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**THE 1992
JOINT ECONOMIC REPORT**

REPORT

OF THE

**JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES**

ON THE

**1992 ECONOMIC REPORT
OF THE PRESIDENT**

TOGETHER WITH

MINORITY AND ADDITIONAL VIEWS



MARCH 31 (legislative day, MARCH 26), 1992.—Ordered to be printed

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LETTER OF TRANSMITTAL

March 31, 1992.

Hon. George J. Mitchell,
Majority Leader, U.S. Senate,
Washington, D.C.

DEAR MR. LEADER: Pursuant to the requirements of the Employment Act of 1946, as amended, I hereby transmit the 1992 Joint Economic Report. The analyses and conclusions of this Report are to assist the several Committees of the Congress and its Members as they deal with economic issues and legislation pertaining thereto.

Sincerely,

Paul S. Sarbanes, *Chairman.*

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**THE 1992 JOINT ECONOMIC REPORT ON THE 1992
ECONOMIC REPORT OF THE PRESIDENT**

MARCH 31 (legislative day, MARCH 26), 1992.—Ordered to be printed

**MR. SARBANES, from the Joint Economic Committee,
submitted the following**

REPORT

together with

MINORITY AND ADDITIONAL VIEWS

Executive Summary

1992 JOINT ECONOMIC COMMITTEE ANNUAL REPORT

The Committee finds compelling evidence that the American economy has gone badly off track and that, under present policies, neither the short-run nor the long-run outlook for the economy is particularly encouraging.

In its FY93 Budget and the *1992 Economic Report of the President*, the Administration projects the weakest recovery on record and lays out a scenario for the future in which the economy operates at far below its potential for many years. This is a very disturbing change from previous Administration reports and represents an admission that even their own policies offer little prospect for achieving strong, sustainable growth.

The Committee believes that we should not, as a nation, lower our sights and accept the economic future that the Administration has in mind for us.

America today faces a double economic challenge. First, we must revive economic growth to close the gap between actual and potential growth as soon as possible. Second, we need to take steps to ensure more vigorous long-term growth.

The recession has brought into stark relief many of the problems built up over more than a decade. Chapter I of this report provides extensive evidence that the foundations of American prosperity have been allowed to decay. As the *Economic Report of the President* points out, the best single indicator of an economy's performance is the rate at which productivity—real output per hour of work—is growing. Unfortunately, the *Report* shows that productivity growth is inadequate either to provide a rising standard of living or to maintain our position in the global economy.

Other basic indicators, such as the rate of investment and the competitiveness of American firms in international markets—which directly

affect the quality of jobs for American workers—have also been disappointing. The economic growth of the 1980s was powered by an enormous increase in debt by all sectors of the economy, not by improved economic fundamentals.

The benefits of growth in the 1980s were also distributed very unequally. Chapter II reviews the evidence on wages and finds clear proof that pay either stagnated or declined for the vast majority of American workers over the past decade.

Average family incomes have risen somewhat more than individual wages because families are working longer hours. In addition, "averages" are quite misleading given the unequal distribution of income. The vast majority of income gains have gone to families at the very top end of the income distribution. Tax policy, which once helped reduce income disparities, now contributes to them, with the largest benefits going to the top 1 percent of families.

For much of the 1980s, massive borrowing sustained economic growth. After 1988, however, economic growth slowed to a crawl, and the economy tipped into recession in the summer of 1990. Chapter III shows that the current recession is part of a pattern of deteriorating economic performance lasting over three years—the longest period of sub-par performance in the entire postwar period. The substantial "overhang" of problems left over from the 1980s—empty office buildings; debt-laden corporations; bankrupt financial institutions; and severely constrained federal, state and local governments—will make for painfully slow growth during the 1990s.

Chapter IV makes the case for a number of policy changes which would help ignite a quicker recovery from the current recession. Further monetary ease, combined with a different approach to debt management by the Treasury, should help lower both short-term and long-term interest rates. Long overdue reforms in unemployment insurance could restore the ability of this program to replace income lost in a recession and bolster the recovery process. Assistance to state and local governments would enable them to contribute to growth rather than impeding it by raising taxes and cutting spending. Finally, a concerted international effort on behalf of world growth is urgently needed.

It is equally important to work toward improvements in the long-term growth path for the economy. Chapter V addresses the changes in policy needed to restore the economic foundations for growth. All economic

actors have roles to play, and, for its part, government needs to refocus on the long term, which means dramatically increasing the priority placed on investment.

Government has two kinds of responsibility: to facilitate private investment and to undertake directly the kinds of public investment that are the necessary complements to expanded economic activity and enhanced efficiency in the private sector. The Federal Government can provide a more supportive climate for private investment through deficit reduction, an effective trade policy, and enhanced support for private research and development. Governments at all levels also need to undertake the kinds of needed public investments in infrastructure, education and training, and R&D, which have been neglected over the past decade.

This will require large sums of money, and the Federal Government, while constrained by the deficit, is not immobilized. The end of the Cold War should permit a substantial shifting of resources from military spending into domestic investment needs. The principle obstacle to mobilizing the "peace dividend" is the artificial "wall" separating domestic from military spending. Removing this artificial barrier could unlock substantial resources for a renewed commitment to public investment, as well as for deficit reduction.

The challenge for economic policy is to ensure that the transfer minimizes economic disruption, while building a strong foundation for growth in the future.

America has faced similar challenges in the past, adjusting to rapid build-downs of military spending following World War II, Korea, and Vietnam. In both of the latter instances, the defense cutbacks were accompanied by recessions far more serious than the brief downturn of 1945 and by relatively weak recoveries. A basic difference between these three periods was the attitude of government toward using military resources to strengthen the economy. In 1944, the Administration presented a full legislative agenda designed to convert resources and maintain incomes. By contrast, in the other two periods, the Administration opposed government action, letting the market adjust on its own.

We recognize the lessons of the past, and strongly endorse the concept of a Marshall Plan for America, with the active commitment of government to facilitate the conversion process through an economic strategy to shift from military to civilian production.

Chapter I

AN ECONOMY OFF TRACK

In examining a broad range of data on past and present performance, the Committee finds strong evidence that the American economy has gone badly off track in recent years. In a number of critical areas, performance was strong for more than two decades following World War II, but deteriorated markedly in the 1970s. During the 1980s, a period of economic expansion failed to reverse this deterioration, and instead added new structural problems to a troubled economy.

Evidence that the American economy is fundamentally off track can be found in many areas, but four stand out as the core of our problem: productivity, investment, competitiveness, and debt.

SLOW PRODUCTIVITY GROWTH

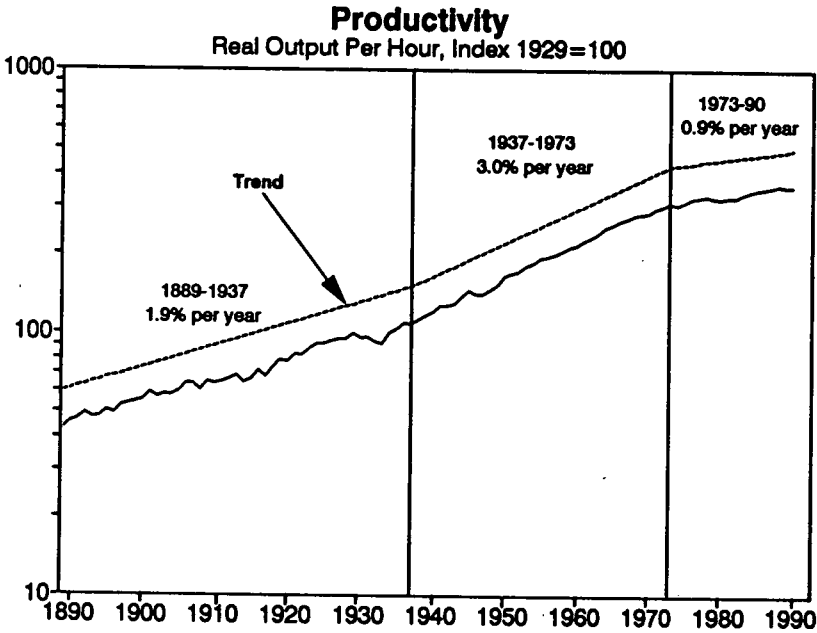
As this year's *Economic Report of the President* points out, the best single summary indicator of the performance of an economy is the rate at which productivity—real output per hour of work—is growing. While other measures of economic performance, such as GDP growth, can be increased simply by putting a larger fraction of the population into the labor force, and having each worker put in more hours of effort, the rate of productivity growth measures improvements in economic efficiency.

The Nation cannot be complacent about the fundamentals of economic growth and productivity. Quite simply, without adequate productivity growth, America's standard of living will neither keep pace with the expectations of our citizens nor remain the highest in the world.

[1992 *Economic Report of the President* p. 29]

Unfortunately, the *Economic Report* provides compelling evidence that recent productivity growth is inadequate either to meet the expectations of our citizens for a growing standard of living or to maintain our position in the global economy.

FIGURE 1



Source: *Economic Report of the President* (1992).

Figure 1—taken directly from this year's *Economic Report of the President*—shows the problem clearly. Fifty years of 1.9 percent average annual productivity growth from 1889 to 1937 was followed by nearly 40 years of 3 percent average annual growth, only to collapse to a mere 0.9 percent average annual growth rate in the years since 1973.

The meaning of this slowdown in productivity growth was described well by William Niskanen, former member of President Reagan's Council of Economic Advisers in testimony before the Committee:

At the prior rate of productivity growth, productivity and our potential standard of living doubled in 24 years. At the present rate, output per hour will double in about 72 years—a dramatic change in the rate at which the economic well-being of the American population will increase. If the productivity growth of the quarter century from 1948 to 1973 had continued to date, real GNP now would be 40 percent higher than it is.

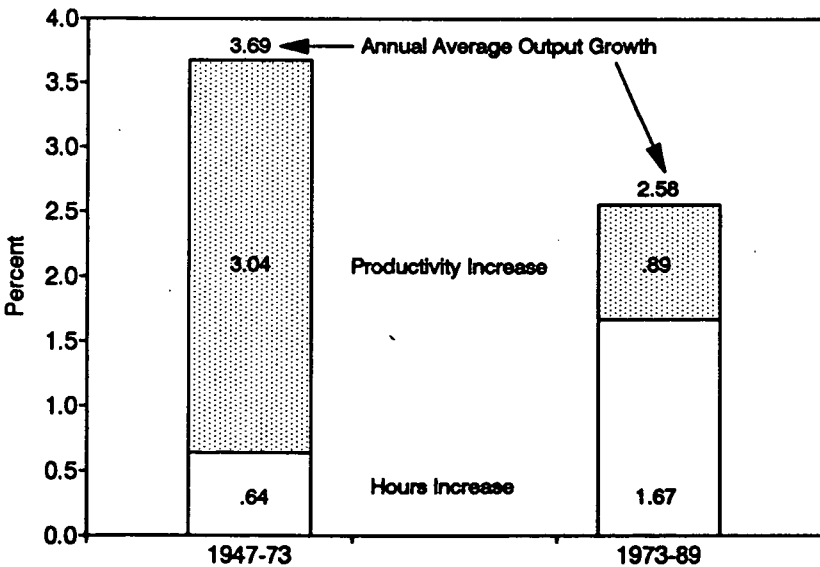
One major result of slow productivity growth is that Americans now need to work longer to produce any given increase in overall output. Figure 2 looks at average annual rates of growth in total output from the private business sector in two periods: 1947-1973 and 1973-1989.

The figure shows two important facts. First, the overall annual rate of growth has slowed from a 3.7 percent average in the first period to a 2.6 percent average in the second. More striking is the fact that increased hours of work accounted for the majority of increased output in the second period, while increased productivity was clearly the dominant factor in output growth in the first. Prior to 1973, Americans achieved increased output largely by "working smarter." Today, the mechanism of growth is simply to work longer.

America's prolonged productivity slump represents an indictment of both economic policy in the public sector and economic performance in the private sector. Rather than confront the unpleasant facts about our productivity problem, many have sought refuge in explanations which minimize the significance of the problem. Two of these deserve closer examination.

FIGURE 2

Working Longer, Not Smarter
Contributions to Annual Output Growth



Source: Congressional Budget Office.

The first is the fact that, while overall productivity growth in the U.S. economy has been disappointing, the manufacturing sector has achieved significantly higher rates of growth in productivity. This suggests to some that our overall productivity problem is largely one of measuring productivity in a service economy.

While measured productivity growth in manufacturing in the United States has been stronger than overall productivity, U.S. manufacturing continues to post lower growth rates than the manufacturing sector in a number of our major competitors. As William Niskanen told the Committee:

In manufacturing, productivity growth was unusually high in the United States in the 1980s; in fact, higher than in the prior period. For all that, that was about midway among the industrial countries, exceeded by Korea, Taiwan, Japan, Britain, and even Italy.

There are also serious questions about whether U.S. statistics on manufacturing overstate productivity gains in the computer sector, and whether they accurately capture the increasing practice of contracting out functions to "service" firms.

There is also some concern about the method by which U.S. manufacturing firms increased measured productivity. Instead of expanding productive capacity by refitting factories with more modern and productive equipment, U.S. manufacturing derived a large share of its improved productivity growth from shrinking capacity and closing factories. By taking older plants out of production, U.S. manufacturing raised overall productivity, but at the cost of a smaller industrial base. This approach to raising productivity has meant that a significant share of total domestic demand for manufactured goods has been supplied by imports, since domestic capacity was scrapped rather than expanded.

Richard Belous of the National Planning Association described this approach toward productivity growth in the following words:

Essentially in the 1980s we raised manufacturing productivity by downsizing blue-collar workers. The productivity gains that we have seen in manufacturing have not come because of an extraordinary burst of capital formation, it has happened because of a fantastic downsizing of workers.

The second argument for complacency is that the productivity slowdown is a worldwide phenomenon, not confined to the United States. It is certainly true that other countries have experienced a similar slowdown in productivity growth, but Professor Robert Gordon of Northwestern University warned the Committee that the American experience was significantly different from that of our major competitors.

For all major countries, productivity growth was especially strong from 1948 to 1973, then slowed perceptibly in the 1970s and 1980s. But in every country except the United States, Gordon found that the rate of productivity growth during the 1980s exceeded the rate of growth for the preceding century. Only the United States was unable to increase the productivity growth rate from that prevailing in the past century. (See Table 1).

TABLE 1
A LONGER LOOK AT LABOR PRODUCTIVITY

	Japan	Europe	United States
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

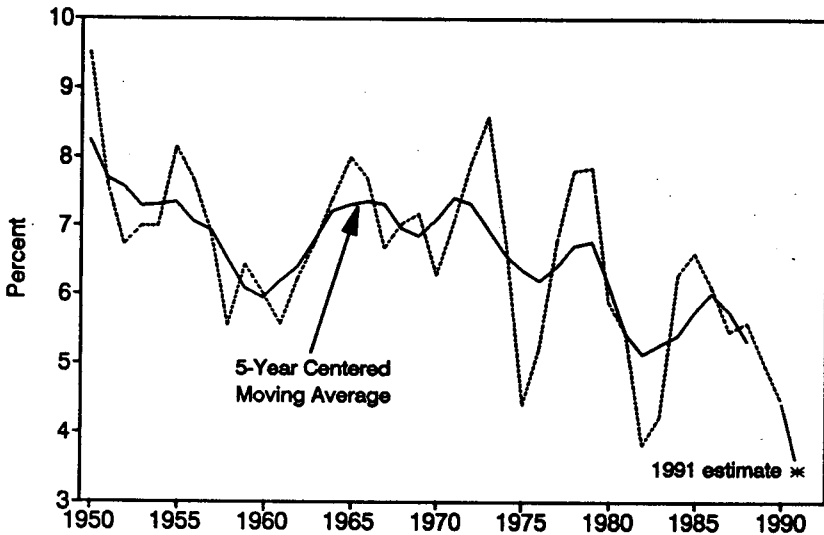
Source: Robert Gordon, Northwestern University

INADEQUATE INVESTMENT

Productivity is closely tied to investment, since healthy productivity growth requires a steady improvement both in the skills of the work force and the machinery with which they work. Unfortunately, recent U.S. investment experience has been disappointing in two aspects: low relative to our own past, and low relative to the investment performance of other countries.

FIGURE 3

Net Private Nonresidential Investment As a Share of Net National Product



Source: Department of Commerce, Bureau of Economic Analysis.

Private Investment in Physical Capital. Figure 3 shows the performance of private nonresidential investment in the American economy since World War II. It measures annual net nonresidential private-sector investment (after subtracting depreciation) as a share of net national product. Net investment represents each year's addition to the Nation's stock of productive capital. Since the early 1970s, this indicator has been on a downward trend. There have been periods when this indicator has grown strongly, but each such growth spurt has topped out at a lower fraction of net product.

It is important to note that this steady downward trend in net private investment continued during the 1980s, at a time when extraordinary public policy efforts were made to encourage business investment through tax subsidies and deregulation. As Professor Paul Krugman of MIT pointed out to the Committee:

During the decade of supply-side economic policies, when tax changes, regulatory changes, everything possible was done to provide a pro-business, pro-investment climate, a time when all sort of policies were rationalized on the grounds that they would lead to greater incentives, greater 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.

Figure 3 shows that the investment performance of American industry has declined relative to our own history, suggesting that we might be content merely to recover the investment levels of the early postwar period. But American investment performance has always been low relative to other countries, and even a return to the investment performance of the 1960s would still leave a considerable investment gap between us and the rest of the world. As this year's *Economic Report of the President* points out:

Among major industrialized countries, the United States had the lowest investment rate and the lowest rate of productivity growth in recent decades. According to a recent OECD survey, 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. Between 1950 and 1979, the United States had the lowest rate of growth of capital per worker among the "group of seven" industrial countries (the others being Canada, France, Germany, Italy, Japan, and the United Kingdom). In 1979 the U.S. capital stock was estimated to be 73 percent older than Japan's. [p. 93]

As the quotation suggests, 1979 is the last year for which we have comparable data on the relative age of the capital stock. Yet gross investment trends suggest strongly that the "capital gap" between the United States and other major countries has grown steadily throughout the 1980s.

As a nation, we systematically invest 5 to 7 percent less of our GDP than do our major economic competitors. In a competitive world, the consequences of such underinvestment are an inevitable decline in relative living standards, an erosion of technological advantage in a broad range of industries, and diminished work opportunities for our citizens.

The data in both of these figures define "investment" very broadly. A closer look at the details of investment in the United States reveals an even more troubling pattern in the qualitative composition of investment in this country.

What matters for long-term economic growth is the rate of increase in the productive capital stock—the plant and equipment with which workers labor to produce GDP. In the United States, however, a large fraction of total investment in the 1980s went into areas whose contribution to productivity is, at best, questionable.

During the 1980s, an unusually large fraction of total investment went into commercial real estate. Generous treatment by the tax code and a rush of capital into this sector, following the deregulation of the financial system, were responsible for an increase in commercial building from 21 percent of total private investment in nonresidential structures in 1977 to over 38 percent in 1985.

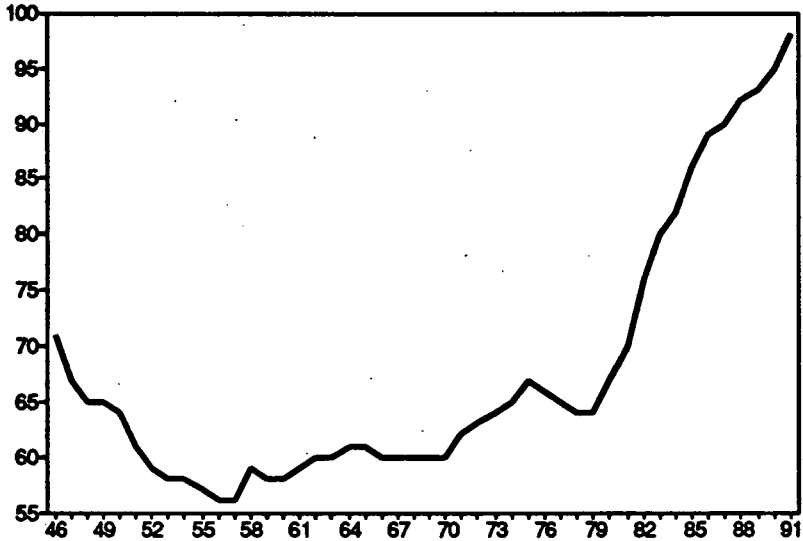
Commercial real estate obviously makes some contribution to national growth: offices are in a sense the "capital" with which service-sector workers produce output. But the evidence is quite compelling that a large fraction of real estate investment has created excess space which no one is using.

Figure 4 provides one measure of excess in commercial building. It shows that the available office space per service-sector employee rose to unprecedented heights during the 1980s. It is but one measure of the "overhang" of excessive building which took place in the 1980s, an overhang which is likely to take years to work off.

American investment in equipment, on the other hand, has lagged badly during the 1980s. A recent comparative study by two Harvard economists, J. Bradford De Long and Lawrence H. Summers, finds a strong link between investment in durable equipment and national economic growth: each 1 percent of gross domestic product (GDP) invested in equipment causes GDP to increase by one-third of a percentage point per year. This is a much stronger association than that between economic growth and any other component of investment, according to the study.

FIGURE 4

Service Sector Office Space Square Feet Per Employee



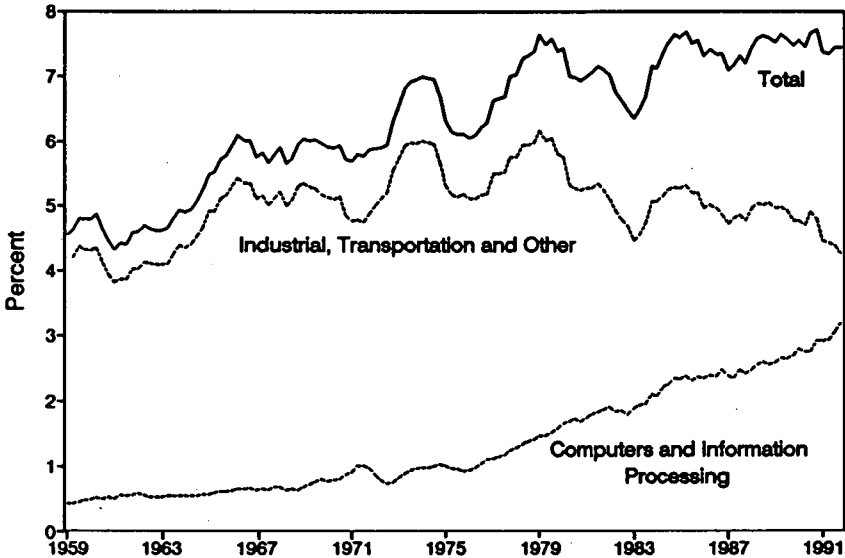
Source: Federal Reserve Bank of New York.

By this calculation, business investment in equipment has failed to increase the U.S. growth rate since the mid-1970s. Figure 5 shows two important trends in U.S. equipment investment. First, equipment investment was on a steady upward trend as a share of GDP until the mid-1970s. After that time, equipment investment as a share of GDP remained essentially unchanged, despite considerable variation over the business cycle. Equipment investment today is no higher as a share of GDP than it was in 1979.

But the figure also shows a disturbing trend in the composition of equipment investment. Since the mid-1970s, the only component of business equipment investment showing an increase as a share of GDP was investment in computers, and information processing equipment. All other types of investment, including industrial and transportation equipment, showed a decline as a share of GDP over the period.

FIGURE 5

Investment in Equipment As a Share of GDP



Source: Department of Commerce, National Income and Product Accounts.

While rising investments in computers and communications equipment may indeed have helped productivity growth in some sectors, some economists have questioned whether much of this investment has been productive. In contrast, there is broad agreement that investment in industrial equipment enhances overall productivity growth, and a concern about the failure of this important category to grow during the 1980s.

In comparative terms, U.S. investment in plant and equipment is clearly inadequate. According to estimates by DRI, Japan in 1989 spent more in dollar terms on plant and equipment than did the United States—\$628 billion compared to \$520 billion for the United States. That is particularly striking because the Japanese economy is only about half the size of ours.

As a result of much higher capital spending levels, the level of technological modernization in Japanese firms is significantly higher than among U.S. firms.

- In developing new products and processes, Japanese firms devote almost double the share of total project costs to tooling and equipment than American firms.
- Japan now uses numerically controlled machine tools at 1.5 times the U.S. rate: 27 per thousand manufacturing workers, compared with 18 per thousand workers in the United States.
- Japan also employs about seven times as many industrial robots per thousand workers as does the United States. West Germany, Sweden, and several other countries have higher robot densities than the United States.
- Ninety-three percent of Japanese steel is continuously cast; the comparable figure for the United States is 60 percent.

Taken together, the investment trends of the 1980s suggest a pattern that is clearly inadequate in the aggregate, and distributed in ways that do not achieve the fastest possible rate of growth in the productivity of the economy. One of the country's leading experts on investment and productivity, Professor Robert Gordon of Northwestern University, told the Committee:

The investment boom of the 1980s 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 makes possible such social annoyances as telemarketing.

Investment in Research. In many industries, investment in research and development holds greater promise for productivity increases than investment in plant and equipment. Despite its importance, it has become clear during the 1980s that American firms are not maintaining a pace of investment in research and development, which is up to the challenge set by our international competitors.

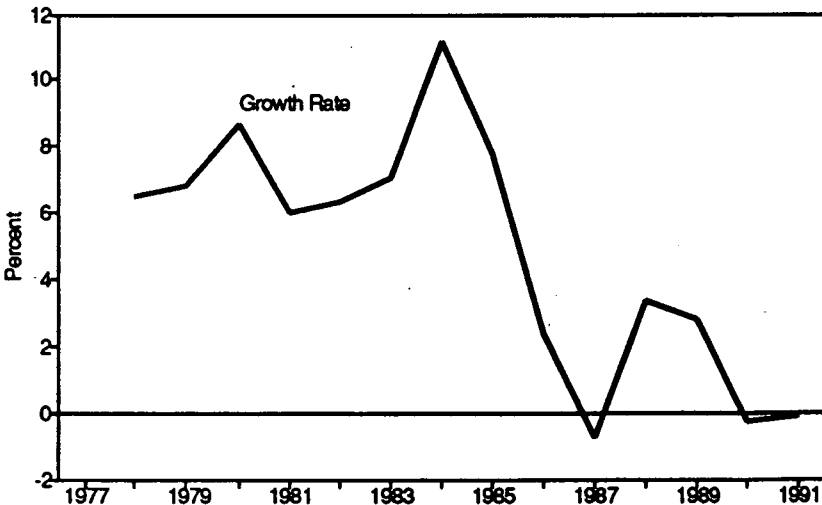
In 1990, American firms spent an estimated \$73 billion on R&D, slightly less in real terms than the \$70.2 billion invested in 1989. Since 1986, real growth rates in industry-financed R&D have been below 3.5 percent, and the picture for the early 1990s looks, if anything, worse: NSF projects that industry investment in R&D for 1991 will not even keep up with inflation. (See Figure 6).

This pattern of declining R&D growth rates stands in sharp contrast to the pattern prevailing in Japan. Japanese industry's spending on R&D decelerated sharply in 1986 and 1987 but then rebounded. With the exception of those two years, private investment in R&D in Japan has grown at double-digit rates since 1977.

Given these trends, technology analysts have known that it was just a matter of time until Japanese industry outspent the United States, despite the fact that Japan's economy is only about half the size of ours. Some recent data suggest that this moment may have already arrived.

FIGURE 6

Company Funded Research and Development
In 1982 Dollars



Source: National Science Foundation.

In 1989, Japanese firms spent between 8.5 trillion and 9.6 trillion yen on research and development. (The range reflects two different estimates of the percent of total Japanese R&D financed by industry. The Japan Economic Institute says it's about 81 percent; NSF estimates 72 percent.) At the 1989 market exchange rate of 135 yen to the dollar, that's equivalent to between \$63 billion and \$70 billion. Preliminary estimates for 1990 suggest that total spending by Japanese industry on research and development may reach 10.72 trillion yen (\$80 billion at current exchange rates.)

Some have sought to minimize the significance of Japan's research and development effort by questioning the use of market exchange rates as the proper mechanism for making international comparisons of research spending. While this may be an interesting theoretical issue, it diverts attention from the important truth that Japanese firms are maintaining a high rate of growth in research spending, while research spending in the United States seems headed for a contraction.

Cost-cutting by U.S. industry appears to be the major reason for this slowdown in research and development spending. While it may make sense for corporations to trim costs in the short run, the long-term consequences are likely to be negative. As *Business Week* put it in its annual survey of R&D spending:

Corporate America, bedeviled by Japanese manufacturing wizardry and numbed by the recession, is squinting so hard at cost-cutting and tiny improvements in existing processes that it's in danger of missing the big picture.

Investment in People. Most discussions of investment focus primarily on growth of the physical capital stock and the technology base of the economy. Recent work on the theory of economic growth suggests, however, that a preoccupation with physical capital investment may not hold the key to restoring overall productivity growth. "Human capital"—the skills and knowledge of workers—is turning out to be a more profound influence on national productivity growth than expansion of physical capital alone.

Statistics on the U.S. labor force suggest strongly that neither the public nor the private sector is making the kinds of investments in human resources that are required for a high-growth economy.

Our weak human resource performance involves both formal schooling and workplace training. At the most basic level, United States lags most of its major international competitors in terms of the percent of children enrolled in pre-primary education. Data published by the OECD include the following percentages of enrollment for four-year-olds:

TABLE 2
PRE-PRIMARY ENROLLMENT
(1987 data, except 1986 for Italy)

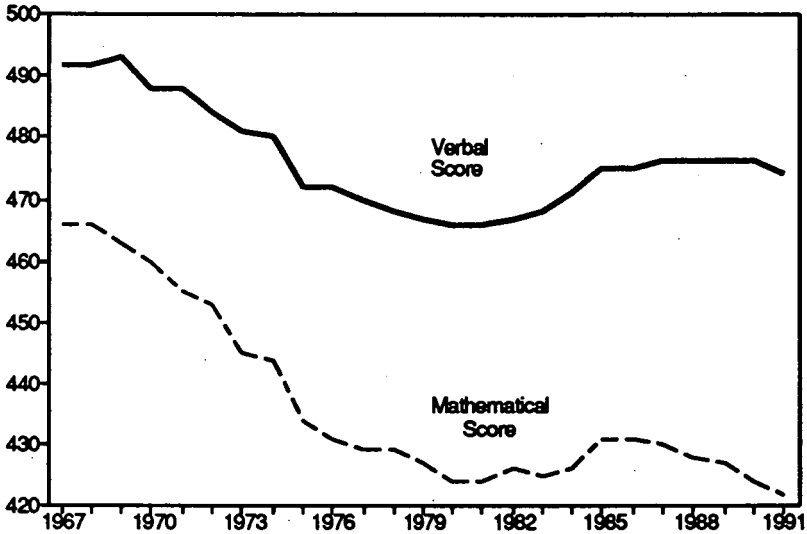
	Percent of Enrollment for 4-year-olds
France	100.0
Italy	86.8
Germany	71.6
United Kingdom	69.2
Japan	54.6
United States	49.0
Canada	41.4

Source: *The OECD Observer*, February/March 1991, p. 40.

While it is difficult to measure the performance of educational institutions directly, several different measures suggest that our system of formal schooling—and secondary education in particular—is not up to international standards. The latest international comparative data show that, while the best American students compare favorably with the best students from other countries in a recently released assessment, the U.S. average scores for math and science at ages 9 and 13 lagged behind the averages of the top ranked countries. Scores on our own SAT tests have improved slightly in the 1980s after a precipitous fall, but progress appears to have stopped for the past several years. (See Figure 7). Michael Peevey, the CEO of Southern California Edison, told the Committee that "only about 20 percent of the people who apply for entry-level jobs are able to pass our tests."

FIGURE 7

SAT Averages for College-Bound High School Seniors



Source: The College Board.

But it is not simply test scores that are at issue. In comparison with many other countries, our "school-to-work" transition is haphazard and less effective. Problems lie both with the secondary school system and with the indifference of a large majority of employers. Schools could do a better job of providing work-related training, especially for the non college-bound. Employers rarely show direct interest in or work closely with schools either to convey the importance of school work or to link it to employment requirements. As Princeton Professor Alan Blinder told the Committee:

But I think one of the fundamental problems we have in getting the school system to work better is that, in some sense, the employers don't care. How well you do in school may have very little to do with where you wind up working, and the kids know that.

This is certainly not the case in countries as diverse as Japan, Sweden, or Germany. An important part of the hiring process in Japan, for example, revolves around the tight relations employers have with schools at all

levels. In Germany, a majority of secondary school students are involved directly with potential employers through an elaborate "dual system" of vocational education and workplace training.

Turning to post-secondary education, on the other hand, it would appear that the United States leads all other nations. According to an OECD study, in 1987-88 the proportion of employed persons with at least one university degree or 4+ years of college was fully 23.4 percent in the United States. This compares with 14.5 in Japan, 6.3 in Germany, and 11.1 in Sweden. Yet, despite a lower proportion of college graduates in these countries, in terms of most measurable indicators— wage growth, productivity growth, international competitiveness—it would appear that they have a more effective system for steadily increasing the skills and productivity of their work force.

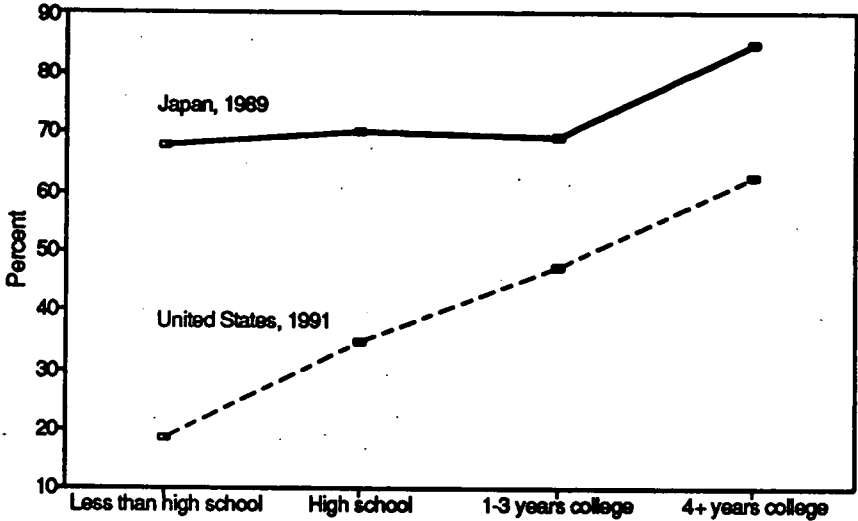
A critical problem is that U.S. companies, on average, appear to put much less effort in training workers, and have work organizations where less skill is demanded. Given the fact that 3 out of 4 members of our projected work force in the year 2000 are already in the labor force, this lack of work-place training is a serious impediment to productivity growth.

Figure 8 shows a considerable training gap between U.S. firms, compared with their Japanese competitors, with the gap widest among workers with only a high school education. Japanese high school graduates were more likely to have received some training from their firms than even college educated U.S. workers.

Enterprises in other countries seem considerably more likely to engage in training their workers and to organize work to take advantage of the skills thus learned. Japanese firms, and not just the large ones, invest heavily in training. A 1989 Survey on Vocational Training in Japanese private enterprises showed that enterprises had given formal off-the-job training to over 60 percent of their new hires coming directly from school. The German "dual system" of apprenticeships, which lead to certifiable and recognized skills under the watchful eye of strong employer organizations, strong unions, and government, also seems to succeed in providing initial occupational skills, which lay the basis for still further skill acquisition.

FIGURE 8

Share of Employees Trained By Their Enterprise



Sources: Human Resources Development Bureau, Ministry of Labor, Tokyo, *1989 Survey on Vocational Training in Private Enterprises*; U.S. Bureau of the Census, *Current Population Survey*.

While many factors contribute to our relative neglect of work-place training, a central one appears to be the attitude of management toward their workers. Compared with German or Japanese ones, many more American firms operate on a "hire and fire" model of labor relations. Such a model is considerably less conducive to skill development, on either the part of managers or employees, than is a system more geared to long-term employment relations.

With their long-term commitments to workers, many more Japanese, German, or Swedish firms are more likely to respond to changes in demand and technology by retraining and business diversification than by layoffs, though layoffs certainly do occur. The benefits of employment security go beyond training incentives. If companies face a high cost of firing, there is a clear incentive to continually look to innovate to avoid layoffs. And empirical evidence is accumulating that a skilled work force in a work environment capable of making use of those skills pays off in higher productivity.

This reality is slowly gaining ground among the managers of American companies. A recent issue of *FORTUNE* pointed out the realities of today's work force:

With fewer young people entering the job market in the 1990s, U.S. companies must also do more to make the work force they already have as productive as possible. Right now, they budget far less for training than overseas competitors, and 68 percent of what they do spend goes to further schooling for college grads—managers, technicals, professionals and supervisors—though the problem (and the opportunity) lies in training craftsmen and production workers.

Public Investment. The final area of investment critical to overall growth in productivity is public investment. Public investment can be defined either narrowly or broadly. The narrow definition includes only traditional public works—the roads, ports, sewers, bridges, and public buildings constructed by federal, state and local governments. The broader definition also includes investment in human and intellectual capital through education, training and public support for research and development.

Even using the narrow definition, the contribution of public investment to the overall economy is quite substantial. According to the *1990 Economic Report of the President*:

Roughly one-quarter of the capital stock of the United States is owned by Federal, State, and local Governments. It is typical for discussions of investment behavior to focus on business investment, but Government capital accumulation can also affect growth. Because the value of its product is not revealed through market transactions, the role of Government capital in supporting the economy is sometimes under-appreciated. But inadequate Government infrastructure can impede improvements in productivity growth. [*1990 Economic Report of the President*]

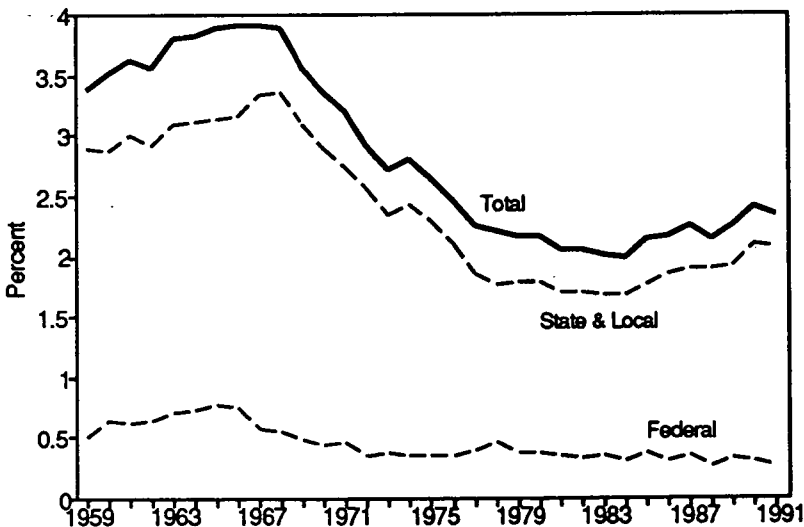
And inadequate public investment is precisely what we have been experiencing. During the 1950s and 1960s, U.S. governments at all levels were heavy investors in physical infrastructure. At the peak of investment activity in the late 1960s, federal, state and local government investment in infrastructure amounted to almost 4 percent of gross domestic product, according to recently released Commerce Department data. Net public investment—government investment above the amount needed to offset the wear and tear on existing infrastructure—was almost 2.5 percent of GDP.

This period of high government investment was followed by two decades of drought. By the early 1980s, gross government capital investment had fallen to just over 2 percent of GDP, half the previous level, while net investment had fallen to less than 0.5 percent of GDP. The amount of investment by governments in the United States was barely enough to offset the annual depreciation on existing infrastructure. Recently, there has been a modest increase in public investment by state and local governments. Federal investment in infrastructure, however, continued to decline throughout the 1980s as the Reagan-Bush Administration sought to channel Federal resources into defense spending and tax cuts for the wealthy. As a result, the overall level of government investment is still well below its 1968 peak (see Figure 9).

The decline in public investment since the late 1960s is harming the competitiveness of American industry. The investment American business makes each year in new factories, equipment, technology, and training is only one component of competitiveness, albeit a very important one. The network of public infrastructure, which ties the American economy

FIGURE 9

Investment in Physical Infrastructure As A Share of GDP



Source: U.S. Department of Commerce.

together, is also an essential component. Without adequate roads, bridges, airports, harbors, water and sewer systems, and schools, business costs would soar and the economy would crumble. Inadequate public investment is also harming the quality of life in many of our states, as illustrated by the case of California (see box).

During the 1950s and 1960s, the efficiency of private capital was enhanced by the growing volume of public capital; by the mid-1960s, each dollar of private capital was supplemented by almost 60 cents of public capital, measured in 1987 dollars. Today, by contrast, each dollar of private capital is supplemented by only 43 cents of public capital, a decline of almost one-third during the last quarter century.

The amount of public capital per private-industry worker has also declined significantly, from \$33,000 per worker (in 1987 dollars) in 1975 to \$29,000 per worker today.

Statistical studies have shown a close correlation between public capital per worker and national rates of productivity growth. Such a statistical connection should not be surprising: deteriorating roads lead to increased vehicle maintenance costs, and air traffic delays produce missed meetings and wasted time. There is a more direct connection between private-sector productivity and public investment in education. Unskilled workers cannot master the complex processes that characterize best-practice manufacturing techniques.

THE PUBLIC INVESTMENT PROBLEM IN CALIFORNIA

In the late 1940s, 1950s, and 1960s, California made massive investments in public education, transportation, the State water plan and other basic systems. California has benefitted enormously from that investment. Its higher education system—the community colleges, State universities, and the University of California—were viewed nationally as the model to be followed by others. This tripartite system provided everyone with a high school diploma the opportunity for a higher education and, hence, greater economic opportunity.

Today, this is changing. California's primary and secondary education system ranks among the lowest in the Nation in per-pupil expenditures. This translates into overcrowded classrooms and inadequate material support. At the higher educational level, high school graduates no longer are assured they can enter a community college or public university and often, if they do, they cannot take the classes they wish.

Also, today the physical infrastructure of California is either cracked or breaking. Regular media reports note a deteriorating quality of life, pollution, water shortages, unaffordable housing, traffic congestion and freeway gridlock, and beleaguered industries.

The very qualities of life that brought millions upon millions of people to California over the past 50 years are disappearing. Yet, the State's rapid population growth will continue.

Excerpt from the testimony of Michael Peevey, CEO, Southern California Edison

COMPETITIVENESS

A third area of concern relates to the competitiveness of the American economy. Over the past two decades, America has moved from a relatively autonomous economy to one highly integrated into world trade and world markets. In 1959, exports and imports combined accounted for only 8.8 percent of U.S. GDP, a much lower percentage than for any other major country. By 1991, that figure had more than doubled to 22.6 percent of GDP.

Given the nature of modern technology, there is every reason to expect that the importance of trade for the American economy will continue to grow through the coming decades. For a whole range of products, particularly those which require massive new investments in capacity and technology, the effective market must be a global one.

For much of the 1980s, meeting the challenge of international competition posed serious problems for American industry. Partly as a result of poor macroeconomic policy, imports soared and exports stagnated during the first half of the 1980s, leading to significant job loss in sectors of the economy exposed to foreign competition. The sharp erosion of our trade balance and the consequent shift from a creditor to a debtor position in international markets gave rise to growing concern about the competitiveness of American industry.

After 1986, however, the U.S. trade deficit began to decline as export growth outpaced the growth in imports. This turnaround prompted some to conclude that American industry had solved the competitiveness problem.

While the turnaround in trade provides some welcome relief for industries exposed to international trade, the United States continues to run the world's largest trade deficits, and the competitiveness problem of American industry is far from solved.

The term "competitiveness" refers to the ability of an economy to generate a rising standard of living for its workers by producing goods and services for sale in international markets at prices which permit a steady increase in wages and profits for producers. As Admiral Inman notes in the adjacent box, "competitiveness" is really about the quality of jobs in an economy.

COMPETITIVENESS, JOBS AND THE FUTURE

When I retired in 1982 from my government service, after looking at a lot of options, I elected to get involved in creating a joint research venture created by competing companies in an industry because of their perception—not a government perception—that they were beginning to lose their competitive edge with regard to the Japanese.

For me the ultimate issue here is jobs. I listened to the macroeconomists say how wonderfully the country has benefitted from these cheap products of great quality and that overall the consumers benefitted. I accept that as valid and set it aside as essentially irrelevant when I think about my country and think about the standard of living that I hope my children and their friends will have.

I look at the period of 1982 to 1988 when we created 8.8 million new jobs in this country. Well, when you look more carefully, we actually created 10.4 million new jobs in what we loosely call the service sector, from investment bankers to fast food emporiums. We lost 1.2 million jobs in manufacturing and 400,000 in the extractive industries. Of the 1.6 million jobs lost, the average weekly wage was \$444. Of the 10.4 million created, the average weekly wage was \$272.

So, for a great many of our citizens who were working in the 1980s, their standard of living had declined, and that has been largely obscured because the economists look at household income, and increasingly indeed there were two adults working to keep that family income growing.

Well, I am absolutely persuaded that we are not only losing our competitive edge in many industries, not just a few, but that directly translates to jobs for American citizens, and unless we address these problems, that trend is indeed going to continue.

Excerpt from testimony of Admiral Bobby Inman

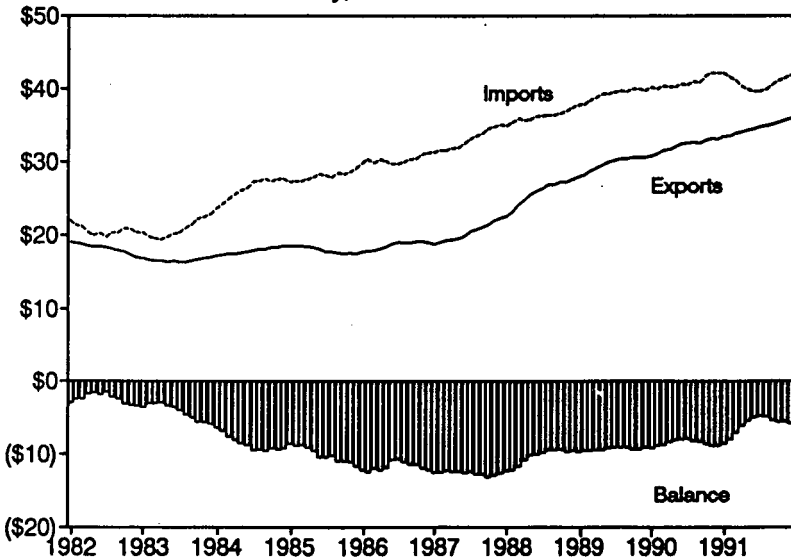
Because of this broad definition, it is a mistake to measure competitiveness simply by the trade balance. A nation's trade balance can improve for a number of reasons, some of which have little to do with its ability to generate a rising standard of living for its workers.

Figure 10 shows the recent performance of the U.S. merchandise trade balance. After a steep descent into deficit in the early 1980s, a turnaround is evident after 1985. For three years, export growth was very rapid and substantially exceeded the rate of growth in imports. After 1989, however, export growth slowed down and import growth picked up, slowing the rate of improvement in the trade balance. The recession brought about renewed improvement in the trade balance, largely through a collapse in imports which reflected the overall stagnation of purchases in the economy.

The improvement in the U.S. trade balance was driven by three principal factors, none of which reflect improved living standards in the United States. First, the dollar fell sharply against other currencies starting in

FIGURE 10

U.S. Merchandise Trade
Monthly, In Billions of Dollars



Source: Department of Commerce.

1985. This raised the price of imports into the United States and lowered the price of U.S. goods in foreign markets. While this boosted sales, it also lowered the purchasing power of U.S. workers relative to workers abroad. The Competitiveness Policy Council, an advisory panel created by the 1988 Trade act, explicitly rejected exchange-rate devaluation as a solution to our competitiveness problem.

The second reason for trade balance improvement is that the U.S. economy after 1985 grew at rates substantially slower than our major trading partners. This kept the rate of demand growth for all goods—including imports—below the rates in other countries, but it also meant that U.S. incomes were growing more slowly than incomes abroad.

Finally, as will be shown in the next chapter, the wages paid to U.S. production workers have continued to decline even as the trade balance has improved. A significant portion of the increased attractiveness of U.S. goods in international markets is accounted for by falling wages for U.S. workers. There is no reason to assume that this is a winning strategy for the U.S. economy over the long term.

Restoring the trade balance by lowering wages, depreciating the currency, and damping down the growth rate are unsatisfactory responses to the challenge of international competition. The United States must find a way to post a sustainable trade balance with a stable currency, high growth rates, and rising wages for our producers.

The United States cannot meet this objective by pursuing a low-wage growth strategy. There are simply too many potential producers in the world with wage rates a tiny fraction of our own to make such a strategy possible. Instead, the United States must compete in world markets as a producer of "premium" goods and services—those which permit firms to pay high and rising wages to their workers.

The key to capturing markets for "premium" goods is improved technology and enhanced productivity of workers. The United States must increase the production of new ideas, increase the rate at which new technologies are integrated into the production process, and increase the "human capital" of workers to make them more efficient users of new technology. Instead, available evidence suggests that U.S. firms continued to lag badly behind our foreign competitors during the 1980s.

With respect to technological innovation, several recent studies have concluded that U.S. industry is falling behind its international rivals. Evidence is mounting that U.S. prowess in technological innovation is slipping. Last year, a study by the Commerce Department looks at 12 emerging technologies that will be critical to future economic prosperity. The list includes such things as superconductors, biotechnology, optoelectronics, and high-performance computing. The study concluded that, in terms of trends (rather than current status) in world competition, the United States is "losing badly" to Japan in 4 of the 12 technologies, "losing" in 6, "holding" in 2, and "gaining" in none.

A more recent report by the Council on Competitiveness, a group of major private U.S. firms, re-emphasized the problem, saying: "The U.S. position in many critical technologies is slipping and, in some cases, has been lost altogether. Future trends are not encouraging."

One useful indicator of technological leadership is patents, yet Table 3 shows that U.S. firms have ceded ground to foreign competitors in patents granted in the United States. Foreign patent statistics show an even less impressive showing by U.S. firms.

TABLE 3
TOP PATENT WINNERS IN THE UNITED STATES

1980	1990
General Electric	Hitachi
Bayer	Toshiba
RCA	Canon
U.S. Navy	Mitsubishi
AT&T	General Electric
IBM	Fuji Foto
Hitachi	Eastman Kodak
Westinghouse Electric	Philips
Siemens	IBM
General Motors	Siemens

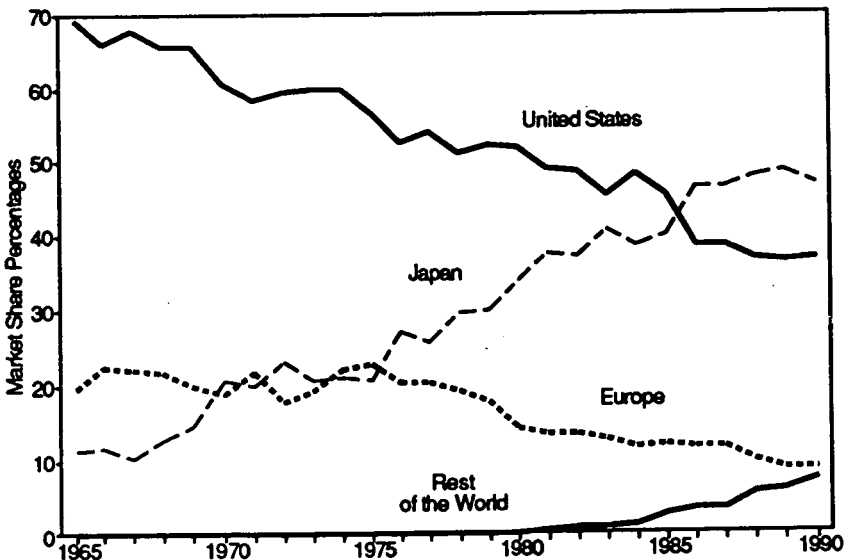
But the production of new technological knowledge is not the only key to improved competitiveness. Michael Dertouzos, the chairman of MIT's Commission on Industrial Productivity, recently summed it up. He said, "We value creativity and innovativeness, and we don't value production. But the money is not in invention, it's in production."

Evidence of the eroding U.S. competitive position in production can be found in data on the share of world markets for important products that is claimed by U.S.-based producers. Figure 11 shows the eroding market-share of U.S. producers in one critical area—semiconductors—but the story is similar in a number of other high value-added products.

It is important to recognize that a continuation of these trends in market share will eventually lead to the elimination of U.S. production of critical high-technology and high-value added goods, as the investments required to stay competitive can no longer be justified by the declining market share. Such an outcome would leave the United States without a strong base in the kinds of industries that are most likely to be able to pay high and rising wages to workers.

FIGURE 11

World Semiconductor Production by Region



Source: National Advisory Committee on Semiconductors.

DEBT: THE LEGACY OF SUPPLY-SIDE ECONOMICS

The problems of slow productivity, stagnant wages, inadequate investment, and diminished competitiveness are not new. They have been part of our economic landscape for some time, and were cited as reasons for the radical experiment in economic policy undertaken during the 1980s under the banner of "supply-side" economics.

The basic tenet of "supply-side" economics was that years of policy focus on aggregate demand had undermined the efficiency of the supply side of the economic equation. Proponents argued that with supply constrained by excessive regulation and burdensome taxation, attempts to stimulate demand would quickly confront inadequate productivity growth and turn into increased inflation rather than increased real output.

To deal with these structural problems, President Reagan adopted a version of supply side economics which emphasized four elements: substantial cuts in tax rates combined with tax incentives for business; large cuts in federal domestic spending and large increases in defense spending; a reduction in economic and social regulation; and a steady reduction in the growth of the money supply to control inflation.

In retrospect, it is clear that these policy changes were based on a faulty approach to the Nation's problems. Except for reducing inflation, the program failed to deliver on every one of its promises.

As Table 4 shows, net investment in the U.S. economy was lower during the 1980s than during either the 1960s or 1970s, not higher as promised. Productivity failed to rise; the annual growth of nonfarm productivity was actually lower during the 1980s than it was during the 1970s. Despite the promise that lower tax rates would stimulate work and savings, the savings rate actually was lower during the 1980s than it was during the 1970s, and the percent of eligible workers actually in the labor force—the labor force participation rate—grew substantially faster during the 1970s than during the 1980s. Nor were the 1980s good times for those who had jobs: real compensation per hour was flat during the 1980s, compared with modest growth in the 1970s and strong growth in the 1960s.

TABLE 4
THE PERFORMANCE OF SUPPLY-SIDE ECONOMICS

	1959-69	1969-79	1979-89
Net nonresidential fixed investment, percent of NNP	3.39	3.32	2.15
Net investment adjusted for foreign investment, percent of GDP	4.01	3.56	0.51
Nonfarm productivity, percent change per year	2.41	1.30	0.80
Personal savings rate, percent of disposable personal income	6.72	7.77	6.57
Labor force participation rate, percent change per year	0.12	0.60	0.40
Real compensation per hour, percent change per year	2.55	1.17	0.04
New business incorporations, percent increase per year	3.45	6.88	2.71

The radical shift in economic policy undertaken in the name of supply-side economics did not deliver on its promise of strengthening the fundamentals of the American economy. Yet, the 1980s did see a recovery in economic activity, which was long by historical standards. Unfortunately, this long recovery was built not on solid foundations of increased productivity and investment, but on the very shaky foundations of massive debt.

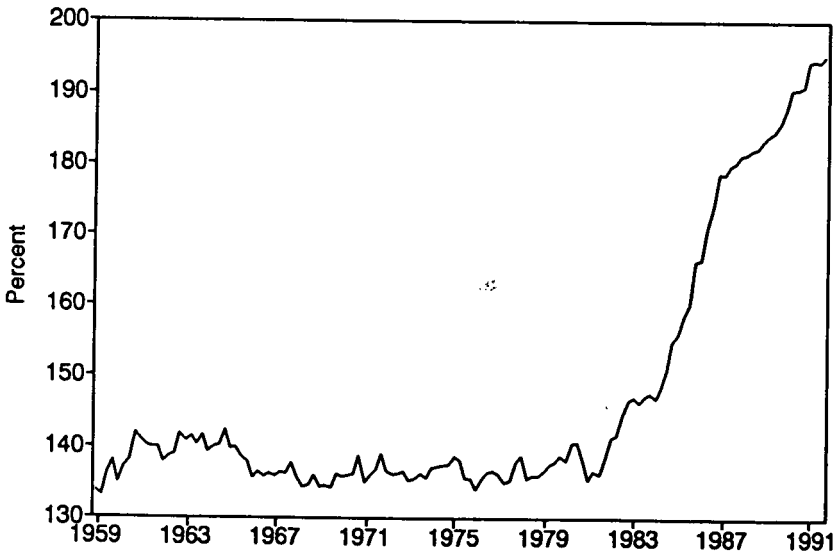
Figure 12 shows the extraordinary runup of debt by all sectors of the economy during the 1980s. What is particularly striking about the figure is the substantial stability of the debt to GDP ratio over most of the post-war period, followed by a huge rise in the ratio during the 1980s.

The buildup of debt in the 1980s was a remarkably broad-based phenomenon. All sectors of the society shared in the debt-creating process for reasons which appear to be related to both the long-term deterioration in the overall performance of the economy and to the short-term changes in economic policy that were initiated early in the decade.

Policy changes were almost entirely responsible for the huge rise in the annual federal deficit. Early in the decade, the deficit was increased substantially by a combination of massive tax cuts and significant increases in military spending. The excessive nature of the 1981 tax cuts was acknowledged through a series of tax increases during the middle of the decade, but by then the deficit had momentum of its own as interest payments on the old debt became the fastest growing item in each year's current budget.

FIGURE 12

Total Debt Outstanding
As a Share of GDP



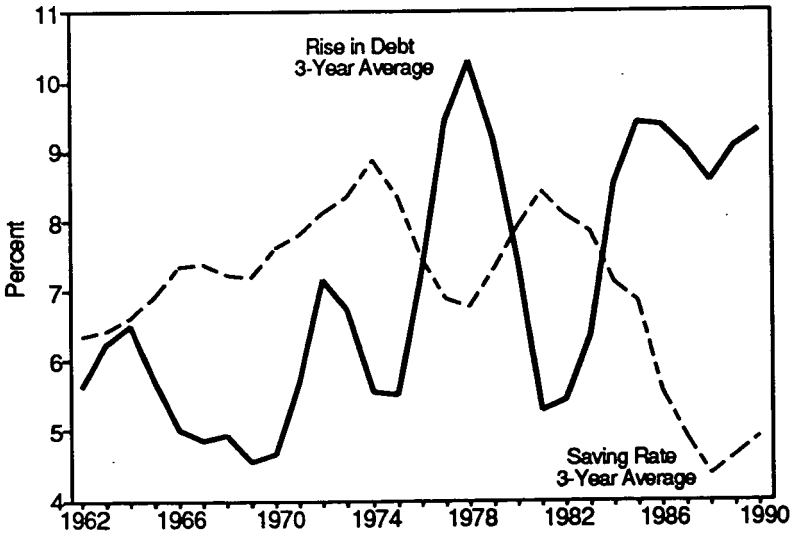
Source: Federal Reserve Board, Flow of Funds Accounts.

Households also accumulated debt at a record rate, apparently driven by two factors—the slowdown in income growth and the increased availability of credit. Financial deregulation resulted in relaxed lending criteria, making credit available in large volumes to households which would previously not have been able to borrow. And the household disposition to borrow increased significantly as income growth failed to keep up with expectations. The income slowdown will be discussed in detail in the next section, but Figure 13 shows that families clearly compensated for inadequate income by increased borrowing and decreased savings.

Corporations also took on debt at record rates during the 1980s. Some of the debt increase was used to finance new capacity, but much of it was used simply to rearrange assets and to replace equity with debt on corporate balance sheets. It has now become apparent to private industry that much of this debt was unwisely acquired.

FIGURE 13

Household Saving and Debt Growth
As a Share of Disposable Income



Source: Commerce Department; Federal Reserve Board, Flow of Funds Accounts.

FIGURE 14



Source: Federal Reserve Board, Flow of Funds Accounts.

Throughout much of the 1980s, this Committee had warned about the negative consequences of the debt explosion for the health of the economy. It appears that the recession has finally brought home to borrowers the damaging consequences of excessive debt growth. Figure 14 suggests strongly that the debt explosion of the 1980s is over, and is being replaced by a much more cautious attitude toward debt by both borrowers and lenders.

The U.S. economy is now entering a period when it must cope with the consequences of excessive debt growth during the 1980s. In this new period, the country will confront four problems associated with excessive debt growth in the past.

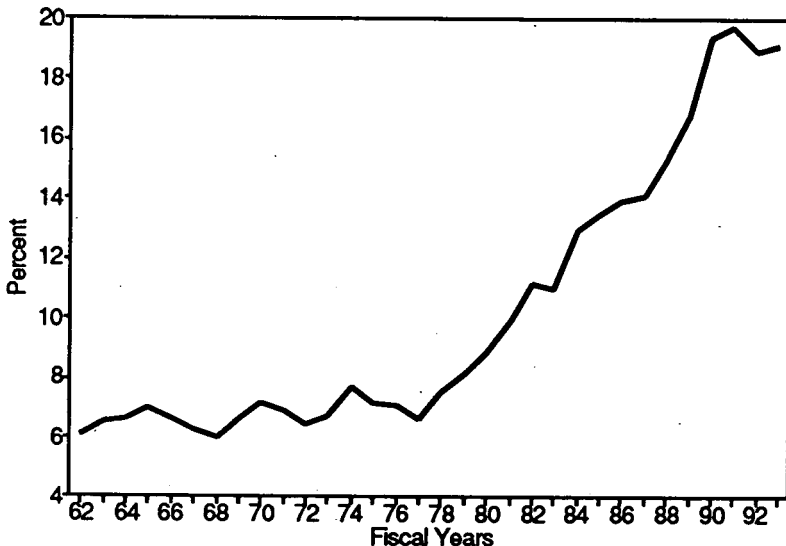
First, the rapid replacement of equity with debt on corporate balance sheets has left firms extraordinarily vulnerable to business cycle fluctuations. The current recession has brought this lesson home with a vengeance to many corporations, initiating a broad-based movement to "de-leverage" by cutting debt and raising equity. This process is likely to continue for a number of years, leading to continuing corporate efforts to cut costs, eliminate jobs, and trim needed investments in the future.

The second consequence of the 1980s debt explosion has been a severe weakening of financial intermediaries. During the boom years, public supervision of banks and thrifts was virtually eliminated under the banner of "de-regulation". Armed with new powers and new market opportunities, financial institutions willingly provided the credit which fueled the debt explosion. When the debt bubble burst, financial institutions found themselves holding loans on assets which had collapsed in value. Massive failures of savings and loan institutions and the consequent huge increases in federal payments on deposit insurance appear to be only the most dramatic consequence of imprudent lending in the 1980s. It will take years to work off this legacy of bad debt in the financial sector, years in which the willingness of banks to lend to even creditworthy customers is likely to be reduced.

Third, the federal debt explosion of the 1980s has crippled the ability of the government to respond to new problems and meet new challenges. The decision to take on debt in the past was a decision to pay for past spending out of future income. Today, the future is here, and the Federal Government finds that the bills for past spending are crowding out current domestic needs and priorities.

FIGURE 15

Net Interest Plus Deposit Insurance
As a Share of Total Outlays



Source: Office of Management and Budget.

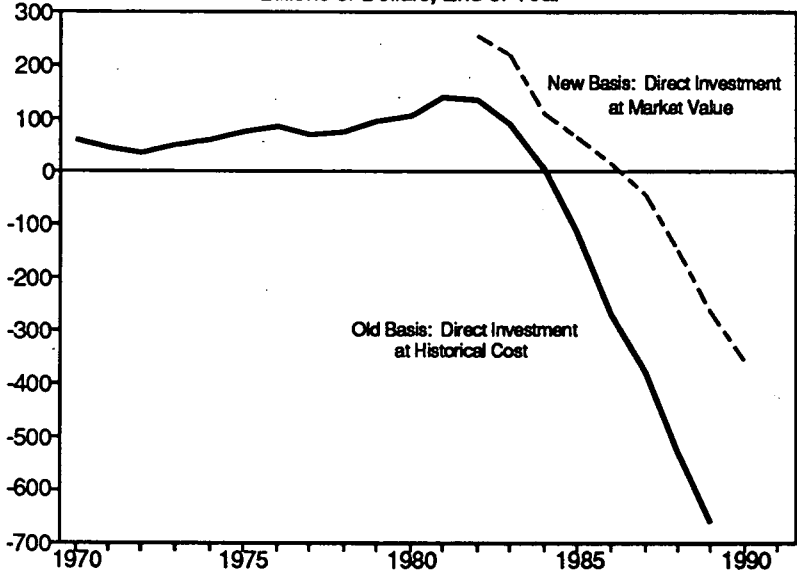
Figure 15 shows the extraordinary claim on current income that is presently being exerted by the policy mistakes of the past. Debt service, which represents the current costs of past deficits, is by far the most rapidly growing segment of the federal budget, and together with payments on deposit insurance—representing the costs of past failures of bank regulation—now accounts for nearly 20 percent of the federal budget.

The final consequence of the debt explosion of the 1980s is the massive accumulation of debts owed to foreigners. Because of the collapse in domestic savings, Americans borrowed from foreigners at record rates during the 1980s to finance both the federal deficit and a substantial portion of private investment. As a result, the United States moved from the world's largest creditor nation to the world's largest debtor nation in the space of a few years, as is shown in Figure 16.

FIGURE 16

U.S. Net Foreign Asset Position

Billions of Dollars, End of Year



Source: Department of Commerce, Bureau of Economic Analysis.

The steady deterioration in America's net asset position poses a number of problems for the long-term health of our economy. Our net external debt represents a claim on the future output of the U.S. economy. Meeting those claims will leave less of future product available either for consumption or investment. Continued need for foreign funds to finance our current account deficit also sets limits to our abilities to manage growth in the domestic economy.

Paul Samuelson described the situation well in testimony to the Committee. Likening investment to the planting of trees, Samuelson noted that reliance on capital imports is likely to have consequences whose full import will be known only well into the future:

We are still planting trees of capital. But on those trees, it is clearly marked: Not owned by Americans; owned by foreigners. When the nuts and fruits of those trees become available in a regime of contract and due process, they will become available for the foreign owners.

The preceding discussion has focused primarily on financial debt, but there is another kind of debt which also expanded greatly in the 1980s, an "environmental debt", the burden of which we are passing along to our children.

The magnitude of environmental debt came into focus during the 1980s. Despite the nation's commitment to cleaning up the environment over the past two decades, we continue to degrade our "natural capital"—air, water, and land—at alarming rates, in many cases. Pollution still exacts a toll on human health, the productivity of agriculture, forests, and fisheries, and on the national ecological heritage.

Some of these debts, such as the legacy of toxic waste contamination, are the result of mistakes long since made. Taxpayers will redeem part of this environmental debt; federal liabilities to clean up hazardous waste at defense sites are likely to rival the S&L bailout, and the Superfund cleanup has barely begun. Some environmental damages—like the stubborn problem of urban air quality—are pervasive but extremely difficult to remedy.

Agriculture too appears to be running up considerable environmental "debts". While off-site damage from soil erosion has been estimated between \$5 billion to \$17.6 billion per year, other water quality degradation, including the chemical contamination of ground water, could add to that estimate considerably.

Other debts, like the increasing risks of future climate change, continue to mount. While it is difficult at this point to measure the ultimate cost of such environmental deterioration, history suggests that cost estimates are more likely to increase as new analysis becomes available rather than decrease.

Chapter II

INCOME GROWTH AND DISTRIBUTION

I start from the fact that everybody in the country, just about, is conscious of a kind of a loss of relative dynamism and competitiveness in the American economy symbolized not by anything that happens from month to month or quarter to quarter, but the stagnation of real family income over a period of a couple of decades.

Robert Solow

The thing that I think is most evasive, where the greatest effort at obfuscation is made in this year's Economic Report [of the President] 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.

Paul Krugman

The deteriorating performance of the American economy is brought home to most citizens through their pocketbooks. Slow productivity growth, inadequate investment, slipping technological leadership and mounting debt all affect families most directly through a relentless squeeze on wages and incomes.

Because income is the area in which the failure of economic management is most directly felt by the majority of citizens, the analysis of income statistics has become a battleground of warring interpretations of data.

Confusion in this area is heightened by the complexity of our wage and income statistics. There are a variety of data sources, each with its own set of income concepts and its own limitations. To avoid presenting an unfair or distorted picture of income trends, great care must be taken in choosing income concepts, time periods and data sources. This year's *Economic Report of the President* shows some of the ways in which data can be shaped to obscure important elements of the income picture.

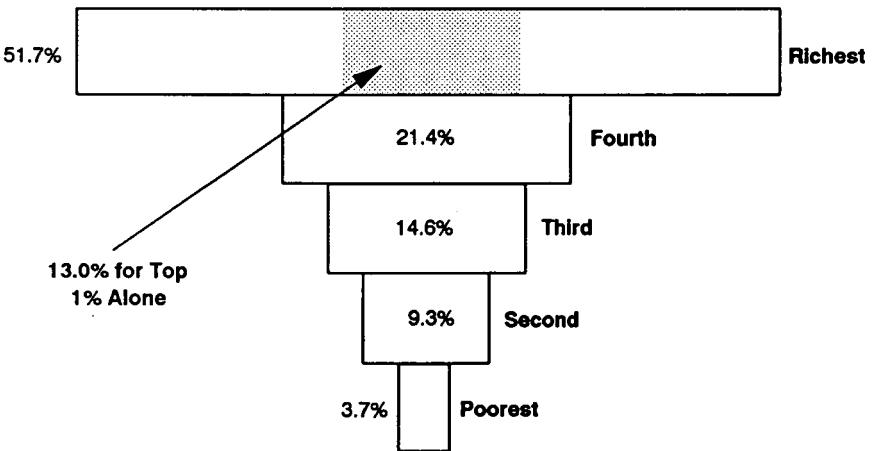
Two of the most common abuses of income data need to be understood at the outset. The first involves the use of averages instead of distributions when talking about changes in income over time.

During the 1980s, there has been a pronounced shift toward greater inequality in all measures of income. No matter what the concept—wages, compensation, take-home pay, weekly earnings, family income—those at the very top end of the distribution have done very much better than everyone else.

Even before the recent sharp turn toward inequality, the rich in the United States had commanded a much larger fraction of total income than in other industrialized countries. Figure 17 shows that for 1989 the richest 20 percent of families accounted for more than half of all income. The richest 1 percent alone obtained 13 percent of all income, equal to the share going to the lowest 40 percent of families, and nearly as much as the share going to the middle 20 percent.

FIGURE 17

Shares of Pre-Tax Family Income, 1989
For Each Quintile of Families



Source: Congressional Budget Office.

With large—and growing—disparities in income, it has become very misleading to talk about "average" income growth because the average is massively distorted by the income experience of the few people at the very top of the distribution. Indeed, because the top 1 percent of families account for as large a share of total income as the bottom 40 percent, a 10 percent increase in income at the top has exactly the same statistical effect as an equivalent rise for the bottom 40 percent, despite the enormous differences in the numbers of people affected. A later section of this report will show that between 1977 and 1989 total family income grew by an "average" of \$3,340 per family. But two-thirds of all the income growth went to the top 1 percent of families alone.

Because of the extraordinary inequality of the American income distribution, any presentation which reports only averages and not distributions is suspect.

A second common statistical problem involves the selection of base years for income comparisons. The results obtained from examining changes in income between two points in time are extremely sensitive to the precise choice of dates. Incomes tend to fall in recessions and grow during recoveries. If the initial year for a comparison is in the depth of recession, and the end year at the top of an expansion phase, the apparent growth rate will be much stronger than if the two years were at the same point in the business cycle.

To remove the artificial impact of the business cycle on income measurements, all impartial observers select starting and ending dates which are at business cycle peaks.

In looking at income growth during the 1980s, the appropriate base years for comparison are 1979 and 1989. Both years were at the top of the business cycle, and income comparisons between those two years show how incomes moved from the peak of the 1970s' recovery to the peak of the 1980s' recovery. Attempts to make income comparisons between, for example, 1982 and 1989 completely confuse long-term trends with short-term business cycle fluctuations, since the comparison is between the trough of a recession and the peak of a recovery.

Keeping these basic caveats in mind, there appears to be a broad consensus among academic experts on income statistics on the following basic points:

- After a quarter century of regular gains, wages for most workers have come to a virtual standstill since the mid-1970s.
- Each range of the wage spectrum has fared differently, as the top has gone up, the bottom down, and the middle little changed overall.
- Households compensated for stagnant or declining wages by working more hours or putting more workers into the labor force.
- Despite additional hours of work, family income growth in the 1980s was lower than in any other expansion in the postwar period.
- Growth in family incomes was concentrated largely among the most affluent of American households.
- Tax policy has shifted in ways which contributed to growing inequality of after-tax income.

HOURLY WAGES

The most basic income concept is that of the hourly wage—the amount earned by an employee for an hour's work. Developing an accurate hourly wage data series requires detailed information on both payments to workers and their hours of work.

The Bureau of Labor Statistics compiles several different measures of hourly pay, the broadest of which is a data series on "real compensation per hour." This income concept covers all workers in all industries, and includes not only money wages, but all additional labor costs for employers, such as health care, pension contributions and contributions for Social Security, Medicare, and unemployment compensation. It is this broad series that the *Economic Report of the President* uses in its analysis of wage trends.

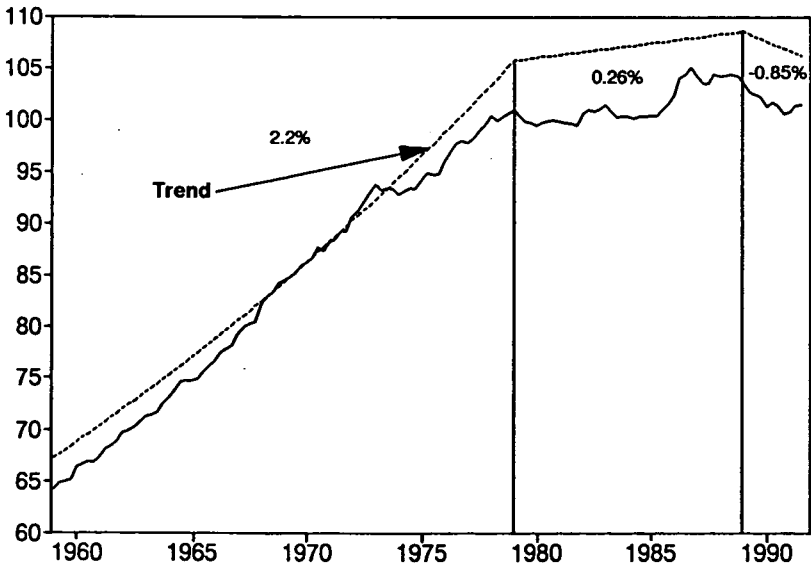
Using annualized data on real compensation, the *Report* presents a chart on p. 96 from which it draws the following conclusion:

... although the year-to-year changes are sometimes small or negative, long term wage growth has been significant. The average real hourly compensation of workers in the U.S. economy has increased 69 percent since 1959 and 11 percent since 1973. [p. 95]

A closer look at the same data reveal a somewhat different conclusion. Figure 18 shows exactly the same data series as is shown in the *Economic Report of the President*, Chart 3-5, but on a quarterly basis (which provides the most recent information) instead of the annualized basis used in the *Economic Report*. Using the methodology applied by the *Economic Report* in its analysis of the long sweep of productivity trends, the figure on real compensation reveals three distinct time trends: a period of rapid compensation growth averaging 2.2 percent per year from 1959 to 1979, a sudden slowing to a mere 0.26 percent per year growth from 1979 to 1989, and a steady decline at a -0.85 percent rate from 1989 to the present.

FIGURE 18

Real Compensation Per Hour
Deflated by CPI-U X1



Source: Department of Labor, Bureau of Labor Statistics.

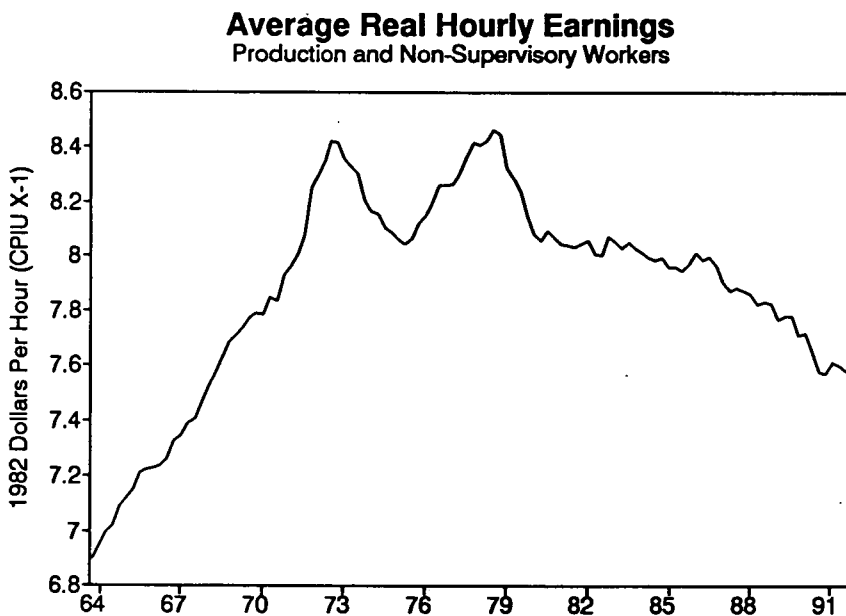
Real hourly compensation has never before declined during four consecutive years of expansion as it did from 1986 to 1990. Real compensation per hour in the fourth quarter of 1991 stood no higher than in fourth quarter of 1976. Despite the assurances of this year's *Economic Report*, compensation growth for more than half a decade (including the entire term of this Administration) has been nonexistent, not "significant".

The real compensation data series has a major drawback for measuring wage trends, in that it is an average of the earnings experience of all workers in the economy. Strong growth among very high earners in the overall distribution may cause the "average" measure to show significantly more growth than most workers experience.

The Bureau of Labor Statistics compiles another data series on hourly wages, which comes closer to describing the direct pay of most workers. It reports Average Hourly Earnings of "production and nonsupervisory workers." These data include only direct pay for wages, salaries, holiday and vacation pay and exclude all other employer costs for fringe benefits and statutory payments for Social Security, unemployment insurance, etc. By excluding high-earning managers, supervisors and professionals, this average is probably largely unaffected by the rapid growth at the upper end of the pay scale. Production and nonsupervisory workers make up some 80 percent of the total labor force, however, and this series gives a reasonably accurate picture of wage and salary growth for the "average" American worker.

Figure 19 shows the series for real average hourly earnings, using the same method of adjusting for inflation as was used in the real compensation series. This measure of real wages shows a sharp and steady deterioration in the average wage paid to over 80 percent of American workers since the late 1970s.

FIGURE 19



Source: Department of Labor, Bureau of Labor Statistics.

Both the real compensation and the average hourly earnings series are aggregate indices compiled for the economy as a whole. Because both data series are derived from aggregate payroll information supplied by employers rather than from data supplied by individual workers, it is not possible to derive any measure of the distribution of wages from either of these series.

Because distribution is an important part of the American income story, researchers have sought other ways to study the wages of individual workers. To do so, they generally turn to a third data source, the Census Bureau's Current Population Survey. Every March, this monthly survey of some 60,000 households adds a special set of questions about their earnings and hours of work. Since the basic data in this survey are on individuals, it is possible to derive a reasonably clear picture of the changing wage distribution.

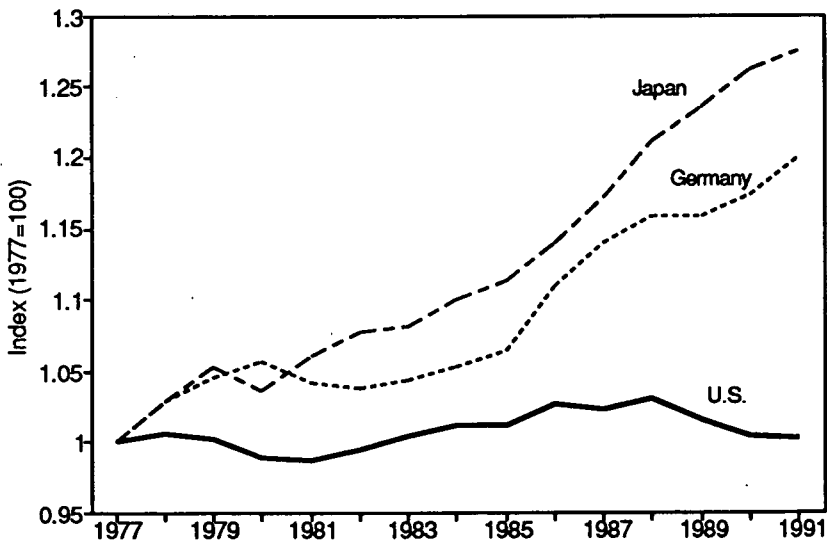
Economists Barry Bosworth and Gary Burtless of the Brookings Institution have done a comprehensive study of wage distribution using the Current Population Survey data. They found that wages have either declined or remained stagnant for the bulk of the American labor force over the past decade. Wages for many women have risen over the past decade, but not sufficiently to compensate for falling wages of men. Drawing on that research in his testimony before the Committee, Barry Bosworth noted:

To the extent that there has been any improvement in real wage performance, it is concentrated exclusively in the top fifth of the wage distribution.

Other major industrial countries have not experienced the stagnation in wages observed in this country. As Figure 20 shows, in contrast to the situation here, both in Germany and Japan, growth in hourly pay has been sustained since 1977. In other words, these countries continue to enjoy gains in pay as fast we did during the initial postwar period, although the rate of growth was slower than they themselves had enjoyed prior to 1973.

FIGURE 20

Real Compensation Per Hour
Economy-Wide Estimates



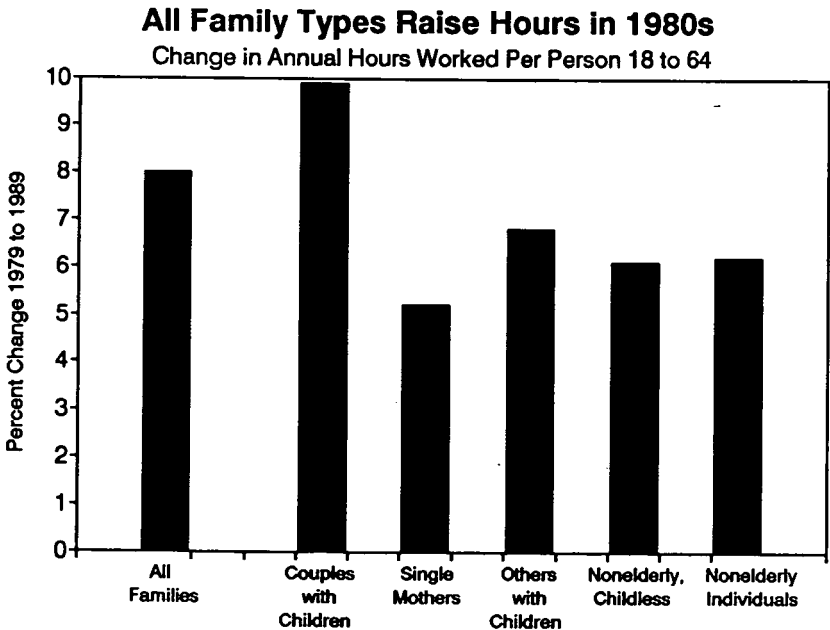
Source: Organization for Economic Cooperation and Development.

HOURS OF WORK

Under pressure from stagnant or falling wages, Americans have been working longer hours. Much of the increased hours are coming from women who have entered the labor force in large numbers over the past two decades.

Although married couples with children increased their hours of work the most, all family types significantly increased their hours of paid work in the 1980s. A recent preliminary analysis by the Congressional Budget Office found an 8 percent increase in the average annual hours of 18- to 64-year-olds in nonelderly families between 1979 and 1989. As shown in Figure 21, the increases ranged from 5 percent for families composed of single mothers with children to a 10 percent among married couples with children. Adults who had been homemakers are now entering the paid work force. Those who had been part-time or part-year are becoming full-time or full-year employees.

FIGURE 21



Source: Congressional Budget Office.

These data are consistent with the discussion of productivity growth earlier in this *Report*. In the past, it was possible to produce rising national output (and rising worker incomes) through productivity growth. Now, most of our annual growth in output and income comes as a result of more hours worked.

This reality creates two concerns: First, is the American standard of living truly rising, as some indicators would suggest, if income gains come only at the expense of more hours? A recent staff report from the Committee examined this issue, and determined that for a majority of two-parent families with children the answer to this question is no. (See below for further discussion of this issue).

The second concern is whether this pattern can be sustained. Several witnesses made the point that:

Some American families have been able to avoid the implications of stagnant or falling real wages per worker by increasing the number of workers per family. That option is also going to vanish in the 1990s, because the two-earner family is now the norm.

Barry Bosworth

And also we have sent spouses to work to increase the household income, even if the individual incomes fell. Obviously increasing hours worked and increasing spousal work is limiting and can't be done indefinitely. And we are finally running into those limits. And, as a result, the household sector is realizing that they cannot continue to generate the household gains in the 1990s if they continue to have economic conditions such as those of the 1980s.

Donald Ratajczak

The phenomenon of rising hours has not affected all segments of the work force alike. Many adults in poor families, for example, are unable to find enough extra hours of paid work to compensate for their falling wages. This reality helps explain the significant fraction of families who are poor, even though at least one family member has a full-time job. The Bureau of Labor Statistics has reported a considerable rise in the number of people with part-time jobs who desire full-time work, a further indication that some workers are having trouble finding as many hours of work as they would like.

COMPREHENSIVE DATA ON INCOME GROWTH AND DISTRIBUTION

Official data on income distribution collected and published by the Bureau of the Census are based on a survey of 60,000 households nationwide conducted each March. These official data are the starting point for virtually all analyses of levels and trends in the distribution of income.

But many analysts, including those at the Bureau of the Census, recognize that there are limitations to the official data. The Census data use the official Consumer Price Index, which many analysts believe distorts the inflation picture in the 1970s. Census data also do a poor job in estimating income at the very top of the distribution, both because there appears to be a serious underreporting of property income, such as dividends, interest, and rent; and because income data are "top-coded" so that incomes of \$100,000 or more are entered into calculations of averages and totals as "\$100,000" rather than their true, larger value.

The Congressional Budget Office (CBO) has invested considerable effort in overcoming these problems. They use the CPI-U-X1 to correct for inflation, and address the underreporting and top-coding issues by adjusting the Census data to make them consistent with data from actual income tax returns as reported to the IRS. This merging of Census and IRS data gives a better picture of the income distribution than either individual source.

These adjustments are essential to obtain an accurate picture, but they are very time-consuming and expensive to undertake. For this reason, the CBO data are widely regarded by responsible analysts as the most comprehensive source on questions of income growth and distribution.

Some have questioned the validity of all CBO income data on the grounds that in 1989 the CBO did not anticipate the sharp decline in capital gains realizations in 1990. This confuses CBO's projections with its actual data. All forecasters, including the Treasury, had similar difficulty predicting capital gains realizations for 1990. The CBO has never been faulted by impartial observers for their merging of Census and IRS data. As evidence of the broad acceptance of CBO methodology, the 1992 Economic Report of the President relied on CBO data in its discussion of income trends, as does this section of the Joint Economic Report.

FAMILY INCOMES

Family income reflects both the hours worked of all family members and the wages that each member is paid. Figure 22 suggests that families have managed to adjust to falling wages with sufficient increases in hours worked to produce a modest but sustained rise in average family income. It is this data which encourage some to regard the 1980s as a period of rising living standards for the average American family.

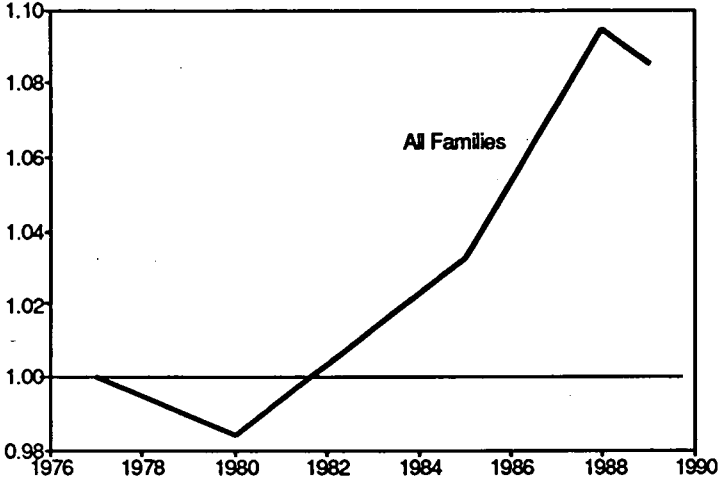
The principal problem with this interpretation is that, once again, averages hide important changes in distribution. To get an accurate picture of the income experience of most American families, it is important to know what has happened to families at different income levels.

It is difficult to get an accurate picture of income distribution using Census Bureau data, which seriously undercounts the income of the very richest households. For that reason, many analysts concerned with family income have turned to the data compiled by the Congressional Budget Office, which integrates Census Bureau data with IRS data. Data from the Census Bureau cover many persons who do not file tax returns. Data from the IRS give a more complete picture of the incomes of the incomes of the highest income households (see box on page 47).

Figure 23 takes exactly the same data as in Figure 22, but separates the top 5 percent of families from the other 95 percent. Income growth at the top of the income distribution was so strong during the 1980s that the top 5 percent of families (with incomes averaging \$215,000 in 1989) accounted for virtually all the gain in average family income. Average income for the remaining 95 percent of families remained essentially unchanged in real terms over the period, despite a substantial increase in their hours of work.

FIGURE 22

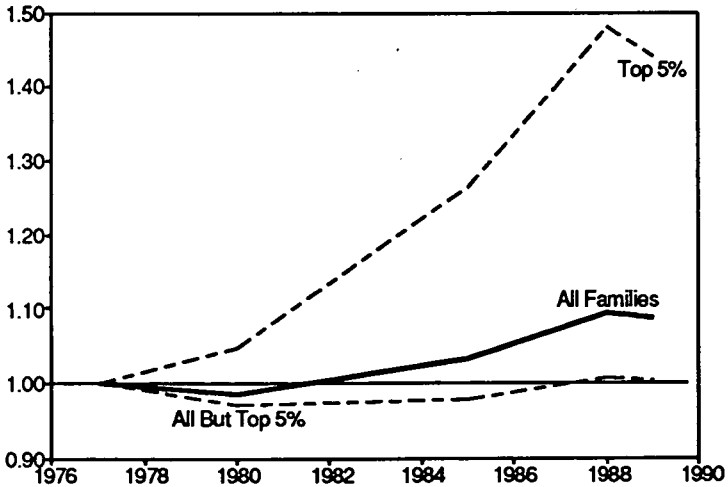
Average Family Income
Index (1977 = 1.00)



Source: Congressional Budget Office.

FIGURE 23

Average Family Income by Income Group
Index (1977 = 1.00)



Source: Congressional Budget Office.

Table 5 provides a breakdown of the growth in family income between 1977 and 1989. It shows that incomes fell for families in the lower 60 percent of the income scale and grew modestly for the next 20 percent. Income for the top 1 percent of the scale soared from \$315,000 to \$560,000. That \$245,000 gain for the top 1 percent represented \$2,450 for every family in the country, that is, two-thirds of the \$3,430 average rise in income for all families.

TABLE 5
AVERAGE REAL PRETAX FAMILY INCOME

	Average Family Income (In 1992 Dollars)			Share of Families (4)	Contribution to Change in Average Income (3) x (4)
	1977 (1)	1989 (2)	Change (3)		
Low Q	9,368	8,391	-977	20%	-195
2nd Q	22,333	20,140	-2,193	20%	-439
Mid Q	34,505	32,681	-1,824	20%	-365
4th Q	46,772	47,913	1,141	20%	228
Top Q	87,268	109,424	22,156	20%	4,431
Of Which:					
81-90%	60,073	65,900	5,827	10%	583
91-95%	76,525	87,711	11,186	5%	559
96-99%	107,945	132,036	24,091	4%	964
Top 1%	314,526	559,795	245,269	1%	2,453
Overall	40,065	43,495	3,430	100%	

Source: Congressional Budget Office

TAXES

Trends in the tax structure since the 1970s have also favored the highest income families and worked to the disadvantage of middle-income families. Taxes, as a share of income, have been falling for upper-income households and rising for those lower down on the income scale. While the overall effect of tax policy continues to be to produce a distribution of after-tax income which is somewhat more equitable than the distribution of pre-tax income—a phenomenon known as "progressivity"—the equalizing effects of taxes have become much less significant than before.

This year's *Economic Report of the President* goes to remarkable lengths to avoid confronting this reality, by confusing the distinction between the tax burden as a share of income with the tax burden by shares of the population (see box on page 52). The progressivity of the tax system depends on taxes as a share of income rising as incomes rise, not on the share of total taxes paid by those with the highest incomes. The share of taxes paid by the rich has indeed gone up in the 1980s, but only because their share of income has gone up much faster. This shows only that pre tax income is more unequally distributed, not that the tax system has increased its claim upon the rich.

Figure 24 depicts the loss of progressivity in the federal tax system since the mid-1970s. The figure plots the average effective tax rate for families at different income levels in 1977 and 1992. Under tax laws prevailing in 1977, the federal tax system was modestly progressive, with tax burdens rising as incomes rose. The changes in tax law during the 1980s sharply changed the progressivity of the tax code, particularly at the extreme upper ends of the income distribution.

The dotted line in Figure 24 shows the tax burden as a share of income under 1977 law; the solid line a estimate of 1992 tax burdens under current law. Tax burdens have risen slightly for families at the lower end of the income distribution, remained largely unchanged for those in the middle, and fallen sharply for those at the very top.

DO THE RICH PAY THEIR FAIR SHARE?

Supporters of the tax cutting experiments of the 1980s frequently defend their handiwork by noting that the rich pay a larger share of total federal taxes today than they did before. While this is true, it is a misleading argument concerning the fairness or progressivity of the tax system. The share of total taxes paid by the rich has gone up, but their share of total income has gone up much more. As a result, their tax burden as a share of pre-tax income has gone down substantially.

This year's Economic Report of the President not only repeats the misleading assertion on the share of total taxes paid by the rich, but it also obscures the truth through selective presentation of the data. They produce two tables on p. 141, the first of which shows federal taxes paid as a share of income for all five quintiles of the population, while the second shows the share of federal taxes paid by each quintile and the top 5 percent.

The inclusion of the top 5 percent in data on the share of taxes paid appears to suggest that the rich are "paying their fair share." The exclusion of the top 5 percent from the table on shares of income paid in taxes is then coupled with the assertion that: "The degree of progressivity of, and the amount of redistribution within, the tax system has not changed significantly since the mid-1970s."

The following table includes the data omitted from the Economic Report of the President (shown in italics). The omitted data shows quite a remarkable reduction in the tax burden for the very richest households and, consequently, a sharp decrease in the progressivity of the tax code.

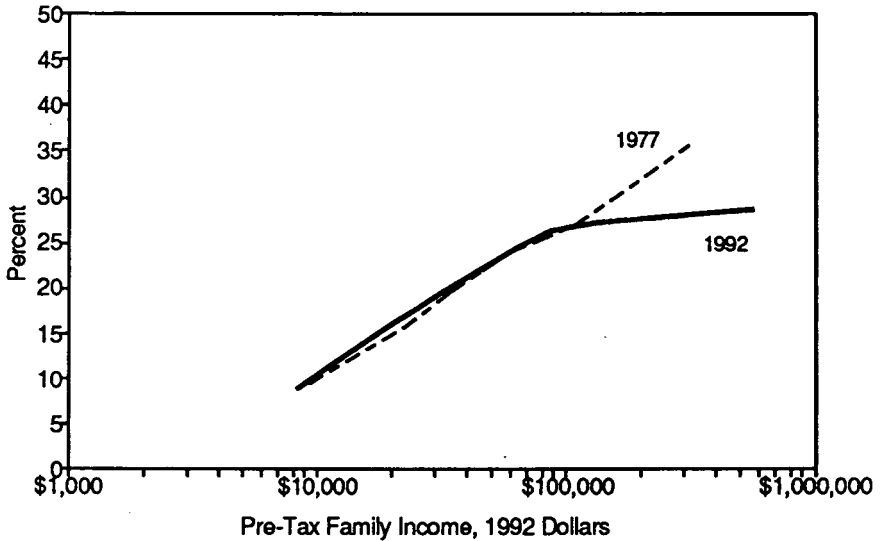
CBO Estimates of All Federal Taxes
(As a percent of income)

Income Quintile	1977	1980	1985	1988	1992
Lowest	9.3	8.1	10.3	9.3	8.6
Second	15.4	15.6	15.8	15.9	15.6
Third	19.5	19.8	19.1	19.8	19.7
Fourth	21.8	22.9	21.7	22.4	22.2
Highest	27.2	27.5	24.1	26.0	26.8
<u>Addendum:</u>					
<i>Top 5%</i>	<i>30.6</i>	<i>29.6</i>	<i>24.6</i>	<i>26.7</i>	<i>28.3</i>
<i>Top 1%</i>	<i>35.5</i>	<i>31.7</i>	<i>24.9</i>	<i>26.9</i>	<i>29.3</i>

FIGURE 24

Federal Tax Burden: 1977 vs. 1992

Federal Taxes as Share of Pre-Tax Income



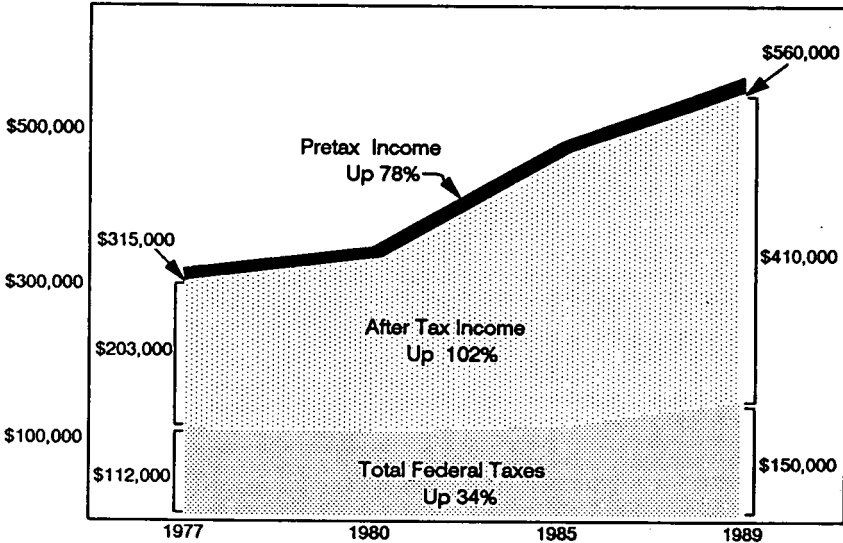
Source: Congressional Budget Office.

Focusing on the taxes paid by the very richest American families has been seen by some as largely a symbolic exercise, since "there are not enough rich people to make a difference." While it is true that the very rich are not very numerous, they control such a large fraction of total income that their tax rates are of considerable importance to economic policy.

Figure 25 shows what has happened to taxable income and taxes for the top 1 percent of families. In 1977, such families earned an average of \$315,000 and paid an average of \$112,000 in taxes. By 1989, their pre-tax income had risen 78 percent, to \$560,000, but their taxes rose only 34 percent. Because taxes rose more slowly than income, their after-tax income more than doubled (up 102 percent) from the 1977 figure.

FIGURE 25

Top 1%: Rising Income, Falling Tax Burden Per Family, In 1992 Dollars



Source: Congressional Budget Office.

In 1989, families in this top 1 percent of families accounted for 13 percent of total family income. They paid tax on this income at an average rate of 26.7 percent. Had they instead paid tax at the 35.5 percent rate prevailing in 1977, total federal tax collections for 1989 would have been \$45 billion higher. While the rich may not be numerous, their share of total national income is large enough that significant tax rate reductions have a major impact on total tax revenues.

CASUALTIES OF THE INCOME SLOWDOWN

The principal casualties of the income slowdown are the majority of American families in the first three quintiles of the income distribution. For such families, there appear to be two distinct and acute problems: a relentless "squeeze" on the quality of life for those who have the ability to work longer hours, and persisting poverty for those whose combination of wages and work hours cannot generate a decent income.

Middle-Class Squeeze. The "squeeze" is apparent from a growing body of survey research in which middle class families complain about a declining standard of living, despite small rises in their measured money income. The reasons for their concern is that money income in some respects does not provide a good measure of the standard of living for American families.

Higher incomes are generally seen as indicating higher living standards, but this may not always be the case. If families must put more effort into earning income, or spend more to offset the costs of earning additional income, then living standards may fall even as nominal incomes rise. This is precisely what appears to be happening to a large number of American families.

The recent staff study done for the Committee on two-parent families illustrates the problem. Such families are working significantly longer hours in order to bring home income, and must spend substantially more on things such as clothing and child care in order to earn the additional income. For example, the middle fifth of the income spectrum had 5 percent more real income in 1989 than in 1979 (both peak years of the business cycle). However, families in that group were spending 11 percent more hours at work to bring in that income.

Spending more time in the labor force means that parents not only lose personal time for family and community, but they have new sources of anxiety. Their flexibility to do the day-to-day chores of life is reduced. They also lose some control and confidence in the quality of the work that they no longer do for themselves. According to a recent poll of families conducted by the National Commission on Children, 59 percent of parents said that they would like to spend more time with their children.

Putting more hours into the labor force creates two types of financial costs. First, added expenses for transportation, clothing, buying food away from home, and taxes come with more time in the labor force. Second, services formerly produced at home, such as care of children and elderly, prepared food, cleaning, and repair are bought in the market place.

Combining the loss of family time and the extra expenses associated with earning income, it is clear why families with children might experience a perceived decline in living standards, even if money incomes were rising.

Poverty. For another large segment of families, inadequate income remains a significant problem. With stagnant or declining wages, particularly for workers with less than a high-school education, increasing numbers of poor people find it no longer possible to pull themselves and their families out of poverty through hard work.

In 1990, 13.5 percent of Americans were poor, a significant jump from the equivalent level of 12.8 percent in 1989. The start of the recession mid-way through 1990 was undoubtedly responsible for much of this sharp rise. But it is also true that throughout the 1980s the share of Americans living in poverty was higher than at any point during the 1970s. Herbert Stein put this problem to the Committee in these terms:

You see, for a long time, or for many decades, we were making progress in reducing the proportion of the population that lived in poverty. Now, for the last 10 years or more, that proportion has been fairly flat, aside from minor cyclical fluctuations. I am concerned about the fact that we are not making progress in reducing that.

Why have poverty rates been so high over the past decade, in spite of the economic expansion? Most of the easy explanations for the persistence of poverty do not stand up to close analysis. The poor appeared to have worked harder in the 1980s than in the past, ruling out work effort as a principal cause of persisting poverty. Including in-kind transfers in the measurement of income does not change the pattern of slowing improvement in poverty. The rise of single-parent families does not explain why the recovery of the 1980s did not produce a more rapid fall in poverty.

Instead, the answer to why poverty rates have remained so high lies in the wage rates for poor heads-of-households. For both men and women in the bottom quintile of the family-income distribution, average hourly earnings actually fell between 1979 and 1989 (see box).

Because of declining or stagnating wage rates, the ranks of the working poor are growing. Census Bureau data shows that an increasing share of the poor are people who are working year round and full time, and yet their families remain in real economic hardship. According to a recent study, the proportion of hourly workers paid wages below the three-person poverty level increased substantially from 9.3 percent in 1979 to 15.6 percent in 1989.

POVERTY: THE RESULT OF POOR WAGES

Changes in the wage structure of the economy during the 1980s made it increasingly difficult to escape poverty through hard work. The answer is that earnings of the heads of poor families grew much more slowly with the economic expansion of the 1980s than earnings did over the 1960s.

Labor market involvement was more responsive to economic growth during the 1980s than during the 1960s. Unemployment fell faster; weeks of work among low-income households expanded at a faster rate. In the 1980s, low-income households took advantage of the greater labor market demand even more than they did in the 1960s, which is exactly what you expect to see as the economy grows. If we look only at labor market involvement, we would actually have expected poverty to fall faster in the 1980s than it did in the 1960s.

Among the poorest 10 percent of the population, which is entirely composed of families below the poverty line, real wages actually fell with economic growth. GNP growth of 1 percent in the expansion of the 1960s was correlated with the \$2.18 increase in real weekly wages. GNP growth of 1 percent in the expansion of the 1980s was correlated with a .32 cent decrease in weekly wages. Quite a strong difference.

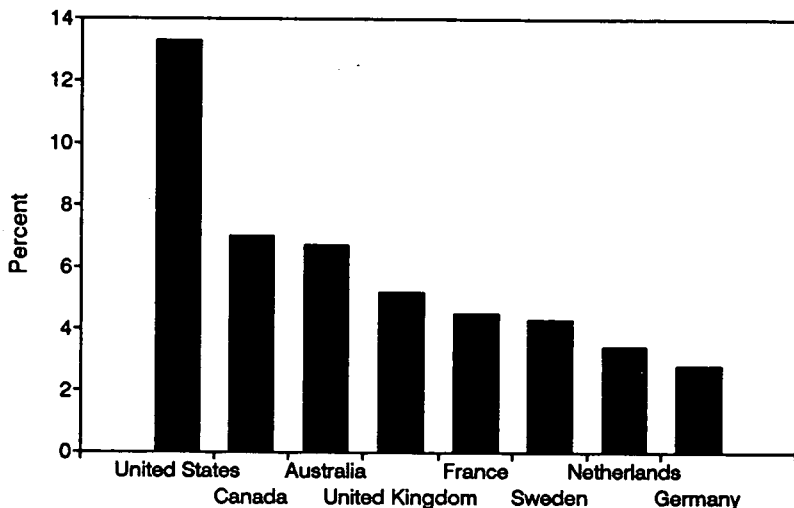
As the economy grew in the 1960s, low-income households both worked more and their wages grew at the same time. The result was a rapid decline in poverty rates. In the 1980s, the poor worked more, but fall in real wages offset the increased hours of work. The result was a much slower decline in poverty rates.

In short, "trickling down" didn't work very well in the 1980s because of flat or declining real wages among low-skilled workers.

Excerpt from the testimony of Rebecca Blank, Northwestern University

FIGURE 26

Percent of Persons in Poor Families After Taxes and Transfers



Source: Timothy Smeeding, "Why the U.S. Anti-Poverty System Doesn't Work Very Well," *Challenge* (January-February 1992), vol. 35, no. 1, pp. 30-35.

How does the poverty rate in the United States compare with that of other countries? As shown in Figure 26, the share of persons in poor families after taxes and transfers is significantly higher in the United States than it is in seven other western industrial countries for which comparisons are possible. Our poverty rate ranges from twice as high as Canada's to over four times the level found in West Germany.

Macroeconomic performance plays some role in generating these differences in poverty, for many of these countries have enjoyed higher rates of growth in both output and wages than we have. But this is only part of the answer. Canada is a useful comparison to make this point.

Canada has an economy with many of the same structural characteristics as our own, and during the 1980s, Canada grew at lower rates than did the United States. Despite less robust macroeconomic growth, poverty in Canada declined steadily during the 1980s. In this instance, the difference lies in a much greater commitment in Canada to both universal (national health insurance) and targeted (low-income tax credits) policies to reduce poverty. The United States, lacking such a commitment, experiences substantially more poverty than any other industrialized nation.

Chapter III

STAGNATION AND RECESSION

This recession is part of an economic slowdown that began three years ago, primarily reflecting long-lasting factors, such as over building, high debt, weakness in the state and local budget position, and banking problems, and a whole slew of ongoing, long-lasting factors, many of which were created during the 1980s.

Lawrence Chimerine

Deteriorating economic fundamentals and misguided macroeconomic policies finally drove the economy into recession in 1990. For a considerable period of time, the Administration misdiagnosed the nature of the country's economic problems. Michael Boskin, Chairman of the Council of Economic Advisers, told the Committee on July 23, 1991 that:

In my view, the direct effect of the oil price shock, the fact that the net oil imported by the United States would be transferring income to oil-producing exporting countries, combined with the very large, in my view, decline in consumer confidence and business confidence and the uncertainty about when the Gulf crisis would end, when superimposed on an already sluggish economy, drove the economy into recession.

This analysis of the problem encouraged the Administration to ignore the recession and hope that it would soon be over. Throughout 1990 and much of 1991, the official view from the Administration was that the recession would be "short and shallow," and that no fundamental reassessment of economic policy was in order.

Unfortunately, this analysis of the recession was incorrect, and the country has paid dearly for this miscalculation. In this year's *Economic Report*, the President's Council of Economic Advisers has finally acknowledged the faulty diagnosis offered last year.

It now appears that the structural imbalances in the economy were larger—and were taking longer to work off—than expected; it soon became evident that the oil shock and the war were not the economy's only problems." [1992 *Economic Report of the President*, p. 40]

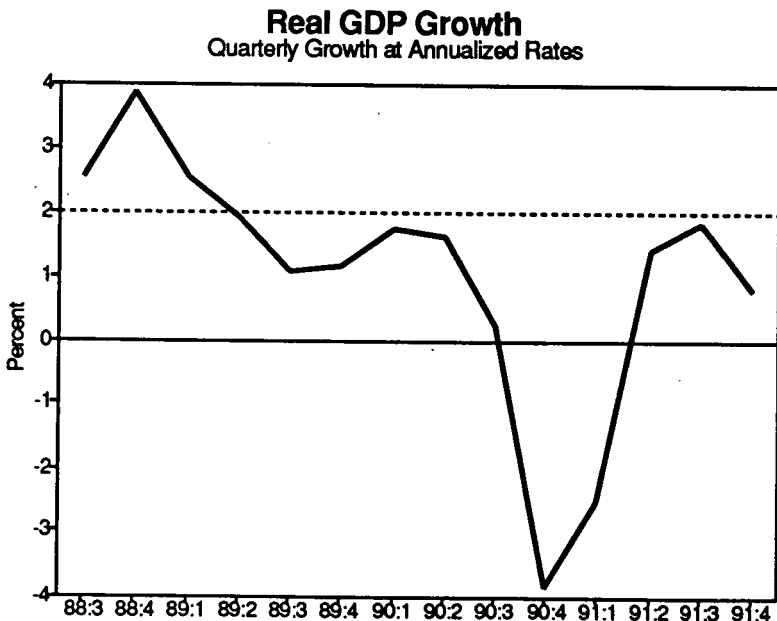
Now that the Administration has abandoned the comforting fiction that the current recession was only the result of "temporary" factors, such as the oil shock and the war, it should be possible to base future policy on a more accurate diagnosis of our current ills.

MONETARY POLICY AND THE RECESSION

The economy was growing sluggishly for more than a year before the recession began. From the first quarter of 1989 through the second quarter of 1990, growth in the Nation's output of goods and services (real GDP) averaged only 1.5 percent per year, compared to an average rate of 2.5 percent per year over the ten years from 1979 to 1989. Moreover, average growth in the 1980s was slower than in any previous decade since the end of World War II.

The result has been an unprecedented period of slow economic growth. For 11 straight quarters, as Figure 27 indicates, the growth of the economy has been below 2 percent at an annual rate, the longest uninterrupted stretch of sub-par growth in postwar history.

FIGURE 27



Source: Department of Commerce, Bureau of Economic Analysis.

STRUCTURAL PROBLEMS IN THE U.S. ECONOMY

The warning signs [of stagnation] are numerous. They include:

- **The virtual elimination of U.S. advantages in productivity in a growing number of industries (we've actually fallen behind in many), due largely to productivity stagnation in this country.**
- **The shrinking technological leadership that once characterized the U.S. economy.**
- **Massive trade deficits, reflecting declining shares of U.S. production in a large number of industries, in response to these changes.**
- **The dismantling of many important companies and industries, with many others headed in that direction.**
- **Widening gaps between the United States and other countries in the quality of education.**
- **Stagnant real wages for the majority of Americans during the last 15 years or more.**
- **A distribution of income which is becoming more unequal.**
- **A banking system which is in shambles.**
- **An increase in resources devoted to essentially non-productive uses.**

Excerpt from testimony of Lawrence Chimerine.

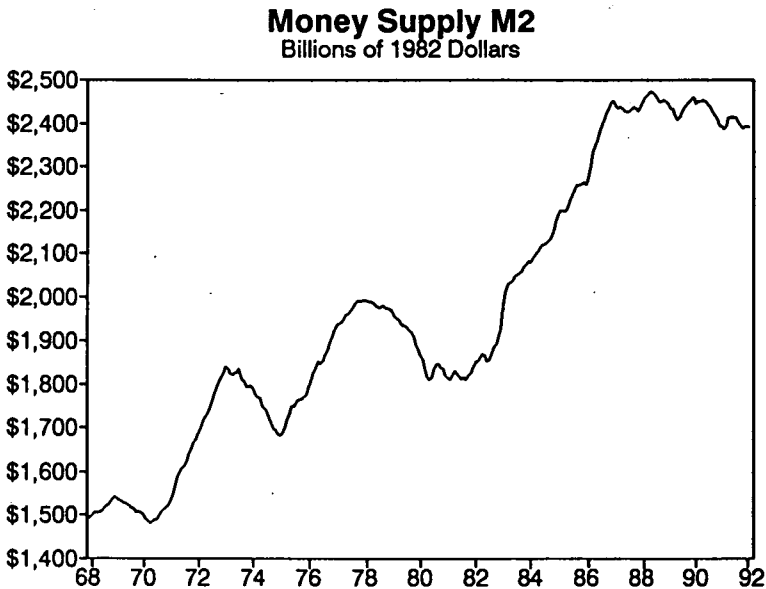
Part of the explanation for the pre-recession slowdown lies in the accumulating structural imbalances, which had been building up in the economy throughout the decade of the 1980s (See box on previous page). Of equal importance, however, was the fact that monetary policy misjudged the state of the economy and was insufficiently attentive to early signs of recession.

Federal Reserve Chairman Greenspan had clearly stated a preference for controlling inflation, even at some cost to growth. As he told the House Banking Committee on October 25, 1989:

I think that [inflation] could be brought down to levels which are closer to zero without putting the economy into recession, though I do suspect there might be some modest loss of economic growth relative to what would otherwise have been the case....

Greenspan's actions as Chairman have closely followed his words. As Figure 28 shows, the Fed brought growth of the real money supply to a halt in late 1987. Since then, the stock of money has been allowed to grow only enough to keep pace with price increases, leaving little or nothing to sustain real growth in the economy.

FIGURE 28



Source: U.S. Department of Commerce.

By mid-1989, as the slowdown became more pronounced, the Fed stopped raising interest rates and began to let interest rates gradually move downward. The move, though necessary, proved too little and too late. The Fed had been too tight for too long. Although the Fed continued to allow interest rates to decline through 1990 and 1991, it was always behind the curve, passively following the economy down rather than aggressively stimulating it.

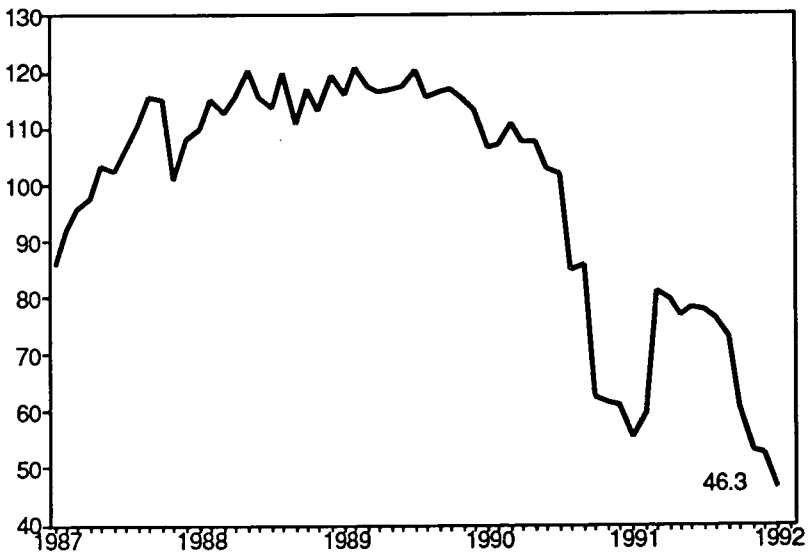
A BROAD-BASED RECESSION

This long period of economic weakness provides a partial explanation for the collapse in consumer confidence shown in Figure 29.

This collapse has puzzled a number of observers who note that declines in the standard business indicators since the downturn began are not as pronounced as in previous recessions, but consumer confidence stands at exceptionally low levels.

FIGURE 29

Consumer Confidence Index 1985 = 100



Source: The Conference Board.

This collapse is partly due to public awareness that economic activity continues to decline, and to the stagnation or decline experienced by most people in their real income (as described in Chapter II). It also stems from the fact that the economy started to falter well before July 1990, giving us a period of poor economic performance, which can be separated into three phases.

The "Slowdown": First Quarter 1989 to Second Quarter 1990.

Cyclical forces typically associated with recession began to slow the economy a year and a half before overall economic activity declined. Employment in the two sectors that usually lead the economy into recession, manufacturing and construction, began to turn down in early 1989 and early 1990, respectively. Manufacturers began cutting production in early 1989 to reduce inventories of unsold goods that had accumulated. In late 1989, ongoing weakness in homebuilding, which had fallen since 1986, overwhelmed a modest upward trend of nonresidential building, and construction as a whole began to slide.

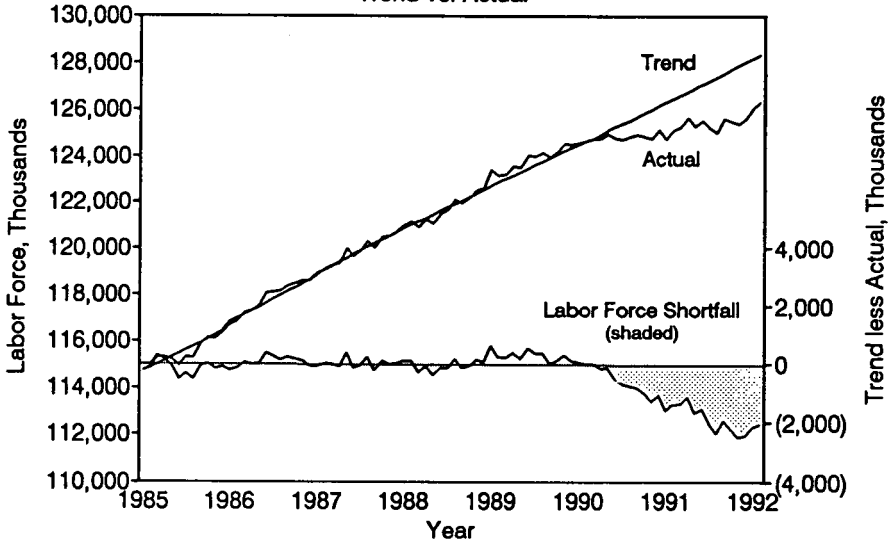
Manufacturing and construction shed relatively small numbers of workers between the beginning of 1989 and the middle of 1990, but these sectors' weakness nonetheless spread to services sectors. Employment growth in services production slowed to 2.5 percent, from early 1989 to mid-1990, from its 3.7 percent pace over the two preceding years. Only when job losses in manufacturing and construction accelerated in the summer of 1990, did services employment actually turn down.

During the period of sluggishness before the actual downturn, the unemployment rate remained steady, but only because of a sharp slowdown in labor-force growth. Figure 30 shows the dramatic drop in labor-force participation from the strong upward growth trend which had prevailed for most of the past two decades. While economists are not yet clear precisely why labor-force growth has slowed so dramatically, it is probable that discouragement among workers about job prospects played some role in their decision to withdraw from the labor market.

Whatever their motivation, the decision by large numbers of workers to withdraw from the labor force helped keep the unemployment rate from rising nearly as fast as would be expected, given the pressures on employment. According to the Bureau of Labor Statistics, had the labor force continued to grow as expected, the unemployment rate in January 1992 would have been 7.8 percent instead of the 7.1 percent actually observed.

FIGURE 30

Slow Labor Force Growth
Trend vs. Actual



Source: Department of Labor, Bureau of Labor Statistics; Joint Economic Committee.

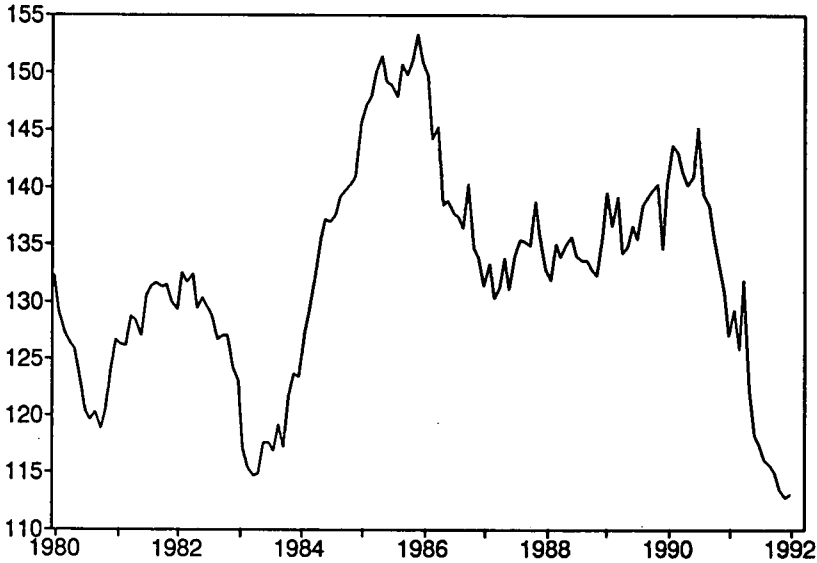
Consumption and all three types of investment (nonresidential equipment, nonresidential structures and residential structures) were weaker in the 1989-90 period than for comparable periods leading up to earlier recessions. Net exports and federal, state and local government purchases of goods and services were stronger.

The Acute Phase: Third Quarter 1990 to First Quarter 1991. The acute phase of the recession coincided with a sharp drop in real consumer spending, unlike earlier downturns when it typically managed to edge up. This presumably reflects the deterioration in consumer attitudes, households' desire to pay down debt, and the poor growth in disposable personal income during the initial slowdown.

FIGURE 31

Real Private Nonresidential Construction

Billions of 1987 Dollars, SAAR



Source: Department of Commerce, Bureau of Economic Analysis.

The falloff in business capital investment has been somewhat more severe than in other recessions, reflecting both the precipitous drop in nonresidential construction (shown in Figure 31) and the slowdown in the computer industry. Deterioration in homebuilding and inventory investment also contributed to downward pressure on the economy, although these sectors closely matched their pattern of performance during other recessions of the last four decades.

Net exports performed much better than had been the rule in past downturns. Weak domestic demand depressed import spending, while exports posted fairly steady improvement. Federal purchases of goods and services were significantly stronger over the course of the recession than they had been in the past. State and local governments, however, played a somewhat weaker role in supporting growth.

Moving Sideways: Second Quarter of 1991 to Last Quarter of 1991. The economy began to expand slightly last spring, but over the next few quarters growth averaged only a 1.3 percent annual rate. This was even more sluggish than the 1.5-percent pace averaged during the initial period of slowdown that preceded the downturn in July 1990. Furthermore, this meager growth began from an already depressed level, given the decline over the three preceding quarters.

Growth overall has been much weaker than in past recoveries, and only two of the basic components of GDP—inventory investment and net exports—have been stronger than in the past. Consumer spending has been much weaker, as has investment. Federal Government spending made a generally positive contribution to growth, and cannot be seen as a major cause of poor economic performance (see box on page 68).

State and local fiscal drag, on the other hand, has had a stronger negative effect on the economy than in the past. State and local governments have been in a precarious financial position for most of the 1980s. The recession early in the decade was a major blow, followed quickly by the Reagan Administration's "New Federalism," which shifted responsibilities onto the state and local governments without a commensurate increase in resources.

The drop in oil prices and problems in agriculture had hit oil patch and farm states hard in the middle of the decade, and the Tax Act of 1986 lowered personal income tax receipts for those states that "piggy-back" their taxes on this part of the federal structure. By the time the state and local government sector was beginning to recover from these events, the national economy was slowing in 1988 and 1989. As a result, revenue growth was falling below expectations, while mandatory spending, such as Medicaid and cyclically sensitive transfer payments, was expanding rapidly. Rainy day funds and accounting adjustments were not adequate to cope with the situation.

THE BUDGET AGREEMENT AND THE RECESSION

The Omnibus Budget Reconciliation Act (OBRA) passed at the end of 1990 represented about \$500 billion of deficit reduction over the 1991-96 period, including what was anticipated to be about \$33 billion of restraint in FY 1991. This represented a substantial reduction in fiscal stimulus compared to what would have happened without OBRA. Some have argued that this fiscal restraint was a major cause of the recession. But a more balanced assessment does not support this conclusion.

First, of course, the recession began in the summer of 1990, and the budget agreement was not reached until the end of the year.

Second, the major effect of the budget agreement was to prevent the budget deficit from widening dramatically; it did not produce a sharp reduction in the budget deficit. According to CBO's calculation of the most common measure of the impulse of fiscal policy, the standardized-employment budget deficit, fiscal policy was largely neutral in FY 1990 (an increase in the standardized deficit of less than \$3 billion compared to FY 1989) and somewhat stimulative in FY 1991 (an increase in the standardized deficit of \$20 billion over FY 1990). Most of the stimulus in 1991 was associated with Desert Storm spending.

Third, it was widely recognized when OBRA was passed that it was incumbent on the Federal Reserve to ease money and credit sufficiently that interest rates could come down, stimulating investment and net export spending. In fact, as noted earlier, the Federal Reserve underestimated the effects of the credit crunch and kept monetary policy too tight for too long.

These governments had little recourse but to raise taxes and cut spending as the general economy turned down. At the state level, alone, the National Governors' Association has reported that 26 states raised taxes in 1991, amounting to an increase of \$10 billion, and revenue increases are expected to amount to a further \$15 billion in 1992. Nevertheless, states are reported to have cut their budgeted expenditures by \$7.5 billion in 1991, and further cuts from this reduced level have been taking place this year. Meanwhile, local governments are under the same pressures; indeed, some of the cuts in state spending have reduced state aid to localities. The results have been scaling back of essential services, including teachers, police, and firefighters. With state and local bond ratings under threat, capital spending has also been cut so as to curb growth of outstanding debt, as well as to restrain debt-service expenses. Even after economic recovery gets under way, it will take some time for state and local finances to recover, and the prospects for a sluggish recovery are likely to prompt caution by local officials.

PROSPECTS FOR THE NEAR TERM

The economy has been in a period of weak economic growth or recession since the first quarter of 1989. While it is unlikely that the economy will remain in a technical recession over the coming year, there is little prospect that growth will be strong in the near future. There are several reasons for this conclusion.

First, labor markets are likely to remain weak for the foreseeable future, making it difficult for the unemployed to find jobs and for those employed to recover a sense of confidence about job security. Labor markets are already much weaker than is generally believed by those who focus only on the unemployment rate. The marked slowdown in the growth of the labor force shown in Figure 30 provides evidence of more severe labor-market problems, as does the recent rise in the broader and more comprehensive unemployment index maintained by the Bureau of Labor Statistics (see box on page 70).

COUNTING THE UNEMPLOYED: THE OFFICIAL RATE AND THE COMPREHENSIVE UNEMPLOYMENT RATE

The Bureau of Labor Statistics provides a number of measures of unemployment in addition to the official unemployment rate, ranging from very narrow to very broad definitions. The two most important are the official rate, which includes jobless individuals who are actively looking for work, and the comprehensive rate, which includes the officially unemployed, plus discouraged workers, plus those who are at work part-time because no full time jobs are available.

While the comprehensive unemployment rate includes all groups that have been partially, as well as totally, affected by joblessness, it is not a complete measure of the hardship caused by recession. It fails to incorporate the loss of income and benefits to workers who have moved down to lower paying full-time jobs, individuals who list themselves as "self-employed" after losing a permanent job, or individuals who have become contract or contingent workers following a corporate down-sizing. But it is helpful in identifying groups other than the officially unemployed who have been partially, as well as totally, affected by unemployment.

In February, the unemployment rate was 7.3 percent, which means 9.2 million people met the official definition of unemployed. On top of this, there were 1.1 million people so discouraged by the current job situation that they have given up looking for work, plus 6.5 million working part-time because they can't find full-time employment, totaling 16.8 million people who are currently affected by unemployment, either totally or partially. The BLS calculates that the comprehensive unemployment rate, which includes unemployed workers, discouraged workers, and half of those working part-time for economic reasons, is now 10.9 percent, the highest it has been in this recession.

There is ample reason to anticipate a continuation of difficult labor-market conditions. Under pressure from foreign competitors and their own internal needs to reduce debt, corporations are slashing costs in what economic analyst Lawrence Chimerine told the Committee was "... the most widespread, dramatic, cost-cutting that I have ever seen since I've been in this profession." Cost-cutting often translates into permanent layoffs and staff reductions of even large and profitable corporations. Labor analysts generally agree that this trend will continue for the foreseeable future.

Labor market problems are also much broader-based in the current downturn. In past recessions, the burden of unemployment was borne disproportionately by blue-collar production workers in manufacturing industries. White-collar and service-sector workers were largely isolated from steep rises in unemployment. In the current recession, blue-collar workers remain hard hit, but there has been an atypical spread of unemployment into the service industries and the ranks of white-collar workers.

During the 1981-82 recession, the rise in the white-collar unemployment rate was only 34 percent of the increase in the overall rate. During this recession, the increase has been equal to 69 percent of the increase in the overall rate. As Richard Belous of the National Planning Association told the Committee:

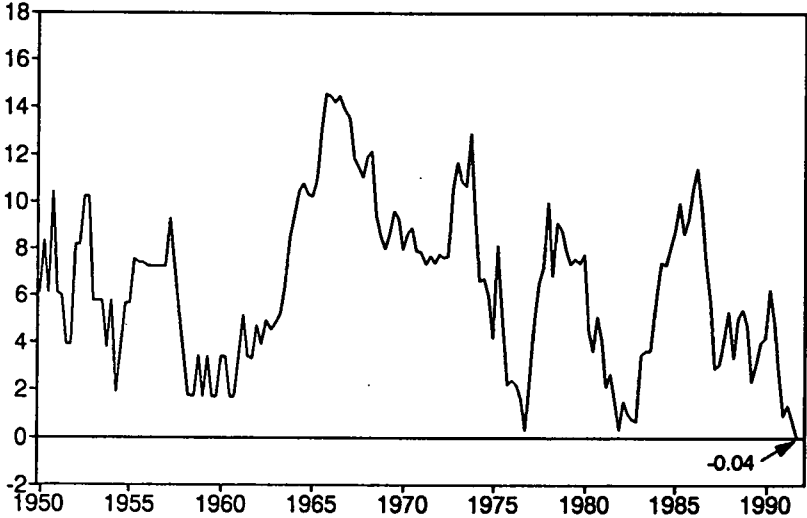
... what has been fascinating about this recession, as opposed to other recessions, [is that corporations] are laying off white-collar workers and high-skilled workers, technical workers, managerial professional workers at a much greater rate than they ever did before.

Even those who retain their jobs have been touched by the slowdown through the mechanism of falling incomes. Figure 32 shows the pattern of change in real per capita disposable income over the past 40 years. Each point on the figure represents the percentage change in after-tax disposable income per capita between the current quarter and the same quarter three years previously. The figure shows that while growth rates in this index have declined during past recessions this is the first time in postwar history where the three-year change in real disposable income was negative. Americans today, on average, have less disposable income than they did three years ago, and this is certain to have a depressing effect on both consumer confidence and consumer spending.

FIGURE 32

Real After-Tax Income Per Capita

Percent Change From Three Years Earlier



Source: Department of Commerce, Bureau of Economic Analysis.

The outlook for other sectors hinges to a considerable extent on the revival of consumer demand. The ability of state and local governments to spend depends heavily upon both growth in personal income and increased retail purchases by consumers. Slow-income growth depresses income tax revenues, while slow-sales growth harms sales tax receipts.

Typically, housing construction is the component of investment which leads the economy out of recovery, but concern about the willingness of consumers to buy new homes has kept homebuilding subdued over the past several quarters. Furthermore, mortgage interest rates have risen significantly since the beginning of 1992. Without a revival in homebuilding, other firms are likely to hold back on investment commitments for fear of inadequate future markets.

Business investment is also likely to remain subdued because of continuing financial problems in many U.S. corporations. The debt boom of the 1980s has given way to pressures for "de-leveraging"—pressures which often translate into reduced willingness to enter into capital spending commitments.

Recent trends in exports and imports suggest that foreign markets may not continue to be a viable alternative to an expanding domestic market. Net exports made a strong contribution to growth over the past several quarters, but recent trends suggest a marked slowing in foreign demand. *Business Week* noted recently that: "Economic growth, particularly in the industrialized countries will not be robust even when recovery comes. That will limit foreign demand for U.S. goods."

This review suggests that the growth prospects for the economy remain weak under current economic policies. Changing this forecast will require substantial new initiatives in both short-term countercyclical policy and long-term growth policy.

Chapter IV

GETTING THE ECONOMY MOVING AGAIN

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

James Tobin

Lawmakers should push for more spending on infrastructure, education and civilian research and development. Such spending would keep the economy growing in the short run and still be the right prescription for the country's long-term health.

Business Week editorial, Feb. 24, 1992

America today faces two important economic challenges: ensuring a swift short-term recovery from recession and shoring up the foundations for sustained long-term growth. In practice, it is difficult to separate the short term from the long term. A prolonged period of stagnation, such as the one we are now in, has a corrosive effect on the underlying fundamentals of growth. Prolonged periods of stagnation:

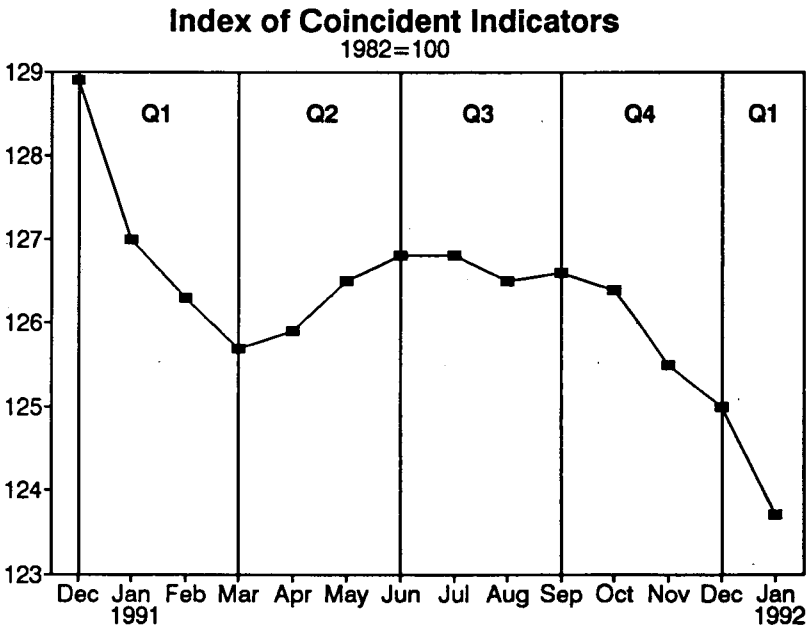
- Undermine the confidence of both consumers and investors in the future of the economy.
- Erode the revenue base of governments, encouraging a destructive process of deferred maintenance and postponed investment.
- Devalue the skills of workers who are forced to go without employment for long periods of time.
- Encourage false economies within firms, such as cutting back on capital investment and research.

For these reasons, an important part of restoring the foundations for long-term growth is ending the current recession and getting the economy moving again. The need for an effective short-term countercyclical strategy is urgent. As this report is being written, there is no convincing evidence that the current recession, already the longest slump since the Great Depression, has been replaced by a sustained recovery.

Despite the urgency of the situation, the Administration has been both slow to recognize the problem and timid in its proposed response. In July 1991, CEA Chairman Michael Boskin drew the Committee's attention to the Commerce Department's Index of Coincident indicators, which in his opinion provided "evidence that the recession appears to have ended earlier this year."

Yet, precisely this same indicator started flashing warning signs at almost exactly the time of Boskin's testimony. As Figure 33 suggests, evidence of renewed deterioration in the economy was clearly available in the fall of 1991, but it was not until January of this year that the Administration brought forward a proposal to address the recession.

FIGURE 33



Source: Department of Commerce, Bureau of Economic Analysis.

Unfortunately, the long wait for an antirecession strategy has not resulted in a robust or effective proposal. The Administration's so-called "growth plan" is based largely on a short-term shift in withholding allowances which is unlikely to induce any significant change in consumer spending, and contains no vision for restoring the long-term vitality of the economy.

Given the broad-based nature of the current recession, there is a need for an equally broad-based countercyclical strategy, one which enhances consumer income and confidence, stimulates business investment, expands export markets, and addresses the contractionary effects of state and local fiscal policy. Such a strategy could have four broad components: further monetary ease, improvements in the automatic income stabilizers, a global growth strategy, and support for state and local governments.

FURTHER MONETARY EASE

In recessions, monetary policy typically focuses primarily on restoring growth, but in this recession, the Fed has been slow to shift to this strategy. Until last December, interest rates had been reduced in small steps, leaving market participants uncertain about the Fed's view of the economy. It was only at the end of 1991—nearly 18 months into the recession—that the Federal Reserve finally moved the federal funds rate down by an amount equal to the historical average in previous recessions.

Furthermore, it is clear that this recession is not typical. Two factors in the current situation call for a more expansionary monetary policy than we have observed to date.

- **The "credit crunch."** Financial institutions have seen their capital base erode as a result of poor lending decisions. This is producing excessive caution and slowing the translation of lower rates into expanded lending activity. With this blockage in the financial system, it will take more aggressive ease from the Federal Reserve to get credit expanding again.
- **The demise of inflation.** A prolonged period of slow growth, a rise in international competition, and cost-cutting associated with corporate restructuring have combined to substantially reduce the threat of inflation to the U.S. economy.

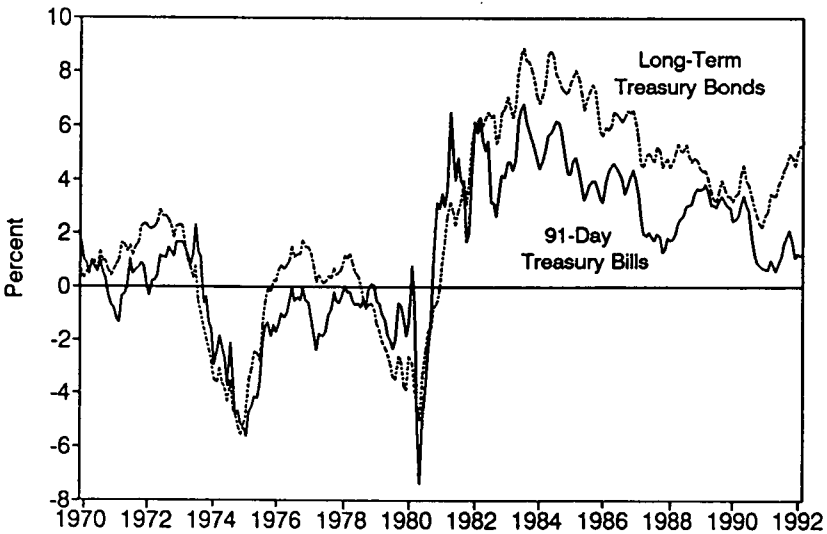
The collapse of inflation has had a profound effect on real interest rates. While nominal interest rates have fallen substantially in the current recession, the steep drop in inflation has left real (inflation-adjusted) interest rates at very high levels. As Figure 34 shows, real interest rates today are still substantially higher than they were at the bottom of any other postwar recession (excepting only the 1981-82 recession when massive tax cuts and a large increase in the budget deficit provided a strong fiscal stimulus that helped push up real interest rates). The federal funds rate could reasonably be reduced to 3 percent or even lower under the current inflation situation, without providing any more stimulus than at the bottom of any previous recession.

The Federal Reserve has been aware of the "credit crunch" for more than a year and a half, but has so far not taken a sufficiently stimulative posture to overcome the credit blockage in the financial system. Chairman Greenspan devoted a large portion of his testimony before the Committee last year to a discussion of the credit crunch problem. In his words:

FIGURE 34

Real Interest Rates

91-Day T-Bills and Long-Term T-Bonds



Source: Federal Reserve Board; Joint Economic Committee.

I do think, however, that we got to the point sometime during the summer of 1990 when we went over the line, if one could basically draw it, and credit was being deprived in a number of instances from otherwise creditworthy borrowers who by any set of criteria were good loan candidates and candidates who would be profitable to the commercial bank, and generalized, would enhance the franchise for the commercial bank. In a sense, I am saying that the commercial banker, the loan officer, are acting against their own long-term self-interests.

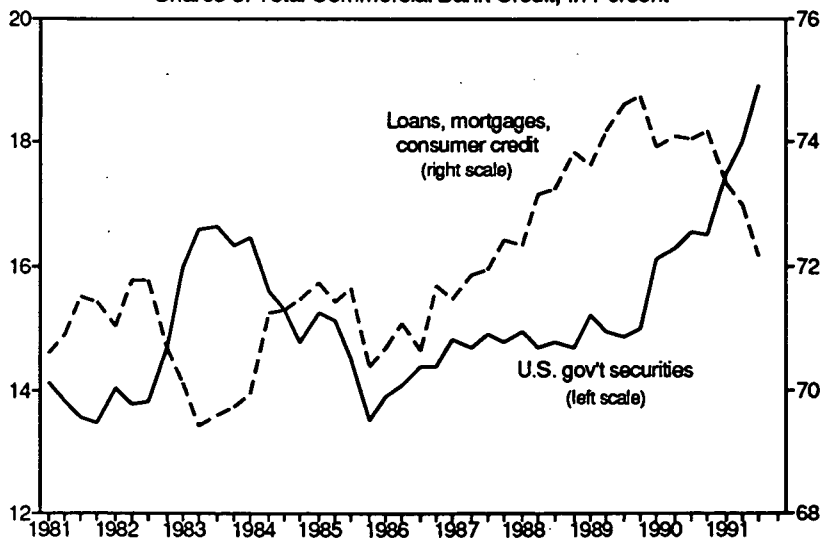
Despite the perception that we went "over the line" during the summer of 1990, there is no evidence that the contractionary effects of the credit crunch have been overcome by Federal Reserve policy.

Figure 35 shows the shifting composition of assets at U.S. commercial banks. It provides clear evidence that banks have shifted away from commercial and industrial lending and toward the holding of low-risk government bonds. At the prevailing level of interest rates, it is more attractive for banks to hold Treasury debt than to bear the risks associated with commercial lending. Lower interest rates would reduce the attractiveness of government securities and encourage banks to get back into the business of extending loans to commercial customers.

FIGURE 35

Loans and Government Bonds

Shares of Total Commercial Bank Credit, In Percent



Source: Federal Reserve Board, Flow of Funds Accounts.

For these two reasons, witnesses before the Committee strongly endorsed further substantial reductions in short-term interest rates. Estimates of the needed reduction varied, but there was strong agreement that rates could and should come down substantially.

So, my first recommendation is this: The dramatic December 20, 1991, full one percent cut in the discount rate should be followed up by a January-February open-market operation expansion, effective to lower federal fund rates by another half or one percent.

Paul Samuelson

Short-term interest rates really ought to be below the ongoing rate of inflation. And that may mean that they need to be down at two percent or less.

James Tobin

The Federal Reserve can, if necessary, cut short-term interest rates by another 300 basis points. [from current levels near 5 percent]

Paul Krugman

At the bottom of a recession, there is plenty of room for strong economic growth, as Greenspan himself testified before the Senate Banking Committee on February 21, 1989:

When the economy is operating below capacity, bringing demand in line with supply can involve real GDP growth that is faster for a time than its long-run potential. For example, in the mid-1980s, the U.S. economy was recovering from a deep recession; with utilization of labor and capital not nearly complete, we were able to bring these resources back into the production process at a pace that substantially exceeded their underlying growth rates. In those circumstances, it is not surprising that growth of real GDP was relatively rapid while inflation performance was reasonably good. [1st *Monetary Report*, prepared testimony, February 21, 1989, p. 9]

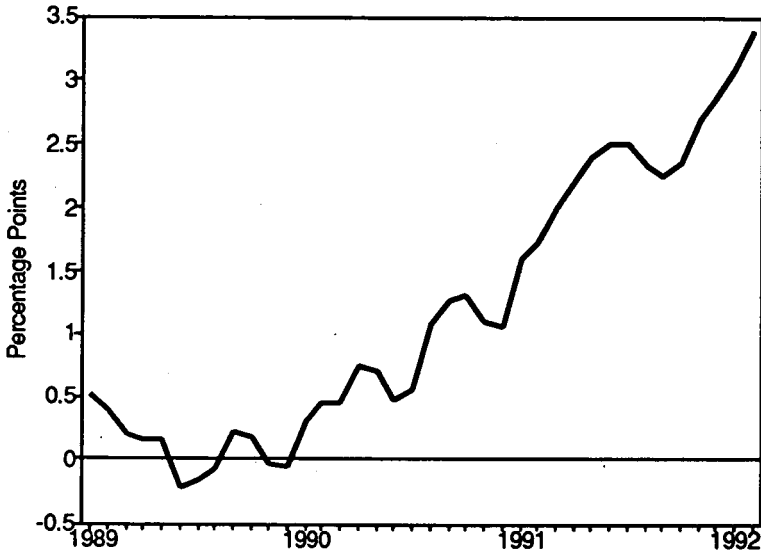
These observations apply as much to the current situation as to the recovery from the 1981-82 recession. It is time once again for the Federal Reserve to follow this proven course.

A second problem with the current stance of monetary policy is the remarkable disparity between short-term and long-term interest rates. Figure 36 shows that the gap between short-term and long-term interest rates now stands near an historic high level while Figure 34 shows that real long-term interest rates have been rising instead of falling.

FIGURE 36

Treasury Yield Curve

Yield on 10-Year Notes Less Three-Month Bills



Source: Federal Reserve Board; Joint Economic Committee.

This disparity between short- and long-term interest rates creates a problem for capital investment in the economy. Investors contemplating long-lived investments face a difficult choice: borrow long term at very high, real interest rates, or borrow on a shorter-term basis to fund long term projects, and assume the risks of later rises in short term rates. In light of these choices, investors may well postpone investments and delay the recovery.

It is important, therefore, that monetary policy be designed to bring long-term as well as short-term interest rates down. While long-term interest rates are influenced by a number of factors, other than monetary policy itself, there are two changes in the conduct of monetary policy which should have an impact on long-term rates.

First, the Treasury Department should use its quarterly refunding as a way of putting downward pressure on long-term interest rates. Given the extraordinarily large gap between short-term and long-term interest rates, the Treasury could both save money for the taxpayers and help

lower long-term interest rates by reducing substantially the proportion of each quarterly refunding operation accounted for by long-term bonds. Such action would reduce the supply of long-term Treasury debt, and lead to a significant increase in bond prices that would lower long-term interest rates.

The Treasury has already taken some small steps in this direction by cutting the proportion of 30-year bonds in the February refunding somewhat below the levels anticipated by the market. Such small steps, however, have been insufficient to convince market participants that the Treasury seriously believes that long-term interest rates are too high. Current conditions demand a firm and public affirmation by the Treasury that issuing significant amounts of long-term debt at prevailing interest rates is both unjustified and imprudent.

Second, the Federal Reserve should support the Treasury debt-management policy by increasing significantly its holdings of long-term Treasury bonds. As of the end of 1991, the Federal Reserve held \$266 billion in Treasury debt—roughly 10 percent of the total stock of federal debt held by the public—but only \$32 billion of the total was in long-term bonds. Open market activities of the Federal Reserve from January to November 1991 were conducted almost entirely with the purchase and sale of short-term securities—\$34.1 billion out of a total of \$35.7 billion in purchases.

If the Federal Reserve were to shift toward longer maturities in its conduct of open market operations, it could easily double its holdings of long-term Treasury debt, adding \$30 billion of demand for the long bond which would drive up its price which drives down long-term interest rates. This shift in demand should be large enough, when combined with a reduction in supply by the Treasury, to have a positive impact on long-term interest rates.

COORDINATED GLOBAL EXPANSION

If the key to reviving investment is lower long-term interest rates, then the key to maintaining momentum for exporters is continued strong market growth overseas. Unfortunately, there appears to be growing concern about prospects for growth abroad in the coming year.

The path of growth for the American economy is increasingly determined by events overseas. Strong growth in net exports has helped

to moderate the severity of the current recession as overseas markets for U.S. goods remained buoyant even as the domestic economy declined.

Over the past several months, concerns have been growing about what appears to be a synchronized slowdown of many of the world's major economies. The rate of growth in U.S. exports has declined substantially over the last two years as our export markets have weakened. Recessions have hit Canada (our largest export market), the United Kingdom, and Australia. Both Germany and Japan were growing at a 5 percent rate in 1990, but have since decelerated abruptly. German GDP has declined in each of the last three quarters, virtually wiping out the effects of a strong first quarter last year. Many Japanese now consider their economy to be in a "recession"—defined in the Japanese context as growth of less than 3 percent per year. Most analysts are predicting continued very slow growth for the Japanese economy in the coming year.

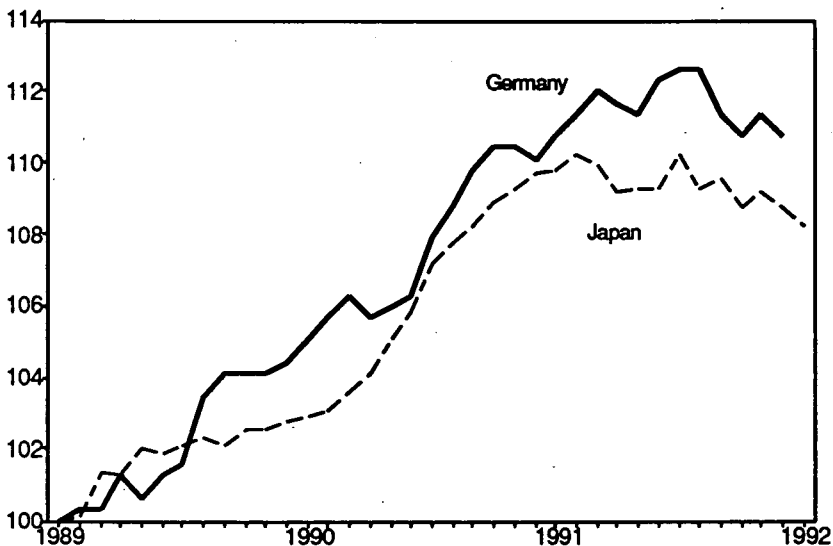
GDP data are always made available long after the end of the quarter, and may not be the most sensitive indicator of either current conditions or the immediate outlook. Data on industrial production, the most important contributor to cyclical movements, are available on a more timely basis, and these data suggest additional cause for concern. Declines in industrial production indices have occurred over the last three months for every major industrial country, including Germany (-4.0 percent) and Japan (-3.6 percent). (See Figure 37.)

Most of our major trading partners are struggling with deep structural problems. For Germany, the issue is the high cost of rebuilding the Eastern Länder and the sharp rise in both interest rates and public debt that have accompanied this process. Japanese financial markets are struggling with the "bubble" of speculation which gripped equity and real estate markets during the 1980s. Japanese banks are allowed to count gains on stocks as part of bank capital, so stock market declines threaten bank capital. As a result, Japan is presently trying to cope with its own version of the "credit crunch" as corporations find it difficult to raise funds from nervous stock and bond markets, and banks are reluctant to lend because of fears of capital adequacy. High public-sector borrowing and rising interest rates in Germany are helping to drag down growth throughout Europe. The United Kingdom has been in recession for nearly two years—its longest slump since the 1930s—and France now appears to have also fallen into recession. With their currencies tied to the Deutschemark through the European Monetary System, the contractionary effects of high German interest rates are spreading throughout Europe.

FIGURE 37

Declining Production in Germany and Japan

Index of Industrial Production, 3-Month Moving Average



Source: Department of Commerce, Bureau of Economic Analysis.

Taken individually, mild recessions in any of the major countries should pose no particular problem. A coordinated, worldwide recession is quite a different matter. Shrinking global markets in a climate of highly leveraged corporations raises the risk of a global financial crisis and a beggar-thy-neighbor trade war. It is now essential that fiscal and monetary policy in the major nations be oriented toward growth.

The precise mixture of growth-promoting fiscal and monetary policy differs from country-to-country. All of the major countries would benefit from easier monetary policy as important segments of the business community in each country have been demanding. Fiscal stimulus appears to have a greater role to play in Japan and the United Kingdom, given the very high fiscal deficits in both the United States and Germany.

A second important component of a global growth strategy involves financing growth in Eastern Europe and the former Soviet Union. Much of the debate about the future of these countries misses an essential point: regardless of how dramatic the market-oriented reforms, none of these

countries is going to experience any significant economic growth without significant external financing. Factories in these countries are totally outdated by world standards, and there is little prospect that they can generate export sales without an almost complete recapitalization. The lack of convertibility of currencies means that even if domestic savings were available to finance such a recapitalization, it would be impossible to purchase the needed capital goods on world markets with purely domestic savings.

External finance on a large scale need not—and perhaps should not—come from governments or other public entities in the west. Private capital, in the form of direct or portfolio investment as well as debt financing, should play a major role in any attempt to move these economies in the direction of market-based growth.

Available evidence suggests, however, that neither private nor public capital are presently being made available on the scale required.

Because we believe the world economy now stands at an important turning point, we recommend an immediate summit meeting of the G-7 nations to seek commitments from all the major countries on a global growth initiative. The most recent G-7 summit issued a vague communique on the importance of coordinated global growth, but few substantive commitments were undertaken by any of the major countries. The world economy cannot afford to continue dealing with the growth problem by rhetoric alone.

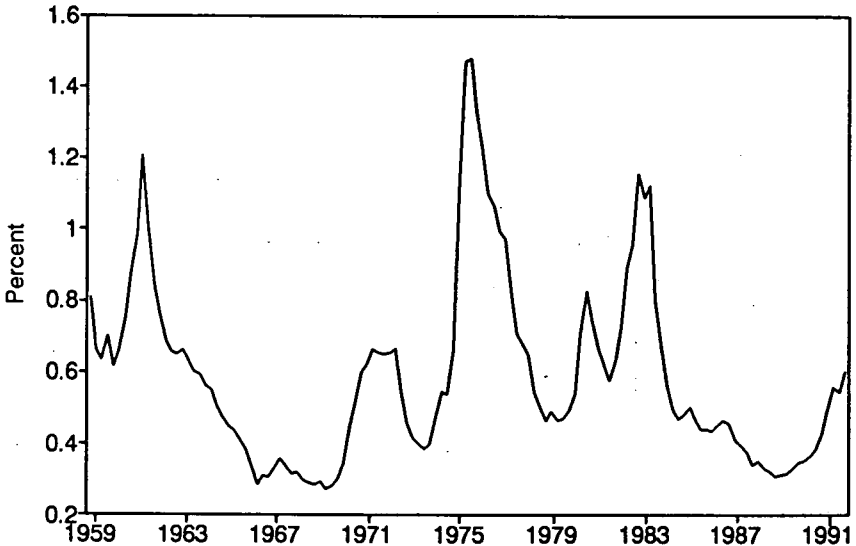
IMPROVE THE AUTOMATIC STABILIZERS

The unemployment insurance (UI) system has lost much of its capacity to stabilize the economy in recessions. Changes at both the federal and state level of the UI system have weakened its responsiveness in recessions. Federal legislation for UI benefits for the long-term unemployed (enacted in November and February after months of opposition from the Administration) has strengthened the countercyclical effect of UI on a temporary basis, but permanent reform is needed.

FIGURE 38

UI Benefits Less Responsive in this Recession

UI Benefits as Percent of Personal Income



Source: Department of Commerce, Bureau of Economic Analysis.

Figure 38 shows the share of personal income provided by the UI payments, both state and federal. This share rises during recessions because more workers lose their jobs and because they must take longer to find new jobs. In previous recessions, the Federal Government has stepped in to provide additional weeks of benefits beyond the standard 26 weeks of state programs. During this recession, however, both the level and increase in UI benefits have been lower than in past recessions.

The UI system stands in need of permanent reform at the federal and state levels. At the federal level, the permanent law for extended benefits was made so restrictive in the early 1980s that it triggered on for only a handful of states for a few months in this recession. After a four month battle to convince the President of the need for change, Congress succeeded in enacting a more appropriate temporary system for extended benefits. The temporary program was further strengthened in February.

The current temporary program of extended benefits will expire in July. Because we expect unemployment and job loss to remain high even

if the economy posts a technical "recovery", it is likely that a further extension of this program will be required. When this issue is taken up, Congress should work toward permanent reform of the EB trigger mechanism. Such reform should insure that the trigger respond more promptly in future economic downturns.

In the state UI systems, there has been a steady erosion in the share of job losers who are made eligible for the basic 26 weeks of UI coverage. Through the late 1970s, the number of people receiving unemployment benefits matched the number who lost jobs. The fraction of job losers covered has fallen steadily through the 1980s, and in the current recession, almost one-third of job losers were not covered by unemployment insurance. The rules in each state differ widely among states, but the trend toward more restrictive eligibility rules has been widespread. This trend toward restrictiveness undermines both the countercyclical and humanitarian purposes of the UI system.

Finally, we should reconsider the adequacy of current programs for workers displaced from their jobs, focussed as they are on income support. The evidence is mounting that an increasing share of job losers have permanently lost their jobs. Many of them cannot hope to find new jobs comparable to their old jobs. While simple income support makes sense for workers on temporary layoff, a more active system of employment counselling, placement service, and training is needed for those who must find very different jobs.

AID STATE AND LOCAL GOVERNMENTS

There is little doubt that the state and local government sector is producing considerable drag on the economy, in sharp contrast to the experience during past recessions. Prior to the 1981-82 recession, state and local spending had been neutral with respect to the business cycle. These units of government generally maintained spending and refrained from raising taxes in a recession, and instead used reserve balances to offset the effects of recession on their receipts.

This year's *Economic Report of the President* acknowledges the pronounced shift from stimulus to restraint in the state and local sector. Rather than measure restraint using a "standardized deficit" concept, the *Economic Report* discussed state and local fiscal activity in terms of growth in total spending.

State and local government purchases were somewhat more constrained than the average for other recessions, falling about 0.6 percent during 1991. The fall in 1991 followed a 3.8 percent rise during 1990. The decline in 1991 reflected the tight State and local government budget situation. In earlier recessions, State and local government purchases were countercyclical, increasing 2 percent on average during recessions. During the first year of recoveries since 1959, State and local government spending increased 2.7 percent on average. [p. 59]

Had state and local spending followed the historic pattern and risen 2.7 percent instead of falling 0.6 percent, this sector would have contributed roughly \$20 billion of new spending in the economy.

Spending growth is an imperfect measure of fiscal drag, however, since it says nothing about how states and local governments manage to finance their spending. Maintaining spending through tax increases simply shifts the contractionary effect on the economy from the public to the private sector, and a large number of state and local governments have been raising taxes during the current recession.

Figure 39 attempts to capture both spending cuts and tax increases in a single measure of fiscal drag. The figure provides quarterly estimates of the change in the "structural" deficit for the state and local sector. This calculation excludes trust funds and the loss of tax revenue associated with the recession, in attempting to calculate the net effect on the economy of policy changes (tax increases and spending reductions) undertaken at the state and local level. It shows several quarters of fiscal stimulus from this sector during 1989 as governments sought to maintain spending through what appeared to be only a temporary slowdown in the economy.

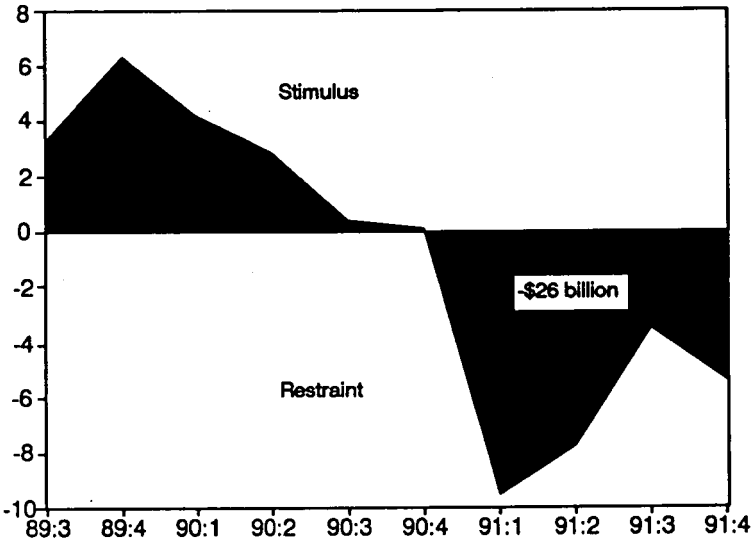
As 1990 progressed, however, and the economy continued to deteriorate, state and local governments realized that their problems were not temporary and had to be addressed with sharp tax increases and spending cuts. The resulting shift toward fiscal restraint is estimated to have produced over \$26 billion in contractionary pressure on the economy in the 1991 calendar year.

And the prospects are for continuation of this trend. Tax increases and spending cuts in state and local governments have been almost a daily occurrence throughout the United States in 1992, and it is reasonable to estimate that this will continue into next year's budget cycle as well.

FIGURE 39

Fiscal Impulse, State and Local Government

Billions of Dollars



Source: Joint Economic Committee.

From a macroeconomic point of view, the fiscal drag exerted by state and local government budget decisions helps to prolong the recession. Of perhaps greater concern is the fact that the fiscal problems of state and local governments are causing significant cutbacks in public investments which the country urgently needs (see box for examples).

The long-term consequences of this recession-induced assault on essential public investments was described well in the testimony of MIT's Professor Paul Krugman:

... the kinds of state spending that are being slashed now are ones that have a very strong spill-over to the nation as a whole. It is not simply a state matter. It is 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.

INVESTMENT CASUALTIES FROM THE STATE AND LOCAL FISCAL CRISIS

In today's fiscal crisis, many of the items being cut from state budgets involve investments critical to the Nation's future. For example:

- **Seventy-four percent of school principals responding from 41 states said their budgets had been cut this school year.**
- **In California, the state has cut education spending 12 percent in real terms over the last three years.**
- **In 1991, according to the Commerce Department, capital spending by state and local governments was down by 2 percent from 1990, after correcting for inflation, the first such cut since the recession of 1981-82.**
- **About 265,000 miles of highway are at or below accepted engineering standards for cost-effective maintenance.**
- **Congestion cost 8 billion hours of delays in 1989 on the Interstate Highways and other major arterials alone.**
- **In the Nation's 39 largest metropolitan areas, the cost of congestion, including costs for delay and fuel consumption, was estimated to be over \$34 billion in 1988.**

In light of prospects for a weak recovery, these facts strongly argue for some program of temporary federal assistance to state and local governments, a program which would also strengthen the foundations for long-term growth in the economy. Any such program should be designed to avoid permanent increases in the federal deficit.

FINANCING A STIMULUS PROGRAM

Some of the short-term proposals discussed above require federal resources. Resources to support such proposals can come from one of two sources: shifting expenditures around within the current spending ceilings in the budget, or temporarily suspending these ceilings and increasing the federal deficit. The first course of action can produce some increased economy activity by "front-loading" already programmed spending, but produces no increase in the economist's measurement of fiscal stimulus.

The Administration apparently sees the need for some fiscal stimulus at this point. The Office of Management and Budget numbers show that the President's budget proposals will add \$23 billion to the "standardized deficit" for the current fiscal year. (See Box on following page for discussion of the measurement of fiscal stimulus.) However, the economic effects of the President's deficit proposals are likely to be much smaller than would be suggested by the anticipated changes in the standardized deficit.

By far the largest element of the Administration's policy package is the change in withholding of personal income taxes—\$16 billion out of a total of \$23 billion. From an economic perspective, the reduction in withheld taxes can be questioned seriously as a source of meaningful stimulus. A sizable proportion of households probably will not change their spending plans because they will be aware of the largely offsetting reductions in their tax refunds or increases in their tax payments due only ten months from now.

DEFICITS AND STIMULUS

Since Keynes, economists have understood that government fiscal policy can help sustain economic activity during a downturn by borrowing the money needed to maintain or increase spending. The United States currently has a very high federal deficit, which leads many to conclude that fiscal policy is now highly stimulative. But what is stimulative of current economic activity is an increase in the deficit, not the deficit itself. Markets adjust to current fiscal policy, and there is no stimulus to the economy if the stance of fiscal policy remains unchanged.

There is also no stimulative effect of federal outlays which do not increase domestic spending, such as payments on deposit insurance. These outlays do not add new stimulus to the economy; they simply prevent the serious contraction that would occur if depositors actually lost money. Finally, there is no fiscal stimulus from deficit increases resulting from recession-induced declines in revenue. Revenues fall because taxable incomes fall, and hence are the consequences of contracting economic activity.

To get a picture of the impact of fiscal policy on the economy, economists compute the change in a measure of the fiscal deficit that is "standardized" to remove the effects of recession and the impact of outlays which do not increase spending.

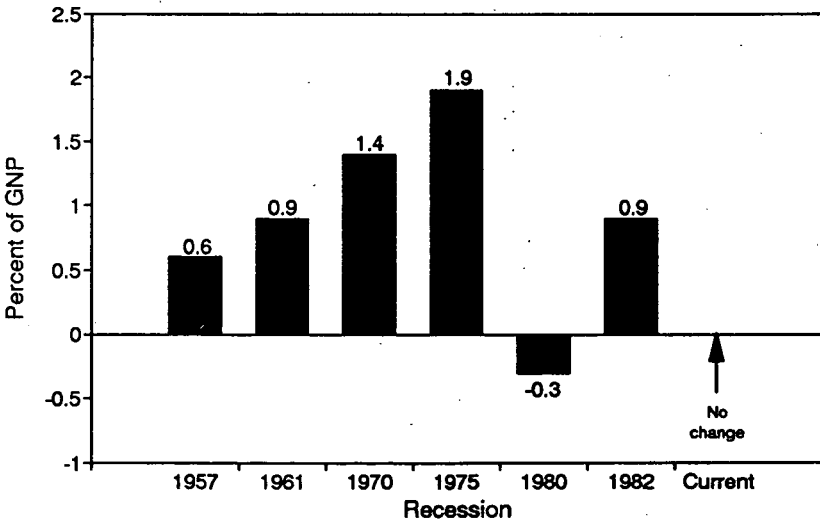
According to CBO calculations, the "standardized" deficit is roughly half of the size of the total deficit and has not changed significantly over the past several years. While this measure shows little real progress toward deficit reduction (a critical long-term problem for the economy), it also suggests that current fiscal policy is not providing much stimulus, despite a very large nominal deficit.

The unemployed, who are under the most financial stress, are not directly affected by the withholding changes because they have no paychecks from which taxes are taken. More highly paid workers generally in the middle-income brackets—those who might be expected to account for the lions' share of any stimulus to consumption spending—would be particularly likely to be aware that their tax liability for the year was unchanged. Indeed, some of them might offset the change in withholding by changing their quarterly estimated tax payments, even if they did not file new withholding instructions with their employers.

On balance, the economically significant parts of the President's program are very small. When they are added to current law, it appears that the budget would shift to stimulus by 0.3 percentage points of potential GDP in FY 92 and would swing in the opposite direction by the same amount in FY 93. This leaves a substantial gap from the amount of stimulus apparently intended by the President and an even larger shortfall from the historical precedent of previous business cycles. (See Figure 40 for historical comparisons.)

FIGURE 40

Federal Fiscal Stimulus
Post-War Recessions



Note: Stimulus measured by change in standardized deficit from 4-quarter period ending with the cycle trough to the following 4-quarter period.

Source: Congressional Budget Office.

The small level of federal fiscal stimulus, combined with substantial fiscal drag from state and local governments, has resulted in an increasing call from the economics' profession to undertake short-term fiscal stimulus (see box). Among those calling for stimulus, there appears to be a consensus that an increase in the standardized deficit by about 1 percent of GDP is roughly the right order of magnitude.

Under normal circumstances, there is little doubt that the Federal Government would move rapidly toward stimulus as a way of counteracting today's long and severe recession. Unfortunately, we do not face normal circumstances. For more than a decade, the Administration has presented budgets with enormous deficits. Since 1980, the total federal debt has risen from \$980 billion to \$3.5 trillion.

One price which the nation is paying for the high deficits of the 1980s is the constraint placed on policy to move the economy out of recession. Given this history of extraordinary deficits, many who would otherwise endorse fiscal stimulus are now counselling caution. They base their concern on two factors: the concern that high deficits already raise the risk of crowding private investors out of credit markets, and a fear that political pressures would make it impossible to limit fiscal stimulus to short-term and temporary measures only.

Witnesses before the Committee expressed these concerns. Those who supported temporary fiscal stimulus agreed that over the longer term, it was important for the health of the economy that the structural budget deficit be reduced substantially. Most agreed, however, that temporary fiscal stimulus, carefully targeted toward addressing long-term problems, would pose no threat to the long-term prospects of the economy, provided that the stimulus produced no permanent increase in the budget deficit.

Economic analysis cannot adequately address the concern that political pressures might distort temporary fiscal stimulus into a permanent addition to our long-term structural deficit problem. For this reason, the Committee has refrained from endorsing fiscal stimulus in the abstract without reference to specific concrete proposals which have yet to be finalized by other legislative Committees.

ECONOMISTS ADVOCATE FISCAL STIMULUS

Because monetary policy has been too little and too late, because at best looking into the future involves variable lags in taking effect, the weakening of our economy in the October-January period persuades me to change my mind [on the subject of fiscal stimulus] and persuades me that judicious fiscal expansions can favor job opportunity and investment in the short run without prejudicing productivity and capital formation in the long run.

Paul Samuelson, Nobel Laureate in Economics

It is prudent to take some demand-increasing fiscal initiatives early in 1992, as insurance against the possibility that monetary ease will not succeed in bringing the economy out of its doldrums....A total 1992 deficit-financed fiscal package of \$60 billion, one percent of GNP, seems in the right ball park.

James Tobin, Nobel Laureate in Economics

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

George Perry, Brookings Institution

We need more fiscal stimulus. We shouldn't be hamstrung by last year's budget deal in every element. We should be willing to be more flexible about shifting funds from the defense account, as the world has changed, into other tax cuts or, where appropriate, domestic spending. And we should be willing to accept a moderate increase in the deficit estimate in order to achieve these goals because the policy goals will lead to a stronger rate of economic growth in '92 and the out years.

Lawrence Kudlow

Should it prove possible to develop adequate safeguards against permanent increases in the deficit, the Committee wishes to re-state a key recommendation of last year's *Report*:

Fiscal policies to stimulate current activity should also address the longer term problems in the economy. Investments in infrastructure and public works, for example, have contributions to make in both a structural and a cyclical context. Such spending creates productive assets as well as current income.

Chapter V

GETTING BACK ON THE RIGHT TRACK

What the U.S. actually looks like is, if we are to compare it to other countries, the performance of Great Britain in the 1950s and 1960s and the first part of the 1970s—a continual, steady but gradual economic decay. Everybody is unhappy and complains, but no one sees it as a sufficient crisis to motivate them to change national economic policy.

Barry Bosworth

Over the course of the four years of the Bush Administration, we will have the lowest growth rate of any Administration since that of Herbert Hoover. And that's according to the Administration's own economic forecast. And the longer term prospects are for quite slow growth.

William Niskanen

An appropriate package of short-term monetary and fiscal actions should enable the economy to get out of the current recession and back to positive rates of growth. But recovery alone is not enough. Under prevailing approaches to economic policy, there is little prospect of achieving the kind of strong, sustainable long-term growth performance which American firms and workers have managed to achieve in the past. Once we take steps to get the economy moving again, we will need to adopt a fundamental re-orientation of long-term policy in this country.

THE ADMINISTRATION'S VIEW OF THE FUTURE

The likely course for the economy under the economic policies of the current Administration was presented in two documents: this year's Budget and the *Economic Report of the President*. In both documents, the Administration lays out a scenario for the future which envisions an economy operating far below its potential for many years.

Administration projections anticipate that recovery from the current recession will be unusually weak. They foresee real growth of 2.2 percent over the next four quarters and 2.8 percent per year until 1997, when they expect the unemployment rate to have returned to its pre-recession level. In the past, real growth averaged 6.7 percent during the first year of other recoveries since World War II, and growth over the five years following a recession, averaged 3.9 percent annually.

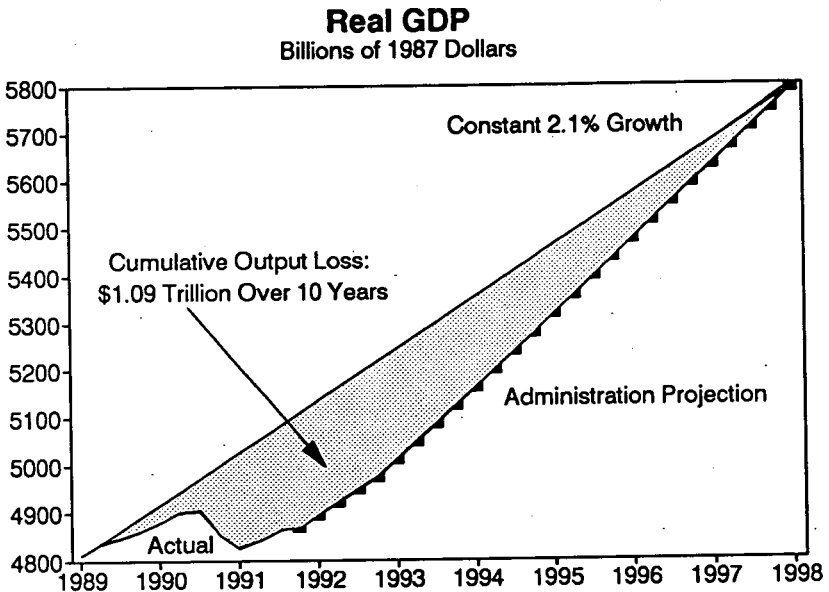
Persistently slow growth—which also is expected by the Congressional Budget Office and many private forecasters—implies that the economy will be operating well below potential for years to come. Economists define "potential GDP" as the value of output which could be produced by the Nation's workers and capital working at the maximum rate consistent with stable inflation. The "potential growth rate" is the maximum rate at which total possible output could grow over time without accelerating inflation.

The cumulative output losses that accrue as the economy operates below potential are quite sensitive to the growth rates assumed for potential GDP. Among recent estimates of long-run potential growth, the Congressional Budget Office offers an extremely cautious estimate of 2.1 percent per year. Using this estimate of the potential GDP growth rate, the Administration's anticipated real growth rate will bring the economy back to full use of resources by 1998.

Figure 41 shows the problem. The top line shows the path that real GDP would have taken if the economy had grown at CBO's estimated 2.1 percent annual rate. The bottom line in the figure shows the path of actual GDP during 1989-91 and, thereafter, the growth path projected by the Administration, assuming that their policy prescriptions are adopted. The area between the two lines represents the cumulative loss of output resulting from the persistence of idle workers and facilities. At these rates, the total cost of such a slow recovery amounts to over one trillion dollars in foregone output and income.

Many regard the CBO path of potential GDP as excessively cautious. The Administration itself assumes that the long-run potential growth rate of the economy is 2.2 percent per year, and under these assumptions, the cumulative value of lost output rises to nearly \$1.4 trillion by 1999.

FIGURE 41



Source: Office of Management and Budget; Joint Economic Committee.

Lawrence Hunter of the U.S. Chamber of Commerce testified before the JEC that potential output was growing even faster, at about a 3.0-percent rate. Under this assumption of potential growth, the cumulative value of lost output by the end of the century would be 4 trillion dollars, and the country would never close the growth gap, operating permanently at a level well below its potential.

Lawrence Hunter described the current Administration plan for our economic future in the following terms:

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, 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.

This lowering of expectations is also clear with respect to the Administration's estimates of productivity growth. Compare the following sentences from this year's and last year's *Economic Report of the President*:

After 1992, assuming the Administration's pro-growth initiatives are adopted, underlying economic growth is expected to approach 3 percent and labor productivity growth is projected to be about 1.6 percent.
[1992 *Economic Report*, p.78.]

After 1991, assuming the Administration's pro-growth initiatives are adopted, underlying economic growth is expected to approach 3 percent and labor productivity growth is projected to be 1.9 percent.
[1991 *Economic Report*, p. 75.]

In the space of a single year, the Administration has thus cut its estimate of long-term productivity growth by nearly a fifth (from 1.9 percent to 1.6 percent). Given that a major premise of economic policy under the Reagan and Bush administrations was that supply-side policies would increase the country's long-term growth rate, this substantial lowering of expectations for the future represents a stunning admission of failure in the conduct of economic policy. As MIT's Professor Krugman pointed out:

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

RESTORING OUR GROWTH POTENTIAL

From this discussion, it is clear that the country faces a double challenge: First, we must revive economic growth to close the gap between actual and potential GDP as quickly as possible; second, we need to take steps to raise the growth rate for potential GDP.

The first challenge must be met with the kind of short-term counter-cyclical policies discussed in the previous chapter. Raising the rate at which the economy can grow over the longer term will require policies

which improve productivity. And the key to productivity growth is improved investment. As Nobel Prize winner Robert Solow told the Committee:

The shortest possible response I know is that the only source of productivity increase is investment, provided you interpret "investment" broadly so that it includes not only bricks and mortar, not only plant and equipment, but also human capital and knowledge. The only way we know, other than to sit and wait to be lucky, is to devote resources to making things better in the future rather than consuming them now.

Any long-term growth package needs to deal primarily with improving both the quality and quantity of investment in the economy. Public policy can contribute to this objective directly through improvements in direct public investment, and indirectly through improvements in the environment within which private investment decisions are made.

PRIVATE SECTOR RESPONSIBILITIES

Increasing the priority placed on investment is going to require substantial changes in behavior from all participants in the economy. The public sector must do its part, but public policies alone cannot be expected to generate changes on the scale required to lift the economy from its present path of anemic growth. Private actors—firms, households, and individuals—will also need to make profound changes in their behavior if we are to build a strongly growing economy in the future.

Government policies can help improve the incentives for these desirable changes in behavior, but incentives alone will not bring about the needed changes. The turnaround we need will require that all sectors take new responsibility for their economic performance.

For individuals and families, these new responsibilities include:

- **Increasing savings**, in order to finance from domestic sources the new investments which the economy requires.
- **Pursuing education.** American workers will not be able to maintain their relatively high living standards unless they remain the most productive in the world. In today's technological economy, high productivity requires verbal, mathematical, and problem-solving skills of a very high order.

- **Focusing on the quality of work and taking increased pride in craftsmanship and performance.**

Business firms also must accept new responsibilities. They include:

- **Improving management.** In too many industries, U.S. managers have failed to incorporate the best available techniques in production and management. The skill with which management combines labor, resources, and technology will largely determine our success in the future.
- **Connecting pay to performance.** The foundation of a market system is that financial reward reflects an individual's economic contribution. The perceived gap between pay and performance for the managers of American corporations is corrosive to this foundation, and may exact a high price in terms of overall performance of enterprises and the economy.
- **Lengthening time horizons.** Firms in many of our competitor countries have very long-term time horizons within which they plan investments. U.S. managers, by contrast, tend to operate with much shorter time horizons, a significant reason for the relatively poor performance of U.S. investment.
- **Increasing the commitment to workers.** Firms in every industrialized economy with high productivity growth have a much different attitude toward their employees than do many American firms. High productivity growth requires both a willingness of firms to invest in their workers, and the enthusiastic participation of workers in the process of production. Neither is likely to develop if management regards workers as disposable.
- **Competing in international markets.** Too many U.S. firms, particularly small- to medium-sized ones, fail to focus sufficient attention on international markets. This is both costly to the country's trade balance and short-sighted from the perspective of the firm. Markets are steadily becoming more integrated around the world, and no firm can hope to retain market share or technological leadership unless it seeks a position in major markets.

PUBLIC SECTOR RESPONSIBILITIES

These brief points make it clear that a large part of the responsibility for improving the performance of the American economy rests with workers, households, and firms. Government has a role to play, and this section will discuss suggestions concerning the appropriate course of government policy. It must be emphasized again, however, that no government policy—no matter how well designed and implemented—will be sufficient by itself to reverse the deterioration in economic performance that we have observed over the past few decades.

In restoring the foundations for rapid growth, government has two different kinds of responsibility. First, it has a role as facilitator, using taxes, laws, and regulations to create a positive climate for increased investment by the private sector. Second, it has a role as investor, carrying out investment projects that the economy needs, but which the private sector is either unable or willing to do only at a level too low to sustain adequate growth.

FACILITATING PRIVATE INVESTMENT

Deficit reduction. The large federal deficit acts as a drag on investment in the economy in three important ways: First, if the federal deficit persists even at full employment, there is a danger that government demands for credit make a large claim on our limited pool of domestic savings, driving interest rates up at the expense of private borrowers. Second, the lack of progress on deficit reduction creates enormous uncertainty about the future. Everyone knows that eventually something major will have to be done about the deficit, but no one knows precisely what this will be. Such uncertainty undermines investor confidence in the future. Third, the debt service demands of the federal debt "crowd out" important public investments and deprive the private sector of needed infrastructure.

For these reasons, reducing the federal deficit needs to be a major goal of long-term economic policy. In exploring ways of reducing the deficit, however, it is essential to understand the origins of the deficit and the forces which are keeping it such a large problem for the Nation. Today's huge deficit problem is largely the result of three factors: excessive tax cuts early in the 1980s, which did not generate the promised increase in growth; strong growth in military spending; and a huge

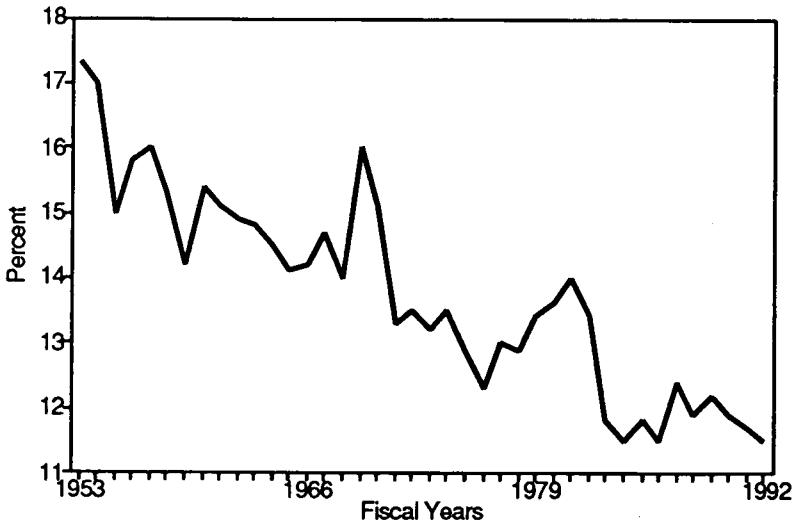
increase in interest payments on the debt resulting from the tax cuts and the increased military spending.

Figure 42 tells the tax story. Social insurance programs are funded with dedicated revenues and generally match revenues and expenditures (see box). Excluding social insurance taxes, the share of GDP accounted for by federal taxes has been on a downward trend since the early 1950s, with the sharpest drops coming in the late 1960s (following the war in Vietnam) and in the early 1980s. These taxes accounted for 14 percent of GDP in 1981 and fell sharply to 11.5 percent in 1991.

On the spending side, the Federal Government has two kinds of outlays: those considered "discretionary" in that they reflect annual appropriations, and those considered "mandatory" because they reflect contractual obligations (e.g. deposit insurance and debt service) or provide defined benefits according to legislative formulas (e.g. Social Security, Unemployment Insurance, and Medicare).

FIGURE 42

Federal Tax Receipts as Percent of GDP
Excluding Social Insurance



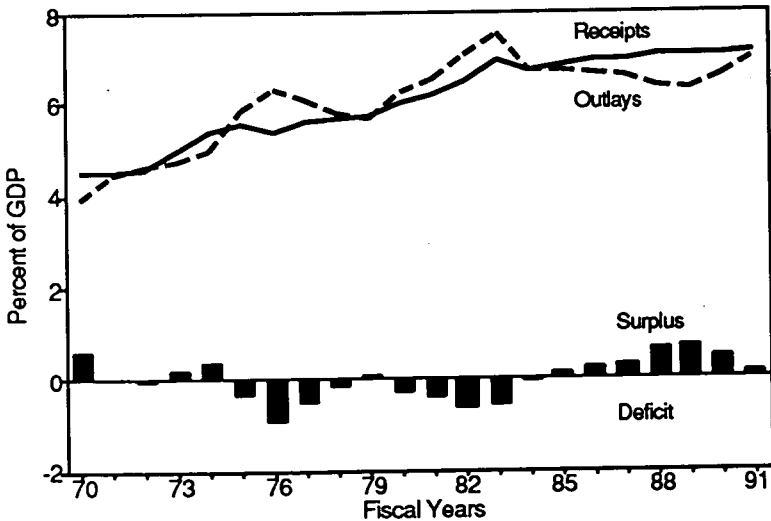
Source: Office of Management and Budget.

**FOR DEFICIT REDUCTION
ENTITLEMENTS ARE NOT THE MAIN PROBLEM**

By far the largest entitlement programs are Social Security and Medicare, which, together with Unemployment Insurance, account for two-thirds of entitlement spending. Yet, these programs are all primarily funded by dedicated taxes, which in some cases (Social Security) substantially exceed current outlays. All other entitlements, including Civil Service and Veterans' Retirement, Medicaid, and Food Stamps, have declined from 4.2 percent of GNP in 1979 to 3.5 percent in 1989.

The following figure shows the implications for the federal deficit of the funded entitlements. It demonstrates that, in recent years, the funded entitlements actually had an excess of revenue over expenditures. Instead of contributing to the deficit, they act to reduce it.

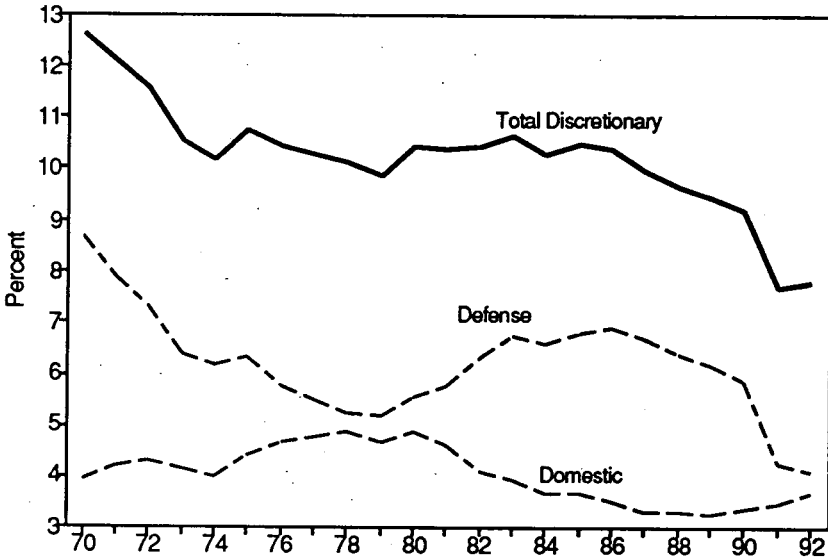
Major Entitlements and Their Funding
Social Security, Medicare and UI



Source: Office of Management and Budget.

FIGURE 43

Discretionary Outlays by Fiscal Year As a Share of GDP



Source: Office of Management and Budget.

Figure 43 demonstrates the principal changes in spending. It shows that the aggregate of domestic and defense discretionary spending has been on a generally downward path as a share of GDP. During most of the 1980s, however, discretionary spending for defense and international affairs rose significantly as a share of GDP, while domestic discretionary spending fell substantially. Had military spending followed the same path as domestic discretionary spending, the huge annual deficits of the 1980s would have largely disappeared. If we include the interest payments on the debt used to finance the rising share of GDP going to the military, the entire deficit of the 1980s is accounted for.

Programs providing defined benefit payments to individuals have played some role in increasing deficits, but their contribution is frequently over-stated by those who argue that "entitlements" are taking over the budget. The largest of these programs—Social Security, Medicare and Unemployment Insurance—are largely funded with dedicated tax revenues which have overall more than kept pace with outlays (see box on p. 107). The principal contributors to the deficit on the spending side have been changes in discretionary spending (largely military) and in the debt service burden associated with past changes in spending.

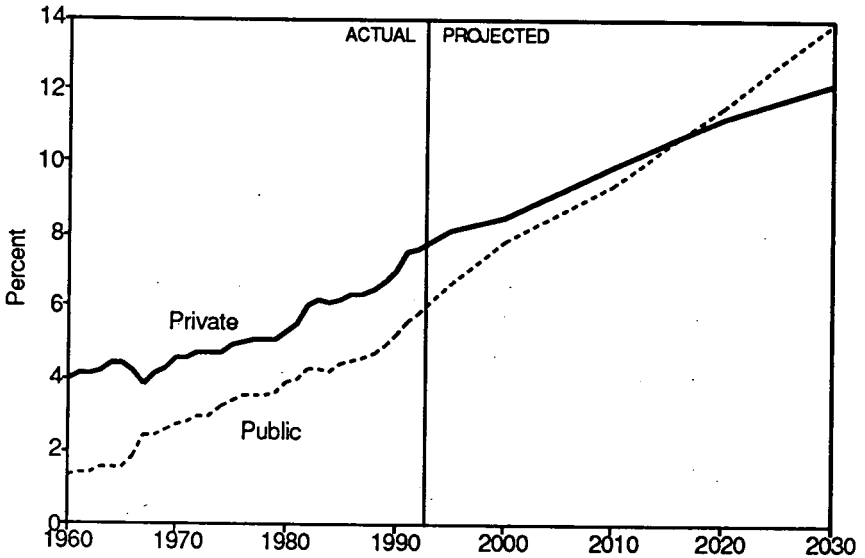
While the contribution of entitlements to the deficit is often over-stated, there is a growing problem in the health care area. Federal outlays for health care—primarily Medicare and Medicaid—are growing rapidly. Health-care expenditures are absorbing an ever increasing share of the federal budget. CBO's latest projections indicate that, under current policies, health-care expenditures will increase to nearly 22 percent of the federal budget by 1997 and 28 percent by 2002, compared to about 10 percent in 1980.

While uncontrollable growth in health-care spending adversely impacts the federal budget, solutions should not be focused only on federal health entitlement programs. That is because the growth in federal health-care spending is a symptom of an economy-wide problem of uncontrolled health costs. Figure 44 shows that health-care expenditures in both the private and public sector are eating up an ever increasing share of the Nation's economic pie. HCFA actuaries project that these trends will continue into the next century. Moreover, as the population ages, public health-care expenditures will increase more rapidly than private expenditures.

The solution to this problem is not simply to issue dire warnings about the "explosion of entitlements," it is to take steps to control cost escalation in the health-care sector as a whole. Experience in Germany and Canada suggest strongly that such cost control is not beyond our capacity.

FIGURE 44

Health Care Expenditures As a Share of GDP



Source: Health Care Financing Administration.

EFFECTIVE TRADE STRATEGY

A second area in which government policy helps create a positive environment for private investment is international trade. With markets for many goods and services increasingly globalized, the willingness of the private sector to make heavy capital investments depends upon some assurance that they will be able to recoup such expenditures through full access to world markets.

Present trade policy, however, does not provide this degree of assurance, as can be briefly illustrated in three different areas. First, the principal focus of trade policy over the past several years has been the Uruguay Round of Negotiations under the General Agreement on Tariffs and Trade. While the outcome of these talks is still in doubt, there is

reason to believe that the our negotiators must press harder if the agreement is to deliver benefits of real value to the U.S. economy.

Of greater concern is that U.S. negotiators are being pressured to make important concessions on aspects of trade law—such as dispute settlement and antidumping rules—which threaten to damage the ability of U.S. producers to defend themselves against unfair and predatory foreign trade practices.

A second area of concern is the almost total lack of progress in opening the Japanese market. Despite more than a decade of intense trade negotiations, the Japanese market remains remarkably closed to imports from all countries, including the United States. A recent Rand Corporation study, for example, found that products originating in Europe or in the United States were far more expensive in Japan than they were in the United States. Products of Japanese origin were also sold at significantly lower prices in the U.S. market than they were in Japan. Japanese consumers and foreign producers are bearing the costs of the longstanding reluctance of Japan to open its markets to foreign goods and permit head-to-head price competition.

The third area of concern is the poor progress which has been made in negotiating with countries that seek to distort trade flows by deliberate manipulation of currencies. The 1988 Trade Act required the Administration to take action against countries found to be manipulating their exchange rate "for purposes of preventing effective balance of payments adjustment or gaining unfair competitive advantage in international trade." This year, for the fourth time in a row, the Treasury Department has submitted a report on this issue which strongly suggests that currency manipulation is taking place, but which refuses to take the required action. Three countries are singled out for special treatment in this year's *Report*: Taiwan, China, and Korea.

... we are again concerned that Taiwan's exchange rate policies, in conjunction with continued limitations on foreign exchange transactions and capital flows, contribute to indirect "manipulation" of the exchange rate." [p.26]

■ The Treasury Department believes that it is imperative that China take steps to eliminate its pervasive controls over foreign exchange allocation and trade so as to reduce its large and destabilizing external surpluses while achieving a more market-determined system of exchange rate determination. [p. 36]

... we remain seriously concerned that pervasive Korean exchange and capital controls significantly constrain supply and demand in the currency market. [p. 21]

It is clear from these examples that the United States urgently needs a more effective trade policy to safeguard the interests of U.S. producers in international markets. Such a policy must be based on:

- **Reciprocity.** Trade concessions granted by the U.S. should be matched by concessions of equivalent value by other parties to the negotiations.
- **Results.** Negotiations need to produce concrete improvements in market access, not empty promises or further negotiation.

It also has become clear that we need to reconsider our negotiating priorities with other countries. Trade in services, intellectual property and liberalization of financial markets are important for U.S. investors but these negotiating priorities must be matched by equally strong efforts to open markets for the exports of U.S.-based producers.

CHALLENGE INDUSTRY TO IMPROVE INVESTMENT

In a recent book, *The Competitive Advantage of Nations*, professor Michael Porter took issue with the conventional wisdom that the best contribution government could make to enhanced private investment was to provide modest support and minimal regulation. Instead he found that industries often flourished when challenged by regulatory standards from government.

Two areas appear particularly appropriate for this kind of challenge from government. The first is the environment where intelligent regulation can help industry gain a competitive edge in world markets.

The logic for this position is straightforward: there can be no doubt that all nations will sooner or later demand improved environmental performance from their industries. Meeting these demands will require substantial new investments in plant, equipment, and technology at some point in the future. How quickly the market for environmentally responsible technologies develops is dependent upon political decisions in many different countries, but it is clear that this market will eventually be substantial.

Given this reality, the country whose domestic industry most promptly adjusts to new environmental technologies will be the country that takes the lead in capturing this important global market.

The Administration's Council On Environmental Quality estimates that the worldwide market for environmental equipment could reach \$60 billion annually. Who will lead this market? Ten or fifteen years ago, the United States had an enormous lead on such technologies, but our leadership has diminished. A recent *Business Week* article entitled "The Green Giant? It May Be Japan" begins with this chronology:

Two decades ago, Japan was choking on its own filth. Acrid clouds of photochemical smog from car and factory emissions assaulted residents of major cities. Then, two oil crises lead to energy shortages and sent prices spiraling. That walloped Japan, a huge oil importer, harder than other industrialized countries. Something had to be done.

So the government enacted draconian measures to clean things up. Other laws fostered energy efficiency—a byproduct of which is less pollution. Now after years of investments that produced dramatic gains at home, Japan is looking abroad ... crisscrossing Europe, Asia, and the U.S. striking deals on equipment or licensing their approach in everything from plant design to waste-water and air pollution control. The Japanese have the edge over the U.S. and Germany in pollution control in basic industry, and Tokyo is spending \$4 billion a year to broaden the country's environmental skills ... Japan ... is starting to target the environmental market.

The key to challenging industry in this area is a regulatory environment which encourages innovation, technology development, and entrepreneurship in responding to problems of the environment. Current experiments with tradable emissions limits and the California state requirement for "zero polluting" vehicles, both appear to have made major contributions toward improved investment by private industry.

A second area for challenge concerns worker training. As was noted earlier, American firms provide much less training to their workers—and to their high-school educated workers in particular—than do firms in other countries. This may make some sense for an individual firm in a society with high-labor mobility, but it is a destructive course for the economy as a whole.

Several witnesses at our hearings drew attention to the fact that our trade policies have created a world in which Americans are increasingly drawn into competition with workers earning a small fraction of our wages (see box).

In this kind of world, high-wage countries can expect to maintain living standards only by a relentless quest for improved productivity, and a significant contributor to productivity growth is expanded training of workers by their employers.

Government has a role to play in a national human capital growth strategy, but it cannot be expected to target training on specific workplace skills with the precision or efficiency which is available to employers. In this area, government should join with firms in establishing policies that enable them to make a significant commitment to the training of their workers.

ASSIST PRIVATE RESEARCH AND DEVELOPMENT

There is a growing consensus that government must become an active partner with the private sector in furthering both the production and dissemination of technological knowledge. Nobel economist Robert Solow argued from the point of view of economic theory that:

There is good micro-economic justification for the notion that a private enterprise system, as well as it does some things, will under-invest in research for well-understood reasons.

Lewis Branscomb, former Chief Scientist at IBM, told the Committee that research and development had much of the quality of a "public good," which would not be produced in adequate amounts by private action alone.

... we all understand that basic science is a public good. There is really no debate about that among liberals and conservatives ... and I would insist from my experience in industry that there are large areas in the world of technology where in fact the technology is a public good. I would cite three examples: the infrastructural generic technologies; path-breaking technologies that have huge potential paybacks to the country, but are long delayed; and investment in the national infrastructure, clearly a community investment and not something individuals can do.

TRADE AND SKILLS

For most of the postwar period, U.S. economic policy has sought to build a world of expanded trade and open markets. Initially, such a policy had a direct payoff for American workers in the form of increased wages, because U.S. firms dominated world markets and were able to pay their workers a premium wage.

This is no longer the case. Not only do American firms no longer dominate key world markets, but technological diffusion has been so rapid that large numbers of countries with wage structures much lower than ours are able to produce even very sophisticated goods at competitive prices.

The consequences of these trends for American workers were emphasized by several witnesses:

So by building an open-trading world, we have placed unskilled people in the U.S. in direct competition with people who will work for much less than we want to see Americans working for.

Robert Solow

It will be increasingly difficult for low-skilled people in a high-wage country to maintain their standard of living. That's true of low-skilled people in high-wage countries everywhere, but it has become a new phenomenon in the United States.

William Niskanen

We must immediately admit that many millions of Americans still have nothing more to sell to the world economy than do citizens of the Third World who have had little or no access to formal education, and who often work for wages that barely support mere survival.

Dan Lacey, Editor, Workplace Trends

A recent report from the Council on Competitiveness—a group of private business firms—warned that the U.S. position in many critical technologies is slipping and, in some cases, has been lost altogether. The Council concluded that:

unless the nation acts immediately to promote its position in critical generic technologies, U.S ... competitiveness will erode further, with disastrous consequences for American jobs, economic growth and national security.

Finally, the Competitiveness Policy Council—an advisory group made up of appointees of the President, the Senate, and the House of Representatives—offered the suggestion that:

On technology, the United States could establish a new mechanism for government and industry to work together to promote the development of generic pre-competitive technologies that are not being financed by the private sector.

This tremendously broad-based consensus has laid the groundwork for a significant expansion of federal activities in support of research and development. We believe action is needed in two broad areas.

First, the Federal Government needs to increase its direct support for research on "generic technologies" (those with broad applicability across industries with significant potential for commercial application). For years, the Defense Advanced Research Projects Agency has provided this type of support in the defense sector. With the end of the Cold War, our national security depends increasingly on maintaining leadership in commercial technologies, and we believe it is time to offer the same type of support to commercial research that we have made available in the past to defense-related research.

Second, the Federal Government must substantially improve its efforts at disseminating technology throughout the economy. In most countries, and in the United States especially, manufacturing is carried out through a vast network of small- to mid-sized firms. There are 360,000 manufacturing firms in the United States, and they account for 10-12 million jobs and more than half of the value added in manufacturing. Yet, a recent Census Bureau survey found that smaller firms consistently lagged behind larger firms in the adoption of new technology.

Japanese and West German Governments make it a priority to strengthen their small- and medium-sized manufacturing firms. Japan

spends \$500 million a year on a public network of 170 manufacturing support centers, known as kohsetsushi centers. Similarly, West Germany has an elaborate system of vocational education—a network of research centers that provides technical support to small- and medium-sized firms—and a well-developed system of industrial standards—all designed to promote engineering and manufacturing excellence.

The United States, too, has innovative programs—largely at the state level—to modernize small- and medium-sized manufacturing firms. But these "manufacturing extension" programs are seriously underfunded and receive almost no federal support; total funding is at most \$70 million a year—about \$20 million of that from the Federal Government. In striking contrast, our Nation spends \$1.1 billion each year on agricultural extension (one-third federal). And yet agriculture accounts for 2 percent of GDP, while manufacturing contributes more than 20 percent.

Given the importance of technological modernization, we believe it is time for the Federal Government to take the lead in building an institutional infrastructure for the dissemination of technological knowledge to small and medium-sized firms.

IMPROVING PUBLIC INVESTMENT

In addition to creating an environment favorable to private investment, the government itself has direct investment responsibilities. It has long been recognized that government has responsibility for investments whose benefits to the society are large but not easily appropriated by private investors. Infrastructure investment, for example, has always been primarily a public responsibility. In recent years, there has also developed a broad consensus that private investors, left to their own devices, will tend to underinvest in certain kinds of knowledge. Here the government needs to find a way of complementing private investment to raise the overall level closer to the needs of the economy.

Previous sections of this report have documented the broad failure of government to carry out these direct investment responsibilities over the past decade or two. The problems have grown so serious that a large group of eminent economists has issued an open letter to the President and Congress, calling for a renewed commitment to public investment (see box). Their letter emphasizes the urgency of the problem and the dire consequences of continued neglect.

**AMERICA'S THIRD DEFICIT: AN OPEN LETTER
FROM 327 AMERICAN ECONOMISTS**

In addition to our trade and fiscal deficits, America faces a "third deficit"—the deficiency of public investment in our people and our economic infrastructure. This deficit will have a crippling effect on America's future competitiveness.

Just as business must continually reinvest in order to prosper, so must a nation. Higher productivity—the key to higher living standards—is a function of public, as well as private, investment. If America is to succeed in an increasingly competitive world, we must expand efforts to equip our children with better education and our workers with more advanced skills. We must prevent drug abuse and dropping out among teenagers. We must fix our bridges and expand our airports. We must accelerate the diffusion of technology to small and medium-sized business.

Yet, these needs have been neglected throughout the past decade. In real dollar terms, federal spending in the 1980s on science and civilian technology has been significantly below the levels in the 1960s and 1970s. Compared to the late 1970s, the Federal Government is now spending less per person on education and less per worker on training. We are devoting less of our national spending to federal investments in highways, mass transit, airports and other transportation infrastructure.

State and local governments have not been able to pick up the slack. In the 1980s, state and local spending on both education and transportation as a percent of GNP has been below the level of the 1970s.

We fully understand the problem that the current U.S. fiscal deficit poses for efforts to expand public investment in these areas. Many of the undersigned have been in the forefront of those arguing that the federal deficit must be reduced. But, in economic terms, budget deficit reduction and an expansion in public civilian investment are compatible. Indeed, over the long run, we cannot eliminate the twin deficits and maintain our living standards unless we expand our public investments.

Clearly, this will require adjustments in other parts of the federal budget. Substantial savings are obviously possible in the military and agriculture sectors. And there is no escaping the need for more revenue.

[continued]

AMERICA'S THIRD DEFICIT [continued]

Raising taxes is never popular. Neither is reducing spending on programs which benefit powerful economic or ideological interests. But there is strong evidence that the people know that there is no free lunch. Polls have shown that majorities support a change in priorities and that people are willing to pay for public services that are vital to the Nation's future.

Thus, while there is no easy answer, there is an answer: it is to devote a portion of new revenues raised, and/or savings made from reducing areas of excess spending, to critical public investments. We can afford it. For example, \$30 billion in net new public investment would come to approximately one-half of one percent of our GNP in fiscal year 1990. Such an investment, if properly administered, would be a bargain for today's working population. The present generation of workers will have to depend on a much smaller working population to support their retirement. Without adequate training and an efficient economic infrastructure, tomorrow's workers will not be able to maintain tomorrow's retirees in a comfortable and dignified standard of living.

The future will not wait. Each year of delay means another million dropouts and an increase in the number of American workers whose skills are inferior to those against whom they have to compete. It means more deterioration in our roads, bridges, and airports. It means falling behind another step in the race for the technologies that will support tomorrow's higher incomes. It means compounding the already massive debt we are leaving to the next generation of workers by denying them the tools they will need to pay off that debt.

We therefore urge you to resist the temptation to deal only with today's crises, as important as it is to solve them. For the sake of our Nation's future, we urge you to raise the monies needed to regain America's competitive edge—before it is too late.

Signed by 327 economists, including Nobel Prize Winners:

*Kenneth J. Arrow
Lawrence R. Klein
Wassily Leontief*

*Franco Modiglianni
Robert M. Solow
James Tobin*

It is important to note that this letter was sent to the President and Congress in July 1989, long before the collapse of the Soviet Union brought about the historic transformation of the international security system. Even in 1989, this group of economists believed there was considerable potential for shifting funds from military needs to domestic investment. Clearly, the potential for such a shift is even greater today.

While this group does not provide any specific targets for increased public investment, historical comparisons help define at least the rough size of the problem.

- In 1968, the public sector spent 4 percent of GDP on physical infrastructure investment. Today it spends less than 2 percent. A return to the prior pattern would involve an increase in public investment of roughly \$120 billion per year.
- Other countries annually spend between 1.9 and 5.1 percent of their GDP on public investment. Moving from the present level of investment to the average of the OECD would mean an increase of \$90 billion per year. Matching Japan's investment performance would mean an increase of \$230 billion per year.
- In the area of research and development, the United States presently invests 1.9 percent of GDP in civilian, as opposed to military research. Germany invests 2.8 percent, and Japan invests 3 percent. Matching German investment rates in civilian research would require increased investment of \$50 billion per year, while equalling the Japanese performance would require over \$60 billion.

These are large sums of money, and seem far beyond the capacity of the government at this moment. But the Federal Government need not watch helplessly as inadequate public investment continues to erode the foundations of our economy. The end of the Cold War should permit a substantial shifting of resources currently programmed for military spending into deficit reduction and critical domestic public investment needs. The immediate obstacle to mobilizing such a "peace dividend" for domestic needs is the artificial wall established in the 1990 Budget Summit agreement between domestic and military spending.

Under the 1990 Budget Summit Agreement, public investment comes under the spending ceilings for "domestic discretionary" spending, ceilings which are set for FY 1993 at more than \$7 billion below the current

services baseline for this function. In other words, the budget summit agreement requires real cuts of at least \$7 billion in all domestic discretionary categories for the coming fiscal year. It is simply not possible to meet these ceilings and fund the kind of increased public investment which the country urgently needs.

Removing this artificial barrier, however, could set the stage for unlocking substantial resources for a renewed commitment to public investment. Estimates about the size of a prudent and responsible transfer of resources from military to civilian uses range from the President's \$50 billion over the next five years to well over \$100 billion. If reprogrammed for domestic investment, such sums could go a considerable way toward eliminating what the group of economists called "America's Third Deficit".

CONVERSION: A MARSHALL PLAN FOR AMERICA

The end of the Cold War means that some shifting of resources from military to civilian uses is inevitable. The question for economic policy is how to ensure that the transfer minimizes economic disruption, while building a strong foundation for growth in the future.

America has faced similar challenges in the past--the question of adjusting to rapid "build-downs" of military spending following World War II, Korea, and Vietnam. The most dramatic changes occurred after World War II. In that period, record high levels of defense spending and war production were rapidly reduced. Despite the suddenness and magnitudes of the cutbacks, the adjustment proceeded smoothly. In contrast, the build-downs following the wars in Korea and Vietnam were less dramatic and more gradual, yet, in each instance, the adjustment was more difficult.

Defense spending, as a share of GDP, reached 39 percent in 1944, and 40 percent of the Nation's labor force was involved in the war effort. By the end of the war, defense spending comprised 90 per cent of the federal budget. The cutbacks were precipitous and brought defense spending and manpower close to peacetime levels within two years. In the process, about 11 million uniformed persons left the armed services; defense civilian manpower was reduced by nearly 2 million persons; and defense related employment in industry declined by about 10 million persons.

Although a 9-month contraction took place in 1945, output expanded throughout the private sector during the immediate postwar years. Investment and expenditures for durable goods, nondurable goods, and services increased steadily. There was strong growth of net exports. Unemployment, to the surprise of many, remained stable at a relatively low level, despite the huge infusion of ex-servicemen into the civilian labor force and the massive shift of workers from defense related to nondefense activities.

The economic circumstances during the defense build-downs following the wars in Korea and Vietnam differed markedly from the earlier postwar experience. In both of the latter instances, the defense cutbacks were accompanied by recessions far more serious than the brief downturn of 1945. In both instances, there were sharp rises of unemployment, as well as declines of business activity, and the economic recoveries were relatively weak and succeeded by further downturns.

A basic difference between these three periods was the attitude of government toward using military resources to strengthen the civilian economy. During World War II, serious consideration of the problems of the coming peacetime economy began in 1943, with studies initiated by the Administration and the establishment by the Senate of a Special Committee on Postwar Economic Policy and Planning. In 1944 the Administration presented a full legislative microeconomic agenda to Congress, based on three objectives: the "reconversion" of industry to civilian production, the maintenance of personal income, and the renewal of the physical infrastructure. That year, most of the Administration's postwar economic reconversion program was enacted, the most remembered part of which was the Serviceman's Readjustment Act of 1944, known as the G.I. Bill of Rights. This was followed in the postwar period by the Marshall Plan for the rebuilding of Europe.

By contrast, following Korea and Vietnam, the Administrations in office at the time was opposed in principle to government actions to counter the effects of defense reductions or to stimulate economic growth. Both were more concerned with the problem of inflation than with unemployment. In January 1954, for example, Eisenhower used his annual *Economic Report* to argue that the government should refrain from "meddling" in the economy.

FIGURE 45

Total Defense Manpower In Millions

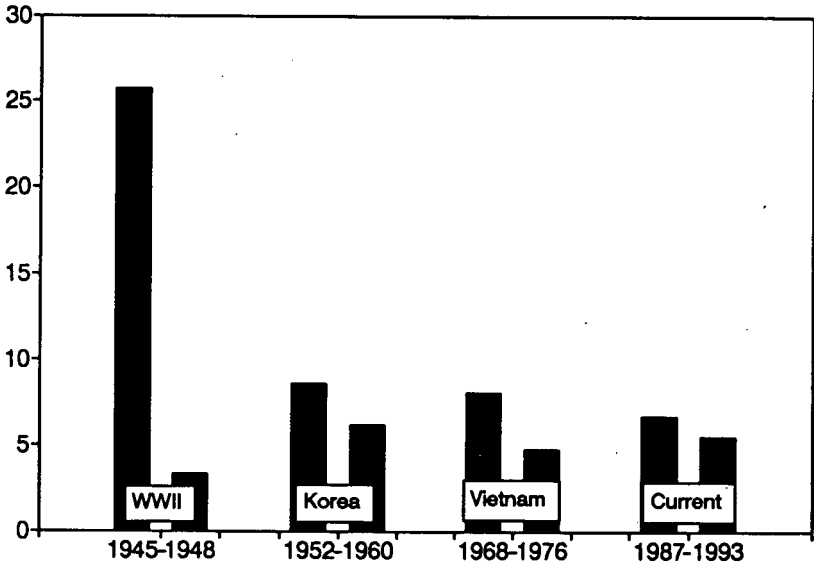


Figure 45 puts today's military spending situation in historical perspective. In terms of total manpower affected or share of GDP, today's economy faces a much less severe conversion problem than experienced in the past. Even the most ambitious plans for shrinking the military sector involve much smaller and less disruptive changes than in the past. But the lesson of the past is that successful conversion requires an active commitment from government to manage the conversion process with a substantial dose of new investment.

Recognizing these lessons from the past, we believe it is time to consider a "Marshall Plan for America"—a plan which would facilitate the conversion process through a substantial expansion in public investments. We strongly endorse such a concept, and support the elimination of the artificial budget walls between military and civilian spending, which presently blocks this type of imaginative reprogramming of funds.

The investment needs of the country are enormous and could, along with deficit reduction, easily absorb the funds released from military spending. In contemplating a new public investment agenda, priority should be given to:

- **Increasing investments in infrastructure.** This should include increased support for traditional infrastructure investment at the state and local level, as well as research aimed at new kinds of public infrastructure, such as a national digital communications network, high-speed rail systems, "smart highways, and the next generation of air traffic control systems.
- **Increasing investments in people.** The GI bill brought enormous returns to the country in the form of enhanced human capital. We should use this precedent to broaden financial support for education at all levels.
- **Supplementing private research and development.** The declining U.S. position in critical technologies threatens an erosion of competitiveness. Government must join with industry to increase technological investment and find new ways to better disseminate throughout the economy the best of existing technology.
- **Expand investments in environmental and renewable resource technologies, and in agricultural technologies that minimize the destruction of agricultural potential and the rural environment.**
- **Rebuilding the "statistical infrastructure" of programs for collecting and analyzing data.** This infrastructure provides the basic information upon which both public and private sectors make critical economic decisions.

These are formidable and important challenges, which, if met, could lay the groundwork for a period of strong growth with an improved distribution of income over the decade ahead. Without such investments, however, there is little reason to expect a growth path much different from the inadequate one laid out by the President in this year's budget. We urge the Congress and the Administration to take another look at our future, and decide whether we should really lower our sights and accept less than we have achieved in the past. Meeting the challenge of public investment will take effort, avoiding it will condemn our children to an economy that fails to live up to its potential.

REPUBLICAN VIEWS

"SCIENCE VERSUS SCENARIO"

SCIENCE VERSUS SCENARIO

1992 JEC Annual Report Republican Views

I. INTRODUCTION

With the swift and successful conclusion of the Persian Gulf War last year, the attention of most Americans turned to a stubbornly stagnant economy. The longest peacetime expansion in American history ended in the summer of 1990, brought to an end by a recession that lasted longer than most projections (including our own) followed by what has been a sporadic, anemic recovery.

A number of factors served to exacerbate the nature of the recession, and the road to robust recovery quickly comes to a fork, one path seemingly leading toward "fairness" and another toward "growth." Policy debates often degenerate into one versus the other, but the two are only mutually exclusive in the minds of those who see America as a caste economic system where "the rich" somehow only "get richer" at the expense of a permanent class of "poor." The numbers show that economic growth is inherently fair, with all income groups prospering in its wake.

The emphasis on "fairness" is reflected in many of the Democrat proposals for recovery, which focus heavily on temporary "middle class tax cuts" paid for by a permanent higher top tax bracket and a surtax on those with the highest incomes, while the growth emphasis is seen in the myriad economic growth packages proposed by Republicans in Congress and the Bush Administration. The debate on pro-growth economic policies in the Second Session of the 102nd Congress is likely to hinge on these two approaches.

As Congress and the Administration seek to restore economic growth in our economy, it's important to have an accurate understanding of our recent economic past. Regrettably, honest economic analysis is often hard to come by in Washington, D.C.. Very often, when policymakers most need objective information and sound data with which to make decisions, they are presented with scenarios.

In this year's Republican Views to the Joint Economic Committee Annual Report, we put forth in as plain and straightforward a manner as possible the facts about our economy, presenting in these pages the numbers as they are and the best methodology of modern economics. In short, we present science versus scenario.

These Republican Views begin with a brief historic perspective of the Federal government's role in fiscal policy, but quickly turn to current economic considerations and pro-growth economic policies.

Other chapters address measures of family income, the growth in entitlement spending and regulation, government spending and taxation in relation to the size of our economy, banking policy, international trade, and the effect of dramatic decreases in defense spending as a result of the break-up of the former Soviet Union.

Much of the basis for our ideas about the value of individual freedom, free markets and limited government were developed by the late Nobel Laureate F. A. Hayek. While his recent passing is a great loss, his achievements in behalf of freedom and liberty will never be exceeded. We respectfully dedicate our annual report to his memory.

II. AN HISTORIC PERSPECTIVE OF MACROECONOMIC POLICIES

The Founders of the United States envisioned a free society in which government played the limited but crucial role of administering justice and ensuring the peace. The Constitution was designed to allow the Federal government to accomplish these vital tasks, while preventing the emergence of a State with the power to oppress the citizenry. This Jeffersonian philosophy was succinctly restated by Henry David Thoreau: "That government is best which governs least..." This ideal dominated American history until the time of the New Deal.

Even then, though, the Roosevelt Administration's economic policy was not a radical departure from the philosophy of the Founders, but a mere emendation. The cornerstone of the New Deal was family income maintenance, not massive income redistribution, and Roosevelt saw the New Deal as a program of emergency measures necessitated by the Great Depression. Many components of the New Deal were viewed as either temporary spending projects (e.g., the Works Project Administration) or supplements to private market activity (e.g., social security, viewed by Roosevelt as a supplement to the system of private retirement plans).

The present imbalance between government and the productive sector began with the Great Society in the late 1960s. Whereas Roosevelt saw his goal as promoting the general welfare by providing equality of opportunity, Lyndon Johnson, neo-Keynesian economics and the architects of the Great Society sought to provide for the general welfare by promoting equality of outcome. Government became far more than simply an umpire, ensuring that the game was played fairly and by the rules; government itself became a major player. This was a new development in American history.

Neo-Keynesian economists suggested that government could "fine tune" the economy to reach desired levels of economic growth and employment without undue inflation. Conventions which constrained Federal spending and deficits were discarded. The Great Society agenda presumed that the only viable, equitable way to assure prosperity was for government to undertake massive interventions and herculean spending programs which would redirect the control of wealth from selfish and greedy private producers to public-spirited government bureaucrats. Only then could society hope to break through the barrier of "private waste" to the society of the future, a society beyond scarcity.

The Great Society welfare state was founded on the notion that the main limiting factor preventing society from achieving higher levels of prosperity was a bloated private sector, which supposedly starved the public sector of vitally needed resources. Scarcity and want were seen as merely side-effects of free markets. The path to a society beyond scarcity lay in the continuing expansion of the public sector. Big government would eliminate poverty, promote social harmony, and raise personal income.

As of 1992, the Great Society program has had almost thirty years to show its efficacy, or lack thereof. The "War on Poverty" has proven a disastrous failure; the poverty rate in 1989 was actually slightly higher than the poverty rate in 1969. While some advances in promoting greater equality of opportunity for all have been achieved, few of these advances bear any relationship to Great Society spending programs; social harmony remains an elusive goal.

The Great Society also failed to deliver on its promise of increased prosperity. The postwar era prior to the Great Society expansion was characterized by modest government growth and fiscal responsibility. Government fulfilled its proper role as umpire, and generally left private enterprise alone to create wealth and jobs. This is reflected in the growth data from the period before the Great Society welfare state took root. Real gross domestic product (GDP) grew at an average annual rate of 4.2 percent from 1960 to 1968. The net national wealth from 1946 to 1968 grew at the impressive average annual rate of 8.5 percent.

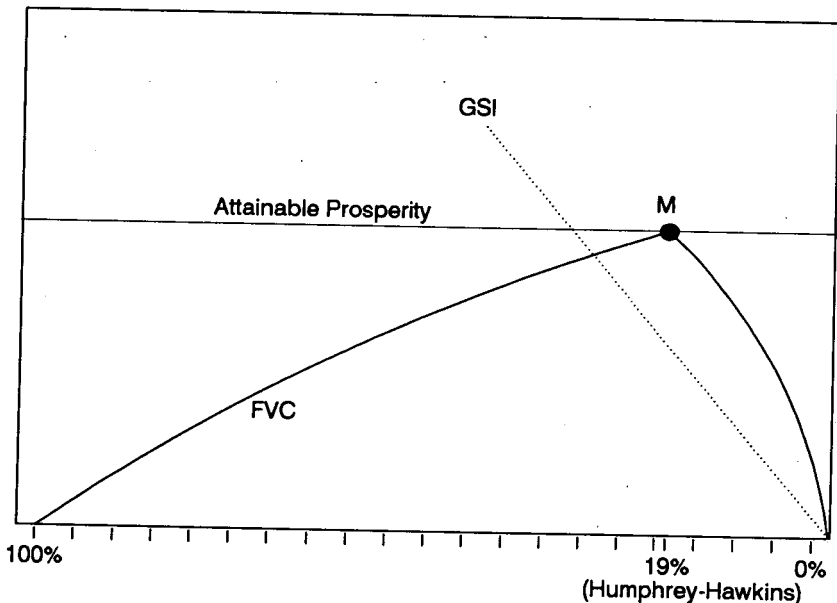
With the advent of the Great Society this impressive performance began to falter. Real GNP grew only an average of 2.3 percent per year for the period since 1968. For the first time since the end of World War II, the net wealth of Americans actually declined in constant dollars, falling from 1968 to 1970, and then again from 1972 to 1974 (in 1975, net wealth was still less than 1 percent higher than 1968 levels). Over the entire period 1968 to 1990, the real net national wealth grew at a sluggish average annual pace of 2.5 percent. A contributing cause of this slowdown in the growth of real net wealth was rapid growth in real net government debt: 135 percent between 1968 and 1990 (the net real government debt had actually fallen by almost 23 percent between 1946 and 1968).

The Great Society experiment was a costly failure. The basic problem with the Great Society idea was that it failed to acknowledge the fact of scarcity. Human desires are always unlimited, while resources exist in finite supply. Therefore, we must choose how to best employ those finite resources. The object of a political economy is to achieve the single-best combination of public and private enterprise, in both relative amounts and substantive composition, to make the maximum level of prosperity attainable by the citizenry. Government cannot abolish scarcity any more than it can square the circle; unfortunately, government can severely impede the ability of the private sector to minimize the effects of scarcity.

The Founders recognized the need for a government to provide a framework, both legal and defensive, for a prosperous republic. They also understood a harsh truth about the nature of government: a government large enough to grant you everything is large enough to take it away. Government needs to be kept on a tight leash. Otherwise, governmental power can turn from being the defender to being the oppressor of a free people.

Graph II.1 illustrates the basic assumptions of these two radically contrasting philosophies of government.¹ The vertical axis represents different rates of economic growth sustainable given available technology. The horizontal axis represents the percentage of economic and social resources controlled by government. Note that when government controls zero resources, individual prosperity is negated by existence in a state of anarchy. At 100 percent, totalitarian government makes individual prosperity virtually impossible. Somewhere between the two extremes lies an optimum mix of private and public utilization of resources in an economy.

Graph II.1 -- Federal Government Control of Resources



¹ This graph was first presented by Rep. Dick Armey, JEC Ranking Republican, in a speech at the CATO Institute on January 30, 1991.

The horizontal line represents the "scarcity constraint." This is the maximum possible sustainable rate of prosperity attainable given the level of available technology and resources.

GSI, the dotted line, presents the Great Society Illusion graphically. Proponents of the Great Society believed that increasing government control, and direction, of resources would generate ever-greater increases in economic performance. Under this scenario, society could literally "spend its way to prosperity," as long as that spending was undertaken by government. The GSI curve rises throughout its length. Note that GSI even pushes beyond the Scarcity Constraint. The essence of the Great Society Illusion is the claim that ever bigger government is the road to economic prosperity, and there is no need for trade-offs, a view embodied in Lyndon Johnson's now famous "guns and butter" speech.

This is the fatal flaw which made the Great Society goal of prosperity-through-big-government a false promise. Scarcity is an elementary fact of life and cannot be repealed by political whim. The neglect of the scarcity constraint renders the GSI curve absurd.

The Founders' Vision is illustrated by alternative curve FVC. Like GSI, this curve indicates that government plays a positive role in promoting economic prosperity; FVC rises for part of its range.

However, FVC also reflects the Founders' understanding that government is a two-edged sword; it has the power to both promote, and impede, the welfare of the social order. By providing for the common defense, a legal framework for resolving disputes, basic infrastructure and a minimum safety net, government establishes the foundation for a growing and productive commonwealth. These positive benefits can easily be swamped, however, if that same government expands its control beyond these basic duties. Excessive taxation, over-regulation, profligate spending and special favors for privileged interest groups have a negative effect on the growth of the productive sector. The same

governmental institutions which can facilitate productive commerce can easily become the stranglers of the economy.

Growth of government spending beyond the optimal level causes economic growth to slow, and becomes counterproductive. At a certain point, Federal spending reaches a level of "excess burden," where every dollar spent results in more than a dollar's loss in opportunity cost because of reduced productivity. The tension between the Great Society Illusion and reality takes the form of an ever-spiraling public sector deficit and wasteful spending.

FVC indicates that the maximum level of sustainable prosperity can only be achieved by ensuring that the government sector is limited to those activities which promote, rather than decrease, economic productivity. This point is indicated by M in Graph II.1. While it is impossible to empirically estimate the precise mix of government and private sector which would be economically optimal, the Humphrey-Hawkin's Employment Act of 1978 recognized a goal for Federal spending of 19 percent of GNP. Our present rate of Federal spending stands at 25 percent of GNP and all government spending in America nears 33 percent of gross national product.

It is easy in Washington to fall victim to a myopic view of "bottom lines," to see things through a prism of "current services baselines" and "revenue neutrality." We present this first graph as a "big picture," and suggest policy makers first decide where the optimum mix of government and private sector resources lies, where we are now in relation to that point, and what policies should be pursued to move us in the direction of a more rational government. As Congress considers economic policies to increase the prosperity of individual Americans, will we move to the left and greater government control of our scarce resources, or to the right and more efficient, private sector control?

III. THE NEED FOR ECONOMIC GROWTH

The recession that ended the longest peacetime expansion in American history began in June 1990 and probably ended in the spring of 1991. The precise ending of the recession is disputed because growth since early 1991 has been sporadic and anemic. A number of factors have served to deepen and extend the recession and have contributed to the anemic nature of the recovery, and these are discussed in other sections.

There is a division of thought on the best means to restore prosperity. One path, which views economic policy as a zero-sum game, takes resources from the relatively wealthy and distributes them to the less well off either through new government spending or the tax code. This path is informed by greed and class envy, and misinformed by dubious "economic analysis." Its hallmark is the "fairness" mantra, which quickly degenerates into a revisionist history of the 1980s and redistributionist goals for the 1990s. Simply transferring money from certain people through government bureaucracies to other people produces no economic growth, although certainly it increases the size of government.

The way to restore economic growth is empirically clear and, despite the drumbeat from the left, does not include punishing any income class. These Republican Views focus on restoring general growth, which benefits everyone, rather than redistributing current resources to specific constituencies, which will ultimately mean less for everyone.

Members of Congress in both parties now advocate Federal tax cuts as a means to stimulate the economy. The Federal government takes too much of private citizens' income, and the overall tax burden should be reduced. Lowering tax rates and restructuring investment incentives is good public policy. While

certain tax changes will do little to aid the economy immediately, the right changes can do enormous good in both the near future and the longer term.

Mainstream projections of near-term economic growth, while higher than the experience of the recent past, are still below the impressive growth rates of the middle and late 1980s. If growth over the next five years is as projected, it will be about two-thirds that of the impressive '80s. This "growth gap" is widely acknowledged, and has serious repercussions.² This level of slower growth will cause \$2.3 trillion in lost output and about \$875 billion in lost wages through 1996. Less output will also cause larger deficits, estimated to total about \$1 trillion in the same period.³

In previous economic downturns, the Administration and Congress adopted policies that stimulated the economy and restored recovery. Perhaps the most successful economic stimulus package was passed in 1981, when marginal rates were drastically cut and the American economy began eight years of uninterrupted growth.

The Federal response to our presently flat economy has been too slow and too small. One reason is that under new budget rules, every pro-growth proposal is automatically subjected to revenue forecasting techniques that virtually ignore economic growth effects. Specifically:

- whereas certain tax cuts clearly stimulate the economy, government forecasting agencies generally assume that tax cuts can only harm the economy by increasing deficits;

² Hunter, Lawrence A., "The Never-Ending Recession," Wall Street Journal, September 19, 1991; and Allan Sinai, "Policies to Raise the Sustainable Rate of Noninflationary Growth," Study prepared for the U.S. Chamber of Commerce, January 1992.

³ National Center for Policy Analysis press release "Study: Tax Cuts Needed to Prevent Malaise," January 16, 1992, pg. 1.

- whereas lower taxes on investment income stimulate investment, government forecasters assume tax rates have little investment effect; and
- whereas tax policy affects capital formation, Federal forecasts assume few capital accumulation changes from Federal incentives.

These assumptions are demonstrably wrong, and it is important for both congressional and administration tax analysts to include more fully the dynamic effects of tax changes on revenue estimation. (We address this need in more detail in Chapter IV.)

An immediate and well-considered economic stimulus package is important. While government cannot fine-tune the economy, it can lay the groundwork for a tax program that increases incentives for work, savings and investment. The debate should not be one of whether these proposals stimulate growth, but over the pace and magnitude of their positive effects.

In the artificial world of policy abstraction, deficits are closed by raising taxes, reducing spending, or a combination of both. In the real world of politics, tax increases are followed by higher spending to assuage the anger of taxpayers. Despite the best efforts of politicians and allegedly bipartisan or nonpartisan research groups to ignore these facts, "deficit reduction acts" often increase rather than reduce, the Federal budget deficit.

Economic growth ultimately depends upon improving a nation's productivity, achieving more economic output at a given level of resources. Higher productivity increases economic efficiency and the real well being of a nation's citizens. The critical question for policy makers is what policies encourage productivity.

There is a broad consensus among economists that increasing savings and investment is critical. New and more efficient machinery and technology enable workers to produce more goods and services, and ready sources of capital are needed to allow businesses to invest in such equipment. If savings are minimal,

private enterprise finds capital more expensive and scarce, driving up its cost and reducing total capital investment.

A major goal of Federal tax policy should be to encourage private savings and capital investment, yet the current Federal tax code penalizes savings and investment in several ways. Taxation reduces capital formation by driving a wedge between how much money an investment generates and how much of that money actually flows to the investor. An investor willing to risk funds at a particular rate of return may be unwilling to make such an investment if that projected rate of return is lowered too far by taxation. Consequently, many worthwhile productive investments are not made simply because of tax-code bias. Because of this anti-investment bias, individual decisions are skewed toward immediate consumption instead of patient investment. Without endorsing all the growth proposals that follow, we list here some of the proposals before Congress and the points made by those who advocate their passage.

INVESTMENT TAX INCENTIVES

Capital Gains Tax Cut

Capital gains income and its taxation may be the object of more misinformation on Capitol Hill than any other economic issue. Is a capital gains tax cut a paean to "the rich," as its opponents argue, or would it spur economic growth that benefits individuals at all income levels, as its advocates argue? Would a capital gains tax cut gain or lose Federal revenue? Does the U.S. capital gains tax rate compare favorably to other countries? At the root of this debate is a good deal of economic data that needs much closer examination.

Opponents of a reduction in the capital gains tax rate often cite Congressional Budget Office (CBO) or Joint Committee on Taxation (JCT) analyses that purport to show that a large proportion of the benefits of capital gains tax reductions would accrue to those with the very highest incomes. There are a number

of problems with these analyses, however, most of which are known to congressional revenue estimators but ignored in order to avoid embarrassment and/or to defeat such proposals in Congress.

Earlier this year two Republican Members of the Joint Economic Committee released a study that refuted the notion that the principal beneficiaries of a reduced capital gains tax rate are "the rich."⁴ That study showed that wage earners, rather than investors, realize 92 percent of the after-tax benefits of lower taxes on capital. There are a variety of reasons for this conclusion, including that capital assets are held much more widely than is usually portrayed, that increased capital and productivity increases worker wages, job opportunities, and that the investment wealth of helps savers at every income level.

The current taxation of capital income at roughly the same rate as other income is inequitable in two ways. First, such tax treatment means that debt has a more favorable tax treatment than equity, which discourages savings and encourages borrowing. Companies that want to expand must finance that expansion either through borrowed funds or through profitable earnings. These companies can deduct interest payments on debt, but cannot limit taxes on equity dividends. These dividends are profits to the company and therefore taxed, and when they are distributed to investors they are also taxed as a capital gain for those investors. This "double taxation" of equity creates a perverse incentive for companies to hold debt versus equity. Eliminating the capital gains tax would eliminate this unfairness, but any reduction in capital gains rates would help redress the imbalance.

The second inequity is that nominal rather than real capital gains are taxed. In effect, inflation "taxes" a large portion of capital and reduces actual investor returns. Ignoring this deterioration penalizes capital income relative to other income such as wages and

⁴ Robbins, Gary and Aldona Robbins, "Capital, Taxes and Growth," NCPA Policy Report No. 169, January 1992, released by Representative Dick Armey and Senator Connie Mack.

salaries. Indexing capital gains for inflation would directly address this problem.

Consider these examples from the U.S. Treasury Department:

- Suppose you invest \$1,000 and the value rises \$70 in a year due to a 3 percent (\$30) real gain and a 4 percent (\$40) inflation increase. If you sell the investment and are in the 28 percent tax bracket, you would pay a capital gains tax equal to 28 percent of the total \$70 increase. That's \$19.66 -- a tax of 66 percent of the real gain.
- Suppose you invested \$1,000 in the stock market in 1970 and sold your stocks in 1988. During those 18 years the Standard and Poor Index rose 219 percent. But inflation was 205 percent. The net gain after inflation would be only \$140. Yet you would pay on the entire 219 percent capital gain. If you were in the 28 percent tax bracket, your effective tax rate on the gain would equal 438 percent.

Lower taxes on capital will create new investment, with immediate positive Federal revenue effects. The Administration has estimated that a 30 percent exclusion of capital gains profits from taxation would yield \$12.5 billion in higher tax revenues over five years. Economist Allan Sinai has estimated that a 15 percent rate would boost GNP by 2.8 percent over five years, or roughly 0.5 percent a year. 2.3 million new jobs would be created and \$30 to \$40 billion in additional Federal tax revenues generated.

In the current economic situation, a capital gains reduction would be especially helpful. There would be an almost instant increase in the nominal value of equity and property. This would improve the balance sheets of banks, increase the value of business and individually held property, reduce Federal exposure because of the savings and loan crisis, and ease credit. In the longer term, the large negative revenue effect predicted by most static analyses would be offset by a dynamic response in higher gross domestic

product (GDP), higher profits, more jobs, and additional Federal revenues from business income, payroll and private income taxes.

The strong linkage between private savings rates, effective capital gains tax rates, economic growth, and national wealth are seen in brief comparisons of the United States over time, and in comparisons between our country and other nations.

Table III.1 shows the changing savings rates of the U.S. private sector and the Federal government from 1970 to the present.

The private savings rate has deteriorated, especially since the middle 1980s, when many of the important tax preferences for tools such as Individual Retirement Accounts (IRAs) and capital gains were removed from the tax code.

Table III.1 -- Gross National Saving as a Percent of GNP

	Total Private	Federal Government	All Government	Total Savings
1970	16.4	-1.3	-1.1	15.3
1971	17.5	-2.0	-1.8	15.7
1972	17.0	-1.4	-0.3	16.7
1973	18.2	-0.5	0.5	18.7
1974	17.6	-0.8	-0.3	17.3
1975	19.3	-4.4	-4.1	15.2
1976	18.3	-3.0	-2.2	16.1
1977	18.0	-2.1	-0.9	17.1
1978	18.5	-1.3	0.1	18.6
1979	18.4	-0.6	0.4	18.8
1980	18.5	-2.2	-1.3	17.2
1981	19.3	-1.9	-1.0	18.3
1982	19.6	-4.3	-3.4	16.2
1983	18.8	-5.3	-4.1	14.7
1984	19.7	-4.4	-2.9	16.8
1985	18.2	-4.5	-3.1	15.1
1986	16.9	-4.7	-3.4	13.5
1987	16.1	-3.4	-2.5	13.6
1988	16.4	-2.8	-2.0	14.4
1989	15.8	-2.4	-1.6	14.2
1990	15.4	-3.0	-2.5	12.9

Source: Department of Commerce, Bureau of Economic Analysis.

Finally, in contrast to Japan and Germany, as well as many other industrialized nations, the United States taxes investment profits, or capital gains, at a far higher rate. This self-inflicted wound reduces our competitiveness and ultimately our standard of living. Two nations, Australia and Great Britain, tax capital at a higher rate; but both countries index gains for inflation. Table III.2 shows the effective capital gains tax rates in the United States and selected nations, as well as holding periods and indexation.

Table III.2 -- Maximum Capital Gains Tax, Holding Periods, and Indexation

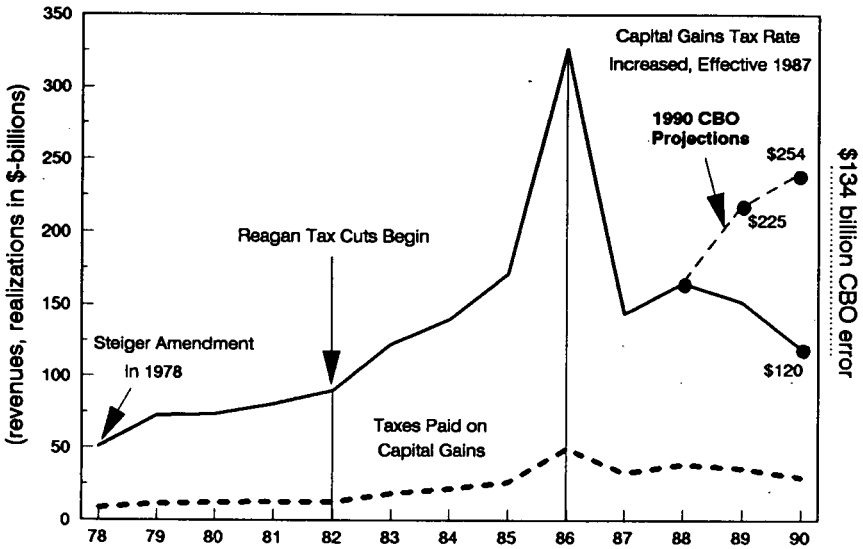
Nation	Maximum Long-Term Capital Gains Tax Rate	Holding Period	Indexed for Inflation?
Australia	50.25%	1 Year	Yes
Canada	17.51	None	No
Germany	0.00	6 Months	N/A
Japan	5.00	None	No
United Kingdom	40.00	None	Yes
United States	28.00	1 Year	No

Source: American Council for Capital Formation, 1989.

This and other evidence illustrates the linkage between higher private savings, lower capital gains taxation and economic well being. It is unfortunate that partisan motivations have served to cloud the issue, and that official revenue estimators effectively prevent the consideration of a stimulative growth package.

The historic data on the relationship between lower capital gains tax rates and increased realizations and revenue is illustrated in Graph III.1. Note that realizations and resulting revenues spike in 1986 as investors responded to the enactment of a higher capital gains tax rate, and dropped dramatically in the following years (despite the scenario presented by the Congressional Budget Office, which projected constantly increasing realizations in the face of a withering tax increase, resulting in a \$134 billion overestimate of capital gains realizations for 1990).

**Graph III.1 -- Capital Gains Income and Revenue Up
With Tax Cuts, Decline With Tax Increases**



Source: Internal Revenue Service and Congressional Budget Office

Individual Retirement Accounts (IRAs)

One needed area of Federal tax policy reform is to increase incentives for private savings. In the early 1980s, fully deductible IRAs increased the level of private savings. Unfortunately, the 1986 Tax Reform Act limited the deductibility of IRA contributions. IRA use declined from these legislated changes. Contributions fell even further because of widespread public belief that IRAs had been "eliminated". Restoring full deductibility to all IRA contributions should increase the savings rate for all income classes.

S. 1921, introduced by Senators William V. Roth and Lloyd Bentsen of this Committee, would restore the pre-1986 deduction rules for IRA contributions so that all taxpayers could make tax deductible contributions to their IRAs, regardless of their income level or whether they are covered by an employee sponsored retirement plan. In addition, Roth/Bentsen would create a new type of IRA where "upfront" contributions would not be tax

deductible but, if held for five years, could be withdrawn tax-free. The bill would also allow for penalty free withdrawals from IRAs for first-time home buyers, and for educational and medical expenses.

Enactment of S. 1921 would increase private savings. Some analysts claim that fully deductible IRA accounts merely shift savings from one type to another, but more careful research shows that unrestricted IRAs increased net private savings in the early 1980s.⁵ Most of the new incentives would directly apply to families with incomes above current limitations, but the universal qualification for IRA contributions would reverse the dampening effects on savings at all income classes caused by the 1986 IRA restrictions.

The long-term revenue effects of the "upfront" IRA are disputed. In the short term, Federal tax revenues would clearly increase as some savers would shift traditional IRA funds into "upfront" accounts. Static analysis of longer term revenue effects show that there would be revenue losses in later years. However, the dynamic effects of additional growth from higher savings rates will recoup at least a portion of these losses.

Payroll Tax Cuts

There are various proposals to reduce the payroll tax for both employers and employees. One such bill, S. 11, introduced by Senator Moynihan, would reduce payroll tax rates for a few years while expanding the wage base. Other bills would reduce rates further without expanding the base, including H.R. 960, the Wallop/Delay/Tallon bill, which would cut the current 12.4 percent payroll tax rate to 10.6 percent.

⁵ Venti, Steven F. and David A. Wise, Government Policy and Personal Retirement Savings, Paper presented at the "Tax Policy and the Economy" conference, November 19, 1991, Washington, D.C., pp. A2 and A10.

There would be several salutary economic effects of lower payroll taxes. First, a payroll tax cut increases overall Federal tax progressivity. Under the provisions in the 1977 Social Security Amendments (P.L. 95-216), both the employer and the employee shares of the payroll tax were increased from 6.13 percent to 7.65 percent. Now over 80 percent of taxpayers pay more in FICA taxes than in income taxes. Second, a portion of the increased wages to workers will go toward savings, increasing the private savings pool. Third, the tax cut for employers will either be passed on to workers in the form of higher wages or used by the firm for new productive investment or increased levels of employment. All three effects are desirable to increase economic productivity. While the temporary payroll tax cut in S. 11 might spur investment in the near term, a permanent tax cut is preferable. The major advantages of a permanent payroll tax reduction (as, for example, H.R. 960 provides) is that the incentives for and benefits of increased private savings, work effort and economic growth would be permanent.

Middle Income Tax Relief

Since World War II, taxes and government spending have become increasingly hostile to families. In 1990, a family with earned income of one-half the median level paid 23 percent of their income in Federal and state taxes. In 1948, the same family paid only 2 percent -- less than one-tenth the proportion -- in those same taxes. The American family is suffering from a huge burden of government, and it deserves relief from the demands of an ever expanding bureaucracy.

The most important element of the tax code accounting for the huge rise in the taking of family income is the shrinking value of the dependent and personal exemptions. The effects of inflation and family income growth on the value of the personal and dependent exemption is most striking. In 1948, the \$4,600 personal and dependent exemption allowed by the Federal income tax code was equal to 42.1 percent of the typical American's income. By 1990, the face value of those exemptions had risen to \$2,050, but the proportion of per capita income has shrunk to 11.1 percent. Restoring the personal exemption to its 1948 value would mean

enacting legislation to raise the personal exemption to about \$8,000 in 1991 dollars.

Several Members of Congress have introduced legislation to raise the personal exemption significantly, most notably Representative Frank Wolf of Virginia. These proposals have several advantages, among them providing true tax relief to the middle class and targeting benefits to families bearing the responsibility of raising children. A major increase in the personal exemption would do much to bring about tax fairness, middle class tax relief and a stronger society by rewarding working families.

Concern about the revenue loss of expanding the personal exemption is usually overstated, expressed by elected officials more interested in expanding government than in promoting tax fairness. In addition, static revenue analysis exaggerates the revenue loss from this reform, ignoring taxpayer response to more family income. For the lowest income workers, raising the personal exemption would take them off the tax rolls, allow them to keep more money in their pockets, and encourage work and other entrepreneurial economic activity. Much of the middle class would drop from the 28 percent tax bracket to the 15 percent bracket, increasing incentives for productive activity. The greater incentives for economic expansion would be additional revenues from greater economic activity which would recoup some of the "lost" tax revenues.

Investment Tax Incentives

In times of economic downturns, calls for stimulative tax reform receives a higher priority. In the wake of the so-far disappointing recovery, tax subsidies in the form of either credits or exclusions are receiving renewed attention.

While there is some debate over the extent to which investment incentives encourage growth, the relationship is positive; that is, such incentives encourage economic growth beyond the level it would otherwise be. It is true that some of the effect of incentives is to speed up investment that would occur anyway,

however, any differential incentive to invest in productive equipment over alternative uses of the same funds certainly shifts at least some additional resources into investment.

Temporary investment incentives would encourage more funds to be invested more rapidly. In addition, a temporary tax incentive stimulates more investment for every dollar of Federal revenue foregone, i.e., more "bang for the buck." In our current growing but weak economy, temporary incentives should be considered. In good, bad or mediocre economic times, however, it is clear that new investment is critical to economic prosperity.

There is a good deal of evidence that investment tax incentives stimulate the economy. Hall and Jorgenson examined the effect of investment depreciation schedules in the 1950s and 1960s, and found a significant effect of investment tax incentives on investment.⁶ Bischoff found that the Federal tax revenue gain from the economic growth effects of the investment tax credit exceeded the revenue loss.⁷ While some other research finds less impressive results, it is beyond dispute that investment tax incentives encourage more investment in productive capital, and that additional capital investment is key to economic growth.

All these proposals would allow individuals to keep more of their hard-earned income, saving and investing more in a growing economy. To the contrary, proponents of class warfare and government bureaucracy assume that all wealth and income are in some way "national assets" that belong first to government. Through its "generosity," government allows citizens to keep a portion of this wealth for themselves. Government takes the rest of it to feed its own bureaucracy and redistribute a portion to preferred constituencies.

⁶ Hall, Robert E. and Dale W. Jorgenson, "Tax Policy and Investment Behavior," American Economic Review 58:3, pp. 391-414.

⁷ Bischoff, Charles W., "The Effective of Alternative Lag Distributions," in Tax Incentives and Capital Spending, ed. Gary Fromm (Washington: Brookings, 1971), pp. 61-130.

Income and wealth belong first to the persons who earn it. Any claim government makes to take private earnings through taxation must meet a high threshold of necessity. While there are legitimate government purposes, the legitimacy of a particular level of taxation must always be scrutinized. Increasing private savings and investment are desirable goals. Tax reductions targeted to encourage such behavior should be immediate priorities and would accomplish the goals of lower taxation, less government interference, and increased productivity.

IV. THE CONTEXT OF CURRENT FISCAL POLICY

THE 1990 BUDGET DEAL IN RETROSPECT

Fiscal policy decisions for fiscal year 1993 and beyond are bound by the constraints of the budget agreement reached in October 1990, frequently referred to as the Budget Enforcement Act of 1990. This agreement was designed to reduce Federal deficit spending by a cumulative total of just under \$500 billion over five years. This was to be accomplished through increased taxes of \$160 billion, of which \$20.6 billion would be extracted in fiscal year 1992, and through cutting projected growth of spending programs by \$281 billion. An additional \$68 billion in net interest would be saved from lower deficit financing.

While some economists raised concern about the dampening effect of higher taxes in a fragile economy, they were told not to worry because consumer confidence would rise and interest rates would drop as a result of lower deficits. Other skeptics questioned whether there was any substance to the claimed spending cuts, since they were taken from an assumed baseline higher than any previously projected spending path. Finally, the new automatic adjustments to the deficit caps for economic and technical considerations were seen by some as making them virtually meaningless.

Nevertheless, Congress and the President agreed to the 1990 budget deal, and it remains before us. Its tax increases, "firewalls," luxury taxes, spending caps and procedural changes are now common parlance in Administration agencies and congressional committees.

In the time since the agreement's enactment Federal deficits have reached record levels despite of, if not because of, the massive

tax increases it contained. Rather than reducing the deficit in fiscal 1991 by \$42.5 billion as was its goal, the deficit was an historically high \$269 billion. Interest rates have come down as a result of aggressive Federal Reserve policy, but it is hard to argue that this positive effect outweighs the budget deal's negatives.

Over the first two fiscal years of spending "restraint" it promised, Federal outlays have grown by 18 percent. In the meantime, Table IV.1 shows that 1991 tax revenue expected from the Budget Enforcement Act has not met projections, nor will outyear revenues meet initial forecasts.

Table IV.1 -- Initial Revenue: Projections versus Reality
(*\$-billions*)

Fiscal Year	Summit Projection	OMB 1/92	Error
1990	1,031.3	1,031.3	
1991	1,137.6	1,054.3	83.3
1992	1,220.9	1,075.7	145.2
1993	1,305.6	1,164.8	140.8
1994	1,395.1	1,263.4	131.7
1995	1,472.9	1,343.5	129.4
Total Revenue Error to Date			630.4

Source: National Center for Policy Analysis, unpublished data, and Budget of the United States Government, Fiscal Year 1993.

Judged by its goal of deficit reduction, the 1990 budget agreement is a dismal failure. Some of its proponents argue that the economy adversely affected the goals of the budget deal, while never acknowledging the possibility that the provisions of the budget deal adversely affected the economy.

Apart from the onerous tax increases and the defaulted commitment to spending restraint, the budget deal proscribes growth-oriented tax policy through the 60-vote hurdle for a "revenue losing" tax cut in the Senate, and a definition of revenue loss

predicated on faulty "static" analysis. Under these budget rules, the viability of revenue forecasting has never been more important to the fiscal policy process.

STATIC VS. DYNAMIC FORECASTING

Average Americans probably don't ponder the intricacies of economic forecasting, thinking it has no effect on their lives. Yet increasingly the laws and regulations that govern and guide their economic destiny are a product of this specialty.

In fact, the discipline of economic forecasting has a great deal more significance in creating policy than many people realize. Before Congress can cut or raise taxes -- something that affects everyone -- it must estimate what will happen to revenues. Before Congress can put a new program into play, policymakers and tax payers should have an idea of its potential costs and benefits.

Until recently, tax and spending initiatives were subject to two criteria -- need and merit. Since the Gramm-Rudman-Hollings Deficit Reduction Act of 1986, however, forecasters must consider a bill's potential effect on the budget deficit as well. In theory, a policy proposal that increases the deficit will be greatly scrutinized and have a difficult time becoming law. In reality, the ability of Congress to abide by the standards it establishes for itself has yet to be proven.

This lack of discipline is evident in the fact that the size of the budget deficit keeps growing. Part of the official explanation for these increases is that Federal revenues are coming in slower than predicted while spending is higher than expected. To the extent that expectations were unrealistic to start with, government forecasts have contributed to higher than expected deficits.

Both private and public forecasting exists, but because government economic and budget forecasting plays a large role in policymakers' decisions, it warrants closer observation. Until the

mid-1970s, only the Executive Branch assessed the budgetary and economic impact of policy changes. Individual agencies like the Labor Department annually estimated what their programs and services would cost, usually over a five-year period. The Office of Management and Budget (OMB) then compiled and reviewed individual agency forecasts and presented an overall budget blueprint for the U.S. government.

Congress did not play a large role in the budget process until 1974, when it established the Congressional Budget Office. Its role was to provide Congress with its own "independent" budgetary estimates and to serve as a check on the power of the Executive Branch. Because the majority party in Congress effectively controls CBO, Congress' reliance on CBO has grown at the expense of Executive Branch agencies and OMB in this period of divided government. Tax policy provides an example of the curtailed Executive role. Traditionally, the Treasury Department had sole responsibility for forecasting revenues. Recently, however, the Congress has used revenue estimates generated by CBO and JCT.

Seemingly, competition among government estimators should improve the quality of forecasts. Recent blunders by both CBO and JCT, discussed in detail later, suggest otherwise. Congressional and Executive Branch estimators generally follow the same "static" ground rules in preparing forecasts describing the impact of spending and tax measures, since dynamic feedback effects are subjective and might, therefore, be "likely to compromise cross-checking of the two estimates."⁸ Though they both have a poor record of estimating actual spending and revenue effects of policy changes, neither seems eager to change.

Forecasting is not a perfect science, yet forecasters should be able to reasonably estimate the effects of a policy change on individuals and the economy. A critical observation of forecasting requires one to scrutinize forecasting methods. Flawed methods will produce flawed results. The danger here lies in that lawmakers

⁸ Letter to Representative Dick Arme from Deputy Assistant Secretary of the Treasury R.Glenn Hubbard, September 11, 1991.

unwittingly make decisions based on inaccurate and misleading data, and leave the taxpayers victims of costly and ineffective legislation.

Currently, government forecasters use a primarily static framework to produce revenue and spending estimates. After producing a snapshot of the overall economy and current Federal policies, they estimate the effect of a particular tax or spending initiative on the budget. While this approach may seem reasonable, it is critically flawed. That individuals and businesses change their work, savings and investment behaviors when Congress lowers or raises taxes is manifest in the most basic laws of economics and past experience. Yet static analysis assumes the level of economic activity and the tax base will remain largely unchanged by the level and incidence of taxation. The snapshot of the overall economy is the same before and after the policy change. In the same way, static analysis fails to account for the impact of policy changes on government spending programs. Although empirical evidence indicates otherwise, a static framework assumes that individuals and businesses will not change their behavior to become eligible for a new or expanded Federal spending program.

Static economic and budget forecasting begins with assumptions about the economy's performance. Both the Executive Branch and CBO prepare a set of projections about the growth in real gross national product, inflation, employment, and interest rates. Implicit in these forecasts are assumptions about monetary policy, movements in foreign exchange rates, labor force growth and other economic considerations. When making economic projections, government analysts look at recent trends and often assume these trends will simply continue. The failure to assess economic activity systematically and to anticipate trend changes has powerful implications on both the spending and revenue sides of the budget.

Once the economic assumptions are in place, they form a baseline from which forecasters evaluate current policies. They also use this static baseline to assess the impact of any proposed tax or spending changes. These static policy forecasts are risky guides for policy making. Static analysis ignores the fact that higher tax rates

often lead to lower levels of employment or growth which would in turn change the baseline conditions. Similarly, static baseline estimates of personal income are used to estimate the cost of a new program, ignoring the likelihood that new Federal subsidies influence the incentive to work.

In the static forecasting scenario, individuals and businesses demonstrate little response to changes in their taxes. Dynamic forecasting is an inexact science which incorporates assumptions about the behavioral effects of policy changes on individuals and the economy and, therefore, on Federal expenditures and revenues. Unlike in static forecasts, each policy change implies a different baseline.

For example, raising the tax rate on labor tends to make work less attractive than leisure. Raising the tax on investment income tends to make saving less attractive than consumption. Tax increases such as these lead to less employment or less investment, and consequently slower economic growth and a smaller tax base. Similarly, offering new or expanded Federal benefits will affect individual behavior. A dynamic projection would account for such changes, so the dynamic projection of program costs would likely be higher than the static projection while the dynamic projection of revenue from increased taxes on labor would be lower than the static projection.

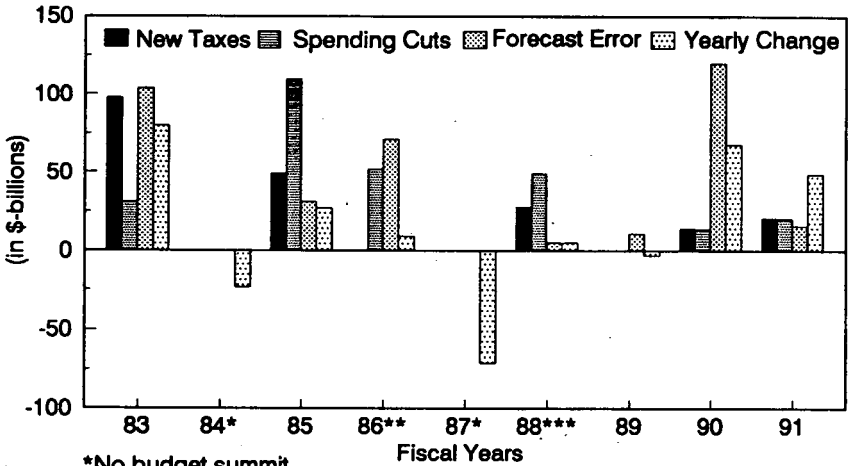
While government forecasters do not use dynamic forecasting methods today, that has not always been the case. For example, President Kennedy's economic advisors used dynamic models to evaluate the effects of his proposed reduction in personal income tax rates. Advisors expected the reduction to stimulate demand in a sagging economy and increase incentives to work, save and invest.

Though the Kennedy tax cuts did stimulate economic growth and the dynamic forecasts were validated, today estimators stubbornly cling to static methods. A tax cut that would lead to higher growth and higher revenue will be rejected if static estimates assert it will increase the budget deficit.

Though forecasters opt for static methods over dynamic methods, no good evidence suggests why. Accuracy is the relevant criteria by which to evaluate forecasting methods. Retrospectively examining policy change outcomes is a good way to assess accuracy and reliability. One set of past policy changes that can be compared against facts are budget summit agreements negotiated by the Administration and the Congress to reduce the deficit levels. Central to these agreements were static estimates of tax increases and spending reductions that government forecasters projected would achieve lower deficits. Interestingly, not only did the budget summit agreements fail to achieve their stated deficit reduction goals, deficit levels actually increased under their provisions.

Comparing the targeted revenue increases and spending cuts resulting from the summit agreements with the change in the deficit shows forecast errors. For example, the 1982 summit was supposed to achieve \$98 billion in tax revenue increases and \$31 billion in spending reductions during fiscal year 1983. As indicated in Graph IV.1, the forecast error is the difference between the deficit target government forecasters predicted (\$104 billion for 1983) and the actual deficit (\$207.8 billion). Interestingly, those years with the largest forecasted revenue increases or spending cuts end up with the biggest increases in the deficit. Conversely, those years with the smallest forecasted tax increases or spending cuts experience the smallest deficit increases. Finally, only in those years in which there were no summits did deficits fall significantly.

**Graph IV.1 -- Record of Past Budget Summits
Target Versus Actual Deficits**



*No budget summit

**No revenue increases were forecasted for FY 86

***1987 budget agreement was a two-year plan for FY88 and FY89.

Source: "Budgets of the United States, Selected Years," Tax Foundation Issue Brief, June 1990.

When policymakers base their deficit-reduction agreements upon static forecasts, past evidence suggest that:

- Static estimates of growth-oriented tax cuts will overstate the tax revenue losses, even to the point of scoring net revenue gainers as losers.
- Static estimates of tax increases will overstate new tax revenues, even to the point of scoring net revenue losers as gainers.
- Static estimates of spending increases will understate new spending.
- Static estimates of spending cuts will overestimate actual savings.

Combined, these forecasting errors all point toward ever higher deficits. When revenues from higher taxes fail to materialize, spending decisions predicated upon receiving them drive up the deficit. Moreover, real program costs are likely to be higher than official estimates because static analysis underestimates the number of people eligible for Federal assistance. These phenomena help explain why, since World War II, every dollar raised in higher taxes has resulted in a \$1.59 in new spending.

The Luxury Tax: A Case Study

Perhaps the best example of the limitations of the revenue estimation process employed by government agencies like the Treasury's Office of Tax Analysis, OMB, CBO, and JCT is the revenue projection from the luxury taxes contained in the Budget Enforcement Act.

The 1990 budget agreement included a number of excise taxes on "luxury items" aimed at purchasers of high-end automobiles, yachts, private aircraft, furs, and expensive jewels. On passage, the JCT estimated their combined effect to be a revenue gain of nearly \$1.5 billion over the five-year life of the budget agreement.

However, actual revenue from the luxury taxes on boats, planes and jewelry are unlikely to meet the JCT's five-year projections, and the cost of job loss resulting from their imposition negates by a large margin what revenue gain there has been so far.

Because of these luxury taxes, 9,400 Americans will have found themselves unemployed, at a cost to the government of more than \$14 million (see Table IV.1). This figure is somewhat lower than the estimate in a July 1991 Joint Economic Committee (JEC) Republican study, because the July study used JCT estimates available at that time for FY 1991. The JCT total estimate was subsequently increased dramatically, from \$25 million to \$121 million. These increased expectations by JCT have been realized by vehicle tax collections only.

■

The effect of the luxury taxes on boats, planes and jewelry when only the cost to the Federal government of increased unemployment is taken into account is to spend \$2.40 to raise \$1. Costs are measured for an average unemployment duration of four months, the BLS standard for skilled blue-collar workers. For boats, it appears that this direct cost to the Federal government of a luxury tax dollar is over \$3. For airplanes, it appears to be much higher (see Table IV.1).

Table IV.1 -- Effect of Luxury Taxes on Boat, Plane and Jewelry Manufacture, FY 1991

Taxed Item	1991 Tax-Related Job Loss	Tax-Related Unemployment Costs (\$-millions)			Actual IRS Filings, FY91 (\$-millions)	Net Federal Revenue Effect (\$-millions)*
		Receipts	Outlays			
Boats	7,600	-16.1	-2.1	-18.2	3.9	-14.3
Airplanes	1,470	-4.5	-0.6	-5.1	0.1	-5.0
Jewelry	330	-0.8	-0.1	-0.9	6.1	5.2
Totals	9,400	-21.4	-2.8	-24.2	10.1	-14.1

Source: JEC Republican staff study, "Luxury Taxes in Fiscal 1991," July 1991.

IRS revenue filings, FY 1991, as reported in IRA Returns Processing and Accounting Division, memo of 11/13/91.

*Total does not include IRS administrative costs (\$0.5 million, IRS estimate, FY 1991, for all five items taxes).

Repealing these counterproductive taxes could alleviate some of the economic stress suffered in these three industries, all of which were already feeling the sting of recession prior to the enactment of the new excise taxes. Allowing workers in the boating, aircraft and jewelry industries to return to their jobs would benefit government coffers to a far greater extent than the revenue accruing from the taxes. Just as consumers reacted adversely to the tax, purchases will increase if the tax is removed.

Unfortunately, revenue estimators ignore the business employment consequences of new taxes when projecting tax revenue. Even demonstrable evidence of job loss will not make a difference given current revenue estimating procedures. If boat dealers sold only one luxury boat in 1991 to reap a single tax payment of \$30,000 and all blue-collar workers in the boat manufacturing industry lost their jobs as a result, revenue estimators could stubbornly insist that this tax gained \$30,000 in Federal tax revenue. Revenue estimators ignore the fact that the tax on boats brings in less than one-fourth of the \$18.2 million that it costs the Federal treasury.

For airplanes, the tax brought in \$53,000, and yet its opportunity cost to the Federal government in FY 1991 is over \$5 million. States are losing additional direct revenues from suppressed boat and aircraft activity. The real victims are the small businesses being put out of business and the blue-collar workers whose jobs and wages have been sacrificed by this misguided attempt to "soak the rich."

The JCT responded, partially, on November 22, 1991 to a request that resulted from a July 23 letter signed by 109 Members of Congress requesting that JCT re-estimate the impact of the luxury tax. Table IV.2 shows the numbers for this JCT estimate, which breaks down JCT's luxury tax revenue by product. The estimate was made nine days after the IRS reported the actual FY 1991 data shown in Table IV.2.

Table IV.2 -- Luxury Tax Revenues Based on IRS Collections to Date, FY 1991

Luxury Tax Receipts on:	JCT Estimate FY91 on 1-30-91 (\$-millions)	JCT Estimate FY91 on 11-22-91 (\$-millions)	JCT Estimate FY91 on Citing IRS Data on 2-19-92 (\$-millions)	Actual IRS Collections in FY91 Reported 11-13-91 (\$-millions)	Percentage Error of JCT Estimate, 11-22-91 Percent Over, (Under)
Airplanes	1	6	(0)	.053	11,220%
Boats	3	9	4	3.910	130
Vehicles	20	86	88	88.000	(2)
Furs	1	4	(0)	.279	1,334
Jewelry	(0)	16	6	6.126	161
Total	25	121	98	98.368	23

Source: JCT letters of 11/22/91 and 2/19/92 to Representative Dick Arme y and 1-30-91 to Senator John Chafee; IRS, Returns Processing and Accounting Division, memo of 11/13/91; and JEC Republican staff calculations.

The breakdown in Table IV.2 shows clearly that offsetting mis-estimates of different industries lower the error in the total estimate for JCT. Sheer luck bails-out faulty methodology. For example, the JCT airplane revenue estimate was over-estimated in FY 1991 by a whopping 11,220 percent.

On February 19, 1992, the JCT, citing IRS data, revised the FY 1991 estimate to match the actual IRS filing data first available on November 13, 1991.

The negative employment and revenue effects of the luxury tax dramatically demonstrate the inherently flawed methodology used by Federal revenue estimators who fail to take into account the dynamic effects of a proposed tax increase when estimating how much revenue will accrue to the Treasury as a result of its passage.

Congress does not tax things. It does not tax expensive autos, yachts, private airplanes, and diamond rings. Congress taxes people who make, sell and buy cars, boats, planes and jewels. Generally, the increased price of a good caused by a newly imposed tax reduces the quantity demanded of it, which in turn leads to lower production levels and employment losses. Since static analysis largely ignores behavioral responses to taxes, it tends to overestimate the revenue gains proposed taxes will generate.

A comprehensive dynamic analysis would include the impact of a proposed tax change on state and local treasuries, lost corporate taxes due to lower profits, reduced capital investment, employment effects in related industries, the impact of slower economic growth in these industries, the impact of laid-off workers returning to work at lower wages and less productive jobs, and the cost of enforcing the tax, among other costs. Ideally, Congress should consider such dynamic effects of any tax prior to its enactment.

The Tax and Spend Correlation

The \$160 billion in new taxes in the budget agreement were justified as a necessary pain to reduce the Federal budget deficit. However, data on the relationship between taxes and spending from

1947 through 1990 demonstrate that Congress's tendency to spend additional taxes rather than devote them to deficit reduction is at an all-time high. In fact, the historic correlation proves that every \$1 in new taxes results in \$1.59 in new spending. True to form, Federal spending actually accelerated after the 1990 tax increases were enacted, and budget deficits have hit record levels.

This stimulation of higher deficits by tax increases is not surprising. Other research as well as practical knowledge about how Congress operates suggests the same general conclusion: New revenues will be spent on more or bigger programs rather than deficit reduction. An analysis of 1947-90 data, and more recent budget information, supports several conclusions about the relationship between new taxes and Federal spending:

- The tax-deficit relationship has remained fairly constant in recent years with no evidence that the tendency of new taxes to stimulate new spending has decreased. If anything, the new data suggests a slight increase so that \$1.00 of new taxes would be expected to generate \$1.59 of new spending.
- Over the history of the United States, the tendency of Congress to spend additional taxes rather than devote them to deficit reduction has climbed to an all-time high. In the first decades of our fiscal history, tax increases were associated with declines in Federal deficits. Currently, increases in taxes have resulted in sharply higher deficits.
- The tax-deficit data at the state level do not show that tax increases spur higher deficits. This suggests that institutional constraints such as constitutional restrictions on deficit spending, and line-item veto power of governors, may be useful tools in controlling the spending habits of legislators.

GROWTH IN ENTITLEMENTS

The fastest growing portion of the Federal budget is the area of so-called entitlement or non-discretionary (mandatory) appropriations. This category of spending derives from budget authority provided in laws which fund these programs automatically until such time as Congress revises them or they are terminated by another law. Thus, these programs continue to grow as more people become eligible for benefits. Congress controls program expenditure levels indirectly by establishing benefit levels or directly by eligibility rules. The fact that many entitlement programs have annual appropriations does not diminish the on-going and automatic nature of their spending.

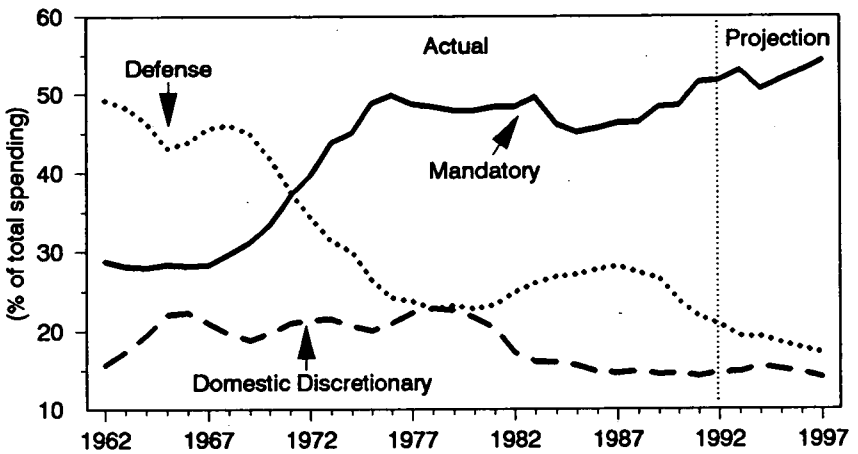
The best known entitlement programs are Social Security and Medicare -- the two biggest such programs -- but entitlement spending also includes programs to support agricultural prices, provide loans to college students and subsidize the lunches of school children. Spending on this category of programs has risen much faster than would be needed to keep pace with a growing population and inflation, and as a result entitlements have become an increasingly larger component of all Federal spending.

Entitlement spending absorbed only 28 percent of the Federal budget in 1962 and grew to 33 percent by fiscal year 1970. Since 1970, spending on entitlements has grown ten-fold, claiming an ever increasing share of the budget until it accounted for \$636 billion or nearly 50 percent of Federal government spending in 1991, excluding interest costs. Nearly 65 percent of the budget is accounted for in mandatory spending when interest is added. Mandatory spending today is almost twice the level of defense spending, when in 1970 it was only four-fifths as large.

Over the past 25 years, entitlement programs have roughly doubled in size relative to GNP, and now comprise approximately 11 percent of GNP. As Graph IV.2 indicates, mandatory programs are projected to grow at an average of 7.2 percent over the next five years, comprising 59 percent of the budget in fiscal year 1996. The impressive feature of this trend is that most of the growth in

spending and the number of recipients has been built into existing law and has occurred despite attempts to curtail entitlement programs. In the last 15 years entitlement spending grew 273 percent, compared to 243 percent for defense.

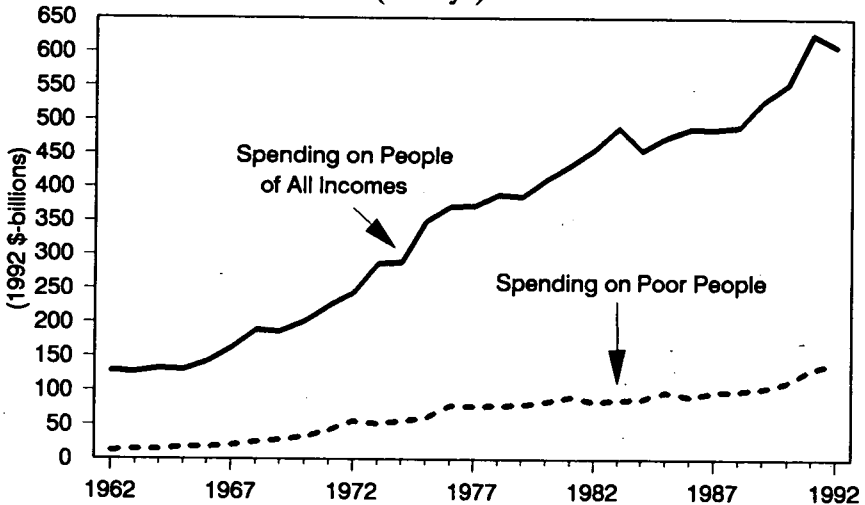
Graph IV.2 -- "Mandatory" Programs Are Taking Over the Budget



Source: Budget of the United States, Fiscal Year 1992: Supplement, 1992, Executive Office of the President, OMB, February 1992.

Although one might suspect that the bulk of Federal mandatory expenditures are concentrated on those individuals and families with the lowest incomes, in fact, overwhelmingly the beneficiaries of mandatory spending are the non-poor. One common approach to distinguish beneficiaries of entitlement spending is to divide expenditures into its two major components -- means-tested and non-means-tested programs. Employing this spending division, four-fifths of all entitlement spending goes to individuals **irrespective of need** and only about one-sixth of entitlement spending meets the common definition of welfare programs (see Graph IV.3).

Graph IV.3 -- "Mandatory" Spending by Income
(outlays)



Source: Budget of the United States Government, Fiscal Year 1992, Executive Office of the President, OMB, 1991.

Further, it is somewhat misleading to divide entitlement spending in this manner, as a common misconception arises due to the changing eligibility for means-tested programs. For example, Medicaid, a program aimed at providing health care to the poor and disabled, has an astonishing 50 percent of its expenditures going to assist people who are **above the poverty level**. How has this happened? Are individuals not eligible for benefits "ripping off" the taxpayer? Not at all. Congress has continued to expand the definition of eligibility for Medicaid far beyond the population of individuals at or below the poverty level so that individuals with incomes up to 185 percent of the Federal poverty level may now receive Medicaid benefits.

In addition, programs that were enacted specifically to assist poor individuals have changed their target constituencies over time. A good example of this phenomenon is the Medicare program. When enacted in 1965, Medicare expenditures were divided nearly equally between the poor and the non-poor. In the ensuing 25 years, however, there has been a dramatic shift in benefits toward

the non-poor so that today they receive almost 90 percent of the benefits of Medicare spending.⁹

Middle class taxpayers find themselves in a "Catch 22" situation. More and more of their hard earned income is being taxed away by the Federal government and the only way to "get anything back" appears to be to lobby for middle-class benefit programs. Families find themselves paying higher taxes to government so that government can give their children student loans to pay for college because the parents cannot help their children directly because of their high tax burden. The recycling of dollars from the middle class to the middle class is not only grossly inefficient but diverts resources away from productive activity to the pursuit of transfers.

The scenario surrounding entitlements is that they comprise an "uncontrollable" portion of the Federal budget. What this means is that Congress has chosen to provide continuing funding for these types of activities outside the normal appropriations process. However, this is legislative fiction. If Congress can set up these "shell spending entities," then it certainly has the means to change the budget process at any point. Why is it in the interest of Members of Congress to declare that 60 percent or more of the budget is beyond their control? It is not uncommon for members of Congress to try to enhance their prospects for reelection by increasing spending and lowering taxes.¹⁰ Increasing spending without making hard choices between budget alternatives is a low cost way to enhance incumbency. Once a program is an entitlement, Congress is off the hook with respect to controlling expenditures as they are by definition "uncontrollable."

⁹ Statement of Richard Darman, Director, Office of Management and Budget, Testimony before the Senate Finance Committee, April 16, 1991.

¹⁰ For an alternative explanation that focuses on the spending lobby's efforts to influence Members' decisions, see, James L. Payne, "The Congressional Brainwashing Machine," The Public Interest, 100, Summer, 1990, pp. 3-14.

Mandatory programs represent a fundamental flaw in the present budgetary system. The procedure for funding these governmental activities must be reformed if long-term Federal spending is to be brought under control. The Bush Administration has proposed a number of reforms:

- cap "mandatory" program growth in the aggregate;
- set the cap at one growth rate prior to the enactment of any comprehensive health reform and at a lower rate after enactment of such legislation;
- set the real growth rates for entitlement programs at about 4 percent per year (over and above adjustment for population increases and inflation);
- require any projected growth beyond the mandatory cap to trigger the legislative reconciliation process to correct the excess spending growth; and
- modify the pay-as-you-go system so that any uncorrected breach of the aggregate mandatory cap automatically triggers the sequester process.

These legislative reforms would go a long way toward restoring accountability to the expenditure process and force Members of Congress to make the decisions for which they were elected.

THE GROWTH OF FEDERAL REGULATION

Regulation is a hidden tax on American productivity. Unlike traditional forms of taxation, the burdens imposed by regulation are not always obvious. Nevertheless, the "regulation tax" constitutes a severe impediment to economic recovery.

This hidden tax is growing rapidly. In October 1991, 59 Federal agencies were preparing 4,863 regulations, of which 919

were new to the government's agenda. The total budget outlays of Federal regulatory agencies for FY 1985 stood at \$7.9 billion; the same figure for FY 1992 is \$13 billion. Staffing at Federal regulatory agencies fell significantly during the Reagan Administration but has returned to its Carter-era level. In the last year of the Carter era, 1980, staffing reached 121,670; following Reagan's regulatory reforms, staffing fell to 101,963 in 1985; but by 1991 the level had returned to 120,004. Regulatory staffing is expected to reach 122,406 in 1992.¹¹

All proposed and final Federal regulations are listed in the *Federal Register*. The size of the *Register* over time is a crude but effective device for estimating the trend in government-wide regulatory activity. *Federal Register* pages per annum reached an historic high of 88,000 pages in calendar year 1980. After President Reagan took office in 1981, *Federal Register* pages declined, reaching 47,418 pages in 1986. Since then, however, the trend has reversed. The last year of the Reagan Administration, 1988, saw a *Federal Register* with 53,376 pages, reflecting an increase in length of about 6 percent a year. This trend continues to accelerate; in 1991, the *Register* included 67,715 pages, a whopping 26 percent increase in length over the previous year.

This increased length reflects the regulatory consequences of legislation recently passed by Congress. When the Federal government is plagued with a ballooning deficit, hugely expensive new spending programs are hard to sell. Recessions compound the skepticism of financially strapped voters. In contrast, the passage of huge new programs of regulation is eased because the cost to consumers is much more difficult to see. But these costs are enormous, and represent a significant barrier to economic recovery.

Although the administrative expenditures of Federal regulatory agencies provide a window on the rate of growth of

¹¹ Melinda Warren, "Regulation on the Rise: Analysis of the Federal Budget for 1992," Occasional Paper No. 89, July 1991 (St. Louis: Center for the Study of American Business, Washington University); Table A-1.

Federal regulatory activity, they reveal virtually nothing about the actual economic burden produced by regulatory activity. American consumers bear these costs in the form of higher prices, limited selection, and reduced quality.

The Office of Management and Budget estimates that the direct costs of regulation equal approximately \$185 billion per year. The National Center for Policy Analysis reports an estimate ranging from \$395 to \$510 billion in 1990.¹² Thomas Hopkins estimates that Federal regulation imposed approximately \$393 billion in costs on the economy in 1988.¹³ The Budget of the United States Government for FY 1993 lists, for 1990, a range of cost estimates between \$430 and \$562 billion.

An intermediate cost estimate is \$461.4 billion per year, although this understates the true costs, probably substantially. A truly comprehensive estimate of the total cost of Federal regulation faces formidable obstacles in the form of data unavailability, and has yet to be attempted by any academic researcher. The intermediate estimate used here breaks down as follows, for 1990:

- **Environmental regulation -- \$115 billion --** The Environmental Protection Agency (EPA) expects that considerable increases in regulatory costs lie ahead. For example, the EPA estimates do not include the cost of the 1990 Clean Air Act Amendments, which may cost an additional \$25 billion per year to the economy. EPA predicts that the total annualized costs associated with the major Federal environmental pollution regulations may reach \$185 billion in 2000.

¹² National Center for Policy Analysis, Executive Alert, Vol. 6 (January/February 1992), pg. 8.

¹³ Thomas D. Hopkins, "The Costs of Federal Regulation," Journal of Regulation and Social Costs, Vol. 2 (January 1992).

The largest environmental regulation costs have been in the area of water pollution, primarily regulated under the Clean Water Act and the Safe Drinking Water Act. Water pollution control accounted for half of all Federally mandated environmental compliance costs in 1990. Air pollution control (including auto emissions, smokestack controls, etc.) is the second largest spending area, representing slightly over one-third of all Federally mandated regulatory costs. The costs of these two areas of regulation alone are expected to reach \$101.5 billion (in constant 1986 dollars) per year by the year 2000, which would represent a real increase of over 151 percent over the regulatory costs for those programs in 1980.¹⁴

- **Safety Regulation -- \$29 billion** -- A vast array of Federal regulations whose stated purpose is to improve the safety of workers and consumers have developed. This includes the activities of the Occupational Safety and Health Administration, the National Highway Traffic Safety Administration, the Nuclear Regulatory Commission, the Consumer Product Safety Commission, and the Food and Drug Administration.

- **Economic Regulation -- \$217.4 to 256 billion (in 1988)** -- These costs break down into two separate components: efficiency costs and transfers. Efficiency costs refer to the value of lost output due to regulation, while transfers are the value of reallocations of wealth from those harmed by regulations to those who are made richer. Such transfers remove spending power from consumers

¹⁴ The estimates for the cost of environmental regulations are from: U.S. Environmental Protection Agency, "Environmental Investments: The Cost of A Clean Environment" EPA-230-12-90-084, December 1990.

and redirect it to favored, and often inefficient, producers. Together these effects constitute the sum total of regulation-induced drag on the economy. Efficiency costs were between \$45.3 and \$46.5 billion; transfers equaled between \$172.1 and \$209.5 billion.¹⁵

- **Paperwork burden -- \$100 billion¹⁶** -- Most regulation requires only minor outlays from the Federal budget. But the cost of compliance with Federal edicts imposes a drag on the economy, regardless of being "off-budget" in the minds of some in Congress. One major cost of compliance is simply the time and resources required to fill out forms. OMB reports that over five billion hours were required by the private sector to comply with government paperwork requirements in 1988, with tax compliance accounting for more than four billion of these hours.¹⁷ Taking the average cost of compliance as \$20 per hour, the total cost per annum for all compliance (including with tax regulations) equals approximately \$100 billion. Of this total, about \$20 billion represents the paperwork

¹⁵ Hahn, Robert W. and John A. Hird, "The Costs and Benefits of Regulation: Review and Synthesis," Yale Journal on Regulation, Vol. 8 (Winter 1991); pg. 251, Table 1, for estimates of total costs. Regulatory transfers include international trade barriers (\$102.9--127.9 billion); agricultural price supports (\$25.1 billion); remaining regulation of airline travel, including restrictions on efficient pricing of existing airport slots, regulation induced airport investment inefficiency, and continuing regulation of international airline markets (\$11.5 billion); continuing railroad regulation (\$9.1 billion); and other, mostly smaller, regulation-caused losses (e.g., milk marketing orders and price supports, between \$1.3 and \$4.4 billion). *ibid.*, Table 1, pg. 251.

¹⁶ Hopkins, *op. cit.*, pg. 14.

¹⁷ U.S. OMB, Information Collection Budget of the United States Government, FY 1990.

cost imposed by non-tax Federal regulatory mandates. But the requirement to fill out incredibly complex tax forms is really a form of regulatory taking of private property, and so should correctly be considered as a component in the overall Federal regulatory burden.

- **Mandates to state and local governments -- \$ large but unknown** -- In October 1991, the Unified Agenda of Federal Regulation indicated that 707 pending regulatory actions could be expected to affect state governments, and another 486 would affect local governments. The National Conference on State Legislatures started a project in 1990 designed to track new Federal mandates, issuing reports 10 to 12 times per year which each identify dozens of new requirements.¹⁸ These costs may be very large, but no comprehensive cost estimate yet exists.

In sum, the Federal government imposes regulatory costs on the American economy every year approximately equal to the entire gross national product of Canada.¹⁹ And these gigantic costs are accelerating. OMB estimates that by the year 2000 Federal regulation will cost between \$542 and \$688 billion (in 1990 dollars) per year.

Federal regulations do not just impose static, one-time only losses on the economy, but also lead to lower productivity and an accumulating loss of future output and jobs. Christiansen and Haveman consider the relationship between labor productivity growth in the manufacturing sector and various measures of Federal regulation, and find that observed increases in regulation over the

¹⁸ Hall of the States Mandate Monitor and Mandate Watch List.

¹⁹ U.S. Census, *Statistical Abstract of the U.S.* (Washington, D.C.: GPO, 1991); pg. 841. The GNP of Canada in 1988 was \$471.8 billion.

1948-77 period explain from 12 to 21 percent of the productivity slowdown in manufacturing.²⁰ Gallop and Roberts examine the electric power industry, and find that the existing sulfur dioxide emission standards have reduced productivity growth by 44 percent at "environmentally constrained" utilities.²¹ In a study of 450 manufacturing industries, Gray reports that the Occupational Safety and Health Administration (OSHA) and EPA regulatory efforts have led to a significant decline in productivity growth in affected industries. OSHA regulations imposed as much as a 2.2 percent productivity slowdown, while EPA regulations induced a productivity slowdown as great as 1.9 percent. The study concludes that OSHA and EPA regulation alone have produced a productivity slowdown of 0.44 percent, or 31 percent of the total slowdown for the average manufacturing industry.²²

Jorgenson and Wilcoxon estimate that environmental compliance costs reduced economic growth by 0.2 percent per year during the period 1974-85. In other words, the environmental regulations of the 1970s and 1980s caused GNP today to be about 2.6 percent lower than it otherwise would have been.²³ Hazilla and Kopp estimate that real GNP lost as a result of environmental regulations was even greater, 5.8 percent lower in 1990 than it

²⁰ Christainsen, Gregory B. and Robert H. Haveman, "Public Regulations and the Slowdown in Productivity Growth," American Economic Review, 71 (May 1981); pp. 320-325.

²¹ Gollop, Frank M. and Mark J. Roberts, "Environmental Regulations and Productivity Growth: The Case of Fossil-Fueled Electric Power Generation," Journal of Political Economy, Vol. 91 (August 1983); pp. 654-674.

²² Gray, Wayne, "The Cost of Regulation: OSHA, EPA and the Productivity Slowdown," American Economic Review, Vol. 77 (December 1977); pp. 998-1006.

²³ Jorgenson, Dale and Peter J. Wilcoxon, "Environmental Regulation and U.S. Economic Growth," Harvard Institute of Economic Growth, Discussion Paper #11458 (October 1989).

would have been in the absence of clean air and clean water regulation.²⁴

The track record of many Federal regulations in accomplishing their officially intended purpose has been dismal. In addition to imposing a drag on the economy, it is often the case that government regulations fail to achieve their intended purpose. A number of studies have found that Occupational Health and Safety Administration regulations have had little or no effect on improving the safety of the work place. Mendeloff finds no statistically significant decline in lost-workday injuries after OSHA began regulating, for the period up to 1974.²⁵ Smith reports no significant decline in lost-workday accidents resulting from OSHA inspections in 1974.²⁶ Viscusi examines the period 1972 to 1975 and could find no evidence of any improvement in work place safety due to OSHA.²⁷ McCaffrey finds no impact of OSHA safety inspections during the period 1976-78.²⁸ Another study by Viscusi

²⁴ Hazilla, Michael and Raymond J. Kopp, "Social Cost of Environmental Quality Regulations: A General Equilibrium Analysis," Journal of Political Economy, Vol. 98 (August 1990); pp. 853-873.

²⁵ Mendeloff, John, Regulating Safety: An Economic and Political Analysis of Occupational Safety and Health Policy (Cambridge, Massachusetts: M.I.T. Press, 1979).

²⁶ Smith, Robert S., "The Impact of OSHA Inspections on Manufacturing Injury Rates," Journal of Human Resources, Vol. (Spring 1979); pp. 145-170.

²⁷ Viscusi, W. Kip, "The Impact of Occupational Safety and Health Regulation," Bell Journal of Economics, Vol. (1979); pp. 117-140.

²⁸ McCaffrey, Daniel P., "An Assessment of OSHA's Recent Effects on Injury Rates," Journal of Human Resources, Vol. (Winter 1983); pp. 131-146.

finds no evidence that OSHA reduced overall accident or illness rates in the work place from 1973 to 1983.²⁹

The Consumer Product Safety Commission's safety standard for matchbooks has been found to have had no significant direct effect on number, or severity of, burns due to matches.³⁰ A study of the CPSC's 1973 Mattress Flammability Standard finds that the regulation had no effect on consumer safety, but that the standard raised prices to consumers by up to 4 percent.³¹ Another study of the CPSC's regulation of bicycle safety standards concludes that over the period 1976 to 1986, the CPSC's standards failed to have any measurable impact on bicycle-related injuries.³²

Sometimes regulations work only too well. The 1962 Amendments to the Food, Drug and Cosmetic Act were designed to tighten Federal control over the flow of medicinal drugs to American consumers. Between 1950 and 1962 an average of 46 new drugs received Food and Drug Administration (FDA) approval every year; from 1963 to 1975, that number fell to only 16.

Even when regulations do achieve some measurable reduction in risk to the public, the cost of such risk reduction varies wildly, and is often absurdly excessive. The Budget of the United States Government, FY 1992 reports the risk and cost-effectiveness

²⁹ Viscusi, W. Kip, "The Impact of Occupational Safety and Health Regulation, 1973-83," Rand Journal of Economics, Vol. (Winter 1986); pp. 567-580.

³⁰ Keating, Barry, "Direct and Indirect Impacts of the Matchbook Safety Standard of the Consumer Product Safety Commission," Quarterly Review of Economics and Business, Vol. 24 (Autumn 1984); pp. 29-36.

³¹ Linneman, Peter, "The Effects of Consumer Safety Standards: the 1973 Mattress Flammability Standard," Journal of Law and Economics, Vol. (1980); pp. 461-479.

³² Petty, Ross D., "The Consumer Product Safety Commission's Promulgation of a Bicycle Safety Standard," Journal of Products Liability, Vol. (1987); pp. 25-50.

of a variety of Federal health and safety regulations. For example, a ban on unvented space heaters, issued by the Consumer Product Safety Commission in 1980, is estimated to avert one premature death per year for every \$100,000 in regulatory cost. But across all examples listed in the FY92 budget proposal, the cost-effectiveness of regulatory actions varies over more than eight orders of magnitude. At one extreme, the hazardous waste listing for wood preserving chemicals is estimated to cost \$5.7 trillion per premature death averted.

Regulations often have unforeseen adverse consequences. A prime example is the Corporate Average Fuel Economy or CAFE. In 1975, Congress passed the Energy Policy Conservation Act which, among other provisions, established the CAFE standards law. This law requires that all auto manufacturers selling new cars in the United States must, on average over the entire fleet, meet a Federal milage-per-gallon standard. For the model year 1991, the National Highway Transportation Safety Administration (NHTSA) set the standard at 27.5 miles-per-gallon.

As an indirect result of CAFE standards, the safety of American cars has significantly declined. Auto manufacturers have reduced the size and weight of their products -- and therefore their crash-worthiness -- in their efforts to improve the average gasoline mileage of their fleets. One recent economic study finds that CAFE is responsible for several thousand additional fatalities [resulting from accidents] over the life of each model-year's cars. The authors calculate that the present CAFE standard of 27.5 mpg costs the nation between 2,200 and 3,900 lives a year due to reducing the weight of American cars.³³

One of the principal concerns motivating the acid rain provisions of the Clean Air Act Amendments of 1990 involved the belief that acid rain was causing acidic lakes, harming red spruce

³³ Crandall, Robert W. and John D. Graham, "The Effect of Fuel Economy Standards on Automobile Safety," Journal of Law and Economics, Vol. XXXII (April 1989); pp. 97-118.

trees, and adversely affecting crop growth. However, a congressionally authorized, 10-year, \$550 million research effort called the National Acid Precipitation Assessment Program (NAPAP) found that acid rain was only a minor contributor to the first two problems, and had no apparent effect on crop growth. Nevertheless, the Clean Air Act Amendments of 1990 mandate a reduction in sulfur dioxide emissions (the major component of acid rain) of 10,000,000 tons per year at huge cost to electric utilities and ratepayers. This program is expected to cost a minimum of \$4 billion per year to implement.³⁴

In addition to the huge efficiency losses Federal regulation generates, there is also the troubling issue of the equity in the mandatory transfers of wealth implicit in regulation. Consumers-in-general, the underprivileged, the sick, the unemployed, and small businesses are not the net beneficiaries of Federal regulation, but the helpless victims.

The FDA denies approval to new drugs if it finds that "sufficient and adequate" drugs for the same purpose already exist. This serves to protect established suppliers from new competitors, and drives up the cost of medication.

The Federal Energy Regulatory Commission (FERC) impedes the building of new interstate natural gas pipelines by use of a complex permit granting process that allows competitors (i.e., the owners of existing pipelines) to argue against new permits. The owners of existing pipelines are thus allowed to influence Federal decisions about the entry into the market of new pipeline operators.

The CPSC mandates detailed bicycle safety standards for all bicycles sold in the United States. These standards have been found to have had no measurable effect in decreasing the total number of bicycle-related injuries, but nevertheless drive up the price of bicycles to American consumers and reduce the prospective

³⁴ Crandall, Robert, "Why is the Cost of Environmental Regulation So High?," Washington University, St. Louis: Center for the Study of American Business, Policy Study No. 110 (February 1992).

purchaser's options in that market.³⁵ One study has suggested that these costly and ineffective regulations are really aimed more towards assisting the U.S. bicycle industry by helping to make it more difficult for foreign bicycle producers to compete in the American market.³⁶

Federal regulations often place unfair burdens on small firms. Although the regulation may raise the costs of doing business to all firms in an industry, small firms are often most severely affected. For example, Bartel and Thomas found that EPA and OSHA regulation systematically benefits large, unionized firms and disproportionately harms small companies.³⁷ Studies by Peter Pashigian also find that small firms are harmed relative to large firms by the costs of compliance with environmental regulations, and further finds that certain regulations have been promoted by some regions of the country in order to reduce the competitiveness of other regions.³⁸ EPA mandated restrictions on economic development have tended to more severely impede the growth of Southern, Western, and rural areas relative to Northern and urban areas.

³⁵ Petty, Ross D., "The Consumer Product Safety Commission's Promulgation of a Bicycle Safety Standard," Journal of Products Liability, (1987); pp. 25-50.

³⁶ Cornell, Nina, Roger Noll, and Barry Weingast, "Safety Regulation," in H. Owen and C.L. Schultze, Setting National Priorities: The Next Ten Years (1976); pp. 457-504.

³⁷ Bartel, Ann P. and Lacy Glen Thomas, "Predation Through Regulation: The Wage and Profit Effects of the Occupational Safety and Health Administration and the Environmental Protection Agency," Journal of Law and Economics, Vol. 30 (October 1987); pp. 239-264.

³⁸ Pashigian, B. Peter, "The Effects of Environmental Regulation: Whose Self Interests Are Being Protected?" Economic Inquiry, Vol. 23 (October 1985); pp. 551-584.

During the last year of the Carter Administration (1980), real spending on regulatory programs reached a high of \$9.01 billion (in 1988 dollars), and staffing at the regulatory agencies reached a high of 121,670. Both these figures fell rapidly following the election of Ronald Reagan. The Reagan Administration made some dramatic progress in reducing the burden of Federal rules and regulation on the lives of Americans. After 1980, efforts by the Reagan Administration made a significant dent in Federal regulation over the U.S. economy. Federal regulations began to be subject to a cost benefit test, designed to identify and correct regulations which would cost business and consumers more than they were worth. Additionally, some deregulatory efforts initiated in the late 1970s began to show impressive results. Airlines were deregulated, the Civil Aeronautics Board (CAB) was abolished, interstate bus service was deregulated, the Federal Trade Commission (FTC) was made more sensitive to the economic costs of intervention, and in general agency regulators were restrained by Administration efforts. By all accounts, this regulatory restraint paid significant dividends to economic efficiency and helped propel the U.S. economy through the longest period of sustained economic recovery in the postwar era. All Americans benefitted from deregulation either directly, or indirectly by way of the sustained 80-month period of economic expansion deregulation helped to create.

Airline deregulation has been a resounding success. Consumers enjoy lower prices, greater choice, more frequent and safer flights than they faced during the regulated 1970s.

In the 1970s, the Civil Aeronautics Board regulated fare prices and routes on domestic air carriers. As a result, airlines were prevented from competitively lowering fares below a CAB-established minimum, the number of airlines in the industry was artificially restricted, and consumers were forced to accept a system of routes and scheduling which was inconvenient and inflexible. Airline deregulation began in 1978, and continued into the 1980s.

In all important dimensions, airline deregulation was a boon to American consumers. By 1986, air travelers had saved \$6 billion under deregulation of the airlines, and airline earnings were higher

by \$2.5 billion per annum.³⁹ Domestic revenue passengers enplaned, a measure of the utilization of air travel by the general public, increased from 254 million in 1978 to 453 million in 1989, an increase of over 78 percent. Airline deregulation caused airfares to consistently fall across the United States.⁴⁰

While air travel was becoming cheaper and more convenient, it also became significantly safer under deregulation. Between 1980 and 1988, the rate of fatalities on air transport per 100,000 travelers fell by half, from 0.8 to 0.4. Air carrier insurance rates are currently 22 percent below what they would have been in the absence of deregulation, a sure sign that the marketplace judges the deregulated air travel market to be substantially less risky.⁴¹ Economists Keith Womer and Richard McKenzie report that between 1979 and 1986, following deregulation, air travel increased by an average of 11.4 percent per year, which in turn reduced passenger-car travel by an average of 3.9 percent per year. This reduction in auto traffic, an indirect consequence of airline deregulation, reduced auto accidents by 600,000 per year from what would have occurred in the absence of deregulation; this accident reduction eliminated potential economic losses of almost \$2 billion

³⁹ Morrison, Steven and Clifford Winston, The Economic Effects of Airline Deregulation (Washington, D.C.: Brookings Institution, 1986; pg. vii).

⁴⁰ According to a recent GAO study, fares per passenger mile in 1988 dollars were lower at large, medium-sized, and small community airports in 1988 than had been the case in 1979; fares were overall found to be 5 percent, 9.6 percent, and 9.3 percent reduced, respectively. See GAO, Airline Deregulation: Trends in Airfares at Airports in Small and Medium-Sized Communities. November 1990.

⁴¹ McKenzie, Richard B., "Making Sense of the Airline Safety Debate," Regulation (Summer 1991): pp. 76-84.

per year, and lowered auto-related fatalities by an average of 1,700 per year.⁴²

The impressive gains from regulatory restraint of the Reagan Administrations are at risk of becoming entirely lost in the 90s, however. President Bush has recently proposed a 90-day freeze on those Federal regulations that are not subject to statutory guidelines from Congress. The Competitiveness Council has aggressively sought to restrain regulatory excesses in Executive Branch agencies. Finally, the Administration has expressed a determination to reduce the burden of bloated Federal regulation from the backs of American consumers. Unfortunately, a wide array of new regulations which promise to increase greatly the cost of that regulatory burden and further jeopardize economic recovery are proceeding unabated. The Budget of the United States Government, FY 1993 lists a total of 57 "significant regulations" expected to become final in 1992, and estimates that these new regulations will generate annual costs at least \$19.6 billion. Moreover, this is a major underestimate that leaves 12 of those "significant regulations" (including several major regulations) listed as having "unknown" costs.⁴³

Increasingly, Federal regulation is supplemented -- and sometimes supplanted -- by judicial branch regulation. The past few years have seen a virtual explosion of litigation combined with huge court settlements, particularly in cases involving product liability. Over and above the costs of Federal economic and social regulation stands the additional cost associated with such tort litigation. One recent estimate of the total expenditure nationwide for tort

⁴² McKenzie, Richard B. and Norman Keith Womer, "The Impact of the Airline Deregulation Process on Air-Travel Safety," Center for the Study of American Business, Working Paper #143 (St. Louis: Washington University, 1991).

⁴³ For example, the EPA's Water Quality Standards for Toxic Pollutants, the Endangered Species Protection Program, and the Coastal Non-Point Source Water Pollution Program (see Budget of the United States Government, FY 1993; Part One, pp. 404-406).

litigation terminated in state and Federal courts equals between \$29 and \$36 billion per year.⁴⁴ Another estimate, which includes the cost of insurance premiums covering claims and lawsuits, is \$68 billion per year.⁴⁵ Most recently, this figure has been gauged at over \$80 billion per year.⁴⁶

These estimates fail to take into account the many indirect costs directly due to the risk of litigation. The American Medical Association estimates that this practice added \$19.3 billion to the cost of health care in 1988.⁴⁷ Including all indirect costs, Huber estimates that the total cost of tort litigation to American consumers is closer to \$300 billion annually.⁴⁸ Huber terms this burden the "tort tax" on American consumers.

Worst of all, American consumers have little or nothing to show for bearing this tremendous burden. Studies have found no discernible positive effect on accident rates due to product liability

⁴⁴ Kakalik, James S. and Nicholas M. Pace, Costs and Compensation Paid in Tort Litigation (RAND Corporation, Santa Monica, CA, 1986); SR-3391-ICJ; pg. vi. The estimate is for 1985.

⁴⁵ Sturgis, Robert W., The Cost of the U.S. Tort System: An Address to the American Insurance Association (Tillinghast, Nelson, and Warren, Inc.; Simsbury, CT, November 1985).

⁴⁶ Hanke, Steve H. and Stephen J.K. Walters, "Social Regulation: A Report Card," Journal of Regulation and Social Costs, Vol. 1 (September 1990); pp. 5-34.

⁴⁷ Todd, James S., "Statement of the American Medical Association" before the Health Subcommittee of the Committee on Ways and Means, U.S. House of Representatives," April 26, 1990.

⁴⁸ Huber, Peter W., Liability: The Legal Revolution and Its Consequences (New York: Basic Books, 1988); pg. 4.

law.⁴⁹ The surge in lawsuits over the past 15 years has had no measurable effect in improving product safety.⁵⁰ Litigation in the correct dose serves to protect consumer safety, but the grossly excessive litigation which has emerged in the last 15 years in the United States actually reduces the ability of private enterprise to improve safety and help the sick. In some areas of the country, malpractice insurance rates have grown so high as to drive all obstetricians out of the market, rendering physician-assisted childbirth impossible. Drugs which have proven safe and effective remedies for potentially serious maladies have been withdrawn from the market by their manufacturers out of fear of litigation expenses.

Excessive government regulation is a net drag on economic growth, harms consumers and costs jobs. Because regulation imposes a "hidden tax" on the economy, it easily grows out of control. Congress enacts new regulation in part because new budget-busting spending programs would have a too-obvious effect on the Federal budget deficit. Regulation seems cheaper to Congress. But this is only an illusion. The real costs are huge, and borne by the private sector plus state and local governments subject to the numerous Federal regulatory mandates. Reform of this Federal regulatory morass is urgently needed. Existing regulations must be reformulated, and forthcoming regulations must be redesigned to minimize the growth retarding effects on the American economy.

On January 28, 1992, the Administration announced a 90-day review period of Federal regulatory programs, during which regulatory agencies will refrain from proposing new or issuing final regulations and concentrate on lightening the burden of existing regulations on the American economy. This is a good start, but can be improved. As a first step, both Congress and the Administration

⁴⁹ Litan, Robert and Clifford Winston, (eds.), Liability: Perspectives and Policy (Washington, D.C.: The Brookings Institution, 1988).

⁵⁰ Priest, George, "The Current Insurance Crisis and Modern Tort Law," Yale Law Journal, Vol 96 (1987); pp. 1521-1590; and "The New Legal Structure of Risk Control," Daedalus, Vol. 119 (Fall 1990); pp. 207-227.

should implement a moratorium on additional Federal regulations until the economy has sustained at least four consecutive quarters of robust GDP growth.

Other improvements over the announced 90-day review should include the following:

- regulatory agencies should cease and desist from imposing prescriptive command-and-control requirements, and instead set performance standards, thereby allowing the regulated community to achieve regulatory goals at the least possible cost;
- all regulations must incorporate market mechanisms in their operation, and cases where this is deemed impossible should be considered as potential candidates for repeal;
- and the moratorium should apply to all Federal regulations not deemed by the Council on Competitiveness to foster economic growth, as necessary to address an imminent danger to human health or safety, issued with respect to a military or foreign affairs function of the United States, or required by judicial deadline.

This last improvement implies that the vast number of regulations subject to statutory deadlines imposed by Congress must be revised by Congress. This single loophole will rob the President's otherwise useful initiative of much of its power, and only Congress has the power to close it.

Before enacting any new regulatory legislation, the Congress must first conduct a detailed cost/benefit analysis of the prospective effects of the regulations on economic growth. At present, Congress passes regulation bills without first establishing even vague estimates of expected regulatory costs. This cost/benefit review of proposed legislation should include OMB as an active participant.

Executive Order 12291, issued by President Reagan in 1981, mandates cost-benefit analysis in the case of all major Federal regulations. This Executive Order (E.O.) needs to be more rigorously enforced. At present, many new Federal regulations slip past the gate. For example, in 1990 the Office of Information and Regulatory Affairs (OIRA) reviewed only 41 percent of regulations issued by EPA.⁵¹ Many categories of agency rules are completely exempt from OIRA review procedures. The current *Regulatory Program of the United States Government* reports that EPA failed to conduct or complete analysis of the expected costs associated with 73 percent of reported significant regulatory actions (SRAs); OSHA similarly failed to conduct cost estimates for 46 percent of its SRAs. It is absurd to allow Federal agencies to design and implement regulations without first ascertaining the likely cost of those rules, but this is the current state of affairs.

Part of the problem is that OIRA has chosen to interpret E.O. 12291 as requiring special attention only to regulations expected to cost in excess of \$100 million per year. This implicitly exempts many potentially damaging regulations from review. E.O. 12291 also defines a "major rule" as one expected to impose "a major increase in costs or prices for consumers," which would include many, many regulatory rules costing "only" \$20 million, or \$50 million, per year. E.O. 1291 should be interpreted more strictly to include all rules expected to substantially increase costs.

Another problem is that E.O. 12291 expressly authorizes the regulatory agencies themselves to undertake the cost/benefit calculations. This is tantamount to the foxes guarding the chicken-coop. Cost/benefit analysis of proposed rules should be undertaken by either OMB or an independent interagency task force constituted for this purpose.

Many existing and forthcoming regulations are subject to congressional directives which explicitly prohibit taking costs of compliance into account in designing the implementing regulations.

⁵¹ OMB, Regulatory Program of the United States Government, April 1, 1991 -- March 31, 1992; exhibit 6, pg. 709, and exhibit 19, pg. 721.

The Clean Air Act Amendments of 1990 are a prime example. Congress must review existing legislation, and remove all such language restricting the employment of cost/benefit analysis in implementing regulations. Cost/benefit analysis of regulations must be extended to periodic reviews of previously implemented regulatory actions. An independent review should annually update projected costs and benefits associated with major regulatory actions.

Unfortunately, at present Federal regulations are not prioritized according to estimates of the effects on public health and safety. Regulations which cost billions of dollars in compliance costs yet only slightly reduce risk to a tiny number of people are implemented while less costly potential regulations languish even though the latter would substantially reduce risk to great numbers. This lack of priorities makes no sense. Risk management budgeting would assess the probable impact of health and safety regulation on preventing ill-health and accidents, and compare this impact with the expected economic cost associated with the regulation in question on a systematic basis. Such budgeting would lead to more efficient regulatory controls, and reallocate scarce resources to programs which have significant health and safety benefits and away from regulations which simply waste money while having negligible effect on the health of Americans.

Regulation of products by the government provides information to consumers about the safety and reliability of those goods and services. But under the present system of regulation, consumers are forced to purchase this information, and are restricted from making free, informed choices among goods in the marketplace. Regulations which ban the sale and use of non-approved drugs, or home products deemed risky by government regulators, force consumers to pay higher prices for approved products and remove the possibility of informed choice from buyers. Congress should amend regulatory Acts, where possible, to permit the co-existence in the marketplace of both regulated and unregulated products. Consumers should be empowered with the right to take regulatory information and use it to make informed choices.

■

Congress should enact legislation requiring the losing party in a Federal court suit to bear the full costs of the litigation (i.e., make the loser pay for all expenses on both sides). Courts should be made responsible for the allocation of this bill between client(s) and lawyer(s).

Every Federal regulation that reduces the value of private property represents a taking of that property by the government. This is a form of disguised taxation of American citizens. One reason the government regulates with such abandon is that regulation allows policy makers to intervene in the economy without bearing the resulting costs. The cost of regulatory takings do not show up in the Federal budget.

This system is unfair, unjust, and harmful to the economy. If the economy is to be protected from the avalanche of ill-conceived, hugely expensive regulatory excess, the problem of regulatory takings must be addressed. One simple legislative solution would be for Congress to pass a law requiring the U.S. Treasury to fully compensate private property owners who are found to be victims of a regulatory taking. Congress could found an independent commission with the job of determining the exact amount owed to individual property owners. This reform would force Congress to recognize the true cost of Federal regulations in the Federal budget, and would substantially reduce overly burdensome regulation emanating from the Federal government.

V. THE INTERSECTION OF POLITICS AND ECONOMIC POLICY

ECONOMIC REVISIONISM

Decisions on future economic policies are based on our interpretation of the past. Consequently, the debate over fiscal and economic policies for the 1990s is framed by our impression of the success or failure of policies in the 1970s and 1980s.

Democrats have made a concerted effort to redefine the economic history of the 1980s, even at times redefining when the 1980s began. Their goal is to recast Republican stewardship of the economy as inadequate, partly to resist current growth proposals and partly for election purposes. Democrat political consultant Stanley Greenberg was unusually frank about his party's goals in the Fall 1991 issue of *The American Prospect*:

For nearly a decade, Republicans ran against the Carter presidency, a period that embodied what was bad about Democrats and this country -- weakness before our enemies, things out of control, bad economic times for average Americans. Stagflation stripped away Democratic association with prosperity. It was around such images that Reagan brought together the affluent and the middle class.

To challenge the conservative hegemony, Democrats need to define the Reagan-Bush years--to create an imagery of Reagan-Bush America that supersedes the Carter years and impeaches the

credibility of conservative governance for middle America.(...)

...The battle to define the Reagan-Bush years is a critical political arena where Democrats have the opportunity to disrupt the Republicans' hold on the middle class, contest again the issue of prosperity, and advance the welfare and values of middle America.

Greenberg's strategy to impose a new definition on the 1980s, or the "Reagan-Bush years," that proves advantageous to the Democrats has been adopted in many partisan quarters. The challenge confronting Democrats who seek to define politically the 1980s to their party's favor is overcoming the economic data from that decade, which are generally positive. Some of these partisans have met the challenge with a vigor unseen since mid-century when Joseph Stalin attempted to rewrite Soviet history.

We look now at some tools of the revisionist trade, and Democrat efforts to rewrite the economic history of the 1980s.

Distorting the Record: Choice of Selective Base Years

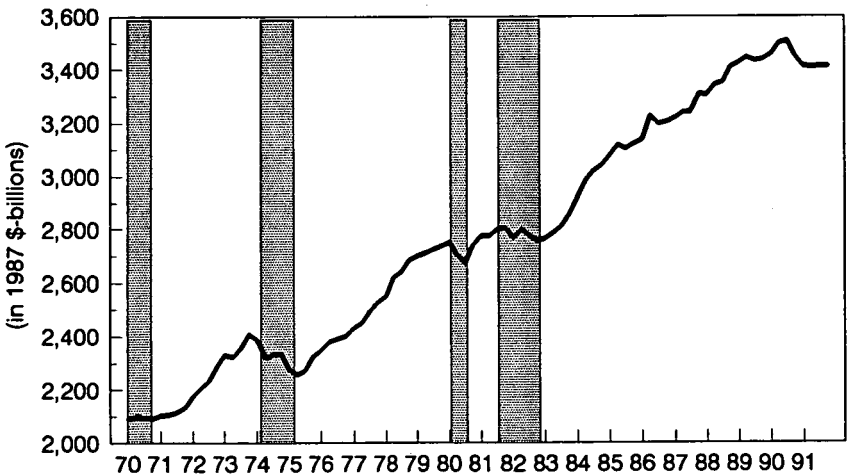
In order to make a case against the economic progress of the 1980s, one must rely on defective inflation adjustments, biased or inappropriate base years, or faulty CBO family income data. One common ploy is to use 1977 or 1979 as a base year in order to capture the disastrous years of Jimmy Carter's presidency in "the 1980s."

Even if one forgets that 1980 is actually the last year of the decade of the 1970s, there is no justification for 1979 as a base year to measure the effects of policies implemented later. CBO and other partisan analysts have argued that 1979 and 1989 are comparable points in consecutive business cycles, thus providing a "peak to peak" perspective. This is untrue. There were two business cycle peaks between 1979 and 1982, before the 1982-89 expansion even got underway (see Graph V.1). A true peak to

peak analysis would have to start in 1981, the peak previous to 1989.

Graph V.1 shows trends in personal income, with cyclical downturns reported by the Bureau of Economic Analysis and National Bureau of Economic Research shaded in grey. As can be seen there are actually two business cycle peaks, one in 1980 and one in 1981, after 1979 but before implementation of a new policy direction in 1981. The 1979-89 peak-to-peak argument is fallacious.

Graph V.1 -- Real Personal Income
(less transfer payments)



Source: Bureau of Economic Analysis

One can argue that annualized data are unavailable for the 1981 peak, but inconvenience of data collection or measurement does not justify analytical error. Confusion of measurement problems with substantive issues is simply a logical mistake. If a

peak that should be measured cannot be measured in a desired way, this does not excuse selection of another peak which is more easily measured. In other words, just because something is worth doing does not mean it is worth doing badly.

Another problem with this argument is what it says about economic and income trends. Even if 1979 were the previous peak, then 1980-82 should be viewed as one long period of economic decline. If so, the trend which started in 1980 cannot be blamed on an Administration which took office only in 1981, and thus the income declines of 1980, 1981, and 1982 should logically be assigned to the previous Administration. This would free the incoming Administration from responsibility for the income declines. However, partisan critics want to blame 1980 on the Reagan Administration by invoking 1979 as a peak year, and by absolving the Carter Administration for the decline which began on its watch.

An illustration from another era might help show the fallacy of this approach. Imagine a partisan Republican report on the economy presenting real GNP for two data points, 1929 and 1939. From these data the GOP report could conclude that since real GNP between 1929 and 1939 grew less than 1 percent, Roosevelt Administration policies were associated with slow economic growth. Obviously this approach would be defective because the impact of the Great Depression would be included with the Roosevelt years. In large measure the Depression explains why Roosevelt was elected, just as the economic malaise of 1979-80 explains much of the reason for Reagan's election.

The data show that income trends follow overall trends in the economy. Sustained income growth is strongly linked to healthy economic growth. Evaluation of the income trends of the 1980s must be viewed in the context of the Carter economic legacy. While income growth during the 1980s expansion was not unprecedented, it was good by the conventional measures of median household and family income, and marked a turnaround from the years of "malaise." The record shows that what is now needed are policies to encourage short- and long-term economic and productivity growth to lay a solid foundation for income growth in the 1990s.

1980 Income Meltdown Dominates 1979-89 Time Period

The most serious issue raised by using 1979 as a base year is the misrepresentation of income changes for the 1979-89 period. Essentially, the effects of a single year, 1980, are inappropriately used to represent a 10-year trend during the 1980s, or "Reagan-Bush years." The usual political misuse of this approach misleads the reader into assuming that the income effects of 1980 are related to policies implemented years later.

According to this view, during that period the rich got richer and the poor got poorer. The average real household income of the top quintile, those earning over \$55,000, did increase during this period, though many of the two-earner couples in this quintile might be surprised to learn they are considered "the rich." On the other hand, the decline in income for the bottom quintile during 1979-89 is entirely explained by 1980, the last year in which Democrats controlled both the White House and the Congress. This was the worst year for family income in the entire postwar period, with real median family income plunging by \$1,209, or 3.5 percent, in 1980 alone.

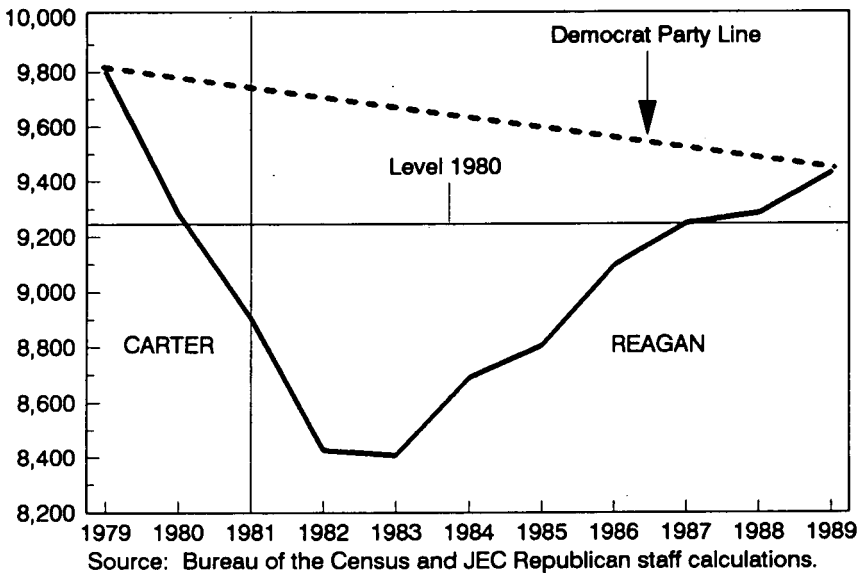
It is difficult to describe this as anything other than intellectual dishonesty, though some might consider a lack of sound training in the use of statistics a plausible explanation. If a 10-year period of income growth in the lowest quintile were claimed by one political party when all the net growth in the period were explained by the one year the other party were in office, this would be exposed as misleading and unethical or intellectually beneath contempt.

In these Republican Views, we present annual income data to permit readers to examine the evidence and reach their own conclusions. There is nothing legitimate to be gained by selective choice of base years which eliminates important information and distorts income trends.

A review of the data shows that the 1980 drop in income for the bottom quintile comprises 139 percent of the income decline

attributed to the whole period (see Graph V.2). However, the average income of this group increased between 1980 and 1989. The scenario that there was a straight drop in this quintile's income between 1979 and 1989 is what we call "the Democrat Party Line," since this fallacious assertion is usually made to score partisan points.

Graph V.2 -- "Democrat Party Line"
Real Average Income of the Bottom Fifth, 1979-89
(in 1989 dollars)



In other words, of the much touted income decline of the bottom fifth breathlessly reported in innumerable Democrat reports from the JEC, Budget, and House Ways and Means Committees, among others, Census data show that all of it occurred in one (Democrat) year. The 1980 Democrat decline is not only large enough to explain all, or 100 percent, of the decline over the 10-year period, but amounts to about 140 percent of the income decline over 10 years. Without the rest of the decade of net income growth, this one Democrat year would have produced an income decline 40 percent larger. The other nine years produced enough

income gain to erase this income deficit and produce a net gain whether 1980, 1981, or 1982 are selected as base years.

A recent report on "Work and Income in the 1980s,"⁵² released by JEC Democrats, used the endpoints 1979 and 1989. An earlier election year report using the same years was released by JEC Democrats on November 2, 1990. Similar selectivity has been used by CBO in preparing income data for political use by Ways and Means Democrat Members and staff, duly released to media and blown up in extensive graphs in newspapers and television news.

Such income data always portray the decade of the 1980s as one in which the average income of the bottom fifth of families declined while that of the top fifth advanced, thus landing the desired headline of "Rich richer, poor poorer." The 1990 Democrat JEC release went further in asserting that "the average real incomes of the bottom 40 percent of families are lower now that they were in 1979," even though the "economic pie grew during most of the 1980s." Unfortunately, CBO data used in the report to illustrate the evils of the 1980s contained a \$134 billion error, selective and biased measures of income, and a miscalculation of real capital gains. Of course, these were never acknowledged nor corrected by JEC and Ways and Means Democrats, who proceeded to use the faulty data for political purposes in 1990, and as late as 1992.

The latest Democrat JEC report also contains numerous factual errors in its presentation of average income data of the 1970s and 1980s. A partial explanation, though hardly conceivable, would be the possibility that the Democrat staff report suffers from the elementary but fundamental error of confusing mean and median values. It hardly seems possible that an organization of economists could make such a rudimentary error, especially in a report that was also reviewed for accuracy by the Congressional

⁵² "Families on a Treadmill: Work and Income in the 1980s," A Democrat JEC staff study prepared for the use of Members of the Joint Economic Committee, January 17, 1992.

Budget Office prior to its release. However, the presence of so many errors in one report is puzzling. A close examination of the movement of real family income in recent decades is needed.

Family Income Since 1973

In reviewing family income data it will be recalled that the composition of each quintile is constantly changing as families move between quintiles. This means the changes in income do not represent the changes of income of actual families, many if not most of whom are only temporarily in a given quintile. Furthermore, average income measures are subject to distortion by changes in the income of relatively small subgroups. Given the degree of income mobility in our society, one cannot reach conclusions about the economic well being of actual persons or gauge how broadly changes in average income of quintiles affect the population from these data.

These qualifications, although important in avoiding misleading and simplistic results, are usually ignored. (This aspect of mismeasurement is discussed in the subsection that follows.) In this section we will take the quintile income data at face value to examine how they can be manipulated to arrive at preconceived results. This narrow examination of these income data is for illustrative purposes only: Income mobility alone makes their use in describing the changing economic welfare of actual families statistically meaningless.

Table V.1 shows real average income levels for each quintile from 1973 to 1989. In general, movement in family income follows that of the business cycle. The income data shown below tend to move in the same direction as the economy. When the economy is performing well, income increases, and when the economy is in decline income tends to fall. For example, average income for all quintiles fell during the 1974-75 recession, and climbed during the subsequent expansion.

Table V.1 -- Real Average Family Income Since 1973
(in constant 1989 dollars)

Year	Lowest Fifth	Second Fifth	Middle Fifth	Fourth Fifth	Highest Fifth
1973	9,783	21,351	31,370	42,872	73,557
1974	9,636	21,035	30,783	42,172	72,121
1975	9,291	20,235	30,153	41,288	70,541
1976	9,509	20,740	31,017	42,379	72,440
1977	9,361	20,817	31,394	43,325	74,276
1978	9,650	21,475	32,319	44,530	76,566
1979	9,801	21,623	32,657	44,970	77,922
1980	9,286	20,852	31,588	43,828	75,049
1981	8,906	20,144	30,916	43,411	74,419
1982	8,427	19,834	30,381	43,093	75,903
1983	8,409	19,869	30,634	43,668	76,823
1984	8,692	20,406	31,554	45,123	79,518
1985	8,808	20,677	31,985	45,845	82,510
1986	9,095	21,396	33,204	47,447	86,423
1987	9,248	21,734	33,749	48,301	88,271
1988	9,284	21,712	33,787	48,524	89,033
1989	9,431	22,018	34,206	49,213	92,663
Change					
1979-80	-515	-771	-1,069	-1,142	-2,873
1979-89	-370	395	1,549	4,243	14,741
1981-89	525	1,874	3,290	5,802	18,244
1982-89	1,004	2,184	3,825	6,120	16,760
Percent Change					
1979-80	-5.3%	-3.6%	-3.3%	-2.5%	-3.7%
1979-89	-3.8	1.8	4.7	9.4	18.9
1981-89	5.9	9.3	10.6	13.4	24.5
1982-89	11.9	11.0	12.6	14.2	22.1

Source: Bureau of the Census and JEC Republican staff calculations.

This expansion ended in the first half of 1980, with renewed, albeit weak growth starting in July 1980 and continuing through July 1981. The slow nominal income growth and high inflation of this period caused a sharp across-the-board decline in real income in 1980, with further declines spilling over into 1981 and 1982 as the Federal Reserve tightened monetary policy. The absence of sustained economic growth along with high inflation proved a damaging combination for families at all income levels.

The pivotal year of 1980 merits especially close examination. As shown in Table V.1, the average real income of the bottom quintile declined by \$515 in 1980 alone, a decline of 5.3 percent. Meanwhile, the average real income of the middle quintile fell \$1,069, or by 3.3 percent. The income decline of 1980 was more than enough to erase all income growth in the bottom quintile occurring in the previous two years. The setback to income growth of other quintiles was also severe. The data are for "all families" since annual two-parent family income averages for quintiles are not published. However, the changes in income shown in Table V.1 would essentially mirror changes for two-parent families, the group used in the latest Democrat JEC study.

Table V.1 shows income growth for every quintile in the 1980s whether 1980, 1981, or 1982 is used as a base year. While the choice of any of these three years does change the amount of income growth, there is no way to show declines for any quintile without relying on the last year of the Carter Administration. This explains the insistence of partisan analysis to rely on the income meltdown of 1980 to taint the income growth under policies adopted later.

Quintiles and Income Mobility

Analyses of "the 1980s" and other periods often focus on the income trends of "quintiles," brackets of families or households ranked top to bottom by income and divided by population into fifths. Such analyses serve as the statistical fodder for the politics of class warfare, and often get condensed into headlines like "the rich got richer and the poor got poorer."

However, the people who comprise a quintile at any one moment constantly move up and down between them, or "permeate" quintiles, to an extent that invalidates the ostensible purpose of comparing average incomes of quintiles over time -- to accurately measure changes in the well being of persons in the quintiles.

The constantly changing mix of individuals and families who make up the quintiles wreaks statistical havoc on the income averages, calling into question not only the notion of superimposing a rigid class structure on a dynamic society but the extent to which quintile measures accurately reflect the quality of life of those who pass through different income brackets.

Forcing a fluid, capitalist economy characterized by remarkably high levels of income mobility into a rigid artifice of income quintiles allows some to paint a scenario of the U.S. economy as a caste system wherein "the rich get richer and the poor get poorer." The statistics tell a different, much more complicated and less easily measured story of an economy where some poor get poorer, some rich get richer, some rich get poorer and some poor get richer.

Census Bureau data from 1985 to 1986, and 1987 to 1988, reveal a great deal of income mobility in the U.S. economy.

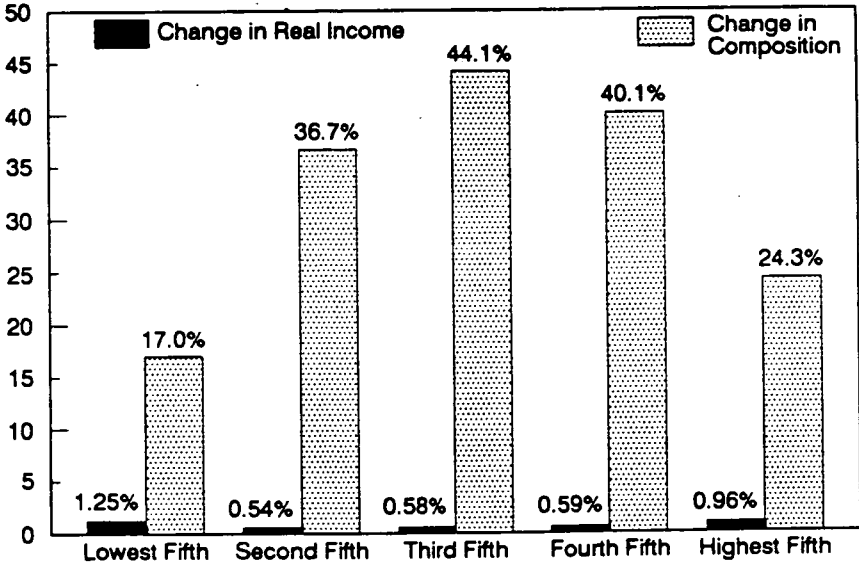
- Between 1985 and 1986, fully one-third of all persons changed quintiles, with nearly 18 percent declining one or more quintiles and nearly 16 percent increasing one or more quintiles.
- In the same period, about 45 percent -- almost half -- of those in the middle quintile moved to another quintile. About one quarter of those in the top quintile dropped down one or more quintiles and were replaced by others who moved up one or more quintiles.
- Factors like age, education and family size dramatically affect income mobility. For example,

young people move up through quintiles as they gain work experience, while older Americans tend to move down in quintiles as they reach full retirement.

The extent to which Americans freely move from one income quintile to another is important to understanding the nature of our economy. Change in average income among quintiles actually reveals very little about the well being of the individuals passing through a given quintile at a given time.

As Graph V.3 illustrates, the startling degree of change in quintile composition is at least as interesting and important a subject for research as changes in average income by quintile. Curiously, the Congressional Budget Office, a frequent source of quintile comparisons, provides virtually no information on this vital subject. Consequently, there is a great need for unbiased statistical agencies to explore the remarkable upward and downward income mobility in American society. While the Census Bureau's Survey of Income and Program Participation (SIPP) is a very good start, a much larger effort to collect and publish longitudinal data for extended periods is urgently needed.

Graph V.3 -- Changes in Income Levels and Composition of Quintiles, 1987-88



Source: Bureau of the Census

A Closer Look at Quintile Permeability

As startling as overall quintile permeability may be, a closer look at factors such as age, family size, and education reveal even higher degrees of income dynamism for specific groups. The degree of permeability varies considerably according to demographic and other characteristics. Under the surface, permeability for some is even more dynamic than the overall statistics would indicate. (It is important to note that these data reflect income changes within specific groups that are unevenly dispersed among the income quintiles.)

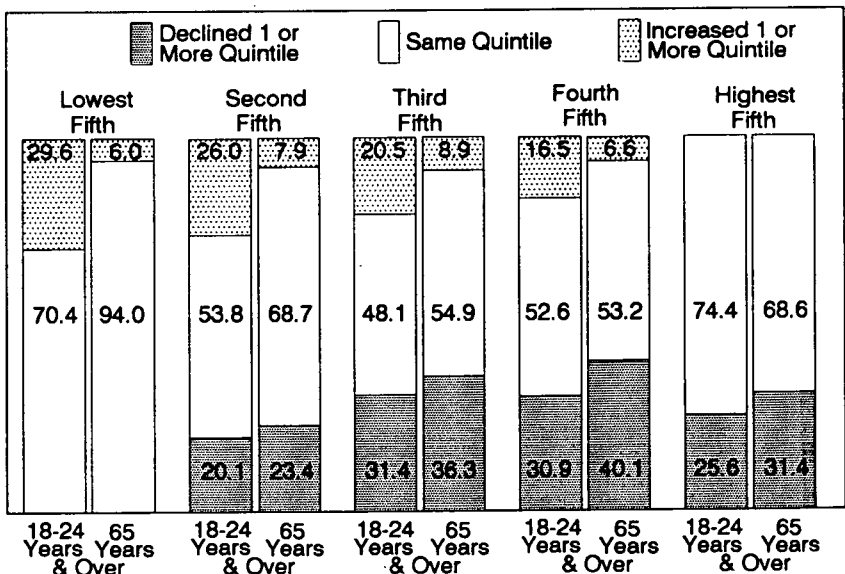
Age and Quintile Permeability

One of the most obvious reasons for income dynamics is demographic. For example, younger workers tend to start in the lower quintiles and work their way up as they acquire more

education and experience. A typical young adult over the last 10 years could well have moved from the lowest into the middle quintile. This person's income would be included in the lowest quintile in 1980 but excluded in 1990. The average income levels of the bottom quintile between 1980 and 1990 do not accurately reflect changes in the standard of living for those who started at the bottom but have since moved to different quintiles. They are also irrelevant for those in the bottom quintile in 1990, but who were not in the bottom quintile, or perhaps in any quintile, 10 years before.

The 1987-88 SIPP report presents the permeability data by age group. Graph V.4 displays some of these data for young adults (18-24) and the elderly (over 65). Not surprisingly, the young permeate upward at a greater rate than the elderly, most of whom are not working full time. In addition, the quintile share of young adults falling into a lower quintile is less than that of the elderly. The most dynamic quintile is the middle quintile of young adults, 51.9 percent of whom exited by 1988. In other words, most of the young adults in the middle quintile in 1987 were gone by 1988.

Graph V.4 -- Quintile Permeability Varies by Age Group, 1987-88



Source: Bureau of the Census.

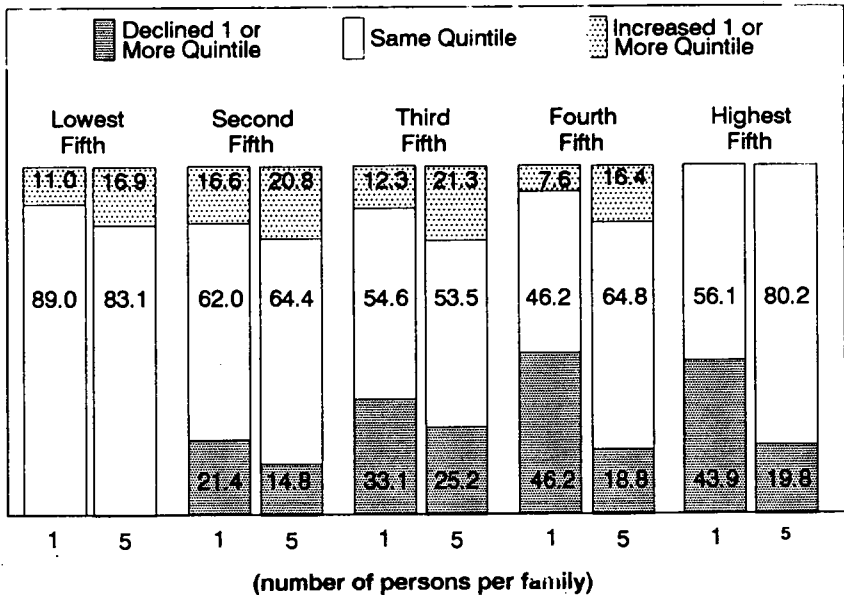
These data show the sharp contrast in patterns of quintile permeability by age group. As noted, the majority of young adults in a quintile can actually leave in as little as one year. The assumption of static class structure ignores not only overall income dynamics, but different degrees of permeability in various demographic groups.

Family Size and Quintile Permeability

An examination of quintile permeability by family size further illustrates how superficial the concrete class assumption is. There are wide disparities in the permeability of families based on family size. These are especially noticeable when comparing one person "families" with others. Here we will contrast one and five person families, as classified by the SIPP.

Of one person families, 72.6 percent remained in the same quintile during 1987-88, compared to 67.6 percent for all persons. However, single persons in the top two quintiles tended to drop into lower quintiles more than other kinds of families. The portion of one person families falling from the top quintile was 43.9 percent, relative to 19.8 percent for five person families. Graph V.5 compares the changes in the income of single families with that of five person families.

Graph V.5 -- Family Size and Quintile Permeability, 1987-88



Source: Bureau of the Census.

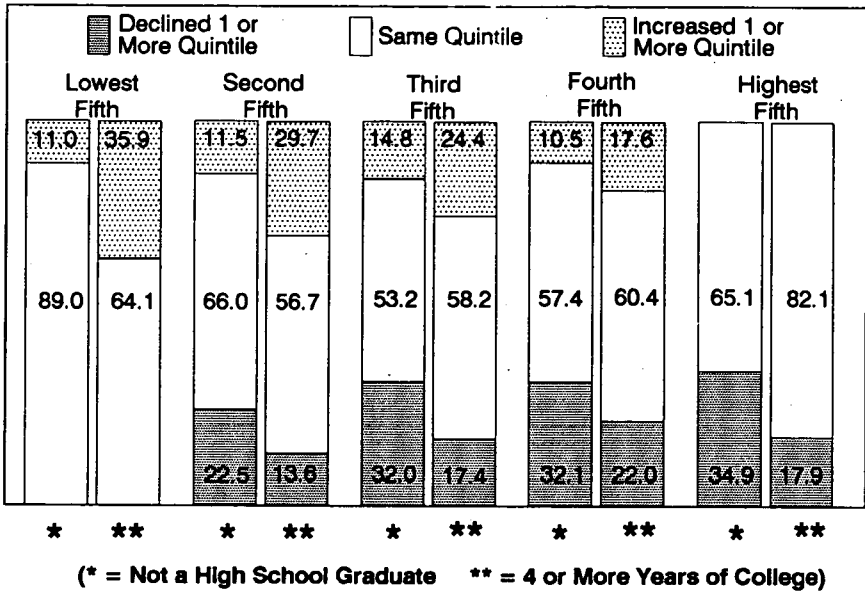
Note that 53.8 percent of single person families exited from the fourth quintile in 1988, while turnover in the third and top quintiles were also well over 40 percent. While the third quintile of five person families shows a 46.5 percent turnover, the other quintiles in this family size reflect more stability. The data show that income dynamics varies by family size, another important fact obscured by the assumption of class stability. Changes in average income by quintile is even more meaningless for some groups than for others.

Education and Quintile Permeability

The SIPP data show that those with more education tend to move up through quintiles at a faster rate than those without benefit of a high school diploma. The data also reflect the fact that those without high school educations have a much higher risk of sudden income declines. Graph V.6 shows that 34.9 percent of

these persons in the top quintile fell into lower quintiles between 1987 and 1988, relative to 17.9 percent of those with four or more years of college.

Graph V.6 -- Education and Quintile Permeability, 1987-88



Source: Bureau of the Census.

The graph reflects the superior economic progress of those with college educations. Not surprisingly, their upward mobility in all quintiles is much greater than for those without high school diplomas. Of course, in the overall population, more of the top fifth quintile is comprised of these college-educated persons than those without high school degrees.

The high rates of change in the composition of quintiles radically affect income averages, altering them to the point that they do not accurately reflect changes in our economy.

To illustrate this point, imagine a tiny country of 50 people, spread evenly over five hypothetical quintiles with the average income for the bottom quintile set at \$14,500, the average for the second \$24,500, the third \$34,500, the fourth \$44,500 and the top quintile having an average income of \$54,500.

In the bottom quintile is Private Smith, earning \$18,000. In the second quintile is Ann Waitress, earning \$27,000. Joe Salesman has an income of \$35,000 per year, putting him in the middle of the middle quintile. Ted and Jane Suburban have a combined income of \$45,000 per year, which puts them in the fourth quintile. And Bob Sportscaster makes \$51,000 per year covering football games for the network, placing him in the top quintile.

In the course of the year Private Smith is promoted to corporal, increasing his salary to \$21,000, pushing him into the second quintile. Ann Waitress finally gets her break in acting, landing a part in a national commercial which propels her into the top quintile with an annual income of \$56,000.

Joe Salesman's wife starts a small catering business, and her second income is enough to edge them from the middle of the third quintile to the bottom of the fourth at \$48,000. On the other hand, Jane Suburban decides to leave the labor force to stay home with her infant child, which causes their household income to drop from the top of the fourth quintile to near the bottom of the third with an income of \$32,000.

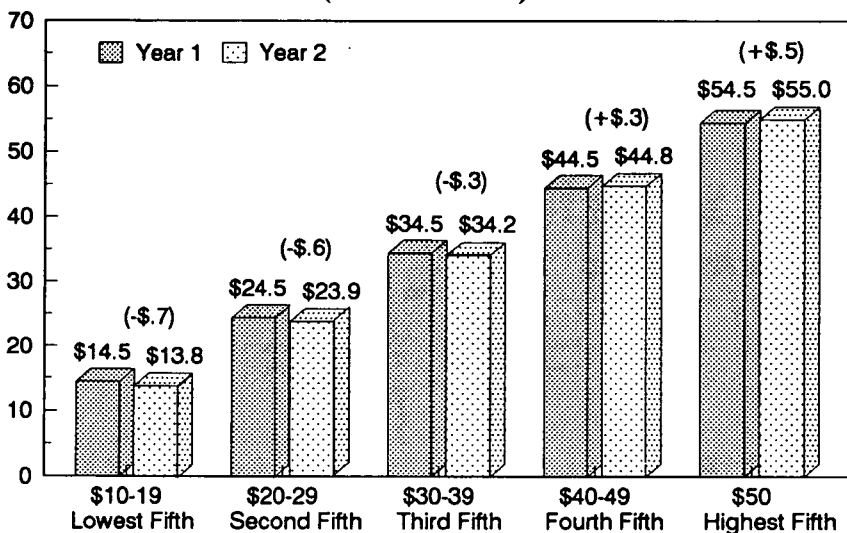
When the network is disappointed by Bob Sportscaster's ratings, he's sent to an affiliate in the Midwest, and his salary declines to \$45,000, dropping him from the bottom of the top quintile to the top of the fourth. In this same year, Dean Teen graduates from high school, leaves home, and begins working full time at the pizzeria, entering the work force and the bottom quintile with annual wages of \$11,000.

Now, all these vignettes are natural occurrences in this country's tiny economy. Most of the households gained income in the course of this year (Private Smith, Ann Waitress, Joe Salesman and Dean Teen), and those who lost income either made rational

choices (the Suburbans) or didn't drop too severely (Bob Sportscaster).

Assuming no significant change in the income of other households, the effect, however, would be to decrease the average incomes in the bottom three quintiles while the top two quintiles see an increase in average annual income (see Graph V.7).

Graph V.7 -- Changes in Average Income Hypothetical Quintiles, Year 1 to Year 2 (in \$-thousands)



Note: Numbers in () represent differences in average income in Year 1 & Year 2.

If CBO were to measure annual income gains and losses in this model economy, however, the next day's headline would be "Rich Get Richer, Poor Get Poorer."

This illustration is not to say that in America poor people never get poorer and rich people never get richer in America, only to demonstrate that the income quintile measures are not only incompatible with the changing nature of our economy, but that the

changing nature of our economy can render the quintile measures meaningless. The oversimplification of the headlines tells us nothing about the quality of life of those passing among the quintiles of this tiny country of 50 people.

The validity of any concept relies on its accurate representation of its subject. A concept, even a seemingly empirical one, which expresses a meaning at variance with its subject provides a false view of reality. As physicist and philosopher Stanley Jaki has pointed out, "without securing reality, the so-called scientific objectivity or empirical objectivity has no secure foundation."⁵³ The common usage of the quintile as a monolithic block of inextricably linked families whose fortunes rise or fall in unison distorts economic and social reality.⁵⁴

Data for 1985-86 show that nearly half the population in the middle quintile moved to a different quintile in the course of a year. Over 18 percent of those in the bottom quintile moved up, and nearly 24 percent of those in the top quintile moved down in a year's time. In other words, it is accurate to say that ours is an economy where some rich get richer, some poor get poorer, some rich get poorer and some poor get richer.

Furthermore, the income gained by a new invention, innovation, investment, or artistic success adds to the well being of all, and is not taken from anyone. If a professional athlete doubles his income over 5 or 10 years, he does no harm to others at a lower level of income.

While it is easy to measure the average incomes of a given quintile over time, this measurement's relationship to economic reality is usually overstated. The truth is that understanding of our market economy is hindered by this approach. In the market

⁵³ Jaki, Stanley L., Chance or Reality and Other Essays, Lanham, 1986, pg. 33.

⁵⁴ See also Bruce Bartlett, "A Class Structure That Won't Stay Put," Wall Street Journal, November 20, 1991.

economy there is no finite, common pool of income to be distributed, and there is no Distributor of Income. As such, there is no "income distribution" per se, but only the income of millions of persons from a wide variety of sources (including business, self employment, and government) which can be summed up.

The most common use of family income data is to provide a pseudoscientific rationale for the policies of income redistribution based on notions of social or distributive justice. The only problem is that advocates of this approach cannot define what a socially just outcome would look like. As Nobel Laureate F.A. Hayek has pointed out, "so long as the earnings of particular individuals or groups are not determined by the decision of some agency, no particular distribution of incomes can be meaningfully described as more just than another. If we want to make it substantively just, we can do so only by replacing the whole spontaneous order by an organization in which the share of each is fixed by some central authority."⁵⁵

Misleading the American public into believing our society is an arbitrary zero-sum class system controlled and exploited by an elite is a very dangerous brand of class warfare. Reducing the free and spontaneous adjustments of the market process to a bipolar system of victims and villains threatens our inextricably intertwined economic and political freedoms. Responsible government requires accurate measures of the changes in our economy.

Government statistical agencies should place greater emphasis on income mobility, or what can also be termed "quintile permeability," a telling economic trait which is often ignored in public debate. After all, what tells us more about our economy and the opportunities it presents: that the average income of the top quintile increased 1 percent in a given year, or that fully one-quarter of those in the top quintile arrived there in the past year?

⁵⁵ Hayek, F.A., Law, Legislation and Liberty, Volume 2, The Mirage of Social Justice, Chicago, 1976, pg. 142.

In the future, data on changes in average income among quintiles should be presented next to changes in quintile composition to portray an accurate picture of our economy. Income quintiles are not monolithic blocks of inextricably linked households whose fortunes rise and fall in unison. Government agencies should not disseminate statistics which lend credence to the notion that ours is a caste society where there exists a permanent class of "rich" who get "richer" by somehow making the permanent class of "poor" get "poorer."

Calendar Year Data

One aspect of the economic revisionism currently in vogue is the assertion that the late 1970s, contrary to popular perception, were actually better years in terms of economic growth and job creation than were the mid-to-late 1980s. In this scenario, the fiscal policies pursued by President Jimmy Carter were better for the country than those pursued by President Ronald Reagan.

As is often the case with revisionist history, these reports are based on flawed evidence and distorted methods. These retrospective economic "analyses" consistently measure a president's fiscal performance from the time he was sworn into office (if not before), even though a president's fiscal policies usually do not take effect until the beginning of the first fiscal year in which he presides. The analysis here on the other hand, examines the average annualized rate for three important economic factors affecting all Americans (job creation, growth in the real gross national product (GNP), and inflation) by extracting data from the fiscal years during which a president served.

The first necessary adjustment for data is to adjust calendar year data to fiscal year end points. One cannot accurately measure gallons with a ruler, and one cannot accurately measure a president's fiscal performance with calendar year data. The proper data base with which to hold a president accountable for fiscal performance is to use data from the fiscal years during which he served.

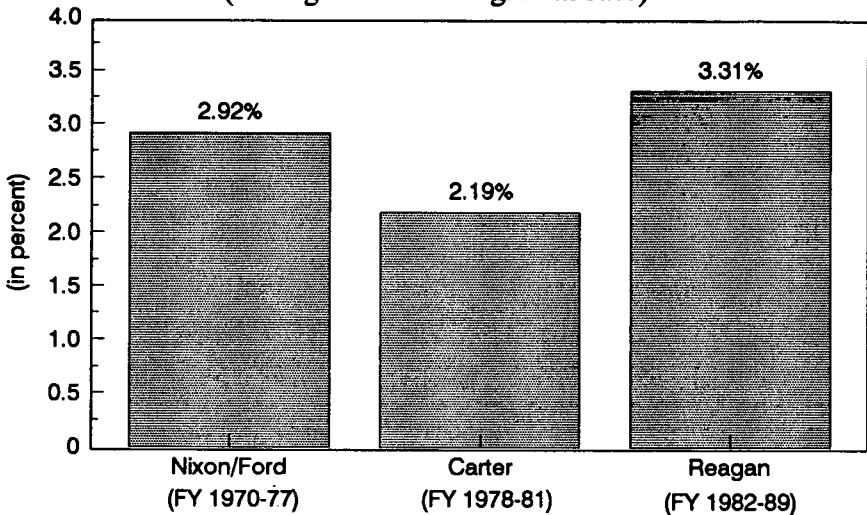
The results are interesting. A recent House Democratic Study Group report based on calendar year data show Jimmy Carter's annualized job creation percentage standing as a peak between the Nixon/Ford and Ronald Reagan administrations, but fiscal year analysis shows his job creation percentage as a valley between the two. And rather than showing a steady rise in real GNP from 1970 to 1989, Carter's fiscal year picture appears as a GNP "Death Valley" between his predecessor and successor (see Table V.2 and Graph V.8).

**Table V.2 -- Real Gross National Product Growth
During Presidents' Fiscal Years**

President	Oct. 1	to	Oct. 1	Real GNP (in 1982 \$-billions)	Annualized Percentage Increase
Nixon/Ford	1969 (FY'70)		1977 (FY'78)	2,433.2 to 3,001.8	2.92%
Carter	1977 (FY'78)		1981 (FY'82)	3,001.8 to 3,264.6	2.19%
Reagan	1981 (FY'82)		1989 (FY'90)	3,264.6 to 4,129.7	3.31%

Source: Department of Commerce, Bureau of Economic Analysis, and fiscal year calculations by JEC Republican staff.

**Graph V.8 -- Real Gross National Product
(average annualized growth rate)**



Source: Department of Commerce, Bureau of Economic Analysis, and JEC Republican staff calculations.

When the partisan distortions are factored out and the improved data are examined through fiscal year analysis, the implications for policy makers are clear. The policies of low marginal tax rates, restrained growth in Federal spending and deregulation offer the best path out of economic stagnation to GDP growth and job creation.

THE ECONOMY IN THE 1980S: SETTING THE RECORD STRAIGHT

Income in the 1980s

During the economic expansion of the 1980s (November 1982 through all of 1989 and part of 1990) family and household income increased across the board. While this growth was not the most rapid in the postwar period, it marked a recovery from the

declines in income growth which began in 1979. The poor economic climate at the end of the 1970s was produced by slow growth and accelerating inflation, a combination ("stagflation") which produced the largest single-year decline in real family income on record in 1980, the last year of the Carter Administration. In 1980 alone, real median family income plunged over \$1,200, or over 3 percent, with an even more severe pace of decline among lower income groups. There were many, including liberal economist Lester Thurow and President Carter, who expressed the view that economic growth had ended and was not a realistic policy goal.

Income growth during the 1980s is also reflected below in Table V.3 on real median household and family income. During the expansion, real median family income increased 12.6 percent. The gray band in the table marks the years of economic malaise which began in 1979 and spilled over into the early 1980s.

Household income reached a 1970s peak in 1978, and then fell in the four following years. This collapse was a painful result of the inflationary excesses of the 1970s evidenced in double-digit inflation and prime interest rates over 20 percent. However, the implementation of new policies in 1982 and 1983 proved a sound foundation for economic growth, with the longest peacetime expansion in U.S. history pushing family and household income to record highs. This upward movement stalled with the onset of the recession which began in 1990.

Table V.3 -- Income Trends
(in constant 1990 dollars)

Year	Middle American Family Income*	Change From Previous Year	Middle American Household Income*	Change From Previous Year
1973	\$33,370	\$648	\$29,108	\$563
1974	32,491	-879	28,197	-911
1975	31,905	-586	27,442	-755
1976	32,913	1,008	27,913	471
1977	33,107	194	28,067	154
1978	34,156	1,049	29,168	1,101
1979	34,595	439	29,074	-94
1980	33,386	-1,209	28,125	-949
1981	32,476	-910	27,669	-456
1982	32,037	-439	27,577	-92
1983	32,378	341	27,581	4
1984	33,251	873	28,197	616
1985	33,689	438	28,688	491
1986	35,129	1,440	29,690	1,002
1987	35,632	503	29,984	294
1988	35,565	-67	30,079	95
1989	36,062	430	30,468	389
1990	35,353	-709	29,943	-525

Source: Bureau of the Census.

*CPI-U-X1 used for inflation adjustment.

Economic progress in the Reagan-Bush administrations was evident among all income groups. The advances of middle class Americans has sometimes been misinterpreted. As we have pointed out in several previous reports, during the 1980s the middle class did indeed shrink, as more became affluent. Between 1980 and 1989 the portion of households earning over \$50,000 annually jumped from 20.0 percent to 25.7 percent (see Table V.4). Meanwhile, the shares of those in the lower and middle income

ranges declined with the general improvement in the standard of living.

Table V.4 -- Percent of Households by Income Group
(in 1990 dollars)*

	Low Income (under \$15,000)	Middle Income (\$15,000-\$50,000)	High Income (over \$50,000)
1977	26.4%	54.2%	19.6%
1978	25.3	53.8	20.8
1979	25.0	53.8	21.1
1980	25.9	54.0	20.0
1981	26.9	53.4	19.7
1982	26.9	53.4	19.8
1983	26.8	52.8	20.5
1984	26.0	52.0	22.0
1985	25.8	51.7	22.5
1986	25.1	50.8	24.1
1987	24.9	50.4	24.7
1988	24.6	50.4	25.0
1989	24.1	50.2	25.7
1990	24.4	51.0	24.6

Source: Bureau of the Census.

*Adjusted with the CPI-U-X1.

Table V.5 shows the real average income of each household income quintile since 1973. As the earlier discussion of income mobility pointed out, these quintile data should be used with the utmost caution, since the composition of the quintiles is markedly different even on an annual basis. Even when taken at face value, however, these data reflect a general increase in household income during the 1980s expansion.

Table V.5 -- Real Average Household Income
(in constant 1990 dollars)

Year	Lowest Fifth	Second Fifth	Middle Fifth	Fourth Fifth	Highest Fifth
1973	\$7,039	\$17,628	\$28,804	\$41,409	\$73,438
1974	7,008	17,419	28,072	40,542	71,830
1975	6,765	16,619	27,266	39,619	69,950
1976	6,935	16,980	27,924	40,552	71,773
1977	6,897	16,977	28,082	41,146	73,374
1978	7,135	17,523	28,934	42,386	75,672
1979	7,075	17,599	29,015	42,580	76,415
1980	6,845	17,035	28,111	41,414	73,842
1981	6,676	16,630	27,549	41,065	73,354
1982	6,549	16,571	27,431	40,796	74,823
1983	6,631	16,656	27,539	41,325	75,873
1984	6,838	17,033	28,226	42,498	78,145
1985	6,819	17,281	28,685	43,148	80,598
1986	6,886	17,712	29,640	44,651	84,515
1987	7,055	17,930	29,977	45,311	86,171
1988	7,143	18,027	30,152	45,578	87,014
1989	7,372	18,341	30,488	46,117	90,150
1990	7,195	18,030	29,781	44,901	87,137
Percent Change					
1973-80	-2.8	-3.4	-2.4	.0	.6
1979-80	-3.3	-3.2	-3.1	-2.7	-3.4
1981-89	10.4	10.3	10.7	12.3	22.9
1982-89	12.6	10.7	11.1	13.0	20.5
1989-90	-2.4	-1.7	-2.3	-2.6	-3.3

Source: Bureau of the Census and JEC Republican staff calculations.

Tax Burdens

In the years leading up to its passage, proponents of the 1981 Roth-Kemp tax cut argued that a 30 percent across-the-board reduction in personal marginal tax rates would lower the tax

barriers to the flow of resources into production. According to this view, these resources already existed in the forms of inefficient tax-sheltered investments, underutilized capital, consumed leisure, unexploited entrepreneurial opportunities, and unrealized capital gains. Lower tax rates, it was argued, would improve economic growth by reducing the after-tax price of productive resources and improving the efficiency of redeployed resources.

It was also argued that shifting these resources from the untaxed to the taxable economy would actually increase the tax payments of those most affected by punitive tax rates. In practical terms, this means that high income taxpayers would be expected to pay more of the income tax burden while middle and lower income taxpayers would assume less. This view was disputed by the Congressional Budget Office and Joint Tax Committee, both of which projected that average tax payments of upper income taxpayers, expressed in nominal terms, would fall after 1981, producing, in the words of then House Speaker Tip O'Neill, a "giveaway to the rich."

The IRS data reported in Table V.6 and Graph V.9 prove conclusively that CBO and JCT were completely wrong about the impact and even the direction of the tax rate cuts' effects. Actual income tax payments by the top 1 percent increased sharply, even after adjustment for inflation. Oddly, CBO simulations of tax payment declines for upper income groups continued to be released in the face of contradictory IRS data on actual returns, a classic example of scenario versus science.

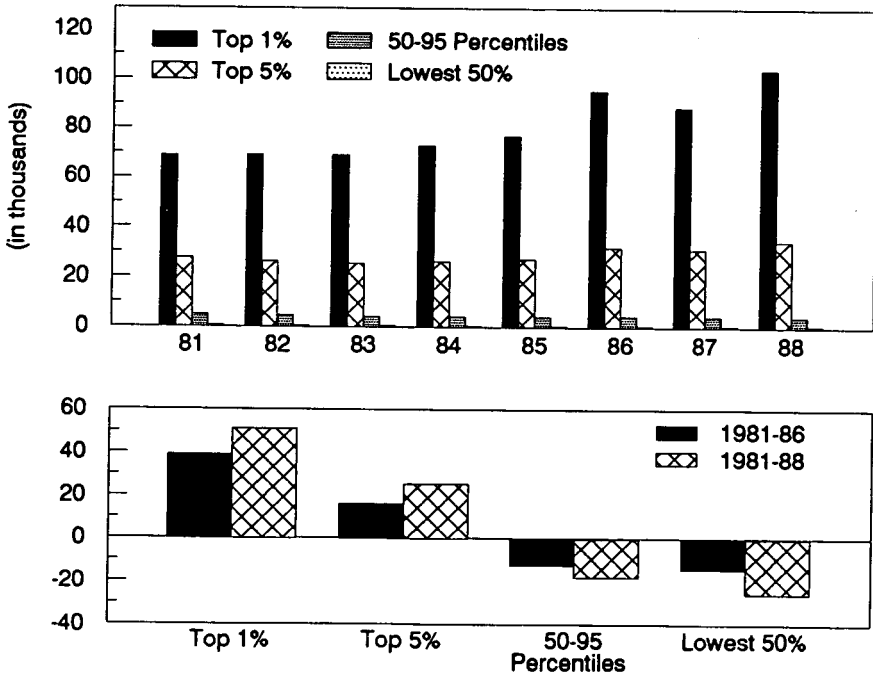
Table V.6 -- Average Income Tax Payments, by Taxpayer Group (1988 dollars)

Year	Top 1%	Top 5%	51-95 Percentiles	Lowest 50%
1981	\$68,725	\$27,415	\$4,995	\$583
1982	68,977	26,199	4,553	533
1983	68,899	25,272	4,187	486
1984	72,723	26,161	4,184	507
1985	76,750	27,296	4,227	504
1986	95,462	31,896	4,377	500
1987	88,685	31,022	4,068	438
1988	104,008	34,446	4,097	433

	Percent Change			
1981-86	39.0%	16.3%	-12.4%	-14.2%
1981-88	51.3	25.6	-18.0	-25.7

Source: IRS and JEC Republican staff calculations.

Graph V.9 -- Income Tax Payments of Affluent Rise After Reagan Tax Cuts, Decline for Bottom Half



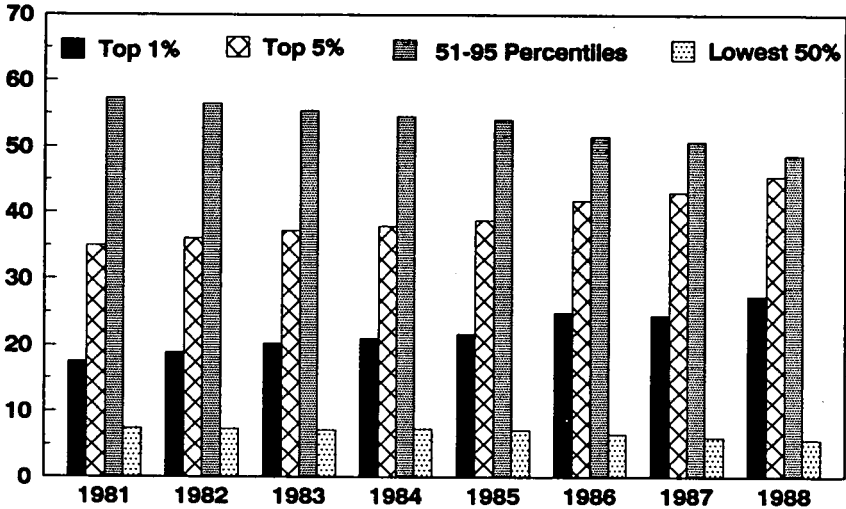
The IRS data clearly show that average income tax payments of the top 1 percent of taxpayers jumped 51.3 percent between 1981 and 1988. Meanwhile, the average tax payment of the lowest 50 percent fell 25.7 percent. Of the \$411.8 billion in personal income taxes collected in tax year 1988, \$113.2 billion, or 27.5 percent, was contributed by the top 1 percent of taxpayers. Over one-fourth of all personal income tax revenue came from the top 1 percent, while the top 5 percent accounted for 45.5 percent. Table V.7 and Graph V.10 shows a massive shift in the tax burden, but its direction is upward onto the shoulders of the high income earners.

Table V.7 -- Income Tax Burden Shifted Towards Wealthy

Year	Top 1%	Top 5%	51-95 Percentiles	Lowest 50%
1981	17.6%	35.1%	57.4%	7.5%
1982	19.0	36.1	56.5	7.4
1983	20.3	37.3	55.5	7.2
1984	21.1	38.0	54.6	7.4
1985	21.8	38.8	54.1	7.2
1986	25.0	41.8	51.6	6.6
1987	24.6	43.1	50.8	6.1
1988	27.5	45.5	48.7	5.7

Source: Internal Revenue Service.

**Graph V.10 -- Wealthy Shoulder More of
of the Income Tax Burden**



Source: Internal Revenue Service JEC Republican staff calculations.

Last year the Republican Members of the Joint Economic Committee introduced the Fairness Ratio in our annual report. This measure is the ratio of the average income tax payment in the top 1 percent for every dollar paid on average in the bottom 50 percent. In 1981 the average income tax payment in the top 1 percent was \$117.89 for every dollar of average tax payment in the bottom 50 percent. By 1988 the fairness ratio had jumped to \$240.2, an increase of 103.7 percent (see Table V.8 and Graph V.11).

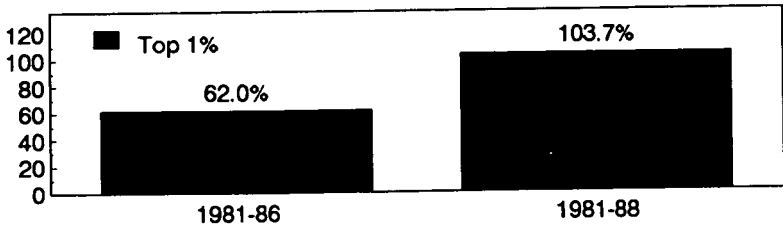
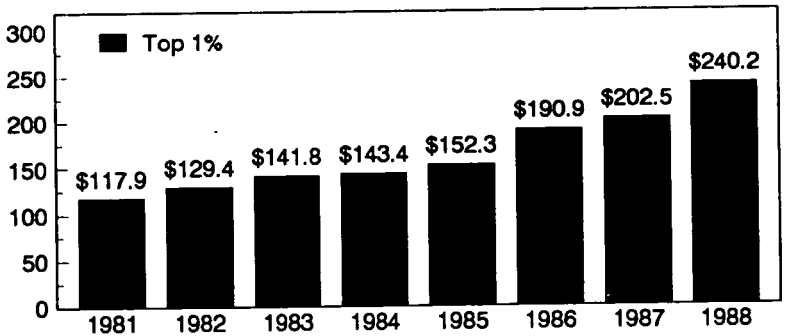
Table V.8 -- Fairness Ratio* in Tax Payments

1981	\$117.78
1982	129.41
1983	141.77
1984	143.44
1985	152.28
1986	190.91
1987	202.48
1988	240.20
Percent Change	
1981-86	62.0%
1981-88	103.7%

Source: JEC Republican staff calculations.

*Average tax payment of taxpayer in top 1 percent for each dollar of tax paid by each taxpayer in the bottom 50 percent.

Graph V.11 -- Tax Fairness on the Rise



Internal Revenue Service and JEC Republican staff calculations.

■

Among the best evidence for the rise in average income tax payments of the affluent in the 1980s is the fact that the CBO no longer publishes these data. Since 1987 a new methodology has been developed. The Democrat majority in Congress derives from CBO a warped income and tax methodology to generate huge estimation and analytical errors. It includes the absurd assumption that the extra income elicited by the 1981 tax cuts can be subjected to 1977 tax rates. The wealth and growth unlocked by the Reagan tax cuts are thus retroactively taxed at 1977 marginal rates. This fantasy "lost revenue" from income that was sheltered from taxes or otherwise would never have been created is labeled a "giveaway" to upper income groups to justify new attempts to raise marginal tax rates. These scenarios are presented instead of average income tax data which dispute class warfare rhetoric. Given the choice between actual IRS data and CBO fabrications, many seem to prefer simulations, even when components of income are mismeasured by over 100 percent.

During the Reagan years the share of the tax burden borne by low and middle income groups declined. By 1988 the bottom 50 percent of taxpayers bore only 5.7 percent of the income tax burden, not counting those removed entirely from the tax roles. Unfortunately, this group is subject to a heavier tax load courtesy of the social security tax increase of 1977, passed by a Democrat Congress and signed into law by President Carter. To the extent aggregate tax burdens have increased for low income groups, the overwhelming proportion is accounted for by these stiff increases in the payroll tax. From 1977 to 1990, the social security payroll tax rate rose by nearly one-third, from 11.7 to 15.3 percent. The current level of the payroll tax was set in the 1977 legislation, though some try to attribute its painful effects to the 1981 tax legislation, which cut personal income tax rates for all groups.

Tax Cuts and Revenue

After the full implementation of the Roth-Kemp tax cuts, Federal revenues increased, contradicting the scenario of a Treasury starved of revenue. Between 1980 and 1989, personal income tax revenues increased 22 percent (after adjustment for inflation). While one can argue about the degree of revenue growth that would

have occurred without the rate cuts, the bottom line is that actual personal income tax revenues expanded with the tax base in the 1980s, as did Federal revenues in general. Federal spending, however, outstripped this growth in revenue.

Upper income taxpayers paid more taxes after the rate cuts, while middle and lower income taxpayers got tax relief, lowering their income taxes relative to projections. When Washington politicians deplore the \$750 billion in lost revenue allegedly resulting from tax cuts in the 1980s, they are really saying that the average taxpayer should have paid \$7,500 more to fund the wasteful growth in Federal spending. This is why liberals tried to block the third year of the Roth-Kemp tax cut and bracket indexing, both of which benefitted primarily middle income taxpayers. Those on the left who now posture in support of temporary middle class tax relief continue to criticize the real middle class tax cut of 1981 because they want to spend even more taxpayer money.

Following the passage of lower marginal tax rates in 1981, annual IRS data confirmed the view that average income tax payments were increasing at the top end. Meanwhile, the third installment of the tax cut as well as tax indexing, both beneficial primarily to the middle class, survived repeated attempts at repeal launched by congressional Democrats. In the end, the Roth-Kemp personal income tax cuts were permitted to reduce income tax payments on middle income taxpayers.

In the absence of Roth-Kemp, families earning \$20,000 per year would pay \$1,600 more in income taxes and families with incomes of \$45,000 would pay \$5,100 more to the Federal government.

■

Senator Phil Gramm's office recently devised a form that allows taxpayers to compare their individual tax burden under current law (reflecting the dramatic changes in individual taxes under the 1981 and 1986 tax acts) with what they would be paying today if the 1980 rate structure were still in effect. We reproduce his "Fairness 1040 Form" on pages 227 and 228 and invite readers to fill it out before accepting baseless assertions that "the middle class did not benefit from the Reagan tax cuts."

FAIRNESS 1040 FORM

1040	Do-It-Yourself Tax Fairness Test U.S. Individual Income Tax Return 1980 vs. 1991	Social Security Number _____
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For Comparing 1980 Income Taxes against 1991 Income Taxes

Label	N	First Name _____ Last Name _____		Occupation
	A	Spouse _____		
	M	Address _____		
	E	City _____	State _____	

Filing Status

Single
 Married filing joint return
 Head of household

Exemptions

<input type="checkbox"/> 1	Yourself		Total number of exemptions claimed <input style="width: 30px; height: 20px;" type="text"/>
<input type="checkbox"/> 1	Spouse		
<input type="checkbox"/>	Dependents _____		
	Names _____		

(Number of kids under 18)

Income	1	List your total income here	1	
COMPARE 1980 TAX CODE VS. 1991 TAX CODE				
<small>Column A for 1980, Column B for 1991</small>				
			1980 Tax Code	1991 Tax Code
			<small>Column A</small>	<small>Column B</small>
Standard Deduction	2	Family's Standard Deduction in 1980	2	\$3,400
	3	Family's Standard Deduction in 1991	3	\$5,700
Personal Exemption	4	Multiply your number of exemptions by \$1,000	4	
	5	Multiply your number of exemptions by \$2,150	5	
Taxable Income	6	Subtract your standard deduction amount and exemption amount from your income	6	
YOUR TAX BILL	7	See 1980 tax table on back to determine TAX OWED UNDER 1980 CODE	7	
	8	See 1991 tax table on back to determine TAX OWED UNDER 1991 CODE	8	
AMOUNT YOU KEPT FROM TAX CUT OF THE 1980'S				
<small>Subtract amount on line 8 from line 7</small>				

1980 Income Tax Schedule			
1 Enter taxable income from line 6, column A. <input style="width: 100%;" type="text"/>			
2 Find corresponding income bracket in table below			
For income over -	but not over -	the tax is -	of the amount over -
\$0	\$2,099	14%	\$0
\$2,100	\$4,199	\$294 + 16%	\$2,100
\$4,200	\$8,499	\$630 + 18%	\$4,200
\$8,500	\$12,599	\$1,404 + 21%	\$8,500
\$12,600	\$16,799	\$2,265 + 24%	\$12,600
\$16,800	\$21,199	\$3,273 + 28%	\$16,800
\$21,200	\$26,499	\$4,505 + 32%	\$21,200
\$26,500	\$31,799	\$6,201 + 37%	\$26,500
\$31,800	\$42,399	\$8,162 + 43%	\$31,800
\$42,400	\$56,599	\$12,720 + 49%	\$42,400
\$56,600	\$82,199	\$19,678 + 54%	\$56,600
\$82,200	\$105,999	\$33,502 + 59%	\$82,200
\$106,000	\$158,999	\$47,544 + 64%	\$106,000
\$159,000	\$211,999	\$81,464 + 68%	\$159,000
\$212,000		\$117,504 + 70%	\$212,000
3 Compute tax and enter \$ amount here and on line 7 on front of this form <input style="width: 100%;" type="text"/>			
Calculation Hint in using percentages: 14% of \$1,000 = .14 x \$1,000 = \$140			
<p><small>Note: In 1980, the present standard deduction was called a "zero bracket amount". While the effect on taxes is the same, the standard deduction prevents an amount of income from being taxed, while the zero bracket amount applies a zero percent rate on an amount of income. For comparison purposes, the zero bracket amount is shown as a standard deduction, and the 1980 tax schedule is adjusted accordingly.</small></p>			

1991 Income Tax Schedule			
1 Enter taxable income from line 6, column B. <input style="width: 100%;" type="text"/>			
2 Find corresponding income bracket in table below			
For income over -	but not over -	the tax is -	of the amount over -
\$0	\$33,999	15%	\$0
\$34,000	\$82,149	\$5,100 + 28%	\$34,000
\$82,150		\$18,582 + 31%	\$82,150
3 Compute tax and enter \$ amount here and on line 8 on front of this form <input style="width: 100%;" type="text"/>			
Calculation Hint in using percentages: 14% of \$1,000 = .14 x \$1,000 = \$140			

Special Note on Earned Income Tax Credit (EITC) for Low-Income Families
<p>The 1980 EITC was 10% on earnings for a maximum credit of \$500. At \$6,000 of earnings, the credit is phased-out by 12.5%, with the total credit eliminated by \$10,000 of earnings</p> <p>The 1991 basic EITC for 2 or more children was 17.3% on earnings for a maximum credit of \$1,235. At \$11,250 of earnings (or AGI), the credit is phased-out by 12.36%, with the total credit eliminated by \$21,242.</p> <p>The average poor family of four with earnings of \$9,833 would have received a \$20 credit in 1980 but a \$1,235 credit in 1991. Thus a \$327 tax on an average poor family under the 1980 code is now a rebate of \$1,235 in 1991.</p>

Labor and Earnings

Partisan claims about recent wage and employment trends are another element in revisionist economics. The media have extensively echoed charges that real wages have not grown, productivity is lagging, and living standards in the United States have stagnated, basing stories on partisan data. For example, the Senate Majority Leader recently painted a scenario where "average wages" of American workers have been virtually flat for the past 30 years. Any look at the real world, however, shows that the well-being of the average worker today is far better than it was in 1960. This immediate observation calls into question both the measure of worker well-being used, and the method in which it is applied.

Wages and Compensation

There are several different measures of worker income, each of which presents a different picture of the recent situation of the American worker. The "real weekly wage" measure presents the worst possible picture of worker well-being. We present here annual data of several measures of worker wages and benefits, allowing the reader to decide the relative circumstances of the American work force.

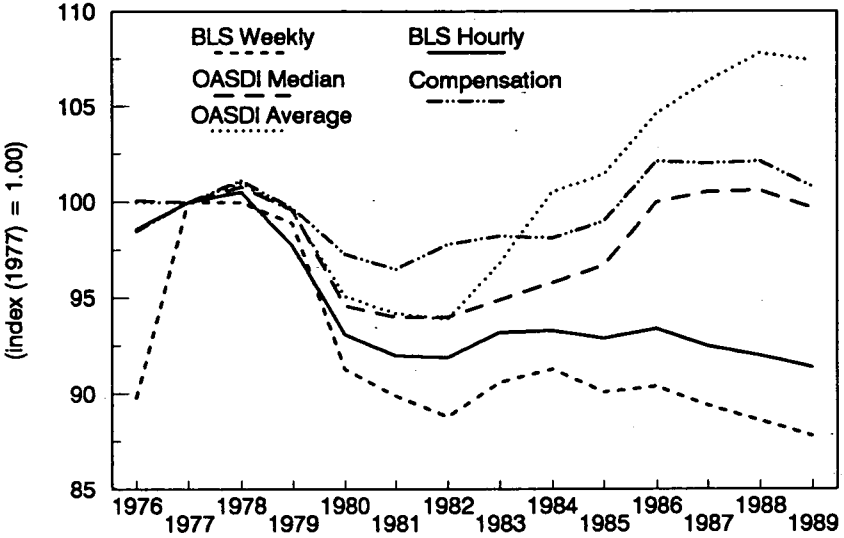
Table V.10 and Graph V.12 portray annual data on five different measures of worker well being. The data are from two different Federal government sources. Three measures -- hourly wages, weekly wages and real compensation -- are derived from the Bureau of Labor Statistics (BLS) of the Department of Labor. Two measures, average (mean) and median annual wages are derived from Social Security Administration data based on Old Age, Survivors and Disability Insurance (OASDI) collections. The graph translates these data into indexes, setting the year 1977 at 1.00 for each measure and the other years as ratios of the 1977 base year.

Table V.10 -- Total and Per Capita Disposable Personal Income and Personal Consumption expenditures, 1976-91

Year	Real Weekly Wages (\$-1982)	Real Hourly Wages (\$-1982)	Real Per Compensation per Hour (\$-1982)	Real Average Social Security (\$-1987)	Real Median Social Security (\$-1987)
1976	\$297.37	\$8.24	100.8	\$13,009	\$12,440
1977	300.96	8.36	102.3	17,012	12,428
1978	300.89	8.40	103.4	17,178	12,527
1979	291.66	8.17	102.0	16,932	12,381
1980	274.65	7.78	99.5	16,171	11,757
1981	270.63	7.69	98.7	16,029	11,686
1982	267.26	7.68	100.0	15,969	11,683
1983	272.52	7.79	100.5	16,468	11,797
1984	274.73	7.80	100.4	17,099	11,879
1985	271.16	7.77	101.3	17,255	12,023
1986	271.94	7.81	104.4	17,788	12,424
1987	269.16	7.73	104.3	18,080	12,491
1988	266.79	7.69	104.4	18,342	12,497
1989	264.22	7.64	103.1	18,265	12,397
1990	259.72	7.53	103.1	18,006	0
1991	255.89	7.46	0.0	0	0

Source: Economic Report of the President, February 1992. Tables B-5, pg. 305; U.S. H.H.S. Social Security Bulletin, Annual Statistical Supplement, 1991. Tables 4.B.1, 4.B.3, and JEC-GOP staff calculations.

Graph V.12 -- Measures of Worker Wages and Salaries
(variation among five common measures)



Several factors reduce the validity of BLS real weekly wage data. First, average earnings estimates that incorporate the 1970s are based on a flawed Consumer Price Index that is usually discarded in serious analyses of historical trends. The old, flawed index (which was revised in 1983) overstated the increase in housing costs. Its use results in a cumulative overstatement of inflation in the 1970s and early 1980s, and a related 9 percent understatement of real wage growth in the same period.

The weekly earnings estimate is also flawed because the average hours worked per week has declined from 36 hours in 1977 to 34.3 in 1991. A decrease in hours worked per week reduces weekly wages at any given wage rate. The decline in average hours worked is a long-term trend of the last several decades, and reflects the ability of employers to offer workers leisure time in response to employee preference.

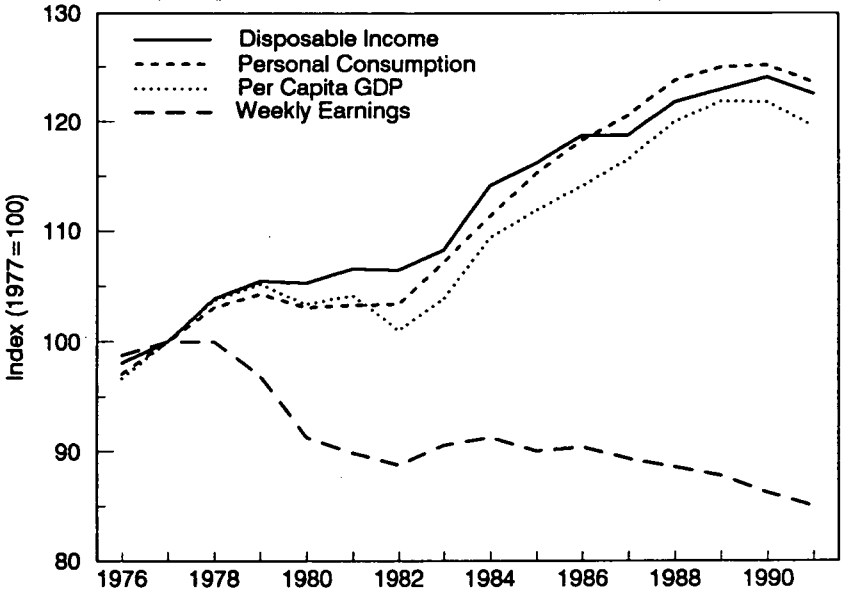
The data in Graph V.12 also illustrates the importance of distinctions between partial and more comprehensive measures of worker income. The most comprehensive wage and earnings measure is real compensation per hour, which is a broad average of the total cost to employers in the private sector for wages, salaries and noncash benefits per hour of work. According to the U.S. Chamber of Commerce, fringe benefits (notably health insurance) accounted for 30.6 percent of the value of a worker's compensation in 1990, up from 25 percent in 1975.

The BLS hourly and weekly earnings measures differ in two important ways from hourly compensation in that they cover only production and nonsupervisory workers, not all workers in the work force. Production and nonsupervisory workers tend to be less skilled than other workers. The divergent trends of wages and compensation suggests a stratification of the labor market, but it does not make any reliable statement about worker earnings in any set of years. The disparity between wages and compensation reflects the additional fringe benefit mandates imposed by Federal, state and local governments. Employers have been forced to alter the total compensation package to workers to include relatively more mandated benefits and relatively less money (often overriding worker preferences in the process).

The measure of hourly wages comes from a monthly BLS survey in which payroll information is collected from private business establishments. Other sources of similar information, such as Federal and state tax records, can be used for comparison purposes. The Social Security Administration OASDI data in Table V.2 and Graph V.10 measure average annual wages per worker. OASDI data reflect wages of nearly all workers, in contrast to BLS data. The only reason not to use OASDI data is, apparently, partisan, since both the average and median OASDI measures indicate a rise in real wages far higher than the BLS wage data. A portion of the OASDI increase is attributed to the fact that higher skilled workers received relatively higher wage increases in the late 1970s and early 1980s. However, because the OASDI data are more comprehensive, they more reliably indicate workers' real wage trends since the mid-1970s.

Measures of real wages or real compensation include only earnings from work. Many Americans have additional sources of income from investments, savings and other sources. Graph V.12 displays three measures of broader economic well being -- per capita disposable income, per capita consumption, and per capita GDP -- and compares them to the BLS weekly earning measures of which the Democrats are so fond. Graph V.13 indexes the four measures, with the 1977 value for all measures set at 1.00, in the same manner as Graph V.12.

Graph V.13 -- Measures of Well Being
(comparison of four common measures)



Again, the contrast between the BLS weekly earnings measure and the other measures are striking. The three new measures are the most comprehensive measures available to describe changes in the relative wealth of all Americans. These measures obviously include much that is useful in describing the changing economic fate of Americans in the 1970s and 1980s. The

sharp rise in personal consumption is perhaps most telling, since consumption is the ultimate goal of earnings anyway.

Several conclusions about worker wages and total compensation can be drawn from even this brief presentation. First, a careful review of the evidence shows that the work force as a whole increased real wage earnings in the 1980s. The debate is only over the size of the gain. Second, real compensation grew at quite an impressive rate during the 1980s, far surpassing the growth in real wages but adding no less to the well-being of the typical American worker and family. Third, the display of annual data shows how important the fate of the economy is to the fate of worker wages and compensation. Recessional periods cause real decreases in worker earnings, but economic growth correlates strongly with increased wages and benefits, even for the least skilled workers.

Finally, the data make obvious the importance of getting the starting date right for any comparisons of wage and compensation trends. The recession and dislocation of the late 1970s Carter recession, before President Reagan took office in 1981 and his economic policies became effective later that year, severely harmed the well being of American workers. Most of the wage and compensation gains of the 1980s simply repaired prior damage from a Democrat administration.

There are also several political observations to make from their data, and the way they are usually presented by Democrats in Congress. First, the graphs and tables show clearly that to distort the trends in wages, compensation, and well-being trends, three critical and disingenuous assertions need to be made. The first assertion is to claim that the 1980s began early, preferably in 1978 or 1979, the first relative peak in worker wages, because picking a "peak" year makes the relative gains in later years appear smaller. Second, it is important to truncate the 1980s early, probably at 1987, to end the surge in wages and compensation before their peak. The third and most problematic assertion is to claim that real weekly wages of production and non-supervisory personnel as measured by BLS is the best indicator of worker well being.

If all these assertions are made and not questioned, "the '80s" can be made to "create an imagery of Reagan-Bush America that supersedes the Carter years and impeaches the credibility of conservative governance for middle America," just the scenario Mr. Greenberg suggests. It is no surprise that most Democrat economic analyses make all three of these assertions. It is, perhaps, more surprising that "nonpartisan" researchers inside and outside Congress often make many of the same assumptions.

The bias in these assumptions has been pointed out before. The defenders of distortion respond that the "business cycle" or some other hegemonic economic trend requires certain cut-off years in examining trends in income and wealth, but this response raises more questions than it answers.

As noted earlier, there were business cycles in 1980 and 1981, refuting any justification for lumping the late 70s into the 1980s for "peak-to-peak" measurement purpose. Even so, if all-powerful economic cycles force one to, for example, include 1978 and 1979 in the 1980s, then these trends must transcend control by politicians and governments. Changes in wages, compensation, disposable income and gross domestic product must all be caused by powerful forces beyond the control of political institutions. If these cycles are uncontrollable by government policy, there is no partisan advantage to tracing the paths of economic statistics. Obviously, however, partisan opponents of growth-oriented economics have invested a great deal of time and resources into painting a particularly bleak picture of the "1980s," attempting to attach responsibility for that picture to Republican economic policies. The frenzied nature of these attacks and the mountain of contrary evidence lead one to question whether critics of the "1980s" are truly interested in restoring economic growth and worker earnings, or would prefer to further damage our economy for short-term partisan gains.

VI. BANKING AND INTERNATIONAL FINANCE

MONETARY POLICY

Monetary policy should not be the sole variable in macroeconomic policy, however, with fiscal policy characterized by dramatically expanding deficits much of the burden of anti-recessionary measures has defaulted to the Federal Reserve Board. In the last month of 1991, the Federal Reserve System moved aggressively to ease monetary policy, after a year of more gradual easing. This action was a justifiable response to the modest pace of the recovery.

Monetary ease does not constitute a complete monetary policy, particularly at a time when increased taxation, government borrowing and regulatory scrutiny have diminished credit availability. The peculiar behavior of money supply growth in 1991 and 1992 reflects problems of monetary policy and its implementation through the banking system.

The adjusted monetary base (the sum of reserve accounts of financial institutions at Federal Reserve banks and currency in circulation, adjusted for reserve requirement ratio changes) grew steadily in the last half of 1991, after flat growth in the second quarter. Growth in the reserves of the banking system makes possible growth in the money supply and its constituent measures M1, M2 and M3.

The narrow definition of the money supply, M1, consisting of currency plus demand deposits (checking accounts), increased steadily in the last three quarters of 1991, averaging about 10 percent in the three months prior to December before falling in the last weeks of the year. Robust growth of M1 resumed in January

as part of the mid-December Federal Reserve policy response to flat third quarter GDP growth.

The M2 measure of the money supply is much broader than M1 and includes many interest bearing accounts of individuals and businesses, financial instruments and money market accounts. In the early spring of 1991, M2 did not grow significantly for six months before surging in the last quarters of 1991 and the beginning months of 1992.⁵⁶ M2 actually fell in December 1991 while M1 was approximately flat. M3, the broadest definition of money, which adds large time deposits over \$100,000 to M2, grew at about half the rate of M2 in both 1991 and 1992.⁵⁷

In 1990 and 1991 the growth rate for M2 was just over 3 percent which was much lower than the more than 5 percent rates recorded for 1988 and 1989. M3 growth in 1991 and 1992 was at about half the rate of M3 growth in the previous two years.⁵⁸

⁵⁶ "U.S. Financial Data," Federal Reserve Bank of St. Louis, March 5, 1992, pg. 8.

⁵⁷ Council of Economic Advisors, "Economic Indicators," prepared for the Joint Economic Committee, USGPO, Washington, December 1991, pg. 26.

⁵⁸ Ibid. , pg. 8.

Table VI.1 -- Growth Rates of Reserves, Selected Monetary and Commercial Bank Indicators
(percentage change in the year ending in December)

Aggregate	1987	1988	1989	1990	1991
Adjusted Reserves	0.9%	4.2%	0.0%	2.3%	8.7%
M1	3.5	4.9	0.9	4.0	8.6
M2	3.5	5.5	5.0	3.2	2.9
M3	5.3	6.6	3.5	1.4	1.5
Commercial Banks:					
Loans	7.5	9.1	7.7	4.2	-0.8*
Small time deposits	5.9	15.3	18.7	12.6	-2.0
Large time deposits	12.8	12.7	9.2	-3.9	-3.1

Source: Monetary Trends, The Federal Reserve Bank of St. Louis, January 1992.

*Compounded annual growth rate from December 1990 through November 1991.

The behavior of M1 is consistent with falling short-term interest rates.⁵⁹ The divergence of growth in M2 and M3 from M1 is also consistent with falling interest rates, as investors move away from long-term time deposits in banks such as CDs and increase investments in non-bank money funds. This movement away from long-term commitment to the banks is a phenomenon economists call disintermediation. In 1991, the volume of large as well as small scale time deposits fell significantly and continually, while savings deposits rose steadily. Money markets benefitted in the first half of 1991, but slipped somewhat in the second half as the

⁵⁹ Federal Reserve Bank of St. Louis, "U.S. Financial Data," March 5, 1992.

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small investor returned to the stock market. During 1990 the Federal deficit began to grow, steadying at lower levels for three years, drawing funds from households, businesses and banks.

Despite these dislocations to the credit system and the frustration they provided monetary policy in 1991, there was evidence of recovery. Gross domestic product up 0.8 percent in the fourth quarter and real exports and real final sales of domestic product up in the fourth quarter are all signs that the economy was growing, albeit at an extremely slow pace.

There are several explanations why M2 and M3 failed to grow as expected. One explanation for the divergence of M2 and M3 from M1 is simply that the opportunity cost of holding cash or other non-interest bearing assets fell dramatically during 1991.

Another noteworthy divergence can be seen in the increase during 1991 of 8.7 percent in adjusted reserves while commercial bank loans actually fell by 0.8 percent. Banking problems suggest that the Federal Reserve might be "pushing on a string," supplying reserves to the monetary system that are not converted into additional loan activity. Loan demand may be weak, or quality loan opportunities so few that bank officers fail to increase their lending activity even with more free reserves.⁶⁰

The Fed policy on interest rates is reflected most immediately in the short-maturity U.S. Treasury debt, with three-month Treasury bills yielding 4.03 percent on March 6, 1992.⁶¹ This short rate minus inflation (about 3 percent in 1991) results in a real rate of interest of around 1 percent. This lower real cost of money should encourage borrowing by businesses and consumers.

⁶⁰ Haubrich, Joseph G., "Do Excess Reserves Reveal Credit Crunches?," Economic Commentary, Federal Reserve Bank of Cleveland, July 15, 1991, pp. 1-4.

⁶¹ Federal Reserve Bank of St. Louis, "U.S. Financial Data," March 5, 1992, pg. 7..

"Crowding Out" and the Credit Crunch

Unfortunately, the fall in real interest rates is coincident with significantly increased credit demand by the Federal government. As Federal outlays exceed 25 percent of GNP over the course of fiscal year 1992 (a post-World War II high), the Federal deficit will grow rapidly to an estimated \$365 billion, up 36 percent over the previous fiscal year.⁶²

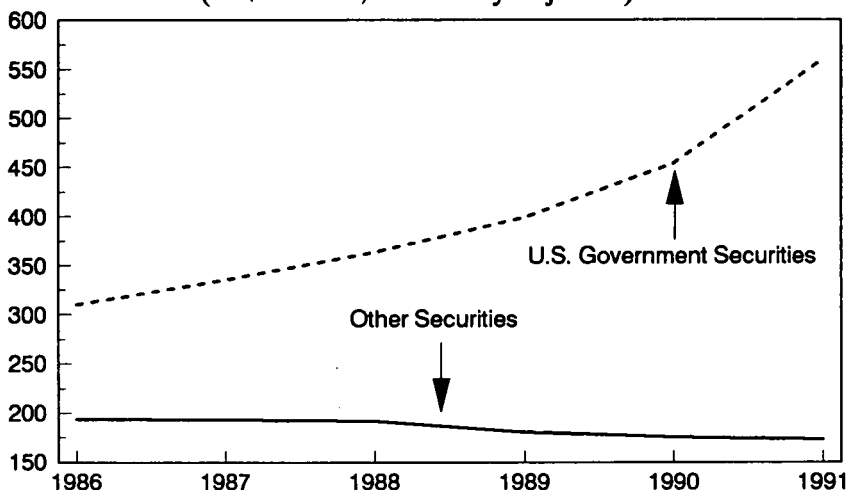
Even with low real interest rates, this borrowing may be causing displacement ("crowding-out") of borrowing by businesses, consumers and state and local government. This crowding out is not by the regular competition in the marketplace that characterized periods of high real interest rates, but rather results from the persisting large spread premia that long rates enjoy over short rates for government securities. The spread has grown to over 3.5 percentage points (350 basis points) over the last several months.⁶³

This spread in rates provides an incentive for banks to invest in long maturity government bonds, utilizing funds that would otherwise be available for potential loans (See Graph VI.1). In an atmosphere of uncertainty about the economy and bank regulatory policy, the relatively certain margin between the long-term bond returns and the short-term rate paid for deposits may be more attractive to bankers than commercial lending.

⁶² Council of Economic Advisors, "Economic Indicators," pg. 32.

⁶³ Federal Reserve Bank of St. Louis, "U.S. Financial Data," March 5, 1992, pg. 7.

Graph VI.1 -- Securities Held by Banks
(in \$-billions, seasonally adjusted)



Source: Board of Governors of the Federal Reserve Board.
CEA, "Economic Indicators," February 1992, pg. 28.

The disruption of this important conduit of monetary policy, loan making by banks, is called a "credit crunch" by some because it suggests a decrease in credit for a given set of economic circumstances.

The longer term rates on Treasury debt instruments fell less, with 10-year Treasury bonds yielding about 6.8 percent at the beginning of 1992 before increasing to 7.25 percent on February 8.⁶⁴ In previous years, rates of money growth have been lower than reported price level increases, so some would say that slow money growth in 1989 and 1990 may have been constraining real growth rates during 1990 and 1991.

The difficulty in interpreting money supply behavior is in identifying the cause of a change in the amount of money in circulation in a society. It may be the result of a shift in consumer

⁶⁴ *op. cit.*, pg. 30.

and business demand for money, or a shift in the credit supply behavior of banks, or both changes in demand and supply. Regulators have an impact on both the supply of and demand for credit. Additionally, the last several years have seen a dramatic downward shift in the value of real estate, causing a wealth effect that has affected business, household and bank behavior. While real estate owners were losing wealth, taxpayers were facing increased taxes and deficit spending to replenish the Bank Insurance Fund and the Resolution Trust Corporation.

To meet the rigors of increased international competition, we need to allow U.S. banks to reach reasonable scales of operation. Federally chartered banks should be allowed to open branches in any state that will allow them in. At the same time, those banks that reach the scale appropriate for international competition should not have an advantage over other banks because they are considered "too big to fail." Unfortunately, a study for the House Banking Committee concluded that for banks that were resolved, that is, merged or taken over, among banks at the same level of capital, "the large banks were less likely to be resolved than small banks during the 1987-89 period."⁶⁵

A problem that disproportionately affects small banks is the crowding out of private sector activity as a result of the heavy Federal borrowing to finance budget deficits. Federal outlays are escalating more rapidly than revenues, usurping private credit availability. Credit is also in great demand worldwide to finance tremendous changes, especially in Eastern Europe. Forty percent of U.S. national income is going to the Federal government at a time when many states and localities face fiscal problems, the private sector is short of capital, and much of the world is looking

⁶⁵ Barth, James R., Brumbaugh, R. Dan, Jr., and Litan, Robert E. The Banking Industry in Turmoil: A Report on the Condition of the U.S. Banking Industry and the Bank Insurance Fund, presented to the Financial Institutions Subcommittee of the House Committee on Banking, Housing and Urban Affairs, December 17, 1990 (Washington:1990, U.S.GPO), pg. 61.

to borrow. About 6 percent of U.S. gross domestic product is consumed by Federal borrowing, nearing a postwar high.

The increased preference for Federal government debt in uncertain times results in a spread of Treasury bond rates below prevailing private sector bonds. Thus, the cost of borrowing to the government is lower than it would otherwise be, an effective subsidy, and the rate to the private sector and state governments is higher than it would normally be, raising their cost of doing business.

This abnormally high spread and dramatically decreased short-term interest rates artificially lower the financing costs of Federal government deficits and facilitate greater deficit spending. In the non-Federal sectors, the higher cost of borrowing money increases the cost of doing business and decreases the demand for loans, compounding the banking difficulties.

Federal government borrowing has several natural advantages over private sector borrowing. The favorable spread results simply because Federal debt is backed by the full faith and credit of the Federal government, including the implicit understanding that the Federal Reserve will prevent any default on Federal debt. Additionally, regulations that require idle balances from various Federal trust funds to be kept in government securities create a captive market for Federal securities.

Rate spreads of debt securities typically show a pronounced pattern over the course of the business cycle. The typical spread between 10-year U.S. Treasury bonds and corporate issues following a business downturn with a lag will exceed 200 basis points.⁶⁶ These spreads at year end were at about 150 basis points. In 1986, this spread approached 300 basis points, in part due to perceived risk of extensive leveraged buy-outs at the time. Research by Goldman Sachs concludes that:

⁶⁶ "The Surprising Course of Yield Spreads," *Financial Market Perspectives*, Economic Research, Goldman Sachs, January 1991.

Since 1986, however, the ballooning Federal budget deficit has pushed Treasury borrowing up much more than the rise in corporate financing. This is likely to continue throughout 1991 at least.⁶⁷

Bank holdings in U.S. government securities began increasing significantly ahead of the downturn in the economy. Graph VI.1 plots this replacement of nongovernment securities with government securities. The event is roughly coincident with passage of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). This Act addressed the use of low rated or "junk" securities by savings and loan institutions, and may also have signaled banks to move into "safer" investments.

Rather than upgrade to more highly rated private sector securities, banks moved into Federal government securities at a time when the return from such securities was historically low relative to top-rated, private-sector commercial paper.

Efforts to restrain savings and loans and banks have made it more difficult for bank customers to maintain liquidity. Both re-regulation and the lingering effects of the recent recession are hitting at a time when our economic system needs to emphasize international competitiveness. It is simply the wrong time for Congress to implement any additional policies that assist deficit spending at an artificially beneficial rate to the Federal government. Deficits crowd out important private sector activity, and in the current environment squeeze activity financed by bank loans and by private-sector commercial paper.

The sheer volume of Federal debt issued, the normal decline in the volume of private sector debt as economic activity lulls, and the decline in foreign investors, who prefer U.S. Treasury debt issues, could serve to keep the rate spread from widening further.

⁶⁷ *Ibid.*, pg. 8.

In 1991, the rate of interest on 10 year U.S. Treasury bonds fell by more than one percentage point, January to January, from 8.09 percent to 6.80 percent. A 1 percent fall in interest rates, with no deflationary effects from that fall, is associated with a net decrease in the Federal deficit of \$4.0 billion. By contrast, the cost in FY 1992 of an additional \$100 billion borrowing by the Federal government was \$2.1 billion, reflecting the upward pressure on interest rates and the resulting "crowding out" of private-sector borrowers as a result of additions to the Federal deficit.⁶⁸ Widening the spread between public and private sector borrowing lowers costs for Federal borrowing and increases them for private sector activity. To keep matters in perspective, rates for 10-year Treasury Bonds have fallen from near 14 percent in the wake of the Carter Presidency to around 7 percent.⁶⁹

A narrower spread, as economic activity strengthens, would move Federal debt payments closer to the opportunity cost of foregone private sector activity. Narrowing rates would squeeze out even more private sector activity. If abnormally high rate spreads continue, the taxpayer will only be spared for a short period. In the ensuing years there will be lower economic growth. Reducing government demand for resources and credit is the only appropriate long-term cure for the credit crunch.

The extent of the regulatory flight (and fright) into safety, is unambiguous but hard to reduce to a single measure. The Congressional Budget Office summarized that "one indication that some slowing in credit came from the supply side is that banks increasingly shifted available funds away from loans and into safe government securities."⁷⁰ As Federal spending accelerates, deficits

⁶⁸ "Budget of the United States Government, Fiscal Year 1993," Table 3-6, Part One, pg. 41.

⁶⁹ "Economic Indicators," January 1992, CEA, pg. 30.

⁷⁰ The Economic and Budget Outlook: Fiscal Years 1992-1996, A report to the Senate and House Committees on the Budget, 1991 Annual Report, Congress of the United States, CBO, January 1991, pg. 26.

deficits once again threaten domestic and international investment. Combined with stringent bank regulation, deficits lessen our ability to compete internationally for the supply of financial services.

A banking policy for financial system integrity, international financial competitiveness and national growth must start with a Federal budget that keeps percentage increases in spending to lower rates than percentage increases in GDP. The Gramm-Rudman legislation passed in 1985 produced outlays in fiscal years 1986-89 with a declining share of GNP (see Table VI.2).⁷¹

Table VI.2 -- Total Federal Outlays to GDP, 1985-92
(data in 1982 dollars)

Fiscal Year	1985	1986	1987	1988	1989	1990	1991	1992
Total Outlays as a Percentage of GNP	23.9	23.7	22.7	22.3	22.3	23.2	24.7	25.2 est.
Federal Deficit as a Percentage of GDP	5.3	5.2	3.4	3.2	3.0	4.0	4.8	6.8 est.

Source: "Budget of the United States Government, Fiscal Year 1993," OMB, Supplement, February 1992, Part 5, Table 1.2, pg. 16.

The 1.7 percent growth in outlays as a percent of GDP in FY 1992 pushes spending beyond the historical postwar high of 24.3 percent of output. The projected rate moves beyond 25 percent of GNP and then, hopefully, falls. Since much of government spending

⁷¹ *Ibid.* pg. 150.

is being financed by deficits, a parallel crowding out occurs in financial markets. This disrupts domestic investment that supports future competitiveness, bank recapitalization, and the provision of financial services. The dire cost of big spending is felt in lower real exports and distressed financial markets.

BANKING AND REAL ESTATE

The limitations of monetary policy are illustrated when other Federal policy problems are considered. One illustration is the central role of housing and land ownership in the individual household's estimation of its wealth. This analysis explains the changes in the real estate market related to the 1986 tax act and describes the regional effects of these changes on the real estate market and the recession.

Government policies toward banking and real estate have contributed to the current sluggish state of economic growth: post-1985 policy changes, particularly 1986 tax changes, play a major role. The 1986 tax bill reduced tax incentives for real estate in four fundamental ways. First, marginal rates for individuals dropped, decreasing the tax advantage of real estate "write-offs." Second, the rise in the effective capital gains rate from 20 percent to 28 percent made real estate significantly less attractive to investors. Third, the depreciation period for real estate was significantly lengthened. Last, the limits on passive real estate losses effectively reduced the pool of investors.

Re-establishing robust growth will take decisive action by the Federal Reserve System, Congress, the Administration and regulators of our nation's financial system. Policymakers must systematically assess credit-system ills, and then respond with policies that restore growth oriented incentives and citizens' expectations of stable monetary and economic policy. Current regulatory, tax, and market price uncertainty in the real estate market may be causing investors to be overly cautious.

A central problem is the residential and commercial real estate market in the United States. Many regions have suffered a decline in real estate prices after robust growth for several decades. Monetary policy fueled real estate activity in the 1970s and tax policy, bank lending and foreign demand continued to motivate real estate activity up to the mid-1980s. The 1986 tax reform slowed and in some cases reversed this trend in banking and real estate related industries, particularly savings and loan institutions.

For many middle income households, residential real estate ownership (of one's own home) is a primary asset in the household financial portfolio. A smaller portion of the population has additional real estate assets (i.e., a second home that is rented, a lot in town, the family farm in the country, or an undeveloped lot at the lake or in the mountains). Investment in owner-occupied and investment properties is the single most important measure of wealth by which many typical Americans judge their financial situation.⁷²

For economists, stores of household wealth are physical "stocks" of wealth, and income sources (wages, salaries and rental income) are "flows" of payments which, over time, add to the stock of wealth of individuals and households.⁷³ A common mistake in economic analysis is to confuse stocks of wealth and flows of

⁷² Individuals perceive as tangible wealth such things as business plant and equipment and individuals' housing, consumer durables (such as autos and home appliances) and land. Financial assets such as common stocks, bonds, mutual funds and CDs are viewed as nontangible wealth. The family home is usually the most costly of individual items of wealth. Tangible human wealth (more difficult to measure) are such things as an education, often called "investments in human capital." Gwartney, James D. and Richard L. Stroup, Economics, Fifth Edition, (San Diego: Harcourt Brace, 1990), pp. 572-74. See also: Becker, Gary, Human Capital, (New York: Columbia University Press, 1964).

⁷³ For a technical discussion of stock/flow analysis, see: Hirshleifer, Jack, Investment, Interest, and Capital, (Englewood Cliffs: Prentice-Hall, 1970), pp. 175-85.

income, thus inadequately considering their interrelationship. This analytical difficulty has been known since the time of Adam Smith and David Ricardo. It is Ricardo's analysis, and the improvements and corrections to it, that has indirectly sharpened the analysis of the "stocks and flows" of real estate. Recessions are downturns in the business cycle that temporarily diminish flows of income. Other events, such as sudden and punitive taxation can directly erode stocks of wealth. Progress in our present economic situation can be made, in part, by simply remembering what is already known about flows of income and measures of wealth.

Interest rates, as the price of credit, send a fundamental economic signal, as do tax changes that affect real estate and financial services industries. In 1989 and 1990, these changes were coincident with fundamental shifts in the demographic character of American society. The "baby boom," followed by the "baby bust," increased the demand for housing and then subsequently contributed to its slack demand. The difficulties in the financial infrastructure that underpins these assets started in the mid-1980s. Savings and loan institutions, which have the unenviable position of turning short-term deposits and borrowing into long-term mortgage commitments, were understandably the first to feel these effects as both interest rates and the structure of demand for housing changed dramatically.

Most Americans think their well being is tied closely to home ownership. Significant changes in U.S. demographics and public policy have greatly affected real estate values. Residential and commercial real estate activity, a form of investment and savings for many Americans who are not "wealthy," felt the brunt of recent changes in tax law. The law has also greatly affected the level of activity for professional investors and developers.

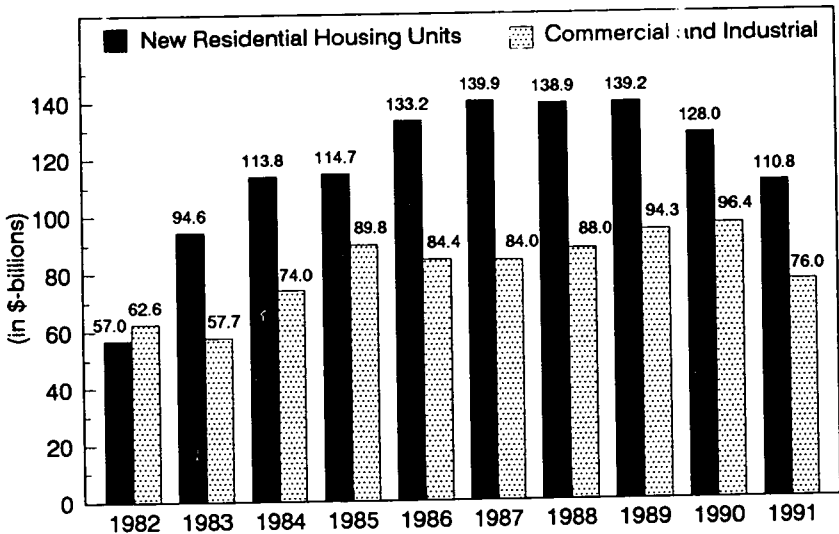
Residential and commercial real estate were affected disproportionately, while industrial and institutional construction grew.⁷⁴ Institutional construction consists of, among other things,

⁷⁴ "Economic Indicators," Council of Economic Advisors, prepared for the Joint Economic Committee, "New Construction," November 1991, pg. 19.

hospital and nursing facility construction. This growth is consistent with demographic changes (the aging of the population) and the explosive growth of Federal spending in health care.⁷⁵

In the 1990s the level of home construction activity has fallen significantly from the levels of the 1970s and 1980s, and commercial and industrial building turned down dramatically in 1991, as shown in Graph VI.2. These are the two common forms of real estate wealth owned by families of moderate means. The flows of rental income from these stocks of household wealth could well be depressed in the current economic difficulties, as well.

Graph VI.2 -- New Construction
(monthly data seasonally adjusted)



Source: Department of Commerce, Bureau of the Census.
CEA, "Economic Indicators," February 1992, pg. 35.

⁷⁵ See JEC Republican staff, Health Care Briefing Paper No. 3, "Health Care and the U.S. Health Care Market: An Overview," released by Rep. Dick Armey on December 11, 1991.

The most volatile component of real estate value has been land prices. These increased spectacularly in the two decades before 1990, creating a significant increase in wealth. In 1990, the value of all land at market value fell by 2.9 percent and the valued land owned by households fell by 9.8 percent.⁷⁶

The credit crunch in the United States exhibits a rolling aspect to its regional impact. Additionally, the timing of credit difficulties in some cases preceded the recession (as in Texas and New England) and in some cases followed the recession (as is the case of the Mid-Atlantic states). Many banks found that they held relatively too many real estate loans given the recent fall in real estate prices. Their response has been to adjust their loan portfolios accordingly, in part by reducing new lending for real estate. Banks that are restructuring their portfolios to include less real estate increase the duress in the real estate market.

In addition to the different timing of real estate difficulties, differences in the type of real estate held by banks affect their balance sheets. Real estate difficulties are weighted toward residences in some states and commercial real estate in others, and values have fallen for both types of real estate in some areas.

Economic growth in the country remains crucial for the future of real estate, banking and business. Federal deficit financing reduces credit availability and further hampers growth. Growth is tied to national budget, tax, monetary and regulatory policies. These policies, since 1986, have not provided a stable time horizon for banks, businesses, or households to make plans. If the current credit market and recessionary difficulties are to be overcome, Federal policy must turn decisively to encouraging private-sector growth.

One measure of distortions in real estate markets and the economy are real interest rates. The **real** interest rate is measured

⁷⁶ Federal Reserve data as reprinted in: Carlson, Keith M., "The U.S. Balance Sheet: What Is It and What Does It Tell Us?," The Federal Reserve Bank of St. Louis Review, September/October 1991, Table 3, pg. 9.

by subtracting the inflation rate from short-term nominal interest rates. This measure indicates that saving or lending money in the 1970s was effectively penalized. For example, in 1978 inflation was almost 9 percent and the nominal interest rate was slightly over 8 percent, the real interest rate a **negative** 1 percent. Traditionally, real interest rates are expected to be at least two percentage points **positive**. During the 1970s, the costs of borrowing and the reward to saving became grossly distorted, with real interest rates that were **negative** in the majority of years of that decade.

Debtors were actually rewarded for using borrowed funds during the negative interest periods of the 1970s. The growth of the real estate industry during this decade was based on the unfirm foundation of this "free-lunch" monetary policy.

The recession ending in 1982 dramatically reduced domestic inflation and speculative international inflation in commodities markets. Robust real growth continued through the next six years. Inflation stayed below 5 percent and tax policy favored real estate without the artificial and non-sustainable stimulus of negative real interest rates and accelerating inflation.

The post-1986 changes in the tax treatment of real estate, combined with regulatory tightening and portfolio shifts out of real estate was perceived as a "credit crunch" on the part of the consumer. These problems resulted in the fall of nominal, as well as real, prices for real estate. Land, the most volatile aspect of residential real estate, was hit hard as its value fell 9.8 percent in 1990. This loss of primary source of household wealth caused a reaction by households, businesses and banks in 1991.

In the 1970s, real estate was pushed by an unsustainable monetary policy that led to rapidly accelerating inflation. As an asset that stayed ahead of inflation, real estate during the 1970s was used as both a shelter from inflation and from the punitive marginal income tax rates and "bracket creep" that characterized the decade.

In the early to mid-1980s, favorable tax treatment and positive price performance made real estate the investment vehicle

of choice for many American families and investors. In 1986, the favorable tax treatment was changed. Adjustments began at that point and continued for the next four years. Price erosion in real estate markets, combined with demographic shifts in the U.S. population, resulted in eroding real estate loan portfolio values for banks at a time when their capital requirements were increasing. The extent, nature and timing of these problems varied from region to region, but four elements were important to the difficulties experienced in recent years by residential and commercial real estate markets:

- The mix of commercial and residential real estate is clearly an important variable in explaining bank portfolio adjustments, bank lending behavior, and household and investor behavior in the recent recession and subsequent, slowly emerging period of recovery.
- Tax laws have unambiguously exacerbated the difficulties of the real estate industry. Only stability over the planning horizon of investors and households will restore balance to the dislocation of the real estate and banking industry.
- Reactionary banking regulation must be curtailed to allow normal, prudent loan-making to the real estate industry.
- There were clearly excesses in lending by savings and loans for speculative projects to unworthy borrowers that contributed to an oversupply of real estate in many markets.

The transmission of Federal Reserve Board monetary policy occurs through the nation's banks and other credit granting institutions. The conduct of this policy failed to take account fully of the impact of regulatory and tax changes in the credit process and, thus, underestimated the tightness of credit that resulted from attempts to engineer a "soft landing" for the economy in 1988 and 1989. The credit difficulties and tax changes for real estate assets

continue to "ground" much of the real estate market, and thus remove the traditional source of bounce-back in economic activity. Misunderstanding these problems and failing to amend policy to resuscitate real estate investment and prices has slowed the pace of economic recovery.

At the same time, it should be noted that international credit markets coped with the events in eastern Europe, the fall of the former Soviet Union and the reunification of Germany. U.S. consumers reduced their installment credit balances in 1991, increased personal savings by 7.2 percent, becoming "more like the Japanese," as they have been so often urged to do. However, Federal government debt, or dis-saving by the Federal government, to finance the historic Federal deficit will capture much of this increased willingness to save by households. The long-term foundation for growth has been improved by these trends in individual behavior, but it remains to be seen if the Federal government can also alter its behavior to help spur needed economic growth.

VII. INTERNATIONAL TRADE AND INTERNATIONAL RELATIONS

A burst of optimism that marked 1991 turned in 1992 to the bracing realization of freedom for the countries of Eastern Europe and the confederation of Republics of the former Soviet Union (FSU). Now begins a period of re-evaluation of economic and political relationships between the Republics. The United States must also re-examine its relationship with these emerging nation-states. The Uruguay Round of trade talks, containing urgently needed improvements to the General Agreements on Tariffs and Trade (GATT), is delayed as the major developed countries cope with slow economic growth and grapple with the demands of their (primarily agricultural) constituencies. In this hemisphere, the completion of the North American Free Trade Agreement (NAFTA) is evidently sidetracked by the Presidential election.

These Republican Views express concern that basic progress in trade relations may be stymied at exactly the time when dramatic events in the world require a strengthened system of international economic relations. The less developed countries, including most of Eastern Europe, are poised to benefit from a functioning international trading system. Significant obstacles in Europe, Asia and the Americas threaten this historic opportunity.

The European Community (EC) boldly targeted 1992 as the year for a unified western Europe, but events in eastern Europe and the Confederation of Independent States (CIS) have overtaken and enlarged this quest. As Europe struggles with events in the East, as well as the intricacies of installing a common currency and an overlay of EC bureaucracy, the schedule for completing the EC slips. Additional pressure on the European governments results from recession and consequent political uneasiness.

In Asia, the trauma of the FSU results in uncertainty for many governments, with talks of reunification of North and South Korea a prescient indicator of the tremors. For the United States, the trade frictions with Japan, exacerbated in a presidential election year, have masked the transformation of the global marketplace. Slowed economic growth in Japan complicates the Japanese political landscape.

In the Americas, the North American Free Trade Agreement is seen as a model for reducing trade restrictions in Central and South America as well. The important extension of NAFTA to include Mexico comes at a time when Canadian politics threaten to unsettle the working portion of the Canadian agreement with the United States.

The future expansion of the world economy is threatened by the return of familiar disagreements on such items as agricultural subsidies that threaten the Uruguay Round of the GATT and long-term European unity. These unresolved national difficulties were lying in wait, hidden behind the grand plans of a united Europe and North American Free Trade Agreement.

In 1992, recovery for the economies of Europe and Japan, reducing U.S.-Japanese trade frictions, and increasing U.S. growth are all short-term goals. Without these developments, positive long-term prospects for world commerce will be impeded.

Slow growth is not the preferred way to improve the trade balance, but the change in exports is welcome, and the current availability of productive capacity in the economy bodes well for positive future performance.

The United States increased exports by \$28.3 billion in 1991, and the U.S. merchandise trade balance deficit dropped by a dramatic 35 percent. As the export sector thrived amongst the modest growth in the domestic economy, imports fell by \$7.2 billion in 1991 over the previous year. Exports in January 1992 were \$35.5 billion, and imports were \$41.3 billion. Although imports increased, the trade balance improved by \$35.5 billion in 1991 compared with 1990.

Moderation of oil prices, following the initial price increases associated with the Iraqi invasion of Kuwait, have assisted progress in the merchandise trade balance. Those who preached of the dangers of the twin Federal budget and trade deficits have discovered that the twins are not identical. The trade picture has dramatically improved for the United States while Federal expenditures continue to grow and the budget deficit swells.

The trading nations of the world need U.S. leadership in order to assure a trading system that provides growth for all nations. We recognize that with the threat of the former Soviet Union gone, our biggest strategic enemies become impediments to U.S. productivity and exports. A proclivity for leadership in the American character results in a natural reluctance to engage in protectionism, even as political opportunists sell it as a cure-all for increasingly stiff international competition. The openness of American society means that actual attempts to protect beleaguered American industries often are inept. Destroying the protectionism of others is the major strategic economic accomplishment to be attained by the United States in the coming years, while protectionism is simply the fastest way to reverse our recent progress in exporting worldwide. America's people and its economic system have a comparative disadvantage in opening international markets, but we have a significant role to play in shaping the new economic order now open to the world.

Those who ignore the moral imperative for the United States to foster an open and fair world trading system simply miss the strategic importance of being the world's lone superpower. Our economic power, enhanced in an open and orderly trading system in which we require open market access abroad, is the road to retaining our greatness as a nation. The prosperity of the United States in this system will be the true "peace dividend" above and beyond the defense budget savings that can now be made.

Protectionism is an example of the opposite thinking, and we should remember that the Eastern Bloc as formerly organized was a nearly closed economic system doomed to extinction. Protectionism begets a fall in the volume of trade, and thus the

losses for all grossly outweigh any gains reported by a small number of countries. The United States stands to suffer a disproportionately large share of the loss of world output from escalating protectionist policies. The U.S. market with a GNP that exceeds \$5.7 trillion will always be a magnet for fair and unfair world traders. We have the power to enforce fair play. The coming years will tell if we have the wisdom as a nation to lead and negotiate a system that will ensure market-based international trade for all nations.

An unfortunate asymmetry exists in the costs of learning one language and set of regulations to enter the U.S. market, compared to the high multiple of those costs for Americans to enter a large array of economies. There is a rational economic explanation as to why efforts of U.S. producers abroad are not relatively greater than those of traders wishing to enter the U.S. market. Unfair barriers to market entry can significantly increase this cost asymmetry. Unfair practices, when not policed by an international agreement, add to the difficult task of increasing U.S. exports. We alone as a nation can provide the leadership that will ensure world prosperity and freedom into the next century.

THE IMPORTANCE OF GATT

The General Agreement on Trade and Tariffs (GATT) represents the potential consensus that can be achieved in international trade among the over 100 signatories of the agreement. The GATT will surely be enlarged by the membership of the former communist countries, and an important influence on those few who retain an outmoded system that commutes individual incentive and freedom. There simply is no alternative to improving GATT so that it can continue to be the basis for international trade.

The GATT came into existence in 1947 and became the basic foundation of global trade expansion. The Uruguay Round is the eighth and latest evidence of the evolution of the GATT, and it shares with the seven previous rounds of talks the concern that it will not meet its very high expectations. The previous GATT

rounds made significant contributions to opening the world trading system, and, with the GATT the likely basis of trade for the next decade, a revolutionary and different trade regime is unlikely.

The United States must utilize its unique status in the world-order to persuade the Europeans and the Japanese to view the improvement of the GATT as a tool for, not an obstacle to, their own prosperity. While there are significant shortcomings in the existing GATT and the market access provided by many of its members, the strategic interests of the United States lie in accomplishing as much as possible within its framework.

Pivotal to continued expansion of U.S. exports in coming years is the utilization and improvement of those parts of the GATT that are working or could work effectively. Successful conclusion of the Uruguay Round provides an opportunity for enhancing the effectiveness and credibility of the GATT. As world economic growth is currently slow, the important progress to be made in the Uruguay Round is of increased importance, and it must be formally concluded. This will help insure an atmosphere in which the United States can retain the recognition of economic superpower, a status that is obviously supported by its production and export accomplishments.

Important areas in the latest round of trade talks include: greater market access for U.S. exports of goods and services; rules governing trade in areas not currently covered, including services, intellectual property rights and foreign investment; reform of agricultural trade; and an effective dispute settlement process.

Of these four topics, agricultural trade has emerged as the most intractable obstacle to the conclusion of the Uruguay Round. All GATT participants, including the United States, and particularly the EC, must work to avoid the failure of the Uruguay Round.

The dissolution of the former Soviet Union requires increased consideration of a broad look at the functioning of the GATT. The dispute settlement mechanism would receive greatly increased attention with the expected increase in GATT

membership. Efforts which increase GATT surveillance of trade policies of members, improve decisionmaking of the GATT, and strengthen the relationship of the GATT with other international organizations such as the World Bank and IMF, deserve serious consideration. These improvements to the GATT contained in the Uruguay Round must be brought to fruition to make the GATT workable for the foreseeable future. They have often been overshadowed in the concern over agricultural trade, services trade, and protection of intellectual property.

The GATT nations have the basis to strengthen the dispute settlement mechanism as it deals with the right to a panel proceeding, a reduction in the ability of a country to block a complaint, and a binding and swift appeal process. These changes would allow a greater range of trade difficulties to be settled under the GATT mechanism, and provide greater transparency and less variance and uncertainty in the settlement process. This would promote greater adherence to GATT rules, and discourage those countries that chose the blunt instrument of bilateral retaliation.

The United States has expressed the desire for an improved GATT Dispute Settlements Mechanism and, at the same time, is one of the leading countries in the application of bilateral approaches to trade dispute settlement. Unfortunately, much of the rest of the world has been quick to develop protectionist tactics. Many of these countries feature a form of bilateralism unconstrained by the niceties of U.S. due-process procedures.

Especially troubling to the interests of the United States are the Japanese *keiretsu* industrial groups. They demonstrate a subtle, finely woven business, finance, and government tapestry that makes consistent discrimination against U.S. imports a part of the fabric of Japanese life. As Japan turns its attention to the rest of the world, the world trade deficit with Japan has increased, even as Japan's has changed little with the United States.

The developments of "Europe 1992" have not fully taken shape, but with rising protectionist reaction to the Japanese export incursion into Europe, the U.S. trade surplus with Europe is a likely target. These challenges require U.S. planning on a multi-lateral

basis. The GATT, with the realization of the Uruguay Round, could provide the basic frame of support for U.S. strategy.

Escalating protectionism threatens U.S. export expansion, and requires that the United States exercise mature leadership in its role as a primary steward of the international trading system. To do less invites disaster for narrowly defined U.S. interests as well as for the international trading system. As a practical matter, the open U.S. society, rightfully indignant about trade restrictions abroad, stands to bear the greatest burden of adjustment resulting from trade disputes and any decline in the volume of international trade.

The lack of U.S. agility in protectionism proceeds, in part, from the democratic nature of its institutions, and should be recognized as a long-term strength of our country. Hard-headed and rational self interest underlie our important leadership efforts toward attaining less restrictiveness among world trading partners.

The vacuum of brute military power resulting from the liberation of eastern Europe can be filled through a framework for international prosperity under an enhanced GATT. The stress of a worldwide economic slowdown enhances the dangers of an unravelling of GATT through piecemeal bilateral protectionist actions. This increases the stresses on emerging market economies in eastern Europe and the CIS. The immediate result would be enhanced military requirements for the United States as well as the serious diminution of U.S. exports. The GATT members have a mandate from the emerging countries to assure the future of the trading system by going the last mile to conclude the Uruguay Round, and thereby to assure the potential for more comprehensive agreements in the future.

THE EMERGENCE OF REGIONAL TRADING BLOCKS

Free trade areas represent a smaller model for comprehensive trade agreements. Although the approaching

presidential election has had the unfortunate side effect of slowing progress on the U.S.-Mexico section of the North American Free Trade Agreement (NAFTA), the lack of significant domestic dissention about the operating agreement with Canada bodes well for the future of free trade in our Northern Hemisphere.

The NAFTA and other free trade agreements are crucial to increasing regional trade, but also have a great potential as laboratories for future improvements to the GATT or its successors. The knowledge derived from innovations in trading agreements will be instrumental to the future of world trade and continued expansion of U.S. exports and jobs.

The conclusion of the free trade agreement with Canada, the expected free trade arrangement with Mexico, and the fuller integration of Europe by 1992, herald an increase in intra-hemispheric trade. Intra-European Communities trade is more than double intra-America trade in recent years, even as Canada remains our largest trading partner. The measure of intra-America trade is relatively small, in part, because the large amount of interstate trade in the United States market, but it suggests the potential for increased trade among the countries of the Americas. Similarly, the potential for increased trade between the EC and eastern Europe is larger than the potential increase among western European countries where a large degree of economic integration has already occurred. Intra-Asia/Pacific trade, at over \$315 billion, has potential for growth simply because many of the countries involved are at a lesser state of development and are growing more rapidly than the countries of the EC, the United States or Canada.

Such high growth potential exists for many of the countries of the Americas, once problems of excessive debt are overcome. Intra-continental and intra-hemispheric trade can be conducted under far-reaching agreements simply because fewer difficulties exist when concluding agreements with a less diverse, smaller group of countries. The emergence of trading agreements among geographically close countries with cultural similarities can be expected simply because such agreements are the most easily reached.

While bilateral and multilateral trade agreements offer the chance to test more complex and complete trading arrangements, they may worsen existing trade problems. This is true of the agreement between the United States and Canada signed into law in December 1988.

The appropriate approach to the U.S.-Canada Free Trade Agreement (FTA) is to monitor the results closely both in terms of the trade impacts of the agreement and the operation of the dispute settlement apparatus put in place by the agreement. The Department of Commerce has international trade data on-line and is making an effort to find more convenient ways to disseminate that information, such as the use of computer compact disks. A similar means must be developed that will allow monitoring of the dispute settlement process on both sides of the border. The participation by the United States and Canadian government research organizations, as well as academic and industry-related research efforts, would be helpful in this learning process.

Continuing U.S. concerns with the Canadian agreement mirror closely U.S. interests in the Uruguay Round, including elimination of tariffs and non-tariff barriers to trade, fair treatment of agricultural trade, an open investment environment in Canada, increased trade in services, and protection of intellectual property.

The operation of the U.S.-Canada FTA provides input into the finalization of design of the agreement with Mexico to complete the NAFTA. For the future, such monitoring of both the changes in trade patterns and volumes, as well as changes in the administration of the trading relationship, will be useful to protecting U.S. interests in future agreements in the Americas, as well as help structure the replacement or supplementation of the GATT.

Agricultural trade remains, for nearly every country, one of the most politically sensitive areas and one which poses the most difficulty in negotiation and implementation of free trade areas. Agriculture is the single issue which threatens the successful conclusion of the Uruguay Round of the GATT. Similarly, it has

provided formidable obstacles to the free trade agreement between Canada and the United States.

The U.S.-Canada FTA tackles these difficult problems between two of the most productive agricultural producers in the world. Both countries have extensive domestic programs for a wide array of agricultural products, and some problems have not come to a full resolution prior to the institution of the agreement.

The handling of agricultural trade in this agreement will be extremely important to future success of additional free trade agreements, as well as successful agricultural trade negotiation under the GATT. The outcome of these discussions between Canada and the United States will also be critical to trade frictions among the Cairns Group. This includes Canada, the United States, and many of the countries that came to be significant producers in international agriculture as a result of excessive, supported prices for commodities over the last decades. The FTA, as an incubator of workable ideas in agriculture, should receive the serious, concerted effort that its potential suggests.

The implementation process of the FTA is as important to U.S. agricultural interests as the initial negotiating process. Indeed, it would be important to the ongoing improvement of agricultural trade relations if the U.S. International Trade Commission (USITC)-Canada emphasized agricultural trade in the implementation, continued development, and elaboration of the FTA.

Extension of the NAFTA to include Mexico will result in production processes that stretch across borders. Canada and Mexico have been the main reasons for a 60 percent increase in shared production imports in the United States between 1986 and 1989. According to the USITC, these two countries make up 52 percent of all shared-production imports brought into the United States. This is ample indication that geography still plays a significant role in the patterns of international trade and that economic integration is ongoing among the economies of North America.

U.S. merchandise exports to Canada, on average, have been double those to Japan in recent years and 80 to 90 percent of those to Western Europe. Trade with Mexico is increasingly important even without benefit of a free trade agreement. U.S. merchandise exports to Mexico increased by 14 percent in 1990 over the previous year, the latest years for which complete data are available. This data represents a period during which Mexico liberalized its trading system, reduced its budget deficit, and privatized many government-owned enterprises. Since the commencement of the debt agreement by Mexico with commercial banks in 1989, significant increases in investment from around the world have occurred. These difficult but important adjustments have prepared Mexico for economic growth and make it a trading partner with significant growth potential.

At \$28 billion in 1990, U.S. exports to Mexico are growing rapidly, up 12 percent from 1989. The potential for growth is reflected in the fact this is one-third of U.S. exports to Canada even though Mexico has more than three times the population of Canada. The U.S. merchandise trade deficit with Mexico has been narrowing in recent years, to \$1.8 billion in 1990. Careful attention to U.S.-Mexico trade problems could help reduce this significantly, and should be an ongoing concern in the NAFTA. The NAFTA needs to result in an agreement that strengthens the international competitive thrust of the countries of North America.

THE NEW EUROPE

The economic interests of the United States in the European Community have replaced the strategic interests which once focused on the threat of the former Soviet Union (FSU). The European trading block significantly influences the flow of commerce in the American and world markets, accounting for some 25 percent of U.S. foreign trade. The EC has made significant strides in the area of trade with its EC 1992 Program, which proposes to internally integrate the markets of the member states.

However, the more difficult task of monetary economic integration has progressed much faster and farther than political integration. As the American interests in NATO and the need for the defense of Western Europe fade, America's long-term goal of free trade between the United States and the EC becomes the prime focus of the U.S.-European relationship.

Two major roadblocks to timely and effective European integration exist: first, national interests of individual EC states in the face of a worldwide slowing of economic growth, and second, the problems associated with the overlay of a new, additional, bureaucracy over decreasingly sovereign member states of the EC. Comments that reveal the depth of European divisions regularly appear in the press; for example, former German Chancellor Helmut Schmidt recently commented, "In a decade's time, the British will wake up to the fact that any importance of the sterling will have evaporated." This remark is indicative of the difficulties of making monetary union work as planned.

The Maastricht Treaty adopted by the European Community in December 1991 made a variety of concessions to individual EC member states. One of the most significant concessions was made to the French, who gained assurances that the EC would pursue a common foreign and security policy.⁷⁷ This introduces another topic of historical conflict for the "Big Three" of Europe. Now two sacred cows feed off the EC budget: a common foreign policy and agricultural subsidies. The Maastricht agreement attempts to rationalize the swelling EC budget, driven by the costs of Kurdish refugees, the Gulf War, Eastern Europe and the CIS. Maastricht underscores the increase in the EC's political ambitions for a more proactive international role for the EC, but its biggest members are resisting the increased fiscal expense.⁷⁸ Substantial resistance exists within each member state for the formation of a common

⁷⁷ "Staggering Under Weight Of Unity Bill," by William Drozdiak, The Washington Post, February 17, 1992, pp. A31 and A36.

⁷⁸ "The Bill for Maastricht," Financial Times, February 13, 1992, pg. 16.

pool of resources for foreign aid and assistance.⁷⁹ Significant surrender of individual political sovereignty for France, the United Kingdom or Germany is simply inconsistent with each country's history or its current political climate.

Maastricht also yielded concessions to interests other than those of the French: The British were permitted to "opt out" of the EC's social policies; Spain received promises of billions of dollars in subsidies for itself and the poorer EC members; and Germany was promised that a strict anti-inflationary policy would be applied to the European Currency.⁸⁰ This last concession suggests that the other EC members will constantly criticize the restraint on their historically more permissive policies of monetary growth. The fallout of Maastricht is simply one of historic frictions in the new framework of a Europe headed toward unity.

The pressure of financial obligations that accompany the decisions arrived at during the meetings in Maastricht is beginning to create a strained atmosphere among the members of the European Community. Jacques Delors, president of the EC Executive Commission, appeared before the 12 member governments to inform them of the financial consequences of the Maastricht agreements. The EC will need an additional \$75 billion, over the next five years, to fund the management of a single market and social policies emanating from the agreement. Delors went on to suggest that the wealthy members of the EC, Germany, the United Kingdom, and France, should be the ones to increase their contributions to fund these management costs. This simply adds fiscal pressure to the historical frictions of the big three of Europe.

After Delors' announcement the major economic powers immediately responded, citing their own economic and financial difficulties as reasons for their inability to increase their

⁷⁹ *Ibid.*, pg. 16.

⁸⁰ "Staggering Under Weight of Unity Bill," by William Drozdiak, *The Washington Post*, February 17, 1992, pp. A31 and A36.

contributions to the EC budget. Germany's responsibilities for the integration of the former East Germany and the \$33 billion it must spend to be rid of the remaining Soviet forces in its territories are of more internal importance than providing momentum for EC unity. With the high price of industrial reunification, as well as the reunification of its agricultural industry, Germany intends to surrender its role as the "milk cow" that nourishes the rest of Europe.⁸¹

France suggested that while it had derived some benefits from the EC, its expenditures were beginning to exceed benefits. France, as Germany, is forced to respond to the desires of its special interest groups, specifically agricultural interests. While the EC's agricultural policy is devastatingly expensive, the governments' hands are bound by the protectionist interests of those elements of their economies which have long enjoyed the shield of trade protection. France's government, in the face of recent election results, is not likely to make the difficult choice of acceding to cuts in the monstrously expensive farm subsidies it currently receives from the EC, which drain the efficiency of the entire system. Britain, which also faces impending elections in April of this year, seems to have adopted a policy linking, inversely, its fears of "continental Federalism" to its financial contributions to the EC.

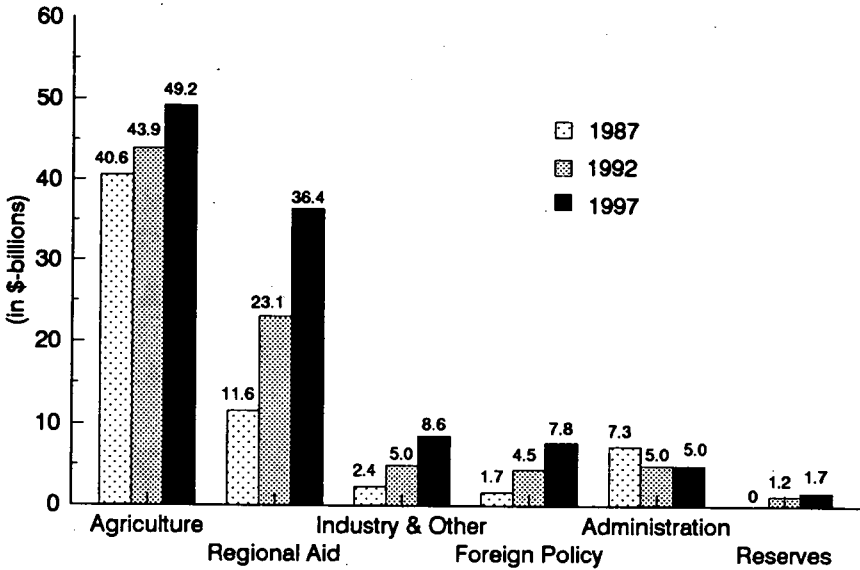
To help industry adapt to change and increased competition from the outside, the EC budget has earmarked an annual increase of \$4.35 billion by 1997 to assist its industries. These increased funds will be channeled through existing programs. Approximately 40 percent will be directed toward research and development, 30 percent to training programs, and the rest toward infrastructure improvement projects for the whole of Europe.⁸² The EC's budget proposal for its second five-year plan (1992-97) was issued on February 12, 1992. In relation to earlier budget years, as

⁸¹ "Staggering Under Weight of Unity Bill," by William Drozdiak, The Washington Post, February 17, 1992, pp. A31 and A36.

⁸² "Reading Between the Budget Lines," by Andrew Hill, Financial Times, February 13, 1992.

compared in Graph VII.1, the 1997 projected budget is substantially larger and reallocated to reflect a renewed emphasis on the development of industry.

Graph VII.1 -- The Rise In EC Spending

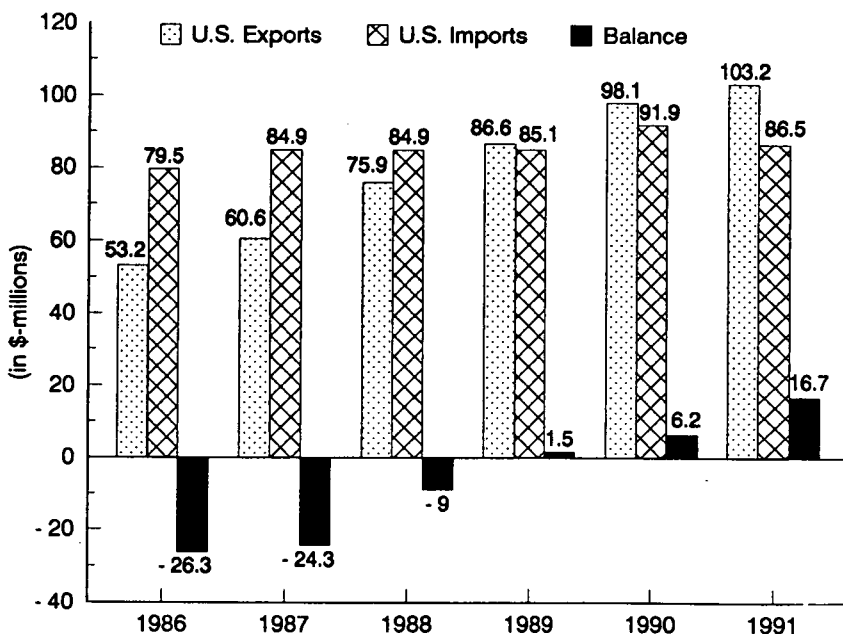


Source: European Community (*Financial Times*, Thurs., February 13, 1992.)

Some of the EC proposals can significantly boost foreign trade and investment in Europe for U.S. citizens and companies. Ultimately, the standardizing of import restrictions that must currently be accounted for by exporters to each of the different member states will allow one product to enter into the individual markets of all of the members. By eliminating duplicitous and onerous product certification and testing, with different requirements in each of the member states, the EC will hopefully offer an enticing uniform market for American export business. A unified system of technological and technical standards for testing and certification will ultimately expand the trade of goods within Europe and ease the burden on importers who attempt to enter the EC market. The United States should continue to voice its justified

concern that standards, testing, and certification; procurement; rules of origin; health and safety; and reciprocity and non-discriminatory treatment for U.S. companies doing business in the EC are of fundamental importance to the U.S.-European relationship. The EC, as a bloc, would become the single largest trading partner for the United States, and it is important for that relationship to continue to grow and prosper. As indicated in Graph VII.2, the balance of trade has significantly shifted in favor of the United States in the period from 1986 to 1991. Barring any trade disputes, standardization of the EC market should continue to be a profitable development for U.S. companies.

Graph VII.2 -- U.S.-EC Trade, 1986-91



When the EC is fully integrated it will have a GDP of about \$6.8 trillion annually, while the United States and Japan are expected to have annual GDPs of about \$5.7 trillion and \$3.3 trillion, respectively. The United States is well advised to keep a cautious eye on the developments that could turn the EC into

Fortress Europe. The principle benefit of the European Community to the United States is the potential of a greater role for American trade and investment opportunities within the EC. However, it will be a difficult and delicate adjustment for the United States to assert a post-Cold War position of influence in Europe.

Trade

The areas in which the United States is clearly a leader in the world are also areas in which the United States continues to have trade difficulties with many countries. Extending the GATT to cover services has been a source of contention. In high technology trade, the United States also faces extensive difficulties among many of the world's trading nations. Most often this takes the form of protectionism for foreign industry far less sophisticated than that in the United States. Such resistance is understandable, but nonetheless unacceptable to the United States and its businesses and workers. The GATT members must recognize that leadership of the world trading system does not mean capitulation of our self interest.

In discussing this subject, it is necessary to bring up the case of a country that is clearly competitive with the level achieved by the United States and yet routinely obstructs reasonable and open access to its markets. Both in high technology trade and in allowing competition in services, Japan is protectionist and mercantilist. In financial services, Japan has used non-monetary barriers and subtle pressure to prevent the success that U.S. firms enjoy in other areas of the Japanese financial market.

Americans soldiers fought and American taxpayers gave bravely to protect the world trading system and the world oil supply from nuclear and conventional blackmail. That freedom of commerce and of the seas underpins the Japanese export machine, and yet the Japanese protectionist apparatus relentlessly works to keep American high technology goods and U.S.-provided services out of the Japanese market.

Tokyo's barring of U.S. financial services is vexing, particularly in the face of the continuing Japanese trade surplus with the United States, and at a time when the major Japanese financial firms have created one of Japan's biggest scandals. Competition would be advantageous to Japanese consumers. Banking and financial services are one of the few areas where the United States is making serious progress in Japanese markets, and obvious efforts to thwart those efforts are an unwelcome threat to cordial commercial relations.

Japan's continued reluctance to live up to the agreement with the United States on computer chips entering the Japanese market increases the protectionist pressures on the U.S. policy apparatus. The Semiconductor Arrangement represents additional evidence of the increasing friction in U.S.-Japanese trade relations. U.S. market share under the agreement, seen as a floor in the negotiations, has become a ceiling to the Japanese industry, and U.S. participation in the Japanese market remains woefully below that expected level.

These problems, challenged by the U.S. Structural Impediments Initiative (SII), indicate why trade frictions are mounting. They could not come at a more inauspicious time in trade relations and world history. As the United States turns from its military role in the Cold War toward the economic challenges of international competitiveness, the failure of Japan to live up to the stature of her economic status is disturbing.

Republican JEC Members firmly support mature U.S. leadership in the GATT as well as in bilateral trade relationships. However, the United States should reasonably expect mature cooperation from those nations that can most afford to display maturity. If the Japanese keep the United States from selling financial services, and the Europeans continue their efforts to keep out the Japanese, both will ultimately feel that they can increase protectionism against the United States. This is a short-sighted perspective for Japan or Europe to adopt. Additionally, the expressed intent of left-of-center elements in Canadian politics to dismantle the U.S.-Canada agreement suggests the need for U.S.

perseverance in firm but fair implementation of an agreement that entailed compromise on both sides.

We owe our best efforts to completing the GATT Round and to providing an example of world leadership in trade through the successful completion of the Mexican portion of the NAFTA, and in order to assure a prosperous future for all the Americas. World trade is poised at a critical juncture, when many societies are initiating democracy. Open and fair trading systems like NAFTA demonstrate to the world the way to future prosperity. Aspirants to real leadership positions should avoid the temptation to show a destructive protectionist face to a world increasingly moving to open markets.

EASTERN EUROPE AND THE FORMER SOVIET UNION

Many issues which the Republican Views addressed last year have been transformed by the situation in the former Soviet Union. Questions about Gorbachev and "Union" have given way to questions about Yeltsin, the Commonwealth, and the republics. Concern over hard-line opposition is reduced, but the reassignment of former Soviet armed forces has become a crucial question. Economic difficulties persist and worsen while the new governments try to implement reform policies, and private entrepreneurs try to develop capitalism on their own.

The disintegration of what is now the former Soviet Union (FSU) and the rise of a commonwealth requires examination of several issues: the political economy of the former Soviet Union, an overview of the condition of the former Soviet Union, the political instability and economic decline since the failed August coup attempt, the new Commonwealth of Euro-Asian Independent States (CIS), and U.S. responses: diplomatic, economic and military.

The crucial, difficult economic reform measures have only begun. Required reforms include monetary stabilization, free market pricing, liberalization, and privatization of property. The

development of small private enterprises must continue in the face of difficulty.

In the mid-1980s, declining economic conditions forced Mikhail Gorbachev to announce reforms to the Soviet communist system. The "openness," or glasnost, led to calls for "restructuring," or perestroika. These were not efforts by Gorbachev to abandon communism; rather, they were his attempts to make communism work. Those attempts failed, and the economy worsened. Individual republics, particularly Russia, asserted more autonomy, especially after the August 1991 coup attempt. Russia holds the overwhelming amount of resources, and Yeltsin has returned the Russian Republic to a historic role of regional leader and "first among un-equals."

The poor performance of collective agriculture in the republics and the vast potential of natural resources will have strong influences on economic reform and rebuilding. The division of the armed forces and the question of nuclear weapons leaves uncertainty in the military forces, but these difficulties appear, for the moment at least, on course to a solution agreeable to the Republics and to the West. Economic conditions for what was the U.S.S.R. requires the reconsideration of some U.S. strategic interests.

Difficulties exist in the integration of the republics into the world economy. With trade between the republics in disarray and decline, the United States must encourage development of market activities within the republics and trade among them.

The August 1991 coup attempt by communist hard-liners against Gorbachev was poorly timed and poorly planned. The event crippled Gorbachev and strengthened Yeltsin, whose image defiantly standing on a Soviet tank contrasted with that of the rescue of the beleaguered Gorbachev. The euphoria after the collapse of the coup presented Gorbachev an opportunity to push through reform legislation. Gorbachev let the opportunity slip away; Yeltsin did not. The events that followed left Yeltsin as the undisputed leader of the Russian Republic. He claimed for Russia what were Soviet resources and obligations, and he announced

drastic economic measures to be implemented by the end of 1991. Yeltsin could support these claims because, with control of Russia, he commanded 76 percent of the land mass, 51 percent of the population and an estimated 62 percent of the GNP of the former Soviet Union.⁸³

Economic reform was delayed though, and production, standards of living, and the general economy continue to decline in the republics as trade relations among them remain undeveloped. Yeltsin's attempt to decontrol prices may produce the first important challenge to him from the populace. The movement to a price system has been delayed and deterred by the remaining elements of the command economy operating as independent operators without any central direction and control.

The operating expenses of the remaining central government, including the overwhelming share of the Soviet military, remains the other significant impediment to a speedy rationalization of the economy and the establishment of free markets. The future of the new union of republics, including Ukraine and Belarus, joined by Kazakhstan and the Central Asian independent republics, weighs in the balance. The formation of the Commonwealth of Independent States made Gorbachev and the central government superfluous, and led to the resignation of the communist leader.

The political instability, economic decline, drastic reform measures, declining agriculture, decaying infrastructure, and military re-alignment present monumental tasks. The longer the delay in tackling these tasks, the more arduous they will become. Despite these obstacles, the resource potential of the Republics of the FSU -- a large labor force, large expanses of agriculture, energy and natural resources -- is enormous.

⁸³ "Russian Republic: Basic Facts," Document 91-710-F, Congressional Research Service, The Library of Congress, October 2, 1991, pp. 1-2.

For over 70 years, the Soviet economy was bound by the central government's "Plan." All decisions on large-scale production, investment, and distribution were made in advance in five-year increments. Industries were heavily subsidized, distorting real prices and masking real inflation. Enterprises were state-owned and monopolistic, removing incentives for efficiency and quality. Employment was guaranteed and individual initiatives were discouraged or obstructed, reducing workers' incentives and productivity.

Despite, or perhaps because of, this massive central planning, over 25 to 30 percent of agricultural goods were produced in the small 3 percent of arable land allowed for private agricultural plots.⁸⁴ Today the massive central bureaucracy, now inherited mainly by Russia, has lost its central control but not its presence in the economy. As a result, the economy struggles under dual difficulties of a lingering and renegade bureaucracy, as well as anarchy because there is no market-oriented infrastructure of law and private property rights on which Western economies rest.

Economic coordination has broken down at the local government and enterprise level. Unofficial barter between local governments, farmers, and manufacturers is widespread, particularly regarding scarce imported goods and scarce food items. Contract obligations for deliveries of goods are often not met. Crops go unharvested, rot in storage, and are illegally sold out the back door before any are stocked on store shelves. Shortages of food and necessary consumer goods are widespread.

The Ukraine, the most productive agricultural area and often called the "bread-basket" of the FSU, pledged to move to a market economy on its own, led by the newly elected President Leonid Kravchuk. The Commonwealth will attempt to coordinate economic reforms ongoing in the independent states.

⁸⁴ Arndt, M., "Soviet Government Won't Cultivate Private Farms," Chicago Tribune, November 3, 1991, Sec. 7, pp. 1 and 4.

The Commonwealth and the independent republics still face the basic requirements of comprehensive reform, which have been urged upon them in the West for some time:

- **Monetary stabilization:** cuts artificial subsidies, reduces inflation and brings wages in line with productivity.
- **Price liberalization:** prices must be allowed to rise to market levels, bringing prices in line with the existing supply of rubles. This will re-establish the demand for the currency as a medium of exchange.
- **Privatization of enterprises, land, and housing:** including selling state-owned businesses, demonopolization of industries, demonopolized commercial laws developed, and property rights and codes created to promote the private market.
- **Better definition of the role of the Commonwealth and the government of the republics:** fiscal and monetary policies, legislative jurisdiction and judicial roles including taxes and commerce.⁸⁵

With the central government extinct, reform action recently has taken place at the republic level, led by the Russian Republic and Boris Yeltsin. In October 1991 he promised several drastic economic reforms, some of which address the stabilization, liberalization, and privatization reforms called for by the West.

Resistance to Yeltsin's control is a consequence of the January 3, 1992 price decontrol on transportation, food, and other consumer items. Nevertheless, plans are being made for the denationalization of small and medium size state owned businesses,

⁸⁵ Yavlinsky, G., Allison, G., Window of Opportunity, NY: Pantheon, 1991, pg. 35.

creation of a viable currency, a halt to foreign aid, and an end to subsidies for other republics.

Ukraine and the other republics will need to take similar measures to assure economic growth and access to international capital markets. Additionally, these goals must be attained in order to restore trade between the republics, and to extend non-barter trade with the rest of the world. The ability and willingness to do so would indicate an improved chance for the republics to make the necessary changes to move to a market economy. The success of Russia and the other republics depends upon initiating necessary reforms, improving economic cooperation between the republics and with other countries, and developing a private sector. The increase of small enterprises already has begun.

Small private enterprises have driven economic development in the most successful countries in the world. They have employed the majority of the population, provided the fastest rates of growth, and produced the most important product development from the first automobiles to computer software. In the transition to a market economy in the new republics, small enterprises must play a crucial role by providing additional jobs, increasing product and service development and choice, and responding promptly to changes in consumer demand.

Small enterprises have several advantages over large enterprises. Small enterprises can be located in large, medium, or small cities, as well as rural areas. They can operate near necessary raw materials, in areas of labor surplus, and near where the products and services will be consumed. They can weaken the monopolistic advantage of larger, less flexible firms by rapidly adjusting production processes and by introducing new technologies. They avoid the slow reaction time of bloated managerial levels and rigid structure of large organizations.

The development of small enterprises in Ukraine illustrates their potential growth throughout the FSU. The total number of registered small enterprises in Ukraine in early 1991 was 10,726. Almost 90 percent of those were started from scratch, while slightly over 10 percent were established through reorganization of

previously state-owned operations. The greatest numbers of small private firms are in Donetsk, Kiev, Kharkov, Crimea, Odessa, and Dnepropetrovsk. The most common industries for the small enterprises are production of consumer goods (18.3 percent), construction and construction-maintenance work (17.9 percent), introduction of new technologies (10 percent), production of building materials (5.7 percent), and production and processing of agricultural products (4.4 percent).⁸⁶

Small enterprises are hindered by many difficulties. Information is scarce on what areas of activity are available for entry and on how to organize such activity. A shortage of production space exists for lease or purchase. Bureaucratic legislation, lack of cooperation from banks, and other start-up difficulties obstruct the creation of small private enterprises. The supply of materials and specialists is insufficient. Government loans and financing systems are underdeveloped and underfunded. The legal foundation for property and contracts is not yet sufficiently developed or secure. Small businesses lack necessary data about market conditions, analyses of their financial conditions, and options in their search for partners. They lack information on choice of development strategies, legal services, and personnel training.

Some businesses have begun to work together to exchange legal, economic and other information, and to coordinate their activities. Eighty-five small firms formed the Ukrainian League of Small Enterprises in June 1990, and 15 other leagues have been formed since then. These leagues assist finding partners, suppliers, and business consumers of raw materials, final products, advertising, and publishing.

⁸⁶ Kulikov, G., "Support for the Development of Small Enterprises in the Republic in the Context of the Transition to a Market," *Ekonomika Sovetskoy Ukrainy*, No. 9, September 1991, in FBIS-USR-91-052, November 26, 1992, pg. 76.

Support for the development of small enterprises should come from the republic and regional levels of government. Financial assistance, such as start-up grants and expansion loans, is unlikely to come from commercial banks which usually deal with larger accounts. Institutions to deal specifically with small enterprises need to be created, possibly with the aid of foreign assistance. Joint-stock funds can play an important role. The banking system will expand with the expansion of small businesses and the economy in general. As part of this process, banking services should move beyond the focus of merely extending credit. Financing small firms' research and development will become an important role, along with providing payroll, retirement, investment, and insurance services.

The small enterprises also need assistance with material and technical supplies. Government's role should be to facilitate coordination of private projects to meet these needs, not to get into the business of providing industrial services or supplies. The government can address the supply shortage by facilitating the growth of commodities markets, communication and transportation systems, and by seeking international participation. It must be careful not to create an economy permanently dependent on heavily subsidized private companies, which would sharply decrease incentives for efficiency, burden the government with huge expenses, and dampen the growth of the economy.

The government does have important functions that only it can perform. It must create a functioning commercial code, based on the guaranteed protection of private property and made compatible with expected trading partners. Bureaucratic regulations which prevent easy, inexpensive entry of a firm into the market, must be repealed. Rationalization of state-owned firms and monopolies should continue quickly if this fiscal burden is to be reduced.

Revenue legislation will help government stay solvent and provide the necessary services. It may consider tax incentives or tax breaks for businesses just starting up, in selected locations based on labor and consumer needs, in selected industries a region wants to develop, for different levels of capital and research investment, and

for foreign direct investment. Rationalization of the tax code to promote growth and provide for basic government revenue for a productive infrastructure will have to be addressed.

One development that has assisted the growth of small enterprises is the creation of commodities exchanges. The Moscow Commodities Exchange opened in May 1989. The exchanges have replaced five-year plans to attempt to increase efficiency in the allocation of goods. Their basic role is to connect buyers and sellers and establish pricing of goods based on domestic demand and supply conditions, and in the longer term, international market demands. Exchanges operate in cooperation with the Chicago Board of Trade, the Chicago Mercantile Exchange, and the New York Mercantile Exchange. The exchanges are providing a valuable service and creating a new class of entrepreneurs.

The increase of services to small businesses will have to grow substantially to meet the anticipated rapid expansion in the number of firms. Widespread growth of small enterprises will require training a large supply of executives and specialists. Development of training programs for management, accounting, marketing, technical, and other specialists will require foreign assistance and should include some foreign training.

The small enterprise is a flexible, economically expedient, and competitive structure whose development is inevitable. It will stimulate the economy by adding jobs, increasing productivity, accelerating de-monopolization, meeting consumer demand, generating investment, and encouraging innovative production. The small enterprise is crucial to the transition to a market economy and must be facilitated by republic, regional, local and foreign public and private interests.

Soviet agriculture has relied primarily on state and collective farms, historically producing about 75 percent of total output. (For relative output by republic, see Table VII.1.) Private farming on state-owned land has produced the other 25 percent of output, although it depends on less than 3 percent of the total agricultural land. Most of the agricultural output had been sold to the state at

low prices. State-owned companies then processed, stored, and transported the food to state-owned retail stores. Inefficiency and corruption caused large losses through the processing, storage, transportation, and marketing chain.

Table VII.1 -- Share of Production and Population by Republic
(1980, in percent)

Republic	Agriculture	Crops	Livestock	Population
USSR	100.0	100.0	100.0	100.0
Russia	46.7	41.6	50.5	51.4
Ukraine	22.1	23.2	21.4	18.0
Kazakhstan	7.0	6.3	7.5	5.8
Belarus	5.4	4.7	5.9	3.6
Moldavia	2.2	3.1	1.5	1.5
Georgia	1.5	2.4	0.8	1.9
Armenia	0.6	0.8	0.6	1.2
Azerbaijan	1.7	2.6	1.1	2.4
Uzbekistan	4.7	7.3	2.8	6.9
Kirgizia	1.3	1.3	1.3	1.5
Tajikistan	1.1	1.8	0.6	1.8
Turkmen- istan	1.2	1.9	0.6	1.2
Lithuania	2.2	1.7	2.6	1.2
Latvia	1.3	0.9	1.7	0.9
Estonia	0.8	0.5	1.0	0.6

Source: USSR Agriculture and Trade Report, USDA/ERS, Washington, 1990, pg.5.

Gross agricultural production declined in 1989 (after significant increases earlier in the decade), largely due to the shortage of agricultural inputs (see Table VII.2). The lack of sufficient feed grain, parts for harvesters and trucks, and gasoline and diesel fuel has reduced farm production, with particularly steep declines in the production of sugar, margarine, cheese, sausage, and meat and dairy products.

Table VII.2 -- Gross Agricultural Output
(billions of 1983 rubles)

	1980	1985	1989	1990
Total of Former Soviet Union	187.6	208.6	225.1	220.0
Russia	86.3	95.6	105.9	103.0
Ukraine	41.5	47.1	50.8	49.5
Belarus	9.5	12.0	13.0	12.2
Uzbekistan	10.1	10.2	10.5	10.9
Kazakhstan	14.1	13.8	14.6	15.4

Source: USSR in Figures, 1990: Concise Statistical Collection, USSR State Committee on Statistics, Moscow, 1991.

The final figures for the 1991 harvest of main agricultural products are lower than both 1990 and the last five-year average. The 1991 grains harvest amounted to 90 million tons, after 116.7 million tons the previous year, and 104.3 million average for the 12th Five-Year Plan. The gross potato harvest fell from 30.8 million tons in 1990 to 30.5 million in 1991. The vegetable harvest fell from 10.3 million tons to 10.0 million.⁸⁷

State retail stores, with their subsidized prices, have had difficulty procuring agricultural products. Midway through 1991, only 40 percent of the total harvested grain had been sold to the state. Farms have increasingly kept more of their output for their own use, for barter, or for sale at higher market prices. The central and regional governments have been unable to meet farmers' demands for consumer goods and agricultural inputs. Consumers and producers lack faith in a ruble not backed by credible monetary policy. Consumers can still find most goods on the black market or private markets, but at significantly higher prices. This hurts those

⁸⁷ Lesnaya Gazeta, November 2, 1991, pg. 3. Translated and reprinted Lesnaya Gazeta, "1991 Agricultural Performance," November 2, 1991, pg. 3, by Foreign Broadcast Information Services (FBIS-USR-91-088), Dec. 5, 1991, pg. 29.

with fixed incomes, large families, and people such as students, bureaucrats, and clerical workers who do not produce tradeable goods.

The FSU has focused primarily on imports such as feed grains and oilseeds to address the decline in meat and dairy production. Imports of consumer goods such as wheat, sugar, meat, dairy products, and other ready-for-consumption products may also be necessary for state stores to provide affordable food. With few gold reserves and decreased oil production and exports, there may be less hard currency to pay for imported food. Hard currency will first be used to make debt payments, to preserve the credit rating needed to obtain foreign loans and loan guarantees for food imports.

The potential for the 1992 crop is larger than 1991. Winter wheat sown in 1990 for 1991 was 16.5 million hectares, in 1991 for 1992 it was 19.9 million hectares, an increase of 21 percent. Land plowed in 1991 for 1992 sowing was 56 million hectares, up 27 percent from the 44 million hectares in 1990 for 1991.

Real long-term growth in agriculture, however, will require structural movement to a market economy. The principal problem of Soviet agriculture was the lack of private incentive on the state farms. The new republics' governments must recognize the role of private farming.

There are 30,000 privately owned farms, which represent less than 1 percent of total Soviet farmland. More than 20,000 of these are in Georgia. Privately owned farms have had difficulty obtaining government-controlled allocations of machinery, equipment, credit, building materials, fertilizer, seeds, livestock, and fuel. The collective managers keep these and other inputs from the private farms, which they view as a threat to the collectives. They also prevent the private farmers from access to schools, health care, water, and electricity. The lack of sufficient private markets limits what private farms can sell. For private farming to play a larger role in agricultural production, the right to private property must be secured. Laws must provide equal access to the goods and services

available to state firms, and they must encourage the development of legal private markets.

Agriculture faces the additional problems of outdated, ineffective food processing, storage, transportation, and distribution systems. The republics must encourage and facilitate the growth not only of private farming, but also private food processing, distribution, and marketing. Action by the republics and by foreign governments could help develop these sectors.

Oil and natural gas production in the republics is of domestic and international significance. The Soviet Union was the world's leading producer of oil, producing 12.5 million of barrels of oil per day in 1988 (see Table VII.3). Oil continues to be a major source of energy for the republics' industries, and its exports will remain the primary source of hard currency earnings.

Table VII.3 -- Former Soviet Union,
Estimated Regional Production of Crude Oil, 1983-88
(millions of barrels per day)

	1983	1984	1985	1986	1987	1988
Total	12.33	12.22	11.91	12.30	12.48	12.45
Russia	10.90	10.82	10.44	10.84	NA	11.00
Urals-Volga	3.13	2.91	2.78	2.71	NA	2.46
West Siberia	7.38	7.55	7.30	7.79	NA	8.28
*Groz, Krasn, Stavr.	0.34	0.31	0.31	0.29	NA	0.19
Far East	0.05	0.05	0.05	0.05	NA	0.05
Central Asia,						
Kazakstan,						
Turkmenistan	0.56	0.57	0.63	0.65	0.66	0.69
Azerbaijan	0.28	0.28	0.27	0.26	0.28	0.27
Ukraine	0.14	0.14	0.13	0.12	0.11	0.11
Komi ASSR	0.39	0.36	0.38	0.40	NA	0.34
Belarus &						
Baltics	0.03	0.03	0.04	0.04	0.04	0.04
Georgia	0.03	0.02	0.01	0.01	0.01	0.01

Source: Pollard, Alan P., ed. USSR Facts and Figures, Vol. 15. Gulf Breeze, Florida: Academic International Press, 1991, pg. 228. Production figures include natural gas liquids.

*Groznyy, Krasnodar, Stavropol.

Oil production and exports, after decades of steady growth, have decline in recent years. In 1989, production fell to 12.1 million barrels per day, and in 1990, dropped to 11.5 million. By 1991, production had fallen 15 percent from 1988, to 10.6 million barrels per day.⁸⁸ Exports have dropped even more rapidly. In 1988, exports amounted to 4.1 million barrels per day, and fell to 3.7 million in 1989 (see Table VII.4). The 1990 level was down another

⁸⁸ Riva, Joseph P., "Soviet Economic Conditions and Relations: Status and Prospects, Soviet Oil," Document 91-639-SPR, Congressional Research Service, The Library of Congress, August 29, 1991, pp. 3-4.

16 percent, to 3.2 million. By mid-1991, oil export was down 50 percent from the previous year, to 1.6 million barrels per day.⁸⁹

Table VII.4 -- Exports of Crude Oil and Petroleum Products 1983-89
(thousands of barrels per day)

	1983	1984	1985	1986	1987	1988	1989
Total	3,667	3,669	3,334	3,752	3,915	4,104	3,693
Eastern							
Europe	1,443	1,444	1,411	1,622	1,598	1,548	1,530
Asia	80	77	88	77	84	77	78
Cuba	248	250	262	141	134	118	109
Yugoslavia	112	137	103	138	171	169	192
North							
America	1	13	9	8	14	24	56
Western							
Europe	1,528	1,546	1,263	1,533	1,642	1,907	1,520
Italy	195	242	174	313	302	347	303
Finland	233	207	200	251	243	246	227
West							
Germany	211	239	211	202	199	254	183
France	168	159	128	224	209	323	170

Source: Pollard, Alan P., ed. USSR Fact and Figures, Vol. 15. Gulf Breeze, Florida: Academic International Press, 1991, pg. 229.

There are several reasons for this decline, including the natural decline from the decrease in supply of "easy" oil from the Volga/Urals region. The other reasons parallel the reasons for decline across the economy: long lack of capital investment, outdated technology, equipment and construction problems, and planning errors.

⁸⁹ Ibid.

Decreased production means domestic shortages and lower exports. Lower exports means loss of hard currency earnings (oil exports had accounted for one-third of all hard-currency earnings) and increased prices for the formerly subsidized customers of Eastern Europe. Less hard currency earnings mean a decreased ability to import food, medicine, and technology. In the face of these declines, Yeltsin has claimed for Russia exclusive control of its oil and natural gas, as well as its gold, diamonds, and other natural resources.

Many joint ventures exist or are in the works with Western oil companies. They have been won by competitive bidding by the foreign companies for exploration and development projects, most frequently negotiated with the local or republic governments, not the center. These joint ventures infuse the industry with technology, capital, and efficiency.

Natural gas production has been soaring over the long and short term. Production in 1970 was 197 billion cubic meters (bcm). In 1979 the figure had more than doubled to 406 bcm. In 1985, production was at 642 bcm, in 1989, 796 bcm, and by 1990 it had doubled its 1979 level, at 828 bcm (see Table VII.5).

Table VII.5 -- Regional Production of Natural Gas, 1983-88
(millions of cubic meters per day)

	1983	1984	1985	1986	1987	1988
Total	1,468	1,605	1,762	1,880	1,993	2,104
Russia	943	1,078	1,219	1,327	1,449	1,566
North						
Caucasus	30	27	27	27	25	23
West Siberia & Far East	733	874	1,019	1,130	1,238	1,359
Urals-Volga & other Russian Republic regions	180	177	173	170	186	184
Central Asia, Turkmenistan & Kazakhstan	308	317	338	355	369	375
Ukrainian SSR	130	122	117	109	97	89
Komi ASSR	49	49	50	52	44	40
Azerbaijan SSR	38	39	38	37	34	34

Source: Pollard, Alan P., ed., USSR Fact and Figures, Vol. 15. Gulf Breeze, Florida: Academic International Press, 1991, pg. 228.

The FSU possesses 38 percent of the global reserves of natural gas, with 59 percent in Siberia (of Russia), 21 percent in European regions, and 19 percent in Central Asia. Export of natural gas provides one-third the hard currency of oil, a proportion that is rapidly rising. Natural gas may provide much of the energy growth for the 1990s. However, the growth is dependent upon massive infrastructure improvements in pipelines, plants, and conversion from oil to natural gas engines.

Gold is valuable to the economic transition of the FSU in two ways. First, gold is wealth. As wealth, it can be used as collateral in obtaining foreign loans, or it can be used to purchase necessary imports. Second, gold can be used to back a newly created currency. Gold-backing lends legitimacy and credibility to

a currency, as its bearers can be assured of its worth. Foreign loans and legitimate currency are two elements necessary for successful economic transition. Questions exist about who owns the gold, and how much gold remains in the FSU. Yeltsin's announcement that the Russian Republic was seizing the assets of the FSU within the republic threatens the claim of other republics to the gold.

Russia produced 67 percent of the FSU's gold, while Uzbekistan produced 25 percent. Gold exports made up three-quarters of the Soviet Union's non-petroleum exports, averaging \$3.5 billion to \$4 billion per year from 1986 to 1990.

The true amount of gold reserves came under widespread suspicion in the second half of 1991. Estimates varied from 370 metric tons to 240 metric tons, far below the 800 to 3,000 metric tons analysts had estimated for years. Accurate figures were not available because no one knew how much had been sold to purchase imports, and how much had been smuggled abroad. *Izvestia* reported that over five metric tons had been removed illegally between October 1 and November 15 alone. In addition, the Russian republic may have under-reported figures to reduce the demands of the other republics, and to emphasize the need for aid.

The potential for increased gold production in the republics comes from two sources. First, the use of modern technology and new equipment from the West can improve the gold industry's mining and processing sectors. Second, production will increase by encouraging the efforts of the entrepreneurial, gold-prospecting cooperatives known as "artels." Artels were the most dynamic sector of the Soviet gold industry, by 1990 accounting for one-third of all production and almost all annual increases in production.

Artels mine the same amount of gold three to four times as cheaply as state enterprises, with much better use and maintenance of equipment and far higher labor productivity.⁹⁰ Artels were accused of crimes and corruption, but they are another indication

⁹⁰ Levine, Richard M., "Glasnost, Perestroika, and Soviet Gold," *Minerals Today*, March 1990, pp. 8-12.

of the economic potential of the republics when state-run industries give way to private enterprises.

The Russian republic dominates production of strategic metals and minerals. The primary exceptions was Kazakhstan's production of 30 percent of the FSU's copper, 40 percent of its zinc, 60 percent of its lead, and 95 percent of its chromium; and Ukraine, which produced 75 percent of Soviet manganese. Most of the other precious and strategic metals and minerals are found in the Russian Far East, land and resources Yeltsin claimed from the central government for the republic, and which now is strictly Russian. Active mines yield iron, nickel, tin, zinc, copper, coal, platinum, and diamonds, and many other metals and minerals. The primary advantage of natural resource production is that it is directly exportable for hard currency, which is needed to buy many necessary imports, but which is in shorter supply as oil exports decline.

Natural resources are attractive to foreign direct investment because they can be exported directly for hard currency earnings. They entice foreign companies to bring to the republics their much-needed technology, capital, jobs, and other expertise. Asian-Pacific (primarily Japanese and South Korean) governments are helping companies in their nations get involved in these opportunities, especially in the resource-rich Russian Far East. U.S. companies, on the other hand, have participated to a far lesser extent because of the obstacles of U.S. regulations and bureaucracy, and because the recession has made funds for expansion scarce.

The newly independent republics will benefit from participation in world trade and monetary institutions. The Soviet Union was granted associate-member status in the International Monetary Fund before it fully disintegrated. For full participation, the new governments will be subject to the economic adjustment requirements the IMF and World Bank impose on other reforming economies. Several republics, including Russia and Ukraine, have applied for full membership and the financial support of the IMF and World Bank.

Creation of a credible, legitimate, and exchangeable currency will be required for increased international trade. Non-extractive, consumer and service companies cannot repatriate profit in non-convertible money, and so must either serve only hard currency-bearing customers or negotiate complicated trade packages. Foreign companies will be more willing to invest in republics with a stable, convertible currency. The integrity of foreign domestic investment and contract sanctity also must be guaranteed in law and upheld by the courts to attract more international businesses.

The proper utilization of exportable natural resources will maximize their hard currency earning capacity. Oil and natural gas exports to the energy-poor economies of Eastern and Western Europe can be extremely profitable. The export of strategic metals and minerals can also boost trade receipts. Improving agricultural production can minimize food import expenditures.

The United States must exercise leadership in encouraging the right actions in the Republics. It must politically support the active, peace and stability minded reformers over those who desire to hold back economic and political progress. It must advise and support the efforts to reform the economic and political structures. It must facilitate the monetary stabilization, price liberalization, and property privatization efforts. It must aid the konversiya process through technical and funding assistance. It must diffuse potential for massive unrest with emergency food aid as necessary, and work closely with the new governments to facilitate the implementation of reforms.

Political and economic encouragement by Western countries for the republics to go forward with the difficult but required decisions can ease the transition. Concessions regarding participation in world financial and trade institutions must be dependent on the real steps taken toward progressive reform. It must facilitate foreign investment to infuse technology, capital, and efficiency in the new economies. Finally, the United States must provide global leadership by encouraging other nations to aid the FSU in manners similar to these.

VIII. NATIONAL SECURITY AND THE SHRINKING DEFENSE BUDGET

During the past year the Warsaw Pact, Cold War, and Soviet Union became obsolete. World events ended the threat of a Soviet-led global war, one that likely would have involved nuclear weapons, as freedom swept centralized governments in the East from power. However, America's overseas strategic interests remain widespread and conflicts with potential adversaries may be intensified by the spread of high technology weapons and the proliferation of nuclear and ballistic missile technology.

The Democrat Congress and the Republican Administration agree that the defense budget can be reduced, but disagree on the magnitude and priorities for cutting programs. Regardless of which programs or units are reduced, it is clear that available funds will have to be allocated in a manner that reflects the post-Cold War environment.

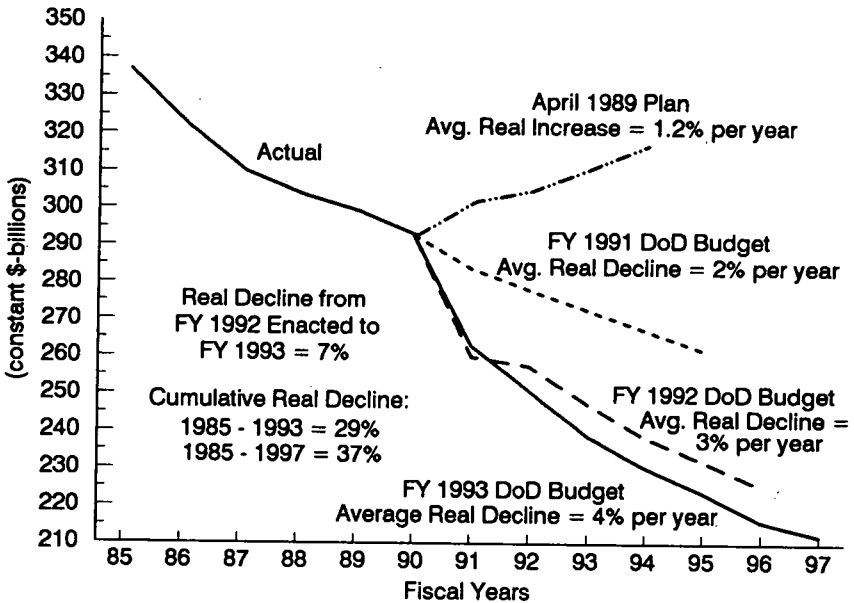
THE DEFENSE BUDGET AND THE ECONOMY

As the Cold War fades into memory, virtually any measure shows that the Defense Department's burden on the American economy is at one of its lowest points this century. As the defense budget declines rapidly over the next six years, so too will its share of gross domestic product and Federal outlays.

Graph VIII.1 displays the reductions in defense spending that have been incorporated by Secretary of Defense Richard Cheney into long-range Department of Defense (DoD) budget plans. Five-year budget plans prepared by the Administration have recognized the reduction in the Soviet threat by projecting defense

budgets that incorporate real spending decreases. In the current budget, the President has requested \$50 billion less over five years than what would have been allowed under the Budget Enforcement Act of 1990.

Graph VIII.1 -- DoD Budget Authority
(excluding Desert Shield/Desert Storm costs)

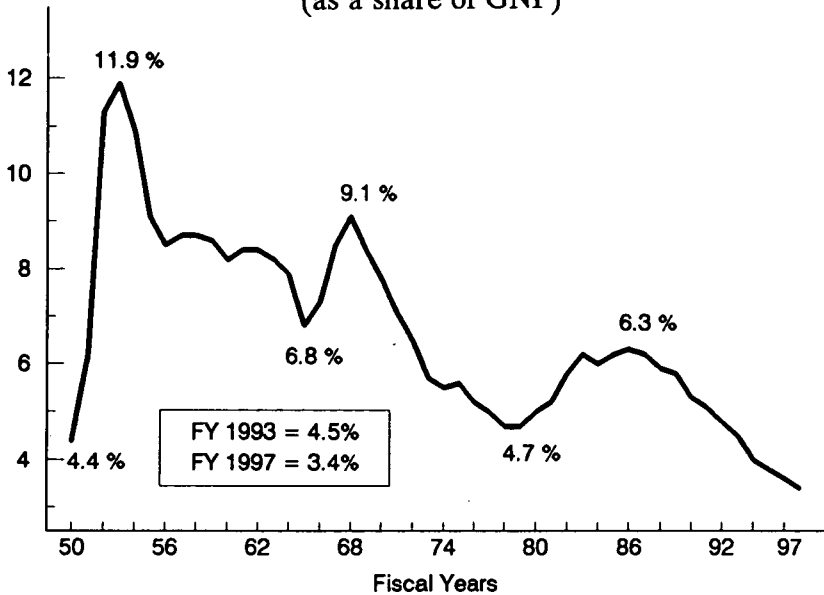


Source: Statement of Secretary of Defense Richard Cheney before the U.S. Senate Armed Services Committee, January 31, 1992.

Graph VIII.2 displays the trend in defense expenditures as a share of GNP. If Congress approves the President's 1993 defense budget request, defense spending, measured by DoD outlays, will account for 4.5 percent of GNP. This share is about what the nation devoted to defense in 1950, near the beginning of the Cold War. According to the President's five-year budget plan, the share of defense spending will drop to 3.4 percent of GNP by 1997, the smallest portion since before the United States was drawn into World War II. Congressional proposals for additional reductions in defense spending would likely result in 3 percent of GNP being

devoted to national security by 1997. At this level of spending, the United States would still devote slightly more of its economy to defense than any other industrialized country, but this amount of spending may be the minimum amount necessary to protect overseas interests and maintain global military superpower status.

Graph VIII.2 -- Defense Outlays
(as a share of GNP)

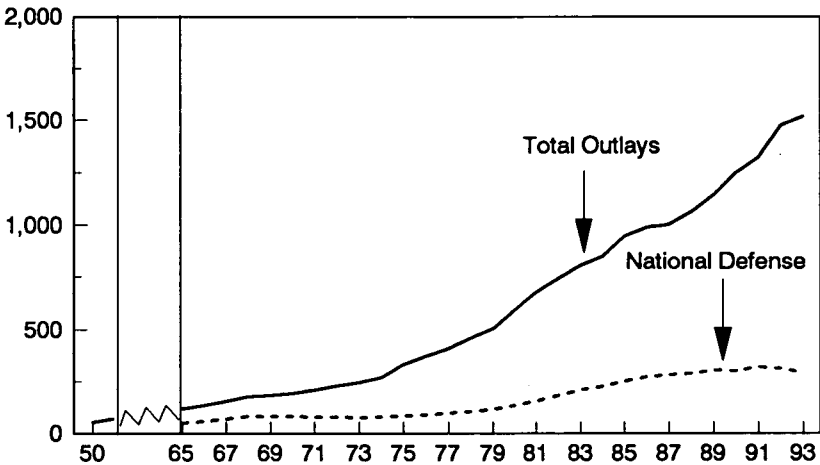


Source; Statement of Secretary of Defense Richard Cheney before the U.S. Armed Services Committee, January 31, 1992.

Many critics of defense spending contend that the defense budget is the primary cause of the large Federal deficit. Graph VIII.3 displays the share of defense outlays as a share of total Federal outlays. It is clear from the graph that defense comprises too small a share of Federal spending to be the primary problem. At the height of the 1980's defense build-up, defense represented 27 percent of total Federal outlays, the same as in 1950. In the President's budget, defense spending represents only 18 percent of

total outlays and falls to just over 16 percent in 1997. More important, as the deficit has grown, defense spending has declined. In FY 1992, the deficit will exceed the defense budget.

Graph VIII.3 -- Defense Outlays
(as a share of Federal outlays in \$-billions)



Source: Budget of the United States, Fiscal Year 1993, OMB and Budget of the United States, Fiscal Year 1993, Supplement, February 1992, OMB

*FY 91 through 93 figures are estimates

Defense Cuts Must Not Recreate the Hollow Army of the 1970s

Theoretically, measures of defense spending as a share of GNP or total Federal spending should not determine how much to spend on defense. Rather, the approach should be to evaluate our national security needs, measure how much it costs to fulfill those needs, and then fund as much of that amount as is affordable.

Now, however, the end of the Cold War has taken away much of the basis for determining what is needed for defense. It was easy to calculate what DoD needed during the Cold War because the Soviets were a well-structured threat. We knew that if they produced 5,000 new generation tanks for Warsaw Pact forces

in Europe, then we needed an appropriate number of armored divisions with M-1A1 tanks to meet our commitment to the North Atlantic Treaty Organization. Without the Soviet threat, we must develop a range of crisis response capabilities to protect American interests. Global arms sales appear to have increased with much Warsaw Pact equipment being sold to the Middle East and China, but the intentions are unclear. The uncertainty in the threat has created uncertainty in what is needed for defense. Consequently, the share of defense spending in GNP has become a primary criterion for deciding what the country should spend on defense.

For much of the past two years, Congress has discussed down-sizing DoD by shrinking defense spending. Many analysts have discussed reducing the number of Navy carrier battle groups, the number of Army divisions, or the number of Air Force tactical fighter wings. Others have discussed cutbacks in reserve versus active duty personnel. These approaches reflect the incremental changes in defense budgets of the Cold War era, and would shrink Cold War institutions rather than reorganize defense resources to address the regional threats of the post-Cold War environment.

Defense Secretary Richard Cheney, General Colin Powell (Chairman of the Joint Chief of Staff), and Republican Members of this Committee have argued the end of the Soviet Union and Warsaw Pact means that the Defense Department must "right-size," rather than down-size. Toward this end, Secretary Cheney and General Powell constructed the Base Force concept, which provides the President with multiple options for responding to regional contingencies.

The concept of right-sizing DoD incorporates questions about strategy, basing, force structures, organizations, roles and missions. Rather than asking what components of our Cold War military organization we still need, the right-sizing concept asks what strategies will we need and how do we cost-effectively implement those strategies. Rather than shrinking existing bureaucratic institutions, which are rapidly becoming antiquated remnants of the Cold War, the Administration has identified new

force concepts and organizations that are necessary for today's uncertain international security environment.

The basic principles of the right-sizing concept derive from cost-effective use of resources in a fluid operating environment, where major threats may demand response and then dissipate within an eight-month time frame. Several key principles are:

- **Unity of Command:** the Goldwater-Nichols management concept that uses streamlined command structure for defining a course of action and decentralized execution.
- **Jointness:** the multi-service concept for conducting post-Cold War Defense Department activity. This reflects the notion that each military service may come to play, but all services play together when the ball game starts; no matter if the ball game is acquisition, providing humanitarian assistance, or fighting against Saddam Hussein.
- **Reduce the ratio of support personnel to combatants:** the concept of retaining the heart of our ability to fight by reducing non-combat positions.
- **Invest in cost-reduction:** the concept of reducing operating costs by the use of modern technology and smart management.
- **Maintain readiness while rearranging into a smaller force structure.**
- **Reduce spending on weapons meant to be used against the Soviets in Western Europe, but maintain sufficient procurement spending to ensure that troops have weapons and support equipment well into the 21st Century.**
- **Maintain options to enable the President to respond to crises.**

Applying these principles to decisions on defense budget will avoid a return to the hollow army of the 1970s.

IMPLICATIONS OF THE PERSIAN GULF WAR

Saddam Hussein awakened America to the non-Soviet threats to our interests. Having used oil profits and aid from other countries to create an extensive military capability, he invaded Kuwait and attempted to impose his will upon Persian Gulf oil producers. Under a multi-national coalition, led by American military and diplomatic capabilities, Iraqi troops were expelled from Kuwait. Saddam was beaten by one of the most successful military operations of all time with all of the United Nations Security Council objectives achieved in a stunningly quick fashion.

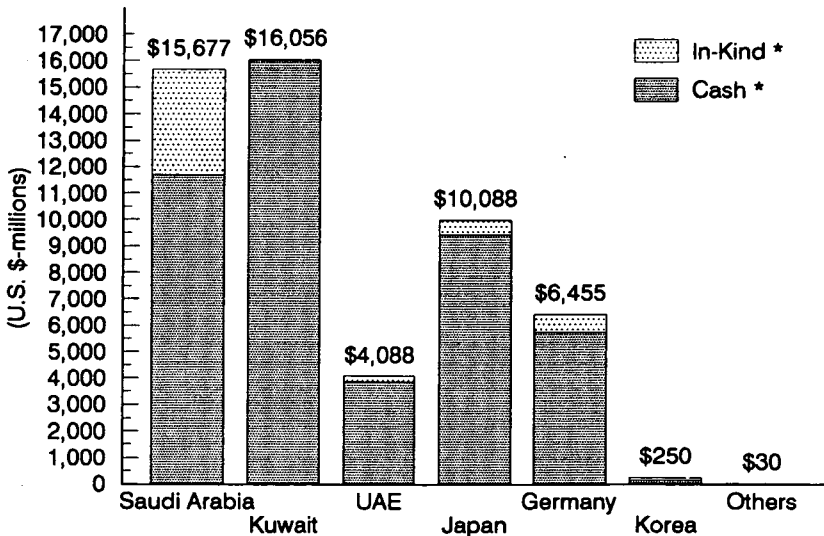
Although no two wars are alike, the Persian Gulf War provided many lessons for U.S. decisionmakers. Regarding international security policy, much can be learned about the dangers of proliferation, the ineffectiveness of embargoes to change the policies of dictators, and the role of the United States in working with other countries to confront threats against mutual interests. Regarding defense management, we saw the success of the Goldwater-Nichols reforms, air power, and 1980's investments balanced across the Four Pillars of Military Capability: force structure, modernization, sustainment and readiness.⁹¹

The Persian Gulf War had dramatic implications for post-Cold War interactions among nations. Thirty-seven nations participated in the multinational coalition. A series of U.N.

⁹¹ Force structure refers to the composition of fighting units, including numbers of people and equipment. Modernization refers to the level of technology of the equipment. Sustainment refers to the ability to support forces throughout a conflict. Readiness refers to the condition of the equipment, troops, and units.

Security Council Resolutions determined the applications of military force and defined the military objectives for Operations Desert Shield, Desert Storm, and Provide Comfort. In a dramatic departure from the Cold War years, the Soviet Union supported the U.N. Security Council actions and attempted to convince Saddam to accept the terms of the resolutions. The fact that the coalition included American, Arab, western, and eastern countries was also a significant departure from the Cold War years. Japan and Germany committed to reimburse the United States for expenses even though they did not send troops. To date, more than seven countries have contributed nearly \$53 billion of the estimated \$60 billion needed to defray some of the U.S. costs (see Graph VIII.4). The multi-lateral support for ousting Saddam's troops from Kuwait clearly demonstrated that nations from all around the globe can join together in defense of their common interests, even when the threat is not the Soviet Union or the spread of communism.

Graph VIII.4 -- Operation Desert Shield/Desert Storm
(foreign government contributions to offset U.S. costs)



* Cash received as of February 6, 1992; In-Kind as of December 31, 1991.

Source: "Operations Desert Shield/Desert Storm: Foreign Contributors Responsibility Sharing," U.S. Department of Defense, Office of the Comptroller, January 1992.

A key lesson that should not be forgotten is the risk of the spread of high technology weapons to U.S. overseas interests. Even with its heavy losses in war with Iran, Iraq amassed the fourth largest military in the world. Saddam had accumulated about 5,000 tanks (of which about a third were high quality T-72s), about 5,000 armored personnel carriers, about 700 combat aircraft, a modern air defense network, and about 2,000 large guns and missile systems. In addition, he had an extensive command and control system, weapons of mass destruction, hardened bunkers, and a battle-trained million man army. We now know that Saddam was much closer to building a nuclear bomb than intelligence agencies had estimated. The inspection activity initiated under the Cease Fire Agreement has uncovered a large sophisticated nuclear weapons program. Iraq's use of SCUD B missiles and such terrorist acts as the oil spill indicate that Third World dictators are willing to make strategic use of whatever weapons they have at their disposal.

Given Saddam's vast military capability relative to the other Moslem countries of the region, his hegemonous desires over the Middle East could have been realized had America and the other coalition partners not ejected him from Kuwait and destroyed the majority of his military equipment. With the potential growth in high technology arms sales and the proliferation of weapons of mass destruction, American forces could find themselves in another major military confrontation with Saddam Hussein or another aggressor.

A FRAMEWORK FOR ANALYZING DEFENSE NEEDS

As we redefine defense needs in the post-Cold War era, we must discern our national security interests, threats to those interests, and a cost-effective strategy for protecting those interests. In the 1990s, the United States will have to deal with such potential threats in the face of declining defense budgets, demanding continuous improvement in the use of defense resources. The collapse of communism and the Soviet Union has changed the Cold War's bi-polar structure of two opposing superpowers to a system

of one complete superpower and several regional economic powers. International relations theory suggests that bi-polarity is more stable than a multi-polar world. The post-Cold War shift away from a bi-polar order has important implications for U.S. strategic interests.

Throughout the Cold War, large nuclear arsenals defined superpower status. Now, the definition of world power has shifted to an economic focus. The global economy may become increasingly hostile among major trading blocks. The international economy has evolved into regional trade blocs, which could pit Japan and the Pacific Rim nations, the European Community, the U.S.-led North American Free Trade Agreement, and China's one-fifth of the global population against each other. The new economic system also must deal with the former Soviet Union, which must undergo economic revival to prevent chaos and the potential return of authoritarian rule. The United States devoted billions of dollars to protecting political interests in Europe, Japan, and around the world. Now, the United States can focus more money and effort to defending its economic interests.

The increased strategic importance of economics should not obscure the fact that territorial, political, and cultural strategic interests remain. Territorial interests are primary in any state. To be sure, the likelihood of nuclear or other attack from former Cold War adversaries is dramatically reduced. However, we are concerned about the proliferation of ballistic missile technology and weapons of mass destruction to an increased number of parties with suspect intentions. U.S. strategic interests also include maintaining the security of trade routes through the Persian Gulf, South East Asia and elsewhere. The advancement of democratic, market-oriented, and non-hostile countries continues to be in the strategic interest of the United States.

Although the end of the bi-polar antagonisms between East and West sharply reduces the degree of superpower-sponsored regional conflict, instability in several regions continues to generate threats to U.S. strategic interests.

- The breakup of the Soviet Union creates the potential of serious regional conflict as the former

superpower's land, resources, and armed forces are divided. Stability in the countries of the former Eastern bloc and other client-states will remain tenuous as their economies continue in disarray, and as potential ethnic fighting persists.

- Instability in the Middle East remains a threat to the economic interests of the United States and allies. Syria, Iraq, Iran and other potentially hostile nations possess, or are trying to obtain, nuclear weapons and ballistic missile technology.
- Chinese and North Korean military efforts are also disconcerting; in particular, the sale by China of certain weapons to countries in strategic and potentially unstable regions, and the possible development of nuclear weapons in North Korea.
- The drug trade continues to threaten not only the countries of Latin America and other drug producing regions, but also to exacerbate economic, social, and health problems in the United States.

A large part of America's success in winning the Cold War must be attributed to the proper definition of a national security strategy and the allocation of sufficient resources to implement that strategy. As the world enters the post-Cold War era, there is much uncertainty and instability, and the Cold War defense spending levels cannot be maintained for political and fiscal reasons. There remains a need to protect our national security interests through a cost-effective allocation of resources.

The President introduced a new National Security Strategy on August 2, 1990. The President, Secretary Cheney, and General Powell recognize reduced likelihood of a Soviet-led conflict throughout Europe and a global war, and have defined a new national military strategy that shifts the defense planning focus to regional threats and related requirements. Consequently, Secretary Cheney and General Powell constructed the base force concept in

order to address the range of possible conflicts in the post-Cold War era.⁹² The base force concept, an emphasis on joint military operations, four "Force Packages" (Strategic Forces, Pacific Forces, Atlantic Forces, and Contingency Forces), and four "Basic Military Supporting Capabilities" (Space, Transportation, Reconstitution, and Research & Development).⁹³ The Strategic Forces, supported by the four supporting capabilities, provide strategic deterrence and defense. The Atlantic and Pacific Forces provide forward presence. Together with the contingency forces and the four supporting capabilities, the Atlantic and Pacific Forces provide the President with a broad range of options for responding to crises.

The Base Force concept was a result of events that occurred in 1990. It may now be unaffordable, since the defense budget is considered by many who oppose deficit reduction to be a source of funds for a wide range of domestic programs. Moreover, international and domestic circumstances argue for re-evaluating the National Security Strategy and the National Military Strategy. In addition, the clash between declining defense budgets coupled with cost growth of 5 to 6 percent per year imply that there is not enough money in the defense budget to sustain 1.6 million troops. If cost and budget trends continue, there will not be enough money to maintain the country's military capital stock and the return to a Hollow Army will be inevitable.

THE ECONOMIC CONSEQUENCES OF DEFENSE CUTBACKS

America's ability to defend its interests is a direct result of its fighting capability and the ability of the defense industrial base to reconstitute that capability during a period of conflict. Moreover, American military strategy relies on weapons that are technically superior to those of our adversaries. It is the American

⁹² Joint Chiefs of Staff, U.S. Department of Defense, National Military Strategy, 1992, pg. 6.

⁹³ *Ibid.*, pg. 17.

defense industry that is the source of our military's technological superiority and ability to reconstitute during conflict. As the defense budget declines, the American defense industrial base will shrink, perhaps below its 1980 size. There will be some form of a defense industrial base that remains as we move towards the 21st century, but it may become so limited in production capacity and so specialized that it cannot meet the surge requirements of a future military conflict. A key issue facing Congress in the 1990s is how to retain essential national defense technology and industrial capabilities.

There is much concern about the future of the U.S. defense industry, since fewer assembly lines and plants will be needed. Under the New Approach to Defense Acquisition, DoD may end-up with lots of *new* weapons designs that cannot be produced because of *outdated* production equipment. Reconstituting the defense industrial base will require training perhaps hundreds of thousands of engineers and manufacturing employees. In addition, plants may have to be built or reconditioned, and equipment and production processes will need to be obtained. This takes time, limiting America's ability to respond to threats that may require a prolonged battle, also referred to as "response time," and consequently reduces our ability to deter militarily strong aggressors.

The Army has recently released its plan for maintaining a viable industrial base. The other military departments ought to follow suit. But, it is not clear whether actual funding of research, development, and acquisition programs will support these plans.

The investments envisioned in legislation proposed by Democrats in Congress may not achieve anything of significance. In fact, they may do more harm than good. They take money away from specific weapons that are needed now, and the funds provided by these bills can be diverted to pork barrel projects. By taking money away from weapons programs such as Strategic Defense, these bills may in fact be less cost effective than funding items that address specific DoD requirements and have commercial utility.

According to the Defense Department, about two-thirds of defense final purchases goes to manufacturing, about a quarter goes to service firms, and about a tenth goes to construction, agriculture and mining firms. For indirect defense purchases (i.e., items bought by firms that support the Defense Department), slightly less than half goes to manufacturing, less than half goes to service firms, and a little more than a tenth goes to construction, agriculture and mining firms. As the 1990's defense spending shifts away from procurement, manufacturing will bear the largest relative impact. As Table VIII.1 illustrates, the largest impacts will occur in the radio, television and communications equipment industry and in industries that primarily manufacture defense equipment.

**Table VIII.1 -- Changes in Defense Spending 1991-97
Production Cuts for Top Five Defense
Manufacturing Sectors**

Radio and TV Communications Equipment	-18.0%
Aircraft	-11.6
Guided Missiles	-22.3
Aircraft Parts and Equipment	-22.8
Shipbuilding and Repairing	-37.2

Source: Assistant Secretary of Defense for Production and Logistics, Projected Defense Purchases Detail by Industry and State, October 1991, pg. 13.

Economic theory suggests that natural market adjustments to the defense budget cycle will yield the most cost-effective solution that responds to DoD needs. This free market approach assumes that DoD is one buyer among many, rather than the sole purchaser. It should work well to the extent that DoD can utilize commercial items, but for many items, Congress and the Administration must consider the loss of unique defense industry capability and investment in new systems. Production lines may be kept warm at very inefficient production rates, driving unit costs very high. DoD will also need to identify and stockpile critical items that are subject to risky foreign dependency. Congress will have to determine which industries are vital to defense needs and

how best to protect them. DoD must identify specific long-term industrial base requirements that coincide with its Future Years Defense Plan. Congress should then evaluate alternatives, such as tax credits and more effective use of Federal R&D spending.

Some proponents of additional defense cuts ignore the employment effects that would be created by those cuts. Defense Department estimates show that the largest reductions will occur among business professionals, who may have skills that are most easily transferred to the private sector (see Table VIII.2). However, other reductions affect skilled workers who may require training in order to transfer to the private sector, and whose skills could be removed permanently from the defense industrial base.

Table VIII.2 -- Reductions in the Top Five Defense Occupations

Business Professionals	-25.5%
Craft Workers	-25.4
Operatives	-31.6
Service Workers	-19.7
Engineers	-30.0
Total for All Occupations (from 4.3 to 3.2 million)	-25.6

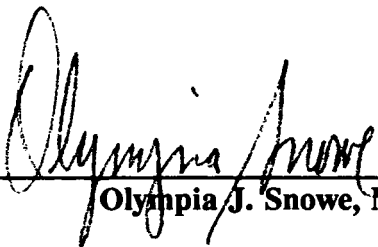
Source: Assistant Secretary of Defense for Production and Logistics, Projected Defense Purchases Detail by Industry and State, October 1991, pg. 14.

Norman Augustine, the Chairman and Chief Executive Officer of the Martin Marietta Corporation, testified before Congress in February that about 50 jobs are initially lost for each \$1 million cut in defense spending. By his estimates, total losses could be 1.5 million jobs in the first half of the 1990s. The President's defense budget request includes a significant reduction in military and civilian employees, totaling nearly 800,000 over a 10-year period. In addition, DoD estimates reductions in defense contracts will result in another 500,000 to one million job losses.

We feel compassion for anyone put out of work by events beyond their control. However, national defense should not be a jobs program, and it must necessarily respond to changes in national security. We must focus now on the economic needs of the country and put to productive use those resources that have been devoted to national defense in the Cold War if those put out of work by defense cuts are to have jobs in the private sector. Unemployment is lower than the national average in six of the top 10 defense-dependent states, where defense cutbacks will likely be most significant. More important, however, is the fact that job growth equals or exceeds the national average in five of the top 10 states.

At issue is weaning defense-dependent communities and workers from government spending programs. Congress should apply effective, innovative approaches to address the economic impact on the communities and families affected by defense budget cuts. The key need is the transition of affected communities and workers into the civilian economy after decades of dependence on the defense budget. The ability to absorb these new entrants into the private sector and non-defense related labor forces heightens the already pressing need for immediate enactment by Congress of a pro-growth economic agenda.

ADDITIONAL VIEWS



Olympia J. Snowe, M.C.

ADDITIONAL VIEWS OF

OLYMPIA J. SNOWE, M.C.

As I have in recent years, I am signing the Joint Economic Committee's (JEC) 1992 Republican Views while filing Additional Views in order to address my concerns about several issues in this year's Views. I support many of the policies and recommendations outlined in the 1992 JEC's Republican Views, however, I would like to offer some comments on those sections in the Views addressing certain economic issues and international trade issues where I differ, to some extent, from the View's positions.

I would like to first offer my comments on Chapter VII, which is devoted to international trade and relations issues. As in past years, the 1992 Republican Views warn repeatedly that a protectionist posture by the United States will result in declining export prospects for American businesses, and thus poor overall economic performance.

I share my colleagues' appreciation for the numerous benefits of free international trade, and their wariness of reactionary protectionism. But I am concerned that in its zeal to eliminate protectionism, this year's Views has largely overlooked legitimate instances in which the United States must respond to anti-competitive trade practices by other countries.

This year's Republican Views state that "we have the power to enforce fair play," and express the hope that in the future "we have the wisdom as a nation to lead and negotiate a system that will ensure market-based international trade for all nations." I couldn't agree more, and I would emphasize that this market-based trading system must include a mechanism which readily identifies and redresses questionable practices by our trading partners -- practices outside an acceptable definition of the market.

I speak specifically of policies such as those in some Canadian provinces where large volumes of timber from public land is sold to commercial ventures below market prices, lowering the price of Canadian softwood lumber imports, and placing producers in the United States, who do not enjoy such government sponsorship, at a serious disadvantage.

I also speak of Norway's salmon farming subsidies which result in overproduction, and subsequently in an attempt by the government of Norway to dump the undervalued surplus product in the United States, where our producers live or die by the market.

And, I speak of abhorrent Chinese labor practices that are condemnable on human rights grounds, in addition to the dilatory impact they have on the American textile industry.

In cases such as these, I am hopeful that the 1992 Republican Views would agree that we cannot merely stand by and watch as our producers are undercut by consortia of foreign governments and their domestic business interests. Action must be taken to police these kinds of market distortions. And whether the agent is bilateral or multilateral, the rules must be enforced.

Effective policing does not constitute protectionism. On the contrary, it enhances free trade by ensuring a stable and fair set of rules. The Republican Views embrace this concept in its advocacy of better GATT surveillance of member trade policies, and in call for the inclusion of safeguards in agreements with Canada and Mexico.

I only wish to highlight these recommendations in the Views and their underlying rationale. Open international trade offers many benefits for the United States as well as for our trading partners, but those benefits are efficiently distributed only when all parties observe the principles of openness.

Although the 1992 JEC Republican Views express strong support for the 1981 Kemp-Roth tax cut legislation, as well as comment on the 1986 Tax Reform Act, I would simply observe that there can be no question that the 102nd Congress must continue to

closely monitor the implementation of the many phased-in provisions of these two omnibus tax bills, paying close attention to how they impact on low-income and moderate-income taxpayers.

In Chapter III, the Republican Views comment on some proposals to permanently cut the social security payroll tax as a first option, with a temporary reduction as the fall-back position. While there has been a great deal of debate about such a proposal in recent years, I remain very concerned about any effort that would result in the social security program returning to a pay-as-you-go system.

For example, if the social security system were returned to a pay-as-you-go system it could place this vital program at risk. A sudden shift in the economy might require that these reserves be used. As such, returning the social security program to a pay-as-you-go system is not a prudent step for both the short-term and long-term solvency of the social security trust funds.

In Chapter IV, the Views endorse several recommendations from the Bush Administration designed to reduce entitlement spending. While I share the View's concern for the magnitude of the Federal budget deficit, and the increase in entitlement spending in recent years, I remain very concerned about proposals that would reduce benefits for social security or Medicare program beneficiaries.

Also, Chapter IV comments on the acid rain issue. While I understand the concern expressed in this year's Views with the economic impact of regulation, I question some of the examples used by the Views to support its contentions on this issue.

Of primary concern to me is the Republican View's reliance on the National Acid Precipitation Assessment Program (NAPAP) to bolster its claim that acid rain controls in the Clean Air Act of 1990 will cost billions of dollars but achieve no significant results. What it fails to mention, however, is the considerable controversy surrounding NAPAP's methodology and findings. Despite its length

and price tag, NAPAP has been roundly criticized for a narrow scope and missed opportunities.

Substantial research into this issue actually indicates that over the long term, acid precipitation can, among other things, alter the composition of forest soils to the extent that tree growth declines. One only need look at the example of Germany for evidence of relentless acid precipitation's troubling consequences. There, thousands of acres of forest with the potential for billions of dollars in forest products are declining in biological productivity. In a state like Maine, where forests are both culturally and economically important, such threats to productivity do not go casually overlooked.

But forest degradation is not the only negative effect. Even NAPAP stated that acid precipitation was the main cause or a primary contributor to acidified lakes in the Adirondacks, the Upper Peninsula of Michigan, and southern New England. The processes which create acid rain can also affect the health of sensitive individuals such as asthmatics, reduce visibility, and corrode certain construction materials and culturally important monuments.

Viewed over the long term, the new Clean Air Act will, if properly implemented, pay important environmental and economic dividends.

