep interest rates low—or cut them further if necessary—to help boost growth with little immediate concern about reintroducing inflation pressures. A quick shift to a significant rebuilding of inventories alone could add a percentage point or more to the rate of growth over the next year. Alternatively, if the in problems are solved very slowly, the economy could perform worse than expected. Tight credit and slow money growth, along with the continuing structural adjustments described earlier could continue to hinder the economy, and under those conditions confidence could remain low and the rate of growth likely would be lower than expected.

The President has presented a comprehensive and coordinated growth agenda for the Nation. The agenda includes fiscal and other measures that will make near-term recovery faster, stronger, and more certain, while solidifying the foundation for long-term growth to help ensure that the United States remains the world's leading economy in the 1990's and beyond.

The Administration's policies for raising long-run productivity growth and thus the standard of living are based on five principles: a pro-growth fiscal policy that enhances incentives for entrepreneurship, saving, and investment, in the context of the final discipline necessary to slow the growth of spending to reduce the multiyear structural budget deficit; a trade policy that promotes growth through opening markets worldwide; a regulatory policy that avoids unnecessary burdens on business and consumers; a human capital investment policy that focuses on education, training, and preventive health care; and strong support of a monetary policy that keeps inflation and interest rates low, while providing adequate growth of money and credit to support solid real growth.

The short-term agenda includes executive actions and proposed legislation that will stimulate economic growth immediately. Executive actions with immediate impact include a reduction in excessive personal income tax withholding and acceleration of previously appropriated Federal spending. Reducing the burden of unnecessary regulation and prudent measures to reduce the credit crunch will improve the environment for growth. Proposed legislation focuses on spurring job-creating investment. The proposed 15-percent investment tax allowance and simplified and liberalized treatment of depreciation under the alternative tax, as well as the reduction in the capital gains tax, will stimulate business investment. The reduction in the capital gains tax rate will quickly raise asset values, improving confidence and encouraging spending. A $5,000 tax credit and penalty-free withdrawal from individual retirement accounts for first-time homebuyers, along with other incentives, will increase housing construction and sales.

Bolstering the short-term agenda are proposals for the long term that invest in the Nation's future by increasing the productivity of people and business. Record Federal investment in research and development and infrastructure, and the extension of the research and development tax credit will help increase business productivity. Record Federal investment in Head Start, children, and education, as well as proposals that strengthen the war on drugs and improve the implementation of job training through Job Training 2000 will help increase labor productivity. The long-term growth agenda also includes continued efforts to expand international markets through multilateral, regional, and bilateral negotiations.

Some of the President's reform proposals are awaiting congressional action. Education reform through America 2000 will revolutionize education, strengthen accountability, and improve performance. Financial sector reform will strengthen the financial system, improve its ability to contribute to business growth, and sustain its international competitiveness. Civil justice reform will curb wasteful litigation and enhance productive activity. And the National Energy Strategy will increase energy security and conservation.

The President has repeatedly proposed reducing the tax rate on capital gains. This will encourage entrepreneurial activity, create new products, new methods of production, and new businesses. These, in turn, will generate new jobs. A capital gains differential will reduce the tax bias against equity financing and the overall cost of capital, thereby increasing investment and growth. Moreover, the Administration has supported a zero capital gains tax for areas designated as Enterprise Zones to spur investment and encourage entrepreneurial activity in inner cities and rural areas.

Innovation increases productivity growth and the standard of living. The Administration has advocated making the research and experimentation tax credit a permanent part of the tax code and has proposed large increases in both basic and applied research and development spending in the Federal budget.

There are also proposals to assist families. These policies include an increase in the tax exemption for each child, a new flexible individual retirement account, and deductibility of interest paid on student loans. Comprehensive health reform will increase the affordability and security of health insurance at a cost that is economically sustainable. The incentives for first-time homebuyers, mentioned above, will encourage homeownership—one of the most important ingredients to family financial and social well-being. The homeownership and opportunities for people everywhere (HOPE) program helps low-income residents of public and assisted housing to manage and eventually own their own homes.

Fundamental banking reform is critical to ensuring efficient operation of credit markets. The recent bill passed by the Congress is at best only a start. Important provisions in the Administration's proposal that would remove many unnecessary and antiquated restrictions on the banking industry are missing from the legislation. These reforms are needed to rebuild the soundness of the banking industry and enable it to be internationally competitive.

The Administration believes a well-functioning legal and regulatory system should increase, not impede, economic activity. Through its Agenda for Civil Justice Reform in America, the Administration has proposed a comprehensive set of reforms to the civil justice system that will improve the efficiency of the legal system and reduce unnecessary and costly litigation. This would free up resources and enhance productivity.

The Administration believes that investments in the Nation's human capital increase its productivity and living standards at home and increase its competitiveness abroad. The National Education Goals, America 2000 Excellence in Education Act, and Job Training 2000 all are directed at improving the quality of our most important resource—our people. The America 2000 Excellence in Education Act focuses on setting world-class educational standards, measur-

ing performance against those standards, and increasing the educational choices available to American families so as to generate the competition that will improve performance and accountability of schools. The Administration's Job Training 2000 system is designed to train millions of workers in the skills needed in the evolving labor market.

Moreover, the President has initiated a variety of measures to expand opportunities and improve the well-being of individuals and families. Although not often thought of as economic policy, expanded tax relief for child care, Head Start, Healthy Start, protecting the civil rights of all Americans, the strategy to eliminate substance abuse, and measures against violent crime all serve to improve U.S. productivity in the long term. Starting our children off on the right path, providing our children the finest education, and continuing to provide programs that ensure safety are sound economic policies.

The President's economic and domestic agenda also includes investing in America's future by improving the Nation's infrastructure, enhancing energy efficiency and security, and improving the quality of the environment and life. The Administration continues to promote an energy policy that relies on the flexibility of market forces to ensure that the Nation's resources are used most efficiently. Implementation of the Administration's National Energy Strategy would enhance competition in the generation of electric power and in the delivery of natural gas and would reduce vulnerability to oil disruptions abroad.

This Administration is committed to free and fair trade. Because trade enhances long-term growth, the Administration is following a multipronged effort to open markets, expand trade, and spur growth. The Administration is committed to achieving a successful conclusion of the Uruguay Round of multilateral trade negotiations, under the auspices of the General Agreement on Tariffs and Trade. These ambitious talks, which were initiated in 1986 involve 108 countries and cover topics ranging from the elimination or reduction of tariffs, to the strengthening of international rules for trade in textiles and agriculture, to the extension of rules to cover trade in services and intellectual property. A successful Uruguay Round would expand market opportunities globally for our exporters, increase jobs, and provide lasting gains for both the United States and world. The Administration also has important proposals to expand trade in this hemisphere—notably the Enterprise for the Americas Initiative and the historic North American free-trade area—and is continuing to achieve market access through bilateral negotiations.

Taken together, the President's proposals constitute a comprehensive agenda to stimulate short-term economic growth and support long-term productivity growth. These policies will expand opportunities for workers and families, increase living standards, and support the global competitiveness of the U.S. economy.

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

Senator SARBANES. Thank you very much.

Do any of your colleagues have anything they want to add?

Mr. BRADFORD. No.

Mr. WONNACOTT. No.

Senator SARBANES. I'm curious as to why the Administration waited so long to propose any recession program.

Mr. BOSKIN. Pardon? I just didn't hear you, I'm sorry.

Senator SARBANES. Why the Administration waited so long to propose any program—and I don't want to argue, now, whether the program you have proposed is adequate or not. We may get to that later, but now I want to ask just why you waited so long to propose any program at all to deal with the recession?

Mr. BOSKIN. Well, first of all, there were a variety of things that were going on, and a variety of proposals that the President had made. I know you would disagree with the Administration about their likely economic impact, but several of those things had already been before Congress. One, the capital gains tax reduction, for example, had gone through the House in 1989 and had a majority of Senators in favor of it, but had not been passed. There were a variety of other pro-growth initiatives that had not gotten through Congress.

In the early fall, as it became clear that the economy was flattening out, I think the feeling was that as the end of the congressional session was nearing that, with due respect to both sides of the aisle, there was a rather intense partisan feeling. The conclusion of the people who analyzed that, which certainly does not include me, was that it would be very difficult to try and get a responsible program passed at that time. Therefore, it would be better to regroup and come back after some of that partisanship had died down.

Now, that was a call made by people other than me. I don't get involved in analyzing the sense of Congress and stuff like that. That's not my position.

Senator SARBANES. Now, your view and testimony in July of last summer, as I recall it, was that we were coming out of the recession.

Mr. BOSKIN. I think the data available then was that the economy had been recovering for several months, and like virtually every other private analyst—the Fed, CBO, etc.— we expected that to continue.

Senator SARBANES. Now, did you expect that if we had a quarter of positive growth that that would go on? In other words, when we have a quarter of positive growth, as in the third quarter——

Mr. BOSKIN. In the second quarter, as well.

Senator SARBANES. ——did you expect that to continue?

Mr. BOSKIN. Yes, we expected modest growth to continue, and the economy flattened out.

Senator SARBANES. In most of the postwar recessions, as I understand it, there were quarters of positive growth, but that wasn't the end of the recession, in fact, in the vast majority of them; is that correct?

Mr. BOSKIN. It is correct that in several of them, in the middle of them——

Senator SARBANES. Well, the majority of them.

Mr. BOSKIN. I would have to go back and do the count. If you've calculated it, it's probably a correct statement that there was at least one positive quarter.

Senator SARBANES. I only make that point because it seems to me that you should have been on guard about misreading a positive quarter. Our

analysis is that in six out of the eight recessions that there was a positive quarter, at least one quarter and maybe more.

Mr. BOSKIN. Well, indeed, in this recession there was because the NBER dates it in the third quarter of 1990 when there was positive GDP growth of over 1 percent.

Senator SARBANES. The point I'm trying to make is that I think you should have been, as it were, on guard. At what point did you think that the economy was in trouble?

Mr. BOSKIN. Well, I never thought it was doing well. I always expected the economy to grow modestly because of the structural imbalances that I've talked about. Other people have used the phrase, "growing into a head wind," with a credit crunch and other problems.

We always predicted a modest recovery. So, I did think the economy had problems, even back when we were in the longest peacetime expansion generating all those jobs. When I was in the private sector looking at the whole picture, there were also problems.

Senator SARBANES. At what point did you think——

Mr. BOSKIN. Let me put it this way. In the May, June, July period, when we were growing, I still had the standard average probability that the economy would slide back, which would, on average, be about 20 percent. That probably grew when we started getting data in September and October for the period when the economy started flattening out.

Senator SARBANES. At that point, did you think measures needed to be taken, antirecessionary measures?

Mr. BOSKIN. Yes.

Senator SARBANES. So, if you had had your preference, measures would have been advanced then and not at the end of January?

Mr. BOSKIN. I wouldn't say that. I mean I made the point and others did, as well. The question was whether there was a likelihood that a responsible good package could get through Congress. People whose job it is to make that judgment made the decision that it was not.

I was pleased that you made a statement about extended benefits. I was pleased that was resolved. Like you, I wish it would have been done earlier. I have a slightly different perspective than you do about the President's role. He always supported it. He just didn't support the original bill that did not pay for itself. I'm very pleased that the current bill has moved very quickly, and the President will sign it quickly.

Senator SARBANES. Merril Lynch's weekly economic and financial commentary, dated February 3—so this is their latest report—says: "Except for some pick-up in housing activity, evidence of a recovery is still completely lacking. Confidence is at rock bottom, layoffs remain high, and the economy is going nowhere at the moment."

What do you think of this observation of Merril Lynch?

Mr. BOSKIN. Well, let me make three points. First of all, as I've been saying for several months, economic growth is flat and sluggish. I've been saying for several months that growth, if any, in the fourth quarter was going to be slight. The advance estimate was 0.3 percent at our annual rate, but that may go up or down a little bit when we get more data. I expect the first quarter, since it's largely locked in already and unlikely that any policy changes can affect the economy for a few months, also to be sluggish. So, I would say right now that economic growth is flat.

I would say that if you look at forecasts of real growth in 1992 on a fourth-quarter-to-fourth quarter basis, Merril Lynch is at the bottom, way below the Blue Chip average. If you look at this chart, the National Associa-

tion of Business Economists averages 3 percent, the CBO is 2.8 percent, Data Resources, 2.7 percent, all the way down, and Merril Lynch is at the bottom.

I would also mention that the CEO of Merril Lynch said, "The President's economic growth package is right on course. In fact, it's a road map for recovery." They could be right. Economic forecasting is an imprecise science, as you indicate, and as we indicate in every report and testimony. There are things that could lead the economy to do better or worse. Hopefully, this time things will do better. So, I wouldn't object to their statement as being plausible, or their forecast as being plausible, but it is toward the bottom of what other people are saying.

Senator SARBANES. Your forecast is that there will be 2.2 percent growth this year?

Mr. BOSKIN. That's right. We're slightly below the Blue Chip average, as well.

Senator SARBANES. Is that right, 2.2 percent?

Mr. BOSKIN. Yes.

Senator SARBANES. Assuming enactment of the President's proposals?

Mr. BOSKIN. That's right.

Senator SARBANES. And as I understand it, Mr. Darman has earlier testified on the Hill that without the enactment of the proposals that you expect a 1.6 percent growth; is that correct?

Mr. BOSKIN. That's correct, but let me again repeat that these are what you might think of as best judgments.

Senator SARBANES. I understand that.

Mr. BOSKIN. There is a range around them.

Senator SARBANES. But on your best judgment, the proposals you have put forth, assuming their enactment, would boost the growth rate $6/10$ of a percent?

Mr. BOSKIN. This year. If enacted in time to have an effect on this year, there will be about a half million jobs by the end of the year, a couple of hundred thousand new homebuyers, a few other things of that sort, and increased investment. Cumulatively, over 5 years it would lead to $150- or $160 billion more in output.

Senator SARBANES. When do you expect the country to be back to the 5.3 percent unemployment figure?

Mr. BOSKIN. Well, in working through these adjustments and imbalances, it's going to take several years. I should point out that the 5.3 percent was the lowest we had experienced in 20 years.

Senator SARBANES. Do you project in your report when we will be back to 5.3 percent?

Mr. BOSKIN. I believe it's 1997.

Senator SARBANES. At the end of 1997?

Mr. BOSKIN. No, I think it's on average during year. So, it would be earlier in the year. It's the yearly average. So, it would be earlier.

Senator SARBANES. So, your expectation is that the average unemployment rate for 1997 will be 5.3 percent?

Mr. BOSKIN. As a general long-term forecast, I would be very surprised if a general judgment about something that may happen 5 years from now is exactly right. A zillion things can happen between now and then, and if a variety of things go right, it could well happen more quickly.

Senator SARBANES. I understand that, and if things go wrong, it could well happen later.

Mr. BOSKIN. That's correct, but I also do want to point out that it was the best unemployment performance we had had since the early 1970's.

Senator SARBANES. Well, my time is up, and I have a vote. I'm going to go vote and return.

I'll now turn to Congressman Armey for his turn, and then, Dave, why don't you pick up at the end of Congressman Armey's round.

Representative ARMEY. Thank you, Mr. Chairman.

Mr. Boskin, let's take a quick trip down memory lane. Let's go back to 1965 when we were both undergraduates. You will recall, at that time, the conventional wisdom was that you had the Phillip's tradeoff. You could have inflation or recession, and the economics profession and Congress, in conjunction with the Fed, could coordinate monetary and fiscal policy, fine-tune the economy, and just always keep everything great, right, and we would solve the business cycle.

Mr. BOSKIN. That's a correct description of what a majority of economists would have said when we were undergraduates. That obviously was very naive.

Representative ARMEY. Absolutely. And then in 1965 Lyndon Johnson gave that infamous guns and butter speech that said we can declare war in Vietnam, and we could declare war against poverty at home, and we can have all this increased government spending with no pay-go provisions. Do you also recall the famous confrontation with Willie McChesney Martin, at about the same time, saying that we should have all the easy money in the world to make all this happen?

Mr. BOSKIN. Yes.

Representative ARMEY. And that inflation, of course, was no concern. Then, we hit some phenomena that fascinated us all that became known in the 1970's as stagflation, the simultaneous occurrence of inflation and recession, contrary to even Keynes's prediction of possibilities, and that baffled the Johnson Administration, the Nixon Administration, the Ford Administration and, of course, the Carter Administration, in the most discouraging ways. The fact of the matter is that it was just a very baffling question, how do you resolve the two.

Then, in 1980 Ronald Reagan came along, and he said that he had a solution to the problem, and, in fact, his solution was to accept the deepened recession in order to break the back of inflation, and that gave us the short, shallow recession at the inception of the Reagan Administration, which also, of course, was accompanied by the end of inflation and stagflation.

Now, following that, we had a very long period of sustained economic growth, which we point to with great pride as the longest peacetime expansion in the history of the world, I believe, and one in which in fact the rich got richer and the poor got richer, as compared to the late 1970's, where the rich just got modestly richer while the poor actually did in fact get poorer, especially the elderly, no longer suffering the deleterious effect of inflation on their fixed incomes.

Is that a correct understanding do you think?

Mr. BOSKIN. I think that's pretty accurate. I would say that the recession in 1981–82 was neither short nor shallow. Compared to what the Phillip's curves predicted would be necessary to reduce inflation by 9 percentage points, it was short and shallow. But compared to previous recessions, the unemployment rate went up a lot.

Representative ARMEY. I'm sorry, I must have misspoken. It was short and deep.

Mr. BOSKIN. Yes.

Representative ARMEY. Right, and by contrast, we are now in a long and shallow recession.

Mr. BOSKIN. Well, I'm using the duck test these days because there is a lot of controversy about what you ought to call it. In January, 58 percent of the Blue Chip forecasters said the recession had ended in the second quarter of 1991, in which case we've had a very anemic recovery. So, I don't want to get into the semantic and technical part of it. We've certainly had a longer period of economic difficulty. Whether all of it was recession or part of it was recession and part of it was very slow growth remains to be seen.

Representative ARMEY. And I don't necessarily want to quibble, but there is that difference between what we're experiencing now, which you could say is long and shallow, relative to what we saw as short and deep in the early 1980's. Is that a fair characterization of the difference between them?

Mr. BOSKIN. Yes, except also from a deeper hole, it took a long time to climb out.

Representative ARMEY. Absolutely, sure. In the 1980's, we were climbing out of the days of national malaise where the nation was suffering such a terrible affliction of lack of consumer confidence that, not only in New Jersey where the recent poll was taken, but even in Texas, we had become convinced that our children would have a lower standard of living than we had. I was despairing myself. Having five children, I thought that I would end up with all of them living with me because they would never be able to afford a house in the late 1970's.

It was a very desperate time, and, in fact, one that prompted Lester Thurow to write that infamous book, Zero Sum Society, where he proclaimed the end of growth and that the only recourse left was for the government to redistribute income on a greater plane which was embraced by the liberals across this town.

Now, what I'm driving at, and the reason I wanted to go through this history, is that you came along, and by 1989 or 1988, you could see, as some of us did, that this longest peacetime growth period was beginning to show the signs of weakening.

I remember very vividly the President's first State of the Union Message after he was inaugurated, or, at least, his first speech before Congress. I'll never understand these formalities, but I remember being in the body and listening to the speech and watching the President.

Maybe you will recall in the spring of 1989, where the President clearly acknowledged that—let's say modest economic miracle—this greatest peacetime growth in the history of the world, after the time when Lester Thurow said growth would never happen again, was starting to weaken.

Mr. BOSKIN. Yes, I was actually involved in editing those remarks.

Representative ARMEY. You probably helped write that speech. And in that speech didn't he clearly say that, in order to prevent this trend that we were perceiving from becoming a reality, it was imperative that we have a reduction in the capital gains tax?

Mr. BOSKIN. Yes, he did.

Representative ARMEY. He did, and didn't, in fact, Congressman Archer and Congressman Jenkins put together a very good package with indexing, as well as a reduction in rate, and take it through the Ways and Means Committee in the House? It passed in the House by, I think, 108 votes. You would have to say that the Ways and Means Committee agreed that it was a necessary thing to do, and the House agreed. That was killed in 1989 in the Senate.

Now, I think it's very important for us to see that because you were getting a bum rap at the Council of Economic Advisers. I have to tell you—given the respect and admiration I have had for the Council in my days—I don't think that bum rap is quite correct because your advice has been there early and sound, and it was in fact Congress—the Senate in particular—that failed to perceive the problem and failed to take the action that was clearly recommended by the President and acted upon by the House.

In fact, if we did not get, as it were, the dose of preventive medicine in 1989 that maybe we should have had, the bottleneck was in the U.S. Senate. That's where the process stopped. We need to be aware of that.

Now, one of the things that I've become concerned about is this whole business of forecasting. We know it's a risky business. Paul Samuelson doesn't even try and never has tried it. It's a difficult thing. But it strikes me that you in your organization with probably, I'm certain, less than half, and maybe even less even than that, of the resources of the CBO, have had a better forecasting track record than the CBO. The CBO has made some egregious errors; the most obvious and recent example being the—we now learn—$134 billion overestimation of capital gains income for 1990, which, of course, projected into billions of dollars of anticipated revenues that never materialized. You know, a fundamental observation I have in business is that, if you make errors and don't admit them and correct them, you go out of business. In politics if you make errors and don't admit them and correct them, you get re-elected. It's a fascinating phenomenon.

But, at any rate, it strikes me that as I watch the performance level of the Congressional Budget Office, in particular, and the Joint Tax Committee that we do not avail ourselves of the best economic science in making these economic forecasts and projections of outcomes for alternative policies. Some of these people actually believe that if you reduce capital gains that there will be a net reduction in tax revenue to the government. Can you imagine that? An undergraduate fails if he believes that. But they also believe that if you raise taxes on such things as boats and ships and airplanes and so forth that it has no negative impact on the industry.

I would like to, as an economist, having acknowledged that you leave politics to other people, ask if I am correct in my perception that we use the least of the science of economics in the worst possible way in these official agencies like the Congressional Budget Office and Joint Tax Committee? Would you like to comment on that?

Mr. BOSKIN. Well, we try to do the most professional job that we can with our resources. We have 10 senior staff economists and a few junior staff economists every year at the Council. Most come for a year from academe. I know that the CBO has several hundred such people, many of whom are career employees, but they do a lot of things that we don't, and put out a lot more reports than we do. I think many of them are quite capable.

I do believe one could argue about these things, but factually, in terms of macroeconomic short-term forecasts, we've been somewhat more accurate than others for the year in question. The differences have not been large, however.

With respect to the Joint Tax Committee and capital gains and so on, there obviously is a very big dispute between the Treasury Department and the Joint Tax Committee on the revenue impact of capital gains. I would just make two observations.

The first is on that and other things, neither the Joint Tax Committee nor the Treasury tends to analyze the possible growth impact which would in-

crease capital gains and other revenues. So, I think that concern of yours is good and properly focused.

Also, I think that neither of them, in the particular case of capital gains, would include in their analysis the feedback effect from higher private asset values that would occur from a lower rate. Either of those effects is likely to generate substantial additional amounts of revenue.

With respect to a variety of other things that are done, the most polite way to put it is that we have methodological differences with how certain things are analyzed and displayed. They might feel the same, and I wouldn't want to be impolite, but I think that that's the record.

Representative ARMEY. I appreciate that. I've noticed that my time is up. I want to thank you again, and I want to encourage you to not only continue to do your best professional work, but to assert the differences between what you do and the shoddy work that is done by CBO as often as possible.

Thank you.

Representative OBEY. Mr. Boskin, how are you?

Mr. BOSKIN. Congressman Obey, good to see you.

Representative OBEY. Let me start by asking you to repeat the response that you gave to Senator Sarbanes. How many years did you say you estimated it would take before the unemployment level will be back to the level where we were before this current recession began?

Mr. BOSKIN. Well, there is a wide range. In the baseline forecast, it would take several years for the unemployment rate to return to its lowest level since the 1970's.

Representative OBEY. But you gave him a specific year in answer to his question. Did you say 1997?

Mr. BOSKIN. In the baseline forecast, it would gradually decline and get there in early 1997.

Representative OBEY. 1997. That means that if President Bush is re-elected that we would go through his entire second term under the policies that you're recommending before we would reach the unemployment level where we were before the recession began. I don't know how the President feels, but even as a Democrat, I wouldn't want to run on that, and I would hope we could do better.

Mr. BOSKIN. So would we.

Representative OBEY. Let me ask, you are forecasting 500,000 fewer civilian jobs, on average, during all of 1992 and 1993 than you forecast last summer. Is that right?

Dr. BOSKIN. I would have to make the calculation, but, yes, we do expect unemployment to be slightly higher and employment to be slightly lower.

Representative OBEY. Do you have any estimate as to how many of those jobs represent permanent job losses rather than the garden variety cyclical job losses?

Mr. BOSKIN. We don't make a specific separate estimate of that, but recent surveys of people who have been laid off suggest that perhaps about 40 percent of them expect difficulty in being recalled.

Representative OBEY. Forty percent expect to be recalled?

Mr. BOSKIN. No, 40 percent expect difficulty in being recalled.

Representative OBEY. Difficulty in being recalled.

Mr. BOSKIN. And that percentage obviously has risen as the economy has not rebounded as rapidly as many had hoped.

Representative OBEY. Have you estimated how many jobs have been lost to the economy permanently because of the job termination announcements of what used to be regarded as this country's corporate jewels—General Mo-

tors and a number of others? Have you estimated how many jobs have been permanently lost just through those announcements since say last November?

Mr. BOSKIN. Well, we've lost very few thus far. General Motors has announced a multiyear plan of gradually downsizing by 74,000, but much of that is through attrition.

Representative OBEY. Right, and that's what I'm leading to. But if you take GM and if you take a number of other corporations that have announced similar actions, they are either taking or intending to take—if you take Teneco, for instance, which happens to have a plant in my district—if you take them all, what's the total permanent job loss that you estimate we will get from those announcements?

Mr. BOSKIN. Well, we haven't added them firm-by-firm, but the economy is and always has been restructuring. It's obviously accelerated in a down economic period, but the economy is always restructuring.

Obviously, there is a major restructuring going on in several industries right now that suggests that a much smaller fraction of those who have been laid off will be recalled in those particular industries. But legislation that Congress passed requires these firms to make these announcements now.

Representative OBEY. But haven't we, so far, been told that permanent job loss just from the corporate giants whom we have regarded as the Cadillac quality companies in the past—if that isn't an oxymoron, at least until recently——

Mr. BOSKIN. Well, Cadillac has made major improvements.

Representative OBEY. They sure have. They've needed them.

[Laughter.]

Not that I drive one. I don't.

Mr. BOSKIN. The record will clearly show.

Representative OBEY. But isn't it true that so far, just from those announcements, that we have lost or will lose over a quarter of a million jobs permanently just from those companies?

Mr. BOSKIN. Yes, but again it will happen gradually over a span of time, much by attrition. Similar processes were undergone in the mid–1970's, in the early 1980's, and so on. If labor markets remain flexible enough, the economy can generally adjust, and those workers can find other employment.

Representative OBEY. I'm trying to keep my questions short, and I would appreciate it if you could keep your answers short because I have a limited amount of time.

Mr. BOSKIN. I'll do the best I can.

Representative OBEY. What I'm trying to get at is this. I assume the Administration's major motivation for its recommendations on capital gains is not that they want to put more money in the pockets of wealthy people, but that they want to create jobs. Isn't that a fair statement?

Mr. BOSKIN. That's right. It's to help new businesses and industries get started, yes.

Representative OBEY. How much does it cost to educate a Yale graduate?

Mr. BOSKIN. It's hard for me to give an estimate of that. If Yale is like Stanford or other prestigious private universities, the tuition now would be over $20,000 a year.

Representative OBEY. So, it costs about 80,000 bucks to educate someone who comes out of the institution the President graduated from.

Senator SARBANES. Well, that's not entirely accurate. That's what it may cost the family, but the tuition doesn't begin to pay the cost of the education. Isn't that the case?

Mr. BOSKIN. That's correct. The total cost to society is higher.

Representative OBEY. But in this instance, I am looking for the cost to the family.

Senator SARBANES. To the family, all right, but the social cost is even more.

Representative OBEY. So, it's about $80,000.

I'm interested because I know that you have different estimates. Several years ago, the Joint Economic Committee staff, then headed by Joe Minarick, now the Budget Committee's staff Chief Economist, took the 1985 Treasury estimates of the job creation potential of the President's capital gains request at that time and, extrapolating from Treasury's own figures, reached the conclusion that, in their words, the most optimistic scenario the capital gains cut might provide would be an increase in the rate of economic growth by about .005 percent and an increase in job growth of as much as 52,000 jobs after 5 years. And based on the Treasury Department expected revenue loss, as estimated at that time by Ronald Reagan's Treasury Secretary—a fellow by the name of Jim Baker—they estimated the revenue loss to be $21 billion, which turned out to be a cost per job created of about 410,000 bucks.

Isn't there a cheaper way to replace those crown jewel jobs that are being lost, even if we replace them all with Yale graduates?

Mr. BOSKIN. Congressman Obey, let me just first clarify. You earlier referred to our current outlook as forecasting 500,000 fewer civilians jobs in 1992 than our estimate last summer. We have just checked the data, and the number is half that amount. So, I hope the record will show that. Clearly, however, the economy is not doing nearly as well as hoped.

With respect to this issue, I was not in the Reagan Administration, and I don't know what they forecast then. Jim Baker is a friend of mine, but I have not discussed this issue with him in many years. The Treasury Department estimates in the Bush Administration forecast that it will raise revenue. So, it would make the number a negative number. You would make money per job created, and certainly we believe that it would be much more beneficial to the economy. I think a wide range of professional opinion would put Joe Minarick's estimate toward the lower end of the spectrum, not that it's impossible.

Representative OBEY. Well, let's double it.

Mr. BOSKIN. There are some who think it would be must larger. What is important is that, if it raises revenue, then it doesn't cost anything.

Representative OBEY. Well that's a great if. If candy didn't have sugar, it wouldn't cause cavities either, but it does.

Mr. BOSKIN. Well, with all due respect, we would disagree with that analysis, respectfully.

Representative OBEY. I'm not surprised. Let me simply ask one other question.

Mr. BOSKIN. I would point to one historical example.

Representative OBEY. I would rather you not because I have only one minute left, and I want to get in another question.

Mr. BOSKIN. Certainly.

Representative OBEY. Do you remember the old recession song, "Brother Can You Spare A Dime"?

Mr. BOSKIN. Yes.

Representative OBEY. Has the Administration really adopted that as its theme song for the next year? I notice that the Joint Tax Committee estimated yesterday that the share of the capital gains tax cut that would go to each income group—I'm reading from the "liberal" magazine of the

Washington Times—it says, "Eighty-five percent of Americans with income under $50,000 would get little more than a dime out of every dollar of the capital gains tax cut proposed by President Bush." Do you dispute those estimates?

Mr. BOSKIN. Yes. In fact, our Treasury has different estimates. First of all, the Joint Tax Committee distributes only the reduction in taxes from people who would have realized gains already, and doesn't even add back in the extra taxes that they themselves will add into the revenues from induced realizations. It's just methodologically incorrect. It's kind of silly.

Second, the fact of the matter is, as you indicated at the start, the whole purpose is to create jobs. To the extent that it's successful in doing that, it obviously will put a lot more money into the hands of workers, and many of these people benefit.

Third, it will help raise asset values, and anybody that owns a home——

Representative OBEY. I know what your arguments are, and I'm just trying to get at your estimate of the percentage of the breaks under this provision that would go to families making less than $50,000? What percentage of the total dollar value?

Mr. BOSKIN. I don't have that with me. I can qualitatively say that our Treasury Department estimates a majority of recipients would be those earning under $50,000.

Representative OBEY. I understand, but we know——

Mr. BOSKIN. It would be something like that 70 percent, not 90 percent, but I don't have the numbers in front of me. I'll get them for you.

Senator SARBANES. Seventy percent of what?

Representative OBEY. Seventy percent of the total dollar value of the capital gains reduction that you're asserting would go to people with less than $50,000?

Mr. BOSKIN. I said I don't have the number, but I will get it for you. I think it would be less than the number that Joint Tax estimates, but I will get it to you.

Senator SARBANES. Well, you must have some range of estimate, in terms of the dollar value——

Mr. BOSKIN. The Treasury Department has the estimate.

Senator SARBANES. ——of the capital gains tax break, and who will get it in the income scale.

Mr. BOSKIN. The Treasury Department has been producing those tables, and I will make sure you get a copy of them. I don't have them with me.

Senator SARBANES. Well, I take it that your 70 percent is what goes to the people at the top, because the figure has been given that 70 percent of the monetary value of the capital gains tax will go to people with incomes above $200,000 a year.

Mr. BOSKIN. In terms of the direct effect, the Treasury estimates clearly that a majority of the benefits would go to people higher up in the income distribution. This excludes the value of the jobs, the higher asset values, etc., which will help people all across the income spectrum. Also, the JCT ignores the extra taxes from people paying the induced realizations, which would dramatically lower those numbers. I don't have the number in front of me. I will get you the numbers if you would like. I'm sorry, I don't have a copy.

Representative OBEY. Mr. Chairman, I would simply like to observe something. I know my time has expired, but I would just like to make this point.

I was here when we went through what I regarded to be the most gutless period in the modern-day history of the Congress, when the Congress rolled through over my opposition to the Reagan budget and tax packages of 1981. I recall that at that time that we had a battle ground, based very largely on different sets of economic estimates and different sets of numerical estimates.

The President used a very optimistic set of assumptions. Jim Jones, who was our Budget Committee Chairman, used what we regarded as a much more realistic set of assumptions, and because we based our budget on what we felt were realistic economic assumptions rather than the Reagan Administration's more optimistic economic assumptions, the President was able to return from his hospital bed after he had been shot—a figure of great national sympathy—took the microphone in the House, and beat the living hell out of us by simply running our budget through his economic model. So, we lost and within 3 years national indebtedness had more than doubled and so had our deficit.

I just have to say that having been here, and being extremely angry about what that has resulted in for our country, in terms of the huge amount of debt, and having seen how long it has taken us to try and climb out of that, I just am not willing this time around to again base my actions—when I'm asked to support a capital gains tax cut by the President—I'm not willing to take the Treasury numbers at face value, which are today much more optimistic and, in fact, in a totally different direction, than they were in 1985.

So, you're going to have to do a whole lot better than a Treasury double reverse in order to convince objective people that capital gains is a revenue gainer long term, because I think everybody understands it's not.

I would simply ask that, with respect to who gets what under the tax code, you not do a repeat of 1981, which David Stockman described as this:

Stockman indicated in his Atlantic Monthly magazine article that he originally felt that the Congress and the President had an obligation to go after weak claims rather than weak clients in eliminating unnecessary spending. But he said, in fact, that didn't happen, and I'm quoting, "What had changed fundamentally was the list of winning clients and not the nature of the game."

It seems to me that the list of winning clients who would benefit under the Administration's capital gains tax cut is the same list of winners that we've seen through the 1980's, the very wealthy. And I think that, rather than seeing that happen again, we need a fundamental change in the nature of the game, or we are not going to get out of this deficit hole. And if we don't get out of this deficit hole, in my view, we're going to threaten the future income potential of every young worker in this country.

Mr. BOSKIN. Well, Congressman Obey, you might be surprised that I partially agree with you. I'm very concerned about the budget deficit, and I have always been. I have a different interpretation of what happened in the 1980's than you do, and I would share the credit and the blame more generally for the good and the bad than you perhaps would. I do believe that the first Reagan economic forecast was way out of line with anything that was credible.

Now, I told Jim Jones that, I told David Stockman that, and I told Howard Baker and a variety of other people at the time. I believe that there were many beneficial things in the program, but I do believe that the growth of deficits and debt in the 1980's was a serious problem. We can discuss who's to blame for that, the American people, the Congress, the President, external events, or a variety of things. And we can get into that if you would like, whether spending went up, relative to GNP, and taxes stayed the same, or what happened. But in any event, I do share that concern.

I would make the observation that there is an historical experiment that was performed in 1978: The Steiger Amendment was passed. And even the Joint Tax Committee admits that it generated additional revenue, additional growth and so on.

Representative OBEY. In the first year and a half.

Mr. BOSKIN. Legitimate disagreements can occur, and I respect your right not only to disagree, but I have a high regard for you. You have a different interpretation of events than I do, and we'll disagree about that.

Representative OBEY. Thank you, Mr. Chairman.

Senator SARBANES. Senator Roth.

Senator ROTH. Thank you, Mr. Chairman.

Frankly, I think that what the American people are interested in is not so much as to who was to blame in the past, because as far as the deficit is concerned, of course, not a single dollar can be spent without being appropriated by the Congress, but what I think has the American people concerned is that we face a unique situation in the sense that we not only have a short-term problem, but we also have a long-term problem. The long-term problem is one of becoming competitive in the emerging global economy. The short-term one is probably primarily one of confidence. How do we restore American confidence so that people will go out and buy, hopefully, American-made products?

One of the things that concerned me in addressing this long-term problem is the question of savings. I think there is general agreement that it's critically important that the United States become more of a savings nation; that our record is rather dismal in comparison with other leading industrial nations such as Japan.

The President in his State of the Union Address made certain proposals with respect to savings, particularly making the IRAs more flexible for withdrawal to buy that first home, higher education and health costs; but he did not expand it, and I would hope, and I would also be interested in your comments, that the Administration would take a more careful look at the super IRA that has been introduced by Lloyd Bentsen and myself.

I would point out that this is a piece of legislation that can be enacted. In the House, it has over 250 members co-sponsoring it. In the Senate, we have something like 70 to 75 co-sponsors, both Republicans and Democrats. As a matter of fact, they vary from Ted Kennedy on the one side to Jessie Helms on the other, and that's a pretty broad scope.

So, here is a piece of legislation that can be enacted that is good for the Nation in that it will promote savings. Savings that are badly needed if we're going to become competitive. It's good for the family at a time when people are predicted to live as long as a hundred. Therefore, the savings rate becomes a serious problem.

Why not include that in the current package? It makes good sense, it seems to me.

Mr. BOSKIN. Well, Senator Roth, we certainly believe that one of the major long-term challenges confronting the Nation is to raise both the private saving rate and to reduce government borrowing in order to free up resources for enhanced investment that will raise productivity and real wages for American workers.

We did include a new IRA, in addition to allowing withdrawals from the old one, that was somewhat similar to our family savings account last year. It's a modest step in the direction that you are taking, but I certainly think that what you and Senator Bentsen and your colleagues in the House have proposed merits very serious consideration. I think that over the long term

that our saving rate is a major problem. Without an increase in saving, I do not believe that we will be able to get the rate of labor productivity growth up to the rate that Americans want in order to provide sufficient improvement in the standard of living.

So, I will once again go back and discuss this with my colleagues. I believe that, while we may differ on some of the particulars and some of the details, you are quite right that the best long-term remedy is greater savings and investment to increase the growth rate of productivity and generate higher incomes.

In the short-term, again, you're quite right. We wouldn't want to encourage everybody to save a lot more right now. As you correctly point out, we need at least a temporary period of spending.

Senator ROTH. Well, one of the differences of this current sluggish economy is one that was alluded to earlier, that you're having both white-collar and blue-collar workers lose jobs without any hope of returning to those once the economy turns up.

Why are we going through this restructuring? I gather, at least, the rationale is that the large companies feel they have to do so to become competitive.

Mr. BOSKIN. That's what not only they say publicly, but what they say privately. In some industries, obviously, it's caused by public policy. There are many well-known defense-related companies now realizing that defense will be downsized considerably. I know there is disagreement about how much more defense spending will be reduced. Engineers and very highly trained people will be affected. I personally worry about anybody that is unemployed and has to be dislocated; whether blue collar, white collar, low paid, high paid, or whatever. If you look at whether this was a white-collar recession, it is true that the proportionate white-collar effect has been somewhat higher. But the unemployment rates of blue-collar workers have been both higher and risen more.

Senator ROTH. But isn't the difference—the important difference—that many of these, whether they are blue-collar or white-collar, cannot hope to be rehired once the economy turns around? Their loss of jobs is permanent. So, what becomes critically important is to create an environment of growth, of new businesses, particularly small businesses. Is that correct?

Mr. BOSKIN. That's exactly right. Small business is the engine of growth and the engine of new job creation. Adding new businesses, new industries, and new products and innovation that opens new frontiers is a way to expand.

Senator ROTH. Do higher taxes and the increase in regulations that have exploded recently create an environment of growth?

Mr. BOSKIN. I would say, in general, they are counter-productive in that regard.

Senator ROTH. So, much of what Congress has been doing has had a negative impact. It may have been done for worthy causes, but they are having a negative impact on the growth of the economy.

Mr. BOSKIN. Some regulations, though created for worthy reasons, impose very substantial costs on businesses. Regulation is especially hard on small businesses that don't have a phalanx of lawyers and accountants to deal with it.

Senator ROTH. Let me ask you this. Would it be better for our economy if policymakers focused on improving economic growth instead of inciting class warfare? What effect do constant threats to raise taxes, for example, have on savings and investment behavior?

Mr. BOSKIN. Well, I would like to see everybody in our society be doing better. I also believe in a society where there is a lot of mobility. That has been one of the strengths of the American economy over the years, relative to European economies, for example. People who may at one point in their life be relatively low-income earners have much more of an opportunity to move into the middle- or higher-income categories later on. Indeed, that does occur. So, I'm very interested in doing everything that's possible to keep the economy flexible and those opportunities open.

I do believe that prospectively higher taxes would discourage people from engaging in activities that would be then taxed higher when the return on them came due.

Senator ROTH. And if you raise taxes on the more affluent, you're also raising taxes on those that are most likely to be the entrepreneurs of the future; is that correct?

Mr. BOSKIN. Well, all of the new entrepreneurs aren't going to come from people who are currently affluent. I prefer to think about it as creating an environment where people have the opportunity to generate a new business and new job, and if in the process of that they become well off, then that's fine with me. They're helping other people as well by generating the new jobs.

I do believe that many of these proposals to tax one group and reduce taxes on another are basically social policy. People will have disagreements about social policy, but it really has very little to do with generating an improved economy.

Senator ROTH. Let me ask you a question from the point of view of competitiveness. We pass many laws for worthy goals which result in regulation, whether it's safety, health, or whatever, but each of these agencies that issue the regulations tend to do it independently of the impact on the economy as a whole. There has never been any organization, not even OIRA, to try to take a look at what the overall impact of regulation is.

Would it make sense to have somewhere in government—in public so that everybody would be aware of what the purpose was—an organization that would review all regulations to determine what their net effective interaction is on the economy?

Mr. BOSKIN. I think it would make eminent sense, Senator Roth. Under Executive Order 122-91, the Office of Information Regulation Affairs of OMB is charged with reviewing rules of Executive Branch agencies to make sure that they comply with a certain set of criteria, that the benefits exceed the costs and so on.

Now, obviously events change. These new regulations interact with old ones, and it's very difficult to go back and rework them all. That's one of the things that we're examining now, to see if there are some opportunities to generate some business expansion and job creation.

The independent regulatory agencies are obviously not subject to this Executive Order. In any event, the general premise is that regulation, in addition to whatever it does to help the environment, or safety, or the like, imposes costs. Sometimes these are wildly irrational relative to one another.

Congressman Obey used an example about the cost per job of regulation earlier. While I don't agree with that particular case, he was right to think about alternative plans which result in different costs per job. We have some regulations that cost millions per job or per case of cancer averted or delayed, and others that are much less effective. We ought to be concentrating on places where we're most effective rather than less. So, I think in general, it's a very good idea.

Senator ROTH. My time is up. Thank you, Mr. Chairman.

Senator SARBANES. I thought Vice President Quayle was to be the focal point for review of regulations. As I understood it, there was a news account that representatives of the private industries being regulated have access to the Vice President or his staff, in order to make their one-sided presentation about the impact of the regulations. Isn't that the case?

Mr. BOSKIN. No. I think that's an inaccurate perception, if I might say. The President has appointed the Vice President to chair the Council of Competitiveness, which does review some of the most potentially costly regulations and rules. Most go through the normal OIRA process, and when the OIRA and the agency can't work out an agreement and when it's potentially a very large effect, there is a discussion of the Council on Competitiveness. Indeed, a wide range of opinions as a rule are sought both in the formal rule-making process and in the docket, for example, and reviewed.

Senator SARBANES. Sought by whom?

Mr. BOSKIN. Sought by, for example, the Environmental Protection Agency.

Senator SARBANES. Oh, yes, when the agency does its regulations. But our understanding is that this Council which the Vice President heads, which, in effect, has been negating agency actions, is available for access by the particular private economic interests being regulated, on a quiet basis.

Mr. BOSKIN. A wide range of interests, not just the private economic interests to be regulated, undoubtedly contact the small staff of the Council on Competitiveness. And I wouldn't say that it's negating the actions of the regulatory agencies. I would say that it has been improving and making them more flexible.

Our standards have only been within the statutes passed by Congress. Given the target set to achieve some objective, whether that's reduced emissions of sulfur dioxide or whatever, we try to regulate in a way that is minimally disruptive to workers and is cost effective.

Senator SARBANES. Well, I'm not quarreling with that. The only point I'm raising is that my understanding is that this Council does not have a process comparable to what the agencies have when they deal with regulations, to ensure, in effect, an open hearing and that all sides with respect to a regulation are heard; and, in fact, certain elements get access to this Council to state their case and others do not.

Senator ROTH. Mr. Chairman, if I just might interject since this is a follow-on to my question. What I am actually proposing and have introduced is legislation that would have Congress authorize an overview under stipulated conditions, among them being, of course, open——

Senator SARBANES. You used the words open and transparent, I think.

Senator ROTH. Open and transparent.

Senator SARBANES. Yes, and I agree with that. I would have to look at that proposal on its merits, but at least it addresses this problem. But I'm trying to address a question to the Administration because my understanding is that there is a process that is now taking place which, under any reasonable standard, would not be considered open, or transparent, or constituting the basis for an objective decision.

Senator ROTH. Again, what I'm seeking to do is to resolve this controversy as a member of Government Affairs. What we would do is authorize OIRA to do so, but it would be under the same conditions that the Paper Reduction Act provided for disclosure. We would protect the right to take it to court if the goals of the various legislations were not being meant. In other words, regulations are very important and necessary. At the same time,

they can be burdensome and depressing if not appropriately done, and it just seems to me to be an area that ought to be addressed.

Senator SARBANES. Senator Bingaman.

Senator BINGAMAN. Thank you, Mr. Chairman.

Mr. Boskin, thank you for coming today.

Mr. BOSKIN. It's good to see you, Senator.

Senator BINGAMAN. I wanted to ask about a specific area of our economy, one that is not referred to very extensively in your report, but one that I think is very important, and that is manufacturing, because I do think that our long-term economic future will, to a great extent, depend upon how robust a manufacturing sector we can maintain.

I'm particularly interested in the problems faced by small- and medium-sized businesses in manufacturing. In answer to one of the other questions, you've said small business is the engine of job creation. I agree with that. It certainly is in my State.

We have been trying this last year—several of my colleagues; Senators Nunn, Gore, Hollings, Mikulski, and myself and others—to get the Federal Government more aggressively involved in supporting small businesses and small manufacturing firms through a manufacturing extension program. In fact, we introduced a bill that contained a national manufacturing extension program, and we enacted it as part of last year's Defense bill. The idea is that the Federal Government would begin to lend some resources——

Mr. BOSKIN. You mean similar to agriculture?

Senator BINGAMAN. Similar, right. It would not set up a whole new set of manufacturing extension centers, but get the Federal Government in the business of helping States and localities that are already moving in this direction by providing some assistance to them to support manufacturing extension programs.

In my own State, 7 percent of our jobs are in manufacturing—one of the lowest in the country—but even we have a manufacturing productivity center that the State government has funded. It's underfunded, but it's there, and we're trying.

The idea of this national manufacturing extension program is to have some money come out of the Department of Defense, the Department of Energy, the Department of Commerce and NASA, have them all come together and put that money into help for localities and States to support the modernization of small- and medium-sized businesses.

Now, when we proposed that, we got a statement of Administration policy, which essentially said, in discussing this along with some others provisions, that these sections were objectionable—these sections in the Defense bill—they attempt to address a broad range of technologies and manufacturing capabilities of potential interest to the private sector; and that such efforts normally should be accomplished by the private sector and not through a centralized, government-planning process.

I guess I can understand the theory there, but as a practical matter, we spend about $1.1 billion a year on agricultural extension. We spend less than $20 million at the federal level on manufacturing extension. This is in sharp contrast to what Germany does, what Japan does, and what most industrialized nations do.

Why doesn't this Administration get behind an effort to support manufacturing extension for small- and medium-sized business?

Mr. BOSKIN. Mr. Bingaman, I would have to admit that I don't know the exact details of the proposal. I will take a look at it, and if you would like, I would be happy to discuss it with you subsequently.

As you describe it, it sounds less in conflict with the Administration's general view, that the role of the Federal Government ought to be supporting pre-competitive, generic technology development, as opposed to things that might be at the commercial——

Senator BINGAMAN. This is not a technology thing.

Mr. BOSKIN. So, in that sense, I'm not really quite sure. I would be happy to go back and take a look at it.

Senator BINGAMAN. This is manufacturing extension. This is stuff that we know about, that has already been developed, and that is being used by some businesses. I'm sure that you're aware that the modernization of our manufacturing sector occurs first in the large firms, and then it sort of trickles down, as the saying goes.

Mr. BOSKIN. If the clear case could be made that there is some market failure here, that there are such scale economies that the government could do this at a much lower cost than could the private sector or could spread this information more efficiently, then I might be quite sympathetic. But I would have to go back and look. I'm embarrassed to say that I don't know the details.

Senator BINGAMAN. Well, I would appreciate it if you would look at that. It's in the Defense bill, which is now law.

Mr. BOSKIN. The Defense Procurement Act?

Senator BINGAMAN. No, the Defense Authorization Bill. It's a national manufacturing extension program. I think it's accurate to say that the Administration has asked for no money for it, although we authorized it. I think it would be a good thing to do. It gets caught up in this industrial policy debate, and it seems to me it's totally irrelevant to that debate. It's something that we ought to be doing.

Mr. BOSKIN. Well, I think we all ought to be past this vocabulary. We all ought to agree that the government needs to do some things, and there are other things that the private sector ought to do. We should try to get out of some of this semantic arguing. So, I agree with you in that.

Senator BINGAMAN. Well, I would appreciate it if you would look at that program and see if it's something we could get the Administration to support. That would be terrific.

Mr. BOSKIN. I will try to educate myself on it, and I apologize for not being up on it.

Senator BINGAMAN. Let me ask about another specific that I have been spending some time on, and that's the proposed sale by McDonnell–Douglas of 40 percent of their commercial aircraft business to a company that the Taiwanese Government has formed. I gather it has some private involvement, but it's also being promoted by the Taiwanese Government.

I have expressed concern about the long-term effect of this from a couple of aspects. First of all, there is evidence that Airbus is being sold into our market at below the cost of production. All the analyses indicate that Airbus is heavily subsidized. The estimate I've heard is that they have received about $26 billion in subsidies from the European countries that are part of that. The sales by Airbus into our market and into the world market are one of the main problems that McDonnell–Douglas has faced financially. They're in very tough competition.

Now, I've talked to officials from the Boeing Corporation, and they are concerned that the sale by McDonnell–Douglas of 40 percent of their commercial aircraft business to the Taiwanese would result in an Asian Airbus, essentially a Taiwanese Government subsidy of another one of their competitors.

Boeing is now about the only nondirectly subsidized company doing this business, and they do it very well. They still have 60 to 65 percent of the world market, but it's dropping, and Airbus' is increasing.

Under these circumstances, why can't we get someone in the Administration to look at this issue and see if there is some national interest that needs to be considered here. So far as far as I can tell, nobody in the Administration is looking at this. The view appears to be that this is one of these things that is a private-sector transaction, and it's not the government's business, and I just think that's very shortsighted.

Mr. BOSKIN. Well, first of all, there is the CFIUS process, and this may wind up going into that process. If it does, then it will be evaluated there.

With respect to possible or alleged dumping by Airbus, to the extent that that is going on, we ought to vigorously use our antidumping laws and enforce them quickly. I know that Ambassador Hills is working very hard in a variety of multilateral and bilateral fora to reduce these subsidies. The best of all things obviously would be to get rid of all the subsidies and compete on a level playing field. I'm sure you would agree with that.

Senator BINGAMAN. I do.

Mr. BOSKIN. So, I think that perhaps we can do a better job of coordinating on this. I'll talk to Ambassador Hills about it, but I think that the Airbus subsidy is being addressed.

Senator BINGAMAN. Well, CFIUS, as I understand it, provides for a 30-day review that hasn't started because there is not a decision. I mean, the negotiations between McDonnell-Douglas and the Taiwanese are ongoing, but because no deal has been firmed up, there is nothing to trigger the CFIUS process, and therefore nobody can look at it through that process, I'm told at this stage.

We currently have a favorable balance of trade in aircraft. I would hate to see that one go the way of automobiles and a lot of our other manufacturing sectors. I think that this is an area where, given some attention by the Administration right now, we might be able to head that off. So, if you could look into that.

Also, I'm concerned about the impact of this proposed deal on the small suppliers to McDonnell-Douglas because they also supply our defense sector. A lot of those folks are going to be up against tough competition to remain suppliers in the future, I'm afraid. If you would look at that, I would appreciate it.

Mr. BOSKIN. Certainly, Senator.

Senator BINGAMAN. Since I have another minute here, let me just ask one other question on the issue of technology policy, technology winners and losers. You were kind enough to respond to a letter that our Vice Chairman, Representative Hamilton, wrote on this whole issue of winners and losers, and you made the point in your response that you think it's okay to pick some technologies. I think you said there are some pre-competitive generic technologies that are appropriate for the government to support and others are not, and then you gave some criteria. You then went on to say that we should not support, or it's inconsistent with Administration policy, to target particular industries for support or particular technologies for commercialization.

I want to ask you about NASA's and the Department of Commerce's offices to promote space commercialization. Those have long been supported by the Administration, and I support them myself. Why shouldn't we have similar efforts to support energy commercialization, commercialization of

our transportation R&D, and commercialization of some of the other areas that we're active in?

Mr. BOSKIN. Well actually there is an ongoing effort right now to greatly improve technology transfer from, say, the Energy Department to our private sector. Henson Moore and Admiral Watkins have led that effort for some time. I think that's one area where America fails badly. We spend a lot on government R&D. We're asking for record levels of spending in R&D in this year's budget as we have in every budget the President has submitted. We need to get the taxpayers a better return on that.

Much of the R&D that is financed federally or done in government labs could broadly affect several firms or several industries, and hence no single firm would have an incentive to undertake it. They simply couldn't appropriate all the benefits to do it themselves. We don't do a good enough job at getting the benefits of government R&D disseminated. We view that as a major management task, and it's underway.

Senator BINGAMAN. My time is up. Thank you very much.

I gather Congressman Fish is next.

Representative FISH. Thank you very much, and I'm getting hungry, too, Mr. Boskin.

Mr. BOSKIN. I appreciate your forbearance.

Representative FISH. I only just got this little volume here of whatever it is, 400 pages, but there is something in it that I was very excited and delighted to see, which I want to explore with you.

Listening to you and scanning as I went along here, we're talking about productivity and employment determining the standard of living of the American worker, and they are two of our problems. Productivity has slowed down and unemployment is far too high.

It seems to me that you identify the cause here as three-fold. One is a reduction in the rate of capital accumulation, which you address in different ways through investment tax—it's not called investment tax——

Mr. BOSKIN. Allowance.

Representative FISH. ——allowance and of course the capital gains reductions. Also, the reduction in the rate of technological advances, and I think that's critically important to recognize because historically it has been shown that increases in R&D have resulted in economic growth.

The third one is what I want to address. The reduction in the rate of improvement in the skill levels of our labor force. That is, of course, overcome by training and retraining to meet the technological changes in the workplace. I can remember hearing the last three Secretaries of Labor, starting with Bill Brock, warning about this—who are going to be additions to the labor force, and how ready are they trained for the experience that they are going to undergo.

I think your report starts here in Chapter 4, page 109, Enhancing Worker Skills, and I wonder if you could just summarize it for us here, because you go into the formal education aspects, the involvement of the private sector, the retraining necessary, and then there are some federal programs—JOBS and others—that go into this. I think this is a key to productivity, to competitiveness, and to our whole economic well-being for the balance of this century.

Mr. BOSKIN. Well, I think that you're absolutely right, Congressman Fish. I think that I would divide it into two problems. One is enhancing the skills of workers whose skill levels are not matched well with the current demands, or the changing demands, in the labor market. Especially with computerization and a lot of other things, jobs in many industries, which tra-

ditionally have not demanded much formal education, are demanding a lot more. A lot of people on production lines are working computers rather than just basically doing direct manual labor, and therefore enhancing their skills through job training and retraining is obviously important.

But I would say, for the long term, even more importantly, our elementary and secondary education system is just not delivering the goods. Now, there are many reasons for that, some of them social and some of them familial. We believe that one of the major elements is the structure of the elementary and secondary education system. That's why the President and Secretary Alexander proposed America 2000, and over 30 of the States have signed up to try to generate a new generation of American schools. Through increased choice and competition, we will try to generate better performance in our elementary and secondary educational system so that our kids not only acquire skills that are more relevant, but also acquire the ability to adapt to change. Both of those are important.

You just never know. It's hard to predict what the economy will do in the next couple of years. None of us can predict what somebody graduating from high school or college will be facing 20 years from now. They may have a good steady job for a while, and then things could change abruptly, and they would have to be trained or retrained and so on. So, I think all of these things are very important.

One of the things we're trying to do is to better integrate, streamline, enhance, better fund and coordinate the job training programs with the demands in the local economies, with the private sector and so on. We're proud of the job training 2000 proposal. We think it will help a lot. This is an area that deserves substantial attention.

Representative FISH. Well, good luck. I thank you. I'm glad it's on the road, and it certainly will be a big help to that generation coming along, and I now better understand the President's emphasis. He put this in the context of education in the State of the Union Message, and the necessity for brevity prevented him from fully covering that topic in a matter of an hour or less. I think some of what you were just saying and elaborating on is what he really was after here.

Thank you very much.

Mr. BOSKIN. Thank you, Congressman Fish. The President clearly believes this is part of his long-term growth agenda, as well as his education agenda.

Senator SARBANES. Senator Smith.

Senator SMITH. Thank you, Mr. Chairman.

Mr. Boskin, when I went over for a vote, I understand Congressman Armey asked about the 1989 House vote on capital gains. I just want to pick up on that for a second. I was a member of the House at that time.

I think one of the unfair characterizations in the debate on capital gains that the President has put forth is that somehow this is one party versus another party. As you are probably aware, 64 Democrats voted for the capital gains cut in that 1989 vote. Among them were Jack Brooks, the Chairman of the Judiciary Committee; Jamie Whitten, the Chairman of the Appropriations Committee; Bob Roe, the Chairman of the Public Works Committee; not to mention other members of Congress who were not generally aligned with Ronald Reagan or George Bush, like Neil Smith, Bill Natcher, and Tom McMillen, to name a few. So, I think that it is an unfair characterization in the debate.

What I would like to ask you is, suppose that it had passed and the Senate had dealt with it as forthrightly as the House did, and that was roughly 2 ½ years ago. Give us a rough analysis of what impact you feel that would have

had on the economy had that capital gains tax cut passed the Senate, as well as the House, and was signed by the President in 1989.

Mr. BOSKIN. Well, I certainly think it would have helped the economy in several ways. I think we're all familiar with how it would reduce the cost of capital, spur investment and create some greater incentives for innovation and entrepreneurship.

Also, as discussed in my testimony and in the Report, one of the serious problems the economy has had—one of its structural imbalances—has been a slowdown in the rate of growth, and in some cases, a decline in asset values. This is one of the reasons why consumers are lacking confidence. One of the reasons that State and especially local governments are having problems is because property values are going down. They are trying to raise taxes on property values that have gone down in some regions and have stayed flat after rising for a while in others. So, I think it would have generally been beneficial to a wide range of sectors in the economy, and the economy would be better off.

Now, we had the oil shock and we had the war and several other things. So, it's not the only factor that would have affected it, but clearly the economy would be in better shape now. I think we would have looked at a less difficult last couple of years had it not been for that occurrence.

Senator SMITH. Is it fair to say that, in your professional opinion, more jobs would have been created rather than lost had that passed?

Mr. BOSKIN. Well, certainly more jobs would have been created than have been created since then, yes.

Senator SMITH. I think another criticism that is thrown out not only against the President, but against all of you in the Administration is that somehow the President must bear the total responsibility for an economy that is obviously, and everybody concurs, not doing all that well. Essentially, the position is that the President has not acted and has not done anything to promote a better economy, if you will, when in fact it is a fact that for the past 3 years in his State of the Union message and in his economic reports that he has advocated capital gains cuts and balanced budgets and line item vetos, not to mention IRAs and other things that have already been discussed.

I just might ask for your observation on this as being one ingredient. We do have a divided government, in the sense that we have a Congress and a Executive Branch, and there are differences of opinion on how the economy should go. They are honest differences. Sometimes they get too personal, but they are honest differences.

Would you offer me your analysis of whether there ought to be some shared responsibility, both credit as well as blame, for, say, the Federal Reserve policy, the congressional actions or inactions—however you want to look at it—and the White House. Just give me your observation on that point.

Mr. BOSKIN. Well, I think that point is very well taken, Senator. In our country, responsibility for economic policy is more widely diffused than in most other countries. Many countries that have parliamentary systems don't have this distinction between the Executive and the Legislative branches, even when the same party is in control in both.

We have quite an independent Central Bank, as does Germany, but most other countries' Central Banks are quite a bit less independent from their Finance Ministries, which then in turn are part of the Parliamentary system. And of course lots of things occur in the economy that have nothing to do

with or are not affected very much by economic policy—events overseas, oil shocks, or wars.

But certainly with the benefit of hindsight, monetary policy had a very difficult time. The Fed was trying to head off an incipient increase in inflation in 1988 and 1989. I think had they known or predicted an oil shock and a lot of other things, including that the credit crunch would have been so bad and so on, or that their steps to expand the money supply, and the steps they've taken have not resulted in as much growth in money creation and in GDP, they might have acted more aggressively.

I think clearly the Fed policy of slow money growth was one of several, certainly not the only, but one of several ingredients. Obviously, the Congress is primarily responsible for many types of policy, including fiscal policy. The President proposes legislation and has veto power, but the Congress is primarily responsible for spending and tax legislation, and initiates a lot of regulatory legislation.

So, I think one should spread the credit for what has gone well with the economy, and the blame for what has not, across all branches of government. If this were done, the 102nd Congress wouldn't have as good a record on their watch as did the previous several Congresses. This is sometimes alleged about the Executive Branch.

Senator SMITH. I know the Chairman is anxious to wrap up here. Just a couple of observations along the lines of your analysis regarding presidential inaction, if you will. I wouldn't ask you to try to comment on what you feel the price of oil might have been had Sadam Hussein, for example, been successful in staying in Kuwait, and perhaps even moving on into Saudi Arabia and controlling all of the Middle East oil in those regions.

Would you even want to speculate on what we might be paying for the cost of oil and what that might have done to the United States economy?

Mr. BOSKIN. That's a very perceptive point, while not done primarily for those reasons.

Senator SMITH. That's a presidential action, wouldn't you say?

Mr. BOSKIN. That's exactly right, while not done primarily for those reasons, had the President not organized the international community, shown the leadership, gotten our troops there, stopped Sadam Hussein and ejected him from Kuwait, Sadam Hussein would have been poised to take over Saudi Arabia and control two-thirds of the world's proven reserves of oil. Oil prices would be vastly higher, and not only the American economy, but all of the oil-importing countries would have been in vastly worse shape. We would not be talking about the serious problems that we're having, but we would be talking about vastly worse ones.

Senator SMITH. Two more quick points, Mr. Chairman.

The issue of unemployment compensation has heartily been debated both on this Committee, as well as on the floor of the Senate and in the public domain, and I would take a different perspective. The President of the United States very clearly said that he supported unemployment compensation, put that matter out on the table, and he said I want to pay for it, I want an offset. For 145 days politics was played with that issue, and a lot of people in my State lost their homes because of it.

When people blame just the President for that, I think that's uncalled for, and I think that there is a clear responsibility in both branches of government for that, in the sense that one policy was laid down and another policy was not agreed to, but I think it was clear that that matter could have been resolved much sooner than 145 days.

Finally, I just want to pose this as a question. Congressman Obey, I think, brought this into his questioning about who was going to benefit, whether people below $50,000 or above $50,000 in income were going to benefit by capital gains. Isn't the key here job creation? I mean isn't that what we're trying to do?

Mr. BOSKIN. Exactly.

Senator SMITH. So, if you're unemployed, you don't have a job and you're looking for a job, are you as concerned about getting a job so that you can feed your family, or are you more worried about somebody who might be in a middle-income bracket moving into "the rich bracket" where somebody who is rich will make a few dollars more, if in fact a job is created for you and your friend down the street?

Mr. BOSKIN. The entire purpose is to create jobs, and we believe that, as several people on both sides of the aisle have expressed, a large key to that is the formation of new businesses, the encouragement of entrepreneurship and innovation, and new products and technologies, and so on.

It's clear to me that the primary criterion in measuring fairness is whether it will help the economy create jobs.

Senator SMITH. So, job creation ought to be the focus of the debate rather than whether somebody makes a little more money than somebody else as a result of the package?

Mr. BOSKIN. I would hope so. I indicated earlier that I thought one might debate social policy, but I would hope that one would concentrate on what would be good for the economy.

Senator SMITH. Thank you.

Senator SARBANES. Congressman Wylie.

Representative WYLIE. Thank you, Mr. Chairman.

Mr. Boskin, I'll say that, as one of the key players in the formation of the Administration policy, you have in the past established, I think, and enhanced your credibility through your willingness to address complex issues and provide practical solutions. I think it's easy to stand back and complain about the state of the economy, but I think it's far more difficult to take the proper action.

I want to commend you for your thoughtful and practical and forthright analysis provided in this year's Economic Report, at a time when partisan politics has made it expedient to focus on the quick-fix solutions. I think you've had the courage to address the broader questions, and I think your proposals give us hope of leading the Nation out of its present economic state. It shows a path forward, ensuring long-term economic growth that can provide for the well-being of all of us, as well our children.

Having said that, actually, Mr. Boskin, your forecast is less optimistic than CBO's. I have it here in front of me. The Administration has sometimes been criticized for being overly optimistic in economic forecasts, and the recovery is projected to begin, or was projected to begin last summer, and maybe someone else has asked this question, and if they have, you can say so, and I'll take a look at the answer in the record, but the recovery projected to begin last summer, if it occurred at all, was clearly weaker than you expected. You said that in your opening statement.

Mr. BOSKIN. Yes.

Representative WYLIE. What is your outlook for economic growth in the short term, and do you feel that it will be more accurate than the one published in last year's Economic Report?

Mr. BOSKIN. Well, let me just state that the one published in last year's Economic Report, as I indicated, was more accurate than all but 8 of the

52 private Blue Chip forecasters. But the entire forecasting profession missed the flattening out of the economy late in the year.

Our forecast is for 2.2 percent real GDP growth this year, the bulk of that coming in the second half of the year. We feel that growth will be more certain, stronger and faster if Congress and the President get together and pass the President's proposals or their economic equivalent. All the "i's" and "t's" don't need to be dotted and crossed. The Administration is forecasting about 3 percent growth for 1993, which I think is probably about where CBO and the Blue Chip are.

You are correct that both this year and last year CBO was more optimistic about the pace of the recovery than was the Administration. If we go back to 1989, probably as a fluke, the Administration was more accurate than all 52 private Blue Chip forecasters.

It's a difficult thing to make economic forecasts. As I said, a year ago, all the private forecasters—the CBO, the Federal Reserve, and the Administration—missed the fact that at the tailend of the year that the economy would flatten out.

I think, over the range of the Bush Administration, our forecasts, relative to those made by the private forecasting profession and the CBO and so on, have been quite credible and quite accurate. Congressman Obey complained about the first Reagan forecasts, but I haven't heard anybody complain that our forecasts were unreasonable. People might disagree with one detail or another of them.

Representative WYLIE. Thank you. I think, given the uncertainties that have crept into our economy, your forecasts were quite credible. That's my observation.

Mr. BOSKIN. Thank you.

Representative WYLIE. I noted in an article recently where you said that you have been the primary force behind an initiative to improve the quality of economy statistics. According to the Economic Report of the President, this initiative would cost over $150 million over the next 5 years. What would be the benefits of this program to those who foot the bill, the taxpayers?

Mr. BOSKIN. That's a very good question, Congressman Wylie. Let me begin by thanking the members of this Committee, especially the Chairman, for their support of this initiative. I think the answer is two-fold.

One benefit is that over time we will receive more accurate data on the economy, and we will receive it sooner. That means that our citizens will have a better idea of where we are, where we're headed, how we got there, and how we compare to the rest of the world.

Second, it will enable not only public policymakers, such as yourselves, the members of this Committee, the President, the Federal Reserve and others, but also millions of private decisionmakers in business, labor, households and so on to make better decisions based on more accurate information.

We all have to know sooner and more accurately what is going on in employment. It will enable the Bureau of Labor Statistics to better automate their employment and unemployment data. It will enable us to have data that are more internationally comparable in our national accounts. So, if we compare our performance to other countries with whom we trade or compete, we'll have a more accurate basis of understanding.

I think it's a modest investment. In the collection and dissemination of the existing data, we spend a fair amount already. I view this as a tiny R&D budget for statistical agencies to improve the quality of their data and adapt

to changes in the economy that may make some of the old measurements less relevant today than they were when international trade was less important, or the service sector less important, and so on.

Representative WYLIE. That sounds like a good answer.

Senator SARBANES. Let me just interject there, Congressman Wylie, to acknowledge the leadership that Chairman Boskin has taken on this issue within the Executive Branch. He has come forward with a number of initiatives, and we've tried to get congressional support for those with mixed results. Although I would say, given the budget times in which we find ourselves, it has not been too bad——

Mr. BOSKIN. I will agree with that.

Senator SARBANES. ——and in fact fairly good. He has chaired an interagency group within the Executive Branch that has formulated a number of worthwhile initiatives. I think there is more that could be done, but we can't get everything done that has been put on the table. I do, following up on your question, want to put into the record his leadership in that regard.

Representative WYLIE. Thank you. I'm pleased to yield to the Chairman for that observation.

In general, Mr. Boskin, short-term real and nominal interest rates are much lower than long-term real and nominal interest rates. Unfortunately, long-term interest rates are more important determinants of investment in housing, autos, and plants and equipment. Would you agree with that?

Mr. BOSKIN. Well, I agree that both are important. I think that increasingly over the last 20 years that innovations in the financial sector have led to the packaging of securities. So, I wouldn't look just at longer term interest rates, but certainly long-term interest rates are quite important.

Representative WYLIE. Well, my question is, is there anything that we, as a Congress, can do to produce significantly lower long-term interest rates? I think that, in the overall, that would be more beneficial, or at least that's my opinion.

Mr. BOSKIN. Well, I think there are several things. It's very important that the projected deficit—and let me use the jargon, structural budget deficit; that is, once we are out of bad economic times and cyclical factors are removed—should be placed on a more permanent downward path. It should be on a downward path once we are over the hump of paying for deposit insurance for a few years. But then the projected growth of entitlement spending, particularly for health care, grows so rapidly that the projected deficits would start rising again in the late 1990's.

I think it would be very good for long-term interest rates if, one, some additional steps were taken to control the future growth of those entitlement programs, consistent with humane treatment of the people that are recipients of those programs. And, second, I think Congress needs to support a systematic and credible monetary policy that keeps inflation low and down, while providing sufficient credit for the economy to grow. It's very important that Congress not end up pushing us into an inflationary period when the economy is close to its potential.

Representative WYLIE. You mentioned monetary policy. One last question, Mr. Chairman. The results of my December questionnaire are coming back, and in one question, I asked the opinion of my constituents, "What do you think is the most serious economic problem facing the Nation." Forty-nine percent of those responding said the budget deficit, and I've a whole list. I think I have ten on there, and then have a place for "other".

What is your opinion as to the most serious economic problem facing the Nation?

Mr. BOSKIN. Well, I would get back to the budget deficit as a primary cause of the problem. The most fundamental problem is the slow rate of productivity growth over the last two decades. That is, the way the standard of living of Americans will increase, and we badly need to increase our rate of productivity growth.

The President's comprehensive program, from education and civil justice reform to job training and a lot of other things, is addressed to the labor market. We must also encourage a higher rate of capital formation so that we can supply our new workers with the equipment and better technology that they need to become more productive, to compete, and to have higher wage growth.

That implies to me that we have to finance a higher rate of investment. The medium- and long-term structural budget deficit is draining away the available supply of private saving for Americans to finance it ourselves. So, you are quite correct, that is a very serious problem.

I would make one kind of technical observation. If you look at the state of the budget now, net of the payments to pay off insured depositors and interest on the debt that are inherited liabilities, paying off things from the past, the budget is roughly in balance.

So, it may be considered small progress, but the Nation went from a situation in the 1980's where it was adding new liabilities to the future to a situation where right now it's rolling over the existing line. It's not paying them off, but it's rolling them over.

Representative WYLIE. Thank you.

Thank you, Mr. Chairman.

Representative OBEY. Mr. Chairman, may I just ask one question?

Senator SARBANES. Certainly.

Representative OBEY. You indicated that in response to Senator Smith's question that the Congress had the primary responsibility for the fiscal policy that has been followed.

Can you name any year, going back to 1948, where Congress ever changed any President's budget by more than 3 percent?

Mr. BOSKIN. It depends on what you mean by the budget. There are many different proposals.

Representative OBEY. I mean changing the amount spent.

Mr. BOSKIN. Not off the top of my head, and I wasn't just referring to spending. I remember President Carter in 1978 proposed dividend relief, and it turned out to be a capital gains tax reduction. I know that many things were added.

Representative OBEY. You said that the Congress had the responsibility for fiscal policy. You weren't talking tax policy. You said fiscal policy.

Mr. BOSKIN. Pardon me if I was not understood. By fiscal policy, I mean all of the Federal Government's spending, tax, and borrowing and credit policies.

Representative OBEY. You say that you can't name any year when Congress changed the President's spending levels by more than 3 percent?

Mr. BOSKIN. I would have to go back and look, but not off the top of my head, no.

Representative OBEY. I think that's because there isn't any.

Mr. BOSKIN. Well, you may be right, sir.

Representative OBEY. Can you name any year when we have changed the President's revenue mix by more than 3 percent?

Mr. BOSKIN. Well, certainly the revenue structure has been changed a lot. In 1981, as I recall, and I think you properly pointed out, a lot of stuff got

added to what was originally proposed. Now, one can argue about who should get credit or blame for that, but certainly Congress added a lot of stuff to the original proposal.

Representative OBEY. You're suggesting that in 1981 it was not the President's package that passed?

Mr. BOSKIN. As I indicated earlier, I worry a lot about deficits. As I recall in 1981, President Reagan made some proposals to which many additional things were added. However, perhaps in the end, President Reagan fully addressed the budget and called it his own.

Representative OBEY. Let me read what Donald Regan said at the time that the President signed the tax bill in 1981.

Mr. BOSKIN. Well, I'm sure President Reagan took credit for it.

Representative OBEY. He said, "We loaded the bases for him—the President—and he hit a home run." Now, does the President have to hit a grandslam home run in order to win, or is it just acceptable if he hits a home run?

Mr. BOSKIN. I was just making an observation, Representative Obey. I know that you were here then, and I know you're aware that in the time sequence that additional things were added. I'm not blaming Congress for that.

Representative OBEY. But this has my dander up for one very simple reason. I was here in 1981. I know what it feels like to lose. I got clobbered because I offered one of the two major alternatives to the President's budget, and I got the hell beat out of me. It was like being hit by Dick Butkus and Ray Nitschke at the same time, not to mention Lawrence Taylor.

I do know who won in the 1980's, and it was not the Democrats in the Congress. We didn't even have the Senate for 6 crucial years. So, when someone suggests seriously that the Congress has the primary influence historically over fiscal policy, I frankly think that is a preposterous assertion. The President has 90 percent of the resources for putting together a budget. Since 1921, he has had the responsibility to present a budget, and the Congress has been able to vary from that budget in excruciatingly narrow terms.

However, I fully agree that the Congress is equally complicit with the Administration in economic policy over the past decade, but not because the Congress played fruit basket upset, but rather because the Congress supinely, in my view, allowed the White House to win virtually all of those debates up until the Budget Summit Agreement of 1990. I will grant you that a substantial change occurred in 1990.

[Congressman Obey holds up a chart.]

This chart demonstrates the change in tax levels by income represented in the Budget Summit Agreement, which the President and the Leadership of both parties in the Congress ill-advisedly endorsed, in my view.

As you can see, persons who made less than $10,000 a year were supposed to get hit with a 7.5 increase in taxes in the original plan. Middle-income taxpayers were hit, on average, with a 3 percent increase in taxes. Those who made more than $100,000 a year were hit with a tax increase of about half that amount on a percentage basis.

It's true that the Congress on this one occasion did make a somewhat significant change, because here's what the distribution table looked like after we turned down that first turkey of a summit and insisted on a different distribution of revenue burdens. So, I think we can legitimately disagree on policy, but I really don't think that we can rewrite history.

The fact is that in this decade President Reagan and President Bush have won virtually all of the arguments when it comes to distributing federal dol-

lars and tax resources, except on this one occasion. I would say that that has not just been true of these Presidents, but it has been true of every President that I've served under, and it has been true of every President going back to 1948; including, in my view, even Harry Truman who railed the good-for-nothing 80th Congress. If you take a look at the numbers, the Congress did not in a huge way change what he recommended.

So, I would suggest that any time that Presidents win 97 percent of the fiscal battle that that's a pretty good batting average in any league you want to play in.

Senator SARBANES. Could I ask about that chart?

Mr. BOSKIN. Can I answer the question, please?

Senator SARBANES. Certainly, but I want to get this chart explained first, if you could hold it up again.

[Representative Obey holds up the chart.]

I take it that the top chart is where the tax burden was going to fall under the Administration's first agreement; is that correct?

Representative OBEY. Right.

Mr. BOSKIN. Agreed to by the Leadership of both parties in the House and Senate, as well.

Senator SARBANES. And resisted, to his credit, by Congressman Obey, who led the fight in the House, which eventually resulted in the taxes being distributed, as reflected in the lower chart, which shows that the bottom 20 percent actually got some tax relief. The amount paid in the middle was reduced. They still paid a little more, and the people in the highest income scales paid significantly more.

Mr. BOSKIN. I might just make one observation, if you would hold the chart up for one second, please, Representative Obey.

[Representative Obey continues to hold up the chart.]

That tax increase at the bottom, first of all, is a very small amount because people at the bottom pay very little in taxes. Most of them were removed from the income tax in 1986. That also does not include over $10 billion of increased transfers to those same people who would have made that bar a negative bar from the earned-income-tax-credit expansions that were agreed to in the Budget Summit before any changes were made. And let me say that, in a totally bipartisan way, some of those proposals were advanced by Congressman Downey and so on.

Representative OBEY. Well, I would simply respond by saying that this chart was prepared by the Joint Tax Committee and not by me. Second, while this might be a very small tax reduction, it's a hell of a lot better than a 7.5 percent tax increase, which the establishment in this town in both parties wanted to impose on taxpayers.

Mr. BOSKIN. I appreciate your perspective. My point was simply that that top chart did not include $10 billion of transfer payments going to those same people, and when you take the net of the taxes and transfers, they were going to be large net recipients.

Representative OBEY. Well, even if I were to grant that for the low income, you still can't justify—and I didn't want to get into a debate about what was good or what was bad—but in my view, you still can't justify raising tax rates on middle-income people—somebody making $50,000 a year—by twice as much as you raise taxes on somebody making more than $200,000, especially not in the context of what happened in the 1980's when the very wealthiest 1 percent essentially doubled their income.

So, my point is not to debate tax policy, although I would be happy to do that. My only point is that I find it strange that the party which has con-

trolled the White House for all but 4 years in which I've served in this puzzle factory, and which has controlled the U.S. Senate in the 6 key years when the basic economic decisions that have governed this past decade were made, I find it strange that they are still pretending as though George did it, and not meaning George in the White House, but some other George, somewhere.

Senator SARBANES. Charlie.

Representative OBEY. Charlie, Henry, anybody.

Senator SARBANES. Mr. Boskin, I want to put a series of questions to you and hopefully get a short answer, because I want to try to find out where you are, and if either of your colleagues disagree, I would like to know it. In other words, I'll take their silence as concurrence as I try to develop this public record. I've been listen carefully to what has transpired this morning, and I just want to make sure I'm clear on one thing.

Senator Smith sketched out an oil scenario for you, and you agreed that it would have had horrendous consequences. Did that scenario encompass Saddam Hussein taking over Saudi Arabia and therefore gaining control of that oil supply, or did it rest on Kuwait alone?

Mr. BOSKIN. It rested on effective control over Saudi pricing decisions, which would not necessarily have meant that he would have militarily taken over Saudi Arabia. He threatened it enough.

Senator SARBANES. Do you think that he was foreclosed from doing that by the presence of forces in Saudi Arabia ensuring their security?

Mr. BOSKIN. If they would have remained indefinitely, yes.

Senator SARBANES. So, it was a question of keeping him from extending his reach over Saudi Arabia; the failure to do that is what would have disrupted the oil market.

Mr. BOSKIN. No. They were disrupted a lot by his invasion of Kuwait, by the Kuwaiti production being taken off line, and by the threat that that would have had in other similar circumstances for other producers in the region.

One could slice the onion in different layers, but clearly the worst case would have been to have had no alliance there, and he invaded and took over Saudi Arabia. Effectively, he would have been able to coerce the Saudis because he had the fourth largest army in the world.

Senator SARBANES. I thought the oil market, after the initial disruption, went back into a stable situation, even though Saddam was in Kuwait. Is that not correct?

Mr. BOSKIN. There was a tremendous increase in supply brought about by expanding available capacity by the Saudis, by the Venezuelans, by the Emirates, and by many others to meet this shortfall. People were operating actually above capacity around the clock to deal with the situation. I think that probably wouldn't have been able to continue.

Mr. WONNACOTT. Senator, it is my recollection that we're talking now about the time between, I think it was October, when the price approximated $40, and the beginning of the operations. My understanding was that there was great concern that overproduction was leading to a rundown of the equipment—there wasn't proper maintenance. That level of production would not likely have been able to continue. We're talking about in Saudi Arabia and so on.

Senator SARBANES. What did the price drop back to?

Mr. BOSKIN. Last year?

Senator SARBANES. Before the hostilities in Kuwait.

Mr. BOSKIN. Well, it bounced around. It was generally in the $30's, it peaked at around $40, it went down to about the $30's, and then fell $10 a barrel overnight on the start of the successful operation of the air war.

Senator SARBANES. Do you think income inequality has any economic consequences?

Mr. BOSKIN. Under certain conditions, yes, in conjunction with how income in general is doing. Certainly distribution has various consequences if it's reflecting poor income or income prospects for those at the bottom. I'm very concerned about enhancing their opportunities and skills. But I also think that if we tried to——

Senator SARBANES. Do you think it has an effect?

Mr. BOSKIN. ——equalize the distribution of income exactly, I think we would shrink income a lot.

Senator SARBANES. Well, let's strike the word "exactly."

That's a strawman, and it doesn't do you credit to introduce it in this dialogue. As I understand it, you said, if we equalize income exactly. No one is suggesting that. Now, let's address the issue.

Do you think that a disproportionate income inequality can actually have harmful economic results?

Mr. BOSKIN. If the incomes of people at the bottom are not improving and are not doing very well, yes, it can have substantially harmful results, both on them and by the necessity for a humane society of——

Senator SARBANES. No, no. I'm talking about macroeconomic impact.

Mr. BOSKIN. I think the macroeconomic impact of the range of changes in income distribution exhibited in the United States and heavily accounted for by demographic factors is not a first order of consideration.

Senator SARBANES. There is a not a concern then about sustaining broad purchasing power that affects macroeconomics?

Mr. BOSKIN. Sure. That's a question of improving the incomes throughout the income distribution.

Senator SARBANES. But it is also affected, isn't it, by the distribution of income, as well?

Mr. BOSKIN. I think that over a span of time that the difference in the propensity to consumer in different income classes is rather modest.

Senator SARBANES. So, you don't think it's affected. We could heavily concentrate income at the upper end of the scale and not pay an economic consequence for that?

Mr. BOSKIN. It depends on what you mean by——

Senator SARBANES. Leave alone the social consequences, not pay an economic consequence?

Mr. BOSKIN. If you would define more precisely, in your words, the strawman that is being set up. I mean, at some point, yes, but not within the range of historical experience that we've had in the United States over the last century.

Senator SARBANES. Are you critical of the Federal Reserve's policy over the past 18 months?

Mr. BOSKIN. In retrospect, I think they probably should have eased sooner and more aggressively, but that's with the benefit of hindsight.

Senator SARBANES. Are you critical of it now?

Mr. BOSKIN. I believe that it needs to stand ready in the event that it does not look like the economy will be improving soon and reasonably steadily.

Senator SARBANES. Do you think it should move now to ease somewhat further?

Mr. BOSKIN. I think it should be prepared to do so if it does not appear the economy is likely to improve.

Senator SARBANES. Well, what does that mean? Do you mean in 3 months from now or when?

Mr. BOSKIN. If data comes out in the next few weeks or other events occur that suggest that the probability is not very high that the economy will be recovering with the monetary policy that has been in place, then, yes.

Senator SARBANES. What is the downside of the Fed moving now to help the situation? Do you perceive a large inflation danger?

Mr. BOSKIN. No. I would agree that there is not a large inflation danger if there were any quite modest movements from where they are now. I do believe that they are concerned about long-term interest rates which Congressman Wylie properly pointed out are quite important in affecting housing decisions, investment decisions, and some other important decisions in the economy.

So, I think they have to be careful that what they do is consistent not only with lowering the short-term rates that they directly affect, but also long-term rates.

Senator SARBANES. You've talked about encouraging saving. Would you say that the first objective in that area would be to lower or eventually eliminate government dissaving?

Mr. BOSKIN. Yes, so long as it was done in a way that didn't harm either private saving or productive public investment.

Senator SARBANES. Are you in favor of increasing government dissaving in order to encourage private saving, particularly if it doesn't produce an equivalent amount?

Mr. BOSKIN. No.

Senator SARBANES. So, you wouldn't want to take measures that would raise the deficit, even though it was contended that they would encourage private saving, if in the aggregate, the two in effect did not increase savings but lowered it?

Mr. BOSKIN. We ought to look at national saving. Unless they are offset by something else, then that is correct. If somebody could encourage private saving, it might have some revenue impact that would be offset some other way. Certainly, we ought to be looking at what the Nation saves as a whole as a first approximation. That is, the sum of household, corporate and governments at all levels.

Senator SARBANES. You talk about the need for a higher rate of investment. When you speak of investment, are you speaking of public and private investment, or only private investment?

Mr. BOSKIN. Both, with a proviso that, as difficult as it is to do, the public investment should pass very serious scrutiny in cost-benefit terms. The private sector obviously has the discipline of a financial market to judge whether it's passing those tests. Hopefully, in the public sector, we could do as well.

I certainly think that in infrastructure and in R&D that there are areas where federal spending ought to be expanded because the social return, as you put it earlier, Mr. Chairman, is likely to be high.

Senator SARBANES. When you speak of capital formation, are you talking about human capital, as well as physical capital?

Mr. BOSKIN. Generally, yes, but it would depend on the context.

Senator SARBANES. It would depend on what?

Mr. BOSKIN. It would depend on the context, but generally yes. I mean, I am concerned about human capital formation, enhancing worker skills and knowledge, as well as just adding more machinery and newer technology.

Senator SARBANES. Right.

Mr. BOSKIN. But sometimes the phraseology or the semantics economists use about capital formation is to talk about physical capital and then add human to the phrase when they refer to human-capital formation.

Senator SARBANES. Well, that's what I'm trying to clarify.

Now, I take it that from what you've said this morning that you think there is a major budget deficit problem?

Mr. BOSKIN. Yes. I think it's poorly understood.

Senator SARBANES. Do you think there is a major trade deficit problem?

Mr. BOSKIN. I think the trade deficit has been improving substantially for various reasons. While I believe the trade deficit and external imbalances over a span of time cause all sorts of problems and, hence, yes, there is a problem, I wouldn't put the trade deficit on the same level as the rate of GNP growth, or unemployment, or inflation as a first order indicator of the economy. I would say that it is the next level down, a structural issue.

Senator SARBANES. That may be one reason that we're having so much trouble on the trade front, if this is the prevailing attitude.

Let me ask you if you think there is an investment deficit? Two years ago, over 300 economists wrote an open letter to the Congress saying that they thought that we also had an investment deficit in this country. In particular, they pointed to infrastructure, but they also included worker training and education and so forth. Do you agree that there is an investment deficit?

Mr. BOSKIN. I agree that it would be highly desirable to raise the rate of investment in all those areas, and where the government is involved, it should pass the scrutiny of a rigorous cost-benefit test, yes.

Senator SARBANES. Where would the money come from to raise the rate of investment in those areas in the public sector?

Mr. BOSKIN. I think it would be desirable, amongst other things, to slow the rate of public consumption. For example, I personally believe that, and it's an Administration proposal, some entitlements, like heath care to the wealthy, should be reduced. Those funds should be used either for deficit reduction to encourage private investment or in other productive ways. We have just had a transportation bill.

Senator SARBANES. Should it be used for health care?

Mr. BOSKIN. Yes. The President announced the health-care proposal about an hour ago in Cleveland. We have not offered a specific way to finance it, but we have laid out a variety of options that we would like to discuss.

Senator SARBANES. And is that one of them?

Mr. BOSKIN. Well it's certainly one of the possibilities.

Senator SARBANES. Do you think that the peace dividend should be used for tax cuts?

Mr. BOSKIN. I think it first should be used for deficit reduction. Second, it should be used to cut taxes. And third, it should be used in whatever way possible to make sure that we fund the highest priority public investments.

Senator SARBANES. So, you put the investment deficit at the bottom of the list then?

Mr. BOSKIN. No. I think that we have a very substantial private-investment deficit, which is why I'm very concerned about the Federal Government's budget deficit.

Senator SARBANES. So, that is why you would use part of it to cut the deficit, right?

Mr. BOSKIN. That's right.

Senator SARBANES. Why would you cut taxes?

Mr. BOSKIN. Because I think our tax system still has a variety of features that discourage private saving and investment.

Senator SARBANES. So, you think we need private saving and investment ahead of public investment? You would rank them ahead of it?

Mr. BOSKIN. No. I would rate them in order of their social rate of return. Those public investments that have a very high social rate of return ought to be undertaken.

Senator SARBANES. Which ones do you perceive those as being?

Mr. BOSKIN. Well, for example, I think in infrastructure. While I wouldn't agree with every single aspect of the Transportation Bill, I think that the Transportation Bill did indeed address a serious problem in surface transportation and previously in aviation.

Senator SARBANES. Why did the President's budget provide less to support transportation than was contained in the Transportation Bill?

Mr. BOSKIN. I think the answer to that—and I would have to go back and double check with Director Darman—but I think the answer to that was that it was deemed unlikely that the full amount would be appropriated.

Senator SARBANES. Well, you've cut the mass transit component significantly, unfortunately.

Mr. BOSKIN. Well, I would have to check into the details of that. I think that there was an attempt to try to leave a lot of flexibility to the States as to where they thought the highest productivity return would be for themselves. If they decided that mass transit was the highest priority, then that's where the extra money would have gone.

Senator SARBANES. Now, you point out in the Report that State and local government purchases have been more constrained during this recession than the average for other recessions——

Mr. BOSKIN. That's correct.

Senator SARBANES. ——falling about six-tenths of a percent during 1991. In earlier recessions, State and local government purchases were countercyclical, increasing, on average, during recessions. You also point out that they have also been raising taxes, thereby dampening private spending.

So, I take it that you would agree with the point of view that State and local governments have been exercising some fiscal drag on the economy?

Mr. BOSKIN. Yes, I certainly would and state it in the Report.

Senator SARBANES. What is your estimate of the amount?

Mr. BOSKIN. In 1991 I think it was probably on the order of two-thirds of a percent of GNP, and this year I think it will be substantially less.

Senator SARBANES. Well, of course, they haven't done their budgets yet, but if you accept the stories that are floating around.

Mr. BOSKIN. The projections are that most of the additional tax increases and spending cuts are smaller than the ones that have already occurred. That could prove wrong obviously.

Senator SARBANES. So, two-thirds of a point of GNP, in other words, about $35 to $40 billion; is that correct?

Mr. BOSKIN. Yes. I would say that, just looking at this chart, if you look at the quarterly change in State and local purchases, the big hit in 1991 was in the first quarter when real GDP fell the most. There was an additional hit in the second quarter, and it was essentially flat in the third and fourth quarters.

Senator SARBANES. Congressman Wylie, I understand you have a question that you want to ask. Please go ahead.

Representative WYLIE. Thank you.

Speaking of the decrease in the housing activity, as you did a little earlier and in the context of using savings—and I ask this question on behalf of a constituent who had what he thought was a good idea—but he said that throughout the United States there are thousands of housing units standing vacant and some have been vacant for several months. I know, as a member of the Housing Subcommittee of the Banking Committee, that's true, and it is clearly in the national interest, it seems to me, to get these vacant units sold and occupied, since they are excess inventory in effect and will have to be worked down before there is any significant new production or home building that can be justified.

Now, the suggestion has been made to allow families to use appreciated funds invested in common stocks and mutual funds to make the 20 percent downpayment on a home and to have these funds used for the down payment, exempt from any tax or capital gains.

What would you think of an idea like that, and would there be any significant tax loss to the Treasury from implementing that suggestion?

Mr. BOSKIN. I think it's an interesting proposal. I really have not analyzed it carefully enough and wouldn't want to give it an insufficient response, and I'll get back to you on it. I do think there is a substantial problem with downpayments and people accessing funds, such as in IRAs or in appreciated assets. I couldn't give you an answer on the revenues, or anything like that, off the top of my head. The President has some proposals directly designed to assist first-time home buyers in his proposals, as you know.

Representative WYLIE. If you could supply that answer for the record, it would be appreciated.

The example that was given to me is, if you want to buy a $100,000 home, you need $20,000 for a downpayment and an $80,000 mortgage, and to obtain the $20,000, an investment in a mutual fund that would have cost $10,000, 10 years ago is now probably worth $20,000. Under current law, if they sell the mutual fund shares, they have to pay a tax at a rate of 28 percent. So, the idea would be that they would pay that out, and if they didn't have to pay it out, they could have a net of about $2,800 from that that could be put on the purchase of a new house.

Mr. BOSKIN. Without making a judgment about it, it sounds to me like an interesting concept. To some extent, it extends the notion of a tax-free rollover of capital gains, if you roll appreciated assets over into the purchase of a first home. That's one way to think about it. We have embedded in the tax code that, if you sell your first home or your second or third or fourth and roll it over within 2 years, you don't pay capital gains taxes. So, it's an interesting idea, and I'll take a look at it and get back to you on it.

Representative WYLIE. All right. Thank you very much for your testimony.

[The information requested was subsequently supplied for the record:]

LETTER FROM EXECUTIVE OFFICE OF THE PRESIDENT, COUNCIL OF ECONOMIC ADVISERS

MARCH 19, 1992.

THE HONORABLE CHALMERS P. WYLIE
U.S.House of Representative,
Washington, D.C. 20515.

Dear Mr. Wylie: During the February 6 Joint Economic Committee hearing at which I testified, you raised a question regarding proposals to stimulate home purchases.

In particular, I thought your suggestion to allow families to use appreciated funds invested in common stocks and mutual funds to make the 20 percent down payment on a home exempt from capital gains taxation has much in common with the President's own initiatives in this area. Your proposal would undoubtedly facilitate the purchase of homes, especially among first-time homebuyers who do not have equity accumulated in a previous residence. The proposal may involve a loss in revenue, at least as conventionally measured, as capital gains on owner-occupied housing are generally treated more preferentially than capital gains on common stocks. As you are aware, however, the Treasury Department is responsible for estimating revenue on behalf of the Administration for all tax proposals.

Sincerely,

MICHAEL J. BOSKIN
Chairman,

Senator SARBANES. Taking a look at the specific sectors of the economy, I would like you to take me through them one-by-one, to show where you expect to get 2.2 percent growth this year—consumer spending.

Mr. BOSKIN. Some will come from an increase in consumer spending, some from an increase in housing.

Senator SARBANES. Do you expect a substantial increase in consumer spending in 1992?

Mr. BOSKIN. A modest increase. I'm sorry, we don't have the work sheets with us, but I would be happy to get back to you. But certainly we expect some continued improvement in consumer spending, in exports and housing which had been devastated during the period of the oil shock and the war. Housing starts have been inching up since then and we expect them to continue to improve, particularly if the President's incentives are passed.

Senator SARBANES. All of the growth last year was essentially from exports. In fact, they more than accounted for the growth in the economy; is that correct?

Mr. BOSKIN. Well, that's one way of putting it. Other things grew and other things contracted. So, everything else about balanced out, and exports were responsible for the very modest growth during the year of a few tenths of a percent.

Senator SARBANES. Now, on what do you base your expectation that exports are going to grow this year, given the—and I don't have the story here—the Business Week story talking about the slowdown of economic activity almost across the board internationally.

Mr. BOSKIN. That's correct. Canada and the United Kingdom entered recessions earlier than the United States did. Theirs were much deeper and more severe. They have started to come out. Canada is our largest trading partner. Some of the other major industrialized countries have had serious problems. France and Italy have been hovering on the verge of recession by our definition. France doesn't have an official definition of recession, I guess out of convenience for the government officials there. Growth in Germany and Japan has clearly slowed since the early part of the year. For example, the Japanese have lowered interest rates recently. We have seen stronger growth south of our border, an area where exports have begun to expand again after having dried up considerably in the 1980's.

Senator SARBANES. And you think exports will register a better performance in 1992 than in 1991?

Mr. BOSKIN. No, I didn't say that. I said I expected them to improve and contribute to growth.

Senator SARBANES. And what is your expectation on government purchases?

Mr. BOSKIN. Government purchases, I think it's down very slightly. Government purchases of goods and services is down very slightly.

Senator SARBANES. So, is the growth essentially coming out of the consumer section? Is that where you expect it?

Mr. BOSKIN. As you know, consumer and residential investment and inventories are quite low. There will be some inventory growth, but not all the way back to where we were a couple of years ago. I think there has been a change in inventory management that was accelerated in the recent period, but I do believe there will be some bounce back to a more normal level of stocks.

Senator SARBANES. All right. Well, let me just close with this observation. It seems to me that the end of the Cold War offers really unique opportunities for the United States. The military dimension is no longer going to be

the dominant one internationally. The economic dimension is going to move more to the fore, and therefore our ability to compete internationally is going to become essential.

The end of the Cold War offers the opportunity for a significant transfer of resources in a constructive way, I would argue, for investment purposes, domestic investment purposes, and for deficit reduction, but it's going to require an overall economic strategy.

You're going to have to have some sort of economic plan for America. Amongst other things, you need a major conversion effort, and I don't see that in any of the President's proposals.

The President's plan focuses on capital gains which—if you really sit and work it over—even under the best assumptions, is going to have a minor impact on the economy. In fact, by your own forecasts, all of the President's program is worth six-tenths of a percent in terms of economic growth.

It seems to me that the Administration, and I assume you—although I don't know that for sure because I'm not sure what advice you are giving, and how much broader it was in its reach, and how much more vision it had—are not seizing a very significant and timely moment in history to address some of these underlying problems with the American economy and to move us to a new and higher level.

I think that's the challenge, and I don't see it being addressed in the program that is being presented to us, whatever the merits or demerits of the program. But the scope of the program is not up to the challenge that we confront.

Thank you all very much, gentlemen.

The hearing is adjourned.

[Whereupon, at 2 p.m., the Committee adjourned, subject to the call of the Chair.]

THE 1992 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, FEBRUARY 12, 1992

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

The Committee met, pursuant to notice, at 2:20 p.m., in room SD–628, Dirksen Senate Office Building, Honorable Paul S. Sarbanes (chairman of the Committee) presiding.

Present: Senator Sarbanes.

Also present: Stephen A. Quick, Executive Director; William Buechner; Lee Price; Chad Stone; and Charla Worsham, professional staff members.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

Chairman SARBANES. The Committee will come to order.

This afternoon, the Joint Economic Committee is very pleased to welcome three distinguished economists to discuss the 1992 Economic Report of the President, transmitted to the Congress just last week, and the economic recovery proposals made by the President in his State of the Union Message and the fiscal 1993 budget.

Before turning to our witnesses, I'd like to address the current economic situation briefly and then the Administration's proposals to try to deal with it.

Last Friday, the Acting Commissioner of Labor Statistics appeared before the Joint Economic Committee, as the Bureau does every month, to present the employment and unemployment data for January.

The news was grim. Unemployment remained at 7.1 percent in January, the highest level in this recession. It was at that level the previous month. That's two successive months at 7.1 percent. Payroll employment declined by 91,000. These are obviously disappointing numbers.

It's important to understand that the Bureau of Labor Statistics calculates the impact of unemployment in different ways.

First, there is the official unemployment rate, the 7.1 percent figure to which I just made reference, which includes only people who are out of work and are actively looking for a job.

The second is what is called the comprehensive unemployment rate, which also includes people who are so discouraged that they've dropped out of the work force and people working part-time who want a full-time job, but can only find a parttime job. There are a number of people who want only part-time jobs. They're not included in this calculation. Only included are people who want to work full time or were looking for a full-time job and have part-time work.

In January, the official unemployment rate, as I indicated earlier, was 7.1 percent, which represents approximately 9 million people. On top of this, it is estimated that 1.1 million have become so discouraged by the current job

situation that they have given up looking for work, and 6.7 million are working part-time because they cannot find full-time employment. In fact, that figure jumped significantly last month, from 6.3 million to 6.7 million.

If you add all that up—9 million unemployed by the standard definition, and 1.1 million discouraged workers and 6.7 million working part-time—you have 16.8 million people currently affected by unemployment, either totally or partially.

The BLS calculates that the comprehensive unemployment rate, which would include all three of these groups, is now 10.8 percent, the highest it's been in this recession.

The President has come forward with proposals to address this situation. Last Thursday, the President's chief economic advisor, the chairman of the Council of Economic Advisers, Michael Boskin, and his colleagues appeared before this Committee to present the economic report and to testify on it. Here is what the report said.

The Administration predicts that the economy will grow 2.2 percent in 1992, assuming that the President's plan is adopted. If the President's plan is not adopted, in other words, if you proceed as usual, the Administration predicts that the economy will grow 1.6 percent.

So the program that they've submitted, by their own calculations, would add 6/10ths of a percentage point to economic growth this year, and it would have roughly the same impact, about half a percent per year, out through 1997.

The effect of the program on the unemployment situation is just as weak. The Administration predicts the unemployment rate would be reduced from 7.1 percent now to 6.8 percent by the end of 1992.

Not until 1997 would the President's plan reduce the unemployment rate to where it was when the recession started.

Now, obviously, this forecast of a very weak, anemic recovery would leave us with all of the serious economic problems we now have. I think it's important to underscore that we will be coming out of the longest recession in the postwar period with the weakest growth that we have experienced after a recession.

In fact, the Washington Post, in an editorial about the President's proposal, said: The President has a plan, the one that you heard about in the State of the Union speech and in his budget. And the Economic Report argues that his plan will help. But there's a striking disparity between the magnitude of the malfunctions now deeply entrenched in the national economy and the conspicuously lightweight proposals that the plan offers.

Obviously, the Committee has a number of concerns about the President's proposals—how effective will they be, how adequate are they, can we do better?

We're pleased to have three able economists this afternoon to help us evaluate the 1992 Economic Report of the President and his proposals.

Our witnesses today are: Professor Robert Gordon from the Department of Economics at Northwestern University; Dr. Lawrence Hunter, acting chief economist at the U.S. Chamber of Commerce; and Professor Paul Krugman of the Department of Economics at MIT.

Gentlemen, we're happy to hear from you. Why don't we proceed in alphabetical order.

Dr. Gordon, if you'd go first, and then Dr. Hunter—unless you worked out a different order.

Dr. GORDON. We agreed that Paul would go first.

Chairman SARBANES. All right. We'll go to Dr. Krugman first.

STATEMENT OF DR. PAUL KRUGMAN, PROFESSOR OF ECONOMICS, MIT; VISITING PROFESSOR, HARVARD

Dr. KRUGMAN. Thank you, Senator Sarbanes.

I'm going to talk about economic policy briefly in this verbal statement, with some reference to the Economic Report of the President. But I'm not going to structure this as a discussion of the Economic Report.

I'd like to talk briefly about three topics. The first is the recession. The second is long-run economic growth. And the third is the question of how to pay for what needs to be done for long-run economic growth.

I think the most important point to make about the recession is that it is not the only problem or even the worst problem facing the U.S. economy.

I don't want to minimize the severity of the recession or the amount of pain that it causes, but because we have very serious—indeed, almost disastrous—long-run problems, above all, in the effort to get out of the recession, we should not take actions that will prejudice our ability to follow a sensible, productive, long-run policy.

What that means essentially is don't cut taxes. Don't cut personal taxes. No middle-class tax cut and certainly no large tax give-aways to the upper end of the income distribution, as are proposed by the President.

What it means is relying, at least at this point, on monetary policy to get us out of the recession. Monetary policy has had disappointing results so far. We are also all very impatient. The Federal Reserve has consistently been behind the curve. It has been delivering too little, too late, in the way of monetary stimulus. But it is by no means demonstrated, nor do I believe, that monetary policy is unable to get us out of the recession.

Monetary policy is a very powerful tool. The Federal Reserve can, if necessary, cut short-term interest rates by another 300 basis points. There is a possibility that we are really in a 1930's-style liquidity trap where the Federal Reserve cannot end the recession, and we need a fiscal stimulus to get out. But I would still give 10:1 odds that that is not the case, and there's certainly no reason for us to start loading up our fiscal problem with additional tax give-aways because we are impatient with the results of monetary policy so far.

So I would advocate continuing to rely on a clean monetary solution to the recession; yell at the Federal Reserve some more. I don't think that we have any reason to start looking for fiscal stimulus at this point.

I would certainly advocate trying to bring forward necessary spending on infrastructure, which is something that we really badly need. But we should really be doing that for its own sake, and if it happens to help us get out of the recession, good. But basically, we should rely on monetary policy.

The second point is long-run growth.

One of the things that I think is very revealing, perhaps unintentionally in this year's Economic Report of the President, is that it implicitly admits that 11 years of Reagan and Bush economic policies have done nothing to accelerate our very poor, long-run growth performance.

There's a chart that shows eras of U.S. productivity growth—the high productivity growth period following World War II and the low productivity growth period, which even the Economic Report of the President says began in the early 1970's and continues right up until now.

So the report implicitly admits that all of the policies, all of the tax breaks for the upper end of the income distribution, and all of the deregulation—the occasional $150 billion mistakes that resulted from deregulation—did nothing at all and had no pay-off.

What can we do to accelerate our long-run growth?

The short answer is investment. We need more investment. But I'd like to make two remarks about investment. The first is that investment needs to be seen broadly. Investment by businesses is not the only kind of investment. It isn't even overwhelmingly the most important kind of investment for growth.

Investment in human capital, which means taking care of children and educating them, and investment in social capital or infrastructure are equally important.

And if you ask what kind of investment the United States has had the greatest shortfall over the past dozen years, the answer would be that while we certainly do have inadequate private investment, we have had even more inadequate investment in human capital and infrastructure.

It is our educational system—taking care of the needs of troubled children, which is a major problem in our society—and infrastructure that have been starved.

Private investment has been close to historical levels for the United States, although well below the rates of investment in other industrial countries.

So the first remark is that when we say investment, we should understand that, in fact, investment which must be undertaken by the public sector is the most urgent priority, although we need more investment of all kinds.

The second remark is that although we need more private investment, we need to understand what it takes to increase private investment.

Another revealing observation made in passing by the Economic Report of the President is that during the decade of supply-side economic policies, when tax and regulatory changes, and everything possible was done to provide a pro-business, pro-investment climate—a time when all sorts of policies were rationalized on the grounds that they would lead to greater incentives and investment and, therefore, growth—private investment as a share of gross national product was a little bit lower than it was in the previous decade.

In other words, the policies that have been followed up until now have not even made the first step in the right direction. Not only didn't they promote growth through higher investment, they didn't even deliver the higher investment.

Furthermore, much of the investment—it's now becoming clear—was of dubious productivity. Unless you think that empty office blocks are our secret competitive weapon against Japan, it's clear that we have had much misdirected investment, largely because of the errors of tax policy and deregulation of the financial system.

What could actually increase private investment? Well, the big constraint on private investment has not been the lack of incentives, but the lack of a sufficient supply of domestic saving. It's the collapse of domestic saving in the U.S. economy largely, though not entirely due to the federal budget deficit, that is the big source of constrained private investment.

What we need to do if we want more private investment is not increase the rewards to wealthy individuals, but provide a greater supply of saving by reducing the budget deficit.

I'm putting that second behind public investment in education and infrastructure. If you gave me the choice between $30 billion of deficit reduction and $30 billion of infrastructure spending, at this point, I would take the infrastructure because I believe that that is the area where we are most severely constrained, where we really have been starving the future. In fact, we need both.

Finally, the question of where the resources for growth programs should come from. If a growth program means more public investment and a reduction in the deficit so as to free up more savings for private investment, we can find some of those resources through military cuts, but we are going to need more revenues. There doesn't seem to be any way around that.

The point I want to make is that a very significant part of the resources for a growth program can and should come from increased taxes on the wealthiest Americans.

The thing that I think is most evasive and where the greatest effort at obfuscation is made in this year's Economic Report is the quite desperate effort to cloud and conceal the extraordinary increase in inequality that has taken place in the United States over the past 15 years.

Let me give you one suggested number that can be extracted from the estimates that the Congressional Budget Office has prepared.

There has been a significant gain in average family income over the past 15 years. It's disappointing by historical standards, but over the past 15 years, there's been about a 15 percent gain in average family income.

But the typical family in the United States has hardly gained at all and if you ask why, the answer is that 60 percent of the increase in average family income went to the top 1 percent of families.

That is, most of the economic growth in the United States over the past 15 years has gone only to a very tiny fraction of extremely well-off Americans.

For perspective, to get into that top 1 percent, a family of four needs an income of $339,000 a year. So people who are well into the economic stratosphere by the standards of ordinary Americans have realized almost all of the gains from whatever economic growth we've managed to achieve.

At the same time, we now know that only those very same people received significant tax cuts during that period. We had very large, significant tax cuts for the top 1 percent, who are also the only people to have realized large gains in income and, in fact, they've received enormous gains in income—134 percent increase in real after-tax income since 1977.

So it seems to me that the obvious thing for us to do, not as a matter of some kind of vindictive, revenge-oriented policy, but simply because we need resources, is to follow a program of investing for growth, financed to a significant extent by higher taxes on the only group of Americans that has benefited significantly from the limited economic growth of the past few years.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Krugman follows:]

Prepared Statement of Paul Krugman

I have been asked to comment on the 1992 Economic Report of the President, and more broadly on U.S. economic policy. I would like to begin with some brief remarks on the report, then turn to the discussion of economic issues.

I think the best word for the 1992 Economic Report is "evasive". That is, its objective is primarily to conceal economic reality rather than to clarify it. In particular, when the report turns to the issues of wages, family incomes, and income distribution it presents a mass of complicated charts and confusing numbers in order to obscure the central economic fact of the Reagan-Bush years: the incomes of the very well-off exploded, while incomes for most Americans stagnated or fell.

It is worth recalling what Ronald Reagan and his economic advisers offered in 1980. They wanted a program that would cut marginal tax rates in order to increase incentives for Americans to save, invest, and be productive. They admitted that such a program might increase inequality, but told us not to worry and to be happy: the program would lead to huge gains in productivity and real wages, so that the rising tide would raise all boats.

After more than a decade of these policies, we now know the results. Marginal tax rates were indeed cut, producing large tax reductions for the top one percent of U.S. families (but for nobody else). Inequality soared: four decades of convergence in income were reversed in a single decade, so that we now have the most unequal society that this country has known since the 1930's. But none of the promised benefits materialized. Consider the realities of the 1980's:

— Savings collapsed instead of rising;

— In spite of massive borrowing from abroad, domestic investment was actually a lower share of GNP in the 1980's than in the 1970's;

— Productivity growth remained at historically low levels;

— The real incomes of most U.S. families stagnated or even declined;

— Real wages declined for a heavy majority, probably 80 percent, of American workers;

— Poverty, especially extreme poverty, increased.

The only good news to which Reaganomics could point was the long recovery from 1982 to 1989. I do not regard that recovery as a tribute to supply-side economics, but rather as a monument both to the depth of the 1979–82 slump—which left plenty of slack to take up over the next 7 years—and to good management by the Federal Reserve. But this argument is in any case now moot, because the current recession shows that the business cycle afflicts Republicans as well as Democrats.

Let me therefore begin my discussion of current policy issues with the recession.

THE RECESSION AND CYCLICAL POLICY

The facts of the recession need not be reviewed here. What we have experienced is a downturn that is probably somewhat worse than the unemployment numbers indicate, but which is still surely less than half as severe as the recessions that bottomed out in 1975 and 1982.

The recession has nonetheless created extraordinary anxiety. I think that this can be attributed to two main factors.

First, this recession has driven home to the American public the inadequacy of our long-run performance. As long as the number of jobs was still growing fairly rapidly, the declining real wages those jobs paid could be ignored. Now the reality that many people are worse off than they were a dozen years ago has become painfully apparent.

Second, the apparent unresponsiveness of the recession to Federal Reserve policy has raised concerns that the financial legacies of the 1980's—a weakened banking system and a heavy burden of corporate and personal debt—will block normal routes to recovery.

These two sources of concern lead to a dangerous political situation. Because the American people have become aware during an election year that "morning in America" did not include 80 percent of them, there is a desperate urge on the part of politicians to throw the middle class a quick bone—even if the supposed benefits to the average American family will actually worsen its situation in the longer run. And because monetary policy has not so far produced economic recovery, fiscally irresponsible actions are now being presented as economic recovery measures.

We should not allow the recession to panic us into fiscal actions we will regret later. As a general rule, business cycle management should be left up to monetary policy. The usual reasons for this rule are that fiscal policy is too slow—anti-recession fiscal packages tend to have their maximum impact well into the next recovery—and that budget-making is hard enough without injecting short-term economic management issues into the process. In the 1990's we have an additional reason to avoid trying a fiscal fix for the recession: the persistence of huge budget deficits which not only drain national savings but also cripple our ability to carry out necessary spending. The last thing we need to do is increase the long-term deficit by offering the public some illusory benefits under the name of an economic recovery program.

Some people claim that the recession represents the wages of our sins in the 1980's, and that the usual remedies will not work. I disagree. Declining real incomes for most Americans are

the (low) wages of our sins; this recession is basically a recession like any other, the result of a series of policy fumbles by the Fed.

It is true that reductions in short-term interest rates have been less successful than expected in turning the economy around. This may in part be due to the troubles of our banking system, and to the overall debt burden. The main culprit, however, is the failure of falling short-term rates to be reflected in a corresponding decline in long-term rates. I am not sure why long-term rates have stayed so high; financial markets seem to have hard-to-rationalize expectations about future short-term rates, and a shift in Treasury financing from long-term to short-term securities could help prick this bubble. But this is a technical matter.

The main point is that the Fed still has plenty of room to pursue economic stimulus, and does not need fiscal help. The Federal Funds rate could be cut another three hundred basis points, if necessary. Congress may be frustrated with the Greenspan Fed, which has consistently been behind the curve. Fiscal giveaways will not, however, help the situation; they may even worsen it, by inducing the Fed to hold off on monetary stimulus and by driving up long-term rates.

At this point, the appropriate policy for dealing with the recession is simply to urge the Fed to cut interest rates still further.

It is possible, though still very unlikely, that the economy has stumbled into a 1930's-style liquidity trap, in which monetary policy cannot get us out of a slump no matter how hard the Fed tries. This possibility looks more likely now than it did a year ago, though I would still give ten-to-one odds that a stiffer dose of normal monetary policy will do the trick.

If monetary policy proves unable to turn the economy around, then—and only then—should we start to use fiscal policy against the recession. And if and when we do, that fiscal stimulus should be targeted at things that we need in their own right. In other words: don't cut taxes.

While the essential responsibility for economic recovery rests with monetary policy, it is possible that public investment can play a role in getting us out of the recession. As I will argue in a moment, the biggest problem with U.S. economic policy is that we have been starving essential public investment in infrastructure and education. We therefore desperately need a program of reinvigorated public investment. We will eventually have to pay for this investment with a combination of tax increases and cuts in other spending. Since we are in a recession, however, it is perfectly reasonable to get going as fast as possible on those public investments where the needs are already well understood, such as highways, and take care of the funding later.

The point is, however, that America's problems did not begin with the recession and will not end when we recover. So fiscal policy should be aimed not at immediate relief but at our long run problems.

With that, I would like to turn to the longer run issues.

PRODUCTIVITY AND GROWTH

At various points in this year's Economic Report of the President, almost by accident, a little bit of truth slips through. There is a revealing chart on page 91 of the report. The chart presents evidence suggesting three eras of productivity growth in the United States: a pre-war era of roughly 2 percent growth; a postwar generation of 3 percent growth; and—revealingly—a period since 1973 of less than one percent growth. That is, even the Administration's own economists make no claim that there has been any discernible increase in U.S. productivity growth as a result of Reagan-Bush economic policies.

It is worth pointing out how shocking an admission this is. Productivity, after all, was what supply-side economics was supposed to deliver. Productivity was the rationale for sharp tax cuts for the rich and sharp cuts in social services for the poor. Productivity was the justification for deregulation of banking, and the excuse for occasional $150 billion mistakes associated with that deregulation. Now it turns out that we didn't get any results from all of that: the rising tide that was supposed to raise all boats lifted the yachts but sank the smaller craft.

Why didn't productivity increase, and what can be done to raise it?

Essentially, productivity growth depends on investment. This is widely recognized, but most discussion overemphasizes the role of private investment in physical capital. Private investment is not the only crucial form of investment. Public investment in human capital and infrastructure are equally important. The basic story of the Reagan-Bush years is that whatever pro-investment policies were followed were aimed entirely at private capital (and failed even to raise investment in that), while human capital and infrastructure were neglected and starved.

Let me begin with private capital. Although recent economic ideology has given tremendous lip service to the need for private investment, this ideology has not delivered. To quote the economic report (p. 93), "Among major industrialized countries, the United States had the lowest investment rate and the lowest rate of productivity growth in recent decades . . . U.S. gross investment as a fraction of gross national product averaged 19 percent in 1971–80, and 18 percent in 1981–89; the corresponding figure for Japan was 29 percent." In other words, all that pro-business policy didn't actually increase investment.

Nor was the direction of private investment especially likely to raise productivity. In particular, the 1980's were marked by massive over-investment in commercial real estate. Unless you think that empty office blocks will be our secret competitive weapon against Japan, you will conclude that private investment in the 1980's was not only unimpressive but misdirected.

This experience strongly suggests that supply-side economic policies, which are supposed to favor investment and hence growth, do not even start to work in the right direction: what we saw in the 80's was slightly less private investment than in previous decades, much of it demonstrably misdirected.

In any case, however, it is wrong to focus only on private capital formation as a key to productivity growth. Although U.S. private capital formation is low relative to that of other industrial nations, during the great productivity surge from 1947–73 investment averaged only about 19 percent of GNP, that is, about the same as in the slow-growth 70's and 80's.

What did fall sharply after 1973 was the provision of human capital and infrastructure, both the responsibility of the public rather than the private sector.

The problems with U.S. education are by now familiar to everyone. The end of the postwar rise in living standards roughly coincides with the beginning of the long slide in SAT scores. We are, without question, on our way to having the worst-educated population in the industrial world. Honey alone will not cure our educational problems, but aid for distressed districts and full funding for early intervention programs are at the very least necessary conditions for turning our educational system around. Yet during the Reagan and Bush years funds for these programs were released grudgingly and only under political duress.

Finally, it is highly likely that a major role in stagnant U.S. productivity has been under investment in public capital. From 1948 to 1969, the "core infrastructure" of the U.S. (roads, airports, water and sewage, etc.) grew at 3.7 percent per year. In the 1970's that growth fell to 2 percent, and from 1979 to 1987 infrastructure grew only 1.3 percent annually.

Let me try to sum all of this up. During the 1980's, U.S. economic policy was ruled by an ideology that emphasized private incentives above all else, arguing that tax cuts would encourage private investment and hence growth. Public investment in education and especially in infrastructure was starved. The result was a sharp increase in income inequality, but no gain in growth.

Meanwhile, other industrial countries—not just Japan, but also Western Europe—maintained public investment, educated their children better, and achieved much higher productivity growth. Ironically, they even achieved higher private investment—partly because they had much higher national savings rates, but perhaps also because productive enterprises are, in the end, more interested in countries with educated workers and adequate public services than they are in a few points off the marginal tax rate.

It has been obvious for some time that under investment in human capital and infrastructure were damaging U.S. growth prospects. Nothing has been done, however, to raise the rate of government investment. A persistent deficit, together with the belief that any increase in taxes would cripple private incentives, have made reversing our self-destructive course impossible.

The lessons I draw from the experience of the 1980's are:

—Private investment is not all that sensitive to tax incentives; cutting the rate of taxes on the rich did nothing to stimulate it.

—The most crucial need for the U.S. economy is not more private investment, even though that would be a good thing, but more public investment in education and infrastructure.

POLICIES FOR GROWTH

It is likely, though not certain, that lower interest rates will lead to a turn in the economy during 1992. A business cycle recovery will, however, do nothing to solve our more basic problems of inadequate growth in productivity and declining real wages. So the crucial question is how to reverse the dismal trends of the 1980's.

There are still a surprising number of the supply-side faithful who believe that what America needs is still more tax cuts for the rich and still further cuts in government services. But the belief that the root of low U.S. productivity growth is an oversize government and an excessive tax burden flies completely in the face of all available evidence. Tax cuts for the wealthy did absolutely nothing to stimulate U.S. growth in the 1980's; among major industrial countries the US has the lowest tax burden and the lowest rate of productivity growth.

Based on what we do know about economic growth, what we really need is a program that contains at least the following elements, which I place in probable order of importance:

1. *Increased spending on children:* This would include both early intervention programs such as Head Start and aid for distressed school districts. Japanese politicians are dead wrong when they describe Americans as lazy, but there is enough truth in their description of us as illiterate to make helping our children the most important national priority.

2. *Infrastructure:* This needs little description. We need more of almost everything: roads, airports, sewers, rail systems, you name it.

3. *Deficit reduction:* The budget deficit remains a serious drain on national savings; reducing it is the most effective pro-investment policy available.

I have deliberately placed deficit reduction last rather than first on this list. The reason is that in my view the biggest cost of the deficit is now the way that it pushes the Federal Government into false economies. Vitally necessary spending on children and infrastructure is put off, because the costs of this neglect are long-term, while stinginess helps with the current budget numbers. If I had to take a choice between $50 billion of deficit reduction and $50 billion of additional spending on vital needs, I would take the spending. There is no good reason, however, why we should not do both.

I might also mention as a fourth item—a distant fourth—the introduction of a limited industrial policy for a few selected high technology industries. Such a policy could play a limited role in helping restore productivity growth, and is worth trying—as long as it is not viewed as a panacea and a substitute for dealing with the main items on my list.

Doing all of these things will require resources—a rough guess might be that growth-oriented Federal spending should absorb an additional 1.5–2 percent of GNP, while we should take as much deficit reduction as we can get. So the next question is where to find these resources.

PAYING FOR GROWTH

Some of the resources necessary for growth can come from cutbacks in military spending. Ideally, some could also come from economies in other areas of government. Realistically, however, a serious effort to get the economy moving again will require additional tax revenues.

Until very recently, any suggestion that we need more taxes was viewed as political suicide, because this seemed to mean imposing still further burdens on the same ordinary American families who have done so badly in the past decade. The realization is beginning to sink in, however, that additional revenues need not come at the expense of most Americans. The reason is that since the 1970's the income of the wealthiest Americans has exploded, while tax rates on these families have fallen considerably. A restoration of the same distribution of the tax burden that we had in the 1970's would raise very substantial revenues.

It may be worth reviewing a few basic numbers, to illustrate how important the surge in inequality is in defining our fiscal possibilities.

First, gains in income have been extremely concentrated among a very small number of people. Most analyses of inequality miss the real story of the 80's by focussing on large blocks of people, usually population quintiles. Even at this level, the rise in inequality is startling: CBO numbers which adjust for family characteristics find that between 1977 and 1992 the real after-tax income of families in the bottom quintile fell 10 percent; that of families in the middle quintile rose less than 3 percent; but income of families in the top quintile rose 34 percent.

But this misses the real story. The big gainers in the 1980's were not the relatively large number of people in the top fifth, but a handful of people at the very top. The bottom half of the top quintile gained only 11 percent, but the top 1 percent gained 134 percent.

Second, the increase in inequality is not an illusion based on demographics, on two-earner couples or the vagaries of the life cycle (as the Economic Report of the President tries to suggest). To be in the top 1 percent, a family of four needs an income of $339,000. In other words, we are not talking about married schoolteachers or small businesspeople having a good year. The beneficiaries of the surge in inequality are the truly rich, people who live in an altogether different economic universe from ordinary Americans.

Third, although there aren't many people in the economic stratosphere, they are not an insignificant part of our economy. In fact, the top 1 percent of the population receives a combined income that is just about equal to the combined income of the middle 20 percent.

The point of these observations is that a proposal to raise money by taxing the rich somewhat more heavily is neither a symbolic nor a vindictive gesture. Families that are truly rich represent a major part of the tax base, and have been the only significant beneficiaries of the modest economic growth we have achieved over the past 15 years. It is not at all unreasonable to consider asking them to bear more of the burden of getting growth going again.

During the 1980's, however, the rich—and only the rich—got a substantial reduction in their taxes. CBO estimates are that from 1977 to 1992 the overall Federal tax rate on a typical family in the middle quintile actually rose by 2.7 percentage points, while the rate on a typical family in the top 1 percent fell by 8.1 percentage points. The same estimates suggest that if 1977 tax rates had remained in effect, the top one percent of households would now be paying more than $70 billion in additional taxes. If tax rates for that top one percent had kept pace with those for the median household, the additional tax revenue would exceed $100 billion.

In other words. higher taxes on the top one percent of American families—taxes that will still leave that top one percent much better off both in absolute terms and relative to the rest of the population than they were in the 1970's—can raise very significant additional revenues. If other government spending is kept under control, and there are no pointless tax giveaways during this election year, it might be possible to pay for a growth-oriented economic program entirely out of defense cuts and higher taxes on the few Americans who can easily afford to pay them.

Conservatives will object that higher taxes on the rich will destroy incentives. But this is pure assertion that is contradicted by all experience. Tax cuts for the rich didn't even raise pri-

vate investment, let alone productivity growth, in the 80's; much higher tax rates for the rich were consistent with high productivity growth in the SOs and 60's here, and are still consistent with superior performance in other advanced countries.

So there is an overwhelming case for raising most of the revenues needed to pay for a new growth program by taxing the top one percent of American families more heavily.

A SUMMARY

This prepared testimony comes down to a very simple set of guidelines for economic policy. There are only four basic principles:

1. *Rely on monetary policy to get us out of recession.* Tax cuts are almost certainly unnecessary, and will cripple our ability to do something about longer-term growth.

2. *Increase public investment in children and infrastructure.* Human capital and infrastructure are as crucial for growth as private capital, and have been irresponsibly neglected.

3. *Reduce the deficit.* The deficit is not the only or even the biggest problem, but reducing it is the only sure-fire way to increase national savings.

4. *Raise the money for (2) and (3) by cutting defense and taxing the rich.* In the 1980's we tried to stimulate growth by cutting taxes on the top I percent even as their income exploded relative to that of everyone else. It didn't work, and it's now time for the biggest beneficiaries of U.S. economic growth to pay their share of the toll.

Chairman SARBANES. Thank you very much.
Dr. Gordon, please proceed.

STATEMENT OF DR. ROBERT GORDON, PROFESSOR OF ECONOMICS, NORTHWESTERN UNIVERSITY

Dr. GORDON. Like Professor Krugman, I'm going to talk about what we need to do to repair America's economic programs in the long run and make only passing comments about the Economic Report.

Politicians view the long run differently than economists. For a politician, the short run is the New Hampshire primary and the long run is the November election.

For economists, the short run is maybe the next 2 years and the long run is at least the next 20. In fact, the right policies adopted today may bear fruit on our productivity performance after many of us here are dead, and that is just as it should be.

President Eisenhower is dead, but we still are all benefiting from the role he played in developing the interstate highway system. And since I have to be bipartisan—President Roosevelt is dead—we still have a lot of post offices in this country because of some of his programs in the 1930's.

Viewed from the long run as an economist looks at it, this country has two big problems—slow productivity growth and low national saving.

Slow productivity growth means that our standard of living can only grow slowly in the long run, and if we can't do something about that, we might as well pack our bags and go home.

That's what the big issue in economics is all about.

Low national savings means that to sustain the unsatisfactory level of domestic investment that we have, we have to borrow from foreigners. And over the years, our net foreign indebtedness builds up and so some of our pathetic productivity gain has to be paid out as interest and dividends to foreigners, and that would not be necessary if we had a higher level of national saving.

Well, so what, you say. You've heard all this from economists before. Let me highlight the main angles that I will deal with, which I think are a little bit different.

First, I'm going to talk about the level of productivity in the United States in connection with the recent debate about Japan-bashing.

The level is better than most people think, even though the growth rate is abysmal.

Second, there are things policymakers can do about the growth rate of productivity, but many of them involve things that economists don't normally talk about. And the best way to develop a long-run growth plan, I think, is to view America with foreign spectacles, to look at America from the standpoint of Europe and Japan and see what stands out in this society and in this economy, and which social and legal institutions we have that raise costs, cut efficiency, foster inequality, and breed crime.

To wrap all this up into one main theme, I think we have reason to be optimistic about the future, but only if we drop our inhibitions about what is politically possible.

In my written testimony, I have quite a bit about productivity. In the oral presentation, let me point to some of the pictures and tables.

In the written version, you have the first chart that shows 120 years of economic growth. This is interesting because it shows that, indeed, our standard of living, real GDP per capita, has continued to grow, and that Eu-

Having been trained earlier this afternoon by Paul Krugman to recognize that real compensation includes that infamous top 1 percent, I would qualify these numbers by saying that everybody below the top 1 percent has done significantly worse than any of these growth rates imply.

What are we going to do about all of this?

I have in my statement a ten-point program for renewing America, and I'd like to run through this briefly. Some of these are complementary with remarks that Paul Krugman has already made.

The first three have to do with education. Number one, let's end our penny-wise/pound-foolish attitude toward government spending.

There are a number of things that will pay for themselves, starting with prenatal care, post-natal nurturing, Operation Head Start, dealing with adult illiteracy and drop-outs with something often called Operation Late Start, using America's public libraries to help people learn to read, trying to provide incentives for German-style apprenticeship programs, and having a student loan bank for college education that is paid back through the income tax system so that people can't get out of the repayment obligation.

All of those are measures that I would support to help develop our human capital.

They pay for themselves by reducing future welfare payments, reducing the construction of new prisons, and other kinds of security expenses.

Number two, we should reinstate fiscal federalism. I recently did a comment for the Brookings panel that showed that virtually all of the State and local government fiscal crisis is due to the twist that came from the elimination of revenue-sharing, together with more mandated welfare payments that must be, to some extent, financed by the State and local government sector.

About 1.5 percent of GNP has been involved in this twist. No wonder we have social problems and ills that the State and local governments can't afford to deal with.

And while I'm on the subject of State and local government, I want to endorse the idea of metropolitan government in the fashion of Toronto, Canada, for which the Federal Government can provide incentives.

Why should we tolerate a system in which suburban schools spend more on their students than inner-city schools and in which we have a bizarre set of incentives for people to move out of the central city into suburbs, leaving our central cities with large social problems and minimal resources to deal with them?

Number three, on education, we should give up our old religious reliance, so to speak, on local control of education and institute national tests and standards, at least for reading and math.

Fourth, we need national health insurance. I will skip over the details here because there's a great debate going on, but I would call attention to some aspects of the problem.

General Motors spends $500 more per car than Toyota in Kentucky on its medical care costs because it has older workers. Toyota in Kentucky spends more than Toyota in Japan.

Any kind of system that relies on employer-financed contributions, whether they're tax-exempt or not tax-exempt, is going to create a subsidy for new nonunion start-up plants and tax more heavily the old plants in the north with older workers, which will steadily close and go out of business as a result.

A minimal set of criteria for a national health system that involves national insurance while keeping private doctors and hospitals, some kind of

national budget to keep the share of GNP from getting out of hand, and the willingness to set priorities as they have begun to experiment within the new program in Oregon.

Fifth, let's curb the lawyers. We need to do something. Thanks to our Vice President for calling attention to this—showing I'm bipartisan—we have 70 percent of the world's lawyers. We need to reduce the tax that our economy pays, which has been estimated in a recent edition of Forbes magazine to be $180 billion, almost as much as net private investment on all the different forms of litigation, including medical malpractice.

Sixth, we need to get serious about banning guns and reforming criminal justice. We've had a tripling of our prison population. Yesterday's New York Times pointed out that we have ten times as large a percent of our population in jail as Japan or the Netherlands and for black males, it's 70 times as many.

Much of this is for archaic, esoteric offenses that do not involve violent crime. I'm all for protecting citizens against violent crime, but a lot of people are in prison who did not commit violent crimes.

Number seven, let's change our short-run mentality. We could do that by prohibiting quarterly reports by corporations, and pass laws that shift power within the corporation away from these in-bred boards of directors. You might even take a hint and show America that you're serious about extending the short-run mentality by raising the terms of congressmen from two to 4 or 6 years.

Number eight, use the peace dividend for government investment. Here I'm overlapping with Paul's comments, but be sure to include public investment, define it to include education in all of the broad senses outlined in point one.

Number nine, if you have to have tax incentives, target them to provide incentives for investment in savings over and above some previous amount, like an investment tax credit for the amount people invest over, say, 80 percent of their previous year's average.

Finally, number ten, let's eliminate the federal deficit overnight by two simple measures. One of them is to impose a one-dollar-a-gallon federal gasoline tax. As we look at America from Europe, the first thing Europeans notice is that you have these incredibly ridiculous low gasoline prices for American automobiles, and then in Congress you're arguing over federal fuel economy standards.

How silly. Why not cure half the federal budget deficit with a gasoline tax? Then you won't have to worry about fuel economy standards. The private market will take care of that.

The other way to cure the federal budget deficit, as Paul Krugman has suggested, is to substantially raise the tax brackets for the upper end of the income distribution. I have some numbers that would involve raising the top bracket to 60 percent for people's incomes that are above $500,000. Remember, the top bracket in Japan is 65 percent. This is not as radical as it sounds.

A number that I'd like you to take home is that if we compare today's tax structure to that in effect in 1977, if there had been no change in income tax rules at all since 1977, our federal budget deficit would be lower by $160 billion per year, of which $80 billion is accounted for by the tax cuts enjoyed by that top 1 percent—the people who earn more than $339,000—and the other $80 billion is the interest that we're now paying on the national debt caused by the last 10 years of those tax cuts effected in 1981.

Would there be antigrowth effects from this?

Ask yourself, would Bill Gates have refused to found the Microsoft Corporation? Would Asian immigrants flocking to Silicon Valley to start computer companies refuse to come just because we have the same upper-end income tax brackets as in Japan?

If we have a problem with venture capital or people forming small business, let's deal with that directly by expanding the Small Business Administration subsidies.

To conclude, Charley Schultze has said that what America needs is higher taxes and more homework. I think that's a great phrase. But it's only two-tenths of my program because I think we need more than just that.

My agenda for the long-run revival of America is one that I think most Americans would support if only some politician would come along with enough courage to propose the whole thing as a package.

It would give us the best of both words—an America to which immigrants are striving to flock because of its tradition of freedom and its high standard of living, together with the reformist atmosphere that answers the snotty disdain of foreigners by saying, okay, we heard you. We're fixing it.

Thank you.

[The prepared statement of Dr. Gordon follows:]

PREPARED STATEMENT OF ROBERT J. GORDON

INTRODUCTION

My concern today is with the long ND. My references to the Economic Report of the President (henceforth ERP) are made only in passing, as I point to particular sections that may elucidate or obscure our understanding of America's economic future.

Economists view the long rvn differently than politicians do. A politician thinks the short run means "the New Hampshire primary," while the long run means "the November election." An economist thinks that the short run covers maybe the next 2 years, while the long run covers at least the next two decades. Some of the policy measures needed to boost America's future productivity performance may not bear fruit for two decades or more, and some of us may not be around long enough to enjoy the benefits. That's the way it should be—President Eisenhower is not here to learn of our appreciation for his role in establishing the interstate highway system almost four decades ago.

Viewed from the economic long run, America has two main economic problems, (1) slow productivity growth and (2) low national saving. If future productivity growth remains slow, it guarantees that America's standard of living will grow only slowly in the future, and we might as well pack our bags and go home. And, for any given rate of productivity growth, low national saving leads us to finance part of domestic investment by borrowing from abroad, further reducing our standard of living as we are forced to set aside future output to repatriate interest and dividends to foreigners.

So what? You've been hearing this from economists for years. So let me change the tune today with three themes you don't hear often:

1. America's productivity level is better than any newspaper has recently reported, but its growth rate is abysmal and has not responded to the policies of the last decade. The slow growth rate can be addressed by policy, but not by the policies you usually hear about.
2. Many of the causes of America's productivity problem lie in areas that economists usually ignore, but which Congress has the power to address.
3. The best way to uncover these causes is to look at America through foreign spectacles. America can't be all bad, say the millions who have immigrated in recent years and the millions more who would drop everything to move here if given a chance. But why, ask foreigners, do Americans shoot themselves in the foot (and often other parts of the body) with a set of social and legal institutions that raise costs, cut efficiency, foster inequality, and breed crime?

To wrap these three subplots into an overarching theme, we should not shroud ourselves in the pessimistic cloak suggested by the title of Prof. Krugman's book, The Age of Diminished Expectations. We have reason to be optimistic about the future, but only if we drop our inhibitions about "what is politically possible." Let's take off the blinders and ask what should be done, not just what can be done.[1]

PRODUCTIVITY LEVEL AND GROWTH: WHERE WE STAND

The sages of Tokyo have recently pronounced that American workers are lazy, illiterate, and lack a work ethic. They have it all wrong. On average American workers are much more productive than Japanese workers, and in problem industries where America has trouble competing, the fault lies with management, not workers—this is obvious from the fact that American auto workers can produce top-quality products in Japanese-owned -plants.[2] Despite the vaunted success of some Japanese manufacturing industries, their economy as a whole is hamstrung by a notorious distribution system that amounts to communal arteriosclerosis.

The ERP reports on the level of American productivity in only a single sentence (p. 91), and so I've provided the needed comparisons in Figures 1–4. Figure 1 takes the really long view and compares standards of living in the United States, Europe, and Japan over the last 120 years. These figures do not translate foreign incomes at today's exchange rates, but rather

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[1] Paul Krugman, The Age of Diminished Expectations, MIT Press, 1990. I object in particular to Prof. Krugman's characterization of the consumption-saving choice that we must "suffer" (p. 15); in contrast, many of the items on my 10-point agenda listed below will simultaneously raise productivity and reduce suffering. Equally, I object to his limited view of what is politically feasible, as when he says "we aren't going to do anything [about productivity growth] (p. 17); this underestimates the imagination of present and future politicans.

[2] Lost in the recent furor of Japan-bashing has been the outrageous failure of the U.S. auto industry to improve its quality record, despite frantic claims to the contrary from Lee Iacocca and friends. Each year from thousands of questionnaires Consumer Reports compiles an overall "trouble index" on hundreds of auto models and highlights with red dots those models "much better" (35 percent) than average and with black dots "much worse" than average. Of ratings of 1289 models over the last 6 years (1985–90), fully 46 percent of the 322 Japanese nameplate models (many built in the United States) had red dots and only 2 percent black dots. In contrast, only 2 percent of 825 U.S. models earned red dots but fully 28 percent had black dots. The 142 models from other countries scored a mixed record, with 13 percent red and 11 percent black. See Consumer Reports 1992 Buying Guide Issue, pp. 160–204.

indicate what quantity of goods and services those incomes will buy (in other words, we knock down Japanese income per person to adjust for the fact that they have to pay more dollars than we do for almost everything at today's exchange rate).[3] The numbers in Figure I show the expected postwar surge of Japan but otherwise may seem surprising. First Europe and Japan have converged to each other but have not gained much ground on us in the 1970's and 1980's. Their standard of living has leveled off at about 70 percent of the United States, as shown in Figure 2. Second, Europe has hardly gained any ground on the United States at all over the last century; Europe fell behind from 1870 to 1950 as a result of wars, protectionism, and the lack of natural resources that gave the United States such a growth advantage, and then Europe spent the first part of the postwar era playing catchup.

[3] Technically, these numbers are created by Robert Summers and Alan Heston at the University of Pennsylvania in what is known as "PWT5" and compare the output of many nations measured in 1985 U.S. dollars. Then the output of each nation is run forward and backward from 1985 from domestic sources and converted into 1990 U.S. dollars.

Figure 1

Standard of Living (Real GDP per Capita)

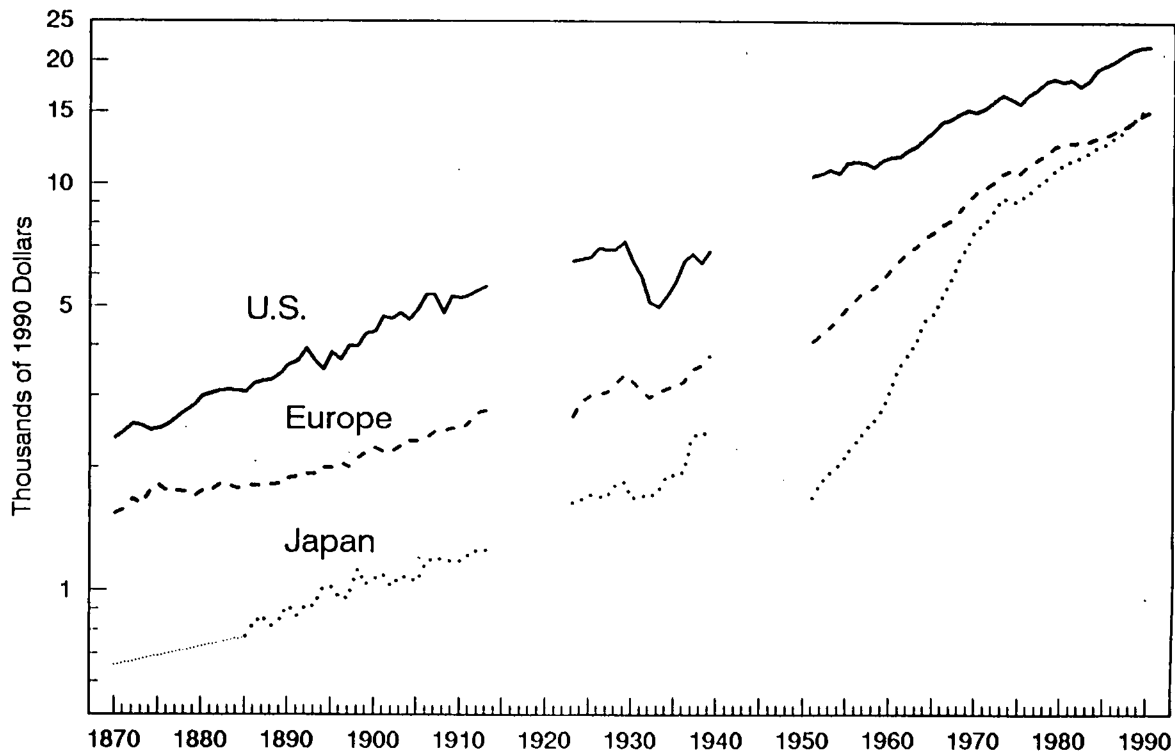
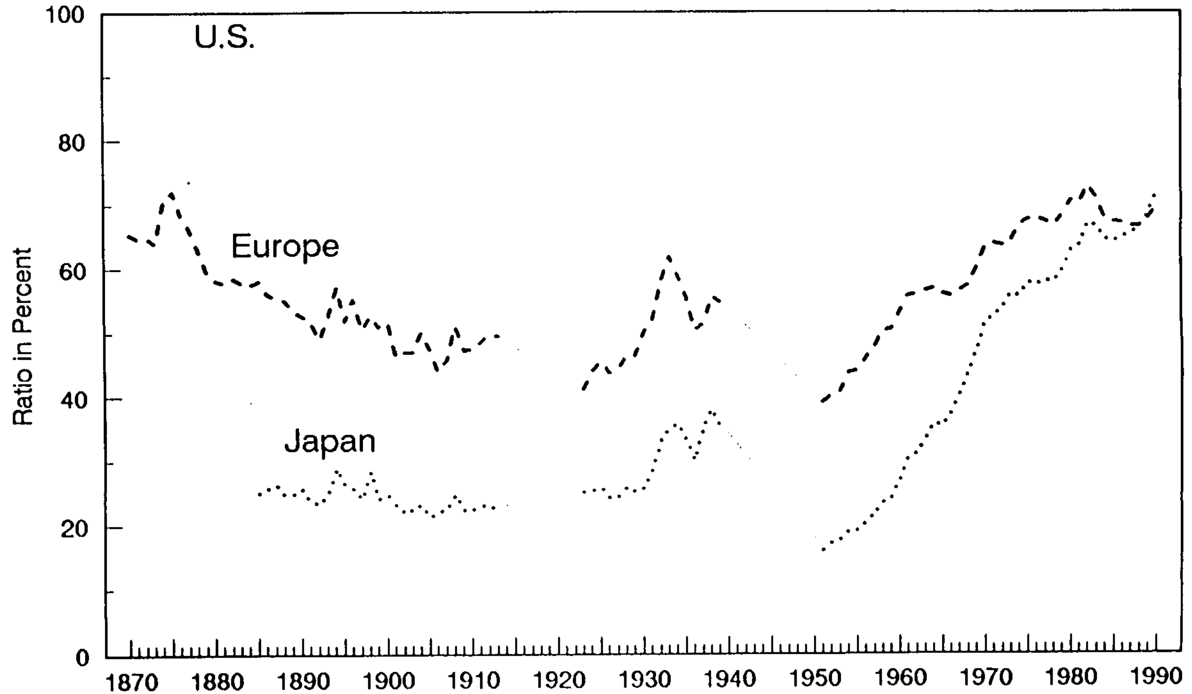


Figure 2

Ratio of Standard of Living (Real GDP per Capita) in Europe and Japan to that of the U.S.

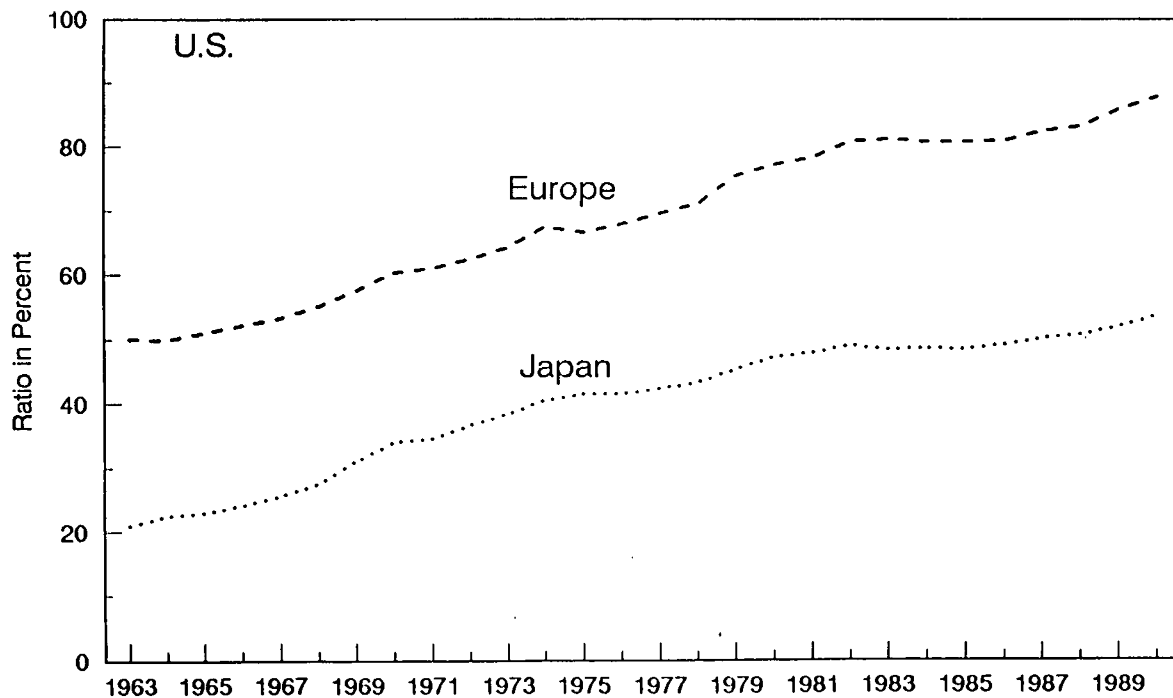


This concept of the "standard of living" is measured by output (GDP) per person. It is not the same as productivity, which is output per hour. A nation may raise its standard of living faster than productivity if each member of the population works more hours, either if each employee works longer hours, or if more members of the population join the work force. The reverse may also happen, as in Europe, where people have chosen to take a substantial part of their productivity gains in shorter hours, i.e., leisure. Since the standard of living graphs do not include leisure, they understate the well-being of Europeans relative to Americans, and they correspondingly overstate the well-being of the hard-working Japanese.

This explains the among result in Figure 3, which startles everyone who sees it. The level of Japanese productivity is only half that of the United States. This ratio has increased only from 47 to 54 percent over the last decade (1980–90). At this rate, it will take 45 more years for the Japanese to catch up, even if we sit idly by and do nothing to boost our productivity performance. And it should not surprise us that the Japanese are behind, for few of us would want to move their and suffer their miserable standard of living, huddled together on rice mats in their tiny little houses when not packed limb to limb into subway trains for their two-hour commutes.

Figure 3

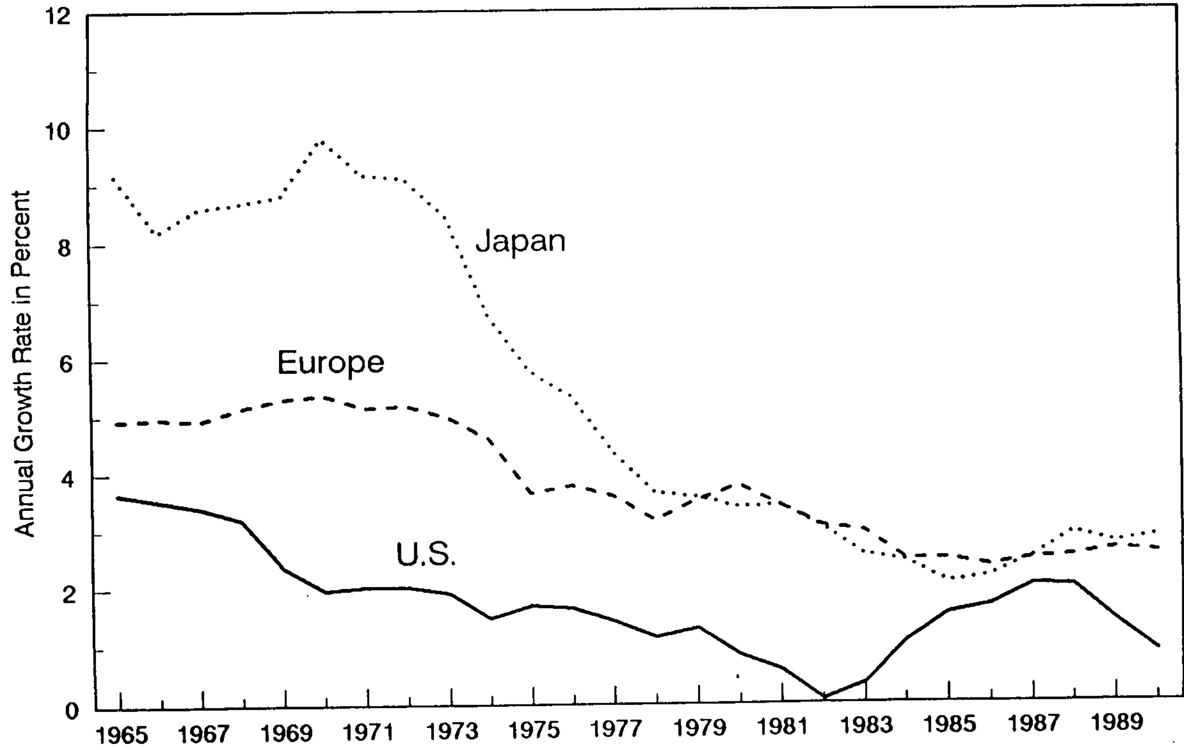
Ratio of Labor Productivity (Real GDP per Hour) in Europe and Japan to that of the U.S.



These comparisons of levels add needed perspective to the much sadder comparative graphs of productivity growth rates shown in the final Figure 4. Here we see the familiar fact that U.S. productivity growth has been slower than that of Japan and Europe throughout the postwar era. They, particularly Japan, have slowed down more than we have, from unsustainable "catch-up" rates. But they are still growing faster, and Europe will overtake our productivity level in just 10 more years if trends of the last decade continue.

Figure 4

Labor Productivity Growth Rates



THE ERP ON PRODUCTIVITY

There are three lapses in the treatment of productivity in the ERP. First, it contains only a sentence about the level of productivity. Second, it waves aside foreign performance with a shrug that "the productivity slowdown happened everywhere" (p. 92). Third, it greatly overstates the contribution of capital to economic growth.

Table 1 helps us to see the relationship between the growth in productivity and the contribution of capital. The top section compares growth rates of output per employee (these numbers are slightly lower than output per hour, since hours per employee have fallen). The next section looks at "capital productivity." If output grew at the same rate as capital, then capital productivity would have a zero growth rate. This would allow us to make a simple calculation: to boost the growth rate of output by one percentage point per year, it would be enough to boost capital growth by one percent per year, from 3.0 to 4.0 per year, or by one-third. This would require raising net private domestic investment by about one-third initially (and more later as the extra capital begins to depreciate), or from about $200 to $267 billion. Just $67 billion extra of national saving would initially do the trick.

TABLE 1

How Bad is U.S. Productivity Growth?

(Annual growth rates, selected intervals)

	Japan	Europe	U.S.
Labor Productivity (growth in output/employee)			
1960–73	8.6	5.0	2.2
1973–79	2.9	2.7	0.0
1979–90	3.0	2.0	0.7
Capital Productivity (growth in output/capital)			
1960–73	–2.5	–0.6	0.2
1973–79	–3.4	–1.4	–1.1
1979–90	–1.3	–0.5	–0.6
Multi-factor Productivity (output growth minus a weighted average of labor and capital growth)			
1960–73	5.9	3.3	1.6
1973–79	1.4	1.4	–0.4
1979–90	2.0	0.9	0.3
A Longer Look at Labor Productivity (growth in output/hour)			
1870–1973	2.7	2.2	2.3
1973–90	3.0	2.9	1.0
1973–90 Compared to the Previous Century	+0.3	+0.7	–1.3

Sources: Top three sections from OECD Economic Outlook, December 1991, Table 48 ("Europe" refers to OECD Europe). The bottom section for 1870–1973 is from Angus Maddison, Phases of Capitalist Development, 1982, Appendix C, Table C-10. For 1973–88 output is from the Penn PWT5 table, extended to 1990 from OECD Economic Outlook. Hours are from unpublished OECD data, and "Europe" is an unweighted average of France, Germany, Italy, U.K.

Except for one problem. The productivity of capital has been falling everywhere. Output has been growing slower than capital, and as a result extra capital growth will boost output much less than one-for-one.

The emphasis on more capital investment in the ERP is inappropriate if we just open our eyes and look around us. The investment boom of the 19805 resulted in the "see- through" office buildings that litter our cities and suburbs, and thousands of unoccupied rooms in luxury hotels. And all those billions of computer equipment purchased by our service sector could not budge service sector productivity, at least as we measure it. While better measurement helps a bit, Martin Baily and I have argued that much of the computer investment has fallen into

a large black hole, as computers sit unused on desks, pile up printouts no one looks at, and make possible such social annoyances as telemarketing.[4]

If the productivity growth slowdown were fully accounted for by slower growth of capital input, as the ERP comes close to implying, then we would observe no slowdown in "multi-factor productivity" (MFP), which is simply the growth in output relative to the growth of both labor and capital inputs. Taking account of capital should explain the whole slowdown.

But this clearly is not what happened. From the earliest (1960–73) to the latest period (1979–90), Table 1 shows that labor productivity slowed in the United States by 1.5 points, while multi-factor productivity slowed almost as much, 1.3 points. Thus capital explains almost none of the slowdown.[5]

This failure to explain the slowdown is almost universally conceded by economists and leads indirectly to Prof. Krugman's pessimistic book title. Perhaps the most dramatic way to dramatize America's productivity failure is shown at the bottom of Table 1. Alone among the industrial nations, only America has failed to boost its productivity since 1973 at a rate faster than the preceding century. Europe and Japan both did better than in the preceding century, but we fell short by a staggering 1.3 percent per annum. Continued for another century, this shortfall is enough to cost every American man, woman, and child $160,000 per year at today's prices![6]

HOW CAN THE STANDARD OF LIVING GROW FASTER THAN PRODUCTIVITY?

The ERP recognizes in Chapter 3 that slow productivity growth limits growth in real earnings but then in Chapter 4 shows that income per person has grown at respectable rates in the 1980's.[7] How can both these things be true?

The first two lines in Table 2 contrast the good news on real GDP per capita (which shows growth as healthy in 1987–90 as in 1950–63) with the bad news on real compensation per hour (as printed in ERP table B–44). The discrepancy for 1972–87 was a full percentage point, and it rose to almost two percentage points over the last 3 years. We have already seen in the graphs that income per capita can rise faster than productivity growth if people work longer hours (line E), and if more people move from household activity into the labor force (line F). It has also helped that the baby boomers have moved from dependent status into the adult population, reducing family sue and raising the number of employees per capita (line G). Another contribution to the discrepancy in the late 1970's was the famous CPI measurement error (line A) and in the late 1980's was the rising relative price of consumer services (relative to such non-consumption goods as computers, line B).

TABLE 2

How Can Real GDP Per Capita Keep Growing While Real Earnings Stagnate?

(Annual Growth Rates, Selected Intervals Between Years of Similar Unemployment Rates, 1950–90)

	1950–1963	1963–1972	1972–1979	1979–1987	1987–1990
1. GDP per capita	1.72	2.60	1.87	1.28	1.48
2. Real Compensation per Hour, Business Sector	3.23	2.72	0.90	0.28	–0.39
Difference to be Explained	–1.51	–0.12	0.97	1.00	1.87
Contribution of:					
A. CPI Rises Relative to Consumption Deflator	–0.22	0.88	0.58	0.15	0.10
B. Rising Relative Price of Consumption	–0.27	–0.56	–0.18	0.15	0.53
C. Total Economy Grows vs. Business Sector	–0.34	0.10	–0.59	0.24	0.41

[4] Martin N. Baily and Robert J. Gordon, "The Productivity Slowdown, Measurement, Issues, and the Explosion of Computer Power," Brookings Papers on Economic Activity, vol. 19 (1988, no. 2), pp. 347–420. NBER reprint no. 1199.

[5] More precisely, capital explains the difference between 1.5 and 1.3, divided by 1.5, which is 13 percent. The equivalent figures for Japan are labor productivity slowdown of 5.6 and MFP slowdown of 3.9, so that capital explains about one-third; for Europe 3.0 to 2.4 indicates that capital explains one-fifth.

[6] Compounded at 1.0 percent annually from today's $22,000, per-capita GDP in today's prices reaches $59,800 in the year 2091, but compounded at 2.3 percent it reaches $219,432!

[7] This table is introduced in part to inform those otherwise well-informed analysts who perpetuate the myth that the real wage "is no higher now than in 1967" (Krugman, p. ix). In fact, real compensation per hour deflated with the personal consumption deflator in 1990 was 28 percent higher than in 1967 (same sources as Table 2).

TABLE 2—Continued

How Can Real GDP Per Capita Keep Growing While Real Earnings Stagnate?

(Annual Growth Rates, Selected Intervals Between Years of Similar Unemployment Rates, 1950–90)

	1950–1963	1963–1972	1972–1979	1979–1987	1987–1990
D. Falling Share of Compensation in GDP	–0.43	–0.56	0.02	0.15	–0.12
Total of A-D	–1.25	–0.94	–0.17	0.70	0.91
Contribution of:					
E. Falling Hours per Employee	0.27	–0.09	–0.41	–0.36	0.37
F. Rising Employment to Adult Population	–0.03	0.24	0.62	0.32	0.61
G. Rising Adult Population in Total Population	–0.49	0.67	0.93	0.34	–0.03
Total of E-G	–0.25	0.82	1.14	0.30	0.95
Real Compensation (Cons. Deflator) per Adult (2+A+E+F)	3.25	2.95	1.69	0.39	0.69

Source: 1963–90 from ERP 1992 tables B-2, B-3, B–5, B–22, B–30, and B–44; 1950 from same tables in ERP 1991, linked in 1959 to post-1959. Economywide hours from NIPA Table 6.11.

One compromise measure that makes some sense is to eliminate the CPI error and then look at real compensation per member of the adult population. This psychological measure allows parents to feel better off when the number of children declines, so that a given income is stretched over fewer people. This measure helps us to understand today's malaise, for rapid and steady improvement through 1979 has collapsed to near-zero growth since 1979.

AN AGENDA FOR LONG-RUN CHANGE

The pessimism of economists over our productivity problem is understandable, but it is also a bit peculiar. We lament our ability to quantify exactly what has gone wrong, and then, after apologizing, we move on to our policy recommendations. Yet to a foreigner this seems the wrong approach. If we come up with an idea that seems sure to raise output per worker, then we should make that recommendation enthusiastically, whether or not we can claim that this particular factor has made a contribution to the post-1973 slowdown. If we can't find the mystery culprits, at least we can march a replacement battalion into place to take over the job of boosting productivity year by year.

So now let's put on those foreign spectacles and assemble a ten-point agenda of what seems most glaringly wrong with America, and how changes might boost productivity growth.

The first three items on the list concern education from cradle to grave. Everyone agrees that better educated workers not only make higher incomes and boost national productivity but also require smaller future public expenditures on welfare, prisons, and health.

1. *End our Penny-wise Pound-foolish Attitude toward Government Spending.* Making pre-natal, postnatal nurturing, and Operation Headstart available to everyone in need will pay off in lower future social costs of all kinds. Even Operation restart and a Library Corps for adult illiterates and high-school dropouts is likely to generate enough future tax revenues to pay for itself. And let's not forget German-style apprenticeships and a student loan bank with automatic repayments as part of the income tax system administered by the IRS.

2. *Reinstate Fiscal Federalism.* Taxes should be levied on the broadest possible base to stop inter-governmental competition to attract residents. This was the original idea behind revenue sharing. Almost all of the State and local fiscal crisis results from the combined effects of the cutback in Federal revenue sharing combined with increased Federal mandates for transfer payments. This crisis leads in turn to paralysis over needed improvements in education. Another Federalist theme is that we should mandate metropolitan government. The model of Toronto-style metropolitan government reminds us that Americans do not have to tolerate gross inequalities in educational spending between suburbs and central cities, or the perverse incentives which have hollowed out many of our central cities, leaving maximum social problems and minimal resources. If the Federal Government can create incentives for HMOs and other types of health organizations, it can devise incentives for metropolitan government.

3. *Adopt National Tests and Standards.* We will never compete with other nations in math and science unless we abandon our obsolete reliance on local control of education and impose a national set of tests and standards for "core" subjects like literacy and math (no matter how much local latitude we allow in "soft" subjects like social studies).

The next three items on the agenda involve areas that are universally agreed to boost business costs and reduce the competitiveness of American firms—they involve doctors and lawyers.

4. *Adopt National Health Insurance*. General Motors has many troubles competing with Toyota, but one we can fix is that GM pays $500 more per car for health insurance for its workers than does Toyota in Kentucky, partly because Toyota has younger workers. Even worse is the burden on both compared to plants in Japan, where health care costs only half the fraction of GDP as here. Another startling comparison is that 10 percent of health-care expenses here is wasted on administration (vs. only 1 percent in some other countries). Unless we abandon our present reliance on group insurance paid by specific employers, we will tilt the competitive playing field toward non-union start-up operations and cause ever-more closings of plants with older workers. No wonder foreigners marvel at our ability to shoot ourselves in the foot to protect our private health insurance industry.

A minimum set of criteria for national health reform is that we (a) nationalize insurance (while continuing private doctors and hospitals), (b) have a national budget for health care to prevent runaway waste and duplication, and (c) be willing to set priorities, as in the new Oregon program.

5. *Curb the Lawyers*. Vice-President Quayle has made many aware that we have 70 percent of the world's lawyers, 10 times as many per capita as the Japanese. Only the national government can dry up the demand for the ambulance chasers and medical malpractice experts by outlawing punitive damages, medical malpractice, litigation involving auto accidents, and many other outrages that have no counterpart in many of our competitor nations. Protect the victims by establishing national boards of reimbursement, don't allow half to two-thirds of the settlements to be wasted on lawyers fees and court costs.

6. *Ban Guns and Reform Criminal Justice*. Costs for security guards and taxes to pay for police join medical costs and litigation expenses in an unholy trinity that drive up U.S. business costs and erode competitiveness. Nothing so repels foreigners as the danger of violent crime in America's cities and the stubborn refusal of politicians to ban guns. Just yesterday we read that the percentage of Americans in jail is ten times that in many other developed nations and for American black males is fifty times as high. While fighting violent crime with gun control and cradle-to-grave education, we should curb our other exceptionally severe criminal punishments (by foreign standards) for intrinsically minor, esoteric, or archaic offenses), and our adoption of pretrial detention (as a result of which some criminal defendants languish in jail for 2 years or more while awaiting trial).

7. *Change our Short-run Mentality*. Politicians must fight their own basic instincts by protecting America from its built-in short-run mentality. Prohibit quarterly reports by corporations, pass laws that take away stockholder decision-making from inbred management and pass it to individual stockholders and banks, and show that you're serious by extending terms of Congressmen from 2 to 4 or 6 years.

8. *Use the Peace Dividend for Government Investment*. This is broader than the usual recommendation of "more infrastructure." We need not only repairs of highways, bridges, and air-traffic control, but funding for the full cradle-to-grave "educational repair" program outlined in #1 above.

9. *Target any Tax Incentives*. Any tax incentive should be judged by a single criterion—will it help foster future American growth? (or reduce inequality—see #10 below). Any investment tax credit should be targeted away from structures (now overbuilt).[8] Stimulus should be limited to equipment and R&D, with more of an incentive for the latter. Tax incentives for households should be limited to those that encourage saving, particularly IRAs (with a cut-off for the top bracket).

10. *Eliminate the Federal Budget Deficit Overnight*. Perhaps more than anything, foreigners are mystified by the inability of American politicians to find those two obvious ways to eliminate the budget deficit, since Congress could generate $200 billion of tax revenue overnight.[9] First, our gasoline prices are still a mere fraction of those everywhere in Europe. A $1 per gallon Federal gasoline tax would still leave gasoline prices below the average European level while generating $100 billion of revenue and making obsolete the strident debate over CAFE standards.

Second, and more important, the Federal Government should reverse the Reagan-era decline in top-rate tax brackets. I recommend a simple scale: 40 percent above $100,000 (taxable income), 50 percent above $200,000, and 60 percent above $500,000. This would still leave our

[8] The construction workers can be re-employed on government infrastructure projects.

[9] The January 1992 CBO estimate of the Fiscal Year 1993 budget deficit, excluding Desert Storm and Deposit Insurance, is $258 billion, of which roughly $50 billion can be attributed to high unemployment, leaving about $200 billion as the net structural deficit. While there is no need to balance the budget, since a deficit of about $150 billion is consistent with maintaining constancy in the debt-GDP ratio, a balanced budget and a falling debt-GDP ratio creates a better environment for investment, low interest rates, and an end to foreign borrowing.

top tax bracket below the 65 percent levied in Japan.[10] We finally must recognize that the incentive argument for lower marginal rates has failed; America's productivity growth did not revive in the 1980's as a result of "supply-side tax cuts." By raising top-bracket tax rates, we allow Steve Ross, Bill Cosby, Oprah Winfrey, Michael Eisner, and thousands of other people who have been blessed by luck and talent to launch the revival of the American economy.

Will there be anti-growth effects of higher top-bracket rates? Ask yourself: would Bill Gates have refused to found Microsoft at such rates? Would immigrant Asians refuse to start new computer companies in Silicon Valley, as they do now? Just as farm subsidies should be reoriented from rich farmers to poor farmers, we can create all the incentives and venture capital we need at a fraction of the cost by expanding SBA loans to talented new businesspeople.

THE SHORT RUN

I have said almost nothing about the short-term proposals put before you by the Administration and your colleagues. My best advice is to judge any short-run proposal as to whether it would support the 10-point long-run agenda advanced here. And remember the economic paradox of short-run vs. long-run:

- Short-run middle-class tax relief raises consumption at the expense of national saving, harming long-run growth, and
- Fostering long-run productivity growth requires encouraging corporate cost-cutting, even if this creates short-term unemployment.

It is the job of monetary policy to reduce interest rates and boost monetary growth, together with providing incentives for banks to lend again, in order to raise demand and generate jobs for the displaced. The best short-run fiscal policy is one which both reduces inequality and promotes economic revival, and that is the extension of unemployment benefits, which you have already approved.

CONCLUSION

Charley Schulze has said that what America needs is "higher taxes and more homework." That's a good beginning, but only two-tenths of my program. My 10-point agenda for the long-run revival of America is one that most Americans would support, if only some politician could summon up the courage to support it. It would give us the best of both worlds, the free and open society that prospective immigrants strive to enter, and a reformist atmosphere that answers the snotty disdain of foreigners by responding, "OK, we heard you, we're fixing it."

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[10] Simultaneously I would index the taxation of capital gains, interest income, and interest expense, and reduce the capital gains rate for holdings of more than, say, 6 years (while curbing the ability of top-bracket CEOs to benefit from huge gains on stock options).

Chairman SARBANES. Thank you very much.

Dr. Hunter, we'd be pleased to hear from you.

STATEMENT OF DR. LAWRENCE HUNTER, ACTING CHIEF ECONOMIST, U.S. CHAMBER OF COMMERCE

Dr. HUNTER. Thank you, Mr. Chairman.

My statement today will be slightly more pedestrian than what we've heard so far. I'd be happy to get into a discussion of how to reform America and improve our character later.

What I wanted to address in my statement goes to the short-run outlook and then to some comments on the long run.

I would like to make one comment before beginning. If the 1960's somehow represented collective adolescence of the Baby Boom coming of age, my greatest fear is that the 1990's is going to represent some kind of collective middle-age identity crisis.

The angst and the pessimism I see is disconcerting.

I come before you this morning concerned about the future. It's not a concern over the nature of our system or the free enterprise system. Rather, it's a concern over public policy that I think, if corrected, would lead to a remedy of many of the problems we've discussed or will be discussing today.

In this year's Economic Report of the President, the Administration says it expects the economy to be sluggish in 1992, but then to pick up in midyear. They made a similar midyear turn-around prediction last year. We thought they were wrong then. It turns out that they were.

This year we believe the Administration has at least a 50–50 chance of being correct, that a recovery will begin. But we think that the Administration remains on the optimistic side as to the strength of the recovery.

They are forecasting real growth for calendar year 1992 at 1.5 percent and 3.0 percent in 1993. We are forecasting 1992 growth at 1 percent, excluding consideration of any policy changes.

In the absence of any policy changes between now and the end of the year, we believe the economy will not be able to sustain growth above 2 percent in 1993.

We are currently in the process of re-evaluating our forecast and very well could reduce our growth outlook. Right now, I would say that the Administration is correct that we will see a recovery midyear, but we could very well be looking at real growth below 1 percent for all of calendar year 1992.

The most interesting aspect of the President's outlook, Mr. Chairman, is something that you referred to in your opening statement, and that's the addition this year of the Administration's business-as-usual scenario, which we interpret to be their baseline forecast, assuming no policy action is taken.

The difference between this scenario and the official forecast, which assumes the President's proposals in force, gives a measure of how effective the Administration estimates the President's growth package to be.

This is shown in Table 1 of my statement.

Using fourth-quarter-over-fourth-quarter numbers, in 1992, the Administration estimates that real growth will be 2.2 percent if the President's economic growth initiative is enacted, a sixth-tenths percentage point increase over the 1.6 percent baseline.

Over the long run, the Administration estimates the effect of the President's growth initiative to average about fourth-tenths of 1 percentage point per year.

We believe these estimates of the growth effect of the President's package are too high. Although the proposals in our mind represent a good first step

and they go in the right direction, we do not see how the proposed policies as constructed could raise growth by more than about a tenth of a percentage point a year after the first year.

And lurking within the details of the package are specific tax increases that may in the long run actually more than offset any short-run benefits that other proposals in the package may produce.

By September 1991, it had become fairly apparent to us that the economy had swerved seriously off course and was not likely to return to its former level of performance without significant policy changes.

At that time, I wrote in the Wall Street Journal of what I called an emerging growth gap. Mr. Chairman, I ask that a copy of the article be included in the record.

Chairman SARBANES. It certainly will be.

Dr. HUNTER. Since the beginning of 1989, the economy has been virtually stagnant, resulting in an amount of real gross domestic product that lies now far below the amount consistent with post–World War II economic growth trends, and this gap is growing.

Even if the economy grows by as much as the optimistic Bush Administration forecasts of 2.2 percent in 1992, the gap by the end of this year will again widen.

If the Chamber's forecast for 1992 is correct, the four-year period from 1989 through 1992 will average only about 0.9 percent points real growth a year, the second slowest four-year period since the 1930's.

Indeed, the most disturbing aspect of the President's economic outlook is found in his own outyear growth estimates. There is a subtle but important change from last year when the Administration saw the economy's performance returning to its long-run trend, though the Administration did not even then expect the lost ground from the recession to be made up.

This year, the Administration shows the long-run performance of the economy actually deteriorating, even with the overly optimistic estimate of the growth effect of the President's plan.

With adoption of the President's plan, the Administration's outlook shows the growth gap widening again after 1995, and if one uses their business-as-usual baseline as the benchmark, the growth gap widens dramatically.

I'll also ask that a graph, which I've distributed to the Committee, be inserted into the record that attempts to show these relationships.

Chairman SARBANES. It will be included.

Dr. HUNTER. In conclusion, while the President's plan represents a good framework upon which to build, even the Administration's own economic outlook illustrates that it alone is not sufficient to address the nation's long-run growth needs.

We urge Congress to work with the Administration to strengthen the President's initial proposals.

Contrary to my fellow witnesses this morning, Mr. Chairman, the Chamber does not believe that American businesses or workers need extraordinary help from the government. All we need is for the government to remove the many obstacles it has placed in our path.

And although we are concerned and think Congress should be concerned about the hardship the recession is bringing, it would be wrong for Congress to mistake the short-run recession and the accompanying fall-off in demand for the long-run sickness that we believe is infecting the economy, which I think could fairly be characterized as an asphyxiation of capital.

Government policies are literally suffocating business expansion and job creation by levying burdensome and distorting taxes, by accelerating regula-

tions that bring fewer and fewer social benefits at skyrocketing costs to businesses and consumers, and by extravagant public-sector spending that diverts desperately needed resources from the private sector where new jobs and businesses go wanting.

The President's Report is right on the mark when it finds that the major explanation of slow productivity growth is to be found in the high cost of capital.

A recent study conducted by the London stock exchange compares tax policies on equity investment among the G–7 nations and concludes that the United States has one of the most capital unfriendly tax systems among the G–7. It is particularly surprising, say the authors, that the United States currently treats its equity investors so harshly.

Let me report to the Committee a summary of the results of a project on economic growth recently undertaken by the Chamber. We asked four prominent economists what policies would work to increase long-run economic growth. I hope to have the full study of the findings complete within the next week or two, Mr. Chairman. I would be happy to provide the complete findings to the Committee at that time.

All of the economists agreed that in order to increase long-run growth, fundamental policy changes are necessary to spur the supply-side of the economy. There is also widespread agreement that measures to stimulate the demand-side of the economy would at best do little to improve the long-run outlook and, in fact, may hamper efforts to raise long-run growth potential.

A strong consensus emerged on specific policy steps to be taken.

Cut the capital gains tax rates sharply and index it to inflation. Increase depreciation allowances for capital investment so that firms can recover the full economic value of their investment. And reduce the growth rate of federal spending.

I know the capital gains tax issue has become contentious and highly politicized. But it's time to lay aside partisan rhetoric and see if there is some common area where we can come to agreement to help the country.

Rather than continuing to argue the unresolvable, let me offer an approach that I hope both sides can embrace.

Everyone now agrees, I believe, that we need to increase capital investment. To get more investment, you have to give incentives to those who have the income to invest.

The opponents for cutting the capital gains tax have argued that doing so will not really increase investment, it will only give rich people a windfall to fuel their further consumption.

Mr. Chairman, let's diffuse the issue by changing the law in a way that guarantees people will reinvest. Cut the rate to spur realizations, index the basis for inflation to give an incentive for longer-term holdings, and allow investors to reinvest their capital gains without paying a tax on the gain if it's reinvested.

In other words, tax capital gains only when they are realized for consumption. This proposal would not only give investors an incentive to unlock capital gains, it will almost dictate that most of those gains be rolled over into new investments, which is precisely what the economy needs.

Congress must also reduce the cost of labor, and cutting the social security payroll tax for both employers and employees is the best way.

As Senator Moynihan has so eloquently stated, the current social security surplus is not saved to pay future benefits, it is pillaged by the Treasury to pay current government bills.

Therefore, cutting the tax will not affect the payment of the future benefits one bit.

I cannot emphasize enough how pernicious payroll taxes are. They are a direct excise tax on jobs. The more you tax something, as you know, Mr. Chairman, the less of it you get.

Payroll taxes are particularly destructive during hard economic times, when many small businesses in particular are struggling to survive until the economy improves and sales pick up once again.

Payroll taxes must be paid regardless of whether or not a business is profitable.

Finally, Mr. Chairman, we urge Congress to enact the neutral cost recovery system to index the depreciation schedule for inflation so that firms can realize the present value equivalent of expensing.

Expensing or its present value equivalent is the appropriate manner to treat capital investment.

The beauty of the NCRS approach is that it achieves the economic objective without radically altering the tax system and the budgetary cost can be kept under control.

NCRS should be permitted for alternative minimum taxpayers. And in this regard, the President's proposal to disallow the capital gains exclusion for AMT payers is seriously in error, and it seems to us at variance with his effort with the investment tax allowance to provide alternative minimum tax relief.

The question, of course, is what will these policy changes cost, and can we afford them? In my mind, we cannot afford not to make these changes.

Mr. Chairman, we have estimated the five-year budgetary effects of the initiative I have just outlined.

I want to emphasize here that this doesn't consist of the entire proposal that we have supported, but it represents a core or basic program that we would like to see enacted.

All of the revenue estimates are taken from either the Joint Tax Committee or the Congressional Budget Office, not because we believe them—we don't—but rather to demonstrate how powerful and practical this initiative is, even under the most stringent assumptions.

The Joint Tax Committee estimates the five-year revenue loss of a neutral-cost recovery system to be $58 billion, and the five-year cost of a 1.8 percentage point reduction of the social security payroll tax to be $254 billion. That would allow a 0.9 percentage point decrease for employers and employees each.

In the case of capital gains, we've been doubly conservative by assuming unrealistically, we believe, that no capital gains would ever be realized for consumption. Thus, we completely eliminate capital gains in this scenario as a source of federal revenue.

Thus, we allow for a five-year total cost of $165 billion for the capital gains component. The combined five-year cost of the program comes to $462 billion under the revenue estimating methodology used by the Congress.

And again, Mr. Chairman, I want to emphasize that using the static revenue estimates does not imply that we in any way agree with them or embrace them, but simply to clear away what I believe is an unresolvable argument that we will continue to have year-after-year over these revenue estimates.

Let's look at the other side of the ledger.

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First, we assume defense spending will be pared to $250 billion by 1997, which will yield a savings of about $143 billion.

Second, we propose that Congress take a page from corporate America's book to face the realities of the 1990's. It's time for Congress to begin restructuring and downsizing the Federal Government.

We propose a modest first step that any CEO in the country will tell you is eminently feasible in an organization with a little bit of will power and direction.

We propose that Congress simply reduce the rate of increase in nondefense federal spending, and here we exclude social security and net interest payments. Reduce all of the rest by 5 percent below the CBO baseline. This amounts to a five-year savings of $110 billion.

And finally, I would refer back to the findings of the Chamber's project on economic growth. There was general agreement that a program such as the one laid out here would increase the economy's growth potential permanently on the order of 1 full percentage point a year.

Again, to be conservative, we have used CBO's own rule-of-thumb on the deficit reduction that results from a permanent 1 percentage point increase in real growth and have gone the next step and have discounted that reduction in light of the proposed changes to the tax code that we have recommended.

We estimate an economic growth dividend amounting to $236 billion in deficit reduction over the 5 years as the economy realizes this higher level of economic growth.

Thus, Mr. Chairman, as the table demonstrates, the initiative I've suggested should on balance actually reduce the five-year deficit slightly. We estimate it would create approximately 1.2 million new jobs by 1996, and spur investment that would increase the stock of U.S. capital by almost $4 trillion by 1996.

In 1961, John Kennedy set an ambitious national goal—placing a man on the moon and returning him safely to earth by the end of the decade.

In 1992, it seems a modest goal by comparison to launch the economy over the course of this decade back to its historic level of performance—boosting economic growth, accelerating productivity increases, bringing inflation down to earth, and returning Americans safely to work.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Hunter, together with Wall Street Journal article, follows:]

PREPARED STATEMENT OF LAWRENCE A. HUNTER

I am Lawrence Hunter, Acting Chief Economist of the U.S. Chamber of Commerce. On behalf of our 185,000 member businesses, associations and State and local chambers of commerce, we thank the Joint Economic Committee for this opportunity to present our thoughts on the U.S. economy and proposals for long-term economic growth.

The debate over growth legislation should begin with one thought clearly understood: Congress cannot fashion a true growth package if the ultimate measure of the package is taken to be its ability to redistribute income. Changes in tax policy affect incentives. The proper task is to improve incentives to invest, save, work and produce so the economy will improve and everyone will benefit. In short, truly pro-growth policies are those which improve long-term economic growth. Tax rate increases do not improve these incentives and therefore should be avoided. The U.S. Chamber views tax rate increases as a clear back-tracking from the current national policy of low marginal tax rates available to both individuals and corporations. Low marginal rates reduce the bias against work, saving and investment, and promote long-term economic growth. The soundness of a low to-rate policy is highlighted by the fact that the tax reform movement has spread worldwide. Tax increases would only serve to undercut any growth package and lead to further economic stagnation for the Nation.

SUMMARY OF FINDINGS

Since 1989, the economy has been virtually stagnant. This represents an abrupt shift from 6 years of strong economic growth from 1983 through 1988. Only one other period of stagnation like it has occurred since the end of World War II—1979 through 1982. The Chamber believes that pro-growth policies worked to bring the economy back in 1983 and must be considered again. We find that:

- The economy is not going to recover robustly under current policies. The economy's resilience has been lost. As a consequence, a considerable "growth gap"—the difference between what would have happened if the postwar trend in Gross Domestic Product was maintained and actual GDP—has emerged and is increasing.
- The primary causes of this recent period of slow growth and recession are mistaken tax, spending, regulatory and monetary policies. The underlying economy is still strong, but has been battered and held down by anti-growth policies that continue to mount.
- Recent studies show that a coordinated set of Federal Government policy changes could have the effect of raising the economy's growth potential by one full percentage point. This would result in economic growth of 4 percent beginning in 1993 and lasting until the growth gap is closed.
- Based on the results of these studies, the Chamber believes it has developed a significant, comprehensive program for economic growth. The recommended policies would reduce the cost of capital and labor and spur more investment, savings, work and production.
- The President's proposals are designed to help the expected 1992 recovery along. They are not enough. Elements of other legislation already introduced in Congress could be added to the President's proposal to generate improved long-term growth potential.
- Some of the proposals contained in the President's initiatives—specifically several tax increases—are detrimental to long-run growth and should not be enacted.

FORECASTING RECORDS

In February 1991, the Bush administration's economic outlook had "the downturn continuing through the first quarter and a recovery beginning near the middle of the year. The current downturn is expected to be short and shallow . . . Growth is expected to strengthen in 1992, with the economy in a relatively high-growth recovery through 1993 before returning to a solid, sustainable expansion" (Economic Report of the President, 1991, p. 24). The report went on to forecast real growth in calendar years 1991 and 1992 at –0.3 percent and 3.1 percent respectively. The economy actually contracted by –0.7 percent in calendar year 1991.

In the Congressional Budget Office's Annual Report, The Economic and Budget Outlook: Fiscal Year 1992–1996 (January 1991), CBO forecasted that "this recession will probably be milder than the average downturn and will end by midyear. . . .higher growth will mark the recovery, as the economy catches up to its potential. For 1992, the growth rate is expected to rise to about 3½ percent." (pp. xviii–xx). CBO went on to forecast real growth in calendar years 1991 and 1992 at 0.0 percent and 3.3 percent respectively.

It is not surprising that both CBO and the Bush administration had such similar, rosy forecasts for the second half of 1991 and for all of 1992. Congress and the administration had made a compact with each other to defend the budget agreement signed just 2 months earlier. Both parties were proclaiming the agreement as the solution to our budget and economic problems. The recession would end in 1991 and a recovery would be well under way in 1992. The Chamber disagreed with both the administration and CBO about the effect of the budget agreement and on the official economic outlooks.

At the time of the budget agreement, we warned, "This [agreement] hardly qualifies as deficit reduction. The precarious status of the economy requires a significant shift in attention toward reviving economic growth. Not only does the budget bill dig the economy into a deeper hole, it may also effectively take away the policy ladder [tax reductions] needed to climb back out," (Economic Outlook November/December, 1990). At that time we forecasted real growth for calendar years 1991 and 1992 at −1.0 percent and 1.1 percent respectively. It is now clear that we were closer to the mark than either the Administration or CBO.

Six months earlier, when both the administration and CBO were still optimistic a recession could be avoided and were maneuvering to raise taxes, the Chamber stated, "For the first time since 1981, the U.S. Chamber of Commerce is forecasting an economic recession" (Economic Outlook July/August 1990). Then, in the aftermath of the budget agreement last January, when CBO and the administration had adopted "short and shallow" recession forecasts, the Chamber became even more pessimistic. The Chamber's Economic Outlook First Quarter 1991, cautioned that Federal Government "forecasts may be overly optimistic. We believe that the recession will last at least until the fall of 1991, which places us on the more pessimistic side of the forecasting pack."

That same Outlook went on to express concern over the long-term outlook: "What concerns us is not only how long and deep the recession may turn out to be, but how strong will be the eventual recovery." At that time we saw so many impediments to economic growth—primarily policy impediments—that we thought "the economy will be fortunate to rise by 2 percent for any extended period in the next few years."

In this year's Economic Report of the President, the Bush administration says it "expect[s] the economy to be sluggish early in 1992 but then to pick up in the second half of the year," (p. 24). The administration made a similar prediction of a mid-year turnaround last year. We thought they were wrong last year and it turns out they were. This year we believe the administration has at least a 50/50 chance of being correct that a recovery will begin, but we think they remain on the optimistic side as to the strength of the recovery. The President's Economic Report forecasts real growth for calendar year 1992 at 1.5 percent and 3.0 percent in 1993. This is almost identical to the Blue Chip Consensus forecast for 1992 and 1993. The Chamber is forecasting 1992 growth at 1.0 percent, excluding consideration of any policy changes. In the absence of any policy changes between now and the end of the year, we continue to believe the economy will not be able to sustain growth above 2 percent in 1993.

The Chamber is currently in the process of reevaluating our forecast and very well could reduce our growth outlook. Right now I would say that the flip side to the 50/50 chance the administration is correct that we will see a recovery in the Spring is that it is just as likely we may be looking at real growth below one percent for all of calendar year 1992.

The most interesting aspect of the President's economic outlook is this year's addition of the administration's "Business as Usual" scenario, which we interpret to be their baseline forecast assuming no policy action is taken. The difference between this scenario and their official forecast, which assumes the President's proposals are enacted, gives a measure of how effective the administration estimates the President's growth package to be.

TABLE 1

ADMINISTRATION ESTIMATES OF THE EFFECTS OF THE PRESIDENT'S ECONOMIC GROWTH PROPOSALS ON REAL GROWTH RATES

REAL GDP FORECASTS

	1992	1993	1994	1995	1996	1997
Congressional Budget Office Forecast	1.6%	3.6%	2.7%	2.5%	2.6%	2.6%
Administration Business as Usual Forecast	1.6%	2.4%	2.5%	2.6%	2.5%	2.4%
Administration Forecast Assuming Enactment of Bush Economic Plan	2.2%	3.0%	3.0%	3.0%	2.9%	2.8%
Administration Growth Effect	0.6%	0.6%	0.5%	0.4%	0.4%	0.4%

Source: Office of Management and Budget and the Congressional Budget Office.

In 1992, on a fourth-quarter-over-fourth-quarter basis, the administration estimates that real growth will be 2.2 percent if the President's economic growth initiative is enacted, a 0.6 percentage point increase over their 1.6 percent baseline growth forecast. Over the long run, the administration estimates the effect of the President's growth initiative to average about 0.4 percentage points a year. We believe these estimates are much too high. Although the proposals represent a good first step in the right direction, we do not see how the proposed policies could raise growth by more than 0.1 percentage points a year after the first year as the package is now constructed. And, lurking within the details of the package are specific tax increases that may in the long-run more than offset any short-run benefits the other proposals may produce.

THE PROBLEM: DETERIORATING GROWTH POTENTIAL

By September 1991 it had become apparent that the economy had swerved seriously off course and was not likely to return to its former level of performance without significant policy changes. At that time I wrote in the Wall Street Journal of an emerging growth gap resulting from a long-term decline in the rate of economic growth: "If the Bush forecast is correct through 1996, the cumulative cost of this shallow dip/weak recovery will be more than double the cumulative cost of a 1982-like sharp dip/strong recovery, or an average loss of disposable income of $19,924 per family of four. And it wont be made up," (The Never-Ending Recession," Wall Street Journal, September 19, 1991). Mr. Chairman, I ask that a copy of this article be included in the hearing record at this point.

The economy's main problem is not that the current recession is long nor that the recovery is slow to come about. Rather the key problem is a deterioration in long-term economic growth. Since the beginning of 1989, the economy has been virtually stagnant resulting in an amount of real Gross Domestic Product that lies far below the amount consistent with postwar economic growth trends. This gap is growing. Even if the economy grows by as much as the optimistic Bush administration forecast of 2.2 percent in 1992, the gap by the end of this year will again widen.

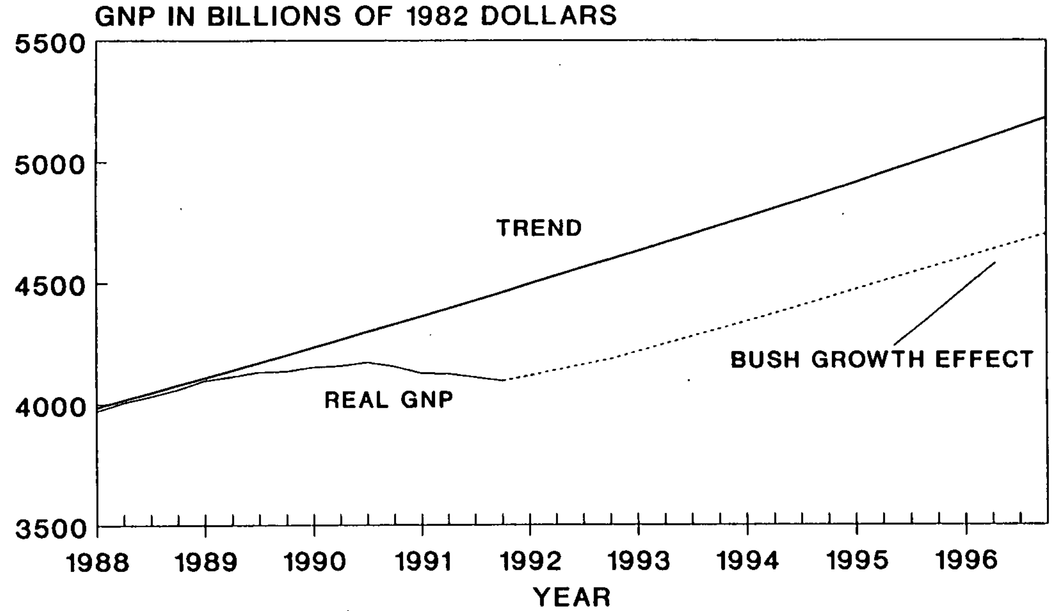
In its recent forecast of the economy, the Congressional Budget Office indicates that this growth gap will get wider during the next several years. A major reason for this is CBO's reduced estimate of growth potential in the 1990's, down to 2.1 percent. By the Chamber's analysis, such low growth potential, an estimate of the upper limit of long-term economic growth, is a result of anti-growth Federal policies and not a failure of the private economy to grow. Low potential growth estimates greatly limit economic forecasts. CBO forecasts that real GDP will rise at an average annual rate of about 2.6 percent over the next 6 years before falling down to meet potential. If we accept this notion of growth potential, the growth gap is a measure of output that is lost forever.

At the beginning of the 1980's, growth potential estimates were lowered from 3 percent to 2.5 percent. After pro-growth policies were enacted in 1981, growth potential returned to 3 percent and the economy was able to get above its potential for several years to close the growth gap that had opened up after the 1981–82 recession.

Indeed, the most disturbing aspect of the President's economic outlook is found in his own out-year growth estimates. There is a subtle, but important, change from last year when the administration saw the economy's performance returning to its long-run trend although the administration did not expect lost ground to be made up. This year the administration shows the long-run performance of the economy actually deteriorating, even with the overly optimistic estimate of the growth effect of the President's plan. With adoption of the President's plan, the administration's outlook shows the growth gap widening 'again after 1995. If one uses the "Business as Usual" baseline as the benchmark, the growth gap widens dramatically.

THE GROWTH GAP

GRAPH 1



BUSINESS AS USUAL ········ BUSH GROWTH PROPOSAL

SOURCE: U.S. CHAMBER OF COMMERCE

In conclusion, while the President's plan represents a good framework upon which to build, even the administration's own economic outlook illustrates that it is not sufficient to address the Nation's long run growth needs.

RESILIENCE LOST

We believe the American economy entered 1992 as it entered 1991—in recession. Throughout the fourth quarter of last year, major economic indicators pointed to a deteriorating economy: employment fell, unemployment rose, consumer expenditures dropped and industrial production plunged downward. Although the initial report on GDP shows a 0.3 percent fourth quarter rise, we expect revisions will reduce that number and put it in slightly negative territory.

As 1992 begins, Americans are gloomy. Consumer confidence, as measured by the Conference Board's Consumer Confidence Survey, plunged to a recession level of 50.4 in January. According to the U.S. Chamber's "Business Ballot" for December, the predominant view among the business community is that over the first 6 months of 1992 the economy will continue its decline, sales will fall, and employment will drop. The Chamber's index of over 8,000 respondents' confidence, nearly 60 in June, was at 39.4 in December.

Instead of moving rapidly back to the trend amount of real GDP as in past economic recoveries, the economy is projected to grow slower than the postwar trend of about 3 percent during this decade, or at about 2.5 percent. This seemingly small difference in growth rates adds up to hundreds of billions of dollars in lost output over the course of 10 years. Indeed, growth potential estimates among many prominent forecasters are currently falling. The Chamber estimates that growth potential under current economic policies is somewhere between 1.5 percent and 2.0 percent. It is these low growth potential estimates that need to be addressed. By raising growth potential, both short-term and long-term economic growth will rise.

ORIGINS OF RECESSION AND SLOW GROWTH

Each decade, from the 1950's to the present, government spending as a proportion of Gross Domestic Product has grown. Averaging 18.2 percent in the 1950's, it grew to 19.2 percent in the 1960's, 20.7 percent in the 1970's and reached 23.2 percent in the 1980's. In 1992, Federal spending will hit more than 25 percent of GDP. Empirical studies show that as government spending increases as a share of the total economy's output economic growth rates tend to slow. Countries with smaller shares of government spending as a percent of GDP have tended to grow more rapidly.

During the past two decades, government spending and regulation have both grown faster than the U.S. economy. Despite a doubling of tax revenues throughout the 1980's, the Federal government continues to run a persistently high and growing budget deficit. And because of the record tax hikes passed in 1990, direct tax burdens continue to increase, as do regulatory "taxes" on businesses forced to comply with costly mandates.

Federal spending on its programs and Federal regulation of business are viewed by program and regulation proponents as exceedingly helpful to the economy. Proponents argue successfully to expand their favored programs by citing the alleged benefits. When government attempts to pay for these programs directly, the impact on the economy can be dramatic. For example, the 1986 Tax Reform Act greatly reduced the return to businesses' capital investment. The economy has since lost approximately $300 billion in growth-creating investments in the private sector. More specifically, by raising the cost of capital, government policy has discouraged the formation of new businesses by making investment too costly and less rewarding.

When the economy is growing at a healthy rate, entrepreneurial spirits are generally very high. In a dynamic economy some new businesses, of course, continue to fail and mature businesses seek to restructure. Under policies that keep the cost of capital low, however, new business growth more than compensates for the losses of jobs and output resulting from failing and stagnant enterprises. As a result, overall business and consumer confidence remains high even though major restructuring and normal business mistakes are causing certain sectors and areas of the country to contract. In a market economy, resiliency is not assured by government-managed stability, but by the prospects for and pursuit of new opportunities according to new discoveries and shifting consumer demands.

The problem is not the private economy's failure, but rather the failure of government policies. The 1986 Tax Reform Act not only slowed investment growth toward but it led to declining real estate values. With the retroactive disallowance of passive losses and increased capital gains taxes, real estate, especially commercial real estate, has declined in value and created a crisis in banking by reducing the value of collateral behind business loans. of course, stringent regulatory enforcement has also contributed to this "collateral crunch."

In 1988, the Federal Reserve embarked upon an ill-conceived plan to deliberately stow credit growth. Its intent was to reduce economic growth in order to quell inflationary fears. However, history shows that inflation is lower when economic growth is above trend. The supposed trade-off between inflation and growth is just bad theory, and the relationship simply does not hold up empirically over the long-run. The Fed's job is to provide enough money supply to facilitate maximum economic growth without adding inflationary pressures in the economy. Its job is not

to act as a brake or accelerator to counter movements in employment and production. It is obvious that Fed machinations, first to jack up interest rates and then to drive them lower, have failed to help the economy. Inflation, as measured by core rates, is no lower than it was in 1988, and growth has been destroyed. The Fed has had to reverse its 1988 course entirely by dropping short-term interest rates to 14-year lows as the recession hit and continued. Unfortunately, the long episode of Fed misdirection has added to the series of anti-growth fiscal and regulatory policies and cannot by itself get the economy going again.

In 1989, Federal regulation, after years of being held in check, began to accelerate. In 1992 alone, the Chamber estimates that Federal regulation will add $70 billion to business compliance costs, thereby cutting productive investments and output and raising the price level further. The 1990 tax increases, coming at a time when the economy was already in recession also contributed to poor economic growth performance. In 1992, Federal, State and local taxes are scheduled to rise by approximately $50 billion, further dampening any hopes for significant recovery this year.

But the largest anti-growth policy has been the increasing burden of Federal spending in the economy that diverts resources from their most productive use in the private sector. Since 1988, Federal spending has grown at an average annual rate of 8.0 percent while the economy has stagnated. More taxes, more borrowing and more money supply have been necessary to fund these excessive spending increases. That means less has been available for private sector investment and production. Projected spending in 1992 will be a full 4 years ahead of an equivalent amount of revenue. Revenues won't achieve the level of this year's spending until 1996. Unfortunately, nothing in the budget agreement reduces this amount of overspending. In fact, the newest budget estimates show that projected spending growth is far outstripping projected revenue growth, and the structural deficit has been ratcheted up dramatically during the past 3 years.

What the Federal Government must do now to promote long-term growth is reduce, and eliminate where possible, the burdens of past policy mistakes on market processes. This entails cutting taxes, sharply reducing the rate of growth in Federal spending, holding the line on new regulations and restricting the role of the Fed. This means Congress should jettison the 1990 budget agreement and pursue policies that hold the promise of actually enhancing long-term economic growth and providing a boost in short-term business and consumer confidence.

HOW TO RAISE ECONOMIC GROWTH

At this point Mr. Chairman, please allow me to share with the Committee the Chamber's suggestions for reviving long-run growth. The ideas are based on the findings of a conference we held last month in which we heard from four prominent economic consulting firms: DRI, The Boston Co., Fiscal Associates, Inc. and Laurence Meyer & Associates. They were asked to use their economic models to determine what government policies serve to raise long-term economic growth. These models are the best that economists have, but they are limited in their ability to simulate many policy changes. For example, it was not possible to obtain estimates of the impact of regulation in these models. However, these models can readily address changes in fiscal policies.

A strong consensus emerged from these studies, and that agreement is consistent with the major finding in the President's Economic Report—that the greatest problem facing the economy is slow productivity growth. It was further agreed that the single greatest cause of slow productivity growth is an extraordinarily high cost of capital that discourages investment. We believe the Administration is right on the mark when it insists that the key to raising long-run growth potential is to boost investment and that the way to boost investment is to lower the cost of capital.

The economists participating in our conference found that long-term economic growth could be enhanced significantly by increasing depreciation allowances for investment, cutting the capital gains tax sharply and indexing gains and by reducing the rate of growth in Federal spending. One point upon which all agreed was that in the long-run, we must strengthen the supply side of the economy. Efforts to correct the long-run problems of the economy by artificially stimulating the demand side of the economy will only lead to inflation and an inefficient allocation of resources throughout the economy.

The effect of public spending on the economy is now thoroughly misunderstood by the public after some 50 years of demand-management indoctrination by some politicians and their hired economists. In a self-destructive cycle, governments undermine the economy while some politicians and members of the public clamor for more Federal spending to stimulate demand. The research presented at our conference indicated, however, that one of the most powerful stimuli to growth is to lower the deficit through spending restraint. While it is imperative that overall spending growth be reduced, the priorities in Federal spending should change toward public investment. Thus, over the long-term and perhaps in the short-term, policy makers should focus on ways to increase infrastructure spending and reduce all other types of expenditures as a proportion of total Federal spending. By limiting the overall growth in Federal spending while simultaneously reordering spending priorities to enhance infrastructure, the deficit could come down over time and economic growth could increase.

These studies zeroed in on the only practical method by which the Federal Government can reduce its deficit: more sustained economic growth coupled with severe spending restraint. This is a prescription that almost everyone now understands will work. Indeed, if last year's disastrous budget agreement taught us nothing else, it should have demonstrated once and for all that we cannot tax our way out of the deficit. It is possible, however, to check the growth in spending and give the economy a chance to grow out from under the deficit. What we lack is the political will to keep spending under control. And, in acknowledgement of that shortcoming, the political process seems quite resistant to giving up any revenue in the short-term for fear of exposing that failure.

COMPREHENSIVE STRATEGY FOR ECONOMIC GROWTH

Building upon the results of this research, the Chamber has fashioned a comprehensive strategy that would lay a new foundation for economic growth. The goals of such a comprehensive strategy for economic growth and opportunity should be to raise economic growth on average to 4 percent for the remainder of the 1990's, and to enhance long-term growth potential to at least 3 percent, the postwar average. A coordinated set of actions by the Federal Government involving tax changes, regulatory relief, spending restraint, and measures to bolster the financial system should be implemented to correct the course of the economy.

TAX POLICIES

Key building blocks of the new foundation consist of a capital gains tax cut to reward investment and raise asset values, reform of the capital cost recovery system to permit full and quicker write-offs of investment in plant and equipment, reform of the Alternative Minimum Tax to eliminate the disincentives to invest, payroll tax relief, reinstatement and expansion of Individual Retirement Accounts and other savings incentives, and permanent extension of various expiring tax provisions, such as the R & E tax credit.

SPENDING RESTRAINT

These tax changes should be accompanied by budget changes to bring Federal spending in line with revenues. Spending must be reduced from 25 percent of GDP—a peacetime high—to rates far more conducive to stronger economic growth. If tax cuts are enacted, part of the work will be done. That is to say, tax cuts will spur more GDP growth. However, current Federal spending is 4 years ahead of projected Federal revenues. To move quickly to get spending in line with what the economy can afford, discretionary spending can be "frozen" at 1992 levels for a few years or held quite a bit below projected increases in economic growth. This is relatively easy to accomplish since $150 billion can be cut from defense spending over the next 5 years.

Another way to contain Federal spending growth is to cut waste. This is easy to say, but difficult to do. Waste can be cut if Federal spending is shifted away from purely consumption activities into investments. Over the long-term, the Federal Government must cut the growth in the fastest growing programs. Accordingly, a commission to reform entitlement spending should be established to alleviate the increasing burden on unaffordable future Federal expenditures.

REGULATORY RELIEF

Until economic growth targets are reached, the Federal Government should adopt a moratorium on new regulations and create a sound process for evaluating regulations in the future. In 1992 alone, regulations that will cost business approximately $70 billion to comply with are already in the pipeline. Halting their implementation and requiring an economic growth impact statement for these and all future regulations would improve the prospects for long-term economic growth. In addition, the Federal Government should allow business to expense any capital investment necessitated by mandated actions to meet current and future regulatory requirements.

INFRASTRUCTURE INVESTMENT

By way of expanding government investment, the Federal Government should accelerate funding to repair and expand specific components of the Nation's transportation infrastructure where required to improve the overall productivity of the economy. The money for infrastructure improvements is available without having to increase taxes. The Airport and Airways Trust Fund has an uncommitted surplus of some $8 billion that is currently being used to fund other Federal Government programs. The Highway Trust Fund balance is approaching $16 billion. Currently, the annual increase in this fund is $2 billion.

DETAILED EVALUATION OF THE ADMINISTRATION'S PROGRAM

The Chamber views the economic recovery program announced by the President to be a step in the right direction and we are very supportive of many of his proposals. However, we believe several of the provisions need to be strengthened and that the numerous tax increases included in the package will undercut its positive economic effects. Changes in the tax code should be made with an eye to improving the supply side of the economy, (i.e., reducing the cost of capital and labor,) not jump-starting aggregate demand and certainly not aimed at raising additional revenue.

Incentives in the housing industry appear quite strong and helpful to the economy. A major part of the economy's problem in this recession is that asset values, especially real estate values, have been falling. Combining the modest capital gains tax rate reduction and the reform of passive loss rules, other proposals by the administration affecting real estate should work to keep asset values from falling.

The President's capital gains proposal, while a good first step, does not go far enough. The proposal should cover corporate as well as individual capital gains. Corporate income is already subject to double and sometimes triple taxation. Failure to provide a capital gains differential for corporations will exacerbate the existing distortions and inequities in the tax system. A significant amount of capital investments are made by corporations and all of the sound arguments that favor a capital gains rate reduction apply to corporations as well as individuals.

The holding period for the President's capital gains proposal is too long and the effective rate is still too high. In order for a rate cut to be a significant incentive for investment, it should yield an effective rate of between 15 and 20 percent and the holding period should be no longer than one year. In addition, the President makes no provision for indexing the basis of capital assets. One of the most unjust aspects of the present method of taxing capital gains is that much of the gain from the sale of a capital asset is attributable to inflation. The taxation of inflationary gains is economically counterproductive. To provide meaningful economic stimulus, the President's capital gains proposal needs to be revised to include the indexing of the basis of capital assets for inflation.

Under the President's proposal, the excluded amount of capital gain would be treated as a preference item under the alternative minimum tax system. This undercuts the capital formation benefits of a rate reduction and runs counter to the provisions making the ITA applicable to the AMT. In addition, this provision violates the spirit of simplification of the alternative minimum tax (AMT) system. We believe Congress and the Administration should be considering ways to comprehensively reform the AMT instead of complicating the system by adding new preference items.

In addition, the President proposes to tax the gain on the disposition of depreciable real property at ordinary income tax rates to the extent of all previous depreciation allowances with respect to the property. The Chamber believes this action will also dilute the economic effects of a rate reduction. The disposition price already reflects the depreciated value of the asset; therefore, the taxpayer does not receive a double benefit. Recapturing prior depreciation at ordinary rates will only serve to discourage new capital formation.

In an effort to encourage investment in new equipment, the President proposes the creation of a temporary investment tax allowance (ITA). The ITA would equal 15 percent of the purchase price of the equipment and would be taken in the year the equipment is placed in service. The ITA would only be available for equipment acquired between February 1 and December 31, 1992 and placed in service before July 1, 1993. The ITA represents an acceleration of current depreciation and only moves the tax benefit forward for companies rather than providing any new incentive. In addition, the ITA is a temporary measure designed to encourage a spurt of investment in equipment. American business needs stable and consistent tax policy and incentives designed to encourage long-term sustained levels of investment, rather than temporary bursts of economic activity.

President Bush recommends the elimination of the tax deduction for interest paid on loans against corporate-owned life insurance (COLI). Corporate-owned life insurance provides funds to offset the loss of income or productivity caused by the death of a business owner or key employee. Without this protection against the loss of owners or key employees, many businesses could fail if a key employee leaves the business. Additionally, businesses use COLIs as collateral for other business loans and to help fund retiree health benefits. Corporate-owned life insurance policies are widely used as investment vehicles and represent a legitimate business expense. Eliminating the deduction will raise the cost of these assets and the retroactive application could cause their mass surrenders.

The administration proposes to deny individuals the tax deferral on earnings accumulating in annuities unless the individual agrees, at the time of purchase, to receive a lifetime income stream during the payout phase and agrees to place at least two-thirds of the value of the annuity contract at risk of loss if the annuitant dies prematurely. Annuities are an important source of retirement savings and are mainly purchased by middle-income Americans. These savings, in turn, are a vital source of capital used to spur capital formation and economic growth. Denying taxpayers a deferral on their earnings would discourage individual savings. At a time when

Congress is considering incentives to boost personal savings, it is ill-conceived to eliminate a successful savings vehicle already in place.

In addition, the President proposes additional new fees or increases in existing taxes and fees. These proposals include establishing Federal Communications Commission processing fees, expanding the communications excise tax, extending abandoned mine reclamation fees, and increasing employee contributions to the Civil Service Retirement Program. In total, the President's proposes almost $41 billion in tax increases over 5 years.

Finally, one omission in the administration's plan is the absence of a substantial tax cut for working Americans and small businesses. Cutting the payroll tax rate by 1 percent for employees and 1 percent for employers would provide much needed tax relief. Since for many workers, the payroll tax is now higher than the income tax, this cut will be particularly welcome. Unlike other proposals, taxpayers would realize the benefit immediately through lower payroll tax withholdings. It would eventually provide increased incentive to work, especially among lower income people. Moreover, the cut in the payroll tax would provide significant relief for small businesses which must pay this tax regardless of whether they earn a profit. Like cutting any cost of operation, a payroll tax rate cut would increase funds available for business expansion.

As the Congress develops growth legislation, the Chamber recommends that the committee give strong consideration to the measures contained in two bills. The first bill is (S. 381/H.R. 960) "The Economic Growth and Jobs Creation Act," introduced by Senator Wallop (R-WY) and Representative DeLay (R-TX). Senator Kasten (R-WI) and Representative Weber (R-MN) are the authors of the second bill—(H.R. 3744/5.1920) the "Economic Growth and Family Tax Freedom Act." These bills, which share a number of similar provisions, should enhance the long-term portions of the administration's proposal 'sufficiently to raise growth potential.

CONCLUSION

In 1961, John F. Kennedy set an ambitious national goal: Placing a man on the moon and returning him safely to earth by the end of the decade. In 1992, it seems a modest goal by comparison to launch the economy over the course of the decade back to its historic level of performance—boosting economic growth, accelerating productivity increase, bringing inflation down to earth, and returning Americans safely to work.

Thank you, Mr. Chairman.

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THE NEVER-ENDING RECESSION

(BY LAWRENCE A. HUNTER)

In the New World Order, even recessions are supposed to be kinder and gentler. The current economic downturn has been touted as both shorter and shallower than most post-World-War-II recessions. But this characterization is true only if one restricts the view of the economy's problems to the number and magnitude of consecutive quarters of negative economic growth.

A more accurate way to gauge the success of economic policies is to compare the economy's performance with some historical trend or standard. And the economy's performance since the middle of 1988 looks meaner and harsher than previous economic downturns. If the Blue Chip consensus of private economic forecasters is correct, economic losses will continue to mount, creating a permanent "growth gap" between actual economic performance and historical precedent. The end result will be a substantial reduction in the American standard of living.

As a benchmark for economic performance, I have plotted the long-term trend in real gross national product between 1954 and 1988. The level of real GNP can be thought of as a rough proxy for the nation's standard of living. Real GNP grew on average at about 3 percent per year during this period. Although the change in real GNP from any one year to the next may be considerably more or less than 3 percent, the level of real GNP growth has oscillated around this trend line—falling down to it after surges of high growth and climbing back up to it after sinking into recession.

By the second quarter of 1988, the burst of economic growth that occurred during the mid-1980's had completely recouped the ground lost during the 1982 recession. The level of real GNP had caught back up to its long-run growth path, and the economy basically was on track. Unfortunately, since the summer of 1988, GNP had been falling farther and farther below trend economic growth.

Not incidentally, that drop coincided with the onset of a succession of pernicious anti-growth federal policies. The Fed squeezed the economy by keeping the growth of the money supply too low, while the detrimental provisions of the 1986 tax act—notably the higher capital gains rate—took full effect. Since that time, Congress and the administration have indulged in a new regulatory binge, record tax increases and what can only be described as a domestic spending orgy.

The result of these policies has been a long economic slowdown, beginning in the third quarter of 1988 and extending through the third quarter of 1990, followed by a "short and shallow" recession from the fourth quarter of 1990 until the end of the second quarter of 1991, and concluding with what the Blue Chip consensus forecasts to be a long, sluggish "recovery" from the third quarter of 1991 to the fourth quarter of 1996, and possibly beyond.

The administration's own—more optimistic—forecast estimates the level of real GNP (measured in 1982 dollars) will be $4.321 trillion by the end of 1992. Were the economy to recover fully and catch back up with its long-term growth path, real GNP in 1982 dollars would equal $4.596 billion by the end of 1992. In other words, even according to the administration's scenario, by the end of 1992—one-and-one-half years after the bottom of the recession—GNP will be about 6 percent lower than it would have been if the economy had followed its long-term trend. On a per-capita basis, this means about $1,110 less for every man, woman and child in 1992, or about $3,000 less after-tax income for a family of four. It also means 6 million fewer jobs than could have been expected.

This gap in GNP growth may not appear too alarming—simply the expected after-effects of a recession. Unfortunately, that is not the case. "Short and shallow" rhetoric notwithstanding, the recent economic downturn has been relatively severe by historic comparison. According to my calculations, the economy would have been better off had it experienced a recession and recovery similar to the "severe" downturn that occurred in 1981–82, rather than the slow decline/shallow recession/anemic recovery cycle that is now emerging. Furthermore, this growth gap is permanent, not cyclical, and it will continue to widen.

If the country had suffered a 1982-like recession and recovery, the cumulative GNP gap—the sum of the annual differences between actual real GNP and the levels of real GNP on historical trend line—would have been $696 billion (1982 dollars). If the Bush administration's forecast is correct, the actual cumulative GNP gap will amount to $808 billion. By the end of Mr. Bush's first term, then, the cumulative cost of this kinder, gentler economic malaise will exceed the cost of a 1982-like recession and recovery by 16 percent. By the end of 1992, the average family of four will have lost about $1,244 more in disposable income than they would have if the Nation had suffered a 1982-like downturn.

And if the Bush forecast is correct through 1996, the cumulative cost of this shallow dip/weak recovery will be more than double the cumulative cost of a 1982-like sharp dip/strong recovery, or an average loss of disposable income of $19,924 per family of four. And it won't be made up.

Real GNP has not been able to achieve an annualized growth rate above 2 percent for the past nine quarters. Today, the level of real GNP stands a scant 2.6 percent higher than it did at the end of 1988. When looked at over the 3-year period, the economy has struggled to eke out an increase in real GNP of less than 1 percent a year. In fact, if the Blue Chip consensus forecast is correct for 1991 and 1992 (real growth of -0.1 percent and 2.7 percent respectively), by the end of 1992 the economy will have experienced second slowest 4-year average annual growth rate since the 1930's.

Even under the president's optimistic economic forecast, real GNP will not move back in the direction of its 40-year growth trend on his watch—it will merely run parallel to it. Remarkably, the administration itself is forecasting a permanent decline in our standard of living during the president's anticipated second term.

Unless dramatic policy changes are instituted, the president's forecast is the best we can hope for. Under the Blue Chip consensus forecast, the growth path of real GNP does not even manage to parallel the 40-year trend line, it actually diverges from it. Under this bleaker scenario, the slowdown that began at the end of 1988 marks a break in the secular trend in real GNP growth. The Nation's standard of living falls further and further behind what could have been expected if the economy performed as it had over the past 40 years.

By the end of 1996, under the Blue Chip consensus forecast, real GNP will equal only $4.778 trillion (1982 dollars) rather than the $5.181 trillion that would have been expected from normal economic performance: The cumulative loss in real GNP would equal $2.193 trillion, or 7.8 percent. This translates into a cumulative loss of GNP equal to $8,374 for every man, woman and child. There will also be 9 million fewer jobs than there should be.

The political and social ramifications of a decline of this scale in the expected standard of living are hard to predict. One thing is certain however: Economic decline of this magnitude will not go unnoticed by Mr. Bush's political opponents. His friends have already taken note.

Chairman SARBANES. Thank you very much.

Dr. Hunter, let me just put a question to you to start off. A couple of years ago, over 300 economists wrote an open letter to the Congress saying that there has been a lot of focus on the budget deficit and also on the trade deficit as major problems, but that there is also an investment deficit in this country, and in particular, an investment deficit in the public sector.

Do you agree with that?

Dr. HUNTER. Over the last 3 years, it's hard for me to imagine that anyone can seriously argue that the public sector has been starved for resources.

This year alone, the Administration is estimating that federal spending will achieve a post-World War II high of slightly over 25 percent of gross domestic product. By any measure that I've seen, government continues to grow larger each year, spending a larger share of national income.

So a simple answer is, no, I don't believe we've been starved for public-sector resources.

But I would hasten to say——

Chairman SARBANES. Now, you've broadened your answer to the question of public- sector expenditures as opposed to public-sector investment.

Let me focus on investment.

Do you think there is a deficit in public infrastructure investment in this country?

Dr. HUNTER. I was just going to say that looking at the overall level of expenditures, we believe it would be eminently feasible to reallocate a considerable amount of the public-sector resources toward what you've called infrastructure spending.

The danger in doing that, of course, is that simply pouring concrete and building new facilities doesn't necessarily mean it's productive investment. And so the political process has to be kept in very tight control so that as we reallocate resources toward infrastructure spending, we're certain it goes to the kind of spending that will increase productivity.

Yes——

Chairman SARBANES. Would you include research and development in that list?

Dr. HUNTER. We have supported permanent extension of the R&D tax credit, yes. We think that——

Chairman SARBANES. What about education?

Dr. HUNTER. Certainly, education. But again, I would add, the evidence we have seen indicates that the education problem we have in this country does not result from a lack of public resources committed to the attempt to educate our populace. Rather, it's an inefficient use of the resources. It's a system of public education in which the incentive structure does not produce the most efficient kinds of institutions.

I want to be careful when we talk about the various problems that arise——

Chairman SARBANES. Is it your view on education that each educational jurisdiction has adequate resources, but some are simply not spending them wisely?

Dr. HUNTER. I don't think you can make a blanket statement that every jurisdiction in the country has adequate resources.

Chairman SARBANES. Do you think there's a significant problem in that there are some jurisdictions with inadequate resources? If that's a significant part of the problem?

Dr. HUNTER. I would say that if the incentive structure through a variety of different reforms—increased choice, giving parents the ability to choose

and local jurisdictions, giving local principals greater flexibility—that every jurisdiction in the country, regardless of the level of resources they have currently, could benefit from a variety of policy changes.

Chairman SARBANES. That's not my question. My question is whether there are a substantial number of jurisdictions that, under whatever most favorable assumptions you want to make, have inadequate resources to address their educational problems?

Dr. HUNTER. My guess is the answer to that is no, although I don't profess to have extensive enough knowledge to make that sweeping a statement.

Chairman SARBANES. Have you looked at the comparative figures on education spending in jurisdictions across the country?

Dr. HUNTER. Let me state this carefully. Simply observing that two jurisdictions have widely divergent levels of resources does not allow one to conclude that either or both have insufficient resources.

Both may have adequate resources. Does that mean that both can provide the same level of education? Probably not. But those are quite different questions, and I interpreted your original question——

Chairman SARBANES. But you should also factor in if you're going to make that analysis, not only the level of resources, but the nature of the problems with which different jurisdictions have to contend.

In other words, an inner city educational jurisdiction may have far less resources than a suburban jurisdiction, which addresses part of the equation, but it may also unfortunately face much more difficult educational problems than the suburban jurisdiction.

Dr. HUNTER. I have no doubt that that is true. I would only be careful in moving from a discussion of macroeconomic considerations and how do you improve long-run growth in the economy, to a discussion of how do you solve educational problems in specific jurisdictions.

Senator SARBANES. I know. But if education is important to macroeconomic growth, in the end, you have to solve the educational problems specifically.

Let me ask the other two panelists to comment on this infrastructure question—the extent to which we have an investment deficit and how much of a crisis you think it is.

Dr. KRUGMAN. I would certainly agree with the assessment that we have a very severe investment deficit. It's true, both by the numbers and to the naked eye. I think anyone coming to the United States from not only Japan but from Western Europe sees the evidence of our deteriorating relative quality of infrastructure on that first cab ride in from Kennedy Airport.

I think there's no question from both an informal view and looking at the numbers. I don't have the numbers immediately at hand, but we had a steadily decreasing rate of public capital accumulation during the years of rapid productivity growth. Immediately following World War II up until the early 1970's, the infrastructure grew at a rate, I believe, close to 3 percent per year. Since then, it has been steadily decelerating. Some people have guessed that we may actually have negative real growth at this point, but it is certainly under 1 percent in the last few years.

Education—it's worth pointing out that whatever one says about spending in school, specifically, once formal schooling begins, preschool expenditure, which should be viewed as equally or more important, has definitely been underfunded. There are programs that, as Professor Gordon pointed out, we know have a very high yield or social return, but have been, I would say, almost criminally underfunded in recent years.

And if we do, by some numbers, spend more on education than some other industrial countries, it should be remembered that we have social problems that need to have something done about them. We have about eight times as high a fraction of our children growing up in poverty as West Germany does.

To say that we spend a little bit more in primary education than Germany, so why don't we get the same result, it must be that we need greater parental choice—maybe we need to think about what is really appropriate to our situation.

Chairman SARBANES. Dr. Gordon.

Dr. GORDON. Let me go beyond that and object to the blanket attribution of Mr. Hunter that we have excess government spending because the Federal Government's share of spending has gradually risen to 25 percent from, say, 20 percent in the mid-1970's.

That is more than entirely accounted for by transfer payments, mainly social security and Medicare. The nontransfer portion of government spending has not increased as a share of GNP.

One reason we've had a decade-long federal budget deficit is that Congress and the Administration have mandated various types of transfer payments, including relatively generous indexing of social security, and have decided they won't pay for it.

Chairman SARBANES. Wait a second. I want to interpose right there.

Everything in social security is paid for.

Dr. GORDON. Viewing the government as a whole, without this bookkeeping——

Chairman SARBANES. But you can't do that. What we have done is to make, in effect, a compact or a contract with the American people on social security in which we have said, now, if you'll pay what amounts to a flat tax, a regressive tax, a huge chunk out of your payroll—and of course you want to cut it as a stimulus, and I understand that—but nevertheless, you make this payment, we're going to cover the benefits.

We more than cover the benefits. A few years ago, when it looked like there was something of a problem, we revised the system, raised the taxes, and cut the benefits in order to get it on a better trendline. It's now producing in the current context about a $70 billion a year offset to the unified federal budget deficit.

Dr. GORDON. I'm uncomfortable with the notion that you can take a piece of the Federal Government's influence on the economy called social security and then isolate it like that.

What I was talking about is the total share——

Chairman SARBANES. Except that has been financed with a specific tax.

Dr. GORDON. Fine. Then, that means the deficit of the rest of the government is just that much bigger.

Chairman SARBANES. That's correct. Exactly.

Dr. KRUGMAN. May I weigh in here?

Chairman SARBANES. Yes.

Dr. KRUGMAN. I don't think you really have a dispute. I think the point is that——

Chairman SARBANES. No, I'm going at this approach that always wants to "cut" entitlements, when the biggest entitlement is social security and is more than paying its way.

What's the rationale for cutting that entitlement? Certainly, in a macroeconomic sense, there is no rationale since you would, in effect, erode the basis for the payment of the taxes.

Dr. GORDON. I didn't say anything about cutting social security. I was making a factual statement about which share of Federal Government spending had gone up as a portion of GNP, and about the fact that the revenues as a share of GNP have not gone up.

It's a factual statement. None of my ten points involved cutting social security, so let's not blame me for that.

Chairman SARBANES. It can't be attributed to the social security system since the revenues have gone up to cover the expenditures.

Dr. KRUGMAN. That's right. Of course.

Dr. GORDON. The rest of the revenues must have gone down.

Chairman SARBANES. Yes, while the balance in that trust fund has increased.

Dr. KRUGMAN. I think the point is that Dr. Hunter's statement that government continues to grow is entirely a question of transfer payments, social insurance.

Whatever one thinks of those——

Chairman SARBANES. Isn't it also a function of the slowdown in the economy? As I understand it, his figure is the government percentage of GDP.

Dr. GORDON. In a recession, that grows automatically.

Chairman SARBANES. In a recession, when you have a downturn, certain government expenditures go up, and since GDP goes down, that percentage is going to grow, is it not?

Wouldn't that be the case, Dr. Hunter? You would concede that, wouldn't you?

Dr. HUNTER. And we are experiencing some——

Chairman SARBANES. If we were in a depression, the percentage would probably be even larger, wouldn't it?

Dr. HUNTER. We are experiencing some of that effect. However, if you go back and look at the decades since World War II, there has been a definite and unmistakable ratcheting up through each decade, a small amount each decade, where government continues to take more of the national product.

It fluctuates with the economy, but it appears, if you look at the Administration's own estimates, that we have now achieved a new higher level once they have the economy coming back. They don't have spending falling back to previous levels.

I would also point out that if you look at CBO's own numbers, trying to calculate how much of the defense builddown will go in what direction, that from 1990 to 1997, it's likely that defense spending will have fallen some $550 billion over that entire period.

If you take the Administration's own baseline this year, what you will discover is that $415 billion of that has already been reprogrammed.

So the level of spending that was built up by the extraordinarily high levels of defense spending especially through the 1980's is not being dissipated. It's being reallocated to other government functions.

What we are suggesting is the remaining $150 billion dividend falling below the President's baseline through 1997 at least be given back to the American taxpayer in the form of tax relief.

Chairman SARBANES. You have no room for a public investment strategy as I read your table.

Dr. HUNTER. The government has already taken 75 percent of the dividend. We think that three-quarters of it is enough.

Chairman SARBANES. As I read your table, there is no money for an investment strategy. To balance out your projected revenue loss—I'm going

to get in a minute to how important the balance is—but to balance that out, you use all of your expected defense savings. You cut all domestic spending by 5 percent, and you make a one-percentage point economic growth assumption.

Dr. HUNTER. There's nothing to prevent the government from reallocating a number of the transfer payments that the other individuals have pointed to.

Chairman SARBANES. But you've taken those down 5 percent before you even start.

Dr. HUNTER. We already know that a number of the trust funds—airport and highway—are running surpluses. Much like the social security situation, Congress is taking money from those trust funds as they come in every year and spending them on other activities.

Congress has it well within its ability to stop this diversion and at least devote the earmarked taxes that are coming in presumably to pay for highway, airport and other infrastructure facilities to devote those taxes to those specific activities.

Chairman SARBANES. Dr. Krugman, you want to comment, I think.

Dr. KRUGMAN. I wanted to make a more global comment.

It seems to me, at this point, to be claiming that the basic problem with the United States economy is that it's being strangled by an excessive burden of taxes and excessively large government is simply flying in the face of every bit of evidence that we have.

A recent Organization for Economic Cooperation and Development study compared the burden of taxation among the 24 industrial countries under the OECD. The United States is tied for twenty-third with Greece. We have the lowest tax rate in the industrialized world.

During the 1980's, marginal tax rates were cut sharply. The incentives to become rich were greatly increased, and we may say that the incentives not to become poor were rather drastically increased.

We got no increase in productivity growth out of that.

I'm reminded—the advocates of a deep capital gains tax cut remind me of medieval doctors who regarded bleeding as a cure for all manner of disease. If the patient, after having some blood let, failed to recover, what they would do is take some more blood out of the patient and keep on doing that, and then say, well, if the patient died, they just didn't do enough of it.

This is completely a matter of faith held by advocates of further tax cuts that has no grounding in experience.

Thank you.

Dr. GORDON. Let me also make a cosmic statement, but try to find a bit of ground for agreement with Mr. Hunter.

Professor Krugman and I both called attention to the remarkable gains made by the top 1 percent in the income distribution over the past 15 years.

Every other group below the top 1 percent had an increase in their taxes and much of that was because of the flat-rate social security tax, which is regressive.

Part of Mr. Hunter's program involves a reduction in social security taxes, which would go in the right direction toward making taxes, on balance, more progressive, but only if joined together with a substantial increase in the top bracket income tax rate.

So let's think of these things together. He has one part of the story, but not the rest.

His capital gains tax reduction has a nice feature in that it converts us part of the way toward a consumption tax. He is going to tax capital gains if they're used for consumption, but not if they're used for investment.

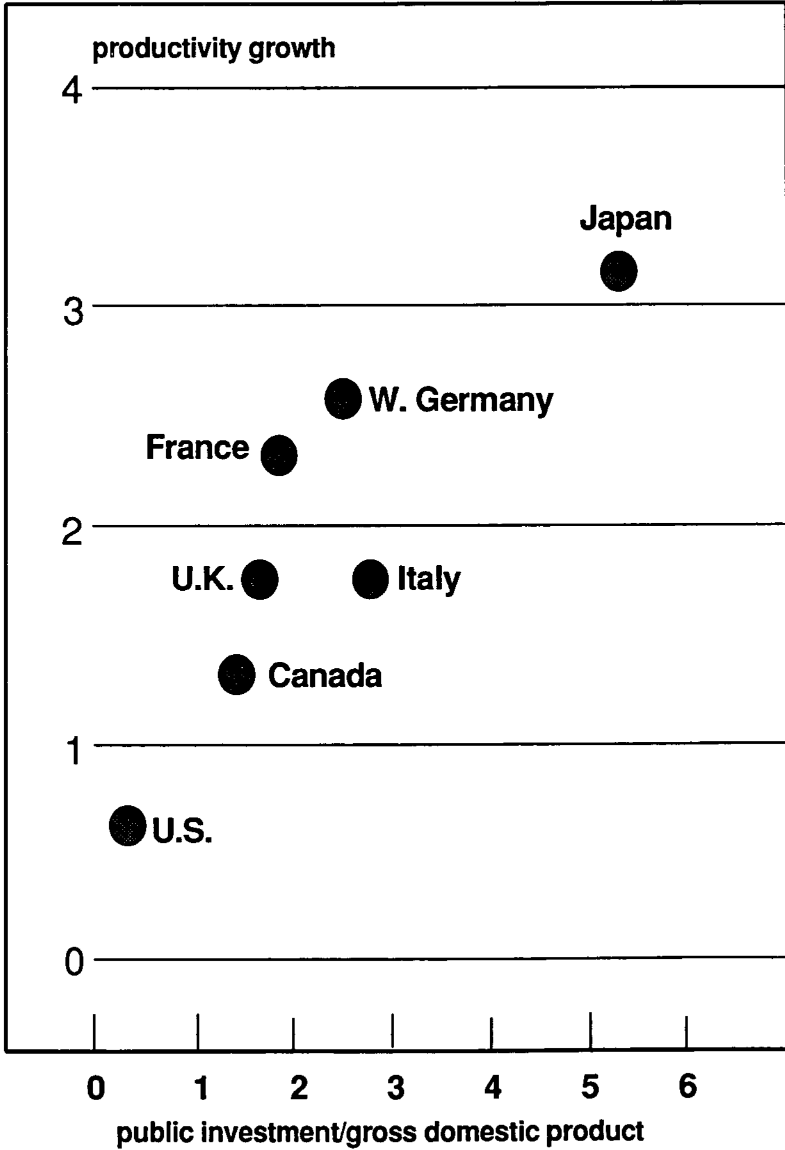
I think many economists are in favor of a progressive consumption tax, one which involves relatively steep rates at the top, where we would tax rich people if they consumed, but we wouldn't tax them if they reinvested.

So there is some, I think, common ground here. We want to create incentives for investment, to be sure, but at the same time, we need to redress the enormous twist toward regressivity in our tax system.

Chairman SARBANES. I just want to make one more observation for the sake of this discussion before I move on to another subject. This is a chart that we had prepared from a study done by David Alan Aschauer of the Federal Reserve Bank of Chicago (see chart on following page). The chart is for the period 1975 to 1985, so I don't contend that it's absolutely current. But it was an involved study. What it shows is a correlation between public investment and productivity growth. Here is Japan with the highest productivity growth on this scale, and they're also the highest on this scale on public investment.

Productivity Growth & Public Investment

Average Annual Change, In Percent



Source: David Alan Aschauer, Federal Reserve Bank of Chicago.

Chairman SARBANES. Here is the United States at the bottom of both scales, and then you have Canada, the United Kingdom, Italy, France and West Germany scattered in between. This underscores the public investment issue and the letter we received from the 327 economists a couple of years ago on the investment deficit problem.

Dr. KRUGMAN. May I introduce—this is probably counterproductive from my own point of view—a bit of intellectual perspective here.

The fact is that by any measure of any kind of investment, the United States is at the bottom, Europe is in the middle, and Japan is at the top, which is also true of productivity growth.

So, in fact, if you take any kind of investment, be it public or private, you can create a similar chart. What we really know is that the United States is underinvesting in all dimensions.

We have some other ways of making estimates of the role of private investment, and we know as well as we can know anything in economics that the private investment deficit by itself does not explain our poor performance, that public investment must be playing an important role.

Chairman SARBANES. Your view is that there is a shortfall in both public and private investment?

Dr. KRUGMAN. Yes. I regard the public shortfall more important.

Chairman SARBANES. Is that your view, Dr. Gordon?

Dr. GORDON. That's right. But I want to——

Chairman SARBANES. Dr. Hunter? Is that your view?

Dr. HUNTER. No, I don't agree, necessarily, that there is a shortfall in public spending. I agree that you can reorder public spending.

Chairman SARBANES. Let me back off of public spending and just ask you if there's a shortfall in public investment?

Dr. HUNTER. In some areas, you could probably find needs.

Chairman SARBANES. But you don't think it's much of a problem?

Dr. HUNTER. Well, I know of no empirical evidence that indicates that, in general, we don't invest enough in the public sector.

Chairman SARBANES. So you think we invest enough in our transportation network, our water and sewer systems and our communications network?

Dr. HUNTER. It depends on where you are.

Chairman SARBANES. Research and development?

Dr. HUNTER. It depends on where you are in the country.

Chairman SARBANES. Education?

Dr. HUNTER. We created fabulous State and local grant programs throughout the 1960's and 1970's to build very large water treatment plants. Many areas benefited from them greatly. Many areas overinvested.

So I don't think that you can make a blanket statement in that regard. You need to look at each individual area and at the government programs that are providing the resources.

All I'm saying is that there are great gains in efficiency that we could find if we would reallocate the spending that's going on in the public sector and change the incentives, especially for State and local transfers, to spend that money.

I would like to go back to an earlier point where we talked about cutting marginal tax rates. I'd be happy to make available to the Committee a study that we have done that looks at marginal tax rates.

If you compare taxes on both labor and capital, trying to get some notion of the average marginal tax rates between 1983 and 1990, in both cases, marginal tax rates have actually increased.

It's true that in 1981, we had a dramatic reduction in marginal rates for individuals. But every year since then, we've had some kind of increase in taxes. And it's true that again in 1986, we had a substantial reduction in marginal tax rates. But again, we followed on each year with an increase.

What we have done is we have redistributed the tax burden, and especially in the 1986 Act, we have changed the nature of the tax burden, especially on business and investment, in ways that were not desirable.

So there, again, these blanket statements that we have reduced marginal tax rates just don't hold.

Chairman SARBANES. Do you have any sense, speaking about the 1986 tax changes, that corporate managers were prepared to trade off the loss of tax incentives in the business and investment sector, which they knew or at least thought would be harmful or disadvantageous to the economic enterprise that they were charged with running, in order to gain significant reductions in personal income tax rates that would redound very much to their personal advantage? So, as a consequence, tax changes were made within a tax package that can be argued were harmful to the company, but were very beneficial and advantageous to the individual manager of the company?

Dr. HUNTER. I wouldn't like to speculate on the motivations.

Chairman SARBANES. Do you think that's what happened as you look at it?

Dr. HUNTER. I wouldn't speculate on those motivations.

What I do know is that in retrospect, there were some very good things in the 1986 Act—the reduction in marginal rates—and there were some very bad things. On balance, the very bad things, I think, have outweighed the beneficial effects of the marginal rate reduction.

Chairman SARBANES. Let me ask each of you, how significant do you think the budget deficit problem is?

Dr. HUNTER. Prior to 1990, or thereabouts, it was going in the right direction. Every year, the deficit as a share of national income was falling, and it was coming down gradually.

Since then, it has reversed itself. This year, I think it is almost doubled as a share of national income from where we were in the late 1980's, and it is a concern.

But there, again, I think overemphasis on the deficit diverts attention from the larger issue. And that is, whether or not the government taxes the money or borrows it. The real question is how much is the government spending?

Chairman SARBANES. You don't think it matters whether it is taxed or borrowed?

Dr. HUNTER. Certainly, it matters who's being taxed and who's lending the money.

Chairman SARBANES. No, for society, from an overall view, does it matter whether the money that the government spends is obtained by taxing as opposed to borrowing?

Dr. HUNTER. Well, as you well know, there's a continuing and lively debate in the economic literature over that issue.

Chairman SARBANES. That is why I'm asking you the question.

Dr. HUNTER. At levels we saw in the late 1980's and the early 1990's, it probably didn't matter. Certainly, between 1985 and 1990, when the deficit as a share of the national income was coming down, I think all of the emphasis on the deficit was misplaced.

When you get the deficit to 6 percent of national income, stuck now at a very high level with no prospect of coming down, yes, it becomes a concern.

But, again, I think last year's budget agreement was a natural experiment. It should have indicated, if we learned anything from last year's budget agreement, it's that we're not going to tax our way out of the deficit.

The only way the deficit is going to come down is with spending restraint and policies that will get the economy growing again.

Chairman SARBANES. Do you think the deficit is now of sufficiently serious dimension that no policy should be undertaken which would add to the deficit?

Dr. HUNTER. That's a loaded question. If we could agree that policies that increased the deficit in the short run and that have a positive effect on economic growth, then I would say, forget the deficit in the short run.

But because the issue of revenue estimating has become so highly politicized, I've concluded that it's very difficult to have a serious conversation addressed to that question.

Chairman SARBANES. Dr. Gordon.

Dr. GORDON. There's a definition in economics which says that if we reduce the budget deficit, only three things can happen. If we reduce the budget deficit, either we're going to automatically get more private investment, or we're going to get automatically less private saving, or we're going to automatically have to borrow less from foreigners.

The experience of the past decade shows that, in fact, when we got into the situation of having permanent structural budget deficits year-after-year, most of that was financed indirectly by borrowing from foreigners.

The international investment position of the United States has deteriorated by something like $800 billion in the last decade and that imposes on all of us and our children an obligation to send abroad in interest and dividend payments—you'll correct me—but something on the order of 1 percent of GNP now and more later.

Let's not forget also that the federal budget deficit has raised the portion of government spending called interest payments to $200 billion, which is something like 3 percent of GNP. And much of the increase in government spending that Dr. Hunter is complaining about came from the fact that year-after-year deficits raised the interest payments.

That's not doing anything except just going around in circles as taxes are levied to pay the bondholders.

Of course, we can minimize the importance of the budget deficit by looking at the ratio of debt to GNP. And as many people have pointed out, that seemed to have leveled off in 1988–89 at something like 45 percent of GDP in the form of debt held outside the Federal Government.

But I don't think it's good enough just to let the debt–GDP ratio stabilize, and we're far from that now. I would like to see it gradually decline, because if we reduce foreign borrowing, we're going to have less of our future productivity growth in the form of payments to foreigners and more to keep for ourselves, which seems to make sense.

And as my statement said, it's relatively easy to fix the budget deficit, because you have that top 1 percent of the income distribution with its enormous gains over the last 15 years that can easily afford taxes to fix half of it and the gasoline tax will fix the rest.

It's really not a big deal if it were sold to the American people in the right way.

Chairman SARBANES. Professor Krugman.

Dr. KRUGMAN. The deficit is an important issue. I regard it as a second-rank issue now. I regard the neglect of children and the infrastructure as first-rank issues and the deficit as a second-rank issue.

I wish I didn't have to make that ranking because there really is no reason why we shouldn't deal with all of them. But at current levels, if we were to reduce the deficit very sharply, a sizable fraction would come out of reduction in our trade deficit.

As it happens, foreign debt is relatively cheap; that is, the interest payments we make on it in real terms are not that high. All these years of running large current account deficits have led to just a slight swing of our net investment income position relative to the rest of the world into deficit.

It's a drain, but if I could have taken that net investment income and turned it all into productive investment, I think it would have been a very good bargain for us, in fact.

So I hate to downgrade the deficit. What's particularly worrisome is that the outyear forecasts seem to be creeping up. And if we keep on in this direction, we might manage to turn it back into a first-rank issue. But I regard it as less important than the public investment at this point.

Chairman SARBANES. You wanted to add something, Dr. Hunter?

Dr. HUNTER. No. I was going to simply indicate—and I will do this so that we can get on—that we all desire to reduce the deficit, and referring back to the project on growth that we just completed, it was universal among the participants that the deficit needs to come down.

Having said that, though, looking back over the last 30 years, the evidence is that the only way we can hope to reduce the deficit is to spur economic growth. And you don't spur economic growth by raising taxes.

What we need is a modicum of spending restraint so that the growth in federal spending is reduced. No one's talking about cutting federal spending. Reduce the growth rate in federal spending and put in place policies that will spur economic growth, and the deficit will shrink.

There, again, after last year, I don't know how anyone can conclude that we can hope to reduce the deficit by raising taxes.

Chairman SARBANES. I'm looking at your table. Maybe I do not understand something in your table, but as I read it, all the items that could be used to reduce the deficit, you use up in your proposed tax cut.

Is that correct?

Dr. HUNTER. That's correct.

Chairman SARBANES. Then, how do you reduce the deficit?

Dr. HUNTER. I should have done this calculation, and I didn't have time to do it.

By the time you're out five or 6 years, what's the ratio you care about—and I do indeed disagree that we need to pay attention to these nominal dollars?

The important relationship clearly is the deficit as a share of national income, GDP. If you get the economy growing again—the denominator is so big; that is, GDP over which you put the deficit—if your objective function is to shrink that ratio, which I believe it should be, the most effective way to do it is to grow the denominator.

And that's what I'm suggesting with this program.

Chairman SARBANES. OK. You're prepared to entertain $400 billion deficits, at least over a five-year period, on the theory that while the nominal figure will stay at that level, the percent of GDP will get smaller because you're going to have a 1-percent economic growth.

Is that correct?

Dr. HUNTER. Mr. Chairman, I'm not prepared to stay with $400 billion. Again, we haven't had time to do the entire analysis.

If you take this program and put it next to even the President's budget, you see——

Chairman SARBANES. Well, $386 billion.

Dr. HUNTER. You see the deficit as a share of GDP, even under his budget, beginning to come down slightly.

If you grow the economy faster, the ratio falls. But the question really is, what is the alternative in the near-term? And the only alternative I can think of in the near-term, if you're worried about the deficit, is to raise taxes. And I can guarantee you that if that's the approach you take, you will fail.

Chairman SARBANES. One alternative is not to use cuts in spending, including defense spending, for tax cuts.

Dr. HUNTER. What is the alternative?

Chairman SARBANES. You stated that the alternative is to raise taxes. There is another alternative, that you neither raise nor cut them.

Dr. HUNTER. What do you do with the savings?

Chairman SARBANES. You use it to reduce the deficit and to make some investments.

Dr. HUNTER. I have never seen that happen and I predict it will never happen. The defense dividend is the best evidence.

Chairman SARBANES. Well, if it could happen, would it be a good thing?

Dr. HUNTER. The social security surplus is the best evidence available that Congress is incapable of taking those kinds of either revenue surpluses or spending reallocations and using them to reduce the deficit.

It simply does not happen.

Chairman SARBANES. Actually, the structural deficit was reduced over the past year by $20 billion.

Dr. HUNTER. As I read the President's budget——

Chairman SARBANES. We did reduce the structural deficit. There's a fiscal drag—it is arguable whether this is a desirable thing to do in a recessionary period—but there is a fiscal drag on the economy of an estimated 1 percent of GNP, about $20 billion of that at the federal level and about $35 billion at the State and local level right now.

Dr. GORDON. Could I jump in? I want to challenge something that's underlying much of this program here. And that is the idea that the proposed tax reductions on capital gains and the cost recovery program will raise real potential output growth by 1 percent per year from the 2.2 estimated in the ERP to 3.2 percent.

That flies in the face of everything that we have learned. To do that would require, I think, raising net private investment by somewhere between two-thirds to 100 percent, say, for round numbers, doubling net private investment of every part of the economy.

And even that wouldn't be enough, because soon the more rapid growth in capital would generate more depreciation, and then you'd have to keep boosting the net investment again and again.

There is a new revival of interest in the theory of economic growth by economists. The new theories put much more emphasis on human capital and research and development, not necessarily just old-fashioned private investment.

It seems to me that the Federal Government would have a much bigger bang per buck in achieving those desirable kinds of higher growth rates instead of giving the money away and then waiting to see if there's any response in the private sector, putting the money into research and education, which maybe will have a slower payoff, but I think a more certain one.

Dr. KRUGMAN. It seems astonishing to me that after all these years of saying, well, if we do irresponsible things, it will all work out fine because growth will respond. And with growth never having responded, that one could continue to do this.

I think we should have a moratorium on justifying regressive and fiscally irresponsible measures on the grounds that they're going to accelerate economic growth.

No one, left or right, has the right to assume to pronounce that they have the magic bullet that is going to kill the problem of slow productivity growth in the U.S. economy.

Chairman SARBANES. Do you think that the ability of other economies to compete so effectively with us and to be doing better on some measures, at least, of economic performance is because they have their aggregate fiscal and monetary policies in a better perspective and in better shape?

Dr. KRUGMAN. No. May I say, not the aggregate. If we were to look at West Germany—I'll say West Germany because they've just taken on a very troubled economy and added it to the total—but West Germany is by almost any measure a much more successful economy than ours.

I prefer to use West Germany rather than Japan because there's so much dispute about what kind of an economy Japan really is.

I don't think that the source of German success is that they have, on the whole, run smaller budget deficits. In fact, in the last couple of years, they're running rather substantial ones for fairly sensible reasons. Nor do I think there's any reasonable argument by which one can claim that their greater monetary restraint, which has led to somewhat lower inflation, is the source of their success.

What they have done is they have maintained an adequate rate of growth of infrastructure, and they have educated their children. They've taken care of business. They have maintained a welfare State that makes ours look niggardly. And if one believed in the view of how economic incentives work that Dr. Hunter is pronouncing, then looking at the tax and welfare State in West Germany, we should conclude that they would be an economic basket case. But, in fact, they do very well because they take care of the things that really do need to be taken care of.

Dr. GORDON. And let's remember two important parts of the German secret, which don't have anything to do with budget deficits. One is their system, which seems to be almost unique in the world, of apprenticeships for blue-collar workers to gain skills. And as a result, German workers in manufacturing are the most skilled in the world.

And the second ingredient is the so-called "middle schtant"—the German success in fostering small- and mediumsized companies. And that's something that is apparently in the scenario we've heard, that these companies would all just spring to life if we cut the capital gains tax. But, in fact, I think we're going to need more than that.

I also want to ask Dr. Hunter if he thinks raising the marginal tax rates on Arnold Schwarzeneggar and Oprah Winfrey will severely hurt the U.S. economic rate of potential output growth?

Dr. HUNTER. No, I don't think it's going to hurt the national economy. But I would only counterpose the question, why are you so intent on raising tax rates to punitive levels for successful people?

Certainly, all the money you could confiscate from them is not going to accomplish what it is you profess to want to accomplish.

I can only conclude——

Chairman SARBANES. Dr. Hunter, was there a time in the postwar period when the structure of the tax system was more what you would like to see than it has been in the last 10 years?

Dr. HUNTER. Certainly, after the 1981 Act, we were making progress in the right direction.

Chairman SARBANES. How about before that, during the 1950's and 1960's?

Dr. HUNTER. During the early 1960's, again, we were making progress. You have to recall that coming through the 1950's and 1960's, we were still in the process of bringing down the very high marginal tax rates.

Chairman SARBANES. We might have had high marginal personal tax rates, but there were a lot of incentives in the tax code for the kind of capital formation you're talking about.

It's arguable how much of one, but there was a capital gains differential. Actually, at that time, it was quite significant because tax rates were much higher. So the differential was much more significant in that context. With Kennedy, there was an investment tax credit.

Wasn't that a better setup than what we have now?

Dr. HUNTER. The situation we always have is we have a tax system in place that double and triple-taxes savings and investments. And so Congress periodically, especially during hard economic times, will be pressured to do something. And so we get a tax system that is built piecemeal, trying to address a large problem through a majoritarian political process.

So you get investment tax credits, accelerated depreciation schemes, and tax measures that only tax lawyers could love.

One solution breeds a whole new set of problems. And then periodically the system becomes so complicated and people become so frustrated that we have these major reform efforts.

The fundamental problem is in the nature of the income tax system that double and triple tax savings and investments.

Chairman SARBANES. Let me ask you this question because I'm trying to get clear in my own mind where you're coming from.

In 1986, Senator Mitchell wanted to keep a capital gains differential, but he wanted to set a higher top marginal rate. That was opposed by every Republican member of the Senate. They controlled the Senate at that time and insisted that we take the rate down and eliminate the capital gains differential.

Was that a mistake?

Dr. HUNTER. Well, there, again, the differential is an artifact of the original problem of taxing capital gains to begin with.

Chairman SARBANES. So you want to bring the top rate down and have the differential.

Is that correct?

Dr. HUNTER. What we need to do is to address the entire system of taxation that continues to double and triple tax savings and investments.

Chairman SARBANES. Let me ask you, Dr. Krugman, what's your concern about a tax break for middle-income people if it's financed within the tax code?

Dr. KRUGMAN. We desperately need some additional revenue from the tax code to finance public investment.

Chairman SARBANES. Let's assume that you make a judgment that that's not going to happen. In terms of easing some of the pressure on middle-income people and rectifying the imbalance that Dr. Gordon discussed at some length, what's the problem with that?

Dr. KRUGMAN. My view is that we are desperately in need of additional public spending. We continue to have a deficit problem.

I would very much like to change the tax code so as to recapture the tax revenue that was lost from very wealthy Americans.

It seems to me that if we can do that, it is shortsighted to use that revenue to reduce taxes on middle-income Americans, because we will all benefit much more by spending that money on public investment than we would from a tax cut, which would be on the order of a dollar a day.

Chairman SARBANES. Let me ask you very quickly some questions, because we've kept you all a long time.

Do any of you think the Federal Government should be concerned with trying to ease the fiscal problems the States and localities are confronting that have led them to make very substantial cutbacks—it's been calculated by some—imposing as much as a $35 billion drag on the economy. We have reports of State and local governments curtailing what I think by anyone's definition would be regarded as essential services.

Dr. GORDON. Could I get into that?

One figure that leaps to mind is that State and local government construction, much of which is infrastructure, as a share of GNP has fallen by 1 percent of GNP over the last 15 years.

As a result of what's happening now, we have such scandals—viewed again from the perspective of Western Europe where they're constantly building more and better trains—of public transit stations being shut in Chicago, and on cold winter days, poor people who rely on public transportation having to walk an extra half mile to the next train station because of financing problems at the State and local government level.

Special programs teaching reading to inner-city school kids have been cut back because of these State and local budget problems.

Chairman SARBANES. The Conference of Mayors has just published a volume of public works projects to fight the recession now, which are ready to go.

Dr. GORDON. And this is a perfect example of how Congress should be thinking about this recession, by using the short-run problem of the recession as a window to undertake things that all agree are needed for the long run.

As you say, there's a whole set of blueprints in the State and local government sector that can result in instant creation of jobs, overnight, just by delaying cutbacks. There's going to be a reconstruction of the biggest interstate highway in Chicago. The question is, is it going to be stretched out to take 4 years, is it going to happen in one year, or is it going to happen in 2 years? That depends on funding. And the number of jobs created in 1992 and 1993 is going to depend on funding.

These projects are the exception to the usual rule in the economic textbooks that fiscal policy takes a long time to work.

In this case, I agree completely with the mayors that this is one of the best ways to fight the recession and deal with the infrastructure problem at the same time, as long as we view infrastructure broadly to include education.

I would certainly be just as happy to see the money go to retain school teachers who otherwise might be fired in the inner city as I would to have one more ton of concrete poured on a highway.

Those two things, it seems to me, are equally valuable.

Dr. KRUGMAN. Let me add one more point, which is that the kinds of State spending that are being slashed now are ones that have a very strong spillover to the Nation as a whole. It's not simply a State matter. It's not

simply that we should be helpful to States because we want to be nice to them.

Students who learn to read in Ohio schools show up in the California work force. Trucks going between New York and Pennsylvania have to drive on New Jersey roads.

So there really is a compelling national case for helping in these areas, yes.

Chairman SARBANES. Dr. Hunter, the Germans talk not about a market economy, but about a social market economy. That's the phrase they use to describe their economic system.

What do you understand them to mean by that?

Dr. HUNTER. I have to confess, I have no idea.

Dr. GORDON. I have an idea.

Chairman SARBANES. I'd be happy to hear from you.

Dr. GORDON. The reason that most advanced European nations have a larger share of GNP going through the central government is that they take a much broader view of central government responsibilities for such things as education, health care, maternity leaves, care for the aged, and the sense that some people are lucky and some people are unlucky, and that some taxes from the lucky people like Oprah and Arnold should be redistributed to those people who are in need.

Some of this is just decency and some of it pays off in better education and better skills.

That's the social part. And then the running of the private firms—the small-, medium- and large-sized firms—is left to the private sector once these taxes are paid and the social welfare system is set up.

That's my understanding.

Dr. KRUGMAN. I think we could say that if you go back a generation, you would say that the United States had something like a social market economy as well. That is, all capitalist countries maintained a reasonably good social safety net, a certain amount of welfare State as a cushion.

We came to the conclusion in 1980, at least a sufficiently large group of the politically elite came to the conclusion, that such a system strangled economic growth and that we had to radically dismantle that system.

In other words, we came to the conclusion that you can no longer have economic growth with a system under which the United States used to have 3 percent productivity growth and under which the Germans still have 3 percent productivity growth, and which now which yields only 0.9 percent productivity growth.

I think that's an amazing triumph of ideology over experience.

Chairman SARBANES. Well, gentlemen, thank you very much.

The hearing is adjourned.

[Whereupon, at 4:09 p.m., the Committee adjourned, subject to the call of the Chair.]

THE 1992 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, MARCH 3, 1992

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

The Committee met, pursuant to notice, at 10:15 a.m., in room SD–50, Dirksen Senate Office Building, Honorable Paul S. Sarbanes (chairman of the Committee) presiding.

Present: Senator Sarbanes, and Representatives Hamilton, Scheuer, Armey, Fish and Snowe.

Also present: William Buechner, Lee Price, Paul Taylor and Charla Worsham, professional staff members.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

Senator SARBANES. The Committee will come to order.

This morning, the Joint Economic Committee continues its hearings on the economic outlook and the 1992 Economic Report of the President.

Our witness this morning is the Chairman of the Board of Governors of the Federal Reserve, Alan Greenspan. We are very pleased to welcome Chairman Greenspan to the Committee this morning.

Over the years, the Joint Economic Committee has had the benefit of the testimony of the Chairman of the Federal Reserve from time-to-time and we look forward to these exchanges.

The question obviously will be for the Federal Reserve to lay before us this morning its view of the economic situation and what the Fed might do to help put some vitality and vigor into the economy.

We will receive the latest unemployment rate figure this Friday morning. Last month, it was at 7.1 percent, the highest it has been during this economic downturn. That figure does not include the people who have been discouraged and have given up looking for work, or the people working part-time who want to work full time.

If the discouraged workers and the involuntary part-time workers are taken into account, the Labor Department estimates that the unemployment rate last month would have been 10.8 percent, not 7.1 percent.

We have mixed news, of course. One indicator seems to move up a bit, other indicators move down. The consumer confidence index is at an extremely low level. And I have heard the Chairman before express his own concerns about that.

Predictions for economic growth are minimal. I think the Fed this morning is going to give us a range of 1.75 to 2.5 percent as their forecast. Private forecasters are at about 2 percent. The President has forecast 2.2 percent.

In previous recoveries, we have always come out with much faster growth than that. In fact, we have averaged over 5 percent, moving out of recessions during previous recoveries.

Chairman Greenspan, we will turn to you now for your statement. But first, I'll defer to my colleagues if they have any opening remarks they would care to make.

Congressman Armey, please proceed.

Representative ARMEY. Thank you, Mr. Chairman.

I do have a statement, but with your leave, I'll put it in the record and just welcome Mr. Greenspan today and I look forward to the hearing.

Senator SARBANES. Fine. We will include the statement in full in the record.

[The written opening statement of Representative Armey follows:]

WRITTEN OPENING STATEMENT OF REPRESENTATIVE RICHARD K. ARMEY

I am pleased to welcome Chairman Greenspan today. The economic outlook shows positive signs of modest, sustainable growth. Still, the economy is a source of concern, and Congress's handling of a pro-growth economic package is unlikely to restore much confidence on Main Street.

The Federal Reserve System currently grapples with long-term interest rates that have remained "sticky," increasing recently after a fall in December, even as short-term rates have fallen dramatically to the lowest point since 1964. The failure of long rates to fall is evidence that the market doubts the resolve of the Congress to control spending and allow economic growth. The Federal Reserve will be hard pressed to avoid inflation over the long term with a Congress unable to discipline itself and strongly considering tax policies that will likely hinder rather than spur a strong recovery.

The economy remams sluggish, in part, because of all that U.S. policymakers have done in the past to discourage real estate and other lending by the banks. Regulatory overkill by bank regulators, the reduction of real estate tax advantages in tax legislation and general banking difficulties have reduced confidence in the economy and reduced household wealth held in the form of real estate. Land owned by households, the most volatile component of residential real estate, fell by 9.8 percent in 1990 according to Federal Reserve data. Tangible net worth of owner-occupied housing of households fell 5.4 percent in 1990. Consumers are understandably reluctant, and long-term rates remain high. The Federal Reserve Board will be challenged to further ease monetary policy without driving long-term rates even higher, and choking off the current moderate recovery in the real estate industry.

In the recent recession, residential and commercial real estate have been affected disproportionately, while industrial and institutional construction (consisting of, among other things, hospital and nursing facility construction) grew. This growth is consistent with demographic changes (the aging of the population) and the explosive growth of Federal spending in health care.

The growth in home construction through the 1970's and 1980's has fallen significantly in the last several years, and so has commercial building, particularly on rural and suburban land. These are the two common forms of real estate wealth owned by families of moderate means. The flows of rental income to these real estate assets would be expected to be depressed in the current real estate difficulties, as well.

Chairman Greenspan has the unenviable task of helping to clean up the wreckage in our banking and real estate industries as a result of Congressional failure to control run-away appropriations and short-sighted, punitive taxation of family savings. Congress bears siginficant responsibility for the difficulties in our banking and real estate industries. Those difficulties obstruct the channels through which monetary policy works. Hopefully, our colleagues will reflect on what Chairman Greenspan has to say before they attempt yet another tax bill that reduces prosperity and family savings in our country.

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Senator SARBANES. Congressman Scheuer, please proceed.
Representative SCHEUER. No statement. I came to hear the Chairman.
Senator SARBANES. Very good. Congressman Fish, please proceed.
Representative FISH. No statement. Thank you.
Senator SARBANES. And Congresswoman Snowe.
Representative SNOWE. No statement.
Senator SARBANES. Mr. Chairman, we would be happy to hear from you. Welcome to the Committee.

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

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

I would like to excerpt my remarks from my prepared testimony and request that the full text be printed in the record.

Senator SARBANES. We'll include the full statement in the record.

Mr. GREENSPAN. Two weeks ago, the Federal Reserve submitted its semiannual report on monetary policy to the Congress. That report covered very specifically the system's expectations for money and credit growth in 1992, as well as our forecast for economic growth and inflation. Today, I would like to focus on some of the broad considerations bearing on the outlook.

The performance of the economy clearly has been disappointing. The recovery in business activity since last spring has been anemic, job losses have continued to mount, and confidence has sunk to depressed levels. As we look ahead, there are a few hopeful signs—but at this stage, they are quite tentative. Anecdotal reports and the early data on activity since the turn of the year suggest that spending is starting to firm in some sectors. And in the financial markets, the cumulative effects of the Federal Reserve's easing actions appear to be manifesting themselves in some strengthening of late in the money supply. These are the types of indications one looks for when business activity is picking up. But as I've indicated previously, there are some extraordinary forces at work in the economy that add an exceptional measure of uncertainty to the current picture.

I refer in particular to the sizable adjustments to business and household balance sheets now underway. These adjustments, which are without parallel in the postwar period, are a consequence of the enormous accumulation during the 1980's of certain kinds of real assets and even faster growth of debt and leverage.

In part, our current economic adjustments can be seen as arising out of a process in which debt is being realigned with a more realistic outlook for incomes and asset values. Faced with mounting financial problems and uncertainty about the future, one's natural reaction is to withdraw from commitments, where possible, and to conserve and even build savings and capital. Not surprisingly, many households and businesses have taken measures over the past few years to reduce drains on their cash flow and to lower their exposures to further surprises. Part of the process has involved unusually conservative spending patterns, and part has involved the early stages of a restructuring of financial positions.

The monetary policy actions of recent quarters have helped to reduce the debt service burdens of households and businesses and are encouraging them to shore up their financial positions. Moreover, the recently announced cut in reserve requirements on transactions deposits should free up some funds for lending and should help—at least to some extent—to break the grip of the so-called credit crunch, which has imposed an undue financial constraint on the activities of many firms.

Businesses have been taking steps to reduce leverage, enhance liquidity, and cut down on interest obligations in order to lower their exposures to risk. In addition, they have been adjusting production promptly in an attempt to keep inventories in line and have cut back staffing levels and closed inefficient plants. Meanwhile, households have restrained their expenditures and have paid down debt to reduce interest expenses. Also, as long-term interest rates have declined, both businesses and households have refinanced mortgages and other loans.

Unfortunately, history provides little guidance in assessing how much additional adjustment to balance sheets is in store, and how fast it is likely to proceed. Our best guess is that this unusual restraint on economic activity should begin to dissipate in the reasonably near future. But the uncertainties in this regard are enormous and add significantly to the typical risks in the economic outlook.

In any event, the restructuring of financial positions is not the only restraint on economic activity in the near term. The activities of State and local governments have been atypically constrained by budget pressures. More important, we are currently coping with a sizable adjustment in the area of national defense. The cutbacks in military spending have been underway since the mid-1980's when real budget authority turned down and orders for defense capital goods flattened out. All told, real budget authority for defense has fallen more than 20 percent from its 1985 peak. Similar trends have been evident in the data on industrial production where the index of defense and space output has fallen roughly 15 percent since 1987. As you know, the 1990 budget agreement established caps on defense funding that imply sizable further reductions over the next several years, and the end of the Cold War raises the prospect that even larger cuts could be made without undue risk to our national security.

From a longer run perspective, the defense cutbacks carry substantial benefits for the U.S. economy. By freeing up resources that could then be devoted to improving the Nation's stock of productive physical and human capital, they should ultimately lead to better productivity performance over time. In the short run, of course, lower defense spending is a depressant on economic activity, jobs and incomes. For industries and regions that depend heavily on military spending, the dislocations could well be sizable.

One sector that has been a bright spot as the recovery has struggled to take hold has been exports, which have benefited from both the cumulative gains in U.S. price competitiveness and income growth in our trading partners. The economies of Mexico, several of the other Latin American countries, and the newly industrialized nations in Asia have been notable areas of strength.

In contrast, the economic performances of the major foreign industrial countries in the second half of last year generally were disappointing. Real output in Germany and Japan, which had been growing extraordinarily rapidly earlier in the year, slowed sharply. Meanwhile, in Canada and Great Britain, recovery from recession is proving elusive. Several of these countries have been struggling with problems of debt burdens and excess leveraging similar to those in the United States.

Current economic indicators are lackluster in almost all the major industrial countries. Consumer spending is weak and confidence is low, while firms are continuing to run down inventories and appear to be hesitant to spend on new plant and equipment. Nonetheless, the odds are good that activity will strengthen over the course of the year. In Canada, the United Kingdom and Japan, the central banks have eased monetary conditions.

These actions should not only facilitate the portfolio adjustments underway in many countries, but should also contribute to rebounds in interest-sensitive spending.

In Germany, monetary conditions remain tight as wage pressures threaten to add to inflation and money growth continues at rates above the Bundesbank's current targets. However, the ending in the middle of this year of an income tax surcharge should help to boost consumption. And in the five new States—that is, the former East Germany—construction and investment spending are vigorous and may well spark the turnaround in production in that region that has been anticipated since the Berlin Wall came down.

In fact, if developments in the industrialized countries materialize along these lines, and if growth in our other trading partners remains robust, exports should continue to bolster production here at home. Such an outcome would elevate the likelihood of a moderate upturn in U.S. business activity in coming quarters.

The recent news on U.S. inflation has been quite favorable. Prices for a wide variety of goods and services have decelerated notably over the past few quarters, and a further slowing in underlying price pressures is expected. Moreover, with appropriate economic policies, the improvement in the inflation trend should extend into 1993, even, I would hope, with stronger growth in real activity than now appears in prospect for the current year.

In formulating its objectives for monetary policy last month, the Federal Open Market Committee obviously had to grapple with the anomalous monetary behavior of the past 2 years and the sizable uncertainties in the outlook for 1992. In particular, the ongoing process of balance sheet restructuring may affect spending, as well as the relationship of various measures of money and credit to spending, in ways we are not anticipating. Judging from the historical evidence, the adopted growth ranges for the monetary aggregates should support our projections for economic activity and could accommodate an even stronger recovery. Nonetheless, we will remain sensitive to signs that the anticipated pickup in business activity is not emerging and will be prepared to adjust money growth, as well as our stance in reserve markets, should the need arise.

Our focus, quite naturally and appropriately, has been on the immediate situation—the causes of the recent slowdown and the prospects of returning to solid growth this year. However, as we move forward, we cannot lose sight of our longer run objectives. Much of the current difficulty and dissatisfaction with the United States economy comes from the sense that it is not delivering the kind of long-term improvement in living standards we have come to expect. The Federal Reserve can help to address this deficiency by providing a stable financial background that fosters saving and investment and encourages sound balance sheet structures. The Congress can help by adopting a budget that is geared to the longer run needs of the economy; at a minimum, that entails maintaining a commitment to the elimination of the structural budget deficit over the coming years. Together, we can achieve the strong economic performance that our fellow citizens rightly expect.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Greenspan follows:]

Prepared Statement Honorable Alan Greenspan

Mr. Chairman and members of the Committee, I am pleased to appear here today. Two weeks ago, the Federal Reserve submitted its semiannual report on monetary policy to the Congress. That report covered very specifically the System's expectations for money and credit growth in 1992, as well as our forecast for economic growth and inflation. Today, I would like to focus on some of the broad considerations bearing on the outlook.

The performance of the economy clearly has been disappointing. The recovery in business activity since last spring has been anemic, job losses have continued to mount, and confidence has sunk to depressed levels. As we look ahead, there are a few hopeful signs—but, at this stage, they are quite tentative. Anecdotal reports and the early data on activity since the turn of the year suggest that spending is starting to firm in some sectors. And, in the financial markets, the cumulative effects of the Federal Reserve's easing actions appear to be manifesting themselves in some strengthening of late in the money supply. These are the types of indications one looks for when business activity is picking up. But, as I have indicated previously, there are some extraordinary forces at work in the economy that add an exceptional measure of uncertainty to the current picture.

I refer in particular to the sizable adjustments to business and household balance sheets now under way. These adjustments, which are without parallel in the postwar period, are a consequence of the enormous accumulation during the 1980's of certain kinds of real assets and even faster growth of debt and leverage.

Rapid rates of debt-financed asset accumulation were widespread during the 1980's. In the business sector, a primary example is that of commercial real estate, where overbuilding was propelled by a combination of relatively low vacancy rates early in the decade and generous depreciation provisions. Meanwhile, a dramatic increase in leverage among corporations was associated with a wave of mergers and buyouts. The debt burdens of households also rose markedly over the course of the decade, as purchases of motor vehicles and other durables ran at high levels for an extended period and home buying in some parts of the country soared.

To a degree, the increase in leverage was a natural and economically efficient outcome of deregulation and financial innovation. It also may have reflected a lingering inflation psychology from the 1970's—that is, people may have expected rapid increases in prices. especially those of specific real assets, that would make debt-financed purchases profitable. Many analysts were well aware at the time of the increasingly disturbing trends in debt and leverage. But in retrospect, as the values of real property and other assets stagnated or declined, the mismatch between debt, on the one hand, and the likely prospects for incomes and asset values, on the other, turned out to be even greater than many had perceived.

In part, our current economic adjustments can be seen as arising out of a process in which debt is being realigned with a more realistic outlook for incomes and asset values. Faced with mounting financial problems and uncertainty about the future, one's natural reaction is to withdraw from commitments where possible and to conserve and even build savings and capital. Not surprisingly, many households and businesses have taken measures over the past few years to reduce drains on their cash flow and to lower their exposures to further surprises. Part of the process has involved unusually conservative spending patterns, and part has involved the early stages of a restructuring of financial positions.

The monetary policy actions of recent quarters have helped to reduce the debt service burdens of households and businesses and are encouraging them to shore up their financial positions. Moreover, the recently announced cut in reserve requirements on transactions deposits should free up some funds for lending and should help—at least to some extent—to break the grip of the so-called "credit crunch," which has imposed an undue financial constraint on the activities of many firms.

Businesses have been taking steps to reduce leverage, enhance liquidity, and cut down on interest obligations in order to lower their exposures to risk. In addition, they have been adjusting production promptly in an attempt to keep inventories in line, and have cut back staffing levels and closed inefficient plants. Meanwhile, households have restrained their expenditures and have paid down debt to reduce interest expenses. Also, as long-term interest rates have declined, both businesses and households have refinanced mortgages and other loans.

Unfortunately, history provides little guidance in assessing how much additional adjustment to balance sheets is in store—and how fast it is likely to proceed. Our best guess is that this unusual restraint on economic activity should begin to dissipate in the reasonably near future. But the uncertainties in this regard are enormous and add significantly to the typical risks in the economic outlook.

In any event, the restructuring of financial positions is not the only restraint on economic activity in the near term. The activities of State and local governments have been atypically constrained by budget pressures. More important, we are concurrently coping with a sizable adjustment in the area of national defense. The cutbacks in military spending have been under way since the mid-1980's, when real budget authority turned down and orders for defense capital goods flattened out. All told, real budget authority for defense has fallen more than 20 percent from its 1985 peak. Similar trends have been evident in the data on industrial production,

where the index of defense and space output has fallen roughly 15 percent since 1987. As you know, the 1990 budget agreement established caps on defense funding that imply sizable further reductions over the next several years, and the end of the Cold War raises the prospect that even larger cuts could be made without undue risk to our national security.

From a longer-run perspective, the defense cutbacks carry substantial benefits for the U.S. economy. By freeing up resources that could then be devoted to improving the Nation's stock of productive physical and human capital, they should ultimately lead to better productivity performance over time. In the short run, of course, lower defense spending is a depressant on economic activity, and on jobs and incomes. For industries and regions that depend heavily on military spending, the dislocations could well be sizable.

One sector that has been a bright spot as the recovery has struggled to take hold has been exports, which have benefited from both the cumulated gains in U.S. price competitiveness and income growth in our trading partners. The economies of Mexico, several of the other Latin American countries, and the newly industrialized nations in Asia have been notable areas of strength.

In contrast, the economic performances of the major foreign industrial countries in the second half of last year generally were disappointing. Real output in Germany and Japan, which had been growing extraordinarily rapidly earlier in the year, slowed sharply. Meanwhile, in Canada and Great Britain, recovery from recession is proving elusive. Several of these countries have been struggling with problems of debt burdens and excess leveraging similar to those in the United States.

Current economic indicators are lackluster in almost all the major industrial countries. Consumer spending is weak and confidence is low, while firms are continuing to run down inventories and appear to be hesitant to spend on new plant and equipment. Nonetheless, the odds are good that activity will strengthen over the course of the year. In Canada, the United Kingdom, and Japan, the central banks have eased monetary conditions. These actions should not only facilitate the portfolio adjustments under way in many countries, but also should contribute to rebounds in interest-sensitive spending.

In Germany, monetary conditions remain tight as wage pressures threaten to add to inflation and money growth continues at rates above the Bundesbank's current targets. However, the ending in the middle of this year of an income tax surcharge should help to boost consumption. And in the five new States (former East Germany), construction and investment spending are vigorous and may well spark the turnaround in production in that region that has been anticipated since the Wall came down. If, in fact, developments in the industrialized countries materialize along these lines—and if growth in our other trading partners remains robust—exports should continue to bolster production here at home. Such an outcome would elevate the likelihood of a moderate upturn in U.S. business activity in coming quarters.

The recent news on U.S. inflation has been quite favorable. Prices for a wide range of goods and services have decelerated notably over the past few quarters, and a further slowing in underlying price pressures is expected. Moreover, with appropriate economic policies, the improvement in the inflation trend should extend into 1993—even, I would hope, with stronger growth in real activity than now appears in prospect for the current year.

In formulating its objectives for monetary policy last month, the FOMC obviously had to grapple with the anomalous monetary behavior of the past 2 years and the sizable uncertainties in the outlook for 1992. In particular, the ongoing process of balance sheet restructuring may affect spending, as well as the relationship of various measures of money and credit to spending, in ways we are not anticipating. Judging from the historical evidence, the adopted growth ranges for the monetary aggregates should support our projections for economic activity—and could accommodate an even stronger recovery. Nonetheless, we will remain sensitive to signs that the anticipated pickup in business activity is not emerging and will be prepared to adjust money growth, as well as our stance in reserve markets, should the need arise.

Our focus, quite naturally and appropriately, has been on the immediate situation—the causes of the recent slowdown and the prospects of returning to solid growth this year. However, as we move forward, we cannot lose sight of our longer-run objectives. Much of the current difficulty and dissatisfaction with the U.S. economy comes from a sense that it is not delivering the kind of long-term improvement in living standards we have come to expect. The Federal Reserve can help to address this deficiency by providing a stable financial background that fosters saving and investment and encourages sound balance sheet structures. The Congress can help by adopting a budget that is geared to the longer-run needs of the economy; at a minimum, that entails maintaining a commitment to the elimination of the structural budget deficit over the coming years. Together, we can achieve the strong economic performance that our fellow citizens rightly expect.

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

I want to say to the members of the Committee, given the number that are here, that we will begin with seven-minute rounds, and then we can have a second go-round if members are still desirous of that.

Mr. Chairman, as I understand it, the Fed polls the 19 participants in the Open Market Committee meeting for their individual economic forecasts in preparing for Humphrey–Hawkins, and then publishes the mid-range of those forecasts as the "central tendency" forecast, which I understand for 1992 is 1.75 to 2.5 percent real growth.

Is that correct?

Mr. GREENSPAN. Yes, sir, it is.

Senator SARBANES. I'm interested in whether this central tendency forecast of 1.75 to 2.5 percent real growth assumes Congress will adopt a fiscal stimulus package or not.

Mr. GREENSPAN. We specifically addressed that question in sending out our questionnaires and decided that rather than impose a specific set of circumstances under which we allow the various Presidents and members of the Board of Governors to make their projections, we decided to allow each to make his or her own judgment with respect to what fiscal policies would or would not emerge, and as a consequence, each individual member made his or her own assumptions, and this is the best guess as to what the combination of policy plus economic forces would create for the year 1992.

Senator SARBANES. Well, did most of them assume there would be a fiscal stimulus or that there would not be?

Is the 1.75 to 2.5 percent assuming some sort of fiscal stimulus or assuming there won't be?

Mr. GREENSPAN. I assume some did and some did not.

Senator SARBANES. Well, how do you avoid getting apples and apples out of that? Wouldn't that be apples and oranges?

Mr. GREENSPAN. It depends on what the basic purpose of this particular projection is. It is not a goal, obviously, because if we had a goal of where we would like the economy to be, the numbers would be higher, obviously, than the numbers that we show here.

We have had some difficulty for precisely the reason you're suggesting, in the sense that not only are you dealing with different assumptions relevant to policies, but there are different assumptions relevant to the questions of exchange rates, what's going on abroad, and a variety of different elements, each of which I'm sure is different with respect to each of the forecasts.

Were we to sit down and to set down a list of specific criteria which would enable them to forecast, we'd get to the problem of either I, if I'm making the list, or some other colleagues or the staff, essentially biasing the forecast.

Senator SARBANES. No, I am not trying to get at that. I can understand a rationale that says, we didn't give them the parameters. We let them set the parameters.

The question I am asking is what parameters did they then choose to set the basis on which their forecasts are made. I am not saying that you had to necessarily give them the parameters. But when they made their forecasts and when you give us this central tendency forecast, what assumption does it come off of with respect to fiscal stimulus?

Mr. GREENSPAN. The answer to the question is we did not separately poll the members for their specific sets of assumptions, of which fiscal policy would have obviously been only one of a number of them.

Senator SARBANES. Well, were you one of the ones who made a forecast?

Mr. GREENSPAN. I always make a forecast.

Senator SARBANES. Did you assume a fiscal stimulus?

Mr. GREENSPAN. I did not.

Senator SARBANES. You did not. And was yours within this central tendency range?

Mr. GREENSPAN. Fairly much within it, yes.

Senator SARBANES. So your figure was within that range, but you did not assume a fiscal stimulus?

Mr. GREENSPAN. That is correct.

Senator SARBANES. OK. Now, the President, in submitting his Economic Report, projected 2.2 percent growth, which included his fiscal stimulus package, which he evaluated at being worth 0.6 of 1 percent.

As I understand it, in the Economic Report, the Administration projected 1.6 percent growth, if everything just stays as it is, and 2.2 percent growth, if we enact the programs that the President asked for.

But you didn't assume the enactment of those programs in making your particular forecast.

Is that correct?

Mr. GREENSPAN. That is correct, Mr. Chairman.

Senator SARBANES. Does the figure of a 0.6 percent addition to growth from the adoption of the fiscal stimulus package of the President strike you as reasonable?

Mr. GREENSPAN. Without having gone through the analysis that they did, it doesn't strike me that the size of the program he is advocating is out of line with that number.

Senator SARBANES. Is it correct, as I said in my opening statement, that we have generally come out of previous recessions with much faster growth than is being projected after this recession?

First of all, do you think we will come out of the recession in 1992?

Mr. GREENSPAN. Mr. Chairman, I think we are already out of it. The question basically is what happens from here. But in answer to your specific question, history has certainly given us far stronger recoveries out of recession than we are seeing now. Indeed, I've rarely seen such a recovery as anemic as the one we are seeing. However, assuming, as I do assume, that the recession bottomed in spring 1991, which I suspect in retrospect we will look back on as the trough, the recovery has been little more than glacial, if I may put it that way.

One of the reasons, of course, is that the extent of the decline was not particularly large by historic standards. So I would summarize by saying, yes, the recovery has been very muted out of this recession, far less than have recoveries of the past. But part of that, not all of it, is explained by the fact that the extent of the decline has also been rather small.

Senator SARBANES. Just one final question. I understand you did not give a parameter to the members of the Federal Open Market Committee on the assumptions they should use about fiscal stimulus and did not poll them, as I understand it.

Mr. GREENSPAN. That's correct.

Senator SARBANES. You said, in making your own forecast, you did not assume any fiscal stimulus.

What is your instinct on the assumptions that your colleagues used for making their forecasts? Would you say that, generally speaking, they followed the path that you took in this matter?

Mr. GREENSPAN. My impression is that some did, some did not. If I had to guess, I would say that it could be more likely 50–50. Other than that,

I would guess the path would be more assuming no fiscal stimulus than any significant stimulus. But I have not polled them, and, frankly, it's not much more than a guess.

Senator SARBANES. Can one logically assume that those who you think assumed a fiscal stimulus also projected a higher rate of growth?

Mr. GREENSPAN. I would suspect that, to the extent that they are using standard econometric techniques, which all of them are to a greater or lesser extent, almost all of those models would create a somewhat higher short-term real growth, and somewhat later, somewhat higher inflation than would be the base case.

Senator SARBANES. Congressman Armey.

Representative ARMEY. Thank you, Mr. Chairman.

Mr. Chairman, I wonder if you can help me refresh my memory a little bit. I seem to recall the old adage, you can't push on a string.

As I remember that, the point was that you can use monetary policy as a restraint against inflation, but it is very difficult to encourage economic growth or economic recovery by pushing on that same string of monetary policy.

Is that the correct interpretation of that?

Mr. GREENSPAN. That goes back to the problems that occurred in the 1930's when extraordinary liquidity was pumped into the economy, but demand was so deficient that it appeared as though the more you pumped in, the more seemed to go out the other end without any effect.

That term has carried over into the post-World War II period. But when we actually analyze period-after-period, there is little or no evidence in the post-World War II period which suggests that monetary policy has been wholly ineffectual.

It is certainly the case that it has been somewhat more effective on some occasions rather than on others. But generally speaking, the effects still appear to be positive in terms of economic growth, except when we go to extremes, creating inflationary pressures, and that induces, as you know, severe imbalances. One can then argue that the net effect of monetary policy is negative. But that is not the concept of pushing on a string.

Representative ARMEY. So we could argue that money matters, but money alone doesn't matter.

Mr. GREENSPAN. Yes, sir.

Representative ARMEY. As you, I'm sure, are very well aware, every member of Congress and everybody else in this town has a perfect idea of what the Fed ought to do, and we're not at all reluctant to tell you.

But I think I'm getting a sense from your statement and testimony today of what you think is the responsibility of the Fed and the responsibility "ability" of the Fed. I wonder if my characterization of this would be accurate in this way.

That is, it strikes me that you would make a projection of where you think the economy is going to go and what would be the level of growth that you might anticipate. Apparently, the use of the SWAG method of making that guess, which, in the end, is all that's left to any of us.

Then, I think I heard you say monetary policy should encourage growth in the money supply to accommodate economic growth.

I think you also just suggested that it is possible to get the money supply out ahead of the growth, in which case you could tip off inflation.

Is that a correct understanding of how you see your relationship to a recession?

Mr. GREENSPAN. I would put it somewhat differently. It is true that we do make projections, and, indeed, there is no way to engage in monetary policy without some tentative judgments as to where the economy is going because, obviously, any action you take presupposes a forecast. But what we try to do is, as best we can, not to fix ourselves with a specific forecast number, but, rather, a set of probabilities with a judgment as to the various risks that are involved and the costs to the economy, both short term and long term, if the direction we take is wrong.

Representative ARMEY. But your point is that you want to be certain that the money supply expands to accommmodate to the growth. You don't want the growth to be hampered by an insufficiency of expansion.

Mr. GREENSPAN. That is certainly the case.

Representative ARMEY. It's been my belief that we ask too much of monetary policy these days. We're talking about how the economy is struggling to deal with this recession, and even our best, most optimistic projections for a recovery are in the 2-percent range, as opposed to the historic 5-percent range.

Is it possible that never in recent business cycle events of this country has the Federal Government responded with such flimsy fiscal policy as what we've seen here?

I think I would argue that not only have we not had a good counter-cyclical fiscal policy to help the economy out of these doldrums, but in fact, if you look at some of the regulatory things that we've done in the last two or 3 years, such as the Clean Air Act and other costly restrictions, we may in fact have had federal policies that further hampered the private sector's ability to recover robust growth.

So that one doesn't question the economy's elasticity or ability to rebound as much as we have hampered the economy with the wrong kind of policies, deficient countercyclical fiscal policy, and then, frankly, the problem is the Fed isn't doing enough of its share.

I think the Fed may be getting a bad rap here. I'm just not sure about that.

Mr. GREENSPAN. That's the last thing I would want us to be exposed to. Let me just say that there is fiscal policy working in the sense that the automatic stabilizers, to the extent that they work, provided some income support as the system weakened.

The secondary effects, regulatory effects and the variety of other elements associated with governmental policies, I would not put in the fiscal policy category. There are separate regulatory effects, and I am somewhat concerned, as you, about the negative effects that those can have, especially in the longer term, although the longer term is made up of a lot of short terms, and you can't affect the long term without affecting the short term as well.

Representative ARMEY. I want to come back to that, but I see that my time is up.

But let me just say, nowhere in the history of countercyclical policy since World War II have I ever seen anybody suggest that the automatic stabilizers would provide relief of sufficient magnitude on their own. And yet, that seems to be the only effort made in fiscal policy for this last two or 3 years. Congress has enacted nothing in the way of fiscal policy, and just said, well, we have the automatic stabilizers on which to rely.

I think that's deficient. I think 20 years ago, if you had suggested that you could get by on those alone, everybody would have laughed at you.

Senator SARBANES. Congressman Scheuer.

Representative SCHEUER. Thank you, Mr. Chairman.

Chairman Greenspan, you spoke in your testimony about the peace dividend, although you didn't use that phrase. But you did say that the defense cutbacks carry substantial benefits for the economy in the long run. And then you state, "in the short run, of course, lower defense spending is a depressant on economic activity."

And you've just said in the last minute that the long term is made up of a lot of short terms.

Can you give us your suggestions as to what our short-term policy should be in terms of a collection of policies which would amount to a bridge policy, a bridge policy to help us move from the depressant of the short-term layoffs and cutbacks and belt-tightening, to the long-term goal of making good use of that pot of gold out there, that peace dividend that we've all been talking about?

What can we do in terms of fiscal and monetary policy, and what can we do in terms of policies for retraining of workers, skills-enhancement, relocation, and education benefits that will get the benefits of all kinds flowing through the economy?

What would your collection of short-term policies be that would lead us with the least amount of pain from the cutbacks and layoffs to that golden era of the peace dividend?

Mr. GREENSPAN. Congressman Scheuer, let me say that the longer term structure of policy is pretty clearcut with respect to this question; namely, we need a significant increase in total productivity, which means that we need more physical capital investment, which implies, obviously, a much higher rate of saving, and we need to enhance our human capital through formal education, retraining and the like.

If all we had to do was to focus on the longer term, then I think the policy mix is very clearcut; namely, significant reductions in the budget deficit over the longer term to free up private saving to finance long-term private capital investment, and to create the type of noninflationary environment that lowers the cost of capital in real terms, and maximizes the capability of getting significant long-term growth out of the system, and, very specifically, enables the resources that have been going into military production, essentially as an insurance premium, to shift into private productive assets.

The problem that we have is that we are, as the Chairman pointed out in his opening remarks, still mired in a very stagnant, short-term situation, and we have to be as reasonably sure as we can that the situation doesn't deteriorate because the short term will not easily glide into a smooth, long-term path if we have a significant continued weakening in the system.

So there is an element of short-term policy which is a precondition to get on the path to long-term policy. But we have to recognize that there is an inherent contradiction in the extent to which we expend part of that peace dividend, if I may put it that way, for short-term consumption expenditures for the purpose of getting the economy going, because to the extent that we do that, that part of the peace dividend is no longer available for long-term investment.

It is a very difficult tradeoff, and my own impression has been that we should forego short-term fiscal stimulus unless it appears that it is needed. I have not yet reached the conclusion myself that it is, although I do recognize that it's a very close call in the sense that the evidence can lead different people in different directions on this. Indeed, a number of economists have been advocating various different packages of fiscal stimulus, although if one just took the numerical count, the majority would say do nothing.

I would therefore conclude that we have to be cautious, but be acutely aware of what's going on on a day-by-day basis to make certain that this emerging recovery, which I think is emerging, although very lackluster, is actually tracking us to a viable, long-term growth path.

Representative SCHEUER. Mr. Greenspan, you suggest a policy mistake could have caused the recession—could have. But some analysts believe that this recession comes from a number of policy mistakes during the 1980's, including policies that encouraged excessive accumulation of debt, overconsumption—a 10-year overconsumption binge by the American public of products, consumer electronics and so forth, which were bought abroad. Policies that neglected infrastructure and education. Overbuilding of offices, commercial space, shopping centers and the like.

Could you address this question and tell us how we could have avoided this recession, if that combination of policy mistakes led us into it, in whole or in part?

Mr. GREENSPAN. First of all, Senator, remember that we had an extraordinarily long period of economic growth during the 1980's, and I know of no market system which doesn't have to go through some adjustment because of imbalances that invariably occur when expansions proceed that far and that long.

I do think that there was a policy mistake with respect to the issue of the tax depreciation lives on commercial real estate. I believe that in retrospect, we looked back and decided that was clearly an inappropriate depreciation policy prior to the 1980's, in the sense that the tax laws allowed commercial real estate to depreciate over far too long a period. But instead of bringing that from excess down to normal, we went too far in the other direction.

Aside from that, I thought that much of what was in the Tax Act of 1981 was very helpful in creating incentives and the like.

The major problem which engendered the rise in private debt, which has been what we are struggling with very specifically now, was largely a change in, for want of a better term, the equilibrium debt-equity ratio in the business sector. Its rise is in large part because of the onset of technology—the extraordinary numbers of risk diversion instruments that were capable of being created as a consequence through financial innovation. The optimum level of debt-to-equity rose, meaning the one which was consistent with long-term maximum economic growth.

The trouble when you go from one equilibrium to another, however, is that you invariably create a huge increase in debt and then a retrenchment, and that is in large part what we're going through today.

Representative SCHEUER. Thank you, Mr. Chairman.

Senator SARBANES. Congressman Fish.

Representative FISH. Thank you, Mr. Chairman. I welcome you, Mr. Greenspan.

Mr. GREENSPAN. Thank you.

Representative FISH. My principal question is nothing new to you, but it's been about 6 or 7 weeks since you were testifying night and day before any number of panels here on the Hill.

I remember at that time you emphasized the unique character of this recession, the deep uncertainty and concerns that our citizens feel their future and about their standard of living.

As I understand your testimony this morning, it is, in part, that this is manifesting itself in the balance sheet adjustments that both households and

businesses are making, and that these conservative spending patterns are certainly contributing to the stagnation we're experiencing.

On the other hand, we in the Congress and in the Administration are looked to by those who are being hurt by the recession. But you and virtually every economist who has come before us to give us the benefit of their thinking have testified over the last couple of months and counselled against Congress attempting to quick-fix or jump-start the recovery.

I ask if you could give us your prescription as to what Congress should do that would be beneficial to the Nation?

Mr. GREENSPAN. Congressman, I've essentially been advocating not short-term fiscal measures, but measures which I believe would be helpful over the longer run and, incidentally, would not be harmful in the shortrun, if I may put it in those terms.

As you probably are aware, I have for a number of years been advocating a change in the way we tax capital gains, which I think unduly restrains economic incentive and efficiency. And I've come to conclude, somewhat reluctantly, that the passive loss provisions that we imposed in the 1986 Tax Act probably overdid it and that some changes in the passive loss provisions to enhance the capability of investing in existing real estate would be a useful change in the tax code.

I do believe that were both of those changes put in place, it would create short-term fiscal stimulus. But my basic purpose would not be that. It would essentially be to improve the tax system over the long run.

Representative FISH. Would you add for the long term greater emphasis on research and development tax credits and investment tax credits for new machinery, whether they call them a tax credit or an allowance?

Mr. GREENSPAN. I certainly would be supportive of incentives which created increased capital. There's a number of arguments pro and con on individual proposals.

Obviously, if we're moving forward to create a fiscal stimulus package, I suspect that the investment tax credit would be in there, or its equivalent, something such as that proposed by the President on depreciation acceleration, which has the same incentive effect.

The main concern that I have with respect to fiscal packages is actually not any of the number of individual packages which have been promulgated on the Hill or in the Administration, because with few exceptions, I don't view them as being a major problem to the long-term structural deficit.

I am concerned that in an endeavor to craft a proposal that would pass the Congress and be signed by the President, that rather than get one or the other of these proposals, we would end up with more than one and with an excess increase in a budget deficit which, as you know, is already at the $400 billion level.

My impression is that the markets are highly sensitive to this as they react to such initiatives, and I would not be surprised upon examination, in retrospect, that a significant part of the problem that we have had with long-term interest rates in recent years is indeed a reflection of long-term budget deficits with their corrosive effects on saving, but also undermining the long-term belief in the possibilities of a truly noninflationary economy.

I would suggest that while we, for the intermediate period, see inflation coming down and believe that it will stay down—a necessary condition over the very longer run that that be implemented—is that we bring our structural deficit, which now appears in the most recent projections to be at the $200 billion level, down to zero over the years ahead.

Representative FISH. I certainly understand, Chairman Greenspan, your comments in relationship to a stimulus. But in terms of a return to a sustained economic growth, an attempt to restore the preeminence of the economy of the United States, which I think is really what's concerning people. They sense that this is on the downturn and may not come back. But wouldn't you say that things like training and retraining of the work force to meet the technological changes expected in the workplace, as well as encouraging greater investment in research and development, would be factors that would contribute to that?

Mr. GREENSPAN. Yes. In fact, as I said earlier, I thought that in the long-term policy, we need to address not only the physical plant and equipment, but also what we economists call human capital; that is, to enhance the capability of individuals to interface with what is an increasingly sophisticated and high technology capital structure.

One of the extraordinary developments of the last 15 to 20 years, especially in the last 10, has been the extent to which the premium of a college education has increased, with respect to earnings, over the levels that a high school education can develop; that is, skills are becoming increasingly more relevant to one's income, and as a consequence of that, it is most important that we focus on the ability of maintaining an educational system that enables us to effectively compete, as indeed, we are now, in the world economic environment.

Representative FISH. Thank you very much.

Senator SARBANES. Congressman Hamilton.

Mr. HAMILTON. Thank you very much, Senator Sarbanes.

Mr. Chairman, it's nice to see you before us.

Do I understand, on the basis of your testimony, that if you had to vote on the various tax proposals that are pending in the Congress, that you would vote "no"?

Mr. GREENSPAN. At the moment, that is correct.

Mr. HAMILTON. OK. I've been interested in the questions coming from the panel about long-term growth. I must say, my mind was running in the same direction.

The economy has been, it seems to me, underachieving for a long time. What strikes me is that when you look at the average growth in the economy during the 1950's and 1960's, it was about 4 percent per year. Then it dropped in the 1970's to 2.8 percent. And then it dropped again very modestly in the 1980's. And then you hit the 1990's, and it's just flat or worse—we have a recession.

You've indicated to us what you think we ought to do to correct that, and I think most of us here would applaud that and agree with it.

But the question on my mind is, are we in a situation now in the U.S. economy where we really cannot expect to go back again soon to the kind of growth rates that we had in the 1950's or 1960's of 4 percent or more?

Is that just beyond us now for the 1990's—we can't hit that. Are we going to have an economy that is going to grow significantly less than it did earlier?

Mr. GREENSPAN. I would want to disaggregate that question, Congressman Hamilton, into two segments. One is the growth of the population and the labor force, which, as you know, is slowing as women's participation, which so augmented the growth in the 1980's, is now slowing. A slowdown in the rate of growth in the labor force will point-by-point be reflected in the average growth rate.

Mr. HAMILTON. Lowering it?

Mr. GREENSPAN. Lowering it. The crucial question really gets to productivity. Here, we don't know as much about the forces that are driving productivity as we'd like. We do know that capital equipment clearly matters. We do know that human skills clearly matter. But as we develop an increasingly sophisticated world economic structure, as we move more, as I like to say, toward a greater part of the gross national product, being conceptual as distinct from physical or material, the possibilities for rapid value-creation productivity growth are there.

For example, if one really looks at where we are preeminent still, it is in the crucial fulcrum where value and growth is likely to emerge in the decade ahead, namely, software; that is, the ability to handle this type of concept.

Mr. HAMILTON. Would you agree with me that the economic debate in the country ought to focus more and more on the question of how to get productivity growth up?

Mr. GREENSPAN. Yes, sir.

Mr. HAMILTON. That really is the key, isn't it? That is the essential point to focus on—how to get productivity up?

Mr. GREENSPAN. I couldn't agree more.

Mr. HAMILTON. OK. Let me ask two other questions.

I was interested in your response to Congressman Scheuer's question about what caused this recession. I'm not sure I understood you completely, but you said something with respect to property depreciation.

Let me be quite blunt with you. Were there no policy mistakes made by the Fed?

Mr. GREENSPAN. By the Fed, in the 1980's?

Mr. HAMILTON. Yes. Did the Fed contribute in any way to the recession?

Mr. GREENSPAN. You mean the current recession?

Mr. HAMILTON. Yes, sir. Were there no policy mistakes made?

Mr. GREENSPAN. I honestly cannot say that we did something that I would say, in retrospect, I'd like to go back and revisit.

Mr. HAMILTON. If you were doing it all over again, you'd do it the same way?

Mr. GREENSPAN. With the knowledge we had at the particular time, as things evolved, I would say, yes.

Mr. HAMILTON. I'm willing to stipulate that there were mistakes made on the fiscal side, Mr. Chairman. But how would you analyze the policy mistakes? Surely, it's more than a matter of property depreciation.

Mr. GREENSPAN. Well, first of all, recessions occur with or without policy mistakes.

Mr. HAMILTON. Did this recession occur without a policy mistake?

Mr. GREENSPAN. I would say that the actual set of events which triggered the recession was the Gulf War and the sharp rise in oil prices.

I fully understand and I agree that it's a debatable issue as to exactly what the effect was, and I don't think we'll ever be able to make a judgment unqualifiably.

But if you want to know the specific timing of how the economy began to start to slide, I would say the specific event which triggered it was the oil price increase and the uncertainty that occurred.

Mr. HAMILTON. You do not look back on the experience of the recent recession and have in your mind any significant policy mistake, fiscal or monetary, that was made that brought the recession about?

Mr. GREENSPAN. Well, let me say this. After a very vigorous expansion of the 1980's, we are inevitably going to have an adjustment. Whether the

adjustment happens in one quarter or the next, or in one year or the next, is related to a number of questions with respect to how policy and events evolve.

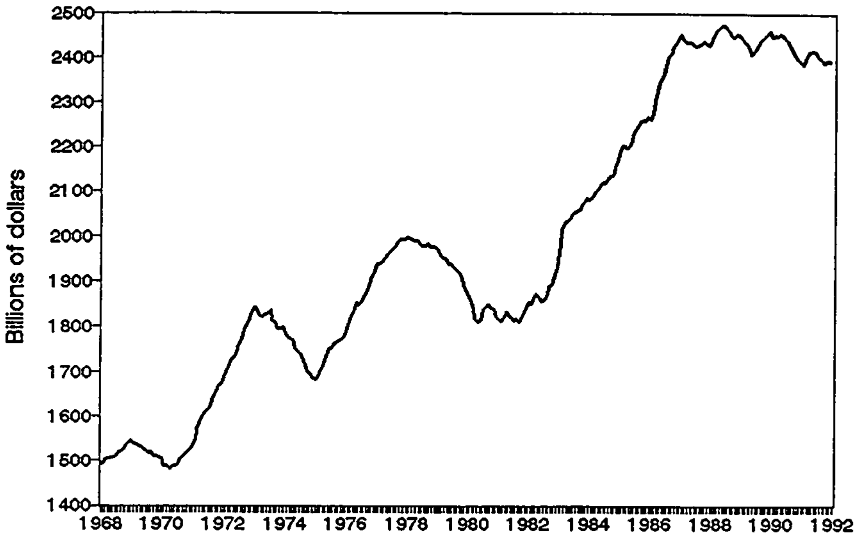
But let me stipulate first, the capability that we would have to go through this period after the adjustments that took place with respect to the balance sheets in the latter part of the 1980's, the ability to go through that without some form of adjustment, I would say is almost nonexistent.

We are really resting the question on what is the specific form of that adjustment and what's the specific cause of it?

I would argue that the specific cause of the adjustment was the Gulf War. But I'd go further and say, if we did not have a Gulf War, at some point we probably would have run into some form of recession because I know of nothing which suggests to me that the business cycle has been repealed.

Mr. HAMILTON. One other question, Mr. Chairman, and it's a technical question on real M2.

One of the charts we have up here shows that it has risen rapidly during each expansion and declined before each recession. There's been no real growth in M2 since 1987. (See chart below.)



Source: Department of Commerce

Now, the question is, can you have an economic recovery now without an increase in real M2? And why haven't we had it?

Mr. GREENSPAN. I would say that at this particular point, growth in real M2 is occurring. Obviously, we are growing at 5 percent, somewhat greater than that most recently, and obviously, inflation has been much less.

While you're certainly correct, Congressman Hamilton, in stipulating that during a goodly part of 1991, real M2 growth was flat to negative and that,

on average, back to 1986, there's been very little real M2 growth, it has certainly not been the case in the last 6 months. And I would think that real M2 growth is probably an important condition for economic expansion at this stage.

Mr. HAMILTON. Why has it been so stagnant since 1986 or 1987?

Mr. GREENSPAN. Part of it is the extraordinary contraction in the savings and loan industry, in the sense that a very substantial part of the decline in small time deposits, which have been a major depressant on the aggregate, has reflected a shrinkage of the savings and loans.

We had expected that a major part, if not all of that shrinkage, would have merely been moved into the commercial banking system. But that did not happen and, as a consequence, M2 growth tended to run under our expectations, indeed, under our desires for a significant part of 1991.

Mr. HAMILTON. And you're now prepared to see growth in M2, and that's happening.

Mr. GREENSPAN. In real terms.

Mr. HAMILTON. In real terms?

Mr. GREENSPAN. Yes.

Mr. HAMILTON. And that's been happening, as I think you've said, in recent weeks.

Mr. GREENSPAN. In the last 6 months.

Mr. HAMILTON. The last 6 months?

Mr. GREENSPAN. Yes.

Mr. HAMILTON. OK. Thank you, Mr. Chairman.

Senator SARBANES. Chairman Greenspan, I want to make sure I'm clear on one answer you gave to Congressman Hamilton, particularly in light of the sharp criticisms we've received from some witnesses about the Fed's policies being too little and too late.

When he asked about policy mistakes, you said, in retrospect, looking back, you didn't think that any of the judgments made at the time were the cause of the recession. I'm not quite clear whether you were saying the judgments the Fed made were, under the circumstances at the time, reasonable ones to make, and you would argue, therefore, that you did not at the time, given the circumstances, make a clearly erroneous judgment, or whether you are going even further and saying that even subsequently looking back at how things have since developed, you still take the view that that decisions should have been what the decisions were rather than some different decisions.

I know, in effect, that is second-guessing and Monday-morning quarterbacking, and it's reasonable for you to say, well, we had to make a judgment at the time, and under the circumstances, it seemed to be reasonable. But I wasn't clear whether you are also asserting that even now, looking back and knowing everything that you know now about how things went, you'd still do exactly the same thing. Or would you do something differently?

Mr. GREENSPAN. No, I was answering the first part, as you put it. I would say it's premature to make a judgment on the second part.

Senator SARBANES. Congresswoman Snowe.

Representative SNOWE. Thank you, Mr. Chairman.

I, too, want to welcome you, Chairman Greenspan, before the Committee.

In looking at this recession, I think we all recognize it's quite different from the previous ones, in terms of emerging from this recession, and also the factors that were present that led to this recession.

Why wasn't it possible on the part of the Federal Reserve and economists to recognize that this recession was in fact quite different? As you mentioned in your testimony, there are a number of problems, such as the personal debt, corporate debt, the State and local governments, the State of the Federal Government's debt, and also the state of the financial institutions.

Why wouldn't we have been able to recognize that this was a much different recession and that we needed to do something earlier, for example, regarding interest rates?

Mr. GREENSPAN. First of all, I think we did, as economists, recognize it was different. And indeed, one of the reasons why we at the Federal Reserve started to initiate ease in Spring 1989, well before any cumulative weakness was evident, was in response to an awareness that the evolving economic structure was different.

However, remember that the issue of rising debt and rising debt burdens have been around for quite a while, and there have been a number of individuals through a goodly part of the 1980's who were saying that this was going to create major problems and were forecasting them at that time and they didn't happen.

What we were looking at was a number of people all recognizing that there was a potential problem out there. We knew that debt could not rise relative to equity or as a percent of household incomes indefinitely. At some point, something would have to give. What we didn't know was what that point was. And as a consequence, you couldn't take specific actions with any certainty because you didn't know whether or not you had 6 months before a problem would arise or 6 years.

And indeed, there were a number who, at various different times and well in advance of anything evolving, were concerned about it, made forecasts that something adverse was going to happen, and then reversed themselves, all before it actually did finally take hold.

Representative SNOWE. We all are very much concerned about the level of the unemployment rate. And what bothers me very much is the fact that we obviously have this consumer confidence problem, which is at its lowest level in 17 years.

What's going to turn this around, because the expectations were mentioned earlier this year and last year that things were turning around, and then, obviously, the economic indicators have suggested otherwise. That has eroded consumer confidence. People are worried about their jobs.

If they have a job, they're worried about whether or not they're going to keep it. They see their friends and neighbors and family members losing their jobs in areas where, heretofore, there had not been an unemployment problem.

What is going to contribute to reassuring people that they will have their jobs? Because if we don't have consumer confidence, I think we can forget everything else. It's not going to change. And certainly not for the short term.

How much are we talking about in terms of the longer term? You have mentioned recently that you would expect that if the economy is moving in the right direction, there will be visible signs in the coming weeks. I'd like to know what those signs are because I obviously don't see it at home, and people are wondering. I think it's going to take a while for people to be reassured that their jobs are secure and that those who don't have jobs will be able to find a job. That's just not apparent right now.

Mr. GREENSPAN. I agree with that. I believe that, even though there are signs to the contrary. We now have seen orders quickening a bit this morn-

ing. We have evidence that we already had some suspicion that new home sales in January were quite strong, that there was an upward revision in the December rate.

There are elements involved here which are suggestive that the economy is edging forward and coming out of this. But it's clearly not the type of interactive, vibrant expansion to which the Chairman referred to in earlier recoveries.

And what I find most disturbing, as I've indicated in other committees before this Congress, is that the objective statistics in the labor markets and in the economy don't describe an economy which is in severe stress. Indeed, we've had three straight quarters of positive growth in gross domestic product. It's been very small, but it's still positive. The unemployment rate is too high, but well under where it was, say in 1982 or 1975. The layoff rate is lower than it was back in those periods.

But nonetheless, people have a very deep-seated concern that raises questions that their notions as to what their future is going to be is a significant problem, because if this were a normal recovery, history tells us that consumer confidence would not be at the levels it is, granted where the macroeconomic elements are.

This tells me that there is a degree of concern out there which is far more deep-seated than I think any of us would have expected, granted the objective evidence of where the current economy is at the moment.

That leads me to conclude that we have to be extraordinarily sensitive in developing an economy that creates a longer term outlook which people can feel optimistic about.

It's one thing to come out of the recession. It's another thing to get restored growth where there's opportunity for new jobs, productive jobs, and a sense that one can go from a particular occupation into something better. There's an opportunity economy out there; that is, what has characterized the United States and why there's always been a sense of buoyancy in the attitudes of Americans—a buoyancy which I find regrettably lacking at this particular point.

Representative SNOWE. How do we get back to that and how do we restore it?

Mr. GREENSPAN. That is the issue that Congressman Scheuer was raising earlier. In other words, how do we move into the longer term balance? It is one of the more difficult policy and political problems that has confronted us in quite a long period of time.

Representative SNOWE. Thank you.

Senator SARBANES. Mr. Chairman, the Wall Street Journal, on Friday, had an article, and I'm going to quote from it.

> "The Fed missed an opportunity to be more accommodating in early January," says Mr. Henry Kaufman. He and some others believe the Fed should have cut the federal funds rate by another quarter or half a percentage point to match the full-point cut that it made in December in the discount rate, another closely watched barometer of short-term rates. But Mr. Greenspan said in early January that there was enough stimulus in the pipeline for a recovery, indicating no further cuts were imminent.
>
> "We were surprised at the Fed's rhetoric over the past month," adds John Costos, managing director in charge of Government Security Sales and Trading at First Boston Corporation. "We've been maintaining all along that the economy is weak and rates should come down."

What's your response to those comments?

Mr. GREENSPAN. We're all endeavoring to find the appropriate evaluation of the short term and take appropriate actions.

As I've indicated to you in other particular committee discussions, it's our view that the process of monetary ease is indeed working in the economy.

It's reflective of some stirring in orders and home sales, slightly better retail sales. It is clearly working.

What is unclear at this stage, and the one thing we'd better not take for granted is that what we're seeing at this stage will inevitably create a self-sustaining economic recovery. That is a likely outcome. It may well be the most probable outcome.

But while I've indicated to you previously that we may well have—probably do have—enough monetary stimulus in the system to create that, I'm not sure that we will not need some insurance or have to revisit this issue. All I can say to you is that we're all looking at the same set of data, the same economy, the same sense of confidence which pervades it. We're all making our judgments with respect to how that is evolving with respect to economic activity and where the risks of various different actions are. There will be differences, inevitably.

Senator SARBANES. Well, what's your response to those who say that the Fed, to some extent, has helped to talk up long-term rates. Long-term rates were coming down, but Greenspan then sent signals that, one, the Fed wasn't going to do anything further on the interest rate front, and second, he sent a signal that the economy was moving out of the downturn and things were starting up. And long-term rates which were coming down, but which were not yet at levels that would sustain a real speed-up in economic activity, took that message and started right back up again.

Long-term rates have gone up, what, half a point, 50 basis points, I guess.

Mr. GREENSPAN. As of this morning, at least as of when I came in here just a little after 10 o'clock, it was close to 8 percent.

Senator SARBANES. And it was down to 7.4 percent, I think, at one point.

Mr. GREENSPAN. Yes. It was responding, the markets were responding to the sharp upswing in housing sales and in the leading indicators.

Senator SARBANES. Right. And the argument is that the Fed helped to contribute to that at an earlier point and started moving them back up when most people looking at them, and perhaps even you, I assume you, would have said, no, we want long-term rates to drop down.

Mr. GREENSPAN. Indeed, I think I said that very explicitly.

Senator SARBANES. But on the other hand, you sent two signals. That was your wish, but you sent two signals, both of which contributed to pushing them back up.

What's your response to that?

Mr. GREENSPAN. First of all, I'm aware of those comments and obviously I have thought about them, and we at the Board have thought about them.

It's very difficult to judge what is causing this particular backing up of long-term rates. It's obviously a series of events. Judging from the term structure of interest rates, it looks as if the most powerful upswing has been in the area of three or 4 years out. That is, the yield curve 3 or 4 years out has gone up the most, relatively speaking, which is suggestive that a not insubstantial part of the turnaround is an expectation that the economy is turning and that interest rates will move up because the demand for funds will move up. I suspect that that is clearly part of the issue.

Also involved here is a significant change in the long-term view of the federal deficit. Remember, up until very recently, it had been the presumption of the market, and most everybody else, that the long-term structural budget deficit was going to disappear in the mid-1990's. Now, the lastest estimates that are emerging from the Congressional Budget Office and OMB are numbers something close to $200 billion and stalled out at that level.

That event is also occurring, I might add, somewhat close to the bottom point of long-term interest rates.

I frankly don't know how we can disaggregate what the various causes are in any realistic manner, and I frankly don't know the answer to your question. I know that people are stipulating that. They're making judgments about what causes markets to turn in the same way that we do.

When we, for example, reduced reserve requirements the other day, the response of the market was an immediate sharp increase in long-term interest rates. There are a lot of technical reasons why that presumably happened, but it's not clear that market commentators did not believe that we were becoming too expansionary. Indeed, a number of them said precisely that.

Whether or not that really characterizes exactly what was happening in the market, there is some question. But my own judgment is that the inflation patterns that are evolving are very clearly moving lower, and that the major pressures that are involved in this economy, even if the economy is starting to rise, are to lower rates of inflation, and I read that in the longer run to suggest lower longer-term rates as well.

Senator SARBANES. When you made your forecast for 1992, what assumptions did you make about the performance of the export sector in 1992?

Mr. GREENSPAN. I assumed, Mr. Chairman, that as a consequence of considerable improvement in the underlying cost structure of American manufacturing, the market share of manufactured goods—I should say the share of American exports in overall manufactured export goods—would continue to rise, as indeed it has since the middle of the 1980's.

Our share of total world manufactured exports has risen from roughly 20 percent to about 25 percent last year. And I would presume that it will creep up somewhat further, which suggests somewhat stronger exports, even though the markets into which we ship are becoming increasingly sluggish.

Senator SARBANES. It is the latter that I'm very concerned about, and it seems to me that you're being overly optimistic.

Business Week, in the March 9 issue, said:

> More worrisome is that the foreign sector will actually subtract from growth if the global slowdown worsens, or if domestic demand for imports grows more strongly than expected. Added to the potholes created by skittish consumers, a deteriorating trade deficit is shaping up to be yet another detour on the rocky road to recovery.

And if you look at the growth rates in these other major industrial countries—and you make some reference to that in your statement, although you then go on to say, if, if and if, but I'm not sure where you find the prospects for optimism—I'm concerned that the industrial world is going to stagnate the economy internationally, and that the growth coming out of the export sector that we experienced in 1991 is going to be diminished and significantly lost in 1992.

The growth in major industrial countries seems to be declining and, in some instances, is even negative, and, therefore, it seems to me that we have the possibility of a worldwide downturn that would impact negatively on our economy.

How serious a concern should that be?

Mr. GREENSPAN. It should certainly be a concern. While it is certainly the case that Europe has slowed and Japan is increasing at a less rapid pace, we do ship a surprisingly large part of our exports to less developed countries and specifically to the newly industrialized economies.

My recollection is that about a fourth of our exports go to the LDCs, and about 10 percent go to the newly industrialized countries, and about 20 percent to Canada.

If we get some improvement in the Canadian outlook—which is at the moment, as you know, quite dull, but looks as though it will make some improvement—and if we get the type of growth that the newly industrialized countries appear to be exhibiting, which is not very much different from where they were moving last year, and the growth in Mexico and other Latin American countries continues, I see no reason to believe that we are in some very serious export trouble, although I will certainly grant you that we need further growth in these markets to get strong export growth.

I don't look for strong export growth, but I do look for continued growth. And if we look at the order figures for exports, while they're clearly not robust, they are nonetheless continuing to rise.

So, overall, the intermediate period is still positive for exports, but it does, as you well point out, depend on the status of the rest of the world and a continued improvement in American competitiveness.

Senator SARBANES. Congressman Armey.

Representative ARMEY. Thank you, again.

Mr. Greenspan, you said that in the spring 1989, the Fed began to be concerned about the possibility of an impending recession and took policy action at that time.

Mr. GREENSPAN. It wasn't an impending recession. It was the fact that the balance sheet structure and the debt structure were beginning to evolve and create some significant slowing down.

Representative ARMEY. Slowing down. I agree. But you certainly saw that the trend was heading in an unfortunate direction.

Mr. GREENSPAN. Yes.

Representative ARMEY. During the Spring and Summer 1989, the House passed the Archer-Jenkins bill on capital gains taxation. You might recall that in that bill, you had a combination of indexing basis adjustment and reduction of the rate.

I think it was a very powerful capital gains tax change, in light of some of the things we've seen since.

Would you dare to hazard a guess as to what the impact of that bill might have been? I think you'd see a decrease in the rate of increase or slowing down.

If we had passed Archer–Jenkins through Congress and signed it into law that summer, is it possible we could have halted that slide or reversed it?

Mr. GREENSPAN. It's very difficult for me to make a judgment of that, Congressman Armey. I do remember the bill, but I don't recall having looked at it in sufficient detail to give you a judgment that I would feel comfortable with.

Representative ARMEY. Well, assume that it was a good, strong reduction. Take my word for it, along with indexation. It had to have helped.

Would you agree with that?

Mr. GREENSPAN. Indeed. My view about the capital gains tax issue is that it is very difficult to make judgments as to how potent it would be under certain circumstances, but I beleive the sign is unambiguous and, in my judgment, the cost of lowering the rate I find very small.

Representative ARMEY. Right. So a policy mistake could have been the fact that the Senate did not take up this legislation and pass it on to the President.

Mr. GREENSPAN. I'm not in a position to make that judgment.

Representative ARMEY. That's interesting. I find that curious. Is there a protocol that says the Fed can't criticize Congress?

Mr. GREENSPAN. No. I just don't think that we are in a position to make judgments about key political matters, and we shouldn't be making such judgments.

Representative ARMEY. I would have thought that that would have been considered a policy matter. But perhaps you're right.

Let me go on for a moment.

We just got done entertaining in the House two different alternative treatments of capital gains. In one bill—I think it was H.R. 4200—we had an option to lower the rate. And in the other bill—the one that in fact passed the House—the option was to have prospective indexing.

It would seem to me that if perhaps we were in the 1970's, with the high inflation rates and the high inflation expectations, one might have argued that prospective indexing might have been a more potent option than lowering the nominal rates.

Clearly, Archer-Jenkins had both.

But these days, with these inflation expectations, which do you think would be most potent in its impact on the economy—lowering the rates or indexing?

Mr. GREENSPAN. Well, it's strictly an arithmetical question because, clearly, indexing is the algebraic equivalent to lowering rates. I mean, if you look at a period, say, 5 years from now, and ask, what is the effect of the capital gains tax rate, you can get there either way, and it would be exactly the same.

Without knowing specifically what the inflation expectation is, and the rate cuts, one can argue either side of that. It's strictly a factual question.

Representative ARMEY. Right. But the lower the inflation expectations, the lower indexing would be and its impact relative to lowering the rate.

Mr. GREENSPAN. Yes, of course.

Representative ARMEY. Your emphasis on reducing the cost of capital is something you connect, though, to a long-run structural impact on the economy. Apparently, I think you're saying that what we have to do for the long run well-being is to get productivity increases. Productivity increases come through capital investment.

Is that a correct understanding?

Mr. GREENSPAN. They come through capital investment and enhanced capabilities of the work force.

Representative ARMEY. Right. The technological innovations embodied in capital and then the technological adjustment in the quality of the work force.

But productivity, you're obviously saying productivity increase is extremely important for our long-run well-being.

Mr. GREENSPAN. Yes.

Representative ARMEY. The other thing that I was curious about, you put a lot of emphasis, as I do, incidentally, on passive losses and the fact that you would shore up real estate values.

It seems to me that there has to be a connection, perhaps, through the wealth effect to increases in real estate values and consumer confidence.

Would you make a connection there?

Mr. GREENSPAN. I'm pretty sure that if we could somehow wave a wand and move commercial real estate values up significantly, not to mention residential real estate values, we would see significant differences in measured consumer confidence.

Representative ARMEY. But that would also change the extent to which the consumer used the bank in lending. That is to say, if they felt more wealthy, they would be more willing to borrow.

Mr. GREENSPAN. I would suspect also that if real estate values had not come down to the extent that they did and impinge on the banks, the size of the credit crunch that we've all experienced with such chagrin over the last several years would be nowhere near the dimension that it has been.

Representative ARMEY. So a proper treatment of capital gains, such as a combination of indexing and lowering of rates, along with passive loss restoration and some other adjustments affecting real estate values, would be a combination punch—a one-two punch—that you think would be pretty important right now?

Mr. GREENSPAN. I would say that it would certainly be helpful.

Representative ARMEY. Thank you. Thank you, Mr. Chairman.

Senator SARBANES. Chairman Greenspan, I'm not clear on one answer you gave to Congressman Armey.

He phrased his question about improving capital in terms of physical capital, technology and so forth. And your response, as I understand it, made the point that human capital is also relevant—improving the skills of the work force. And then, in accepting that answer, he put it in terms of technology again, which I take to mean workers having modern machines to work with.

But how important is just upgrading the skills and capacities of the work force—literacy and so forth. The Germans, as I understand it, have an incredibly developed apprenticeship system and a worker retraining system, which we don't have in this country. There are some who think that is a very important part of improving our long-run productivity performance, that you need both.

Some have even argued the health issue the same way. If you can improve the health of the work force, that too can improve your productivity, let alone containing the cost of a health care program.

But those are all pieces of the puzzle, I take it.

Mr. GREENSPAN. I would certainly agree with that, and I would stipulate that in formulating any training or educational human capital enhancement program as an economic policy, we be cognizant of the fact that the type of knowledge, the type of skill, the type of training that our work force has is reflective of what the needs for productivity growth are.

If, for example, as I was mentioning to Congressman Hamilton, we are becoming an increasingly conceptual value-creating economic system, with very heavily increasing emphasis on computer technology, and specifically software, that the skills that we have to create have to be consonant with the economic market forces that are driving values.

In this particular instance, what is basically driving values is a high technology industrial structure, which does not mean that individuals have to have a detailed knowledge of how to write some complex software program. We obviously have to have a number of these people, but we do have to have large numbers of people who can work in that type of infrastructure and create high-value products.

Therefore, the mere issue of the formulation of retraining or of how many years people spend in school, while important, is not as important as it is to make certain that the focus of the upgrading of human capital be against the type of changes that the world is in fact creating.

Senator SARBANES. Congressman Scheuer.

Representative SCHEUER. I would just like to add a footnote to this entire line of discussion, Mr. Chairman. In your last stint as chairman, you set up a task force on education and health.

Senator SARBANES. Which you did a very effective job of chairing.

Representative SCHEUER. Thank you, Senator Sarbanes.

The point I want to make is that we had a long set of hearings—I think we had 11 days of hearings—on what we had to do with our work force to make it competitive in a global environment.

And the one major area of fault we found was in the programs and the concern and the attention that we give to our noncollege-bound youth. We do pretty well at the college level. We don't do so well at the preschool and elementary level.

In the programs for noncollege-bound youth, we lag shamefully behind other developed countries. They put us to absolute shame. It's pitiful.

We had investigators going through the length and breadth of Europe. Scotland has incredible programs for noncollege-bound youth, as do Germany, France, Italy, Hong Kong and Singapore.

In Singapore, they have several institutes on computer sciences for noncollege-bound youth. They have the most sophisticated, state-of-the-art, computerized machinery, which the kids are going to have to cope with when they get a job.

We have virtually nothing corresponding to that. We're very derelict in the way we help noncollege-bound youth cope with the technology that's already out there. And one thing that we don't do at all that they do abroad is to help phase kids in an easy transition from the world of education to the world of work—summer apprenticeships, plant managers going into the school and teaching shop, and heads of the shop or industrial arts department working for 6 months or a year in a plant so that the school knows what's relevant and what's needed. I can't emphasize the importance of our doing a far better job than we're doing now for our noncollege-bound youth.

Chairman Greenspan, let me refer to a comment you made on the last page of your testimony, that the Congress can help by adopting a budget that's geared to the longer run needs of the economy, and maintaining a commitment to the elimination of the structural deficit over the years.

Can I ask you what you mean by the elimination of the structural deficit? Do you mean on the spending side, the entitlement programs? Do you mean on the income side or tax rates?

What lessons do we have to learn from the fact that not only are our tax rates for both personal and corporate income at a 50-year low point, but that in terms of what other industrialized countries' demand of their citizens—the OECD has just completed a report, in terms of total tax rates at the federal, State, local, municipal, village level—we are at the bottom of all of the industrialized countries of the world, tying with Greece.

Is there a lesson in that? Can you look at the various elements on the two sides of the equation—spending and income—and tell us where you think we ought to address the problem?

Mr. GREENSPAN. Congressman, what I meant by the structural deficit, in just very rough terms, is what a current services budget deficit would be at reasonably high levels of employment.

Senator SARBANES. What's the definition of reasonably high level of employment?

Mr. GREENSPAN. This is what economists call, as you know, Mr. Chairman, the NAIRU; that is, the noninflation accelerating rate of unemployment

which is consistent with stability. And that number most economists are projecting is in the low 5 percent area at this point.

What I'm referring to when I mention the structural deficit disappearing is that over the long run, the current services budget, on the assumption that we have a level of unemployment in that particular area, vanishes.

As you know, existing estimates, even in that context, do not vanish. They used to. This is the first time in a very long time that I can recall when projections of the existing current services budget have stalled out at less than budget balance or surplus. And I find that really quite disturbing.

Representative SCHEUER. I guess we didn't get around to answering my question.

Mr. GREENSPAN. I'm sorry.

Representative SCHEUER. What do you think the Congress ought to do in the way of addressing income and expenditures? Are there specific programs that you would look at? Do we have any lessons to learn from what the OECD tells us about how we make demands upon our citizens? From the long-term point of view, you say that we should adopt a budget for the long-term needs of the economy.

Mr. GREENSPAN. We've been over these grounds for year-upon-year. You may recall, Congressman, there was a budget commission several years ago.

I'm not sure that the issue at this particular stage really rests on specific programs. We first have to create the political will to do it because the differences between the various different proposals, frankly, are not that important. Some are better than others. I would argue strenuously for one versus another, but it really doesn't matter all that much.

What matters is a commitment to basically remove this long-term inflationary bias from the system, because I think it is undercutting the capability of our achieving growth in productivity and growth in standards of living that we had been discussing earlier.

Representative SCHEUER. Thank you, Mr. Chairman.

Senator SARBANES. Congressman Fish.

Representative FISH. Thank you, Mr. Chairman.

I wonder, Mr. Greenspan, if I could ask you a question about the recent General Motors announcement of its retrenchment of the beginnings of downsizing significantly.

I think within a week after the initial announcement that a number of plants across the country were going to be closed in the next few years, General Motors announced a joint venture with Poland. My recollection is there was some $300 million to produce, I think, 35,000 Opal Astors in Poland.

This doesn't anywhere near compare with the production and plants that are being closed in the United States, or the amount of money is way over what would be necessary to take whatever steps are needed to make a given plant in the United States more efficient and productive.

I just wonder whether you had any comment on this with respect to interest rates, or with respect to policies of the United States government—monetary or fiscal—that could justify this action by General Motors, or, in turn, actions we might take that would help reverse this decision.

Mr. GREENSPAN. We're all chagrined at the status of this extraordinary corporation. I, frankly, don't remember a time when Willow Run was not a major American industrial facility. I remember it as a major defense contractor during World War II, and it was one of the most famous plants that existed in this country.

We're all of the opinion that a viable institution such as General Motors is important to the vitality of the country. Anything that they can do which they perceive to enhance the value of the firm, which is a corporate worldwide organization, is something that historically America has supported. That is, we have supported extensive increases in investment abroad to enhance the viability of American corporations, which in turn, has enabled them to create jobs in this country and to create a much higher standard of living than exists anywhere else in the world.

There is obviously a legitimate discussion about whether choices should be made about investing abroad or investing here, and there's legitimate questions about judgments in certain particular instances that I frankly don't have the capability to finetune.

But as a matter of principle, I would certainly be favorably disposed to supporting American investments abroad that are productive and will enhance the viability of American business.

Representative FISH. I thank you, Mr. Chairman.

Senator SARBANES. Well, Mr. Chairman, we thank you very much for your testimony. We appreciate your appearing before the Committee.

The Committee stands adjourned.

[Whereupon, at 11:55 a.m., the Committee adjourned, subject to the call of the Chair.]