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THE ECONOMIC OUTLOOK AT MIDYEAR

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

ONE HUNDRED SECOND CONGRESS

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THE ECONOMIC OUTLOOK AT MIDYEAR

TUESDAY, JULY 23, 1991

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

The Committee met, pursuant to notice, at 10:00 a.m., in room SD–628, Dirksen Senate Office Building, Honorable Paul S. Sarbanes (chairman of the Committee) presiding.

Present: Senators Sarbanes, Kennedy, and Smith; and Representatives Hamilton, Solarz, Mfume, and Armey.

Also present: Stephen Quick, Executive Director; William Buechner; Chad Stone; Doug Koopman; Susan Lepper; and Rick McGahey; professional staff members.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

SENATOR SARBANES. The Committee will come to order.

This morning, the Joint Economic Committee begins its review of the economic and budget outlook at midyear. For much of the past year, the economy has been experiencing a significant recession. While there are now some signs of recovery, both the strength and the permanence of the recovery remain very much in doubt. It is for these, and other questions, that we are very pleased to have as our witnesses this morning the Chairman of the President's Council of Economic Advisers, Michael Boskin—Michael, nice to have you here—and his colleague on the Council, Dr. John Taylor.

I think there is a vacancy on the Council at the moment; is that correct?

DR. BOSKIN. That is correct.

SENATOR SARBANES. When is it going to be filled?

DR. BOSKIN. Someone will be arriving to undertake some of the duties of Dr. Schmalensee in the first week of August. That nomination will be coming up in the Senate sometime in the next few weeks.

SENATOR SARBANES. Do we know who it is going to be?

DR. BOSKIN. Yes, Dr. David Bradford.

SENATOR SARBANES. Today's hearing will focus on two issues: the severity of the recession and the prospects for recovery.

In the Mid-Session Review of the Budget, the Administration characterized this recession as "short and shallow," a term which might suggest that the recession is not a very serious matter and that the problems of those who have been hurt by it do not need to be addressed.

I am very frank to say to you that I have rebelled against the Administration's use of this phrase, "short and shallow," which you have applied to the recession, from the very outset. I think it seriously misrepresents the severity of this recession and hampers our ability to develop responsible and compassionate policies for dealing with the human and social consequences, which the recession has brought to families and communities all across the country.

We have a chart that compares this recession with the average of previous recessions (see chart on following page). This is the Nonfarm Payroll Employment, the percent change from the peak. It shows that this recession has roughly tracked the average of the five previous recessions. I have a great deal of difficulty, given this chart, in understanding the Administration's insistence on characterizing it as short and shallow, and I hope you will address that.

I gather that part of the case for claiming it is short and shallow rests on the fact that the unemployment rate has not risen above 7 percent. Three features of the current recession, however, make the unemployment rate—in my judgement—a poor indicator of economic hardship and a very poor guide for the need for policies to address this hardship.

First, the labor force has grown only half as much as normal during this recession, in terms of the predictions, and that has artificially depressed the unemployment rate. Apparently, a lot of people have not come into the labor force because job prospects have been so poor. Earlier this month, Commissioner Norwood of the Bureau of Labor Statistics testified that the unemployment rate, if we had normal labor force growth during the past year, would be at 7.5 percent.

Second, the decline in the number of jobs during this recession has been just as severe as in the average of previous post-war recessions. Since last July, payroll employment has fallen by almost 1.5 million, which is in line with the post-war average. That is what is indicated by this chart in terms of the drop in payroll employment.

Third, there is a lot of hardship that doesn't show up in the official unemployment rate. A broader measure of unemployment, which includes discouraged workers—people who have become so discouraged about their job prospects that they have given up looking—and people who are working part-time because they can't find full-time jobs, reached 10 percent in the second quarter of 1991—10 percent. That is a comparison of what we call the official rate versus the comprehensive rate. I think, under current circumstances, the comprehensive rate may be a better indicator of the kind of suffering that exists out there.

All of these figures point to the reality that the current recession is taking a heavy toll on the jobs and incomes of American workers. Yet, despite this hardship, the programs we have designed to help provide support in hard times simply are not doing their jobs.

More than 2.3 million workers have exhausted their regular unemployment benefits over the past 12 months without finding a new job, and another 1.4 million are within a few weeks of running out of benefits. In past recessions, the number of long-term unemployed has continued to rise for several months after the official trough of the recession. If this pattern holds—and there is every reason to assume it will—then the number of long-term unemployed will continue to rise in the months ahead, even if the economy has turned the corner from recession to recovery.

If you disagree with that, I would be very much interested if you would expound on it in your testimony. Previous experience has shown that even after you turn the corner on the recession—and it is not yet clear that we are there, although some will argue that we are, and I assume you will probably argue as much this morning. First of all, you are going to say it is short and shallow; and, second, we are coming out of it, I assume.

But look what happened. In this chart, the red lines mark the trough of the recessions. Even after we start to come out of the recession, the long-term unemployed continues to go up, which means you continue to face this unemployment problem and particularly in the unemployment insurance program, which is the last point I want to turn to.

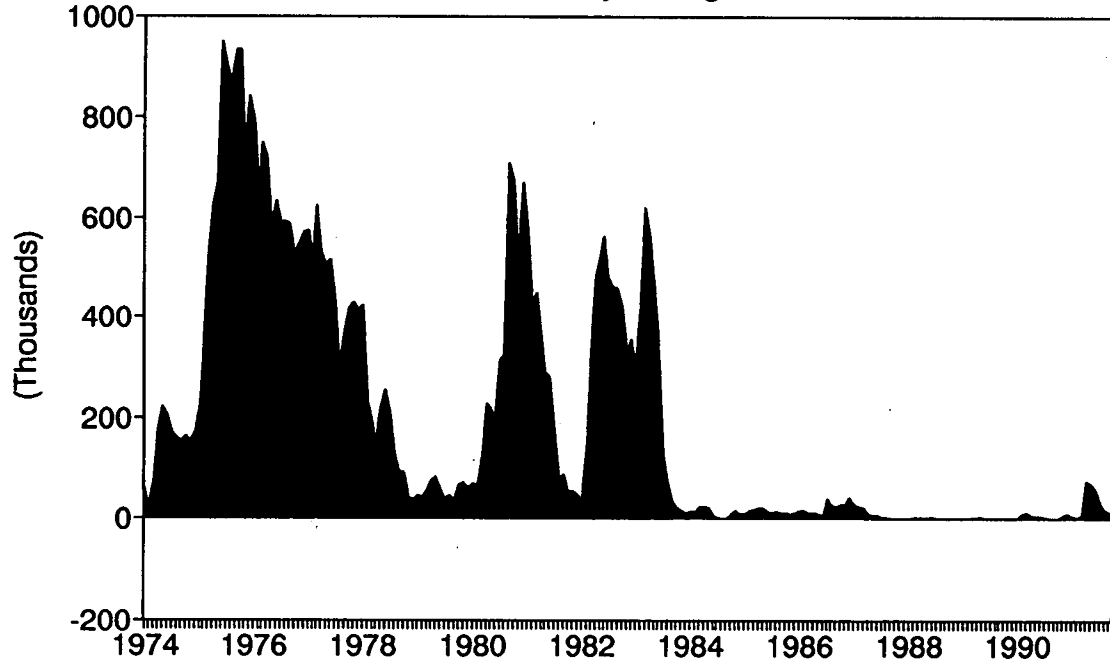
Our safety-net programs have failed to do their jobs in this recession. Because of outdated formulas, few states have triggered on for the payment of extended benefits for the long-term unemployed. Recently, several states that had been receiving extended benefits have been removed from the program, despite unemployment rates well above 8 percent.

The Senate Finance Committee is now developing a proposal to address this problem by providing additional extended benefits to those who have exhausted their regular unemployment benefits, an effort which I very strongly support.

Let me just show you this chart (see chart on following page). This is "Persons Receiving Extended UI Benefits," which is on top of the 26 weeks—the standard program. Of course, the recession now has run more than 26 weeks, well above 26 weeks. Anyone who lost their job at the beginning of the recession, or even some months into it, who was drawing unemployment insurance on a regular program, would now have exhausted it; would no longer have unemployment benefits; and would be searching for a job in a job market that actually has gotten worse than when they lost their job, since the 7 percent unemployment rate that was reported last month was the highest during this recession. It has gone from 5.3 to 7 percent, and the 7 percent is the worst we have experienced in four years time.

Persons Receiving Extended UI Benefits

Monthly Average



Note: Excludes Federal Supplemental Benefits and Federal Supplemental Compensation recipients.

As you can see from the chart, hardly anyone is getting unemployment insurance benefits in this recession. Concern for fixing the unemployment compensation system is heightened by the possibility that any recovery will be weaker than average, leaving persisting labor-market problems for a long time in the future.

A number of economists hold the view that the recovery from this recession will be anemic by historic standards and some have commented that it will be hard to distinguish the recovery from the recession. The Administration forecast, which was released last week, is somewhat more optimistic but still projects less than usual economic growth for the rest of this year and next.

This is the final chart I want to show, Chairman Boskin, and I really hope at some point that you will address this (see chart on following page). Employers pay money into an Extended Benefit Trust Fund to pay extended benefits for unemployment insurance. Now, on October 1 of last year, that fund had $7.2 billion in it. It is building up a surplus this year right in the course of a recession. Unemployment has gone up. Workers are exhausting their benefits. Yet, the Trust Fund to pay extended benefits continues to accumulate a surplus. Now, I can't think of any rationale that justifies that procedure. You build up the surplus ostensibly in good times to use it in bad times to provide a safety net for workers who have lost their jobs and for their families, and to provide some countercyclical stimulus for the economy.

Of course, we are not doing any of that in this instance, and this unemployment trust fund will add better than a billion dollars to its surplus in the course of a recession year. It has been my very strongly held view that this is a problem that we need to address and need to address promptly, and we would be interested in hearing your comment about that.

With that, I will turn to Congressman Armey, the ranking member of the Committee, and then we will go to Senator Kennedy, Senator Smith, and Congressman Hamilton.

Representative Armey. Thank you, Chairman Sarbanes.

I do have a prepared statement that I'd like to put in the record and then, at this point, I'd like to welcome Dr. Boskin and Dr. Taylor.

Dr. Taylor, I understand you're going to retreat to the Ivory Tower—a safe and more secure world, I'm sure.

Dr. Taylor. That's right, Congressman Armey. I've been on leave from Stanford University, where I'll be returning in a couple of weeks.

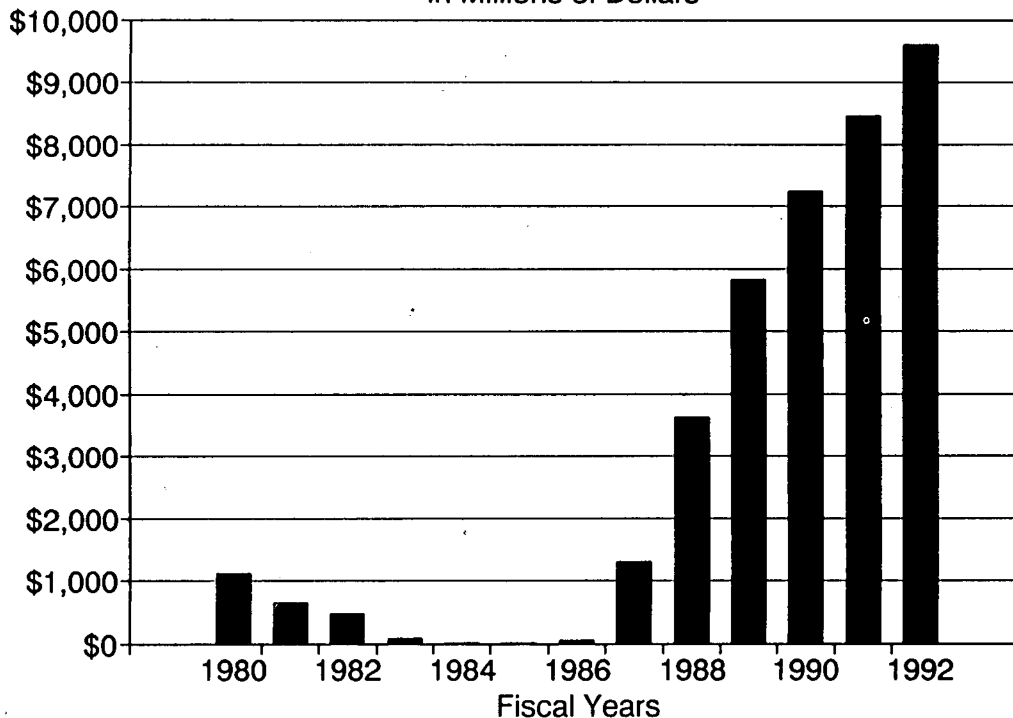
Representative Armey. I wish you godspeed.

I know it is a much more pleasant environment, but let me again remind you that politics is much more nasty in the university than you'll find in Washington.

Dr. Taylor. I can attest to that.

Extended Benefit Trust Fund Balance*

In Millions of Dollars



* Excludes transfers to loan account.

REPRESENTATIVE ARMEY. Woodrow Wilson said that the politics in a university are so nasty because so little is at stake. I will let it go at that.
Thank you.
[The prepared statement of Representative Armey follows:]

WRITTEN OPENING STATEMENT OF REPRESENTATIVE ARMEY

Mr. Chairman, I am pleased to welcome Dr. Michael Boskin and Dr. John Taylor of the President's Council of Economic advisors to testify before the Joint Economic Committee. It is good to see both of you again.

I especially want to take notice that this is Dr. Taylor's last appearance before the committee, at least in his present capacity. I understand that he is going back to the security of the "ivory tower" at Stanford University. Dr. Taylor, I wish you the best of luck.

As someone trained as a microeconomist and who taught economics, I am skeptical of macroeconomic questions and predictions. They often seem little more than shots in the dark. I admit that it would be nice to have an accurate picture of the future state of the economy. It seems to me that it is better to focus our energy on the microeconomic question of how real people respond to real incentives. However, I am certainly willing to lerm the magic of macroeconomic forecasting.

It appears that economic recovery has returned, in—in my view—of Congress' best efforts to extend the recession by higher taxes and increased government regulation. Tax increases do not encourage economic growth; on the contrary, most taxes discourage savings, investment and work. Higher taxes do not automatically translate into higher revenues. Rather, they often have the opposite effect of reducing revenues because they discourage productive economic activity. I believe the length of the recent recession was extended by new disincentives passed in last year's budget Reconciliation Act.

A tax cut now would be good economic policy. I support a lower capital gains tax rate and a reduction in social security payroll taxes. Unfortunately, our current revenue estimating process prevents pro-growth tax cuts from being analyzed under dynamic models. I would appreciate comments from the witnesses on the way Congress and the Administration score tax proposals. For example, the luxury acted last Fall—especially the boat tax—have obvious and severe negative economic consequences. I have recently seen compelling evidence that their repeal would not only benefit workers and tax-affected industries, but would actually end up gaining revenue for the Treasury.

I am also interested in the Council's view of monetary policy. I understand that the Administration believes that the inflation monster has been tamed, if not slayed, and that there is some disagreement between the Administration and the Fed on monetary policy. I would like to hear more on this dispute from Dr. Boskin.

Again, I want to extend a warm welcome to Drs. Boskin and Taylor.

SENATOR SARBANES. Senator Kennedy, please proceed.

OPENING STATEMENT OF SENATOR KENNEDY

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

This is a very important hearing on a subject of vital concern to citizens across the country, especially those in states like Massachusetts that have been the hardest hit by this recession.

Although we keep hearing from the economists that the recession is over, I can tell you that it doesn't look that way when you get out of Washington and start talking to working men and women and the owners of businesses who are hurting.

For the past months, I've been going to different parts of Massachusetts, chairing a series of hearings on the recession and its impact on the work force. And at those hearings, I've heard eloquent and somber testimony from working families, business and labor leaders, and policy and economic experts. And not one of them has testified that they see an end to this recession. Most of them see things getting worse, with little or no relief in sight.

So, I'm glad to have the opportunity to hear from Dr. Boskin and Dr. Taylor on their view of the economy.

The policymakers in this Administration should hear firsthand about what people are going through. Perhaps, then they would not be so complacent.

Lou Marani is the President of Vanessa Manufacturing in New Bedford, which makes women's jackets. In recent years, he has done everything that a small business should. He has sought out new, high-value business niches; he has invested in new technology and, in cooperation with his workers and their unions, instituted training programs.

Mr. Marani testified that, because of the credit crunch that is choking small businesses throughout New England, he cannot obtain financing for his firm. He was planning to take a second mortgage on his home and invest those funds in his business. If his firm goes out of business, people will lose their jobs and the local economy loses the payroll. You can't tell Lou Marani that the recession is over.

Other businesses are suffering too. In New Bedford, Freestone's Restaurant has been operating successfully for 20 years. They are an anchor in the town's historic district, and they've always paid their bills and been successful—never missed a bank payment in 20 years. Now, they cannot find credit no matter how hard they try. This is a business that has a stellar record of operation. They cannot get credit. Don't tell the owners of Freestone's that the recession is over.

Dr. Paul Harrington of Northeastern University in Boston presented a report showing that Massachusetts has lost 9 percent of its jobs in two years, the worst losses suffered by the state since the Great Depression. Dr. Harrington sees no turnaround in sight.

Another economist testified that unemployment in Massachusetts could hit 11 percent this year. These experts don't think the recession is over.

And finally they should hear the eloquent testimony of working men and women who have lost their jobs and see no real hope on the horizon. They are proud men and women who have worked all their lives at blue collar or white collar jobs. Now, they cannot find work and fear that they will not be able to provide for their children and their families.

There are people like Dick and Joan O'Neil, a family from Lawrence with eight children. Dick O'Neil was laid off from a computer firm. They lost their home; they lost their health insurance; they were homeless for five weeks. They were placing their children in different homes for a period of five weeks. They are constantly looking for new jobs but nothing is available.

There are families like Ed and Carol Riley from Swansea. Ed Riley was employed for 18 years at a sailboat building firm, working his way from an entry-level job to a quality-control position. His unemployment benefits have expired; they have no health insurance and they're in danger of losing their home. And their little girl told her mother that she no longer prayed to God because her father cannot find a job.

There are people like Octavio Mattas, a Portuguese immigrant from Angola, who couldn't speak English when he first came to Fall River. He's now a citizen who testified in his new land about the trouble he now faces. His unemployment insurance is running out. He fears that he will lose his home. He told me, "My American dream is turning into a nightmare."

And they include Craig Harbour, who was called to active duty for Operation Desert Storm, and has now returned and is unable to find work. Mr. Harbour is a stellar employee, who has a long history of working in the medical supply industry, making $55,000 a year.

He was called up in Desert Storm. Now, his family has exhausted their savings. He's constantly looking for work and can't find it. He testified that he didn't have it as hard in Saudi Arabia as he now has it here in the United States.

These people are not isolated examples. The hearing record that has been compiled is full of such stories. And at every hearing, other people come and ask to be heard.

So, I look forward to the testimony of Dr. Boskin and Dr. Taylor. I want to know, and the people of the Nation want to know, when will this economy improve? Can we do more to help turn the economy around and assist the innocent victims of this recession?

I'm particularly concerned about the credit crunch that continues to strangle our small businesses, the failure of the Federal Reserve to follow adequate antirecessionary policies that can lead to a sustained expansion.

And I continue to be concerned that after one full year into this recession we have not provided decent help to the unemployed. The national unemployment rate is at its highest level in five years. Some states are approaching double-digit unemployment. The Federal Govern-

ment, as the Chairman has pointed out, accumulated billions of dollars of surplus in the Unemployment Trust Fund. Yet, workers in Massachusetts and other states are seeing their benefits cut off.

Our national policy on unemployment benefits makes no sense. Congress is entitled to know whether the Administration supports extending unemployment benefits to deserving workers and their families, both as a matter of simple justice and as a way of getting more spending power back into the economy.

This has never been a partisan issue. Those extended and supplemental benefits were made available by President Kennedy, President Nixon, President Ford, and President Reagan. What does this Administration know that the other Republican and Democratic Presidents didn't know?

We have had such programs during previous recessions, and it's irresponsible not to enact such a program now.

I look forward to the testimony from our witnesses. I hope that the Congress and the Administration will work more closely together to ease the burden of the recession.

[The written opening statement of Senator Kennedy follows:]

WRITTEN OPENING STATEMENT OF SENATOR KENNEDY

This is an important hearing, on a subject of vital concern to citizens across the country, especially those in states like Massachusetts that have been the hardest hit by this recession. For although we keep hearing from the economists that the recession is over, I can tell you that it doesn't look that way when you get out of Washington and talk to working men and women and the owners of businesses who are hurting.

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They are people like Dick and Joan O'Neill, a family from Lawrence with eight children. Dick O'Neill was laid off from a computer firm. They lost their home. They lost their health insurance. They were homeless for five weeks. They constantly look for new jobs, but nothing is available.

They are families like Ed and Carol Riley from Swansea. Ed Riley was employed for 18 years in sailboat-building firms, working his way from an entry-level job to a quality control position. His unemployment benefits have expired. They have no health insurance. They are in danger losing their home. And their little girl told her mother that she no longer prays to God, because her father cannot find a job.

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And I continue to be concerned that, one full year into this recession, we have not provided decent help to the unemployed. The national unemployment rate is at its highest level in five years. Some states are approaching double digit unemployment.

The Federal government is accumulating billions of dollars in surplus in the unemployment trust fund. Yet workers in Massachusetts and other states are seeing their benefits cut off. Our national policy on unemployment benefits makes no sense.

Congress is entitled to know whether the Administration supports extending unemployment benefits to deserving workers and their families, both as a matter of simple justice, and as a way to get more spending power back into the economy.

We have had such programs during previous recessions, under both Republican and Democratic Presidents, and it is irresponsible not to enact such a program now.

I look forward to the testimony from our witnesses, and I hope that Congress and the Administration work more closely together to ease the burden of this recession.

SENATOR SARBANES. Thank you very much, Senator Kennedy.
Senator Smith, please proceed.

OPENING STATEMENT OF SENATOR SMITH

SENATOR SMITH. I'd like to welcome and once again look forward to hearing the testimony. And, I think, I'll just briefly pick up on what Senator Kennedy said in his opening remarks.

We've been through recessions before, the dips and curves, if you will, of recessions, but it's the worst that I've ever seen in the New England area. And I think that there are two factors that make it worse—as I see it—than it otherwise would be.

One is the total lack of confidence in banks and banking due to the bank failures in New England. And the second is the whole savings and loan issue, with the tremendous portfolios within the state that are being piled up in the RTC, and with, what I perceive, has been very little effort to get rid of it, at least not from the focus I'm getting.

So, I would hope that you might, in your testimony, respond to that. There are two of us on the panel from New England and if you might respond specifically to New England.

In any case I look forward to your testimony.

Thank you.

SENATOR SARBANES. Thank you very much, Senator.

Congressman Hamilton.

REPRESENTATIVE HAMILTON. Thank you very much, Mr. Chairman.

I just want to say a word of welcome to Chairman Boskin and thank Dr. Taylor for his service to the Council and to the Nation and wish him well as he returns to Stanford.

DR. TAYLOR. Thank you very much.

REPRESENTATIVE HAMILTON. Usually, you have three members on the panel, Chairman Boskin. Are you going to be all by yourself when Dr. Taylor leaves?

DR. BOSKIN. No. There will be people coming on board. The nominations will be sent up within a couple of weeks.

REPRESENTATIVE HAMILTON. We look forward to your testimony.

Thank you.

SENATOR SARBANES. Thank you very much.

Chairman Boskin, we are happy to year from you.

DR. BOSKIN. Thank you.

I'd appreciate it if the full written remarks could be placed in the record. I'll summarize and then ask Dr. Taylor to say a word or two. And then of course we'll be prepared and happy to answer any questions.

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

STATEMENT OF MICHAEL J. BOSKIN, CHAIRMAN PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS

DR. BOSKIN. As always, Chairman Sarbanes, I am pleased to have the opportunity to appear before the Joint Economic Committee to discuss the Administration's economic outlook with you and your colleagues.

There have been a number of changes in the U.S. economy since I appeared before the Committee in February, but they have occurred largely as had been anticipated.

In February, I repeated to the Joint Economic Committee what I've been saying for some time, a phrase that I know you may not care for: the Administration expected the recession to be relatively brief and relatively mild.

I should say that the term relatively was not at all meant to be disrespectful to the parts of the country that were harder hit or to the people who have become unemployed. It was meant purely as a comparison to previous post-war recessions, a point you raised and one that I'll return to.

We expected real GNP to decline in late 1990 and early 1991, to level off in the Spring, and then to improve in the second half of this year. In February, I spoke of various preconditions for economic recovery. Many of those preconditions did indeed fall into place: oil prices returned to where they were prior to Iraq's invasion of Kuwait; consumer and business confidence have increased since the beginning of the year; and interest rates have declined.

The evidence continues to mount that the recession appears to have ended in the second quarter: housing starts and building permits have increased and industrial production, real incomes, and total production work hours are increasing.

And, while the United States remains the world's most prosperous Nation, the country still faces serious challenges in both the short and long run. The most important challenge that the Nation faces is to begin growing strongly again and to generate sustained increases in our standard of living by raising the Nation's long-run productivity growth.

Meeting this challenge will require sound economic policy. I'd like to state a few words about that.

First, we need a pro-growth fiscal policy that substantially reduces the multiyear, structural budget deficit. Chairman Sarbanes, you properly drew attention to the counter-cyclical nature of the automatic stabilizers in the budget.

Second, we need a monetary policy that promotes growth with low and stable inflation.

Third, we need a trade policy that promotes growth through opening markets worldwide, importantly through a comprehensive Uruguay Round agreement. Dr. Taylor will have more to say about that in a moment.

And fourth, we need a regulatory policy that promotes growth by avoiding unnecessary burdens on business and consumers. Those are our

basic policy objectives and our policy principles. We will try to work with the Congress, the Federal Reserve and others to pursue them.

The Administration's revised economic projections, which were reported—as you indicated, Mr. chairman—in the Mid-Session Review, were developed by the Council of Economic Advisers, the Treasury, and OMB, commonly called the Troika. The projections embody, in our view, the best available forecasting methods, informed judgement and basic economic principles. In preparing the projections, the Administration routinely consults with private sector economists and other analysts in the business and labor communities.

Economic forecasting is an imprecise science. Human behavior is complex and difficult to predict. Human beings don't always respond in the same way or to the same extent to a changing economic environment, such as changes in oil prices or interest rates, as they have in the past in their roles as consumers, workers, and employers.

Further, unforeseen events, from unusual weather to foreign political developments, such as Iraq's invasion of Kuwait, make forecasting the course of the economy even more difficult. So, you should view the projections as our most likely scenario.

But, as I always say before this Committee and anytime I discuss an economic outlook anywhere, there are factors that could well cause the economy to perform better or worse than projected. Dr. Taylor and I will mention a few of those factors in a moment.

Thus far, as I mentioned, the Administration's forecast used for preparing the President's FY 1992 Budget has been accurate.

We thought that the bulk of the hit to the GNP from the oil shock would be in the fourth quarter of 1990 and the first quarter of 1991.

Last November and December, we prepared a forecast that predicted real GNP would decline for those two quarters. That information was conveyed to the Congress in early January in order that they could be notified of our intention to put the forecast in the budget the following month. This was done to follow the procedure in the Budget Law that requires, I believe, the Senate, and allows the House, to vote on temporary suspensions of some of the features of the Budget Law.

The Administration's forecast for real GNP is thus far, according to the available data, within one-tenth of 1 percent of the actual value.

Most private forecasters expect GNP to be up slightly in the second quarter. Even if, hypothetically, it was flat, the decline in real GNP in this recession would be 1.1 percent, slightly under one-half the average decline for all previous post-World War II recessions.

Likewise, the decline in payroll employment in percentage terms was slightly less than one-half as much as the average change for post-war recessions. The unemployment rate, which is a lagging indicator of the economy, has risen in percentage points about one-half the post-war recession average, not for comparable periods—because we think the recession appears to have ended and recovery has started—but for the duration of the previous recessions.

After its longest peacetime economic expansion, the economy entered its ninth recession of the post-World War II period in the third quarter of last year. There were numerous reasons to believe that the recession would be shorter and milder than those that followed the two oil shocks in the 1970s.

Let me spend a moment on the factors that led to the recession.

In my view, the direct effect of the oil price shock, which resulted from the fact that higher priced net oil imports by the United States transferred income to oil exporting countries, combined with the very large decline in consumer 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.

There were several reasons for the sluggish growth. Both Senator Kennedy and Senator Smith alluded to one of the most important.

First, there were the lingering effects of the Federal Reserve's tight monetary policy in 1988-89. As you recall, the Fed was trying to engineer a so-called soft landing to ease some of the incipient inflationary pressure out of the economy.

Second, there were unexpectedly tight credit conditions—the so-called credit crunch—which, as I will note below, remains a major concern, in my view, with respect to the length and strength of the recovery.

Several factors contributed to the credit crunch—obviously, regional real estate problems, particularly in the Northeast. Those have since spread down the East Coast and to California. There also was without a doubt some overly zealous regulations by bank examiners, perhaps reacting to the savings and loan problems. The Administration has sought safe, prudent, pendulum-right-in-the-middle regulation and oversight of financial institutions all along. But I think it is clear from what used to be called anecdotal evidence—but when you have 12,000 independent anecdotes, it's no longer anecdotal—that the pendulum has indeed swung too far and credit is being unnecessarily constrained. And, in my view, that continues to be a problem. There are some people who think it's begun to improve; I believe it remains a serious problem.

At the end of 1990—and this will happen again at the end of 1992—new international capital standards for banks went into effect. These standards have been set up by the central banks for the major industrialized countries—the Federal Reserve, the Bank of England, the Bank of Japan, the Bundesbank, and so on. These capital requirements were both designed to be set at a reasonably high level and to harmonize the ratio of equity to assets—so-called capital ratios—of banks across countries.

At a time when it was quite difficult to raise new equity—the numerator of that ratio—many banks met the higher ratios either by shrinking lending or, in many cases, by shifting out of assets in what were required to be high-risk categories, by the mechanical formulas used in these agreements, such as commercial and industrial loans, and into low-risk government securities. This shift out of high-risk assets [illegible]sted the

composition of these banks' assets to what was viewed by this mechanical formula as lower-risk, whether in fact it was or not, and without raised equity, raising their capital ratios.

Finally, there was a worldwide increase in long-term interest rates early in 1990. Our own analysis indicates that an important factor in this rise was the anticipated increase in demand for capital associated with developments in Eastern Europe, especially the unification of Germany.

Germany's budget shifted from a surplus to a deficit of 2 percent of GDP in 1990. The deficit is expected to be higher in 1991, and I think most people in the financial markets expect the deficit to continue for many years to come.

Their deficit put upward pressure on interest rates in Germany and, through the exchange rate mechanism, on interest rates throughout Europe. This in turn placed upward pressure on U.S. long-term interest rates because of the linkage in international capital markets.

Some of the preconditions for recovery began to fall into place earlier this year. As I indicated, oil prices returned to their pre-invasion levels fortunately within a few hours of the successful launch of the air war in mid-January, as it became clear that the oil supply and the transportation system were safe.

With the end of the war, consumer and business confidence rebounded. It's retreated a bit since then—there was sort of a post-war euphoria—but it remains substantially higher than prior to that period last year and early this year.

Short-term interest rates have come down, in part due to the Federal Reserve's easing of monetary policy early this year. Long-term interest rates fell and then rose partially back to where they were at the beginning of the year. They now remain somewhat below their levels of last Fall.

All of these factors—the decline in interest rates, the decrease in oil prices, and the restoration of consumer and business confidence—have contributed to the economic recovery that now appears to be underway.

In addition to its well-known index of leading indicators, the Commerce Department calculates and publishes an index of coincident indicators that is designed to measure the current state of the economy rather than predict the future course of the economy, as the leading indicators are designed to do.

The components of this index—real personal income less transfer payments, industrial production, real manufacturing and trade sales, and payroll employment at nonagricultural establishments—are among the key items that economists use to date business cycle peaks and troughs, including those of the the National Bureau of Economic Research (NBER), a private organization that officially dates business cycles.

These indicators provide evidence that the recession appears to have ended earlier this year, although the NBER has not yet dated the trough and probably won't for some months to come. The coincident index reached its low in March and April. The components all bottomed out

between February and April. I won't bore you with the details that are in the written testimony.

It is important to understand that, while the overall economy appears to be in recovery, some regions and sectors still lag behind. Indeed, as I've said often to this Committee and elsewhere, even when the economy is doing well, some regions and sectors grow slower than average; and when it does poorly, some regions and sectors still do reasonably well.

During the recession, the automotive, real estate, and construction sectors, in particular, were hit very hard. Regions such as New England especially, Michigan heavily and, more recently, California declined more than the national average.

During the 1980s, the media often claimed that "the coasts are recession proof," while the middle of the country experienced serious problems. There was never an economic rationale for such a simplistic observation.

During the recent recession, the geographic distribution of the decline in economic activity has been markedly different than during the last recession. New England was hit earlier and much harder than average, and much of the remainder of both coasts has declined more than proportionally.

On the other hand, most of the Midwest—with the marked exception of Michigan and the automotive industry—the Mountain states, and the oil patch have done much better than the national average. Importantly, our exports have continued to increase during this recession and certain regions have benefited as a result.

In fact, the severity of the recession for the economy as a whole was reduced substantially as a result of the improvement in our trade balance. This is one of the major differences between this and the previous recessions.

By way of comparison, during the 1981-82 recessions, real net exports measured in 1982 dollars fell by over $30 billion at an annual rate, representing roughly 30 percent of the decline in real GNP during that recession.

Conversely, since the third quarter of last year, real net exports have actually risen by $53 billion at an annual rate. This represents 1.3 percent of real GNP. Without this strong trade performance, the recession would have been much worse.

Legitimate questions remain, Mr. Chairman—as you and your colleagues have indicated—about the strength and durability of the recovery. While the economy appears to have stabilized in the second quarter, uncertainty remains about whether GNP increased during that period.

Inventory liquidations could offset other increases in the second quarter, and there are some other technical issues that may have the second quarter official GNP number fluctuate between a slight negative number and a small positive number.

We do expect to return to more solid growth later this year and into 1992.

The serious problem of the availability of credit in the United States is probably the single biggest threat to a sustained recovery. This is particularly a problem for small- and medium-size businesses that normally rely on banks for their funds.

Many large firms have direct access to the commercial credit market and have for many years—increasingly in recent years—gone directly to the commercial credit market rather than to financial intermediaries for their funds.

Fiscal problems at the state and local government level also are a cause for concern. The total surplus of the state and local government sector generally increases during economic recoveries. However, tax and spending adjustments needed to reduce apparently secular state and local budget imbalances could be a drag on recovery. That is, the decline in state and local government fiscal positions has gotten worse secularly over time, and the recession is being superimposed on it.

Recent improvements in our trade balance could reverse if exports were to fall due to declines in worldwide growth beyond what has been experienced and expected.

Inflation, as anticipated, has declined significantly in the first half of this year from the relatively high levels of last Fall. Looking at six-month periods, consumer price inflation was 2.7 percent at an annual rate for the six months through June. The peak came in November 1990 at a 7.2 percent annual rate for the preceding six months due to the oil price increases.

The underlying rate of inflation has been on a downward trend since the Winter, including wage inflation or using the traditional Consumer Price Index, excluding food and energy.

The recession has caused significant dislocations for workers, which should not be underestimated. And several of you in your presentations did not indeed underestimate it.

Nonfarm payroll employment has fallen by 1.6 million from June 1990 to June 1991, and the unemployment rate has risen from 5.3 percent to 7.0 percent over the past 12 months.

However, it is important to note that, following large increases in the first three months of this year, the level and rate of unemployment have risen only slightly in recent months. Average weekly hours for manufacturing, production, and non-supervisory workers have risen. And that usually precedes an upturn in employment.

The Administration's projections, especially those concerned with the long-term—as I have said over the years to this Committee—are conditional on the Administration's economy policy proposals. If these policies, or their economic equivalent, are not implemented, the projections would not be our best judgment of future economic conditions.

However, there were some slight changes in the Administration's projections, and let me summarize those very briefly: these projections basically incorporated the small differences between what we had expected to happen in the economy last November and December when

the forecast was prepared, put into the Budget in January, and released in early February, and what's actually occurred over the intervening seven or eight months.

Real GNP is projected to grow 0.8 percent in 1991 and 3.6 percent in 1992, as the recovery continues.

Consumer spending, business spending on new equipment and inventory rebuilding are likely to be the driving forces behind real GNP growth.

We have strengthened our forecast for the second half of 1991 very slightly. The level of GNP in the fourth quarter of 1991 is now projected to be slightly higher than our earlier estimate for that quarter.

The unemployment rate is projected to average 6.6 percent in 1991 and 6.4 percent in 1992. This is down very slightly from our earlier forecasts. The unemployment rate has increased this year but not quite as much as we had expected in our earlier forecasts.

Inflation has come down a little bit more than we had anticipated, and we have therefore revised down our inflation forecast for the total year. The CPI-U is expected to be 3.5 percent in 1991 and remain under 4 percent in 1992.

Short-term interests rates have fallen further than expected so far this year and so we have lowered our projection for 1991, accordingly. Long-term rates were down from their levels of last Fall but not quite as far as we had expected.

The longer term outlook for 1992 through 1996 is pretty much as had been reported to this Committee earlier this year. For the 25 quarters from the third quarter of 1990—the beginning of the recession—through the fourth quarter of 1996—the end of the projection period—the Administration projects that the growth rate of real GNP will average 2.7 percent at an annual rate.

By way of comparison for the same period, the Congressional Budget Office's projection is 2.4 percent, three-tenths of a percent lower than ours.

There have been eight previous business cycle peaks in the post-World War II era. In the 25 quarters following those peaks, real GNP has grown slightly over 3 percent on average at an annual rate.

We believe that the unemployment rate will decline steadily and be back down to the 5 percent range in the next several years.

Significant progress in implementing growth-oriented policies, consistent with steady reductions in inflation, are expected to lead to gradual declines in both real and nominal interest rates through 1996. A more stable economic environment would be likely to wring out inflation and some of the uncertainty premiums in interest rates.

Table 4, attached to my prepared statement, compares the Administration's forecast with those of private forecasters. The Administration's forecast is very similar to the Blue Chip consensus, which is really not a consensus but a mathematical average of a wide range of forecasts among the Blue Chip private forecasters.

I might say a word about the role of the economic assumptions in the budget projections and in our conclusions.

Budget outlays and revenues depend on many factors, including the state of the economy. The minor changes we have made in our economic assumptions account for a minute part of the change in the projected federal deficit for 1991 and 1992. The bulk of the changes, as has been well-documented in the deficit projections reported in the Mid-Session Review of the Budget, results from changes to the estimates of outlays for Operation Desert Storm and deposit insurance and to technical reestimates of receipts conditional on the state of the economy, resulting from any given set of economic assumptions.

In conclusion, last year I concluded my remarks to this Committee by stating that economic expansions do not end on their own; they end as a result of external shocks to the economy, economic imbalances that have to be worked off, or inappropriate economic policies.

The economic expansion that ended last year did so as a result of an external shock—the Iraqi invasion of Kuwait—superimposed on a fragile economy already growing sluggishly because of the lingering effects of tight monetary policy and the credit crunch.

The economic recovery appears to be underway. We expect the economy to continue to expand in the second half of this year and to continue to grow in 1992 and beyond.

But the Nation cannot take economic growth for granted. Unless sound policies are followed, there is no guarantee that American living standards will continue to rise substantially from one generation to the next or that the United States will remain the world's leading economy.

The Nation must choose between sound policies that will promote long-term growth and policies that will reduce economic flexibility, stunt incentives, and place its economic future at risk.

Mr. Chairman, this concludes my prepared statement. I'd like to ask Dr. Taylor to make some brief comments and then turn to questions.

[The prepared statement of Dr. Boskin follows:]

PREPARED STATEMENT OF HONORABLE MICHAEL J. BOSKIN

Chairman Sarbanes, Vice Chairman Hamilton, and other distinguished Members of the Committee, I am pleased to have the opportunity to appear before you to discuss the Administration's economic outlook.

There have been a number of changes in the U.S. economy since I appeared before this Committee in February, but they have occurred largely as anticipated. In February, I repeated to you what I had been saying for some time: the Administration expected the recession to be relatively brief and relatively mild. We expected real GNP to decline in late 1990 and early 1991, to level off in the Spring and then to improve in the second half of this year. I spoke of various preconditions for economic recovery. Many of those preconditions did indeed fall into place: oil prices have returned to where they were prior to Iraq's invasion of Kuwait, consumer and business confidence have increased significantly since the beginning of this year, and interest rates have declined. Now I can report that evidence continues to mount that the recession ended in the second quarter: housing starts and building permits have increased, and industrial production, real incomes, and total production hours worked are increasing.

The United States remains the world's most prosperous nation, but the country still faces serious challenges. The most important economic challenge that the Nation faces is to begin growing strongly again and to generate sustained increases in our standard of living by raising the Nation's long-run productivity growth.

Meeting this challenge will require sound economic policy: (1) a pro-growth fiscal policy that substantially reduces the multi-year, structural budget deficit; (2) a monetary policy that promotes growth with low and stable inflation; (3) a trade policy that promotes growth through opening markets worldwide, importantly through a comprehensive Uruguay Round agreement; and (4) a regulatory policy that promotes growth by avoiding unnecessary burdens on business and consumers.

The Administration's revised economic projections, reported in the Mid-Session Review, were developed by the Council of Economic Advisers, the Treasury, and OMB (the Troika). In our view, the projections embody the best available forecasting methods, informed judgment, and basic economic principles. In preparing our projections the Administration routinely consulted with private-sector economists and other analysts.

Economic forecasting is an imprecise science. Human behavior is complex and difficult to predict, and people don't always respond in the same way or to the same extent to a changing economic environment, such as changes in oil prices or interest rates, as they have in the past. Unforeseen evens—from unusual weather to foreign political developments, such as Iraq's invasion of Kuwait—make forecasting the course of the economy even more difficult. The projections should be viewed as a "most likely" scenario. The economy may well perform better or worse than projected.

The forecast of the Administration used for preparing the President's 1992 Budget has thus far been very accurate. Early last Fall I argued that the bulk of the hit to GNP from the oil shock would be in the fourth quarter of 1990 and the first quarter of 1991. The Administration's forecast, prepared last November and December, predicted that real GNP would decline for those two quarters. The Administration's forecast for real GNP is thus far within one-tenth of 1 percent of the actual value based on the most recent data.

Most private forecasters expect GNP to be up slightly in the second quarter. Even if, hypothetically, it was flat, the decline in real GNP in this recession would be 1.1 percent, slightly under one-half the average decline for all previous post-World War II recessions. (See Table 1.) Likewise, the decline in payroll employment in percentage terms was slightly less than one-half as much as the average change for

post-war recessions, and the unemployment rate thus far has risen in percentage points about one-half the post-war recession average.

Recent Economic Developments

After the longest peacetime expansion in the history of the United States, the economy entered the ninth recession of the post-World War II period in the third quarter of last year. There were numerous reasons to believe that the recession would be shorter and milder than those that followed the two oil shocks in the 1970s. To understand why, it is important to examine the factors that led to the recession.

In my view, the direct effect of the oil price shock—together with the indirect effect via the sudden decline in consumer confidence and the uncertainty about when the Gulf crisis would end—when superimposed on an already sluggish economy, drove the economy into recession. There were several reasons for the sluggish growth. First, there were the lingering effects of the Federal Reserve's tight monetary policy in 1988-89. As you recall, the Fed was trying to engineer a so-called soft landing to ease some of the incipient inflationary pressure out of the economy.

Second, there were unexpectedly tight credit conditions—the so-called credit crunch, which, as I will note below, remains a major concern. Several factors contributed to the credit crunch. There were problems in real estate markets in certain regions of the country, particularly the Northeast. There also was without doubt overly zealous regulation by bank examiners, perhaps reacting to the savings and loan problems. Moreover, at the end 1990 new international capital standards in banking went into effect. These new standards, which had been set up by the central banks of the major industrialized countries, harmonized the ratio of equity to assets—so-called capital ratios—of banks across countries. At a time when it was quite difficult to raise new equity, many banks met the higher ratios either by shrinking lending or shifting out of assets in high risk categories—such as commercial and industrial loans —into low-risk government securities.

Finally, there was the worldwide increase in long-term interest rates early in 1990. An important factor in this rise was the anticipated increase in demand for capital associated with developments in Eastern Europe and the unification of Germany. (In fact, Germany's budget did shift from surplus to a deficit of about 2 percent of GDP in 1990, and the deficit is expected to be higher in 1991.) This put upward pressure on German interest rates, and because interest rates in the U.S. are influenced by developments in world markets, there was upward pressure on U.S. interest rates as well. Although long-term interest rates have been relatively stable recently, I remain concerned that future world capital demands and uncertainty about them may keep upward pressure on world interest rates.

Some of the preconditions for a recovery began to fall into place earlier this year. Oil prices returned to their pre-invasion levels within a few hours of the successful launch of the air war in mid-January, as it became obvious that the oil supply and transportation system was safe. With the end of the war, consumer and business confidence rebounded. Short-term interest rates came down, in part due to the Federal Reserve's easing of monetary policy. Long-term interest rates initially fell and then rose, but now remain below their levels of last Fall.

All of these factors have contributed to the economic recovery which now appears to be underway. In addition to its well-known index of leading indicators, the Commerce Department also calculates and publishes an index of coincident indicators that are designed to measure the current state of the economy rather than predict the future course of the economy. The components of this index—real personal income less transfer payments, industrial production, real manufacturing and trade sales, and payroll employment at nonagricultural establishments—are among the key items that economists use to date business cycle peaks and troughs, including the National

Bureau of Economic Research (NBER), a private organization that officially dates business cycles. These indicators provide evidence that the recession appears to have ended earlier this year. (The NBER not yet dated the trough). The coincident index reached its low in March and April. The components all bottomed out between February and April. Real personal income less transfer payments reached its recent low in February; industrial production and real manufacturing and trade sales are up from their March lows; and, payroll employment at nonagricultural establishments appears to have hit its trough in April.

It is important to understand that while the overall economy appears to be in recovery, some regions and sectors still lag behind. Indeed, even when the economy is doing well, some regions and sectors grow slower than average; and when it does poorly, some regions and sectors still do reasonably well.

During the recession, the automotive, real estate, and construction sectors in particular were hit very hard. Regions such as New England, Michigan, and California, declined more than the national average. During the 1980s, the media often claimed that "the coasts are recession proof," while the middle of the country experienced some serious problems. While there was never an economic rationale for such a simplistic observation, during the recent recession the geographic distribution of the decline in economic activity has been markedly different. New England was hit earlier and much harder than average, and much of the remainder of both coasts has declined more proportionally. On the other hand, most of the Midwest, with the marked exception of Michigan and the automotive industry, the Mountain states and the oil patch have done much better than the national average. Importantly, our exports have continued to increase during this recession and certain regions have benefitted as a result.

In fact, the severity of the recession for the economy as a whole was reduced as a result of the improvement in our trade balance. By way of comparison, during the 1981-82 recession, real net exports measured in 1982 dollars fell by $30.4 billion at an annual rate, representing roughly 30 percent of the decline in real GNP during that recession. Conversely, since the third quarter of last year, real net exports have risen by $53.6 billion at an annual rate. This represents 1.3 percent of real GNP. Without this strong trade performance, the recession would have been much worse.

Legitimate questions remain about the strength and durability of the recovery. While the economy appears to have stabilized in the second quarter, uncertainty remains about whether GNP increased during that period. Inventory liquidation could offset other increases in the second quarter. Also, on a more technical note, as U.S. oil companies' earnings abroad move back to a more normal level, investment income from abroad will fall back from higher levels, temporarily reducing measured GNP growth. We expect a return to more solid growth later this year and into 1992. We then expect the economy, if sensible policies are followed, to be poised for a sustained expansion.

The serious problem of the availability of credit in the United States is probably the single biggest threat to a sustained recovery. This is particularly a problem for small and medium-size firms that normally rely on banks for their funds. Fiscal problems at the State and local government level also are a cause for concern. The total surplus of the State and local government sector generally increases during economic recoveries. However, tax and spending adjustments needed to reduce apparently secular state and local budget imbalances could be a drag on the recovery. And, recent improvements in our trade balance could reverse if exports were to fall due to declines in worldwide growth.

Inflation, as anticipated, has declined significantly in the first half of this year from the relatively high levels of last Fall. Looking at six-month periods, consumer price inflation was 2.7 percent at an annual rate for the six months through June. The peak came in November 1990 at a 7.2 percent annual rate for the preceding six months. While much of the decline in inflation can be attributed to the 40 percent decline in oil prices from October of last year, the decline is widespread. The underlying rate of inflation—excluding food and energy—has been on a downward trend since the winter. Wage inflation, as measured by the Employment Cost Index (ECI) and is lower than it was a year ago.

The recession has caused significant dislocations for workers, which should not be underestimated. Nonfarm payroll employment has fallen by 1.6 million from June 1990 to June 1991, and the unemployment rate has risen from 5.3 percent to 7.0 percent over the past 12 months. However, it is important to note that, following large increases in the first three months of this year, the level and rate of unemployment have risen only slightly in recent months, and average weekly work hours for manufacturing, and of production and non-supervisory workers, have risen.

The Projections

The Administration's projections—especially the long-term—are conditional on the Administration's economic policy proposals. If the policies or their economic equivalent are not implemented, the projections would not be our best judgement of future economic conditions. In light of developments during the first-half of 1991, the Administration has slightly revised the economic projections for 1991 through 1996 as follows:

The Near-Term Outlook: 1990-1992

Real GNP Growth. The Administration's forecast for the remainder of this year and 1992 projects renewed growth of the U.S. economy. Real GNP is projected to grow 0.8 percent in 1991 and 3.6 percent in 1992. (See Table 2.) Consumer spending, business spending on new equipment, and inventory rebuilding are likely to be the driving forces behind real GNP growth. The growth projections have changed very little from those we presented in the FY92 budget: 0.9 percent growth for 1991 and 3.6 percent growth for 1992. The decline in real GNP in the fourth quarter of last year was less than we had previously forecast. This meant that there was a larger base on which 1991 growth was calculated. We have strengthened our forecast for the second half of 1991 slightly, and the level of real GNP in the fourth quarter of 1991 is slightly higher than our earlier estimate for that quarter. As before, growth is expected to rebound during the second half of this year and into 1992.

The Unemployment Rate. The unemployment rate is projected to average 6.6 percent in 1991 and 6.4 percent in 1992, down slightly from our earlier forecast. The unemployment rate has increased this year, but not quite as fast as would have been consistent with the earlier forecast.

Inflation. Inflation, as measured by the rate of increase GNP implicit price deflator, is projected to be 4.2 percent in 1991 and to fall to 3.8 percent in 1992, almost exactly the same as our earlier forecast. For consumer prices, measured by the CPI-U, inflation is expected to be 3.5 percent in 1991 and 3.9 percent in 1992.

Interest Rates. Short-term interest rates have been lower than expected so far this year, and we have lowered our projection for 1991 accordingly. Three-month Treasury bill rates are projected to average 5.7 percent in 1991 and 5.9 percent in 1992. Despite recent increases, long-term rates are down from their levels of last fall. Because they are higher than we had expected, the Administration raised its projection of the average level of long-term interest rates for 1991. We still expect long-term rates to decline into 1992. Ten-year Treasury notes are projected to average 8.0 percent in 1991 and 7.8 percent in 1992.

Longer Term Outlook: 1992-1996

For the 25 quarters from the third quarter of 1990, the beginning of the recession, through the fourth quarter of 1996, the end of the projection period, the Administration projects that the growth rate of real GNP will be 2.7 percent growth at an annual rate. (See Table 3.) By way of comparison, for the same period the Congressional Budget Office's projections average 2.4 at an annual rate. There have been 8 previous business cycle peaks in the post-World War II era. In the 25 quarters following those peaks, real GNP has grown at slightly over 3 percent on average at an annual rate. The Administration also projects that the unemployment rate will decline steadily and reach 5.2 percent in 1996.

Significant progress in implementing growth-oriented policies consistent with steady reductions in inflation are expected to lead to gradual declines in both real and nominal interest rates through 1996. A more stable economic environment would be likely to wring out inflation and some of the uncertainty premium in interest rates.

Comparison to Other Projections

Table 4 compares the Administration forecast with those of private forecasters. The Administration's forecast for real growth for 1991 of 0.8 percent is very close to the average Blue Chip forecast of 0.9 percent. For 1992, the Administration forecast of 3.6 percent growth is somewhat above the Blue Chip average of 2.8 percent. The Administration also forecasts slightly lower interest rates than the average Blue Chip forecast.

The Role of Economic Assumption in the Budget Projections

Budget outlays and revenues depend on many factors including the state of the economy. The minor changes we have made in our economic assumptions account for a minute part of the change in the projected Federal deficit for 1991 and 1992. The bulk of the changes in the deficit projections reported in the Mid-Session to Review of the Budget results from changes to the estimates of outlays for Operation Desert Storm and deposit insurance and to technical reestimates of receipts conditional on the state of the economy resulting from a given set of economic assumptions.

Conclusion

Last year, I concluded my remarks to this Committee by stating that economic expansions do not end on their own; they end as a result of external shocks to the economy, economic imbalances that have to be worked off, or inappropriate economic policies. The economic expansion that ended last year did so as a result of an external shock (the Iraqi invasion of Kuwait) superimposed on a fragile economy already growing sluggishly because of the lingering effects of tight monetary policy and the credit crunch. The economic recovery appears to be underway. The Administration expects the economy to continue to expand in the second half of 1991, and then continue to grow in 1992 and beyond.

But the Nation cannot take economic growth for granted. Unless sound policies are followed, there is no guarantee that American living standards will continue to rise

substantially from one generation to the next, or that the United States will remain the world's leading economy. The Nation must choose between sound policies that will promote long-term growth and policies that will reduce economic flexibility, stunt incentives, and place its economic future at risk.

Mr. Chairman, this concludes my prepared statement. I am now prepared to answer any questions you or other Members of the Committee may have.

TABLE 1
COMPARISONS OF RECESSIONS

	Changes From Peak to Trough		
	1981-82	1990-91[1]	Postwar Average
Real GNP (percent)			
NBER Peak to Trough[2]	-3.2	----	-2.2
Actual Peak to Trough[3]	-3.4	-1.1	-2.6
Payroll Employment (percent)	-3.1	-1.2	-2.7
Unemployment Rate, Civilian (percentage points)	3.6	1.3	3.0
Industrial Production (percent)	-8.2	-4.9	-8.9

[1] Changes are from third quarter 1990 to first quarter 1991 (assumed trough) for real GNP and from July 1990 to March 1991 for other series.

[2] Changes based on real GNP values at business cycle peak and trough quarters as determined by the National Bureau of Economic Research.

[3] Changes based on real GNP values at actual peak and trough quarters for the GNP series.

TABLE 2
ADMINISTRATION NEAR-TERM OUTLOOK
(Calendar Years)

	1991	1992
	(Percent Change, 4th Quarter to 4th Quarter)	
Real GNP		
Mid-Session Review	0.8	3.6
FY1992 Budget	0.9	3.6
GNP Implicit Price Deflator		
Mid-Session Review	4.2	3.8
FY1992 Budget	4.3	3.8
CPI-U		
Mid-Session Review	3.5	3.9
FY1992 Budget	4.3	3.9
	(Percent, Annual Average)	
Unemployment Rate (Total)		
Mid-Session Review	6.6	6.4
FY1992 Budget	6.7	6.6
3-Month Treasury Bill Rate		
Mid-Session Review	5.7	5.9
FY1992 Budget	6.4	6.0
10-Year Treasury Note Rate		
Mid-Session Review	8.0	7.8
FY1992 Budget	7.5	7.2

TABLE 3
ADMINISTRATION ECONOMIC PROJECTIONS
(Calendar Years)

	Actual	Projections					
	1990	1991	1992	1993	1994	1995	1996
	(Percent Change, 4th Quarter to 4th Quarter)						
Real GNP	0.5						
Mid-Session Review		0.8	3.6	3.4	3.2	3.0	3.0
FY1992 Budget		0.9	3.6	3.4	3.2	3.0	3.0
GNP Implicit Price Deflator	4.0						
Mid-Session Review		4.2	3.8	3.7	3.5	3.4	3.3
FY1992 Budget		4.3	3.8	3.6	3.5	3.4	3.3
CPI-U	6.3						
Mid-Session Review		3.5	3.9	3.7	3.5	3.4	3.3
FY1992 Budget		4.3	3.9	3.6	3.5	3.4	3.3
				(Percent, Annual Average)			
Unemployment Rate (Total)	5.4						
Mid-Session Review		6.6	6.4	6.3	5.9	5.5	5.2
FY1992 Budget		6.7	6.6	6.2	5.8	5.4	5.1
3-Month Treasury Bill Rate	7.5						
Mid-Session Review		5.7	5.9	5.8	5.6	5.4	5.3
FY1992 Budget		6.4	6.0	5.8	5.6	5.4	5.3
10-Year Treasury Note Rate	8.5						
Mid-Session Review		8.0	7.8	7.0	6.6	6.4	6.3
FY1992 Budget		7.5	7.2	6.8	6.6	6.4	6.3

TABLE 4
COMPARISONS OF ECONOMIC PROJECTIONS
(Calendar Years)

(Percent Change, 4th Quarter to 4th Quarter)

	1991	1992
Real GNP		
Mid-Session Review (7/91)	0.8	3.6
CBO (1/91)	1.3	3.4
Blue Chip Average (7/91)	0.9	2.8
GNP Deflator		
Mid-Session Review (7/91)	4.2	3.8
CBO (1/91)	4.1	3.6
Blue Chip Average (7/91)	3.9	3.6
CPI-U		
Mid-Session Review (7/91)	3.5	3.9
CBO (1/91)	4.0	3.5
Blue Chip Average (7/91)	3.5	4.0

(Percent Change, Year-to-year)

	1991	1992
Real GNP		
Mid-Session Review (7/91)	-0.2	3.2
CBO (1/91)	0.0	3.3
Blue Chip Average (7/91)	-0.1	2.7
Blue Chip Top 10 (7/91)	0.4	3.5
Blue Chip Bottom 10 (7/91)	-0.5	1.9
GNP Deflator		
Mid-Session Review (7/91)	4.0	3.8
CBO (1/91)	4.3	3.7
Blue Chip Average (7/91)	3.9	3.6
Blue Chip Top 10 (7/91)	4.2	4.1
Blue Chip Bottom 10 (7/91)	3.6	3.0
CPI-U		
Mid-Session Review (7/91)	4.5	3.8
CBO (1/91)	4.9	3.5
Blue Chip Average (7/91)	4.4	3.8
Blue Chip Top 10 (7/91)	4.7	4.6
Blue Chip Bottom 10 (7/91)	4.0	3.1

TABLE 4 (Cont'd)
COMPARISONS OF ECONOMIC PROJECTIONS
(Calendar Years)

	Percent, Annual Averages	
	1991	1992
Unemployment Rate (Total)		
Mid-Session Review (7/91)	6.6	6.4
CBO (1/91)	6.8	6.4
Blue Chip Average[1] (7/91)	6.6	6.4
Blue Chip Top 10[1] (7/91)	6.8	6.9
Blue Chip Bottom[1] 10 (7/91)	6.4	5.9
3-Month Treasury Bill Rate		
Mid-Session Review (7/91)	5.7	5.9
CBO (1/91)	6.6	7.0
Blue Chip Average (7/91)	5.8	6.1
Blue Chip Top 10 (7/91)	6.1	6.7
Blue Chip Bottom 10 (7/91)	5.6	5.5
Long-Term Interest Rates		
Mid-Session Review[2] (7/91)	8.0	7.8
CBO[2] (1/91)	7.9	7.7
Blue Chip Average[3] (7/91)	8.9	9.0
Blue Chip Top 10[3] (7/91)	9.1	9.6
Blue Chip Bottom[3] 10 (7/91)	8.6	8.4

[1] Blue Chip total unemployment rate, which is the published Blue Chip civilian rate less 0.1 percentage point.

[2] 10-Year Treasury Bond Rate.

[3] Corporate Aaa Bond Rate.

SENATOR SARBANES. We'll be glad to hear from him.

STATEMENT OF JOHN TAYLOR, MEMBER PRESIDENT'S COUNCIL OF ECONOMIC ADVISERS

DR. TAYLOR. Thank you very much, Mr. Chairman.

And thanks also to the members, especially those who had some fine remarks about my near-term departure and my service in Washington.

It's a pleasure to be here today, as it has been in the previous times I've appeared before this Committee. I hope this testimony is as pleasant as the previous four or five have been.

I want to mention two or three points related to our forecasts.

The first has to do with the strength of the recovery. Our forecast, as Dr. Boskin has indicated, is for what would be called a moderate recovery; very similar to what many private forecasters have predicted. It's somewhat less strong than previous recoveries, but that relates to the fact that the recession we have been through has been shorter and shallower than previous recessions.

And while there are risks—as Dr. Boskin indicated—with forecasts, I'd like to just mention some of the issues on the other side, suggesting that we might have an even stronger recovery than forecasted.

In particular, inventory developments could very well lead to more rapid growth in the next couple of quarters than we are forecasting. Less liquidation of inventories or perhaps even the beginning of some inventory accumulation could actually bring rather rapid growth for a quarter or two in the latter part of this year.

Moreover, I think it's important to remember that there was a considerable amount of capacity gap created during the period right before we went into recession. We had a period of economic growth that was below what most economists estimate to be our potential for several quarters before the recession began, thereby creating more room for recovery than I think many economists are predicting.

In measuring the level of the economy's potential, economists call on many factors. It's very difficult to project the level of the economy's potential. I believe the gap between where we are now and our potential is quite a bit larger than the simple 1.1 percent decline that we've had in this recession. Therefore, we have more room to grow than many economists indicate.

The second point I'd like to refer to is our longer term forecast. Dr. Boskin indicated that our longer term forecast for the mid-1990s is for the economy's potential to be growing at around 3 percent. That's larger than many private forecasters project.

One of the reasons that it's larger is that, as we emphasize so strongly in our forecast, it's conditional on the implementation of President's pro-growth policies.

I would say our forecast is about a half a percentage point higher in the mid-1990s than that of many private forecasters. I think that this half

a percentage point is of tremendous importance for the future of our country. It's very important that we achieve that extra half percent.

In the 1990 Economic Report—the first Report we put together as a Council—we indicated, as an example, that Italy began, in the latter part of the last century, with a per capita GNP only 40 percent of that of the UK. And, with a half percent higher growth rate than the UK since then, it has achieved a per capita income even higher than the UK's.

I can't emphasize more strongly that these pro-growth policies are essential to achieving a strong growth, which is so important for our country and for our children in the 1990s.

I worked on trade policy during my term on the Council of Economic Advisers, and I think trade policy is a crucial component of our pro-growth policies. We've estimated that successful completion of the Uruguay Round could increase the economic growth rate by 0.3 percentage points over the next ten years, taking into account many of the additional factors that could affect growth by lowering our trade barriers.

We have a number of other trade initiatives: the North American Free Trade Area; the Enterprise for the Americas Initiative; and the Structural Impediments Initiative with Japan. We even have a trade enhancement initiative with Eastern Europe. Each of these initiatives would reduce trade barriers and help increase our growth rate.

We have proposals on the domestic side as well. I would begin with the Budget Act passed last year that has put a mechanism in place that will reduce the structural federal deficit by a substantial amount compared to what it otherwise would be.

I also would focus on the proposed capital gains tax reduction and its anticipated stimulus to entrepreneurship, saving, and investment, which are so essential for long-term economic growth.

And finally, I would note the proposal to create family saving accounts to stimulate private saving, which needs to be increased if we are to achieve a higher growth rate.

Finally, Mr. Chairman, let me conclude on a more technical note about our forecasts.

Most of the discussions of economic forecasts focus on the growth of output and inflation. There's another part of the forecast that is very important for budget analysis and that's the growth rate of income.

I'm happy to say that our forecasts for the income side of the accounts—profits, wages and salaries, personal income—have also been very accurate since the budget was submitted. They therefore require very little adjustment. In fact, we are adjusting somewhat upward our forecasts for profits, reflecting a somewhat higher growth rate for the economy.

Our projection is now that profits will rise to 5.3 percent of GNP in 1991, and 5.6 percent of GNP in 1992.

I should note that this projection for the income side of the accounts is much like that of private forecasters. I think it's credible; it's reasonable, and perhaps more reasonable than the income side forecasts that have appeared in previous Administration forecasts.

Thank you, Mr. Chairman.

SENATOR SARBANES. Thank you very much, Dr. Taylor. We will now go to questions.

Chairman Boskin, let me say to you very candidly that I am distressed by this statement that you have submitted this morning. I listened to it very carefully, and I have gone through it very quickly. As best I can find, there are only two or three references to the unemployment situation and the problem of the unemployed.

On page ten you say: "The recession has caused significant dislocations for workers, which should not be underestimated." That is cold comfort to the millions of Americans who are out of work and have exhausted their unemployment benefits.

On page 13 of your prepared statement, you say: "The Administration also projects that the unemployment rate will decline steadily and reach 5.2 percent in 1996," but I think as you delivered it, you said it would go down to 5.2 percent in the next several years.

By your own projections, the unemployment rate is going to be 6.4 percent in 1991—that's next year—6.3 percent in 1993; 5.9 percent in 1994, which is still well above the unemployment rate a year ago, just before the recession began.

DR. BOSKIN. Well, a year ago in July it was 5.5 percent, up from 5.3 percent, which it had been for about 18 months.

SENATOR SARBANES. So, it was at 5.3 percent.

Now even by your own predictions, you are still going to have it above 6 percent through all of 1992 and 1993. That means anyone who has lost his job and is looking for a job—even by your own predictions—is going to be operating in a more difficult job market than when they lost their job. The unemployment rate in November of last year was 5.9 percent, correct?

DR. BOSKIN. I believe so.

SENATOR SARBANES. And you don't project getting back to 5.9 percent until 1994; is that correct?

DR. BOSKIN. Well, with a minor technical proviso, we actually get there in late 1993, early 1994.

SENATOR SARBANES. Well, I'll keep that in mind. But the point still stands.

Now, what are we going to do about these long-term unemployed—do you contest the analysis that indicates that the long-term unemployed continues to rise after a recession ends? That's been the previous experience and it's reasonable to assume it will be the current experience.

DR. BOSKIN. Yes, for a short period after the recession ends, certainly unemployment will——

SENATOR SARBANES. Now, what are we going to do about these unemployed people?

You have 2.3 million workers who have exhausted the regular unemployment benefits over the past 12 months during this recession and

have not been able to find a job. They're now trying to find a job in a job market that is more difficult than when they lost their job.

The unemployment benefits have not carried them through a period that has seen the economy start up again, so they're now trying to find a job in a less favorable job market; it's a tougher job market than when they lost their jobs. And you have another, almost 1.5 million, who are within a few weeks of running out of their benefits.

We are talking about people who were working, supporting their families, making a contribution. They lost their jobs; they are entitled to unemployment benefits; they started drawing unemployment benefits; they ran out after 26 weeks.

Now, in every previous recession, the Administrations—as Senator Kennedy indicated—Democratic, Republican, and the Congress, provided additional unemployment benefits. Why have we not done it in this recession?

DR. BOSKIN. Well, I can't speak for the Congress, sir, but I can say that, as a technical matter, which I realize is not a help to those who have been unfortunate enough to lose their job in this recession, the labor market situation started from its best situation in 16 years. And while it has deteriorated, and we're concerned about that deterioration, and we want it to improve as rapidly as possible, it is still somewhat better than the rate that we entered the last recession. Indeed, the unemployment rate is somewhat lower than when the extended unemployment benefits that were adopted—I believe it was in September 1982 during the last recession—were removed in 1985. They were removed when——

SENATOR SARBANES. What comfort does that give to an unemployed person who may be watching this hearing; who had a job; lost it; drew his unemployment benefits and has now exhausted the unemployment benefits and is going to lose his home and can't support his family? I mean what are we going to do about these people?

It's not as though we don't have money in the Trust Fund. I want to ask you, what is the justification for having an Extended Benefit Trust Fund balance that continues to build up during a recession? Under what theory would you justify building up the surplus of the Extended Benefits Trust Fund during a recession, instead of using that money in order to pay unemployment benefits?

DR. BOSKIN. Well, I think it would depend some on the severity and expected length and duration of the recession, sir. I also think one would want to look at the stance of total fiscal policy to get an idea of what the fiscal picture was doing to the economy.

SENATOR SARBANES. Massachusetts has an unemployment rate of 9.5 percent—9.5 percent; Michigan has an unemployment rate of 9.1 percent, and they have just been cut off of Extended Benefits for unemployment insurance. Do you think we ought to have unemployment levels that high and not be paying Extended Benefits?

DR. BOSKIN. I wouldn't make a particular statement with respect to either of those states. As I said in my testimony, they've been hit far worse than the national average.

One could try to contemplate readjusting the formulae, as suggested in some proposals. Those are states that have been hit probably harder than almost any other. Their situation——

SENATOR SARBANES. Well, shouldn't Extended Benefits be paid in those states if they have unemployment rates at those high levels?

DR. BOSKIN. I think the formulae in the program anticipated not just the level but the rate at which it was changing. I was not here and was not a participant in any of the programs that were developed earlier, but I believe that the original rationale was that as the unemployment rate stopped deteriorating the programs would kick off.

SENATOR SARBANES. So, you are just telling these unemployed it's tough turkey. Nothing is going to be done, even though there is more than enough money in the Trust Fund?

The employers are paying this money into the Trust Fund ostensibly to pay unemployment benefits. In fact, we have been hearing complaints from employers, who pay these unemployment taxes for the purposes of their workers receiving unemployment benefits when they are laid off. The employers are saying to us that the system isn't working the way it is supposed to be working. They pay these taxes in order for them to be used in a recession so that their workers could receive unemployment benefits. Instead, they are being used to build up the surplus in the Trust Fund, and the workers, having exhausted their 26 weeks, find themselves in a personally, incredibly difficult situation.

What do you say to those employers? Isn't that an abuse of the use of their tax money that was directed for this purpose?

DR. BOSKIN. I certainly agree that there are a substantial number of long-term unemployed and that number has risen in the recession, and that it's likely that it will rise for another few months before it turns around. But we expect this trend to turn around over the next few months and to improve steadily thereafter.

Some states—the two you mentioned in particular—have been hit very hard. But we started from, as I indicated, the best labor market situation we've been in since the early 1970s.

With respect to paying taxes into the extended fund and what is done with those, I would again get back to placing this into the context of the stance of our overall fiscal policy and the impact that it has had on the economy. And I would not currently support spending increases that weren't accompanied by other spending cuts.

SENATOR SARBANES. So, you would tell an unemployed worker, who has run out of the benefits: you started from a very nice position in terms of what the unemployment rate was and you simply have to bear that burden; is that it?

DR. BOSKIN. No. I would——

SENATOR SARBANES. Well, what are you going to tell him?

DR. BOSKIN. I would start by saying that I think if the Congress is desirous of extending unemployment benefits and so forth, then it should seek cuts in other spending programs.

SENATOR SARBANES. Where does your counter-cyclical policy go with that approach?

DR. BOSKIN. Well, we're relying on the current automatic stabilizers in the budget, as applied by the existing set of instructions.

SENATOR SARBANES. Do you disagree with Paul Samuelson, when he told this Committee two weeks ago, that the unemployment insurance system is not performing the stabilizing role that it has in the past?

DR. BOSKIN. I would take some exception with that. He is correct that if one looks at the fraction of covered unemployed to total unemployment, while that has risen substantially over the last 18 months, it is lower than it was many years ago, primarily because states have changed their eligibility requirements. I think we have to go back to why they did that. I think that's one reason the states are in some fiscal problem now.

SENATOR SARBANES. Well, my time has expired. I'll come back on a second round.

Congressman Armey.

REPRESENTATIVE ARMEY. Thank you, Mr. Chairman.

Thank you, Dr. Boskin and Dr. Taylor, for your excellent testimony.

I hope that you will take time later in the day when you have time to read Senator Gramm's extremely impressive editorial in today's *Washington Times*. I always, of course, expect outstanding work from the Senator but he really outdid himself today.

The gist of his editorial is that the reason we have enjoyed such incredibly low unemployment rates during the last eight years, relative to what we experienced in the old days of stagflation and malaise, was that the Reagan Program was consciously and assertively a program of growth.

He points out that there are some people that frankly and surprisingly have a political agenda of no-growth for the country, and they were of course frustrated by that success and desire to discredit it. So, it's a fascinating job.

I was fascinated with——

SENATOR SARBANES. Will the Congressman yield for me just to make one point?

REPRESENTATIVE ARMEY. Yes.

SENATOR SARBANES. This [indicating] is the payment of Extended Benefits under the Reagan Administration when we had our last recession, just to put that in context. This [indicating] is what we are experiencing in this recession.

DR. BOSKIN. May I make a point?

SENATOR SARBANES. Sure.

Dr. Boskin. Which is, that the peak you just pointed to occurs in a period when the unemployment rate was almost 11 percent.

Senator Sarbanes. That's fine.

Dr. Boskin. Thank you, Mr. Chairman.

Representative Armey. Mr. Boskin, you make a really very reassuring comment on page two. I have to tell you, as you know, Dr. Boskin—I don't know if you know, Mr. Taylor—that I was a practicing academic economist for 20 years before I decided to come to the real world and come to Washington. And I remember teaching my students in macroeconomics, when I was forced to teach the course——

[Laughter.]

Representative Armey. ——that in Washington they have very sophisticated models, very elaborate databases, and complicated stepwise regression models and econometric gimmicks by which they make all these projections.

Now, as you might guess, I was sorely disappointed in my naivete when I got here and saw what we really did in this town.

But, Mr. Boskin, you reassure me when you say on page two: "... the projections embody the best available forecasting methods, informed judgement, and basic economic principles."

Now, it strikes me that perhaps the most basic—certainly among the most basic economic principles and certainly among the most irrefutable of basic economic principles—is what we used to call the law of downward sloping demand. I see no exception to it, including the alleged "Giffen good," which is only a matter of a super inferiority in the income effect as opposed to the substitution effect—and I won't get into that. I've found very few people as fascinated with the "Giffen good" as I am.

But to go on, you always say: "Human behavior is complex and difficult to predict." I couldn't agree more.

When we were in the Budget Summit last year and there was such a searching for a tax in this town, I had a lot of fun trying to evaluate it.

Let me just give you my truck driver's evaluation of some of the taxes. The gas tax, I thought, was an incredibly bad idea because of the high linkage effect of gasoline prices, which I felt was a clear precursor of the stagflation days of the 1970s, which you referred to as the oil shock recessions; stagflation was a simultaneous occurrence. So, I put that at the top of my worst list.

The income tax would have perverse employment effects but would be very difficult to pin down and to document. I considered those, as pure employment effects, would be more perverse than even the tax but without the stagflation effect.

The luxury tax, I said, would probably have the least worst-employment and inflation effect because of the low linkage effect on prices, but it would be most tractable.

Congress, in its misjudgment, opted for the luxury tax and got the tractability that's embarrassing us so much now, precisely because the

Joint Tax Committee and the Congressional Budget Office, having acknowledged that "human behavior is complex and difficult to predict," chose a model that assumed there would be no human behavior when we imposed these taxes. That is to say, they felt it was better to be clearly, absolutely, and definitively wrong than risk being approximately correct.

As a fellow who tried to guide young minds into understanding that there is some wisdom hidden somewhere in the cracks and corners of Washington, I find this a very disappointing thing to have to point out to young people. I'm sure you will have that unpleasant task.

Now, as you have mentioned, Mr. Boskin, our recessions were the oil-impact recessions of the 1970s; we are currently in a similar recession. I notice Michigan where luxury automobiles may be produced because of the luxury tax on automobiles; I notice Massachusetts, which I'm certain had a thriving boat industry in the past, is less thriving today because of a luxury tax on boats, both having taken a good microeconomic hit from our Tax Committee.

The Tax Committee now, I understand, is talking about a gas tax.

Now, do you suppose it would be possible for us to convince the Joint Tax Committee and the Congressional Budget Office, in light of what must be their certain embarrassment over the perverse employment and revenue effects—that the Federal Government is now losing—it is estimated by people who do take human behavior into consideration—five dollars for every dollar it's taking in through the luxury tax and destroying thousands of jobs.

In light of that embarrassment, do you think it's possible we could require the Joint Tax Committee or the Congressional Budget Office to use a somewhat more sophisticated model, perhaps one that approximates that which you will demand of your sophomores when you go back to academia, before we jump into this gasoline tax?

Is there any way that, perhaps in your function on the Council of Economic Advisers or in your function in academics, you could either cajole or embarrass our Joint Tax Committee or our Congressional Budget Office into trying to be as smart as we require the average college sophomore to be. That's probably my bottom-line question?

Dr. Boskin. Well, we certainly oppose a gasoline tax increase. We think it would be very bad for the economy. And we also do believe that it would, certainly in the current stage, be unproductive.

With respect to your analysis of the luxury tax, as we've said, we would be receptive to possible amendments to those parts of it that could be clearly demonstrated to have been counter-productive.

With respect to CBO and the Joint Tax Committee, they have had their failures as well as their successes over the years. They sometimes seem to use estimates, or basic economic grammars, with which the Council and I do not agree. But the ability to cajole or embarrass them, as you indicate, I think, depends in part on the receiving end as well as the transmitting.

And to that, I'll have to defer to Dr. Taylor, whom I think knows them better than I do in terms of the receiving end.

DR. TAYLOR. I think one of the things that we can do about the methodology of assuming that the economic response to any tax policies will be minimal or nonexistent is to do it right ourselves in our analysis.

By way of example, there are many cases, I think, that will be coming up in the future, where it's going to be mandatory to have a more accurate assessment of the effect of tax change.

One such case is the trade policy area where we're thinking about changes in tariffs that will affect revenues. If there's not an intelligent analysis of the trade response and volume that will come from those changes in tariffs, we'll be getting it wrong. So, I think it's very important to try to get it right and get the system on the right track.

REPRESENTATIVE ARMEY. Thank you. And I, too, would like to come back to the trade issue later.

Thank you, Mr. Chairman.

SENATOR SARBANES. Senator Kennedy.

SENATOR KENNEDY. Mr. Chairman, I join with those who believe that the Administration's economic policy has been one of standing by while the economy has been staggering.

First, they denied that we were going into a recession. They minimized what the economic impact was going to be in terms of working families. And now they are prematurely giving us their observations that we're getting out of the recession.

Listening to their explanation reminds me of the patient whose temperature goes from 98 to 101 in one day. And then it goes from 101 to 102 in two days. And people say, you're getting better because you're getting sicker slower.

And that is what I'm hearing from the Administration when they're talking about the 9.5, 9.6 percent unemployed, not even including those who have given up looking for employment, in my state.

The testimony this morning was almost as though Massachusetts, New England, California, Michigan, and West Virginia were islands; they don't really belong to America. There are a few areas here, and they have some problems but they really don't matter.

I always thought we were one country with one history and one destiny. When we had problems in different parts of this Nation, which all of us know happens over the economic history of this Nation, we bring together some attention, some focus, some effort, and some energy.

Now, the Congress of the United States is going to pass an extended unemployment benefit program. What's your recommendation to the President—to veto it, or to sign it?

DR. BOSKIN. My recommendation, under the current situation, would be, if it was passed without offsets, in violation of the Budget Act, would be to veto it.

SENATOR SARBANES. Well, it's not a violation of the Budget Act if the Administration regards it as an emergency.

You come in here and ask for an emergency to give lots of money overseas, and you won't find an emergency to help unemployed workers in America.

SENATOR KENNEDY. We have seen, as the Chairman has pointed out, that there is a surplus in that trust fund.

How much has the Administration requested as an emergency, outside of the budget, for the period of the last 12 months for overseas aid?

DR. BOSKIN. I couldn't give you an exact amount.

SENATOR KENNEDY. It's hundreds of millions of dollars.

DR. BOSKIN. Hundreds of millions of dollars.

SENATOR KENNEDY. It's hundreds of millions of dollars.

And, just by your answer now, you're saying that you would recommend a presidential veto, even though this Administration in the period of the last 12 months has requested hundreds of millions of dollars—over a billion—in terms of foreign aid?

Now, that's the reality. That's what you're saying up here.

And Mr. Taylor talks about trade policy. We're debating trade policy right over on the floor of the United States Senate with regard to most-favored-nation status for China.

You responded earlier about future employment resulting from the Canadian agreement, what we might expect in terms of Canada. You talked about the Uruguay Round and what that is going to mean.

The Administration has a foreign trade policy. When are you going to have a jobs policy of putting people back to work in this country? That's what people are asking in communities all over this Nation.

There's a new poor in this country—men and women who have worked their lifetime and now find that they are unemployed. And 30,000 of them this past month in my own state have just gone off extended unemployment benefits. They just don't know how they're going to feed their families or how they're going to make ends meet. They are proud men and women who have been a part of this whole process.

And you're saying that we have had better economic conditions going back a few years, and now those people are out there, and we just don't really understand why we're not getting the credit for that.

You bet you're not getting the credit out there, but what have you been doing about it? You say we have some problems, some "overzealous regulators." None of us are saying regulators should not be efficient, not protect the consumers' interest, and not protect the deposits. But where are you saying what you're doing?

Recently, Secretary Brady came up and gave pious comments about what the Administration planned to do by way of instructions to regulators. But go into any community in New England and talk to any small businessman or woman, any Republican or Democrat, whoever it is, and ask them whether there's been any change? None. Virtually none.

So, how can we listen to this and believe it's relevant to what is really happening in community after community across this country? It seems to me that you have a real responsibility—if these characterizations are true that have been made by my other colleagues from New England and others on this Committee—to ask you why you're not bringing attention and focus to these issues, and why you do not have some recommendations or demonstrated concern, because this testimony leaves it blank.

Mr. Chairman, I had hoped that we were going to have a response from this Administration. When we hear from Mr. Boskin, the unemployment situation is going to get even worse; it's just going to get worse in the next few months. People are falling off the cliff, in terms of unemployment compensation, and unemployment's going to get worse.

And we still have nothing from the Administration, other than the comment that basically things are getting better, generally.

I yield to your years of academic experience in terms of the economy, but it just doesn't answer what's happening out in the real world on Main Street, in my part of the country and in many other communities.

My time is up.

SENATOR SARBANES. Thank you very much, Senator Kennedy. Senator Smith.

SENATOR SMITH. Thank you, Mr. Chairman.

Dr. Taylor, I'll bet you wish you'd started off to Stanford a little earlier.

[Laughter.]

DR. TAYLOR. I commented on how I was hoping that this testimony would be as pleasant as the previous four or five.

SENATOR KENNEDY. Well, it's very unpleasant for a lot of other people out there.

DR. TAYLOR. Yes, sir.

SENATOR SMITH. With all due respect to some of the comments of my colleagues, I realize that there are a lot of people hurting out there—there's no question about it—but I think if you look at it there's enough blame to go around.

Just on the issue of the luxury tax alone—you get differences of opinion on the estimates—that cost 9000 jobs. And that's not much of a dent in 5.5 million unemployed, but it is 9,000 people who have lost their jobs.

As I was listening to Senator Sarbanes and Senator Kennedy, I am reminded of the time of the eight years of the Reagan Presidency when the economy was very good, at least in the last six years of the Reagan Presidency. And I am reminded of some of the comments at that time that it wasn't the Reagan policies that was giving us 2 to 3 to 4 percent unemployment, and 2 to 3 percent inflation, and the benefits they were yielding; rather, it was the low cost of oil or some other excuse.

Then my mind goes back to the late 1970s, when the other party had control of the Senate, the House, and the Presidency, we had 13 and 20

percent interest rates, and unemployment at 8, 9, 10 percent. So, I think, with all due respect, to come down as far as you have this morning, gentlemen, on Mr. Boskin is a little bit out of line.

As I see it, unless we're willing to deal with what I believe is the number one crisis facing this country, and that is the budget debt—the National debt—which is now fast approaching four trillion dollars on a fast track. Unless we're prepared to deal with that, not only are jobs going to be eliminated, but, to me, there will be no benefits left—the benefits that my colleagues speak of.

In the very near future, interest on the National debt is going to surpass what we spend on National defense; that's coming, perhaps by the end of this century. So, I think that's really where the problem is.

Let me bring it into focus on something I'd just appreciate your response to, either one of you gentlemen. And it's something that I've felt was a problem for a long time.

You addressed four points, Mike, in your testimony.

One is pro-growth fiscal policy. The point is that the pro-growth fiscal policy of the United States of America is not controlled by the Administration; it's not controlled by the Congress. There's a tremendous difference, by at least a majority of members of Congress, with the Administration on the pro-growth policies and what the pro-growth policies are. And I'm going to quickly touch these four and ask you to respond.

Second, the monetary policy is out of both of our hands. We've created an independent agency—it doesn't have to answer to anybody for setting monetary policy. You certainly have your disagreements with it; I do; others do for different reasons.

Third, trade again was back in the conflict between the current Administration and the Congress on what good trade policy is.

And, fourth, regulation, again going back to the conflict between the Congress and the Administration.

And recapping, I think we regulate too much. I think we tax too much. I think we spend too much. And these are conflicts between some of us here in the Congress, and then that conflict takes on a new life with the conflict with the Administration.

So, I don't see how, with the current structure being the way it is, that we're ever going to get out of it. You essentially have a monetary policy controlled by an independent agency and tremendous philosophical conflicts—basic, fundamental philosophical conflicts—between the Congress and the President on how to deal with it.

We could sing loud on one particular thing or another, whether it's unemployment—unemployment certainly is part of the problem, but unemployment results from, in my opinion, bad fiscal policy. It results from too much regulation and from too high taxes in this country. And it results also from the fact that the Federal Government has to be the wherewithal, the catchall, the do-it-all entity that's somehow going to

solve all these problems, when in fact every time it gets involved in it, it screws it up.

The Federal Government is out there competing with every single businessman and woman in this country for borrowing money; competing big time. So I'd just like, in a general sense, a comment on the structure, whether there's any recommendations you might have or perhaps you, Dr. Taylor—since you're leaving—can throw something out, maybe as a parting shot.

But what ought to be done structurally about that? I certainly support separation of powers. I'm not in any way advocating doing away with that. But I think, in terms of the independent agency part of it, number one, I'd appreciate a comment on the gold-backed bonds.

There's an opportunity, if you want to try something dramatic—and I think we are in a dramatic situation. What about gold-backed bonds? I'm not saying gold standard. What about selling gold-backed bonds? You can get them out at 2 or 3 percent interest; we pay 8 percent interest now. There's a tremendous whack we could take out of the deficit.

But anyway, just those two or three points, I'd like some comments on that.

DR. BOSKIN. Well, let me start, sir, by saying that I basically agree with your major point, which is the deficit and debt is a very serious problem, and that we need to make sure we try to get spending under the best control. We cannot overtax nor overregulate; we can only tax and regulate where necessary, and do so where we have to and as efficiently as possible.

And while some improvements have been made over the years, for example, in lower marginal tax rates after 1981 and 1986 Tax Reforms, and in some slowdown in the explosion of regulation in the 1980s, we still have a long way to go to get to sensible policies.

I think we do overregulate. We have a variety of social goals. And I think the tendency to regulate and to mandate on the private sector has grown. With the budget agreement, and previously with Gramm-Rudman, it's going to become more difficult to reach some of the social goals through direct government spending.

I think that overregulation is imposing a very large burden on our businesses as they try to compete internationally; in some cases, it's caused loss of employment.

With respect to independence and independent agencies, while I have had my differences with the Federal Reserve, I do think that it is an empirical fact that those countries, which have relatively independent central banks, have had lower inflation. They may not have done as well in other dimensions, but they have lower inflation than countries that had central banks that were under more direct political control.

So, I guess I'm a little nervous about thinking about radical change in the structure or independence of the Federal Reserve. But I do believe that the Fed had a monetary policy, which in 1988, when the economy was booming, the unemployment rate was historically quite low, and capacity

was rising, correctly, in my view, worried about an incipient increase in inflation; which, thereafter, to wring out, would require still tighter monetary policy.

But I think they probably, certainly with a bit of hindsight, went a little too far and eased too slowly. That was certainly one of the things, as I indicated in my testimony, that lead to the economy being in a rather fragile condition at the time the oil shock hit.

But I certainly would not favor changing the independent status of the Federal Reserve. I know that Congressman Hamilton has had some suggestions to make some changes in the relations between the Federal Reserve and the other parts of the Government.

I think Secretary Brady phrased it pretty well when he said that, while he respects the Fed's independence, it has to be part of the team. And if the Congress and the Administration are doing what they can to control the deficit and spending, and do other things, the Fed has to chip in in its regard. I think it did make a significant improvement in monetary policy in late 1990 and early 1991.

With respect to this sort of inherent conflict, I think some improvements were made in the Budget Act in terms of putting in pay-as-you-go provisions; putting in caps on spending with automatic sequesters; requiring super majorities on a set-aside to stem various of these features.

Most academic economists, I think, are very sympathetic to notions like super majorities and other such policies designed to eliminate logrolling and things of that sort. But I think that we go back to these disputes. I'd rather not try to partition blame between Congress, the Administration, and the Fed.

For all the successes and for all the failures, we are, after all, despite the recession, the wealthiest economy in the world, with a corner on the world's economy and the highest standard of living. A lot of success is shared.

But I appreciate the point that I think is not often enough appreciated, when one assigns credit or blame to the President, or the Administration, or the Congress, or to anybody else, there are a lot of other factors involved in how the economy performs, some outside the control of any economic policy.

But the economic policymaking possibility is quite diffuse in our system, much more so than in other countries, which have, in some cases, unicameral legislatures and parliamentary systems with the central bank as part of the Treasury, where you have a tremendous concentration of economic authority.

I suppose that the founding fathers, on the fiscal side, and the Congress and the Executive Branch, when the Federal Reserve Act was passed in the early part of this century, thought that, despite some problems that would result, there was some desirability of having less of a concentration of economic policy authority than existed in other countries.

DR. TAYLOR. With regard to the philosophical conflict that's getting in the way of formulating policy, I just have two comments.

One, and perhaps this reflects too scholarly a position, it seems to me that discussions of the idea, like we're having now, and more informal discussions, like they have at the Federal Reserve, is really the way to get at the heart of some of the philosophical differences. Sometimes these differences are technical.

There have been various proposals to try to bring the Congress and the Administration together on estimating revenues for different types of tax changes.

It seems to me that you can go a long way in resolving some philosophical differences just by getting the facts on the table and get together reasonable people who disagree in a room to discuss them. There's a lot to be said for that.

The budget deal puts constraints on the totals and incorporates a serious, bottom line discussion: if we want to raise this, we have to lower that. If we want more in one program, some other program has to be looked at. This forces the discussion on the merits of the issues. It seems that such a discussion is also very healthy.

The second point I would mention relates to deals. You are, I think, the experts with respect to getting one program passed and getting someone else's program passed in terms of making a deal.

By contrast, our trade policy actually focuses on trying to balance different interests. Some interests think that this is more important; other interests feel that something else is more important. The trade package, which you put together in the nature of fast-track legislation, tries to bring into one package something where some gain, some gain less, and some even lose. The package tries to reflect these differences that way.

SENATOR SMITH. Mr. Chairman, my time has expired. I just want to make one statement in conclusion.

It just seems to me that we have an economic and a tax policy in this country—and, as I say, there's enough blame to go around—that throws people out of work. And then we spend a great deal of time in this Committee and other places debating how we can compensate those people when they're out of work. It seems to me that it makes better sense to not throw them out of work and to have a better economic policy.

There's nothing complicated, frankly, about balancing the budget—an across-the-board freeze. Everybody may not be happy with it but that would do it; if anybody's got the courage to do it. And it doesn't mean you have to freeze Social Security. I mean across-the-board in the sense that at the top you freeze it at 3 or 4 percent, and you'll balance the budget, pure and simple. But nobody wants to do that. It's much easier to posture.

DR. BOSKIN. Well, without commenting on the last part, I do believe that we have a long way to go in our regulatory, trade, monetary and fiscal policies, in order to have a policy that, on balance over time, keeps the economy closer to its potential and also enhances that potential.

And I think that, as Dr. Taylor indicated, it's immensely important, not only currently but to the future of our Nation, not to sell our economy to our Nation's gold supply.

SENATOR SARBANES. Mr. Boskin, gold-backed bonds, are you for them or against them?

DR. BOSKIN. I am for a study that would try to get at the merits and demerits. I think the case has been made by its proponents that it has some intellectual justification, but it's not fully worked out. And I think some of the estimates may prove to be optimistic.

I do believe that, while gold prices have been relatively stable in the last few years, if one goes over a longer span of time, the price of gold has fluctuated a lot.

SENATOR SARBANES. Congressman Hamilton.

REPRESENTATIVE HAMILTON. Thank you very much, Mr. Chairman.

Chairman Boskin and Dr. Taylor, I want to focus on your pro-growth policies and, particularly, I want to focus on monetary policy and how you feel about it.

On page two of your statement, you put tremendous emphasis on pro-growth fiscal policy, pro-growth monetary policy, pro-growth trade policy, and pro-growth regulatory policy.

If I understand what Chairman Greenspan is currently saying, it is that there will be no cut in interest rates. I think his words were, "watchful waiting" is the posture of the Fed. And that was interpreted, so far as I remember, by every commentator as meaning that the Fed is not going to cut interest rates.

Now, when I listen to President Bush and his economic statements, he says the emphasis is on growth, just as your statement said it is on growth.

When I hear Dr. Greenspan talk about inflation, he says the policy that we ought to follow is zero inflation. I've never heard President Bush say that the policy of the United States Government ought to be zero inflation. He's always balancing it toward a little more growth.

Now, the Fed has come in and their growth forecast is much lower than yours. Their growth projections are less than your 3.6 percent.

DR. BOSKIN. This is a technical matter. It's partly because they're more bullish about the second half of this year.

REPRESENTATIVE HAMILTON. Well, they're substantially under you. They're projecting 2.25 to 3 percent; you're projecting 3.6 percent.

And, on monetary policy, they are recommending a target for M-2 of 2.5 to 6.5 percent, with the midpoint at 4.5 percent.

I saw an article the other day in the *Wall Street Journal*—I think it was by Marty Feldstein—arguing that M-2 growth ought to be 8 percent.

So, I get the impression then, in comparing what the monetary authorities are saying and what President Bush is saying, that you're very far apart with respect to monetary policy.

So, the question is, can you achieve your 3.6 percent growth in 1992 if the Federal Reserve uses monetary policy to limit growth to a range of 2.25 to 3 percent?

DR. BOSKIN. First of all, the Federal Reserve doesn't control real growth, as you well know, sir. It controls bank reserves and that supplies money, and the money supply affects interest rates, and the interest rates in turn affect the economy through a variety of channels. There's obviously dispute among various people about exactly which channels work, when they work, with what lag they work, and how strongly they work. But the goal is achievable with the Fed setting monetary policy at the upper end of its range.

I think that what we've seen from the Fed over the last couple of years should not necessarily be interpreted as what is likely to happen in the future.

What we've seen from the Fed is that they have set progressively lower target ranges, and they've come in consistently below the midpoint of the targeted range, not rebased back up to the midpoint. One might look at those charts and conclude that the midpoint is kind of an upper bound, and the money supply turns down whenever it gets close to the midpoint.

REPRESENTATIVE HAMILTON. Let me see if I understand you. You're saying then that if the Fed hits the midpoint of 4.5 percent growth for M-2, that's not satisfactory?

DR. BOSKIN. It would be satisfactory if velocity, the rate at which money turns over, rebounds, as it often does in the early stages of an economic recovery and following a decline in short-term interest rates. If that occurs, then——

REPRESENTATIVE HAMILTON. Would you expect it to occur?

DR. BOSKIN. I expect some rebound. I think the jury's open on how much.

REPRESENTATIVE HAMILTON. That 4.5 percent, is that a satisfactory target for you?

DR. BOSKIN. I believe that the range leaves sufficient room up to 6.5 percent——

REPRESENTATIVE HAMILTON. You favor the upper side?

DR. BOSKIN. It would be conditional on what we see as we move through time with respect to velocity. But I think the Fed has to be prepared to be above the midpoint in its range as well as below.

REPRESENTATIVE HAMILTON. Do you think the Fed should cut interest rates now?

DR. BOSKIN. I think the Fed should be taking a very careful look at how robust the underlying strength of the economy is going to be over the next couple of years, not just the next quarter or two, and formulate its monetary policy accordingly. I think it's going to have to add sufficient reserves to achieve its target—I think inflation is declining and coming under control.

REPRESENTATIVE HAMILTON. I remember very well—and I've never seen it done by any other President, ever—when President Bush said in his State of the Union address, "I want interest rates down now," or words to that effect. That's the most remarkable jawboning by a President to the Fed ever.

Is it the position today of President Bush that he wants interest rates down now?

DR. BOSKIN. Well, let me separate that from interest rates in general and the policies to get real, after-inflation, interest rates—especially long-term rates—down from a short-term move by the Federal Reserve. If the Federal Reserve cut short-term rates now, it's not totally clear what would happen in the bond market to long-term interest rates.

So, I think that there is some reason for the Federal Reserve to adopt, for a very short period, a wait-and-see attitude, to see if the recovery really is as robust as they seem to think it is likely to be for the next few quarters, and to get reassured that inflation is under control.

But I do believe that they're going to have to. It happens every time. I can never predict when what I'm going to say is going to clear the room. They're going to miss the punchline by putting up the first part—the wire services. So, I'll ask that they be sent back out as soon as they come back in.

The Fed is going to have to be prepared to add more reserves to the system if the economy looks like it's going to continue to be sluggish.

REPRESENTATIVE HAMILTON. OK. Then I understand you to say that you would not favor the Fed's lowering interest rates now. They ought to be watching it very carefully.

DR. BOSKIN. They have to be prepared to move. I wouldn't say that things are unambiguous now, but they may well have to move soon.

Certainly, if the money supply does not rebound and velocity does not rebound, as expected, then they will have to do so.

REPRESENTATIVE HAMILTON. And you believe that your 3.6 percent growth rate can be achieved with the announced targets for monetary policy?

DR. BOSKIN. They'd have to be at the upper end unless velocity rebounds a lot.

REPRESENTATIVE HAMILTON. My time has expired.

Thank you very much.

DR. TAYLOR. Mr. Chairman, maybe I could just add one point.

Our forecast for nominal GNP growth in 1992 is 7.5 percent. Economists focus on the historical regularity between M-2 growth and nominal GNP growth; those growth rates being very similar for long periods of time. But of course in recoveries and downturns, a potential dissimilitude exists. But our forecast for nominal GNP growth of 7.5 percent is actually 1 percent above the upper range of the Federal Reserve target, which is 6.5 percent for 1992. So, that does imply some additional

velocity increase in order for the monetary targets—strictly speaking—to be consistent with our forecast.

And, I think, in its report to the Congress last week, the Fed was clear that if velocity did not develop that way then changes in its targets would be made. These ranges set by the Fed are always conditional. Ranges for 1992 are conditional on assumptions about velocity and events that occur at that point in time.

So, in that sense, I think the forecast can be thought of as consistent with the Fed's targets.

REPRESENTATIVE HAMILTON. I think you're quite right to focus on the question of growth in your economic policy. I like that emphasis in your statement.

I have doubts as to whether you can get to the kind of growth you want with that kind of monetary policy which, as I understand it, is the most important factor in the economy at the present time. And I have real doubts whether you can get there with the monetary targets that the Fed has announced. And that's the reason for my questions.

DR. BOSKIN. I certainly agree that all the empirical evidence suggests that monetary policy is a very strong determinant of output and employment in the short- to medium-run and the primary determinant of inflation in the long run.

SENATOR SARBANES. That problem is compounded by your own statement this morning that credit is unnecessarily constrained and remains a serious problem. But it's not clear to me what you're doing about it at the moment, if anything. What are you doing to address the credit crunch?

DR. BOSKIN. The Treasury, in which the Office of the Comptroller of the Currency resides—one of the regulatory bodies of banks—has called together the Comptroller, the FDIC, and the Federal Reserve, and has worked through a variety of proposed changes—clarifications of accountings, loan-splitting, and a variety of other things—which address the credit crunch.

I know Secretary Brady and Deputy Secretary Robson have been trying to make sure that that message gets down to the level of the examiners. I think we're all frustrated that that has not happened yet, apparently.

From what I hear back from bankers and from borrowers, is that the behavior of the regulators really has not changed yet. So, that's still a problem.

So, we continue to try to get sensible, prudent oversight, but based on economic reality, not based on unfounded fears of a repetition of the problems in the banking industry.

The Treasury is trying to make sure that the people who are responsible for regulating—only some of whom are under the auspices of the Treasury—get the message out much more forcefully and much more clearly on this.

Nobody wants any forbearance, but we want to make sure that the bank examiners—the level of people going into the banks—are looking at the economic reality of the various portfolios, not at artificially-imposed formulae and overly-pessimistic assumptions about the future course they're on.

SENATOR SARBANES. Congressman Solarz.

REPRESENTATIVE SOLARZ. Thank you, Mr. Chairman.

Mr. Boskin, there's a Yiddish word, rachmones, which means pity for people, sympathy. Do you have any rachmones for these poor regulators? When they don't regulate tough enough on the S&Ls, we beat them up for being lax. Now, it's said they're regulating too strongly on the banks, and we beat them up for being too tough. It seems like those poor fellows, no matter what they do, get beaten up.

DR. BOSKIN. Well, while I would agree that they have been in the headlines and have had a certain amount of public concern expressed on both sides, I think probably—as a rough historical generalization—they probably were too lax some years ago, and probably now the pendulum has swung a little too far.

I would have at least as much concern about the businesses that can't get credit and the employees of those businesses that are having their job opportunities cut back.

REPRESENTATIVE SOLARZ. Let me ask you a few questions about this matter of the extended unemployment benefits, which seems to have generated some heat around this table. Maybe you can shed some light on it.

How many people do you estimate will exhaust their unemployment benefits over the course of this year?

DR. BOSKIN. I believe the number is about a million.

REPRESENTATIVE SOLARZ. A million. I'm told that you had estimated three million.

DR. BOSKIN. I thought you meant for the remainder of the year. There is a some substantial number already.

REPRESENTATIVE SOLARZ. So, is three million about right for the current fiscal year?

DR. BOSKIN. That sounds about right. I think it's 2.3 million so far for the recession, which is obviously a substantial number.

REPRESENTATIVE SOLARZ. Well, let's say by the end of the fiscal year, according to a chart that's put out here, it seems to be about three million. What would it cost us to provide these three million people with extended benefits?

DR. BOSKIN. Several billion dollars.

REPRESENTATIVE SOLARZ. Four or five billion dollars?

DR. BOSKIN. It would depend on the nature and length of the proposal.

REPRESENTATIVE SOLARZ. Now, how much money is in the Trust Fund?

DR. BOSKIN. We see the chart right behind you that Senator Sarbanes put up. It looks to be $9.5 billion, but that's projected for 1992; it's a little over $7 billion now, according to your chart.

REPRESENTATIVE SOLARZ. Would you favor providing extended benefits if the Congress did provide for offsets in other spending, so there's no net increase in the deficit?

DR. BOSKIN. I would look much more favorably on that. I'd have to look at the specifics of the proposal. But I would think that it would be something that ought to be looked at carefully and given due consideration.

REPRESENTATIVE SOLARZ. Well, are you prepared to offer any suggestions as to programs that might be cut in order to provide an offset?

DR. BOSKIN. I think that's Congress's responsibility. You know the priority setting, etc. I wouldn't make a statement on that.

REPRESENTATIVE SOLARZ. Mr. Boskin, I'm trying to be a little bit more gentle than some of my colleagues. It's absurd to say that this is solely the responsibility of Congress. We do have a responsibility to set priorities but so does the Administration. The President submits a budget every year in which his priorities are established.

It's entirely legitimate to ask you to let us know what offsets you would recommend. And for you to say, it's your job to set priorities, are you going to go out of the business of submitting an annual budget?

DR. BOSKIN. No. You're quite right about that, and I didn't mean to phrase it quite that way. My sole concern would be that any such proposal would stay within, to the maximum extent possible, the same general area of the budget.

REPRESENTATIVE SOLARZ. Well, if the Congress did provide offsets, why wouldn't the Administration accept it? You said you would look at it more favorably than without it, but you haven't said that you would accept it.

DR. BOSKIN. I'd have to see the nature of the proposal and the nature of the offsets.

REPRESENTATIVE SOLARZ. So, why doesn't the Administration come forward with a proposal?

We have here three million people who have run out of unemployment. I have an analysis before me that indicates that 20 percent of the people who are unemployed fall below the poverty level without unemployment insurance. We're talking about a substantial number of our fellow Americans who will be driven below the poverty line without extended unemployment.

Why doesn't the Administration recommend, if you feel that you don't want to increase the overall deficit, the offsets to make it possible to provide extended unemployment for these people whose benefits have been exhausted?

DR. BOSKIN. Well, as you said, we made an analysis of the economy—an analysis of how much things would deteriorate and when they would

turn around—when we submitted the budget. Things have gone, more or less, according to that general course of events. I think we are standing by the general set of policies that we proposed at that time.

We obviously will work with the Congress as it makes various proposals.

REPRESENTATIVE SOLARZ. Well, I think Chairman Sarbanes indicated before that, under the budget agreement, items can be exempted from the requirement that offsets must be provided if the President declares an emergency.

Why won't you declare this an emergency with three million of our fellow Americans running out of unemployment benefits. Certainly, for them, it's an emergency.

DR. BOSKIN. We believe that it would be desirable for the offsets to occur.

REPRESENTATIVE SOLARZ. But you haven't recommended any offsets either.

So, you take the position it's not an emergency. Therefore, you would veto any effort to extend the benefits that doesn't provide offsets.

But then you refrain from recommending offsets of your own and neglect to indicate you would approve it even if the Congress does provide offsets.

DR. BOSKIN. Well, as we both know, sir, there's a procedure that's followed. If one of the bills that has been proposed works its way forward and gets through committee, at each stage there would be a response from the Administration to indicate which things we approved or disapproved. And there would be a process to deal with it.

REPRESENTATIVE SOLARZ. Now, are I understand it, when we calculate the unemployment rate ... I see my time's expired. Let me finish this one question. When we calculate the unemployment rate for the purpose of determining unemployment benefits to be provided, we're actually making that determination based, not on the overall unemployment rate but on the percent of those who have unemployment insurance who are unemployed, which I gather in a number of instances, is a lower percentage than the overall unemployment rate?

DR. BOSKIN. Generally.

REPRESENTATIVE SOLARZ. I am informed by staff in this bill that Senator Bentsen is working on that one of the things he does is to change the formulas for the trigger to relate to the unemployment rate as a whole rather than as it is now, the percentage of those who have unemployment insurance who are unemployed. And that would seem to me, as an economic layman, to be a more a more equitable and responsible approach.

After all, as a Nation, what we're concerned about is the total number of unemployed. And if someone is unemployed and looking for a job, the fact that they have unemployment insurance should in no way diminish our sympathy for them or our desire to help.

So, my question to you, in conclusion, is would you be sympathetic to this change in the trigger that Senator Bentsen is apparently proposing? And, if not, why not?

DR. BOSKIN. Well, I think it certainly merits some consideration. I think that there has been a historically secular change in the ratio of the pool of insured unemployed to total unemployed by different states of the economy. However, this heavily reflects—as I said earlier—the States tightening eligibility requirements over the past ten years. I think there would have to be some reflection, some serious determination, as to why the States have found it necessary to tighten requirements. Perhaps, that was just a way for them to save money at the time when times were somewhat better. But I think we would have to balance those kinds of considerations.

It may be that some combination of looking at a federal proposal and at what States have done to alter that ratio deserves careful consideration and perhaps some favorable consideration.

But I would certainly say that the concern about the decline in the ratio of the insured unemployed to the total unemployed is a relevant one and reflects reality, and that's certainly not something out of the norm.

SENATOR SARBANES. I just want to make this observation. I think Congressman Solarz is onto a very important point. Because, as I understand it, if you exhaust your unemployment insurance and no longer have a job, you cease to count in the insured unemployment rate because you've run out of your unemployment. Therefore, the rate will drop in the very states in which the long-term unemployed problem may be the most severe, in terms of the people who aren't able to collect unemployment insurance. It is absolutely bizarre.

REPRESENTATIVE SOLARZ. But, if the Chairman will yield, I have to confess I wasn't aware of this bizarre formula until it was pointed out to me. But it strikes me as not unlike saying that once someone dies, they're not counted in the death rate because they're not living.

I mean the point is that if you're employed for 27 weeks and you've lost your benefits and you're still looking for a job, you are unemployed. You're defining the problem out of existence. How it ever got in there, I don't know.

SENATOR SARBANES. Congressman Mfume.

REPRESENTATIVE MFUME. Thank you, Mr. Chairman.

I understand there's a vote on. I'll try to be as brief as I can.

Dr. Boskin, Dr. Taylor, let me just say that you paint a rather rosy picture, a rosy forecast that, in my estimation at least, is in violent contrast to what I see and hear and experience throughout this Nation, but even more so in the greater Baltimore area, where people who are having a different experience would probably argue *ad infinitum* about your point that we are on this great road to recovery.

And that—using your own terms—despite the recession, we are still the wealthiest nation with the highest standard of living. Perhaps that standard of living is relative in their opinions.

I also found interesting your reference to the war in Iraq, as both the external shock that concluded the previous expansion and also the precursor that has begun this one, which is an interesting place to be relegated in history, particularly economic history.

But I don't want to talk about Desert Storm as much as I'd like to talk about urban storm and, from my heart, the conflict that I see going on in our society, and then perhaps on to a couple of technical matters.

In that particular conflict, gentlemen, jobs are at a premium. And they're at a premium because, in many instances, regional unemployment is devastating.

Unemployment benefits are finite and, based on your own testimony to this Committee, it appears that proposals to extend those benefits are without champions on the Council of Economic Advisers.

Millions of American are at work. But, more importantly, millions more are out of work or working at jobs that provide them only a scant living and no real dignity. Oppression, deprivation, denial, and disprivilege still remain very real impediments to millions of people in this country who, again, don't feel buoyed by the rosy forecast that you painted.

The homeless and the hopeless are growing. And the largest group in each category are children. In many instances, the only industry that has experienced an expansion in those areas is the drug industry, run by a bunch of thugs who are trying to suggest to the larger population that, since you are not part of this larger expansion, this is in fact the only way out.

So, speaking from my heart in that sense, I would have to disagree in great contrast to what you have offered up as a rosy picture of economic recovery.

There are a couple of things on the technical side that I need to address quickly. And maybe you can respond to some of those.

I have had some concern about the lack of emphasis on three things that I think remain impediments to a recovery.

First of all, fiscal problems at the state and local level were referenced in your remarks but, in my estimation, deserve a great deal more attention. Those problems are very real in my own State of Maryland and, more importantly, in all the states that are experiencing deficits on the state level and all the local governments that are near bankruptcy.

As long as they remain in the state of almost being comatose financially, it's difficult to assume that this economic recovery will continue in spite of that.

You talked also about the expansion that you thought took place in the GNP in the second quarter. I have some real reservations about whether or not the GNP increased in the second quarter, because I believe

inventory liquidation ultimately will offset any of those increases that make the economy appear to be growing.

And I hope that you will take time, not only to expand on that more, but to include it in your own thinking.

The final thing is this issue of the credit crunch. In your written testimony that certain preconditions began to fall into place after the war, you stated:

> Oil prices returned to their pre-invasion level ... consumer business confidence rebounded ... and short-term interest rates started coming down ... long-term interest rates remained below what they were last Fall.

And that's all attributed to this economic recovery. And yet, I know, and if you're honest about it, most of us know that this credit crunch is very, very real. And it is not all due to overzealous regulators.

And that goes back to some of the things that you alluded to in your testimony but that went unaddressed.

And so, if I might conclude on that point and ask you to respond, could you focus your remarks particularly on this credit crunch, not so much what your observations are—which tend to be the observations of all of us—but what your recommendations to this President would be to end this credit crunch so that borrowers will in fact be able to borrow.

The Senator from New Hampshire, whom I agree with, said that maybe we ought to start removing barriers or removing jobs. I think removing the credit crunch is key to that. And I'd like to know what you would suggest and recommend to this President as to how he and his Administration can do something about it.

DR. BOSKIN. Well, Congressman, let me just say that I hear what you have said, and I appreciate the fact that you were speaking from the heart. And let me just say, before getting into that, we've noted in the Economic Report, and numerous times to this Committee and elsewhere, that when we talk about GNP or average GNP per capita, there is a substantial number of people who remain poor. In dealing with that problem, the most important thing is to have a growing economy because that would provide the foundation. But we've also noted that economic growth by itself is not enough to solve the problem.

So, I do want to make sure that you understand and I appreciate some of your concerns.

I would also say that when the term "rosy scenario" or "rosy forecast" is used, most people tend to relate that to what private-sector economists are projecting for the economy. But we're quite in line with their projections.

On the other hand, if your view is that things are not going to improve and we're all wrong, you may well be right. We could all be wrong that the recovery has begun and that the economy will begin to grow in the second half of the year and into next year. Or we could all be too pessimistic as well.

But I do want to indicate that there's a great deal of imprecision in economic forecasting. So, I wouldn't say that it's 100 percent certain that

the economy will follow the course that we're indicating as our baseline scenario. It's far from it.

With respect to the credit crunch, as I indicated in my testimony and my remarks, I think it is the single biggest impediment to sustaining a robust recovery. I think that it has caused serious problems that will not be removed quickly. I think, besides the lack of availability of credit currently, it has caused serious problems in long-term relations between financial institutions and their long-term clients and so on.

And I think that there are a variety of other things. Congressman Hamilton emphasized monetary policy, and I said the Fed was going to have to be prepared to expand the money supply more rapidly than it has in the past couple of years, and it has to stand ready to do so unless velocity rebounds.

I emphasized in my remarks about the mechanical nature of the higher capital ratios that the central banks have agreed to, which have caused a lot of our banks to stop lending to commercial/industrial members, and to park their assets in government-backed paper.

We lambasted that in the Economic Report and have conveyed that to the Fed. And, as I understand it, there is a committee reviewing those things at the Bank for International Settlements in Basel that negotiated the original banking capital ratios. They're going to try to have a more balanced view of risks so that commercial/industrial loans aren't automatically viewed as risky, regardless of whether the person has been paying their bills for 20 years, as some of the people on the Committee have indicated.

I have no line responsibility in regulation, but I hear from people when I travel around the country, or who come to see me to try to inform me about what this is doing to the economy, as you have so eloquently done today about Maryland. We have tried to make sure that the message has gotten down to the examiner level.

Now, Mr. Solarz indicated that these people were berated previously for being too lax. My own view is that the pendulum went too far to the lax direction for a while, and now it's swung too far in the other direction. He indicated we should have some pity on them for being beat up, first for being too lax, and then for being more severe than is desirable for prudent financial policy. But I think we have to do that to get them to move to a different overall policy.

I think this is a serious issue. For example, there are many loans that were made on a so-called bullet basis—for 5 and 7 years rather than fully amortized over 30—that are starting to come due. And I think many of those are quite current and from what various people on both sides of the transaction—the lenders and the borrowers—tell me——

Representative Mfume. Dr. Boskin, just let me interrupt.

What would you recommend to the President that he do to end the credit crunch?

Dr. Boskin. Well, I think that the recommendation has been made to the people that have direct line responsibility—the Federal Reserve, the

Chairman of the FDIC, and the Comptroller of the Currency—to get at the problem more aggressively through the bureaucrats in their system.

And the Treasury has tried to do that. As Senator Smith so eloquently stated, power is diffuse in this regard. Much of the banking regulation is outside the control of the Administration. The Comptroller is in the Treasury, but the FDIC is an independent agency and the Federal Reserve is an independent agency.

SENATOR SARBANES. There is a vote in the House, and I am told they have four minutes.

REPRESENTATIVE MFUME. And I'm going to leave right now, Mr. Chairman. I'm anticipating coming back for another round.

Let me just say to Dr. Taylor that I listened to his insistence that we ought to focus in on international trade and what's going on with the Uruguay Round and Structural Impediments Initiative in Japan. We need structural impediment initiatives in the cities and the towns and townships of this Nation, not Japan. I couldn't care less about what happens to the structural initiatives there.

People here are hurting, and we'd all like to be part of this fine forecast. But let me just say that rising tides don't lift all boats. We saw that in the Reagan Administration. Direct action does.

I will conclude, Mr. Chairman. I thank you for letting me go over my time, but I have to go vote now.

SENATOR SARBANES. Congressman Armey, do you have any other questions?

REPRESENTATIVE ARMEY. Thank you, Mr. Chairman.

I'd like to make three quick observations and if I can leave my question with you, Mr. Taylor, I'll pick it up in the record later.

DR. TAYLOR. Certainly.

REPRESENTATIVE ARMEY. The first observation is that there is no money in this Trust Fund nor any other Trust Fund. All other things constant, anybody seeking expenditures of benefits under the authorization of the Trust Fund could only do so because we borrowed more money. And that should be in the record.

Two, Mr. Taylor, for you to defend the forecast by saying that we reduced the deficit more than otherwise would be is like saying it's good enough for government work, and I agree with you.

Three, this week the House Committee will bring a new milk bill to the floor that will create a milk products surplus that will be equal in its weight to the entire population of the United States west of the Mississippi River.

Now, my question is, should Congress do the predictable thing, which is to pass that bill, and the President do the unthinkable thing, which is to sign this bill; what will it do to the GATT agreement?

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

COUNCIL OF ECONOMIC ADVISERS
EXECUTIVE OFFICE OF THE PRESIDENT
WASHINGTON

MEMBER OF THE COUNCIL

July 26, 1991

Dear Congressman Armey:

During the hearings before the Joint Economic Committee on July 23, you asked me to provide for the record my views on the likely effects on the Uruguay Round negotiations if the Milk Inventory Management Act of 1991 (H.R. 2837) became law.

Enactment of H.R. 2837 would seriously undermine the U.S. position in the Uruguay Round of GATT negotiations. Substantial liberalization in agriculture is essential if we are to make progress in other sectors and thereby complete a successful Uruguay Round. In establishing a two-tiered support program combined with mandatory supply controls, the act would establish a dairy program similar to the European system--the very system that the United States has strongly argued must be dismantled as part of any agreement reached in the Uruguay Round. A two-tiered support program would provide for a separate reduced price received by each producer for milk marketed in excess of that producer's quota which is supported by a higher price. It would subsidize those producers who hold quotas at the expense of those who don't and would penalize the more efficient producers by discouraging expansion.

Market orientation has been the primary goal of this Administration's farm policy. The 1985 and 1990 Farm bills have begun to move toward market orientation in some areas by lowering loan rates and increasing planting flexibility. H.R. 2837 would reverse this trend and replace market signals with government regulations for production and investment decisions. A U.S. endorsement of a new farm program which rejects market forces and seeks further government subsidy contradicts our fundamental aims in the Uruguay Round talks.

Sincerely,

John B. Taylor

John B. Taylor

The Honorable Richard K. Armey
U.S. House of Representatives
130 Cannon House Office Building
Washington, D.C. 20515-4326

50-586 O - 92 - 3

Gentlemen, I just have a few questions to put to you in the course of concluding this hearing.

Mr. Boskin, you indicated in response to a question that you were opposed to the President declaring the situation with the unemployed in this country an emergency in order to, in effect, use some of this huge surplus that has built up in this Extended Benefits Trust Fund for the purpose for which it was intended, as a matter of fact. You took the position that there had to be offsets.

What was it about the situation in Bangladesh, Ethiopia, Sudan, and Angola that made that an emergency but makes the plight of the unemployed in America not an emergency?

DR. BOSKIN. Well, let me just say that the term "emergency" has a lot of meanings. In the specific context of the budget law, it is a trigger for when offsets do not have to be made.

For the items you just mentioned, the amounts were small. The bulk of them have been related to unforeseen international events.

The notion that the unemployment insurance fund isn't being triggered as an emergency does not suggest that we're not concerned about the unemployed. It's just that——

SENATOR SARBANES. You are not doing anything about them.

DR. BOSKIN. It just suggests that we believe that——

SENATOR SARBANES. You are just leaving them out there to hang.

DR. BOSKIN. Given the situation, we believe that it ought to be done within the context of the budget rules.

SENATOR SARBANES. Do you regard the unemployment insurance program as an automatic stabilizer?

DR. BOSKIN. On balance, yes.

SENATOR SARBANES. What is the definition of an automatic stabilizer?

DR. BOSKIN. It is a program or a policy and its instruments—tax, budget, others—which, when the economy goes into recession, cushions some of that decline through a smaller decline or a lessening of what would have been a decline in incomes, for example.

SENATOR SARBANES. So, the unemployment insurance works as an automatic stabilizer, in effect, by increasing when the economy turns downward; is that correct?

DR. BOSKIN. That's correct.

DR. TAYLOR. There are other automatic stabilizers, too, of course, Senator. Some of the other transfer payments and our tax system all combine to provide for automatic stabilization.

DR. BOSKIN. The tax system.

SENATOR SARBANES. Would you call a program in which the surplus in a program rose during a recession, would that be performing the way an automatic stabilizer would be expected to perform?

DR. TAYLOR. In this case, the outlay to the unemployed workers is considered an automatic stabilizer because it adds to their ability to continue purchasing goods, and continues to stabilize demand in the

economy, and makes the recession less deep than what it would otherwise have been.

SENATOR SARBANES. If I told you I had a program, and the surplus in the program increased during a recession, you would be hard put to think of that program as an automatic stabilizer, wouldn't you?

DR. TAYLOR. Treated in isolation, if you match up one fee or tax with a given expenditure, it might look like it's not a stimulus to the economy. But I can assure you, on balance, all of the fees and taxes, along with all the transfer payments, on balance, do represent a significant degree of automatic stabilization in the U.S. economy.

SENATOR SARBANES. Now, how can you justify this fund buildup? If the unemployment insurance program is an automatic stabilizer, which is supposed to rise in a downturn, and here we have the Extended Benefits Trust Fund building up at a rather rapid pace right during a recession—$1.1 billion this very year in addition to the surplus. That's taxes paid and interest earned on the accrued balance, offset by whatever additional payment they pay out.

Why are these employers paying these taxes if they're not going to be used to address the situation of the long-term unemployed? That is the question that is being asked of us by employers.

DR. BOSKIN. Senator——

SENATOR SARBANES. Actually, they are prepared to pay them. They want them to be paid out for their workers.

DR. BOSKIN. Let me just clarify that about 10 percent goes into the Federal Extended Benefits program, while 90 percent goes into the State Trust Fund Accounts for unemployment benefits. And those obviously are being paid; those outlays are being made; and those indeed are automatic stabilizers and are cushioning the decline in income.

SENATOR SARBANES. Well, how about the balance of the program that deals with the long-term unemployed who are left out there hanging after 26 weeks in a recession that has run well beyond 26 weeks? You don't even count them in the unemployed insurance rates. So, the more of them there are in a state in dire circumstance, the lower the state's rate is. It is absolutely bizarre, isn't it?

DR. TAYLOR. Senator, the unemployment rate you're referring to here has the number of workers who are receiving unemployment benefits divided by the population of workers in the program. When a worker goes off insurance, he drops off of both—if you like, technically speaking—the numerator and the denominator.

So, it's not quite the way you characterize it. But that doesn't mean the formulas could not be reconsidered or adjusted if that's thought to be desirable. We would consider that, as we've indicated.

But I think the importance of looking for offsets elsewhere in the budget is important. The budget, as a whole, is working to stabilize the economy. And if we think that one component of spending is not working right—as you do—then let's look for an adjustment somewhere else in

the budget, but keep the overall stimulus to the economy, the overall increase in the budget deficit constant, which is, after all, what automatic stabilizers are all about.

SENATOR SARBANES. What advice did you give the President when he declared an emergency with respect to these foreign programs—when we had a program to help everybody overseas but not a program to help our own people—what advice did you give him with respect to declaring those an emergency?

DR. BOSKIN. The advice has been consistent throughout. When they are small and not foreseeable and have a good justification, then I would not oppose declaring——

SENATOR SARBANES. So, you supported that?

DR. BOSKIN. Yes. When they are either very large——

SENATOR SARBANES. So, you supported an emergency designation to provide help abroad, but you are not prepared to support an emergency designation to provide help at home?

DR. BOSKIN. For the much larger sums involved——

SENATOR SARBANES. Well, if you add all the sums up, they are in excess of a billion dollars, well in excess of a billion dollars. And that is not counting the emergency designation for the military action. Of course, those are in the tens of billions of dollars.

DR. BOSKIN. Well, that's correct. And I assume we all agree that they were necessary and unforeseen and——

SENATOR SARBANES. But some of us also think that it is necessary to address the problem of the long-term unemployed in this country. Some of us are not satisfied with or prepared to accept, as you seem to be prepared to do, simply leaving these long-term unemployed out there to withstand the wind; saying, well, the economy started from a stronger position. We think the economy is turning around.

That is small potatoes to these people. They are losing their homes. I mean we are getting all kinds of reports from people that are losing their homes. These are people who have been working, employed people that used up their 26 weeks.

The theory of course, as I understand it, was that the unemployment insurance would carry you through the period of the downturn so that, at least when it expired, you were trying to find a job in a more favorable job market. In previous recessions, as they have extended, we have added time in order to accomplish that.

Now, you have a situation where someone lost their job at a time when, let's say, the unemployment rate was 5.6 percent, 5.8 percent. They then started drawing unemployment benefits. They keep on looking for a job and have not been able to find one because the unemployment rate has been getting worse and worse. They have exhausted their 26 weeks of benefits, so that has stopped. They are still looking for a job in a job market in which the unemployment rate is now 7 percent. They are looking for a job in a job market that is worse than when they lost their

job. They no longer have unemployment benefits to provide them at least with a minimum amount of income in order to support themselves and their family, and at least to keep the creditors at the door so they don't lose their home, or lose their car, or lose their durable goods, and have their whole life go to pieces.

Now, we are not talking about people who haven't been working. We are talking about working people by definition, or they are not entitled to unemployment benefits. I mean one of the requirements is that you have to work, isn't that right? You have to have a job employment record in order to warrant drawing unemployment benefits?

DR. BOSKIN. That's correct.

SENATOR SARBANES. By definition, you are talking about people who have been working. Now, they are just falling off the edge of the cliff. And you sit there and say, well, that has happened. I guess that is the way life is, right?

DR. BOSKIN. I wouldn't characterize it that way. I have said that we think that the economic harm that would be done from a large rise in the budget deficit is substantial, and we think that this program ought to be dealt with under the rules established——

SENATOR SARBANES. You have $7.2 billion in October 1990, and the fund is going to build up to close to $8.5 billion over the course of this fiscal year. You are building up a surplus in a Trust Fund that is supposed to be used in a recession. You are going to come out of the recession with a bigger balance in the unemployment trust fund for extended benefits than when you went into it. It defies any logic about the trust fund, and about unemployment insurance, and about automatic stabilizers. And it is not a theoretical question. I mean that is the theory of it.

But the real life situation is people out there in communities all across the country, who find themselves exhausting their unemployment benefits and have nowhere to turn. Their personal lives are being put into absolute ruin as a consequence.

I hope you will go back and think about it. I hope you take the message back to the President too.

These people are hurting; these are Americans. The President reacted when he saw people abroad hurting. He labelled it an emergency, and he came to Congress, and the Congress concurred in the judgment that it was an emergency and to provide assistance. We ought not to do any less for our own people in this circumstance.

The hearing is adjourned.

[Whereupon, at 12:30 p.m., the Committee adjourned, subject to the call of the Chair.]

THE ECONOMIC OUTLOOK AT MIDYEAR

FRIDAY, JULY 26, 1991

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

The Committee met, pursuant to notice, at 10:00 a.m., in room SD–628, Dirksen Senate Office Building, Honorable Paul S. Sarbanes (chairman of the Committee) presiding.

Present: Senators Sarbanes, Bryan, and Symms; and Representatives Hamilton and Armey.

Also present: Stephen A. Quick, Executive Director; William Buechner, Chad Stone, and Chris Frenze, professional staff members.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

SENATOR SARBANES. The Committee will come to order.

This morning the Joint Economic Committee will continue its review of the economic and budget outlook at midyear.

I want to explain to the witnesses at the outset, I am involved in managing a bill that is on the floor of the Senate, and I will not be able to stay for this entire hearing. I apologize to the witnesses for that. We have three very good witnesses here this morning. But we do have your statements, and I will have a chance to read the transcript of the hearing.

For much of the past year, the economy has been experiencing a significant recession. While there are now some signs of recovery, both the strength and the permanence of recovery remain very much in doubt. Recent statistics on durable goods orders and new car sales were disappointing. In fact, the *Wall Street Journal* called this development "a setback for economists looking for a strong economic rebound." Yesterday, the Commerce Department reported that nonfarm personal income growth in the first quarter was the lowest in two decades. Let me repeat that. The growth in nonfarm personal income—people's personal income —for the first quarter was the lowest in two decades. Such low-income growth provides a weak basis for any recovery.

Today's hearing will focus on two issues: the severity of the recession, and the prospects for recovery.

In the mid-session review of the budget, the Administration characterized this recession as short and shallow, a term which unfortunately might

suggest that the recession is not a very serious matter and that the problems of those who have been hurt by it do not need to be addressed. I have been very concerned about the use of that phrase, because I think it carries with it the notion that you really do not have to do anything. I believe the short and shallow label seriously misrepresents the severity of the recession and hampers our ability to develop responsible and compassionate policies for dealing with the human and social costs, which the recession has brought to families and communities all across the country.

In fact, the current recession closely resembles past ones. The decline in the number of jobs during this recession has been just as severe as in the average of post-war recessions. Since last July, payroll employment has fallen by almost 1.5 million, which is on line with the post-war average for recessions, as this chart indicates (see chart on following page). The red line is the average of past recessions, and the black line is the job loss in this recession. As we can see, they very closely track one another. So, I find no basis to use the short and shallow characterization.

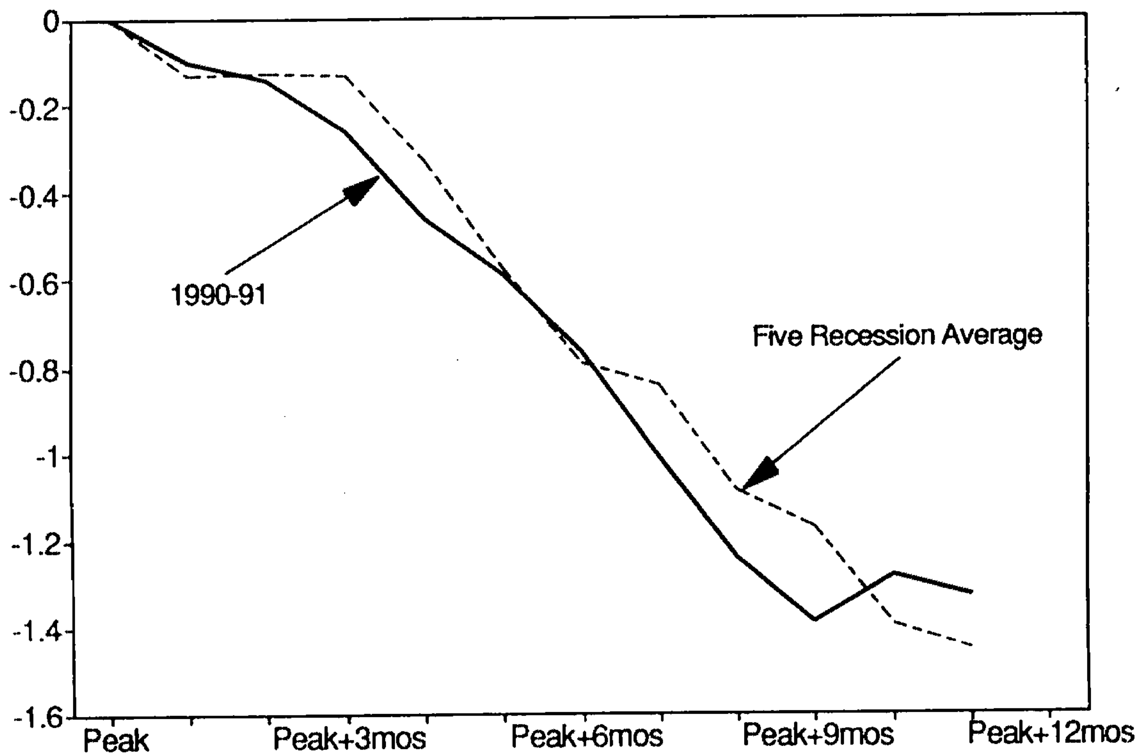
The fact that the unemployment rate has risen to 7 percent, which is perceived by people as a low figure, but it went there from 5.3 percent, may have led some to call this a mild recession. The fact is that the labor force has grown by only half as much during this recession as is normal, thereby artificially depressing the unemployment rate. We had testimony from the Commissioner of the Bureau of Labor Statistics that if there had been normal labor force growth during this year—what they would have anticipated or projected for people coming into the work force—that the unemployment rate today would be about 7.5 percent. In addition, this rate does not reflect a lot of the hardship that exists because the official unemployment rate does not include discouraged workers. People have become so discouraged about their job prospects that they have given up looking, and the people who are working part-time are discouraged because they cannot find full-time jobs. If you factor in those two considerations, you get an unemployment rate of 10 percent in the second quarter of 1991.

These statistics point to the reality that the current recession is taking a heavy toll on the jobs and incomes of American workers. Yet, despite this hardship, the programs designed to provide support in hard times simply are not doing their job. More than 2.3 million workers have exhausted their regular unemployment benefits over the past 12 months without finding a new job.

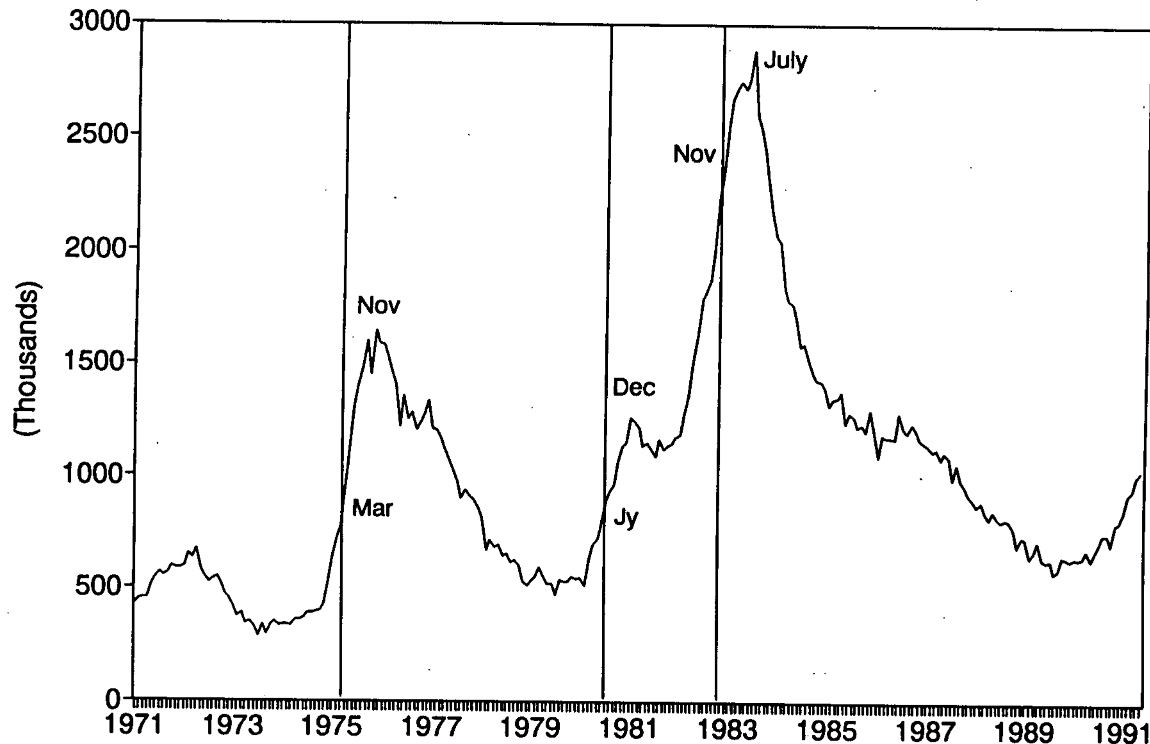
In past recessions, the number of long-term unemployed continued to rise for several months after the recession ended. If this pattern holds, and there is every reason to believe it will, then the number of long-term unemployed can be expected to rise in the months ahead, even if the economy turns the corner from recession to recovery. I have a chart I want to show on that (see chart on p. 70). This chart shows that in previous recessions, when the economy turned the corner and you started

Nonfarm Payroll Employment

Percent Change from Peak



More Long Term Unemployed After Recessions End



Note: End of recession represented by vertical lines.

coming out of the recession, the number of long-term unemployed continued to go up even after you turned the corner. This addresses the assertion that once the recession is over with or almost over with everything is going to be okay. Everything will not be okay on the basis of past experience. There is every reason to assume that the same thing will happen this time. What will happen is that you will get a continued increase in the long-term unemployed after the recession ends.

Despite these rising numbers of the long-term unemployed, our safety net programs have failed to do their job. Because of outdated formulas, few States have triggered on for the payment of extended benefits to the long-term unemployed. Several States that had been receiving extended benefits have been removed from the program despite unemployment rates in those States above 8 and 9 percent. Massachusetts, with an unemployment rate of 9.5 percent, and Michigan, with an unemployment rate of 9.1 percent, both triggered off of the extended benefit program. So, you have this really very high level of unemployment, and workers in those States are not able to draw unemployment insurance. When we talk about unemployment insurance, we are talking about people who have been working. You do not qualify for unemployment insurance unless you have been working. You must have held a job for a sustained period of time in order to draw unemployment insurance.

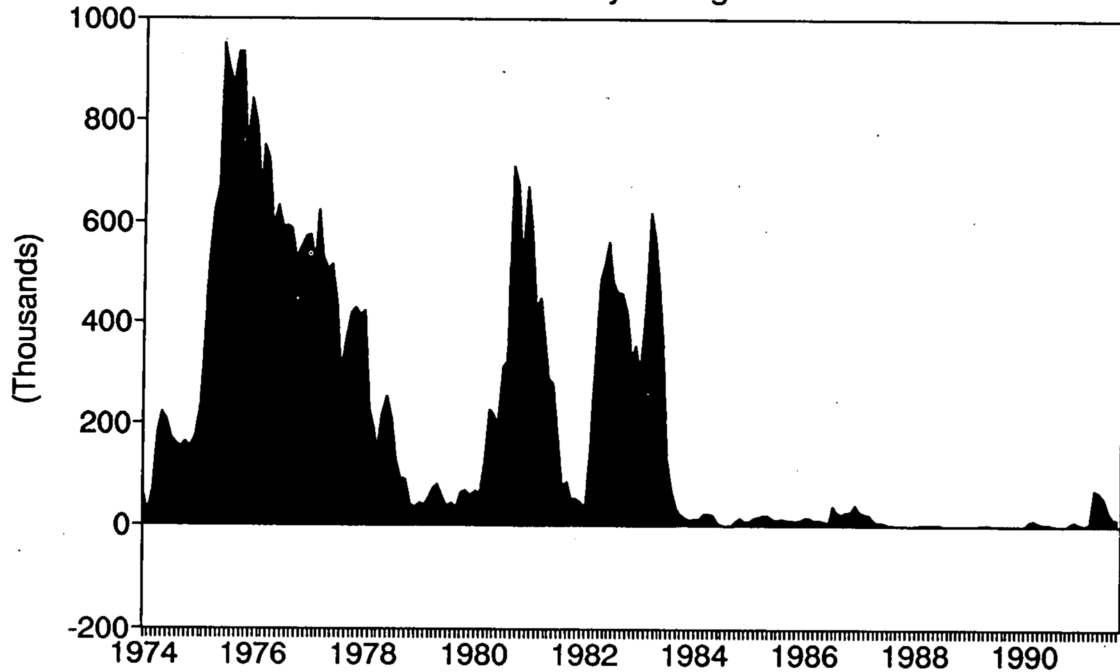
Fortunately, both the House and the Senate are working on proposals to address this unemployment insurance problem by providing additional weeks of extended benefits to those who have exhausted their regular unemployment benefits, an effort which I very strongly support. Yesterday morning, the Senate Finance Committee reported out legislation to extend the unemployment insurance benefits. I just want to point out two charts on this situation (see charts on pps. 72 and 73).

One is the number of people receiving extended benefits in this recession. The contrast is just incredible. These are the benefits on top of the 26 weeks. This is the 1974-75 recession, the 1980, and this is the 1982. As you can see, there was a significant increase in the number of people drawing extended benefits. You can hardly see the increase in this recession. It hardly exists. That is an increase in this recession for extended benefits despite the fact that the extended benefit trust fund has a balance in it on October 1st of $7.2 billion, and it will accumulate an additional balance of over $1 billion in the course of this fiscal year.

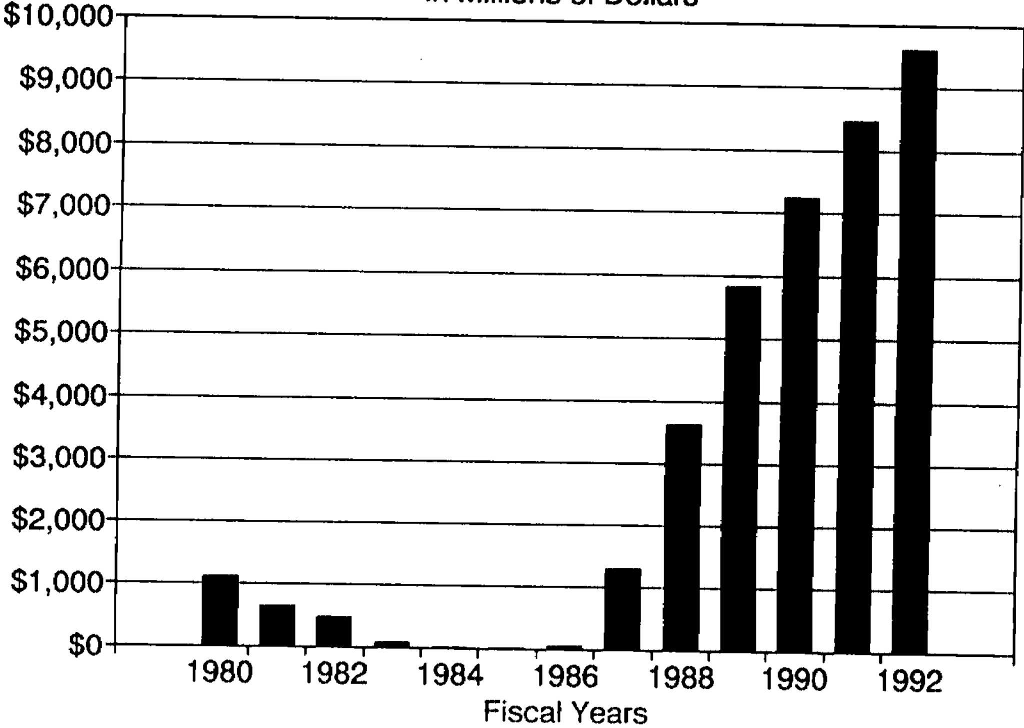
We are in the bizarre situation in that we are building up a surplus in the unemployment insurance trust fund in the middle of a recession. It makes no sense at all. You build the surplus up in the good times in order to use it in the bad times. In fact, we have been getting complaints, not just from workers who cannot get their benefits, but from employers who say we have paid taxes into this trust fund to be used in a recession in order to pay our workers who have to be laid off because of the economic downturn. It is another instance of using a trust fund to try to mask the federal deficit, and it is abuse of the purposes of the trust fund.

Persons Receiving Extended UI Benefits

Monthly Average



Note: Excludes Federal Supplemental Benefits and Federal Supplemental Compensation recipients.



* Excludes transfers to loan account.

Finally, let me make the observation that there is considerable concern that the recovery from this recession, if and when it comes—and that is hard to predict, but most people think it is beginning to show up—will be anemic by historic standards. In some respects, it will be difficult to distinguished the recovery from the recession. In fact, we have some concern that we will get a double dip recession, like we have experienced in the past. We will start back up, then come back down again. In fact, these latest economic figures are a matter of some concern. The number of people filing for unemployment claims has gone back up again. We have had some fairly optimistic forecasts by the Administration, but even it does not project strong economic growth.

I want to welcome our three witnesses this morning to discuss the economic outlook and economic policy. We are very pleased to welcome three of the Nation's leading economists: Dr. Lawrence Chimerine, Senior Economic Adviser for DRI/McGraw Hill and a fellow at the Economic Strategy Institute; Dr. William Dunkelberg, Dean of the School of Business and Management at Temple University; and Dr. Donald Straszheim, Chief Economist for Merrill Lynch Capital Markets.

Before I turn to the witnesses for their opening statements—and I am probably going to have to excuse myself because I hear the bells ringing—I will turn to Congressman Armey for an opening statement and then to my colleague, Senator Bryan. Congressman Armey, please proceed.

OPENING STATEMENT OF REPRESENTATIVE ARMEY

REPRESENTATIVE ARMEY. Thank you, Mr. Chairman. It gives me great pleasure to join in welcoming the panel of witnesses before us today. This is a timely hearing, given the view of most economists that the recession has ended and the economy is poised for renewed growth.

Over the last year of recession, the U.S. economy has displayed resilience in the face of huge tax increases, oil price shocks, and financial problems. In particular, it is clear that the massive federal tax increase of 1990 was one of the worst policy blunders in recent memory. This self-defeating tax hike damaged the economy, encouraged more congressional spending, and pushed the budget deficit to an all-time high.

Nevertheless, the economy, despite falling into recession and being bludgeoned by policy mistakes and external forces, has proven itself able to recover, thereby validating Armey's axiom that the vitality of the market is so great that it can even overcome ill-advised public policy. The resumption of economic growth is important for renewed job creation and economic opportunity. As policymakers, it should be our objective to avoid making mistakes that could weaken or cut the recovery short.

Furthermore, we could help unemployed workers in several industries by repealing the particularly destructive luxury taxes. As Congress has learned at the expense of these workers, jobs are not a luxury.

Naturally, there is a whole range of views about what the current expansion will look like. It is hard to say because no one really knows what the future will bring. However, I vividly remember many economists voicing the same doubts about the 1982-1990 expansion, the longest in peacetime history. Moreover, if we in Congress do not hamstring the economy with more taxes, mandates, and regulations, the prospects for stronger economic growth could be improved.

At this point, Senator Bryan, I would happy for you to have an opening statement.

OPENING STATEMENT OF SENATOR BRYAN

SENATOR BRYAN. Thank you very much, Congressman.

Let's begin with our distinguished panel of witnesses this morning. Let me state for the record that we have copies of your prepared statements that will be made a part of the record of this proceeding, and we will begin with Mr. Straszheim. Do I pronounce your name correctly, sir?

MR. STRASZHEIM. Yes, you do, Senator.

SENATOR BRYAN. Welcome. Nice to have you with us this morning.

STATEMENT OF DONALD H. STRASZHEIM, CHIEF ECONOMIST, MERRILL LYNCH CAPITAL MARKETS

MR. STRASZHEIM. Thank you. I am delighted to again appear here. My testimony is on my own behalf. I do not necessarily represent the views of my employer.

Let me do two things: first, comment a little bit about the economic circumstances as we see them, and then spend most of my time on some longer term issues that I think need attention. I should also add that at the beginning of the introductory section of my testimony that all of these basic points are given and then elaborated on in the remainder of that testimony.

We think the recession has ended. When there is a boom, all the numbers are good. When there is a bust, they are bad, and in the middle, they are in the middle. That is what we are beginning to get now, a mix, a blend of data, some good and some bad.

I think the recovery will be slow and sluggish. The average post-war recovery rate is 6.4 percent for the first six quarters of recovery. At this time, we think that recovery rate will be about 3 percent, about half as fast as normal. There are a variety of reasons for expecting this recovery to be slow and sluggish. Let me give them to you quickly.

The consumer is still highly leveraged. Consumers are worried about the value of their houses—their most important asset. The business sector is highly leveraged. We are not likely to get a big inventory pickup in the economy. The white collar service industries are still in difficulty. Many of our export markets are weakening or at least still weak. We do not have a fiscal policy lever in Washington to pull. We pulled that lever a

decade ago, and we have left it pulled. I will come back to that in just a moment. The State and local budget situation is the worst in 40 years, and, lastly, the banks do not have the wherewithal to provide the kind of lift that they normally do. So, for all of those reasons, I think you ought to expect this recovery to be slow and sluggish, not rapid and robust.

There are a variety of implications to this slow and sluggish recovery. First of all, the cyclically sensitive sectors will come back less fast than normal. The improvement in profits will be less rapid than normal. The growth of federal revenues from taxes will be less than normal because it is a less than normal recovery. That is the bad news. But the good news is that any upward pressure on inflation and any upward pressure on interest rates will also be slower to develop than normal.

A double dip? Perhaps. I would bet against it, but there are risks in the economy, many of which I regard as structural: one-time kinds of problems that relate more to our long-term economic circumstance than they do to the current short-term condition.

Now, let me say something about this longer term situation. I think the 1990s will be the slowest growth decade since the 1930s. There are a variety of reasons for that. The numbers are shown in Exhibit B in my testimony.

Our GNP potential growth has slowed over the last quarter century from about 4.3 percent to roughly 2.5 percent. Part of that slowdown is demographics, a slower growth in the labor force. But most of it is productivity, and I think that productivity slowdown is primarily related to self-inflicted wounds: 25 years of incoherent policy out of Washington in which we encouraged people to consume instead of save and invest; 25 years of ignoring our education system; 25 years of ignoring our infrastructure. Unless there is a real metamorphosis in Washington—and I think that is the right word—and attention to these longer term problems, I believe that the 1990s will see our GNP potential growth decline even more, to a rate of perhaps 2 percent or below, and if we just achieve that potential, it will give us the slowest growth decade since the 1930s. That is not a very optimistic viewpoint, but that is what we think is in prospect for the longer term.

We also find ourselves at the point of facing a variety of other longer term issues that are extraordinarily serious, both in the present circumstance and later. Take the state and local budget situation. The first chart in Exhibit D in the testimony shows that state and local budgets are farther out of balance now than at any time in the last 40 years, worse than in the bottom of the 1974-75 recession, worse than in the bottom of the 1981-82 recession.

The solution is not mysterious. It is just painful. We have two choices: either higher taxes or lower spending, or any combination thereof.

Concerning the actions taken on June 30 and July 1, at the ending and beginning of the fiscal year that many States have just been through, I thought the results were mixed. A lot of hard decisions have been made, but it seems to me there was an awful lot of creative accounting, budget

gimmicks, and the best solutions the lawyers could buy. Sooner or later, we have to attend to these problems because they are dragging the economy down in a substantial way.

I think the circumstance in Bridgeport, Connecticut, which has filed for bankruptcy protection under Chapter 9 of the Bankruptcy Code, is much more important than just the circumstance of that individual city. Here, you have elected officials who got elected because they wanted to contribute to the country in some way and make those public policy decisions that they thought were best. Those officials have become so frustrated that they have thrown up their hands, dumped the problem in the lap of the courts and said, here, take it.

Many other local officials will watch this episode, and if those other officials regard this experience of dumping this in the lap of the courts as a successful venture, you could have many others follow suit. Three months ago I would have bet against this local bankruptcy approach as becoming widespread. I no longer would make that bet, and I must say I don't know, quite frankly, where this leads us in this state and local budget problem.

Health care is another issue that needs much more attention, and it is beginning to get it, and all to the good. Our health-care spending has risen from 4 or 5 percent of GNP to about 11 or 12 percent right now, and these numbers are in Exhibit C in the testimony. It is headed to 20 percent because most of the increase, it strikes me, in health care spending has been technology driven—some, legal system driven—but it has not yet been driven by the demographics, because the baby boomers are not yet in the age groups in which they spend a lot of money on health care. But they will gradually get there.

Health-care spending is the fastest growing cost item for virtually every company in this country, in every industry. If health-care spending rises from 12 to 20 percent of GNP over the next 10 or 15 years, it is ultimately consumers who pay these health-care costs. The consumer sector is two-thirds of the economy. That implies a 12 percentage point increase in the slice of the pie that consumers spend on health care.

The question then is, as you increase the slice given to health care to 20 percentage points, what will that be taken out of? Drive the car an extra year; drive to the beach instead of flying to Bermuda for your vacation; recover the couch instead of throwing it away and replacing it, and so on and so forth.

The system is broken. The American mentality on health care is that whatever the highest tech procedures are known to man I deserve to have them applied to me. We cannot sustain this path and everybody knows it. It is going to be the issue, it seems to me, in terms of the economy for all of the decade of the 1990s.

Three other quick points. Commercial real estate. We have had three commercial real estate booms in this country in the 20th century. The first was in the 1920s, the second in the 1950s, and the third in the 1980s. The next one is about 18 and a half years away, give or take 6 months. We

simply have too much capacity out there. Nobody needs it, and it will take us a long, long time to work our way out of that problem. Much of the cause of that problem, I believe, relates to the 1981 tax law in which we encouraged people to build too many office buildings, because they were given a tax life of 15 years, even though the economic life of those structures was perhaps 40 years. We can talk about that perhaps a bit later.

Lastly, the budget circumstance. I was struck by the Chairman's opening remarks in which he indicated that even though the recession might be ending, everything is not okay. I couldn't agree more. Everything is not okay. I suspect there are many in Washington who would love to have the fiscal policy lever to pull to provide some stimulus to the economy and give these people who are in pain some help. The problem is not with the phraseology of "it's a short and shallow recession" or whatever. The problem is that we pulled that lever a decade ago and left that lever pulled, and now we find ourselves in the unpleasant circumstance of being near the bottom of a recession without the lever available to pull. That is the real problem.

Lastly, on that point, let me show you Exhibit G and Exhibit H in my testimony. The dark line on Exhibit G shows budget estimates of the President's over the last 15 years, all the way back to fiscal year 1975. The light colored lines that angle up and to the right, with a date behind them, are the budget estimates of our Presidents over that same period. What you see, of course, is this recurring portrayal of terrific budget progress that never comes to pass, and it strikes me we are in roughly the same circumstance right now.

Exhibit H goes briefly to that point. This curious looking table shows the economic assumptions of the Presidents over the last 15 years. Reading across any row shows what President X thinks the economy is going to be doing for the next 6 years. Across the bottom of the table is the actual economic performance, and what you see is the economy goes up and down. We have recessions; we have recoveries. The first 2 years of most of these presidential forecasts are not too bad. Some are too high, some are too low, but that is all right. But the outyears always portray this wonderful economic performance, and it never comes to pass. So, the consequence is that revenues fall short of what was expected; outlays are higher than expected, and so forth.

So, it seems to me, in summing up, Mr. Chairman, we have an economy that has come through a recession. We have a variety of longer term problems that need attention, and I think the place to start is right here in Washington.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Straszheim follows:]

PREPARED STATEMENT OF MR. STRASZHEIM

I am delighted to again appear before the Joint Economic Committee to discuss the current condition of the economy and some of the problems which we will face in the decade of the 1990s. The views expressed here are my own and do not necessarily represent those of my employer.

The following basic points are elaborated in this testimony. A series of charts and graphs are shown as supporting exhibits.

- The recession appears to have ended around mid-year, it was of approximately average length, and highly varied across sectors in terms of depth.
- Inflation is expected to remain quite moderate (around 4%) with interest rates remaining in a narrow band well into 1992.
- The recovery is likely to be slow and sluggish, not rapid and robust.
- The decade of the 1990s is likely to be the slowest growth decade since the 1930s.
- Our GNP potential growth rate continues to slow. This is largely the result of progressively poor productivity which stems from self-inflicted policy wounds.
- Healthcare will be THE issue of the 1990s as technology advances and costs remain out of control. Healthcare spending will take an ever larger share of GNP.
- The commercial real estate construction excesses—there is simply too much space—are so severe that the next upturn in that sector may not occur until about 2010.
- The regional unevenness of our economy is apparent with the Northeast doing badly, and a few scattered southern and western states doing well.
- State and local budgets across the nation are farther out of balance than at any time in the last forty years, far worse than in the 1974-75 or 1981-82 recessions.

- o Federal budget problems persist, justifying the public's disillusionment with our decision-making mechanism.

II. RECESSION AND RECOVERY

During booms, most of the economic statistics are positive. During busts, most are negative. At times such as the present, statistics are mixed—some good, some bad. The recession ended around mid-year and a slow and sluggish recovery has commenced. The central tendency of the data is improving.

A. The Present Circumstance

- o Nonfarm payroll employment rose by 119,000 in May, although it fell by 50,000 in June.
- o Domestic auto sales are now in excess of a 7 million unit annual rate, versus just over a 5 million unit rate three months ago.
- o Housing starts in June were at 1.04 million unit annual rate, well above their January rate of 0.85 million.
- o Industrial production rose at a 7.4% annual rate over the last three months.
- o The June consumer confidence index was 78.0, a nice advance from the low point of 55.1% registered in January.
- o New durable goods orders fell 1.6% in June after rising for two months.

The housing sector is fulfilling its normal cyclical role—the first down and then the first up. So are consumer cyclicals. Capital spending is also behaving normally—the last to decline and the last to recover.

Housing and consumer spending were hurt as badly as in any postwar cycle. But relatively good trade performance, inventories held in check, and moderate capital spending kept the overall downturn mild. Corporate profits are now at their cyclical low point, but should improve gradually over the next year.

The recovery is not likely to be so strong as to result in a troubling rise in the inflation rate. Similarly, the well-advertised deflation in the price of certain asset classes—most notably commercial real estate—is unlikely to yield price declines in a broad range of goods and services. Rather, the prospect is for inflation to remain around 4% for the foreseeable future, with unit labor costs rising by approximately that amount.

Additionally there are three irritants which each aggravate the inflation rate by about 0.3% annually, and none are especially responsive to fiscal or monetary policy. They are: health care costs, environmental clean-up costs, and state and local taxes.

Interest rates, both short-term and long-term, should remain in a fairly narrow band for the remainder of 1991. A modest cyclical rise in short term rates is likely during the first half of 1992 as the Federal Reserve gently leans against the recovery in order to assure that inflation does not reaccelerate. With relatively steady long term rates, there will be some flattening of the yield curve during the next year.

B. A Slow and Sluggish Recovery

Exhibit A shows our forecast for the U.S. economy for the next six quarters. Historically in the post-war period, the median growth rate during the first six quarters of recovery has been around 6.4%. Our forecast for this recovery is about 3%, almost half as fast as normal.

Nine major reasons can be identified that will cause this recovery to be slow and sluggish.

- o Consumers are highly leveraged. Consumer spending growth will be constrained by income growth.
- o Consumers are worried about the value of their house, their most important asset. This is in distinct contrast to the last 20 years.
- o The business sector is highly leveraged.
- o White-collar service industries continue to suffer from their specific problems.
- o U.S. export markets are weakening in many parts of the world.
- o No major inventory build-up is likely because inventories never got far out of balance.
- o We have no fiscal lever available to pull in Washington in order to stimulate the economy. That lever was pulled a decade ago—and we have left it there ever since.
- o State and local government actions will restrain the economy as they struggle to achieve budget balance.
- o Banks, many of which are in trouble, will be less able to provide support than normal.

There are various economic implications to this slow and sluggish recovery. Any upward pressure on inflation and interest rates will be slower to develop than normal. Any pick-up in corporate profits and cyclically-sensitive sectors of the economy will also be slow to develop. The unemployment problem will recede slowly. And, the tax revenue gains of an expanding economy will be disappointing.

In addition to normal cyclical challenges, the economy faces a wide array of structural problems and other one-time situations, any of which might derail the recovery (more on these in Section IV). After a brief spurt of good economic news, a "double-dip" recession is not out of the question—but it is not the most likely outcome either.

III. THE 1990S:THE SLOWEST DECADE SINCE THE 1930S

For a variety of reasons, our GNP "potential" has slowed markedly during the past quarter century. Unless there is a metamorphosis in Washington, our growth rate will slow further making the 1990s the slowest growth decade since the 1930s.

A. Our GNP "Potential"

Changes in our GNP "potential", or total capacity to produce, can be thought of as the joint product of changes in the labor force, productivity, and average workweek. Exhibit B is an approximation of our GNP potential for the years 1965 and 1990, and an estimate for the year 2000. At present, labor force growth is about 1.3%, productivity growth is about 1.4%, and the average workweek is declining about 0.2% giving us a GNP potential of about 2.5%.

In 1965, our GNP potential was growing by about 4.3%. The slowdown in our capacity to produce over the past quarter century has been partly labor-force related, which is linked to our changing demographics. But the majority of the slowdown in our GNP potential has been due to lower rates of productivity, largely the result of what can be described as self-inflicted wounds. It represents 25 years of incoherent fiscal policy that encourages people to consume, instead of saving and investing. For 25 years we have ignored our education system and our infrastructure. Unless there is a metamorphosis in Washington (and I believe that is the right word) the growth rate of our GNP potential by 2000 will fall to around 1.8%, composed of 1.0% labor force growth, 1.0% productivity growth, and a continued decline of 0.2% in the average workweek.

B. Growth: 1900 to 1990

Real GNP growth by decade since 1900 is also shown in Exhibit B. If growth in the 1990s just equals our GNP potential of 1.8%, the decade will be the slowest since the 1930s—not a pleasant prospect. But 1.8% GNP growth would still be higher than our population growth, so per capita incomes would still continue to rise, albeit modestly. Indeed, an appreciation of the concept of the "opportunity cost" of these past failed policies is needed in order to get agitated about this growth slowdown.

Most Americans—ordinary citizens, business people, Washington policy makers—seemingly take for granted this past slowdown. It didn't have to be so in the past, and we can arrest this future self-inflicted slowdown if we just get to it. We need to rethink both the level and composition of our public spending, and the structure and level of taxes, and how each affects our economy's long-term performance. We need to focus less on the cyclical wiggles and jiggles in the economy, and more on the secular forces that can either erode or enhance our long run economic fortunes.

This growth slowdown is why the budget, tax code and savings rate mean so much. In addition, there are problems that need to be addressed to improve our economic performance: a badly decayed infrastructure, the debilitating effects of drug abuse, an elementary and secondary education system that in too many cases is largely warehousing, a crime problem so pervasive that it causes individuals and companies to spend money on "defense", an ever more litigious society with delays and appeals, a failing healthcare system, and a growing mismatch between needed skills and skills available in our labor force.

What are the implications of this slow growth? Most obvious is that our standard of living will grow more slowly than in the past. Our worldwide competitiveness will continue to suffer and our capital stock will become older and increasingly out of date. We will not be

able to deliver as many public sector goods and services to our citizens as we would like. But these economic problems are man-made, and we can solve them if we have the political will. We need to take a longer term perspective, and there is no time like the present to start.

IV. ISSUES FOR THE 1990S

While much attention over the last year has been focused on the depth and duration of the recession, Washington has no counter-cyclical fiscal latitude available—our chronic budget deficits have taken care of that. The focus needs to be on long-term issues. We face healthcare problems of unprecedented proportions. State and local budgets are collectively farther out of balance than at any time since the depression years. Banks are in trouble, and consequently, so is the FDIC. Commercial real estate excesses will take years to work off. The various regions of the nation are economically quite uneven.

The Soviet Union is headed for economic convulsion and collapse, with unknowable damage and consequences to eastern and western Europe and the rest of the world. Our savings rate remains inadequate to fuel a robust economy. The following touches on just a few of these issues.

A. The Healthcare Situation

Healthcare spending as a share of GNP has risen from 5% in 1960 to just over 11% in 1989 (see exhibit C). This share seems to be headed to 20%. To date, most of the increase has been technology driven. As our demographics change and baby boomers reach the age groups in which they will spend a lot of money on healthcare, these costs will rise even more.

The United States devotes more of its total product to healthcare than any other nation in the world, although we lead the world in only one healthcare statistic—life expectancy at age 85.

The statistics which document the healthcare problem are becoming well known. There are 34 million Americans who are uninsured, and they are the sickest of us all. There are well over 50 million Americans who receive no preventive care whatsoever and whose primary medical facility is the hospital emergency room. The vast majority of medical costs at the urban emergency rooms are unrecoverable, causing widespread closures of emergency rooms, a further decline in the quality of healthcare available, and require spreading these costs to those who can pay—in an arbitrary and ill-designed way.

The American attitude on healthcare seems to be that every patient deserves to have the best technology available, regardless of cost. Our third-party payment system is a bureaucratic nightmare with no accountability. Redundant testing and unnecessary procedures proliferate as doctors practice defensive medicine to avoid malpractice suits. There is a collision between medical ethics and medical technology. The medical ethics/technology dilemma at the end of life is dwarfed by a similar dilemma at the beginning of life. The traditional retirement age of 65 is rooted in history and is now embedded in many government practises and institutions. Perhaps our concept of retirement is upside down—maybe we should think of retirement as x years from expected death, rather than as x years from birth.

Healthcare spending is the fastest growing cost item for every company in every industry in the country. Companies with an old work force are less competitive than those with a younger work force. We are unable to devise new institutional payment mechanisms fast enough to keep up with the changing pressures in the system. Yet the changes are too fast for the general public to understand and view confidently.

But as our delivery system staggers and costs continue to run out of control, the public will demand more governmental involvement in the healthcare business.

If healthcare spending continues to rise during the 1990s as the technology, our chaotic system and the aging of the population would seem to suggest, the American public will be in for a rude awakening. The key consumer question will be: what goods and services do I cut back in order to accommodate the enormous rise in healthcare spending? The key national question will be: how does the overall economy behave as industry after industry is damaged by the accelerating reallocation of spending toward healthcare?

B. The State and Local Budget Mess

Exhibit D reveals that the state and local budgets are farther out of balance now than at any time in the postwar period, far worse than in the depths of the 1974–75 or 1981–82 recessions. The solution to these budget problems is not mysterious—it is just painful. The fundamental choices are higher taxes, lower spending, or some combination thereof. But elected officials at the state and local level don't want to deliver either of these choices any more than the public wants to hear the unpleasant news. As a consequence, the budgetary imbalance has become a chronic condition. While some hard choices were made at the recent June 30 fiscal year end (for most states), the more common steps seem to have been creative accounting and an impressive array of budget gimmicks which only delay the day of reckoning amd boosts the long-term costs.

We have overpromised as a society at the state and local level, just as we have at the federal level. Real state and local spending for the last seven years has increased about 3% a year, a rate of growth inconsistent with the dominant anti-tax mentality.

In addition, the state and local budget situation has been dramatically aggravated by the cutback in federal grants-in-aid. In 1980, 16% of the federal budget was grants-in-aid to lower levels of government. That share has declined to 10% and is probably headed much lower, given the federal budget problems. In essence, Uncle Sam is sending the programs, but not the money to the states. And the states are taking a lesson from Uncle Sam—sending the programs, but not the money, to the localities. As a result, problems are accumulating at the lowest levels of governance. This is not a sustainable path.

In 1990, in aggregate, 23 states raised taxes while none lowered them. In 1991, the score will probably be about 26 up, none lower. And despite the best efforts to cut spending and eliminate programs where possible, spending continues to compound with 20-to-25% annual increases in medicaid costs, and a prison population which has more than doubled since 1980. Well-advertised layoffs and rising taxes will be an important drag on the economy during the present economic recovery.

The financial situation which has developed in Bridgeport, Connecticut is instructive. Here is a case in which elected officials have become so frustrated with the budgetary impasse that they have thrown up their hands, dumping the problems in the lap of the courts. Three months ago, I would have bet that such an approach would not become widespread. I am no longer confident that that is the case. If the taxpayers and elected officials regard this budgetary "situation" as successful, more will follow with the potential for real disruption in that portion of the economy and markets.

C. Commercial Real Estate Excesses

The office vacancy rate is over 17% nationwide and headed higher (see Exhibit E). More space continues to be completed than is being taken up by the expansion of the economy. The contraction and consolidation in commercial banking will aggravate the problem.

This vacancy rate understates the true condition because there is a substantial amount of what could be described as "hidden" vacancy. That is, space which is rented but which is unoccupied because of prior business contraction. Companies will have to grow back into those empty desks and offices before they rent new space.

The origin of the commercial real estate problem extends back to the 1981 tax law in which companies were allowed to depreciate their office buildings over 15 years, although the economic life of the building was, in many cases, 40 years. With tax life being much shorter than economic life, a surplus developed in a short period of time. The present difficulties in commercial banking, and the emerging difficulties in insurance are an outgrowth of the commercial real estate situation.

In general, there have been three commercial construction building booms in this country in the 20th century—the 1920s, the 1950s, and the 1980s. If history is any guide, this sector may be a drag on the economy until 2010.

D. Regional Unevenness

The U.S. economy at the beginning of this expansion is quite uneven (Exhibit F). In each chart, the darkest line is the rate of gain in employment in the particular state. The dashed line is the rate of gain in employment in the United States, and the dotted line is the rate of gain in employment in that state minus that of the U.S. Hence, a dotted line below zero indicates the state is not doing as well as the nation as a whole.

Economic circumstances in Massachusetts are, in a word, grim. Massachusetts has been falling below the national average for each of the last four years and no end is in sight. The circumstances in New York, New Jersey, Connecticut, and Rhode Island—other northeastern states—are similar. All are confronted with aging infrastructures, relatively high tax burdens, labor force problems, and are badly positioned for growth in the 1990s.

The Colorado economy, conversely, is beginning to grow after suffering early in the 1980s due to energy sector problems. Their growth is now well above the national average. In general, the problems mentioned for the Northeast are advantages for the South and the West. In addition to Colorado, states which stand out positively relative to the nation are Texas, Florida, Hawaii, Arizona, Utah, and Nevada.

Maryland's economic performance is representative of the majority of states, pretty much mirroring that of the nation. Maryland's economy did well in the mid-1980s and suffered during the recession but not inordinately so.

As the 1990s unfold in a slow growth mode and severe state and local budget problems persist, the 50 states may become increasingly competitive relative to each other in attempts to attract employment and economic activity to their particular state.

E. Budget Issues in Washington

No discussion of the economy is complete without a comment about our federal budget situation. Exhibit G reveals graphically the nature of the budget problem and perhaps explains why the public is so skeptical of our budget problems. The dark line is the actual federal budget deficit from 1975 to date. The thin lines that angle up to the right are the budget estimates of the presidents made in the noted years.

The pattern is striking. Every year, the president anticipates dramatic budget improvement. And every year, the performance falls far short of that which is promised. That the current mid-session review was a disappointment, with a worse budget outcome, should not be surprising. And the new estimates for fiscal 1992 to 1996 look no more plausible than those of the past. Routinely, outlays are greater than programmed, and receipts lower.

One problem with the budget is that the economic assumptions of the presidents are routinely too optimistic. In Exhibit H, reading across any row indicates the assumptions for real GNP growth of a particular president made on the specified date for the next six years. A careful reading of this table is instructive. First, the economy goes up and down as recessions come and go. Indeed the first two years' forecasts (for the current year and the next year) are usually not too bad. But in the "out years" the assumptions are invariably for a prolonged and rapid expansion which rarely comes to pass. The resulting weaker economy leaves revenues lower and outlays higher than projected.

The public is not served well by this process. Our federal deficits are no longer cyclical, they are chronic. During economic expansions, the public sector never gets out of the capital markets, draining our already too low savings away from the private sector. And during recessions, we have no fiscal policy discretion to apply in a counter-cyclical sense as our current circumstance so vividly reveals.

A real fiscal policy, not a happenstance fiscal result, would do more than any other single act to reverse the economic damage we are now causing ourselves. But a time horizon longer than the next election will be required.

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Exhibit A

	ACTUAL		FORECAST						ANNUAL		
	1990.4	1991.1	1991.2	1991.3	1991.4	1992.1	1992.2	1992.3	1990	1991F	1992F
Real GNP (Bil 82$)................	4153.4	4124.1	4119.6	4135.2	4181.8	4227.6	4259.6	4285.9	4157.3	4140.2	4270.3
% Change, SAAR..................	-1.6	-2.8	-0.4	1.5	4.6	4.5	3.1	2.5	1.0	-0.4	3.1
% Change, Year Ago.............	0.5	-0.6	-0.9	-0.8	0.7	2.5	3.4	3.6			
Nominal GNP.......................	5527.3	5557.7	5617.7	5698.5	5814.1	5935.8	6039.4	6137.5	5465.1	5672.0	6086.6
% Change, SAAR..................	0.9	2.2	4.4	5.9	8.4	8.6	7.2	6.7	5.1	3.8	7.3
% Change, Year Ago.............	4.5	3.4	3.2	3.3	5.2	6.8	7.5	7.7			
Industrial Production (87=100)....	108.5	105.8	105.7	106.0	107.6	109.4	110.5	111.5	109.2	106.3	110.9
% Change, SAAR..................	-7.2	-9.6	-0.3	1.1	6.2	6.9	4.1	3.7	1.0	-2.7	4.4
% Change, Year Ago.............	0.3	-2.3	-3.4	-4.1	-0.8	3.4	4.5	5.2			
Capacity Utilization, Mfg (%).....	80.8	78.0	77.4	77.1	77.7	78.4	78.7	78.9	82.2	77.6	78.7
Unemployment Rate, Civilian (%)...	5.9	6.5	6.8	7.0	6.9	6.6	6.5	6.5	5.5	6.8	6.5
Auto Sales, Total (Millions)......	8.97	8.23	8.40	8.80	9.50	9.90	9.80	10.00	9.51	8.73	9.93
Housing Starts, Total (Millions)..	1.04	0.92	0.99	1.15	1.25	1.30	1.32	1.32	1.19	1.08	1.32
CPI, Consumer Prices (% SAAR).....	7.0	3.5	2.1	4.0	3.8	4.0	4.0	4.2	5.4	4.4	3.9
% Change, Year Ago.............	6.3	5.3	4.8	4.1	3.3	3.5	4.0	4.0			
Corp. Profits After Tax (Bil $)...	177.6	166.4	163.9	168.5	178.5	191.4	196.6	199.4	172.5	169.3	198.6
% Change, Quarterly Rate........	-1.0	-6.3	-1.5	2.8	5.9	7.2	2.7	1.4	-0.1	-1.8	17.3
% Change, Year Ago.............	6.8	-0.4	-1.3	-6.1	0.5	15.0	20.0	18.3			
S&P 500 Earnings Per Share ($)....	4.40	5.20	4.90	5.10	5.55	5.80	6.00	6.40	21.34	20.75	24.50
% Change, Year Ago.............	-8.3	-6.1	-19.3	-4.3	26.1	11.5	22.4	25.5	-6.7	-2.8	18.1
Treasury Bills (3 Months) %.......	6.99	6.02	5.56	5.50	5.60	6.10	6.50	6.85	7.49	5.67	6.58
Treasury Bonds (30 Years) %.......	8.55	8.20	8.32	8.35	8.50	8.65	8.60	8.55	8.61	8.34	8.57
Budget Deficit, NIA Basis (Bil $).	-184.3	-126.9	-159.9	-207.5	-239.9	-249.1	-240.0	-236.1	-166.0	-183.5	-241.6
Merch Trade Deficit (BOP) (Bil $).	-27.7	-18.4	-19.8	-20.8	-21.9	-22.6	-23.0	-23.2	-108.1	-80.9	-92.0
Japanese Yen (Yen/$)..............	131	134	137	138	140	135	130	125	145	137	129
German Mark (DM/$)................	1.50	1.53	1.73	1.83	1.85	1.85	1.85	1.80	1.62	1.74	1.83

Exhibit B

Our GNP "Potential"

	1965	1990	2000
Labor Force	1.8%	1.3%	1.0%
Productivity	2.7	1.4	1.0
Workweek	-0.2	-0.2	-0.2
Total	4.3	2.5	1.8

Real GNP Growth

1900's = 4.6%
10's = 1.5
20's = 2.7
30's = 2.1
40's = 4.3
50's = 3.2
60's = 2.9
70's = 2.8
80's = 2.8
90's = ?

50-586 O - 92 - 4

Exhibit C

Health Spending as a Percentage of Gross Domestic Product						
Country	1960	1970	1975	1980	1985	1987
Australia	4.6%	5.0%	5.7%	6.5%	7.0%	7.1%
Austria	4.6	5.4	7.3	7.9	8.1	8.4
Belgium	3.4	4.0	5.8	6.6	7.2	7.2
Canada	5.5	7.2	7.3	7.4	8.4	8.6
Denmark	3.6	6.1	6.5	6.8	6.2	6.0
France	4.2	5.8	6.8	7.6	8.6	8.6
Germany	4.7	5.5	7.8	7.9	8.2	8.2
Greece	3.2	4.0	4.1	4.3	4.[illegible]	5.3
Iceland	1.2	4.3	5.9	6.4	7.3	7.8
Italy	3.3	4.8	5.8	6.8	6.7	6.9
Japan	2.9	4.4	5.5	6.4	6.6	6.8
Netherlands	3.9	6.0	7.7	8.2	8.3	8.5
Norway	3.3	5.0	6.7	6.6	6.4	7.5
Spain	2.3	4.1	5.1	5.9	6.0	6.0
Sweden	4.7	7.2	8.0	9.5	9.4	9.0
Switzerland	3.3	5.2	7.0	7.3	7.[illegible]	7.7
United Kingdom	3.9	4.5	5.5	5.8	6.0	6.1
United States	5.2	7.4	8.4	9.2	10.6	11.2

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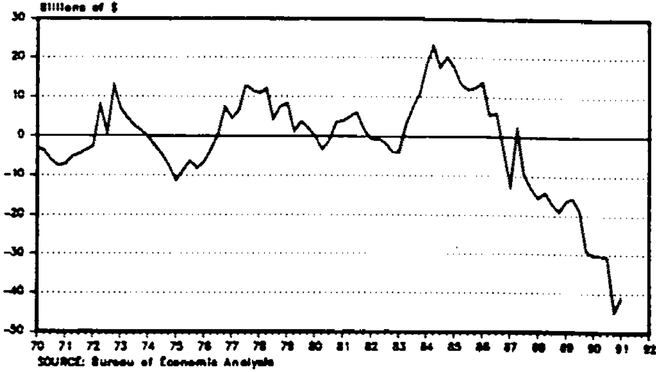
Exhibit D

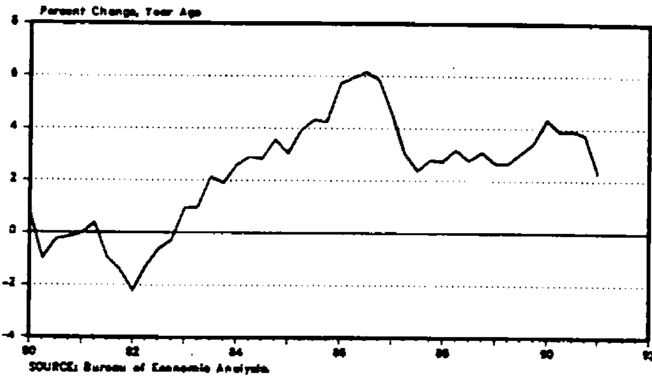
States Running on Empty

State and Local Government Operating Deficits



State & Local Spending Cutbacks

Total Real State & Local Outlays



Fewer Federal Grants-in-Aid

As Percent of Total Federal Budget

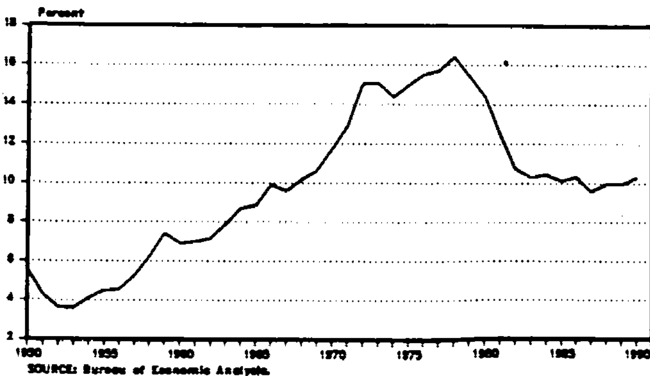
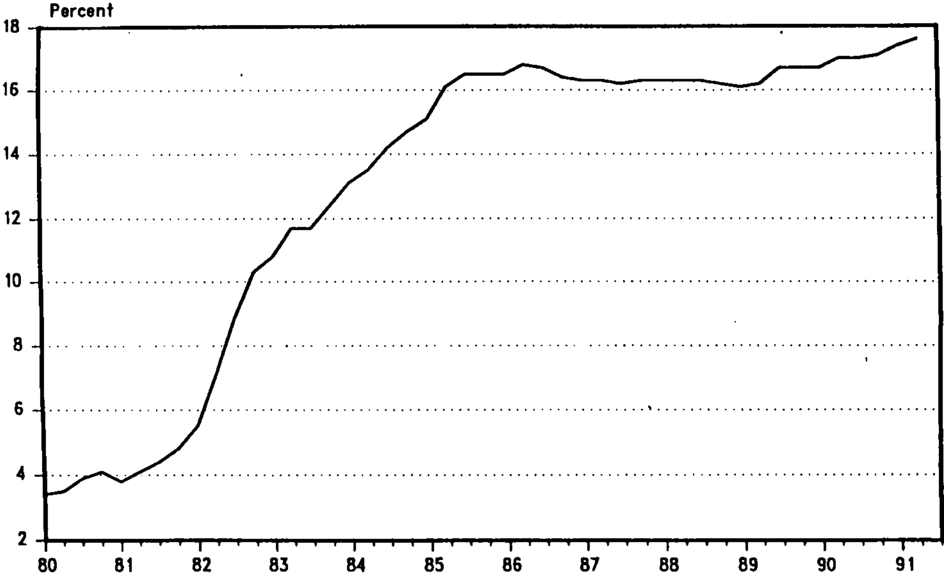


Exhibit E

Empty Offices

Office Vacancy Rate, U.S.

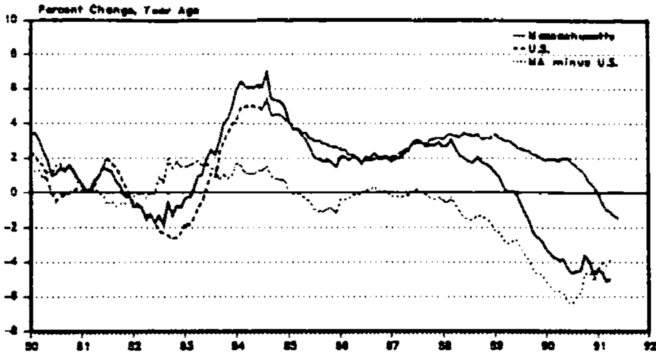


SOURCE: Coldwell Banker

Exhibit F

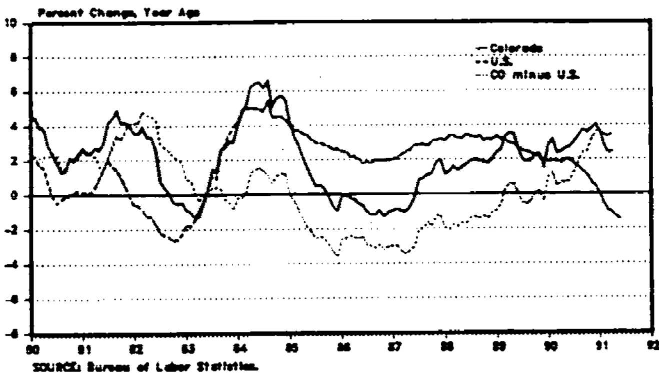
Massachusetts Employment

Massachusetts minus U.S. Employment Gains



Colorado Employment

Colorado minus U.S. Employment Gains



Maryland Employment

Maryland minus U.S. Employment Gains

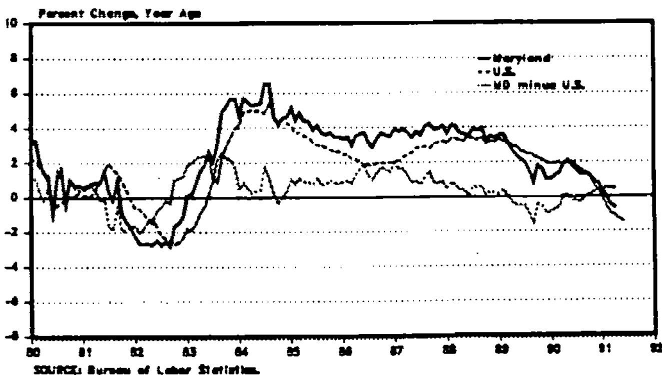
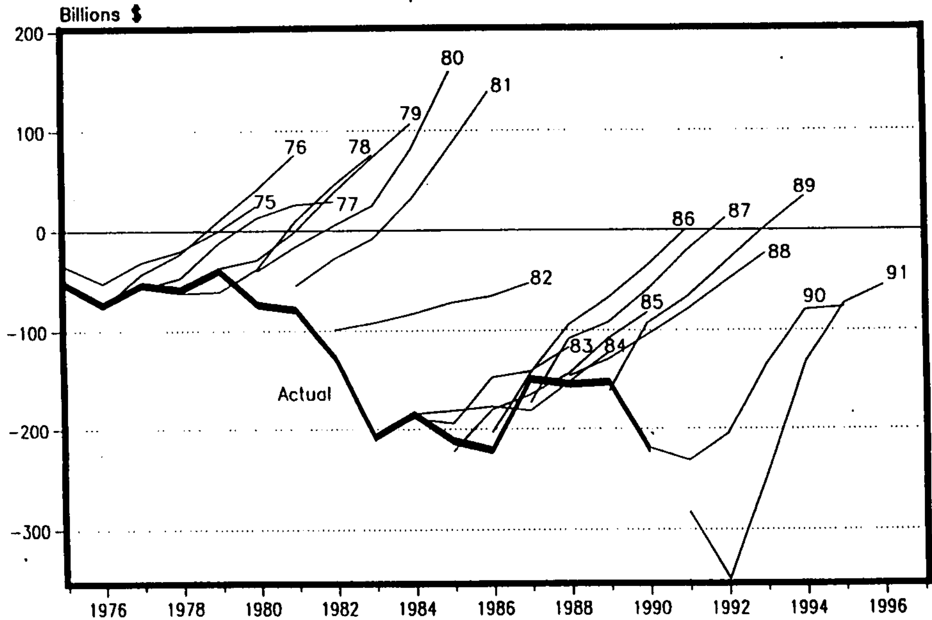


Exhibit G

Budget Estimates of the Presidents

Surplus or Deficit



SOURCE: Office of Management & Budget.

Exhibit H

Economic Assumptions of the Presidents: Real GNP (% Change)
Calendar Years

Date & Source	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996
	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----	----
2/75 Ford	-3.3	4.8	5.6	6.5	6.5	6.5																
1/76 Ford		6.2	5.7	3.9	6.5	6.5	6.5															
1/77 Ford			5.2	5.1	5.9	5.5	3.9	3.5														
1/78 Carter				4.7	4.8	4.8	5.0	4.7	4.2													
1/79 Carter					3.3	2.5	4.2	4.7	4.4	3.4												
1/80 Carter						-0.6	1.7	4.3	5.0	4.9	4.7											
1/81 Carter							0.9	3.5	3.5	3.7	3.7	3.7										
2/82 Reagan								0.2	5.2	5.0	4.7	4.4	4.3									
1/83 Reagan									1.4	3.9	4.0	4.0	4.0	4.0								
2/84 Reagan										5.3	4.1	4.0	4.0	4.0	3.9							
2/85 Reagan											3.9	4.0	4.0	4.0	3.9	3.6						
2/86 Reagan												3.4	4.0	4.0	3.9	3.6	3.6					
1/87 Reagan													3.1	3.5	3.6	3.6	3.5	3.4				
2/88 Reagan														2.9	3.1	3.5	3.4	3.3	3.2			
2/89 Bush															3.2	3.2	3.3	3.2	3.2	3.2		
2/90 Bush																2.4	3.2	3.2	3.1	3.0	3.0	
2/91 Bush																	0.9	3.6	3.4	3.2	3.0	3.0
7/91 Bush																	-0.2	3.2	3.5	3.3	3.1	3.0
Actual	-1.3	4.9	4.7	5.3	2.5	-0.2	1.9	-2.6	3.6	6.8	3.4	2.7	3.4	4.5	2.5	1.0						

Source: Budget of the U.S. Government, various years.

Note: Reading across any row shows the assumption of a particular president made on the specified date for the next six years.

Reading down any column shows the various growth assumptions for a particular year made over the space of six years.

REPRESENTATIVE HAMILTON. Thank you very much, Mr. Straszheim. Mr. Dunkelberg, please proceed.

STATEMENT OF WILLIAM C. DUNKELBERG, DEAN SCHOOL OF BUSINESS AND MANAGEMENT, TEMPLE UNIVERSITY

MR. DUNKELBERG. Thank you, Mr. Chairman. I will try to keep my comments fairly brief primarily because I do not find that I do not disagree too much with Mr. Straszheim. I will attribute that to our shared history at Purdue University.

I will take a little bit different perspective in that on behalf of the National Federation of Independent Business, I get to talk with over half million member firms each month, and so I will say a little bit about what we see about the current economic situation, based on my conversations by mail with these firms, and then give you a few concluding comments about the prospects for the next year and the major structural problems, as well.

As far as we can tell from NFIB surveys, we hit bottom somewhere in the second quarter. We had a record high percentage—when I say record high, I am referring to a history of our surveys that goes back to 1973—of firms reporting that their sales were falling compared to the prior quarter. Clearly, sales losses were very pervasive in that period, and we have seen a turnaround since that time.

We have had huge inventory decumulations that show up, of course, in the national income accounts numbers, as well. In fact, we are a little surprised at the magnitude of the decumulation, since most of our firms have been managing their companies as if a recession would happen for 3 or 4 years now. Once we got about 4 years through the expansion, most firms thought that it could not last any longer. It did extend for another 2 or 3 years, but nonetheless, they were managing fairly carefully.

So, it looks like we hit bottom early in the year. Now, the question is, of course, once you are at the bottom, do you just move along the bottom or do you move up. If you get up, will you maybe drift back down and have the so-called double dip?

As far as we can see, there will not be a double dip in the recovery, whatever that recovery looks like. Of course, the risk is that the recovery may be so modest that we won't be able to tell whether or not we are off the bottom.

The areas that I expect to see strengthened over the next 6 months would be a reversal of inventory decumulation; that is, if we stop decumulating inventories to the tune of $20 billion, we will get a 1.5 point or so increase in GNP growth. Exports will probably turn out to be stronger than we are expecting. Capital spending, especially now that we have some certainty with the Clean Air Act, will be stronger than many people are expecting. There is a lot of activity going on in that area now.

We have—although we are not sure why—heavy-scheduled production of domestic cars in the third quarter. That will certainly add to GNP. The

question is, of course, will someone buy them, or will they end up in inventories in the fourth quarter. Nonetheless, these four factors should be enough to give us noticeable positive growth sometime between now and December.

The consumer, accounting for two-thirds of GNP, is the big question mark. I think the consumer will be at this party—the recovery party—but with a serious hangover from the 1980s. During the 1980s, with this record expansion, we had 8 years in which we were able to accumulate lots of "stuff." Consumers bought everything and anything in sight. Job generation was substantial. We employed a record-high percentage of the over-16 population. Once you get a job, of course you want to rent an apartment, maybe buy a house, but you certainly buy a car, stereo, CD players, all those things. All that stuff is out there now, and it has not worn out.

This overhang will be depressing on consumer spending. Consumers bought that stuff with debt, and now they have a lot of debt that they have to pay off. Real disposable income has not increased for three quarters now. Job creation in our small firms is not happening because we are not starting a lot of new companies, and the existing companies are not growing. Interest income, which is important for consumers, and during the 1970s and early 1980s was the fastest growing component, both in terms of percentage and dollars of consumer income, is not growing but falling. Taxes are up. Net worth is down because real estate prices are falling. So, the psychology is bad, and all of these factors say to me that the consumer really is not going to do anything very interesting to help us get out of this funk that we are in now in the economy.

The financial sector remains an incredible uncertainty for us. The real estate disease is spreading. It is starting to affect other institutions—the insurance companies, and so on—and, as Don pointed out, the problems we are having in real estate are going to really impair the financial institutions in their ability to funnel capital from savers into investment for the next 5 and maybe even 10 years.

The Federal Reserve has a very difficult role to play. Since fiscal policy is immobilized, all the weight falls on the Fed. Its major job is to avert a crisis. It certainly has done that very well, but beyond that one wonders how much the Federal Reserve through monetary policy can really accomplish to help the economy out.

The fiscal situation is absolutely outrageous, and it really does need to be addressed in a very serious manner. I think Don went over those points very well, and so I will not go over them.

So, as we look at the recovery, we do expect a very anemic recovery. We will probably set a new record for having the most unspectacular recovery in history, probably under 5 percent growth in the first two quarters. I think 5.4 percent is the lowest we have ever had to date. So, I think we will see something substantially less than that in the first two quarters of the recovery.

The main reason is this 8-year supply overhang that we have. Not only did consumers buy everything, but we built too many office buildings, too many strip malls, and too many single-family houses. We did too much of everything. We have an unusual problem, compared to the rest of the world, in that we are having a recession because we have too much stuff. Everybody else has too little stuff.

Our expansion during the 1980s died a natural death. It may not have been quite so weak in the fourth quarter were it not for Saddam Hussein's action. The dramatic increase in oil prices was like a big tax increase. The money left the country and was not respent here. That certainly did not help us any.

The general scenario of what happened to us might be best illustrated by what happened in New England where, based on our surveys of small firms for almost 8 years, more firms in New England told us that it was easier rather than harder to get their financing, compared to the prior quarter when they were in the market trying to borrow money. In short, the New England banks somehow figured out how to print money. They have financed anything and everything in sight. Employment was wonderful in New England. People were very busy, especially in the construction industry. Real estate prices were bid up, and of course, banks and other financial institutions made a lot of loans based on those escalating prices. Then, when they had too much of everything and nobody to live in it, buy it, move it, drive it, the economy fell apart. New England is now the weakest economic region in the United States.

There is some good news here. The outlook for inflation looks really good, based on the surveys of small businesses in NFIB's membership. We found 18 percent of the firms reporting that in the last 6 months—that is the first half of this year—selling prices were cut. That is very close to the record 20 percent that we achieved in the 1980-82 recession. Only 17 percent plan to raise prices over the next 6 months, and that is a record low in the history of our survey. So, we have never seen so few firms planning to raise prices. Just to give you a comparison, in the 1980-82 period, over half the firms planned to raise prices, and as many as 80 percent raised prices; in fact, once they found out what happened to them with costs through the back door.

So, near term we have lower inflation, which means lower interest rates. That is good news. That will happen without the Fed doing anything except letting it happen. The unemployment rate will remain sticky because we are not generating enough jobs to take it down very far, and we will have basically unspectacular growth. The consumer really will be watching the ball game rather than participating in it. Longer term, we have structural problems with the deficit, taxes, and regulation and, in particular, the mandated benefits.

There are two things that NFIB's members identify as being the most important problem facing small business. One is taxes. The second is regulations. Each of those received the same number of votes in June. Regulation is just another tax. Rather than the government taking the

money and spending it on something, you just tell the firms how to use the money. The point is that they cannot use it in the ways that they are best able to use it, and that is to make the best goods and services they can and deliver them at the lowest possible prices. That, of course, relates to the productivity issue. If we continue to tie up the hands of the entrepreneurs of this country, we cannot expect to have major productivity gains. Therefore, potential GNP will grow slowly, and the decade of the 1990s will be a very unspectacular decade of growth.

The fiscal situation—state, local, and federal—is incredible. In the discussion period, we might talk about why we are able to get away with this nonsense. We all know that it is nonsense. We all know it does not make any sense, and we all know that this chicken is going to come home to roost sooner or later. The longer we wait to deal with the problem, the bigger the chicken is going to be. When holders cash in all these claims—and they will sooner or later—or the willingness to finance these deficits diminishes, we are going to have some serious problems.

So, the economy has turned. The recovery will be slow and uninteresting, and unless we do something interesting from a leadership perspective, particularly dealing with the federal fiscal problems—and some of the States have, in fact, taken action to deal with theirs—we can look forward to a decade that is going to be pretty uninteresting, that is not going to deliver anything to our consumers close to what it has the potential of delivering. The reason we will fail is that we will not have provided the right policy leadership here in Washington to get the job done.

Thank you very much.

[The prepared statement of Mr. Dunkelberg follows:]

PREPARED STATEMENT OF MR. DUNKELBERG

The U.S. economy has already bottomed out, and there is little chance that it will slip into a "double dip" recession. The major factors contributing to a reversal of negative economic trends are:

* A reversal of inventory decumulation
* Additional strength in exports
* Unexpected strength in capital spending
* Resumption in auto production in the third quarter

GNP growth will benefit by 1.5 to 2 percentage points simply from a cessation of inventory decumulation. Any accumulation beyond that point will add to the GNP growth rate.

The dollar is at 1/2 of its 1985 value. In the view of many economists, it is fundamentally undervalued, but this make our products and services an exceptional buy. Exports will be higher than expected.

A low dollar discourages investment abroad by U.S. firms and encourages foreign investment in the U.S. This will boost plant and equipment spending. March was probably the low point as orders for steel for appliances, cars and durables are picking up. The Clean Air Act passage will trigger major projects that were delayed until the bill passed and compliance costs became certain. High on the list will be petroleum refining, gas pipelines, electric utilities, petrochemicals and basic health care product production and research.

Domestic auto inventories are very low and production will pick up substantially in the second half. Foreign car inventories are very high. Imports, rather than domestic production and inventories, absorbed a substantial part of the recession.

The big question is how many consumers will come to the party. Real disposable income has fallen for 3 consecutive quarters, interest income is down, debt is high [meaning that consumers bought a lot of goods and are in no real hurry to replace them], taxes are up, and real estate values [net worth] are down. None of this is supportive of increased consumer spending.

Defense spending should resume its negative profile, and state and local government spending will be constrained by fiscal problems.

The financial sector remains a major uncertainty. There are a number of "surprises" left in the system. The inventory workout being supervised by the RTC is not close to being over, the weakness in real estate [due in part to the 1986 tax law changes] is spreading to other financial institutions [insurance companies for example] and bankruptcies are still rising [they typically peak after the turn in the economy however]. The FED's main job, of course, is to avert panic. It has done so with remarkable skill [particularly in light of the fiscal crisis that has disabled fiscal policy] and can be counted on to continue on its course.

The leading indicators say "recovery". The National Federation of Independent Business [NFIB] Optimism Index indicated that the economy hit bottom in March. Consumer optimism has also rebounded, although neither measure has regained expansion levels.

We could easily set a new record for anemic recoveries. This means a GNP growth rate of under 5% in the first 2 quarters of the expansion. New job creation will barely keep pace with labor force growth, holding the unemployment rate near current levels. The economy had about 8 years to accumulate "stuff" - new single and multi-family homes, office buildings, strip malls, retail space [triple 1975 per capita square feet], cars bought on special deals that borrowed from future demand, CD players, etc. etc. Now, we have too much of everything and the recession has not been deep or long enough to work off the excesses. The "supply overhang" will slow down the pace of recovery.

Indeed, the 1980's expansion came as close to any of experiencing a natural death. We simply were producing too much and we couldn't absorb it any longer. The "oil tax" imposed by the invasion of Kuwait simply insured that the fourth quarter softness became a real recession. This process was most obvious in New England where for nearly 8 years, more firms reported that getting loans was "easier" than reported "harder". Banks were financing anything and everything. Consequently, growth was strong and employment was "overfull". Eventually, however, supply overwhelmed the ability of the economy to absorb it and New England crashed, with a multi-year supply of office space, retail space, homes etc. This precipitated a crash in real estate values that crippled the financial system, and it will take years for New England to really recover.

In the June NFIB survey, almost 1 in 5 firms cut average selling prices during the last six months, and a record-low

17% plan price increases during the second half of 1991. This is good news for inflation and will facilitate a further decline in long-term interest rates.

In summary, the near term offers lower inflation and interest rates, with a second-half recovery in GNP growth that is likely to set a new record for "unspectacular". Unemployment will stick near its current levels and the consumer will be at the party at best with a bad hang-over from the 1980s gala.

Long term, we are still looking for some leadership on the fiscal side. Even state and local governments are in serious trouble - they also thought the party would never end. But it has. Most states, however, are taking action to solve **immediately**, not at some meaningless future date on a piece of paper, their budget crises. If there were one single action that could be taken to improve saving, investment, and economic growth, it would be a meaningful solution to the federal fiscal crisis. Sooner or later, this chicken is going to come home to roost. The longer we wait, the bigger the chicken. We have made some good progress in recent years, but it still isn't enough. We all know that what we are doing does not make sense, but as long as we can get away with it from day to day, we seem content to ignore the long-term implications of our actions.

SMALL BUSINESS AND THE ECONOMY

MONTHLY UPDATE - JUNE, 1991

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

William C. Dunkelberg
(215) 787-6810

THE **NATIONAL FEDERATION OF INDEPENDENT BUSINESS** REPRESENTS OVER 500,000 FIRMS NATIONALLY. EACH MONTH, NFIB SURVEYS A RANDOM SAMPLE OF ITS MEMBERSHIP. THE RESULTS OF THE LATEST SURVEY ARE SUMMARIZED IN THIS REPORT. 735 FIRMS RESPONDED TO THE JUNE SURVEY.

################################

*** THE NFIB SMALL BUSINESS OPTIMISM INDEX FELL 2.3 POINTS FROM MAY, PUTTING THE INDEX AT 100.1, STILL WELL ABOVE THE 89.5 READING FROM LAST NOVEMBER.

*** 7 OF THE 10 COMPONENTS OF THE SMALL BUSINESS OPTIMISM INDEX LOST GROUND AND ONE REMAINED UNCHANGED.

CAPITAL SPENDING STAYS FLAT

30% PLAN CAPITAL OUTLAYS DURING THE NEXT 6 MONTHS, UP 2 POINTS FROM MAY - A LITTLE LIFE, BUT NOT MUCH ENERGY.

HIRING PLANS ARE OK

16% PLAN TO EXPAND EMPLOYMENT, WHILE 8% WILL REDUCE EMPLOYMENT, VIRTUALLY UNCHANGED FROM MAY ON A SEASONALLY ADJUSTED BASIS.

LABOR MARKETS STABILIZE

14% OF ALL FIRMS REPORTED JOB OPENINGS THAT WERE DIFFICULT TO FILL. THE JUNE FIGURE REPRESENTS AN IMPROVEMENT FROM THE MAY FIGURE ON A SEASONALLY ADJUSTED BASIS.

INVENTORY INVESTMENT - FLAT

12% PLAN TO INCREASE INVENTORY HOLDINGS, WHILE 12% PLAN STOCK REDUCTIONS. 11% REPORTED THAT INVENTORIES WERE TOO HIGH, WHILE 9% FELT THAT STOCKS WERE TOO LOW.

THE PACE OF PRICE INCREASES - SLOWING AGAIN

22% REPORTED RAISING PRICES DURING THE PAST FEW QUARTERS. 18% REPORTED LOWERING AVERAGE SELLING PRICES, ONE OF THE HIGHEST FIGURES IN THE PAST 6 YEARS.

17% PLAN TO RAISE PRICES IN THE NEAR FUTURE, WELL BELOW THE EXPANSION-HIGH OF 32% AND DOWN A BIG 7 POINTS FROM FEBRUARY.

****
NOTE: TEXT TABLES SHOW MONTHLY STATISTICS FOR COMPARABLE MONTHS IN PRIOR YEARS, BUT SHOW HIGH AND LOW FIGURES BASED ON SURVEYS IN THE FIRST MONTH IN EACH QUARTER (labeled **"QUARTERLY"**). *THESE MONTHS USE VERY LARGE SAMPLES AND THE STATISTICS ARE THEREFORE MORE RELIABLE.*
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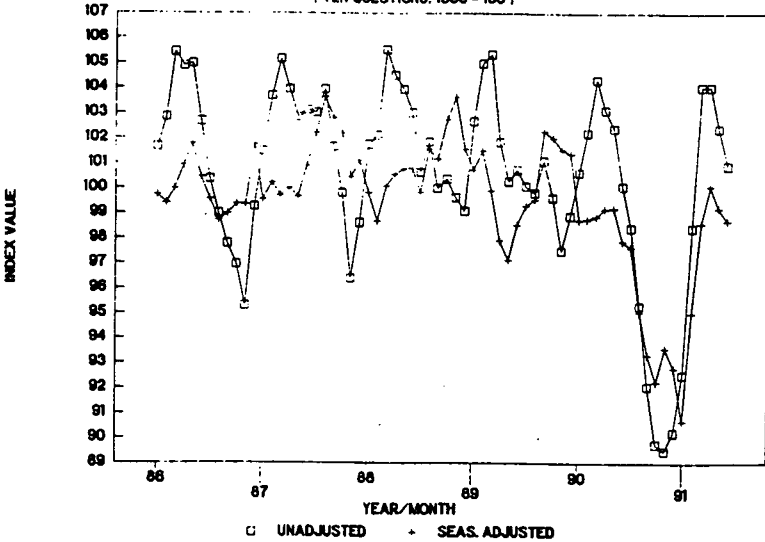


TABLE 1

Small Business Optimism Index [1978=100]

	1986	1987	1988	1989	1990	1991
January	101.7	101.5	101.8	102.7	100.7	92.5
February	102.9	103.7	102.1	105.0	102.2	98.4
March	105.4	105.2	105.5	105.4	104.3	104.1
April	104.9	104.0	104.5	101.8	103.1	104.1
May	105.0	102.9	104.0	100.3	102.4	102.4
June	102.7	103.1	103.0	100.7	100.1	100.1
July	100.4	103.0	100.7	100.1	98.4	
August	99.0	104.0	101.8	99.8	95.3	
September	97.8	101.7	100.0	101.1	92.1	
October	97.0	99.8	100.4	99.6	89.8	
November	95.3	96.4	99.6	97.5	89.5	
December	99.3	98.6	99.1	98.9	90.2	

TABLE 2

	NET GAIN [LOSS]												
	1990							1991					
INDEX COMPONENTS	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	May	Jun
Expectations													
Economy Better	- 2	- 5	-16	- 1	- 8	+ 9	+16	+ 7	+27	+14	0	- 5	- 2
Good to Expand	- 1	- 4	- 3	- 3	- 2	0	+ 1	- 1	+ 5	+ 4	0	- 1	+ 1
Inc. Real Sales	- 5	- 8	- 5	-14	- 9	- 7	+ 1	+ 5	+18	+29	+ 4	- 6	- 7
Planned Spending													
Net Hiring	- 6	- 6	- 4	- 2	- 2	- 4	+ 2	+ 7	+ 7	+ 8	- 2	- 3	- 5
Capital Outlays	- 4	- 1	+ 1	- 3	0	+ 3	- 3	0	0	+ 1	+ 3	- 3	+ 2
Inventory Inv.	- 4	- 3	- 4	- 5	- 1	0	- 2	+ 5	+ 5	+ 4	- 5	- 4	- 3
Current Status													
Invent. Too Low	- 1	0	0	- 3	+ 3	- 1	- 3	+ 3	- 1	+ 5	- 1	+ 1	- 2
Earnings Higher	+ 1	+ 3	- 2	- 5	- 5	0	- 6	- 1	+ 2	- 5	- 1	+ 1	- 1
Job Openings	- 4	+ 1	+ 1	0	- 2	- 3	- 2	- 1	- 1	+ 3	- 1	0	0
Expect Easier Credit Cond.	+ 1	- 1	- 2	+ 1	- 1	0	0	+ 1	+ 2	- 2	+ 3	+ 2	- 1

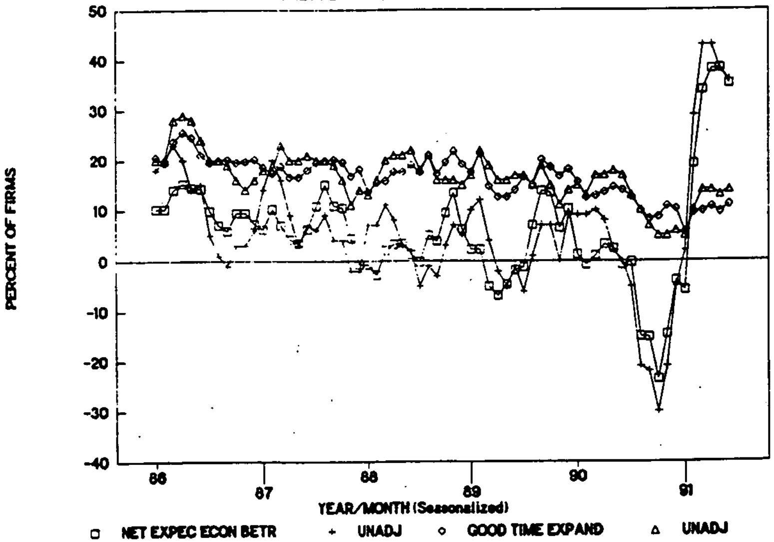
Figures represent the *change* from the prior quarter in the NET percentage of firms providing a favorable response [the percent giving a favorable answer less the percent giving an unfavorable answer]. For capital spending plans and job openings, there are no "unfavorable" answers, so figures reflect changes in the actual percent planning outlays and reporting job openings. These ten questions make up the INDEX OF SMALL BUSINESS OPTIMISM.

HE GENERAL OUTLOOK

The Small Business Optimism Index lost 2.3 points, falling from 102.4 to 100.1. It appears that after the surge registered in February and March, that optimism is stabilizing, holding at roughly the same levels reached in June of 1990 and 1989. This lends support to the notion that the recovery, which started late in the second or early in the third quarter, will not be dramatic. The recession was not long or deep enough to work off "excess supply", particularly in the construction and development sector of the economy.

The outlook for economic activity lost 2 more points after posting a net gain of 73 points between October and May. Expectations for real sales gains posted a 7 point loss after a 6 point loss in May. Actual sales performances improved with almost as many firms reporting gains as losses. Everything is better than last fall, but there is no strong direction in the economy.

JUNE	86	87	88	89	90	91	*	QUARTERLY HI	DATE	LO	DATE
Good Time to Expand:	24%	21%	22%	17%	17%	14%	*	29%	86:2	3%	80:2
Expect Economy to Be:							*				
Better in 6 Mo.:	26%	22%	18%	16%	20%	45%	*	68%	83:2	10%	79:3
Worse in 6 Mo:	11%	15%	16%	17%	20%	9%	*	52%	79:3	3%	84:1
NET PCT BETTER:	+15	+ 7	+ 2	- 1	0	+36	*	64	83:2	-42	79:3

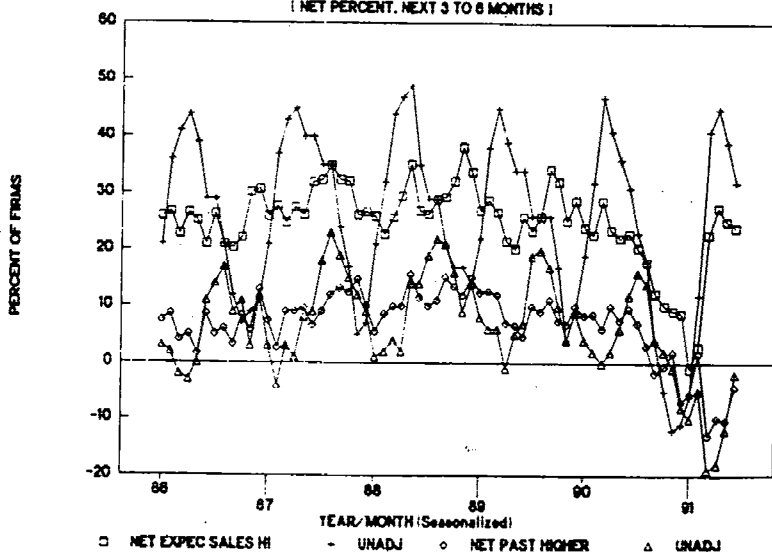


ST SALES GAINS AND EXPECTED REAL SALES

30% reported higher sales during the last three months but 32% reported sales declines. Although this represents an improvement over May, these are among the worst sales reports in the history of the NFIB survey. It is clear that the pervasive sales weakness has started to fade, but sales are not showing much exuberance.

50% expect real sales gains in the next 6 months, while 18% look for weakness. Expected sales gains are now "on track" with prior June observations after setting a low in February for the 5 year history of the monthly data.

JUNE	86	87	88	89	90	91	QUARTERLY HI	DATE	LO	DATE
Past Sales vs Prev. Qtr.:										
Higher:	35%	34%	36%	34%	34%	30%	48%	78:3	23%	82:2
Lower:	24%	25%	22%	27%	22%	32%	39%	75:2	13%	78:3
NET PCT HIGHER:	+11	+ 9	+14	+ 7	+ 8	- 2	35	78:3	-16	75:2
Expected Real Sales Volume:										
Higher:	48%	52%	52%	50%	50%	50%	64%	84:2	26%	75:1
Lower:	19%	12%	17%	16%	19%	18%	44	75:1	9%	77:2
NET PCT HIGHER:	+29	+30	+35	+34	+31	+32	54%	84:2	-18%	75:1

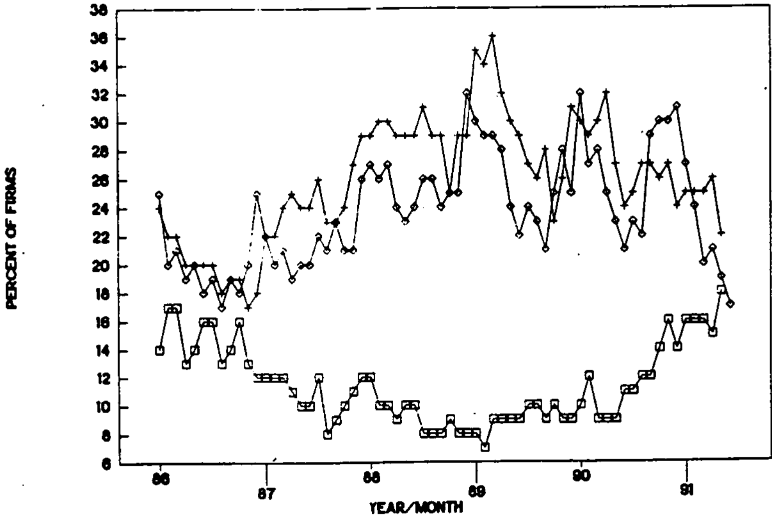


TUAL AND PLANNED CHANGES IN PRICES

17% plan to raise prices in the next few months, well below the expansion-high 32% recorded in December, 1988 and January, 1990 and below the historic low of 18% set in 1986:4. Plans to raise prices have moderated substantially, indicating that more good news on inflation will occur in the next few months.

Good news continued to prevail for actual price increases as well, with 22% reporting actual price increases and 18% of all firms reporting reductions in average selling prices. This is the fourth good month in a row for frequent price-cutting activity. This is good news for inflation and ultimately for bond prices and interest rates.

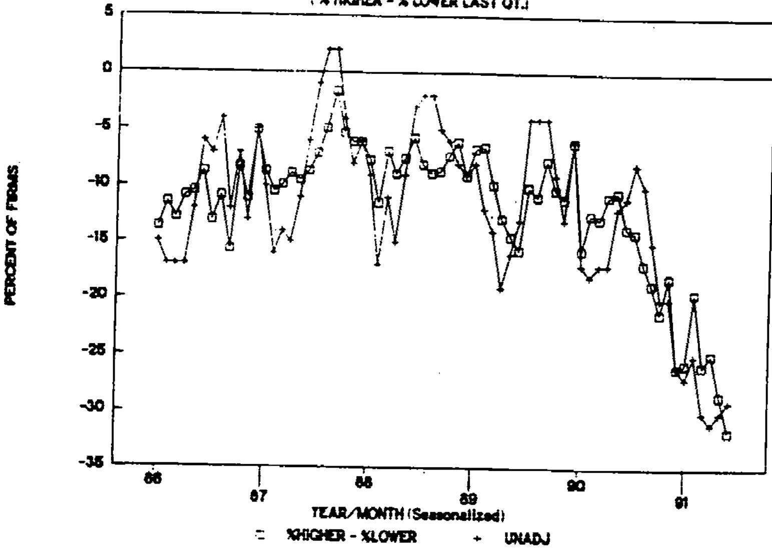
							*	QUARTERLY			
JUNE	86	87	88	89	90	91	*	HI	DATE	LO	DATE
							*				
Price Changes							*				
Increased, Last 6 Mo.:	20%	24%	29%	30%	27%	22%	*	71%	74:2	18%	86:4
Decreased, Last 6 Mo.:	14%	10%	10%	9%	9%	18%	*	20%	82:3	3%	78:4
							*				
Plan to Raise:	18%	20%	24%	22%	21%	17%	*	46%	80:1	18%	86:4



SMALL BUSINESS EARNINGS TRENDS

Earnings growth stayed strongly negative for the nation's small businesses. 17% reported GAINS in earnings, while 46% reported that earnings were LOWER than in the prior quarter. These figures are consistent with the large number of firms reporting sales declines during the last three months. Sales are weakening faster than firms are able to adjust costs, and the result is hitting hard on the bottom line.

JUNE	86	87	88	89	90	91	*	QUARTERLY HI	DATE	LO	DATE
Recent Quarter Compared to Past:							*				
Higher:	26%	24%	27%	23%	22%	17%	*	29%	84:3	14%	82:1
Lower:	32%	30%	30%	36%	33%	46%	*	26%	84:3	55%	80:2
NET PCT HIGHER:	- 6	- 6	- 3	-13	-11	-29	*	3	84:3	-41	80:2

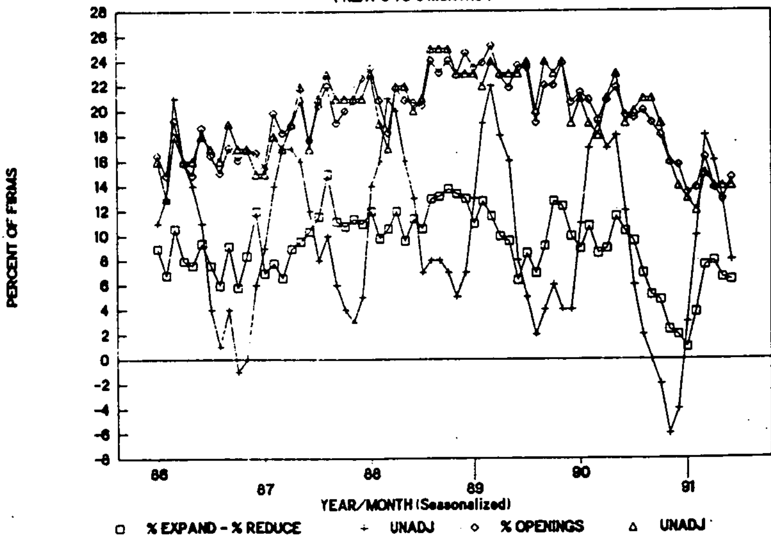


HIRING PLANS AND JOB OPENINGS

14% percent of all firms reported one or more job openings that were difficult to fill, the lowest June figure since 1986 when monthly data were first collected. Labor market tightness has dissipated. Few firms now report openings for unskilled labor, a distinct change from a year or two ago. Upward pressure on wages and compensation appears to be at very low levels.

16% plan to expand employment and 8% plan to reduce employment. Job creation will show some life, but the unemployment rate will likely continue to wobble around its current levels, with economic growth too weak to mop up the available supply of unemployed workers.

JUNE	86	87	88	89	90	91	QUARTERLY HI	DATE	LO	DATE
Job Openings										
Hard to Fill:	18%	17%	20%	23%	19%	14%	30%	78:4	9%	82:4
Plan to:										
Increase Employment:	18%	17%	18%	16%	17%	16%	26%	78:2	8%	75:1
Reduce Employment:	7%	5%	5%	8%	5%	8%	14%	82:4	4%	77:2
NET PERCENT ADDING	+11	+12	+13	+ 8	+12	+ 8	21	78:2	-6	75:1

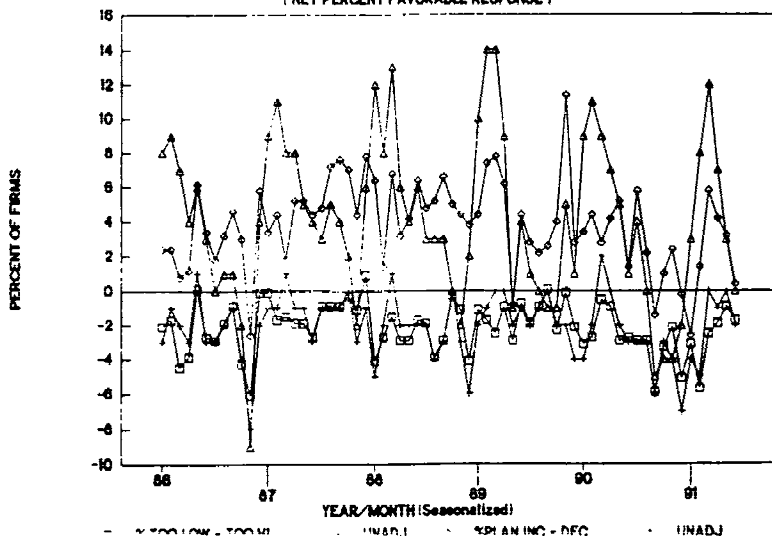


NVENTORY SATISFACTION AND PLANS TO ACCUMULATE

In spite of a record number of firms reporting sales declines in recent months, relative satisfaction with current inventories remained good. This reflects the fact that after three or four years of expansion, most firms were managing their enterprises as if the recession would start the next day. Thus, for the last 4 years of the expansion, inventories were managed very carefully. After widespread sales declines, satisfaction with inventory holdings could actually improve as expected sales rebound.

Actual plans to add to inventories weakened relative to other June figures for the expansion. The balance between plans to add to stocks and plans to cut are the weakest June figures since the monthly surveys were initiated, even though firms seem relatively satisfied with current inventory holdings.

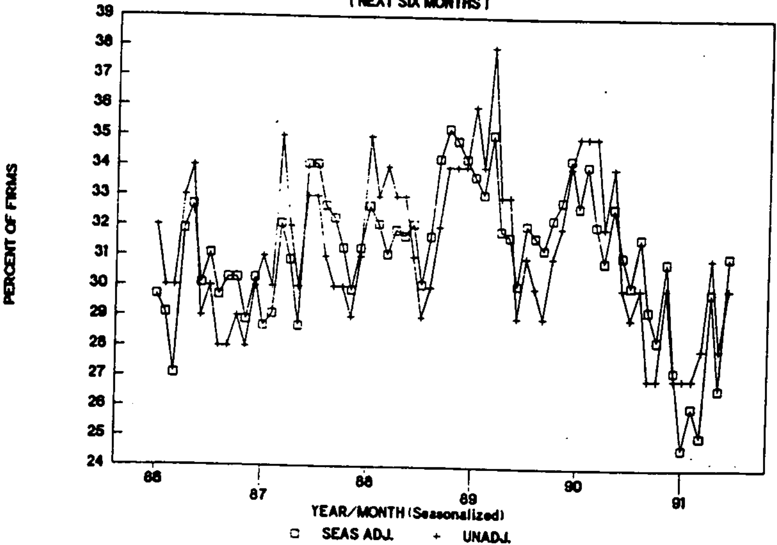
JUNE	86	87	88	89	90	91	*	QUARTERLY HI	DATE	LO	DATE
Inventories:							*				
Too high:	10%	12%	11%	11%	12%	11%	*	19%	80:2	10%	88:4
Too low:	7%	9%	9%	10%	9%	9%	*	16%	75:1	9%	86:4
NET PCT. TOO LOW:	- 3	+ 3	- 2	· 1	+ 3	+ 2	*	4	74:1	-10	80:2
							*				
Increase:	18%	16%	18%	19%	14%	12%	*	24%	84:1	11%	74:4
Reduce:	12%	12%	12%	15%	13%	12%	*	25%	80:2	10%	81:3
NET PCT. ADDING:	+ 6	+ 4	+ 4	+ 4	+ 1	0	*	12	88:1	-13	80:4



PLANS FOR CAPITAL SPENDING

Capital spending plans improved, with 30% reporting planned expenditures for the next six months. Spending plans and actual outlays have shown no life during the past twelve months, and are not likely to until the economy shows more evidence of a recovery underway. Currently, there is too much excess capacity in the economy to warrant heavy capital spending on a broad scale.

JUNE	86	87	88	89	90	91	* QUARTERLY HI	DATE	LO	DATE
Plan Capital Outlays:	29%	33%	31%	29%	30%	30%	* 35%	88:1	16%	75:1

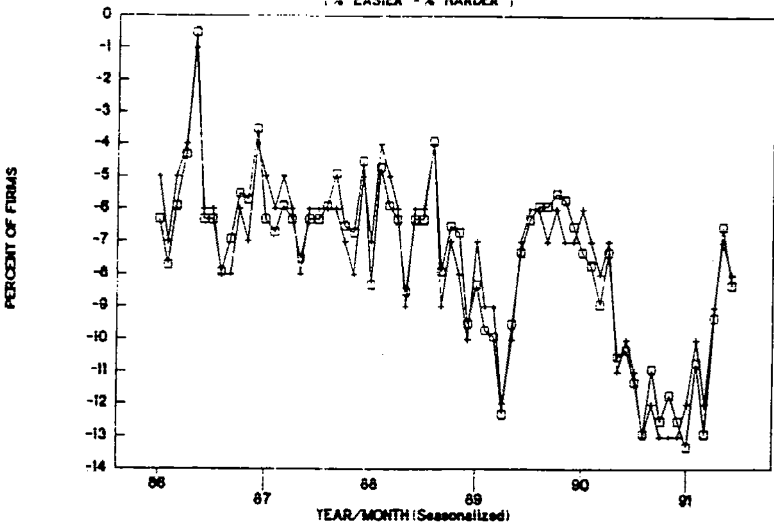


EXPECTED CREDIT CONDITIONS

Only 3% [9% of those borrowing regularly] reported paying higher rates on their loans last quarter while 17% [47% of those borrowing regularly] reported lower rates. If credit were in short supply, one would pect its price to be rising. It is not. The percent of firms reporting that "loans were harder to get than three months ago" was 11% [32% of those borrowing regularly], definitely not indicative of a credit crunch. These figures are only a third of the levels recorded in the 1980-82 period. Only 35% reported borrowing "regularly", slightly above the record low of 33% for the monthly surveys [35% in the Quarterly Surveys]. Although reports of financing difficulties have gradually risen over the past twelve months, there is no indication of serious trouble when compared to 1974-75 or the 1981-82 period. As is reported below, a record-low 5% of all firms reported financing difficulties as the #1 problem for small business. During the 1981-82 period, this percentage rose to over 30%.

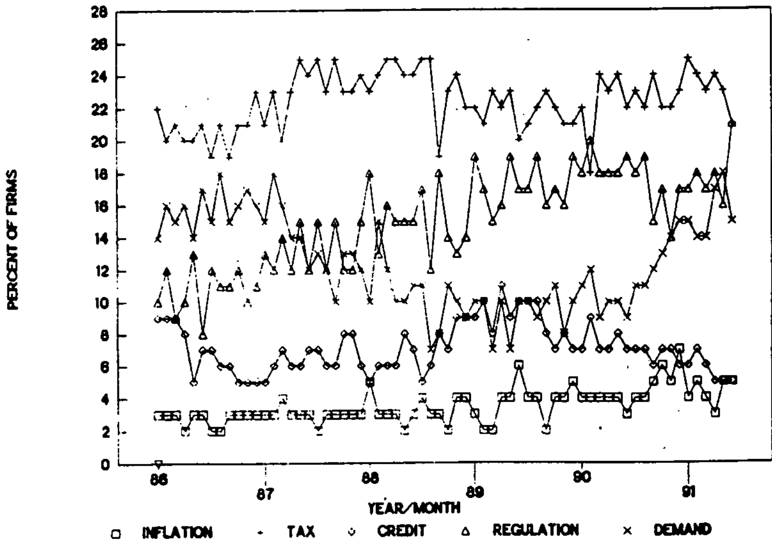
10% expect credit conditions to tighten and 2% expect monetary ease. Rates are likely to continue to fall as the Federal Reserve allows weak credit demands and good inflation numbers to bring down nominal interest rates. There appears to be no serious credit availability problem beyond that which would be expected at the end of a cyclical expansion. We're just short on qualified borrowers.

JUNE	86	87	88	89	90	91	QUARTERLY HI	DATE	LO	DATE
Expected Credit Conditions:										
Easier:	3%	2%	2%	2%	1%	2%	7%	80:3	0%	80:2
Harder:	9%	8%	8%	9%	11%	10%	31%	80:1	6%	83:2
NET PCT EASIER:	- 6	- 6	- 6	- 7	-10	- 8	0	83:2	-31	80:2



MOST IMPORTANT PROBLEM

Taxes, and not financing problems, gained the most "votes" as the "Most Important Problem" for small business, getting first place votes from 21% of the NFIB members. 21% voted for regulation [another tax] as the worst problem, a jump of 5 points. Inflation got only 5% along with financing problems, well below the double-digit figures of the early 1980s. No credit crunch in sight, nor has there been during the past two years. Labor costs received 5% of the first place ballots and labor quality problems garnered 6% of the votes [down from 11% in November, 1990]. 15% voted for weak demand, an improvement from the record-high monthly figure of 18% recorded last month.



REPRESENTATIVE HAMILTON. Thank you, Mr. Dunkelberg.
Mr. Chimerine, please proceed.

STATEMENT OF LAWRENCE CHIMERINE, SENIOR ECONOMIC COUNSELOR, DATA RESOURCES–MCGRAW HILL, INC.

MR. CHIMERINE. Thank you, Mr. Chairman. I am delighted to be back, and it is good to see you again.

Despite my enormous respect for the institution and the State within which it is located, I was not trained at Purdue, so my views are probably slightly different than my two distinguished colleagues this morning.

I would like to begin, Mr. Chairman, by looking back a little bit, because I think this recession has been very misunderstood. It might seem like nothing more than an historical exercise here, but it is not because I think the roots of this recession are very important in understanding where the economy is likely to go from here.

I would like to begin by strongly endorsing an observation made by Senator Sarbanes at the start of the hearing, and that is with respect to the comment that has been made very frequently, that this has been a mild, brief recession. It disturbs me greatly. It makes it appear as if we have just gone through a little blip, a temporary inconvenience, when in fact there is a lot of pain and suffering. The only thing mild about it are the GNP statistics. Most of the other data show a fairly sizeable decline. And they are going to revise the GNP data down anyway later this year to show a much bigger peak-to-trough decline.

Really, when you take the recession and look at it in the context of 18 months of stagnation that preceded the recession, this has been a very long period of extremely poor economic performance. We are now more than 2 and a half years into a period in which the economy has not grown at all, with marginal growth for 18 months, followed by a reasonably significant recession since that time, with a lot of pain and suffering. Profits are weak in most parts of the country, and therefore there has been lots of layoffs and job losses. To make it seem as if this is a mild blip, I think dramatically understates the severity of the situation.

The second myth or misconception is that this was an oil recession. I do not understand that conclusion at all in view of fact that, as I mentioned a moment ago, the economy was hardly growing for 18 months before the invasion of Kuwait. And it looks as if, even on a national basis, the economy was starting to enter a recession a month or two before that time, and of course many regions and industries were already in steep decline for a long period before that invasion took place. And if it was an oil recession, we would have gotten the quick bounce back after the oil shock and the war ended. That has not happened, to say the least.

So, I do not think that that is an accurate diagnosis. The truth is the economy was extraordinarily vulnerable at that time, and it didn't take much of a shock to push us into a recession. In fact, we might have been

in one in any case. Oil did make it worse, but it was not the fundamental cause of economic weakness.

Nor was this a Fed-induced recession. The Fed was easing, at least modestly, for 12 months before the start of the recession. We can debate whether they should have brought interest rates down faster or earlier. But we did not have the upward spike in short-term rates that has preceded most previous recessions.

And in my judgment, this was not a budget agreement recession either. The recession started well before the budget agreement took place, and there is no evidence at all that the economy would have done better had we not had the budget agreement, even though restrictive fiscal policies have probably contributed somewhat to the severity of the recession over the last year or so.

I think there are some other important fundamental points about this recession, and they get to the fact that it was a very different recession than any of the others we have experienced since World War II, probably unique in almost every single respect.

First, as I mentioned a moment ago, we had this long transition between the expansion of the 1980s and the start of the recession, 18 months of almost no growth. This is unprecedented. We usually go almost immediately from strong growth into recession without a transition or adjustment in between, and I think that tells us a lot about the underlying state of the economy.

Second, it has been very different insofar as its impact on labor markets is concerned. In most recessions, we see lots of layoffs, lots of job loss. They are usually confined to manufacturing industries, mostly production workers, and in most cases, they are put on either layoff or indefinite furlough. This time was different. This time we have seen unemployment hit a much wider range of industries and occupations than is normally the case, including professionals, midlevel business managers, bankers, attorneys—that may be the silver lining. Well, never mind. But in any case, it was very different in that respect, and also in the sense that these are not temporary layoffs or furloughs. These are terminations. These jobs are being eliminated. I think it is important because it has created a much wider range of anxiety regarding job insecurity throughout the population, which has implications for the recovery.

It was different in what happened to the saving rate. We are coming out of this recession—hopefully, we are coming out of it—with the lowest saving rate we have ever had to come out of a recession. In fact, unlike almost all, at least most, previous recessions, the saving rate fell during this recession, suggesting it wasn't just a confidence problem. We have income constraints here that are quite serious.

Finally and most importantly, this recession is different because it has been caused primarily by structural long-lasting factors, many of which have already been mentioned several times this morning: overbuilding, high debt, restrictive fiscal policies, state and local budget imbalances, banking strains, and weak real-income growth. Unlike most previous

recessions that were caused by temporary forces—cyclical factors—such as brief periods of tight money, a brief oil shock, an inventory overhang, and the kinds of things that work through in a short period of time, and then they no longer constrain growth. As a result, we almost always—always in fact—have a very speedy recovery afterwards, because these factors fade out. This is different.

In my judgment, these structural factors are an outgrowth of the 1980s. Yes, we did have a long expansion in the 1980s, primarily making up for the two recessions earlier in the decade. In fact, one of my colleagues this morning mentioned that the 1990s will be the slowest growth decade since World War II. I think that is right. The second slowest will be the 1980s. As of now, the 1980s was the slowest growth decade since World War II, despite the long expansion, because all we were doing was catching up from the two deep recessions in the first 3 years of the decade.

Not only that, the expansion was somewhat artificial. It was produced by massive construction and military booms, by tax cuts we could not afford, by cheap energy for a while, by leveraging the system upward, and by borrowing enormous amounts of money from overseas. You do not build longstanding, healthy expansions with these factors, and quite the opposite, we have now seen all of them peter out and left with overbuilding, high debt, being a big debtor nation, and all the things that we have all referred to before.

At the same time all of this was taking place, the underlying fundamentals were getting worse. Our rate of saving, our rate of investment as a country, our international competitiveness, our productivity growth, the quality of our education, and our infrastructure, all were getting worse during the entire decade. We have not been building for the future in this country. We have been borrowing from the future, and we are starting to pay the price, and that process started more than 2 years ago.

As a result, I do not think you should look at this recession as an isolated event. It is part of this long adjustment process that began 2½ years ago, temporarily made worse by events in the Middle East, but that was not the fundamental cause.

Now, where are we now? Clearly, the economy bottomed out about 2 or 3 months ago, at least temporarily, and I emphasize the temporarily. I will get back to that in a moment. We have seen a slight pickup in the last 2 months. It is noticeable primarily in retailing, in parts of the housing industry, in air travel, and in some sectors that were particularly hard hit during the height of the recession when people were watching CNN, or afraid to fly, or whatever, and when conditions were extremely bad. We have seen some rebound from that.

Other sectors of the economy are still very weak—capital goods, the commercial construction sector, and export orders are slowing. So, it is a mixed bag, but the best you can say is that we have had a slight, marginal improvement over the last couple of months. Of course, the question becomes how sustainable is it?

There are some, including the Administration, who think that we are now beginning a relatively good recovery, maybe not quite as strong as the average recovery in the past, but still a fairly healthy, strong growth recovery. Those people cite four reasons to support that forecast or conclusion.

One, they argue that consumer confidence has bounced back up now that the war is over, and that this should lead to a big increase in consumer spending. Unfortunately, you cannot spend confidence. As has been mentioned several times this morning, real income is extremely depressed, mostly because we are losing jobs and raising taxes, and those were the sources of growth in purchasing power in the 1980s. Real wages have not been rising in this country for a long time. So, as a result, nothing is creating any growth in purchasing power. And consumer debt is high. Savings have been reduced. So, there isn't a big reservoir or backlog of savings that has been accumulated recently that can be easily converted into spending.

As a result, we are almost in an asymmetrical situation. It is going to be hard to convert better confidence into more spending, but if confidence were to slip back down again, we could have even weaker spending and easily slip back into a recession or a flattening out of the economy again.

So, I would not argue by any means that we can get strong growth in consumer spending simply because confidence has picked up. That pickup is simply a reflection of what happened in the Middle East. Anxiety regarding job security is very high, and we could easily see a reversal of the confidence improvement, much like happened in 1974 or 1975, which triggered a second downward leg to that recession.

The second argument made by the optimists is that the Federal Reserve has been easing, and short-term interest rates are 400 basis points lower now than they were 2 years ago. That is true, but I do not think it matters all that much because the fundamental problem in this country is not interest rates. We are deleveraging the economy. We are reversing a lot of the leverage that we put in place in the 1980s, and as a result, most corporations and families are trying to cut their debt levels. They are not interested right now in borrowing more to finance new spending.

SENATOR SYMMS. Say that again, please. What do you mean by deleveraging?

MR. CHIMERINE. Reducing debt.

On top of that, the construction sector is wildly overbuilt, as you have heard. I do not think a 50-basis-point drop in mortgage rates is going to encourage another builder to go out and build another empty office building or a new shopping center somewhere. We already have enormous excess retail space and so forth.

And, of course, the drop in short-term rates has not been translated into a decline in long-term rates. That is good for the stock market perhaps, but it is the long-term rate that is essential for economic activity.

Finally, the banks have shown no interest in lending in any case, even with more reserves being pumped into the system, for reasons that are well-known to everybody in this room.

Thus, I think people are grossly overestimating the impact of lower short-term interest rates on economic activity. It will help cushion the economy because it makes it easier to service existing debt, but by itself, again it is almost asymmetrical. Easing is not going to create much stronger economic growth, but if the Fed were not to ease or, in fact, were to tighten, it could push us down into a second leg of the recession.

By the way, in other recovery periods, the Fed has always eased. But we always simultaneously had stimulative fiscal policies and an accommodating banking system to support that. Now, we have one out of three. As a result, we are not going to get anywhere near the bang for the buck that we have gotten in the past from lower short-term interest rates.

The third favorable argument that you hear is inventories, and while I agree that inventories are relatively under control, I can assure you there are no companies out there that I am aware of that have any interest whatsoever in rebuilding their inventories. They might not need to cut them too much more, which might reduce any further downward pressure on the economy, but, at best, inventories will be a neutral factor for this recovery. Most companies still have a very high real interest rate and, by the way, much higher than most economists I think would argue. Long-term rates are now 8.5 percent, and they say the inflation rate is 4.5 percent, so it leaves a 4 percent real interest rate. However, all that inflation is health care and college tuitions. Retailers are not raising prices. Manufacturers are not raising prices. For them, real interest rates are still extraordinarily high, and they cannot afford to hold inventory. Their profits are being squeezed on top of that. So, I do not think that is a plus.

Then, the fourth argument you hear, of course, is that exports will carry the day. Well, exports are slowing. Every major exporter in this country is now reporting a slowdown in orders, reflecting weakness overseas and some strengthening of the dollar, and exports are just not big enough anyway to offset weakness everywhere else in the economy. As a result, I would say it is virtually impossible to get anything resembling a healthy, strong recovery over the next 18 months. Of course, add the other factors that you have heard about this morning, all the tax increases and layoffs and spending cuts now being put in place by state and local governments, the absence of any commercial construction in most parts of the country, and the credit crunch that will probably have a bigger effect on the recovery than it did in the recession because nobody was borrowing before. Now, some people who want to borrow are not going to get money. So, all of these factors are constraints.

We have never come out of a recession before with as many constraints on economic growth as we have had now, pure and simple. There is absolutely no source of strength anywhere in the economy.

And not only that, it is possible that even some of this modest pickup we have had in the last couple of months has been temporary—a postwar euphoria. The people who traveled to Europe a few weeks ago because they could not go 3 months earlier, well, they have made that trip already. The same for the other pent-up demands created during the war. And we had an early summer that seems to have been pulling some spending forward, some summer-related spending.

What I am saying is that this recovery so far is anemic. The best we can hope for is a continuation of an anemic recovery, and there is still a sizeable risk here that things will flatten out again, and we will get either no recovery, or slide back into recession. I do not think that that is the most likely outcome, but I think a very slow, uneven, erratic recovery is the absolute best we can get.

Before concluding with a couple of policy recommendations, I want to make a couple of other points.

In this day of unreliable economic statistics, I think it is important to look at other evidence regarding the economy. I depend a lot on the anecdotal information I get from most of the companies that I talk to regularly, which is very mixed. But you can also look at other sorts of indirect indicators—tax receipts is a good example. Most State governments, as well as the Federal Government, will tell you that their tax revenues are not improving, which is a further sign that this recovery is very tiny, at best, so far. Commodity prices are in the tank. They are still declining, which again does not suggest a very strong recovery. Loan demand is weak. At this point, the one thing I am positive of, if we have had a pickup so far, it has been marginal. You need a microscope to see it. Again, I think a very slow recovery is the best we can get.

What do we do from a policy standpoint? I will make some very quick suggestions.

First, it seems to me that we ought to try simultaneously not only to strengthen the recovery and to reduce the risk of sliding back into recession, but to do so in a way that strengthens our long-term prospects. Any objective evaluation would suggest that the long-term fundamentals in this country are poor, and that economic growth in the long term will be weak, reflecting weak productivity growth and a deterioration in our fundamental competitiveness. Yes, we can keep pushing the dollar lower and cutting wage rates to cut the trade deficit, but that is not the best way to compete. That does not improve living standards and economic growth.

As a result, I feel strongly that we need to try to generate what is very difficult to do, namely, an investment-led recovery, because I think we need more investment if we are going to improve our productivity and competitiveness. It can help in the short run by stimulating demand if we can do it, and at the same time help long-term growth by addressing some of these fundamental problems. I will make the following suggestions.

First, I strongly support the move toward extending unemployment benefits. It is unconscionable what we are doing. Most of these people losing jobs now are going to find it very tough to get new jobs. We are

seeing new layoffs and cutbacks being announced every day. There is no logical reason why we should not be doing it. To me, it is an emergency. We should put it off-budget just as much as we have done some of the other programs, particularly some of the aid to foreign countries. Not only that, it doesn't increase the structural budget deficit. If we ever get out of this recession, unemployment benefits will come down. We have to worry more about the structural budget deficit, not just the next 6 months.

I think there is another reason for extending some of the other automatic stabilizers that we have cut back. It will help demand in the short term. We would be putting income in the hands of people with a high-marginal propensity to spend, and as a result, it will help stabilize demand.

Second, on investment, I would like to see some stronger investment incentives enacted, but before I tell you what I think they should be, I recognize the budget constraints. As a result, it is extremely important to be creative and selective, and put things in place that get the maximum bang for the buck.

As a result, I support a large investment tax credit on incremental investment only. For example, we can take the average of how much a company spent on productive equipment during the last 3 years and give them a large investment tax credit on any new investment over and above that baseline. We cannot afford to give them an investment credit on everything, because we do not have the bucks. It will add too much to the deficit. But if we take the average or maybe 90 percent of the baseline average, because there is some recession slippage now taking place, and give them a 20 or 25 percent credit on any investment above that, it provides an extremely strong incentive at the margin. Yet, we do not lose tax revenues on investment that would have been made anyway.

An alternative way of doing the same thing would be dramatically accelerated depreciation on incremental investment. But I would confine it to productive investment, and only above a certain baseline. The budget impact is small. If it brings forth a lot of new investment, it will pay for itself because the economy will generate the revenues. If it doesn't, it won't cost the Treasury anything. So, it does not bust the budget, and it provides a strong incentive at the margin.

I would also change the structure of capital gains taxes in this country. I strongly support the sliding scale capital gains structure, raising the rate on short-term gains, and phasing it down over time to almost zero on long-term gains. I would make it available only on productive investment, not on rare coins, second homes, etc., and not on old investments. I think it will help push us more toward a long-term focus in this country.

Third, I think the Administration should lead the way by urging the corporate sector to make investments that are in the national interest, as well as their own interest, and by setting goals for the economy for productivity, investment, savings, and economic growth through the 1990s, and exercising the same kind of leadership to bring about more

investment that we did with Operation Desert Shield and Operation Desert Storm.

Well, I think I have used up my time, Mr. Chairman, but I would be delighted to elaborate on some of these recommendations during the discussion period. Thank you.

[The prepared statement of Mr. Chimerine follows:]

PREPARED STATEMENT OF MR. CHIMERINE

My name is Lawrence Chimerine. I am currently a Senior Economic Counselor to Data Resources-McGraw Hill, Inc., and a Fellow at the Economic Strategy Institute. I appreciate the opportunity to testify before the Joint Economic Committee on the current economic situation, the near term outlook, and on my policy recommendations.

In sum, my views are as follows:

1. Several misconceptions regarding the recession that recently ended (at least temporarily) have spread. These include (a) that the recession was brief and mild, when in fact it was not as mild as the GNP data suggests; (b) that it was an oil shock recession, when in fact the economy was already starting to turn down before Iraq invaded Kuwait, and several industries and regions were already declining sharply; (c) that it was a Fed-induced recession, when in fact the Fed had been easing at least moderately for a year before the national recession began; and (d) that it was a typical recession in most respects, when in fact this recession was far different than all previous post-war recessions.

2. The major differences of the 1990-91 recession were (a) that it was preceded by a long period of transition (18 months of growth averaging only about one percent), instead of following quickly on the heels of rapid growth; (b) that the job losses during the recession were spread across far more industries and occupations, and included more terminations rather than layoffs, then in previous recessions; (c) that the personal saving rate was both very low and declining, unlike most previous recessions; and (d) that it was caused primarily by long-lasting structural factors, rather than the temporary factors that have caused most previous recessions.

3. These long-lasting structural factors include high levels of private debt, massive overbuilding in commercial construction, restrictive fiscal policies, tighter lending standards, widespread state and local government fiscal imbalances, weak real income growth, etc. In effect, the 1991 recession was more of a balance sheet, financial recession than an inventory, tight money, or inflation caused recession. Furthermore, the recession should not be considered as an isolated event but rather as part of the sharp slowdown which began more than two years ago.

4. The economy bottomed out in early spring and on an overall basis has improved modestly since that time. The data, anecdotal evidence and other indicators remain very mixed, however, suggesting that the improvement thus far is uneven and erratic, in addition to being relatively slow.

5. The Administration and others believe that a robust recovery will emerge in the months ahead and continue for the rest of this year and 1992 (and possibly beyond), based largely on the rebound in consumer confidence since the war has ended, on easing by the Fed and the resulting decline in short-term rates during the last two years, and the expectation of a rebuilding of inventories following the liquidation earlier this year. However, consumer spending power is extremely weak, suggesting that the improvement in confidence will not cause a surge in consumer spending; easing by the Fed is having a limited impact on the economy because of tighter lending standards, still high long-term interest rates, and efforts to deleverage the system now under way; and, while inventories are relatively lean, most companies will not rebuild them, suggesting that inventories are only a neutral factor for the outlook.

6. In addition, the structural factors discussed above will continue to limit economic growth as we move forward. In effect, the fundamentals are relatively poor, in large part reflecting a reversal of the forces that generated the expansion of the 1980's. Thus, I believe that at best the recovery will be extremely slow and gradual, and that a significant risk remains that it will peter out some time later this year. The relatively small increase in the leading indicators in recent months, and reports that retail sales and housing sales have flattened out again, are consistent with this view.

7. In view of this high probability of only a slow recovery or no recovery in the near-term, and because of the relative ineffectiveness of monetary policy, I believe that budgetary measures should be considered. Any such measures should be directed toward reducing hardships from the recession and to improve long-term economic prospects, rather than just creating a temporary recovery. Furthermore, given the size of current budget deficits, it is essential that any new measures be designed to generate maximum bang for the buck, or they may prove to be counterproductive by raising deficits even more. I thus suggest a program which includes an extension of unemployment benefits, efforts to reduce the trade deficit in the near term, and either a large investment tax credit or dramatically accelerated depreciation on incremental investment.

Introduction

In order to look ahead with some degree of confidence, it is necessary to examine the performance of the U.S. economy during the last several years, with particular reference to the recession that

at least temporarily appears to have ended. First, there have been several misconceptions regarding the recent recession that should be addressed. These include the following:

A. This recession was mild. This view has been expressed repeatedly by many economists and others but in my view, it is dangerously misleading. While currently available GNP statistics show a peak to trough decline of only a little more than 1%, or about half of the average decline in previous recessions, these data understate the recession. Other measures, such as the rate of job loss, the rate of decline in industrial production, the decline in retail sales, and others were much closer to those that were experienced in many previous recessions, including some the more severe ones. Furthermore, revised GNP data to be issued by the Department of Commerce later this year will show a much larger peak to trough decline, reflecting lower estimates of capital spending (especially for computers) and weaker expenditures for consumer and business services. While the 1990-1991 recession was far from the worst, it nonetheless was a significant recession, with a lot of pain and suffering, that should not be passed off as a mild blip or temporary inconvenience.

B. This was an oil-shock recession. One popular view is that the recession was the result of the increase in oil prices, the drop in consumer confidence, and the rise in long-term interest rates that followed the Iraqi invasion of Kuwait last August. In my view, such a conclusion is misleading. It appears that the national recession may have begun one or two months prior to that invasion; furthermore, many regions and industries were in fact already experiencing recessionary conditions well before the national recession began. And, overall economic growth averaged only a little more than 1% at an annual rate for the eighteen months prior to the beginning of the recession, indicating an extraordinarily high degree of vulnerability. The aftermath of the invasion clearly made the economy worse, thus making what might have been a milder recession more severe, or at best, a period of stagnation into a recession. But had the economy not been so vulnerable, that is, had it been experiencing more normal growth, the fairly small increase in oil prices (without any supply disruptions) would not have been enough to produce a recession. This is far different than the stock market crash in October of 1987--the economy was growing very strongly at that time so it was easily able to absorb that shock without recession. This was not the case in the summer months of 1990 and thus, the focus should be on the forces that were already causing stagnation. In effect, the 1990-91 recession should not be considered a separate or isolated event. Rather, it was part of a relatively long process of stagnation that began more than two and a half years ago, and which was made worse at least temporarily by the invasion of Kuwait.

C. This was a Fed-caused recession. It has been fashionable to also blame the recession on the Federal Reserve. However, the Fed began to ease at least a year before the recession began, as indicated by a near 200 basis point decline in the federal funds rate from the spring of 1989 to early summer of 1990. While we can all debate whether they should have eased earlier and/or more sharply, the recession nonetheless was not preceded by a sharp reduction in reserves, and an upward spike in short-term interest rates, as has frequently been the case in the past. Thus, in my judgement, it is not appropriate to blame the recession on Federal Reserve policies.

D. This recession was typical. Regardless of the cause, many economists view this as another in the long string of recessions that have occurred in the post-war period, with very similar characteristics. Many of them, therefore, expect a rather typical recovery. I believe, however, that this recession was in fact very different than virtually all of the other post-war recessions. As discussed below, it was caused more by structural, long-lasting factors than the relatively temporary factors (such as excess inventories, brief Fed tightening, inflationary spurts, etc.) that have been responsible for most previous downturns.

This Recession Was Different

There were numerous differences between the 1990-1991 recession and the previous eight that have taken place in the post World War II period. The major ones are as follows:

1. The long transition between rapid growth and recession. As discussed earlier, economic growth had fallen sharply by early 1989, averaging only 1.2% from that time until the summer of 1990. This is unprecedented--every other post-war expansion moved into recession almost immediately, without the long period of stagnation or transition that occurred this time around. In my view, this suggests that an adjustment process was under way well before the recession began, reflecting numerous factors that had not played a major role in previous recession periods.

2. Behavior of labor markets. Unemployment always increases sharply in recessions, reflecting both the difficulty of new entrants into the labor force finding jobs, and losses of jobs among the previously employed. However, in virtually all previous recessions, most of the job losses were concentrated in manufacturing industries, primarily among production workers, and layoffs or indefinite furloughs accounted for a large fraction of those job losses. This time around, however, job losses were spread across a large number of

industries and occupations, and a larger fraction have been accounted for by terminations (i.e., jobs were eliminated) rather than temporary or indefinite layoffs. This is significant because it has created a much wider range of job insecurity across the United States, which may have significant implications for the recovery.

3. The saving rate is extremely low. No previous expansion period has begun with the personal saving rate as low as it is at the present time--furthermore, the saving rate actually declined during this recession, unlike most others. This is also significant because it suggests that consumers have a smaller pool of recently accumulated savings to convert into spending, and also that the recession is less caused by poor confidence than by income constraints.

4. It has been caused by long-lasting structural factors. While cyclical forces clearly played a role, especially reduced pent-up demand, and oil price increases were an added depressant, I believe that a large part of the recession and earlier slowdown reflected more longer-lasting, structural factors than those which have produced recessions in the past. This in part explains why the sluggishness has already lasted for almost two and one half years, beginning well before the contraction that began last summer. These factors include the following:

   (a). Both corporate and household debt (in relation to profits and incomes) remain far higher than at previous cyclical peaks. In my view, high outstanding debt levels have been holding down spending on consumer durables and on new investment (especially since both real incomes and profits are being squeezed).

   (b). Rising credit quality problems in real estate and other loans, coupled with regulatory changes requiring higher capital, have tightened credit standards--thus, even if households and corporations do not feel constrained by current debt levels, they are not having as easy access to credit as during the previous five or six years.

   (c). Despite the rising budget deficit in nominal terms, fiscal policy is now becoming restrictive, and is likely to remain so for many years. The increases in the nominal deficit are primarily due to rising interest expense, weak tax receipts due to the sluggish economy, and the explosion in thrift bailout costs, none of which are now stimulative. Meanwhile, the deficit package adopted last year will produce sizable fiscal drag on an ongoing basis.

(d). Many state and local governments are in the process of cutting spending or raising taxes to ease budget problems as well.

(e). The enormous overbuilding of most types of real estate in many areas, coupled with weakening property prices, has caused a sharp decline in new construction.

(f). Nominal and real long-term interest rates remain very high at a time when most high rate of return expenditures have already been made.

(g). Real incomes have been falling, reflecting wage restraint in many sectors of the economy, job loss, and higher taxes.

These factors are very different than the inventory overhangs, oil price shocks, or other factors which caused previous mild recessions or slowdowns. In effect, we experienced an expansion in the 1980's built largely on cheap oil, large tax cuts, military and construction booms, and the willingness of foreigners to invest heavily in the U.S.-these factors are all being reversed. At the same time, the factors which are critical for long-term growth, such as saving and investment rates, productivity growth, the quality of education, competitiveness in world markets, etc., have all deteriorated. And, of course, we have borrowed heavily from the future--we are now paying the price.

Current Economic Situation

The current economic situation can be summarized as follows:

1). On an overall basis, the economy appears to have bottomed out in early spring and a small improvement has occurred since that time. The improvement is most noticeable in retail sales, industrial production, and housing.

2). The pickup has been both modest and uneven, however. In particular, orders for capital goods still appear to be trending downward-anecdotal evidence indicates that export orders have also softened somewhat in the last several months. Furthermore, after a good pickup during the spring, non-auto retail sales and housing sales appear to have flattened out during the last month and a half. And, of course, both commercial construction and military procurement are still extremely weak.

3). Other indicators also point to a mixed picture. For example, while the index of leading indicators has risen for the last four months, the total increase during that time is far below

the rate of increase in the first four months of previous recoveries. Furthermore, commodity prices are still falling, federal and state and local tax receipts do not appear to have picked up, and loan demand is reported to still be extremely weak.

In sum, both the data and anecdotal evidence indicate that the improvement in the economy thus far is very modest at best, and that the pattern is very uneven and erratic.

Short Term Outlook

There are, of course, three general scenarios for the next year or two. These are (a) that a slow and uneven recovery has begun, and that it will continue in that fashion; (b) that the economy will accelerate in the months ahead, leading to relatively strong growth over the next eighteen months or longer; or (c) that the recent pickup is mostly the result of an early summer, a one time end to inventory decumulation, and post-war euphoria, so that the economy will flatten out again and perhaps enter into a double dip recession.

In my view, even though this recession was relatively sizable (which usually means a stronger recovery), the evidence favors the first of these scenarios with a still high risk that scenario (c) will actually materialize.

This conclusion is supported by the following:

1). As described above, the recovery thus far has been very modest, despite some data to the contrary. Furthermore, it is reasonable to assume that some of the pickup has been the result of the temporary factors cited above. In particular, production in the auto industry, and several others, have increased, following a long period of inventory liquidation. However, this is basically a one time adjustment--production increases will not continue unless demand increases. Furthermore, retailing, utilities, manufacturers of summer apparel, etc., were all helped by the extremely hot weather in May--however, this appears to have borrowed activity which normally would have occurred in June or July. Finally, it seems clear that some of the pickup in the spring in housing, air travel, etc., simply reflected activity that would have taken place in January or February, but did not because of the war conditions which prevailed at that time. If these temporary factors have been significant in recent months, then the rate of improvement during those months is not sustainable--the flattening out of housing sales and retail activity in the last month or two would suggest that that may be indeed be the case.

2). As indicated earlier, the underlying fundamentals remain extremely weak. In particular, I believe that the structural factors listed earlier will continue to hold down demand for the foreseeable future. It will take a number of years for debt to be brought down to levels that it is no longer a constraint on new spending; for banking problems to be worked out so that normal credit standards can re-emerge; for vacancy rates to move toward more normal levels, so that new commercial building can increase; for budget deficits to be brought down to acceptable levels, so that fiscal policy will no longer be a drag on the economy; and for many state and local governments to eliminate their fiscal imbalances.

3).. The arguments cited in support of a stronger growth outlook do not hold up under scrutiny. For example, while the upturn in consumer confidence following the end of the war has been substantial, the financial constraints on consumers are equally substantial. In particular, the absence of any meaningful growth in real incomes, combined with high debt levels and extremely low saving rates, will make a strong rebound in consumer spending virtually impossible during the period ahead. In addition, anxiety levels regarding job security appear to be increasing significantly, so that renewed weakness in confidence could actually emerge in the period ahead. Thus, we appear to be in an asymmetrical situation, whereby higher confidence can not be translated into significantly higher spending, but whereby a decrease in confidence could cause renewed spending declines.

The optimists also point to the easing by the Federal Reserve during the two years, with particular reference to the nearly 400 basis point decline in short-term interest rates during that time. However, while this has and will continue to cushion the economy on the downside, by making it easier to service existing debt, it is unlikely to produce a surge in activity because (a) the decline in short rates has not been translated into the long end of the market because of still enormous budget deficits, and our dependence on foreign capital-while declining short rates help the stock market, it is long-term rates that influence economic activity; (b) rising credit quality problems in the banking system and tighter lending standards are discouraging bank lending, so that the added reserves being supplied by the Fed are being used by banks to buy securities rather than to make new loans; (c) the economy is in the process of being deleveraged-most households and corporations are trying to reduce debt levels, rather than responding to declines in interest rates by increasing debt in order to finance new spending; and (d) the overbuilding of the 1980's has reduced the sensitivity of construction to interest rates--historically, stimulative monetary policy has worked primarily by stimulating new construction. Thus, it is unlikely that the easing moves

engineered by the Fed can stimulate strong economic activity in the months and years ahead.

Another factor frequently cited in support of strong growth is the low level of inventories. However, it is highly unlikely that most companies will try to rebuild inventories in the months ahead because of the uncertain outlook for demand, because of squeezed profit margins and because of still extremely high real interest rates for manufacturers and retailers (where there is little or no inflation at the present time). Thus, once liquidation ends, the inventory situation will be a neutral factor for the near-term outlook.

4). An additional factor supporting a slow recovery at best is the slowdown in economic activity in other parts of the world, which, coupled with the stronger dollar in recent months, is apparently causing export orders to flatten out after the strong growth in recent years. This is especially important because a relatively large fraction of overall economic growth in the United States in the last three years was accounted for by exports-exports will not contribute much to growth in the next year or so.

There are some bright spots. As implied earlier, the relatively low level of inventories suggests that additional declines in production in order to liquidate inventories are unlikely-in fact , and end to the liquidation process itself is, or will create, a one time increase in production in many industries. In addition, the inflation outlook remains extremely favorable, as indicated by still declining commodity prices, by modest wage increases, and by the difficulty of most companies to make any price increases stick in the current environment. This not only suggests that higher inflation will not further erode purchasing power, but that inflation will not be an obstacle to additional easing by the Fed in the months ahead.

On balance, therefore, I believe that some recovery will take place during the next eighteen months, in part because the dampening impact of war related factors is now fading out, and in part because of the favorable inventory and inflation outlook. However, the other factors cited above will limit that recovery-I therefore expect economic growth to average approximately 2 1/2% during the next eighteen months, or less than half the typical rate of recovery. Furthermore, there are several downward risks which could produce either a weaker recovery, or, a second downward leg of the recession sometime during this period. These are (a) a renewed decline in consumer confidence in response to anxieties regarding job security; (b) the ongoing effect of financial strains and high debt; and (c) even weaker growth overseas, which could cause a bigger slowdown in U.S. exports.

Policy Recommendations

The do nothing strategy currently in place is not enough in my view--a proactive program to stimulate the economy is badly needed to insure a stronger sustainable recovery, and simultaneously to bolster our long term growth prospects. The way to meet both of these needs is with an investment-oriented, countercyclical program that will dramatically increase our rate of investment in new, productive assets, thus helping raise our abysmal productivity growth and improving our competitiveness in world markets, while at the same time increasing short term economic activity. Corporate and national investment needs are substantial--they include modernizing our capital stock, reducing our dependence on foreign oil, upgrading our infrastructure, and building communications and data-handling systems for the future.

An effective program must not only lead to more investment, but also encourage a shift away from the short-term to the longer term investments that will be needed to increase productivity and to add future capacity in many sectors.

An investment-led recovery won't be easy to accomplish, since investment usually lags the business cycle (recent order rates for capital goods already indicate a market deterioration in near-term investment prospects). Depressed corporate profits, the fact that increases in investment will further depress near-term profits, as well as weak underlying demand and the credit crunch, are all working against a pickup in investment. And our enormous fiscal imbalance and dependence on foreign capital are compounding the problem by limiting the usefulness of our traditional anti-cyclical tools.

The following program will help overcome these obstacles and achieve the objectives laid out above:

1). Tax incentives are necessary to help stimulate both near and longer term productive investment--however, they will have to be designed in such a way that they do not significantly increase the budget deficit. This can best be accomplished by restoring the investment tax credit, which has an excellent track record in stimulating new business investment. To minimize the revenue loss, but still provide a substantial incentive, a new investment tax credit at a relatively high rate (i.e. 20-25%) should be enacted, but only on incremental investment over a base period. Under this approach, there would be minimal cost to the Treasury if new investment does not increase--if it does, the added economic activity will generate enough new tax revenues to essentially offset the cost of the credit. An equally effective alternative would be to permit extremely rapid depreciation on new, incremental investment. In both cases, the tax benefits should be available only on investments in productivity enhancing

equipment, or new capacity. The base period could be defined as the average of the last three years (or, perhaps, 90% of the average, to allow for some recession-related slippage).

A change in the capital gains tax structure would also be very desirable in the current environment, but not a straight reduction in the capital gains tax rate. The latter is unacceptable because: (a) it would unnecessarily reward investments that have already been made; (b) it would increase the structural budget deficit; (c) it would be applicable on investments for nonproductive uses; and (d) the differential between the top income tax rate and the capital gains rate would not be large enough to significantly change behavior. What would be more desirable would be a sliding scale capital gains tax structure, incorporating a significant increase in the rate on gains held for short periods, with the rate falling as the holding period increases (ultimately to near zero for assets held for, say, 5-7 years). Furthermore, the very low long term rate should be applicable only on productive investments (and not, for example, on art, collectibles, vacation homes, etc.), and only on future investments.

Such a structure would dampen the speculation and preoccupation with financial transactions that was rampant in the 80's, shift the mix in fixed investment to desperately needed longer term projects, and help encouragte many of those now losing jobs to consider entrepreneurship. To further encourage a long-term focus, the capital gains tax exclusion for pension funds should be cut or eliminated.

These combined tax changes will not only stimulate new product investment, but do so in a way that maximizes "bang for the buck."

These tax changes and incentives must also be supplemented by the same kind of leadership President Bush exhibited in the Persian Gulf Crisis. He should begin by admitting that the economy is beset by serious problems, and that a new approach is needed to maintain the prosperity of the 1980's. In addition, he should set some specific national economic performance goals (including quantative targets) for boosting our savings, investment, productivity, etc. in the 1990's.

Most importantly, it is time to recreate the concept of the "national interest" (a phrase the President did use in his last State of the Union address), namely that if the economy continues to flounder, we will all suffer, so that it is in everyone's interest to contribute to making the economy healthier. In particular, the President should ask those companies with sizable cash reserves, and whose survivability is not threatened by the recession, to take advantage of the

tax incentives and increase their investment plans by funding investments that will bolster their own competitive position, and improve national economic prospects in both the short and long term at the same time.

Increases in private investment should be augmented by privatizing the Tennessee Valley Authority and other publicly owned facilities, and using the proceeds to build highways and other transportation systems for the future, as well as attending to the long neglected deterioration in our current infrastructure.

2). A period of falling consumer demand is obviously not an environment likely to increase corporate investment. Lower oil prices have helped stabilize consumer demand by at least partially reversing the downward trend in purchasing power. Yet, as mentioned earlier, consumer spending will be held back in the months ahead by tax increases and, especially by declining employment earlier this year. As is well known, it was the increase in new jobs which generated most of the growth in purchasing power during the 1980's--real wage rates hardly rose at all. In order to help bolster purchasing power, as well as to reduce the hardships on those who have and/or will become unemployed, some of the automatic stabilizer programs that were dramatically cut during the 1980's should be strengthened--in particular, consideration should be given to widening the eligibility for unemployment benefits, as well as extending the duration of such benefits, since the newly unemployed are not likely to find new jobs for many months. In addition, easier access to food stamps and other such programs may be required in the months ahead.

These steps are not only humane, but will help stabilize consumer demand because the recipients of these benefits are likely to have a high marginal propensity to consume in the short-term. In addition, federal government procurement policies should be reviewed in order to shift as much federal government spending to domestic suppliers for replacing materials used in Operation Desert Storm, and for ongoing programs, as is possible. In addition, we should insist that the U.S. be awarded the lion share of contracts that are being let for the rebuilding of Kuwait.

Finally, the U.S. slowdown is now being accompanied by a significant deceleration in growth around the world. This emerging global slump raises the possibility that producers in many countries will dump their unsold products form other markets into the United States, displacing domestic production and further limiting a U.S. recovery. It is absolutely essential that Washington tell our trading partners that America will not tolerate dumping and other practices that enable foreign producers to unfairly grab larger market shares in the U.S. while our own economy remains so underutilized. In fact, stronger efforts are

needed to reduce our still enormous trade deficit, especially in light of the sluggishness in domestic demand--to accomplish this, funding should be increased for the EX-IM bank, and Washington should work with foreign owned businesses to help them increase domestic content in their U.S. production.

3). Some of the increased investments will have to be financed by borrowing. In addition to the steps recently announced by the Treasury, designed to make it easier for banks to lend, consideration should be given to temporarily easing the new, higher capital requirements for those banks that have been prudent lenders. And, given the relatively favorable inflation outlook, I urge the Federal Reserve to continue to bring short term interest rates down, especially if the economic statistics continue to be spotty in the months ahead. As mentioned earlier, this will help cushion the recession, although by itself, it will not be sufficient to generate a much stronger recovery.

The above program would be a first in American history-an attempt to use investment, not consumption, as a vehicle to stimulate an economic recovery.

Representative Hamilton. Well, thank you very much, Mr. Chimerine. I thank each of you for your testimony.

I kept looking for an optimist in this group as we went down the line. I don't think I found one, but what strikes me, of course, is the astoundingly stark contrast between your pessimism about the economy, and the remarkable optimism of Mr. Greenspan about the economy, and, to some extent, the remarkable optimism of Mr. Boskin when he testified before this Committee just the other day. You are all highly qualified expert economists, and here we are—the politicians—and it makes me think you are looking at different countries in your analysis of the economy. So, that is just an overall impression that I have, and you do not need to respond to that in any way unless you want to.

Let's begin with the recommendations made right at the end on the investment tax credit. I have not heard that for a long time. We used to hear a lot about the investment tax credit. Mr. Chimerine, you are talking about applying it, as I understand it, to the incremental investment only, and that also applies to the capital gains recommendations that you made. Also, in the short term, you would raise the rates; long term, you would lower the rates down to zero, I think you said.

I would like to get the reaction of the other two witnesses to those specific proposals. How does it strike you?

Mr. Dunkelberg. Well, I will start, and then you can correct my mistakes.

There is a fundamental law in economics that nobody has been able to change, and that simply is that if you raise the price of something, people will take less or do less of it, and if you lower the price, they will do more. Exactly how we should deal with investment, whether we should in some way subsidize it, is always an interesting policy issue. But one thing is very clear. If you want more investment, the thing to do is to raise the return on investment or to penalize it less so that you encourage it at the margin.

Certainly, Larry's proposal makes a lot of good sense because it avoids giving away a lot of budget or tax dollars to things that would happen anyway, or to things that we probably regard as not particularly productive, like the real estate investments. In terms of increasing output person hour in this country, we think of investment in machinery, or equipment, or even education.

A proposal that established in some simple way a benchmark and provided tax breaks for increasing investment above this level would certainly increase the incentive to engage in investment activity with minimal net revenue cost.

The real concern about capital gains in the past has been the fact that we have taxed inflation gains rather than any real gains. Another alternative would just be to get the inflation taxation out of capital gains. That would help a lot.

But to focus on long-term gains really suggests that we do not want people to engage in short-term strategies speculating on asset prices. So,

I like the idea of making it long term. It focuses firms on the investment to get the tax gains. When you think long term on an investment, you are really talking about productivity. An investment's value in real terms is what it adds to an income stream—how it affects productivity.

REPRESENTATIVE HAMILTON. Do you worry about the impact on the deficit? Now, Mr. Chimerine didn't provide any figures here that I recall. These are going to be very expensive proposals, aren't they, or are they not?

MR. DUNKELBERG. Larry has thought about it more than I, so maybe he should comment.

The way that he is suggesting implementing them may not be so expensive. First of all, you do not have to pay anything out if nothing happens. That is, if a company does not invest more this year than last year, nothing is triggered. So, you lose nothing there, and the firm does not get any benefit from doing the same level of investment that they engaged in the year before. So, that works out pretty nicely from the revenue loss perspective. If they do engage in additional investment and it raises productivity, it generates more income and more tax revenue from higher wages and spending.

So, in a sense, it tries to self-finance itself. Whether it works out dollar-for-dollar is not clear since we do not know what kind of rate we are proposing and so on. But the general direction is a very favorable. Any of these "tax breaks" will have an adverse impact on tax revenues, at least initially. That means that we just have to make some hard choices here about what is worth doing and what isn't worth doing.

The nonsense with the deficit is going to have to quit sooner or later. A lot of what we are doing is just moving money around. It is true that if I tax you and take a dollar from you and I give it to me, which is a nice idea, total spending stays the same—that is, you would spend it or I would spend it. But the fact that we just use taxes to transfer that money—that is, we tax you and discourage you—has a bad impact on the behavior of the work force and on our institutions.

REPRESENTATIVE HAMILTON. Mr. Dunkelberg, I do not mean to interrupt you, but you keep talking about the nonsense of the deficit. I must say it triggers memories of very distinguished Secretaries of the Treasury sitting at that table you are at now arguing that deficits don't matter at all—just let her rip.

MR. DUNKELBERG. Deficits do not matter as long as the people we are selling the debt to are willing to sit there and do nothing with it. Eventually, as in the 1970s, we can double the price and halve the value of debt they have. Inflation is a way to default on debt.

Let me just give you a real simple example of what I think has been happening. Suppose that the U.S. economy is represented by all of us sitting here in this room, and you are the government and want to increase spending. You have two ways you can get it. One, you can raise my taxes and just move the money out of my pocket into yours. That means you have the money to buy something, and I do not.

The second thing you can do is borrow it. Now, if you have to sell the treasury bill to me, you still move the money out of my pocket. You have it, I don't. I have a claim that you promised you will make good sometime in the future, and we can debate about whether you really will in real terms. But the point is that you still reduce my purchasing power, and you have then the money and can use it to hire resources, and I can't. Now, that is as long as we have a closed economy.

With an open economy, we have the following kind of a problem. You need to borrow money. You do not want to raise my taxes because it is politically not cool. So, you go out to borrow the money, and instead of my stepping up, a Japanese investor steps up. Now, the difficulty we have is that you have the money, and I have my money, and we all go out to buy. That is when we create problems. We either create inflation or, as we did during the 1980s, we imported lots of stuff because we could not really make it all right here. That is why we are getting away with this borrowing.

So, deficits have not "mattered" because we have not been forced to make a real resource transfer here in our own economy. They have mattered budgetarily because, as you know, the debt-service cost gets bigger every year. If you figure we are going around $3 trillion in debt and you pick 7 percent as the average cost of government debt sometime in the future, seven times three is $210 trillion. I like the dictionary definition of trillion: a very large number. But it is going to become a real problem for us. So, in the short run, we are going to get eaten up by the interest, and then some day somebody is going to say I want to cash these in, and that is when we pay.

Representative Hamilton. Mr. Straszheim, why don't you comment on these proposals and any other comments you want to add.

Mr. Straszheim. Yes, Mr. Chairman.

On the capital spending issue, I like, in principal, the idea of stimulating investment spending for growth in the long term, but there are a variety of concerns and questions. I like the idea of doing that on just the incremental spending. This strikes me as perhaps an accountant's dream, as companies try to set up the books in such a way that most of the spending looks like incremental spending and so forth.

It takes me back a bit to the 1981 tax law. In 1981, we passed the Kemp-Roth tax cut—the 5-10-10 tax cut—to stimulate the economy. People ask now and then, how did the supply-side tax cuts work. My answer is always, I don't know. We ought to try it sometime.

The reason I say that is because your taxes and my taxes went down 5 percent in that first year, whether we wanted them to or not. Here is an extra 5 percent. We didn't have to do anything different, no change in saving, no change in consumption, down 5 percent. The next year they went down another 10 percent, no strings attached. In the third year, another 10 percent, no strings attached.

A good supply-side tax cut—something like Larry suggests—is one in which you get the most new private investment per dollar of governmen-

tal revenue foregone. That is in some sense a conditional tax cut, like an investment tax credit. Your company gets the benefit if and only if you make this new investment spending. So, that is the essence of what these kinds of changes ought to be like.

Mr. Dunkelberg just mentioned the issue of transfer payments. I think it is very important in terms of incentives in our economy. Transfer payments have risen dramatically, and that is money out of one pocket into another. So, as that transfer payment share of total spending rises in the overall budget for good and sufficient reasons, you have this ever heavier burden of taxation on those who are paying the taxes and do not ultimately get to spend the money. So, that is another one of these longer term, negative incentives that is created.

There will be costs in the budget, and it strikes me that, in the last analysis, what Washington is about is deciding. It is about priorities. If, in fact, we choose to increase our investment in the long run—and I think it would be a good idea—it will enhance our longer run growth rate, perhaps get us out of the 1990s, being the slowest growth decade since the 1930s. It will be up to somebody in Washington to make the hard choices. If you are going to cut taxes one place, to some extent, you will have to raise them somewhere else. If you are going to raise spending someplace, perhaps even in the public sector, you will have to cut spending somewhere else as, at least, a partial offset.

Representative Hamilton. Mr. Chimerine, have you made any estimates of the revenue tax impacts of your suggestions?

Mr. Chimerine. Yes, I have, Mr. Chairman. It is not easy to do because obviously it will depend upon how much new investment comes forward, and there are so many other factors affecting it. But the one thing I am pretty confident in saying is that with a 20 or 25 percent investment tax credit on incremental investment, if it does not work, it will be a rounding error in terms of its cost. There will be some cost because some companies might do it. If some companies do it, they get a tax break; if others don't, they don't get it. So, it doesn't balance out precisely. But the cost will be infinitesimal.

But if it works, and if we get $20 billion to $30 billion of additional investment, let's say, in the first year, over and above what we would have gotten, then fundamentally it will be a wash. You can do the arithmetic. If we get, let's say, $25 billion of investment, if we had a 25 percent incremental investment tax credit, what is 25 percent of $25 billion—$6 billion or $7 billion. But the added tax revenues coming from $25 billion of added economic activity plus the multiplier effect, if anything, will be larger than that.

Now, I do not want to go back to the 1980s and predict positive revenues from tax cuts. That is how we got into this mess in the first place. But the point is that the way this is set up it will not cost anything if it does not work, and it will not cost a significant amount if it does work.

Representative Hamilton. It is a seductive song you sing.

MR. CHIMERINE. I think it is an accurately seductive song.

REPRESENTATIVE HAMILTON. It may be. I hope it is.

MR. CHIMERINE. The key point, Mr. Chairman, is that we do not have much choice now. We have a $350 billion budget deficit. We do not have a lot of flexibility. Now, maybe this is not the best idea, but the one thing I am positive of is that we are going to have to be very creative, very selective, and very imaginative now because we cannot afford across the board tax cuts or other kinds of across the board programs. The investment tax credit has worked in the past. It has been very effective, and not only that, I feel very strongly that the do-nothing, count on a postwar euphoria strategy for getting us out of this, is dangerous and inadequate. We have to do something. If someone has a better idea, I would love to hear it.

REPRESENTATIVE HAMILTON. Congressman Armey?

REPRESENTATIVE ARMEY. Thank you, Mr. Chairman.

Well, Mr. Chimerine, you are not exactly a ray of sunshine, but I did detect a little ray of hope in your comments, and I do want to come back to that. Forecasters, I think, tend to be on the gloomy side. I have always had this personal theory that with forecasters and pollsters there is always a greater advantage in being pessimistic than optimistic. If you are pessimistic and wrong, they are going to forgive you. If you are optimistic and wrong, they will not forgive you.

I do not want to quibble over semantics, Mr. Dunkelberg, but I am not sure I heard you right. You would not suggest that decreasing the rate at which we tax investment—capital gains—is subsidizing capital gains.

MR. DUNKELBERG. Well, as I said, that's a political decision. Should we allow interest deduction on mortgages? It is a political choice that we made. I cannot think of a good economic reason why we should allow those things. Yet we do, and we regard them as very important. So, again, the question is should we give a tax rebate on income generated for firms that invest versus those who do not.

REPRESENTATIVE ARMEY. Let me see if I can just be more assertive in usage here. I would suggest that if we enacted a reduced capital gains tax or did something even smarter and indexed capital gains, so people gave the government less of the money they earned from investment, that what you would do is reduce the extent to which investors subsidize the government. I just somehow or another feel like I want to be clear on that point. Because, in fact, the government produces nothing and lives off the production and earnings of its citizenry. Sometimes, we tend to miscomprehend that and think somehow or another that the government supports the economy when, in fact, it is supported by the economy. This is always evidenced by the fact that after we get all done with our budget magic we then go back and reassess our economic assumptions and see if, in fact, they might hold up. That is to say, the performance of the government might hold up so that our budget will hold water, taking us back to the fundamental point.

You had talked, Mr. Straszheim, about the chronic tendency of the Presidents' budgetary projections to be more optimistic than reality later proved. Mr. Chimerine, you made a comment about the unreliability of statistics. I think, Mr. Dunkelberg, you said something to the effect that forecasting is a tenuous business at best. You all are, could I correctly say, forecasters by trade? I am an economist, but I am not a forecaster. In terms of technical training— Purdue, mathematical models, econometrics, databases, multiple regression analysis—do you all have this hardware and software behind you?

MR. STRASZHEIM. We all do some of this, yes, sir.

MR. DUNKELBERG. We forecast because we are asked to, not necessarily because we can.

[Laughter.]

REPRESENTATIVE ARMEY. Mr. Chimerine, I am curious. If you are not from Purdue, where did you get your——

MR. CHIMERINE. I did my graduate work at Brown.

REPRESENTATIVE ARMEY. I have a concern about the manner in which we make forecasts in official Washington circles that result in the kind of consistent error that you have documented. It seems to me that in the vernacular of the discipline we rely on static models and preclude any access to dynamics in our analysis. Certainly, as you become more dynamic—that is, as you have a model that is less abstract and more cognizant of the fact that there is a real world there and changes do take place in real worlds—that your tractability goes down. A static analysis must have some comfort in knowing that whatever we project here that we know we will be wrong with certainty, whereas dynamic static analysis must risk being only approximately correct.

Now, we have just passed in the 1990 budget fiasco, a set of luxury taxes. The revenue projections for these luxury taxes were made on the static assumption that there would be absolutely no change in sales and consequently production in the tax areas. I think that is probably as quick an example of the vagaries of static analysis.

I am told by people that the reason we do not do dynamics in OMB, CBO, Treasury, the Joint Tax Committee is because we cannot do it. I suspect what they are saying is we cannot do it perfectly and in perfect agreement with one another about how to do it. Isn't that a classic example of the perfect being the enemy of the good, to turn down dynamics on that kind of a, frankly, feeble argument?

MR. CHIMERINE. Well, I will take a shot at it, Congressman. In fact, I would like to make one or two other comments as well.

I think you are right. I think they should be done, factoring estimates of what the impact of the tax will be on activity and revenues. It can be done. No forecasting technique is perfect. You can try to do it, but it is hard to justify not making an attempt to do it.

But in all fairness, I think if you look back at the 1980s and why tax revenues have been below expectations, it is not because of the dynamic

or feedback effects, it is because economic growth was way overestimated, even without the dynamic effects.

Second, even more than that were the constant underestimates of interest rates and the effect on the interest component of the federal debt. Eventually, we have done a leveraged buyout of the Federal Government in this country, and we are paying the price for it now. A lot of the deficit is accounted by that, and somebody has to pay taxes. I do not like to pay them, and I would like to keep taxes as low as possible. But somebody has to pay some taxes in this country.

I would like to make one comment about the pessimism. Yes, I sounded pessimistic, and I did it for a reason, because I think our prospects are not favorable. But this is not Bangladesh or other places where there are serious economic problems, where living standards are tiny, where poverty is rampant, and so forth. This is still a relatively prosperous country, but it is different now in the sense that we are not improving. Our living standards have stagnated. Prospects for the next 5 or 10 years are not particularly bright.

It does not mean it is a disaster. We are not falling off a cliff, and we are probably not going downward very rapidly. But I think we can do better, and I think we ought to try to do better. I think it is our obligation to our kids. Instead of burdening them with big debts, try to lay the groundwork for a better environment, and we are not doing that. And that was my point.

REPRESENTATIVE ARMEY. I couldn't agree with you more.

MR. CHIMERINE. So, when I say I am pessimistic, it is all relative.

The other point. On capital gains, I must respectfully disagree. I do not think indexing capital gains will have anywhere near the desired effect on achieving what I think are the important objectives as the kind of structure I described, because fundamentally, we not only need more investment, we need more long-term investment. We have a terrible absence of patient capital in this country, and I think a tiny change in the capital gains tax rate will not change behavior much. What will change it is a big difference between what you pay on the short rate and the long rate. That will encourage you to shift.

REPRESENTATIVE ARMEY. Let me just mention that it has been my empirical observation that during the 1980s the tax take doubled, and that what happened was government spending went up at higher rates. So, the problem was not so much that we overestimated the exuberance of the economy, but that we overestimated our restraint as people spending other people's money, most often foolishly.

The methodological point is absolutely essential. The fundamental theory of choice—all of life is choices, and you can only make good choices if you have good information. If you have bad information, you make bad choices. If, in fact, we have an errant database—you talked about unreliable government statistics—and a flawed methodology, how, then can, we be expected to make responsible and effective choices among policy alternatives that affect hundreds of thousands of lives?

MR. DUNKELBERG. Let me make a quick comment on that. I think your example about the revenue forecasts, based on an assumption that sales would not change, is a good one. As I pointed out earlier, there is one law that we have never been able to repeal, and that is the law of demand. If you raise the price, people obviously are going to spend less. Common sense would tell you that. A good forecaster ought to be able to figure that out.

I would make one other point, that even though you designed a good model and put it in a box—and we will call it the black box for the moment—and you gave that box to Larry and to Don and to me, we could come up with very different forecasts because the box does not crank out an answer until we put in some input, some assumptions. I think if you look at, for example, the Presidents' forecasts that Don has looked at in great detail and asked why are those so optimistic, the answer is simply that the input assumptions were always very optimistic. That is, the raw material that you gave the box to work with was very optimistic.

That seems to be a disease of the politics of Washington. It is just not a good idea to be pessimistic, and if you are trying to sell a program, you have to show it brings the deficit down. The politics seem to flavor your thinking when you work with these models. So, even if we have the same model and it is a good one, we are going to get different answers.

One final comment on your observation about taxes. I always argue that the best measure of taxation is government spending, because that is the measure of the goods and services that you glom onto and take away from the private sector. The way government finances that is another interesting issue. Taxes, borrowing, and, of course, printing money are the alternatives. But if you want to really know what the burden of government is, look at that big chunk of government spending, the purchase of goods and services. Then, second to that, of course, is the regulatory tax that is becoming ever more burdensome on the private sector.

REPRESENTATIVE ARMEY. Do you want to make a comment on that?

MR. STRASZHEIM. Yes.

The point about assumptions is important. No matter how complicated these models are, they are dramatically simpler than the real world. If you use different assumptions, you will end up with a different set of results. We do not have a lab to work in. We live in our lab, and that is just a fundamental difficulty with economic forecasting. We will always make errors, but we ought to seek to have those errors have two characteristics. They ought to be small and randomly distributed, and they are not. They are neither small nor randomly distributed.

I think the point is a good one about dynamic models versus static models. If we cannot come up with a perfect answer, we ought not avoid progress. Progress is one thing. Perfection is another. We ought to be moving in that direction, even though we realize that we will still have errors in the whole forecast process.

REPRESENTATIVE ARMEY. I know my time is up. If I could just very quickly ask for a yes or no response to this question. Would you accept this methodology from a college sophomore, writing a research paper, projecting the revenues from a possible tax?

MR. STRASZHEIM. No.

MR. DUNKELBERG. Probably not.

MR. CHIMERINE. It depends for what purpose it is going to be used.

REPRESENTATIVE ARMEY. I would like a second round to talk about policy options.

REPRESENTATIVE HAMILTON. Sure.

Senator Symms, please proceed.

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

Gentlemen, thank you very much for your testimony.

I appreciated your view, Mr. Dunkelberg, when you said that the measure of what is happening is government spending. I have argued that case not, I would have to say, as successfully as I wish over these many years. It is what the government spends that matters. And we continue to allow escalation in spending.

We had a very interesting discussion yesterday, for example. Dr. Chimerine, you talked about the unemployment tax. In the Finance Committee, a bill was passed out to extend unemployment benefits. I guess what I am getting at here—as one who has great faith in capitalism—I am astounded, frankly, that our economy is as good as it is knowing from the inside of Congress how lousy the policies are, how antiprivate property, how anticapitalistic, how antilabor the Congress is to a market economy.

I have often said that with respect to the government regulators in the EPA and the ABCDEFG alphabet soup agencies—not just the EPA, but all of this massive army of regulators we pay—it is not what it costs to have them on the payroll that breaks America, it is what they get involved with and mess up. They are like cockroaches. It is not what a cockroach eats that is so expensive.

When I look at our economy, as a businessman who is in Congress, they just devastate the part of the economy that I come from—the produce industry—with constant government interference. It is one government agency after another harassing the producers.

How can we expect to have a robust recovery when one-third of our land is owned by the government? The softwood timber supplies are held under a government monopoly. If Weyerhaeuser or Boise Cascade or Louisiana Pacific owned the softwood timber supplies that the Federal Government owns, they would be in the court for restraint of trade because the government will not sell any trees.

We have now given the spotted owl priority over people. Sixty thousand people are unemployed.

One of the driving forces for the new unemployment benefits bill is the ranking member of the Committee, who happens to be from Oregon, which is feeling the brunt of this.

Our oil reserves, our gas reserves, for example, the ANWR, Congress has been fighting over that for 10 years and won't let people go look to see if the oil is there. Coal is locked up. The Clean Air Act has been passed. The taxation of regulation—I think it is a miracle we are not in a depression.

At what point do you think that the economists will be able to give Congress some kind of data of what it is costing us to try to comply with all this regulation?

Banking. This is the most hostile country in the world to be in the banking business. Anyplace else you could go, the government will be less hostile to you than they will in the United States. In Japan, in Germany, in Great Britain, in France, anyplace you go the government is less hostile to the people who are trying to be the engines of prosperity.

How does this weigh into your calculations, and how much do you think this contributes to the decline of our economy?

MR. STRASZHEIM. Well, let me start, if I may, the response to that.

One interesting study that I started on behalf of NFIB in 1985 was to look at 5,000 new firms and follow them for the last 7 years. We got a lot of information about them, and how much capital they started with, and so on. One of the questions we asked them was something like the following. We said here is a list of things that small business people have to deal with and plan for; which of them were worse problems than expected, which were easier than expected, and which were about the same. We found out from the entrepreneurs, as we asked them about competition from other firms—difficulties hiring labor, planning, marketing—that all those things pretty much turned out to be as expected. The one thing that really stunned the entrepreneur in about a 3 to 1 margin was dealing with government regulation. They underestimated the cost of that by orders of magnitude. Now, that is really sad because, if you look at these small firms, the median amount of capital spent to start the company was $20,000, which is nothing.

Obviously, the real resource we have here is the 80 hours a week of entrepreneurial time that is going into this business, and yet we tax it incredibly heavily by diverting it into all this nonsense stuff. Not in every case, because we do not want to condemn government regulation across the board. Lots of it is very good and productive. But we do not seem to sort it out very well. So, there is this whole pot of stuff that really draws down on the entrepreneurial talent, and that is probably the most important asset we have. That is the job creation. That is the wealth creation.

Two weeks ago I was invited to Portugal to talk to the government about how to get their entrepreneurs started. I had one very simple piece of advice. I said let them make money because, if you look at the way these firms grow, almost all of them count not on somebody else's

money, not on bank loans, but internally generated funds to grow. That is how they grow. And it is okay if somebody becomes a millionaire if he provides 6,000 other jobs and lots of wealth and lots of output.

SENATOR SYMMS. Larry?

MR. CHIMERINE. Yes, Senator. Let me take a crack at that because, while I fundamentally agree with you, I think it ought to be tempered a little bit because, like anything else, it is a matter of balance. Everyone here believes in free markets, but I think most of us believe that free markets by themselves, acting completely alone, are not necessarily the right solution either. By the same token, I do not want to overregulate. The point is finding the right balance.

You mentioned the Clean Air Act. I don't know if you ever had an occasion to travel to Pittsburgh 15 or 20 years ago and if you go there now. I do all the time.

SENATOR SYMMS. It is a beautiful city now.

MR. CHIMERINE. I can't tell you whether every provision in this current Clean Air Act is good or bad or too costly or not costly enough, but one thing I can tell you, there was no clean air in Pittsburgh 15 or 20 years ago, and without some kind of legislation, that would probably still be the case today.

So, the point is finding the right balance.

SENATOR SYMMS. How much steel do they produce in Pittsburgh now?

MR. CHIMERINE. How much steel do they produce?

SENATOR SYMMS. A lot still?

MR. CHIMERINE. A lot less than they used to. Is that part of the problem? Possibly, but so is the high-wage structure in the industry, and the fact that it lost its technological leadership in the world market. Can you blame all of that on the Clean Air Act?

SENATOR SYMMS. No.

MR. CHIMERINE. It is finding the right balance, and I do not know where that is.

SENATOR SYMMS. I agree with you on that, but just as a note of interest, next week I will be out at Kellogg, Idaho. We used to have a huge nonferrous smelter there. Today, we haul our mill products from the mines in the Coeur d'Alene up to Canada. Cominko has a big plant up there just north of the border, and they do it there. We closed our plant because our people could not comply with the costs.

You may be right. Maybe that is what we want to do.

MR. CHIMERINE. No.

SENATOR SYMMS. Even Gorbachev says that the Russian people ought to own 60 percent of the land in the Soviet Union. It is remarkable that the head of Communist Russia is recognizing that private ownership is best. But you go to Alaska and the government owns 98 percent of the land. Then, the government sits here in Washington and says, no, we will not let you drill for oil out here. It is just absolutely pathologically insane. There is no explanation for it other than that we allow politicians to mess

up what could be great opportunities for Americans so they could have jobs.

Where is Abraham Lincoln when we need him? We ought to homestead some of that land off up there, and let people go out and work those forests and cut down some of those dead and dying trees, and drag them down to the road, and let the lumber company buy them.

The price of houses are up $3,000 a house—just in wood products right now—and we are sitting on huge supplies of timberland in the Pacific Northwest.

There is no common sense to it. I find it very frustrating sitting here in Congress. I agree with you that it needs to be tempered, and I probably paint a worse picture than it is. But I find it very frustrating.

MR. CHIMERINE. I am sure it is.

SENATOR SYMMS. In my State, the government owns 64 or 65 percent of the land. There is more private land in Georgia than there is Idaho, and Idaho is over twice as big as Georgia. It is amazing to me. We have a Congress that wants to lock more of it into a wilderness area and deny Americans the chance to go out and find those resources. We deny ourselves the opportunity.

If we had a perfect fiscal monetary policy, I wonder if we could still survive the professionalism and the ability of the government regulators—they are getting good at this now. I know that within NFIB, you are very well aware that the small business people are under terrible pressure to comply.

MR. STRASZHEIM. Senator, these regulatory costs that you point out are important and large, and that is why they are important. But as an individual businessman, I do not really give a damn how large they are in the aggregate. I care what they mean to me and my own company.

If you want to find out what these regulatory costs are to society, the only way to find that out will be for the government to make a study, and that is not going to be free. So, it is you in Washington who will have to decide, do you really want to find this out or not. If you do, it is a little additional staff or whatever, some staffing up, and that runs, of course, right against the cut spending mentality and so forth.

SENATOR SYMMS. Let me just say one thing. My time has expired, and the Congressmen want to get back to you.

But let me just say that we did that with respect to the Clean Air Act. We ran a study that we funded—the Congress, the taxpayers, the American people—a $600 million study—the biggest, most expansive study ever done to find out what the problem of acid rain was. But the politicians in the country—led by a President who wants to be an environmental President, and a Congress who wants to outdo him—ignored the results of the $600 million study, and passed a very costly acid rain portion of a clean air bill, which was the driving force to pass the bill. I am saying we could have had a much more moderate bill. And Larry would have been very happy going to Pittsburgh. The air would have been clean. It is clean now without the last bill we passed. We have

been making tremendous strides with our technology. But the politicians and the press in the country are driven by things that are not really true. In other words, the sad part of it is that the press and the politicians are not liars. They believe things that are not true. So, then they pass laws to regulate it. Those laws just become an avalanche of burdens on our economy.

Like I say every year, I am astounded that business can still survive it. I know when I go back home, my brother thinks we will never be able to get by one more year with what all you people in Washington are doing. We have managed to stay in business now for over 75 years. The government is still our biggest enemy. Our biggest problem in doing business is the government. They are the number one problem for American business. I just find it frustrating. The best way to cure it would be to starve them out. Cut the spending, and then there will not be so many of them, and they will not hurt so many people.

MR. STRASZHEIM. It is encouraging to me, Senator, that the biggest problem is politics, not the inaccuracy of our economic forecasts.

[Laughter.]

SENATOR SYMMS. I think it is amazing that you can be as optimistic as you are. You must not understand everything or you would not be so happy.

[Laughter.]

REPRESENTATIVE HAMILTON. Let me go to some of the policy matters that have come up before us in the last few weeks. You can give me a quick reaction to how you feel about it.

In his testimony, Mr. Boskin came out in support of the Fed's current policy of holding interest rates steady. What is your comment on the Fed policy on interest rates?

MR. STRASZHEIM. I would have no complaint. Greenspan used the term "watchful waiting". I think that is the right stance at this point. We perhaps have a recovery on our hands. Let's let the evidence come through for the next few months, and see where to go from there, but make no change immediately.

REPRESENTATIVE HAMILTON. Do you agree with that, Mr. Dunkelberg?

MR. DUNKELBERG. Yes. I would second that. I still think the main thing to worry about is inflation and long-term interest rates. I think that Mr. Greenspan and the Fed really are still taking the right posture. I also agree with a couple of observations that lower rates right now are not going to matter anyway, as Larry correctly pointed out. So, let's not take a risk on scaring the inflation numbers back up again. Let's get long-term rates down.

REPRESENTATIVE HAMILTON. Mr. Chimerine?

MR. CHIMERINE. I would take the opposite view. I would encourage the Fed to lower short rates whenever they can, especially if the long market improves and gives them the opportunity to do so. Again, I think the inflation problem is a dramatically overblown problem.

REPRESENTATIVE HAMILTON. Mr. Greenspan has testified that the primary goal of monetary policy should be zero inflation. Should that be the Fed's primary goal, zero inflation?

MR. DUNKELBERG. Well, let me take a shot at that and then the other panelist can go from there.

I use a very simple analogy. It is kind of like sailing a boat between two islands where the rocks get progressively sharper as you deviate from the center. Now, we know we will never make it dead center except by luck, that is hitting zero inflation. It is virtually an unachievable goal. But as soon as we say, well, okay, not zero but 2 or 3, we are really then backing off and raising the probability that we are going to hit even bigger rocks as we try to steer between these two islands. I think it is not a good idea.

We all understand that zero in this economy really cannot be sustained on a long-term basis. Structural rigidity, all those reasons. But I think to keep thinking that this is where we want to be is the right way to frame our policy prescriptions, and I think we should continue to look at zero as an objective.

REPRESENTATIVE HAMILTON. As a matter of economics, we can hit zero inflation pretty easily if we want to, can't we?

MR. DUNKELBERG. I think not, and I think not for very long.

REPRESENTATIVE HAMILTON. If we were willing to take the downside of it, we can hit zero inflation, can't we? If you say zero inflation is the goal of the economy, we can hit it. That is not all that hard, is it?

MR. DUNKELBERG. Well, it is hard to maintain it. We could hit it by depressing the economy to death and cutting prices all over the place. We can go negative, but we can't maintain it. We have to think long term. There is a long-term concern for inflation and the relationship between the inflation numbers that we see and what happens with monetary aggregates. That really ought to be the focus, not short-term stabilization.

REPRESENTATIVE HAMILTON. I want to get to those monetary aggregates in a minute, but go ahead on this question of zero inflation.

MR. STRASZHEIM. There are some structural impediments in the economy that suggest to me that perhaps zero is not the right goal. Maybe it is 1 percent. Who knows? It is a small number, and I think it is smaller number than where we are right now.

I know of no evidence in economics that suggests that the economy will inherently do better in the longer term at a 4 or 5 or 6 percent inflation rate than at a 1 percent inflation rate, for example. So, in that sense, yes, I think the objective of grinding the inflation rate down somewhat from current levels is reasonable.

REPRESENTATIVE HAMILTON. Remember, Greenspan said the goal is zero inflation. Don't we have other goals in the economy than zero inflation? What about jobs. Isn't that a pretty important goal?

MR. STRASZHEIM. Yes, it is.

REPRESENTATIVE HAMILTON. Growth. Isn't that a pretty important goal? How can we put all of our focus on zero inflation? Do we just forget about jobs and growth and the rest of it?

MR. STRASZHEIM. No, Mr. Chairman, I do not think we should forget about all of those others. But your question was I think about the inflation goal, and I think a low-inflation rate is a reasonable goal. We also ought to be concerned about full employment.

REPRESENTATIVE HAMILTON. No question about that.

MR. STRASZHEIM. And we also ought to be concerned about reasonable cyclical stability, up and down, absolutely.

MR. CHIMERINE. I think that last statement that Don made is right on, Mr. Chairman. The appropriate goal should be to get inflation low enough so that it is not a constraint or a distorting factor in the economy. Quite frankly, I think we are pretty close to it now. I think the official statistics are overstating inflation. It should definitely not be our only goal. By the way, it is not just short inflation, because one of the ways to get inflation down on a long-term basis is to promote a more productive economy with more productivity. And putting the economy through the wringer does not do that on the long-term basis.

REPRESENTATIVE HAMILTON. Let's talk a little bit about those monetary targets Mr. Dunkelberg mentioned. The Fed has set a target of 2.5 to 6.5 percent growth in M-2 for the rest of the year. Mr. Boskin, again, when he recently testified here, appeared to support that path under the assumption that velocity would grow enough to support a 7 percent growth in nominal GNP. I think he said, as I recall, that he thought the targets ought to be at the upper end of that 2.5 to 6.5 percent growth for M-2.

But we have also seen the article in the *Wall Street Journal* recently by Marty Feldstein that said the Fed ought to aim for 8 percent growth in M-2. So, I just want to get your reaction about the targets here for M-2.

MR. DUNKELBERG. Since I started the last one, let me start again and talk about targets, including a reference back to the zero.

Let me refer again to my example again about New England. New England banks, in a sense, conducted their own monetary policy. They became very liberal, made lots of credit available in order to get jobs, and they did a great job until the whole thing finally collapsed. Of course, now we are in very serious shape.

That is why I think the long-term perspective is a very important consideration when we think about monetary policy. In the short run, we could juice the economy and really get jobs and so on, but it is a short-lived deal, and we want long-term jobs, long-term productivity and growth. Those, I think, are supported by a fairly carefully crafted monetary policy of the kind we have.

Now, in terms of the current targets, there is a simple equation that we are basically working with, which is, if we allow total GNP—nominal

GNP—to grow 8 percent, the two numbers have to add up to 8, and that is real growth plus inflation. Obviously, with zero inflation, 8 percent nominal GNP growth and 8 percent real GNP growth, what a deal, and that is the mix we are worried about.

Whether or not those ranges are exactly right, I don't know. I would not err to the high side too much. I would stick to the low side. You might give up some jobs in the short run, but again you are trying to change the mix in that total growth between inflation and real. We are trying to get the inflation part down and the real part up, and the way you do that, of course, is not let the monetary aggregates grow too fast; get long-term interest rates down so that we can fund the kind of investment and productivity enhancing investments that we would like to get long term.

REPRESENTATIVE HAMILTON. You are comfortable with the 2.5-6.5 percent target range?

MR. DUNKELBERG. Yes.

MR. STRASZHEIM. I am comfortable with it as well. I would rather have seen them knock that target down another half a percentage point and made it 2 to 6 percent, as a tip of the hat to the longer term objective of getting inflation down somewhat further from where it is right now.

The other point that I would make about it is the point that Bill just made about the mix. Greenspan talked about 4 percent nominal growth as being in the middle of that 2.5 to 6.5 percent, and then splitting that between perhaps 1 percent inflation and 3 percent real growth, adding up to the 4 percent.

One of the objectives on the fiscal side in Washington ought to be to take those actions that gradually shift that mix in favor of better long-run growth and against inflation, and that involves capital spending initiatives, a higher savings rate, more investment, less consumption, and that sort of thing.

MR. CHIMERINE. I guess I am in favor of it. I would shoot for the high side, but I am not sure it matters, Mr. Chairman, because the truth is the Fed does not control long-term interest rates in this country. Long-term interest rates are not high because of inflation fears in my view. They are high because of our dependence on foreign capital and an incredible supply of Treasury financing day after day, it seems like. That is why they are high, and the Fed cannot do much about that. The Fed can ease or not ease, or pump more money or not pump more money, and long-term interest rates ... we have lost control over our own capital markets. This is one of the other legacies of the 1980s.

So, whether it is 2 to 6 percent or 2.5 to 6.5 percent, I don't think matters much. I think the Fed ought to be as accommodative as they possibly can be in this environment, and that is the key point.

REPRESENTATIVE HAMILTON. I want to make sure I heard you right. The Fed no longer has much control over——

MR. CHIMERINE. Over our capital markets, over long-term interest rates.

REPRESENTATIVE HAMILTON. Long-term interest rates.

MR. CHIMERINE. Yes. Fundamentally, it is the Germans and the Japanese and everybody else that controls them, and our rates are going to be as high as it takes to attract the money we need to finance our deficits in an environment where we are no longer the only capital importer. Everybody else is trying to get capital, and it is not inflation that is the big problem for capital markets in my judgment.

REPRESENTATIVE HAMILTON. I want to turn it to Congressman Armey. Let me sum up here.

You all believe that the recovery is going to be weak. I think that is right, isn't it, if I heard you correctly?

MR. DUNKELBERG. Yes, that's correct.

REPRESENTATIVE HAMILTON. Do you all believe that there will be no double dip recession?

MR. STRASZHEIM. That's also correct.

MR. CHIMERINE. I believe there won't be, but I would probably say the risk is higher than I think my two colleagues would.

REPRESENTATIVE HAMILTON. So, the three of you think weak recovery, but still a recovery and no falling back into a recession.

The GNP figures that came out this morning—I don't know if you had an opportunity to see them—reported that the real gross national product increased at an annual rate of 0.4 percent in the second quarter. Does that affect your thinking very much?

MR. CHIMERINE. No.

REPRESENTATIVE HAMILTON. That is about what you anticipated? It does not have much of an impact?

MR. DUNKELBERG. I expected it would to be a little better, but mostly because of inventories.

REPRESENTATIVE HAMILTON. You are not shocked by it?

MR. DUNKELBERG. No.

REPRESENTATIVE HAMILTON. Congressman Armey?

REPRESENTATIVE ARMEY. Thank you again, Mr. Chairman.

This is so enjoyable and useful, we may go on all day. I don't know.

REPRESENTATIVE HAMILTON. You may go on all day.

[Laughter.]

REPRESENTATIVE ARMEY. Mr. Straszheim, I just have a couple of cleanup points. Senator Jeffords said today, "it was very hard to get the last word in on Dick Armey." I hope that he is correct.

You had indicated that the only source of any study that we could do that would testify to the productivity or wastefulness or inefficiencies generated in the private sector from the ill-advised public policy would have to be done by the government. Is that correct?

MR. STRASZHEIM. Well, any kind of comprehensive study, yes, but I am sure you are inundated with reports from trade associations and the like,

who are always making these assessments and providing you with their results.

REPRESENTATIVE ARMEY. When you said that, Mr. Chimerine, I had to grin because we are still concerned about these unreliable government statistics. It occurred to me that if my choice was between relying on the Federal Government's accuracy and that found at the University of Chicago, I would quickly opt for Chicago.

That reminded me of a study Yale Brozen did, relying on the Marshallian definition, where he had gathered together in one article an assessment of the inefficiencies of public policies from a group of scholarly articles. A fascinating piece of work. I do not have the exact citation, but it is one I could commend to everyone. This was an interesting article. I forget the time at which it was written, but looking back in the past decade, he found $1 trillion worth of waste generated in foregone prosperity in the private sector because of the impact it endured from ill-advised public policy.

Then, at the same time, if you look at the Grace Commission, which was given the mandate to assume that what the government is doing is what the government ought to be doing, are they doing it as efficiently as they can, generating a good deal of testimony about how terribly inefficient the government is doing what it does do. Now, from my point of view, since I believe that most of what the government does it ought not to be doing—it does not bother me to see them be particularly inefficient at doing it—but it did bother Peter Grace.

I am also enjoying the fact that I am a microeconomist by trade, and my life is so orderly compared to yours. The macroeconomists, during my graduate school days, always gave me a bad time for being a microeconomist. So, I love to see your world in such disarray and mine in such perfect order.

But going back to my struggles, and you all did too, remember when we struggled reading Keynes and were thanking God for Hansen, so that we could understand what we were reading, and the first formulations of fiscal and monetary policy? And then we went through the days of the finetuning the debate, and the great debate where McChesney–Martin gave Johnson the definitive word at a barbecue in Texas that the Fed is in fact independently responsible for monetary policy and will do what it does. Frankly, I think, we, in the legislative part of the government, spend too much time debating what the Fed should do and not enough time realizing the Fed will do what it does and be the first to tell us what they do is not our job, as Martin told Johnson to my gratification, at least back in 1965, I guess.

But assuming that the Fed is going to do monetary policy, and you have an interesting point that our deficit becomes part of the explanation for why the Fed can no longer have the control on long-term interest rates, and our reliance on foreign sources of capital, which is a product of our highly touted failed savings rate. Certainly, then, if we could find some way to encourage savers to save more, and one obtains the reward

for saving through the capital gains earnings on the investment of that savings, but I depart.

You, Mr. Straszheim, had made the point that we had pulled all our fiscal policy levers at the beginning of the decade and they are no longer available to us. But as I recall my reading of Keynes—made clear to me by Hansen, Keynes said in the arena of fiscal policy—we have basically two sets of levers, those that are on the spending side and those that are on the taxing side. He pointed out that if you are facing a recession, you either increase spending or decrease taxes, or some combination of both. If you are in a period of overexpansion, overheated inflation, you reverse the process.

I would say that the fact that we have made a fundamental structural redefinition of the Federal Government's budget, in that today 52 percent of our budget is devoted to entitlements, approximately another 20 percent of our budget is eaten up by the mandatory spending on the deficit, none of this available for discretionary countercyclical policy, leaving us only about 30 percent of our budget available for those purposes, most of which is not only required for dire emergency in the continuation of existing programs, but supplemented by an emergency depending on what special interest has the command of what attention span, at a given time, so that, in effect, our spending levers are at least tiny in their potential availability to us.

But that still leaves us with the taxing levers. I remember as a young student of economics, just learning my Keynesian analysis, that Kennedy was the great genius of the early 1960s when he proposed the Kennedy tax cuts. And the expressed argument was that when we cut these taxes, we will have a recovery from the recession that will result in the Keynesian multiplier effects throughout the economy that will feed back into the process revenue to the treasury, and that we will, in fact, have more money at lower rates. As I recall, the definitive confirmation of the Kennedy thesis was the third quarter of 1963, which generated more revenue than the third quarter of 1962. Kennedy was, therefore, proclaimed by the academics—at least by those I heard at the time—to be the definitive genius of our time, teaching us economics, and I believe that was all correct analysis. So, Kennedy did, in effect, say that not only does the Keynesian prescription for the countercyclical impact work, but it is good for the government, as well as the economy, and that it increases the revenues accrued to the economy.

Now, we find that we have a recession that everybody agrees began before the Kuwaiti oil shock, began during the time that the President found himself in this ill-fated summit that he should not have been in, in the first place, last year around the middle of July. So, we all knew that we were in or headed for a recession by July, August, September, October, during the time in which we were cobbling together the budget summit agreement, that the recession was either here or imminent. The fiscal levers were by and large left intact on the spending side. There was

some pretention that we were going to restrain spending, which did not fool anybody. But we raised taxes during a recession.

So, it seems to me that what we are practicing now is not fiscal policy, leaving the burden on the Fed, but malevolent fiscal policy, adding to the burden of the Fed, and then spending our time taking Milton Friedman's advice, and cursing the Fed because they have not yet bailed us out of our problems. I profoundly believe that Friedman was correct when he said if you can say nothing bad about the Fed, say nothing at all. I am not quick to rush to the defense of the Fed, but it seems to me that we have made them a bit of a whipping boy for their failure to save us from our own ill-conceived policies on the fiscal side. There is only so much we can ask of them.

Well, I wonder how you react to all that.

MR. CHIMERINE. Can I comment on that, Congressman?

I think it is terribly unfortunate that we put ourselves in a position where we have raised taxes during the middle of a recession. That is another outgrowth of what we did, or really did not do and should have done in the 1980s. We should have dealt with these deficits years and years ago instead of using optimistic assumptions, fraudulent budgeting, and all the other stuff we did to either explain them away or assume them away. We didn't. As a result, they began to feed on themselves.

I do not agree with you that spending was not cut in the 1980s. A lot of spending was cut in a lot of nondefense programs. The problem is that it got chewed up by all the extra interest and by the skyrocketing entitlement programs that we have not dealt with. As a result, we find ourselves with $200 billion and $300 billion deficits at the start of a recession.

But the real problem is why didn't we do something when it was obvious we should have done it a long time ago. If we keep waiting until there is no longer a recession, we will be at $500 billion.

I would say the second point is that the world is not linear, Congressman. I am a Keynesian by heart, but the effect of a tax cut on the economy at one time is not necessarily the same at another time. After the Kennedy tax cuts, we did not have big budget deficits. Underlying economic conditions were different. We were not dependent on foreign capital. We did not have high real interest rates. As a result, you cannot say the effect of any given tax cut this time is going to be the same as it would be at another time.

My preference would have been not to raise taxes last year, but we have no choice but to put in place a long period of fiscal restraint. I would like to see more of it done by cutting back the entitlement programs, and probably even making more cuts in defense.

But the point is that we are committed now to a long period of fiscal restraint that is a drag on the economy at the absolute worst time, because we did not do what we should have done 3, 4 and 5 years ago when the problem was more manageable, when the tax increases necessary would have been smaller. That is the real problem in my judgment.

REPRESENTATIVE ARMEY. But we already know in the first 6 months of the luxury taxes that they have lost $5 for every dollar's worth of revenue they have generated.

MR. CHIMERINE. But that was a tiny fraction of the program, Congressman. That is not what is causing this recession.

REPRESENTATIVE ARMEY. Well, it is not a tiny fraction of the program for the poor fellow that has lost his job out there. We have aggravated the circumstances.

MR. CHIMERINE. What would have been the alternative? Take a $500 billion deficit?

REPRESENTATIVE ARMEY. What I am saying is that if we were rational in our thought process, and we understood that a luxury tax on boats was going to result in reduced boat sales, and that would mean less production, that would mean lost jobs. Lost jobs means less income tax receipts, less FICA tax receipts, less other tax receipts. If we had been the least bit foresighted, we would certainly have left this component out of the budget in pointing out the fact that, look, why create another 19,000 unemployed people and another $5 worth of revenue lost to the Treasury for every dollar gained through this tax by passing the tax. It is linear in that regard.

The fact is the Reagan tax cuts of the 1980s completed the job. The tight money crunch that we went into right after he took office broke the back of inflation. You have to remember the 1970s were special. Keynes did not allow for the possibilities of the 1970s. Most macroeconomists were befuddled. The Phillips curve said you are going to have a recession or going to have inflation. We had stagflation. Nobody could cope with it. Reagan said tighten down the money. We will break the back of the inflation. Then we will deal with the recession, and the tax cuts did exactly that. So, it was linear in that regard.

I guess what I am driving at is that we do have fiscal policy options, but we are not using them well, despite the fact that, yes, we should have done something about the deficit earlier. We didn't, but we still, today, have fiscal options—in fact, we are using them exactly opposite from how we ought to be using them.

MR. STRASZHEIM. In some sense, I guess, it goes without saying that we always have fiscal policy options. We can always raise taxes or lower taxes, raise spending or lower spending. The question is when is the right time to do which and how much of either. It is also clear that, it seems to me, last fall when we did the budget deal, we were contracting fiscal policy at a time in which the economy was contracting as well, and it should not be all that much of a surprise that perhaps it contributed to the size of the downturn.

Having said that, there are both cyclical and secular kinds of questions that are involved here. My point earlier was simply that we have run these deficits up year after year. You will recall in 1981, when David Stockman at OMB said, we are going to have $100 billion deficits as far

as the eye can see, and he was taken to the woodshed by Reagan in that well-advertised story and so forth. He was right, and we now are ending up with $100 billion of new financing in the third quarter and $100 billion in the fourth quarter as well.

REPRESENTATIVE ARMEY. Let me take you back to the floor debate on the budget summit deal when it came to the floor. I said at that time I have no model, I am not an econometrician. I just plain have what you earlier said, Mr. Dunkelberg, common sense. If we enact these luxury taxes, the Treasury will lose money. Now, the reason it seemed imperative to put the luxury taxes in the deal was because we needed the revenue. Yet, you did not have to be an econometrician to know that if you enacted the taxes, the Treasury was going to lose money, and 6 months into it, it is confirmed. We are losing $5 for every dollar raised by the tax and 19,000 people have lost their jobs. It is malevolent public policy. There is no winner. Everybody is a loser.

MR. CHIMERINE. Congressman, can I quickly comment?

I think you have to make a distinction between whether we should have had a budget agreement in the first place at this time; second, what the mix between spending and taxes should have been; and third, for the tax portion, whether the specific tax increases that were chosen were the best ones. Now, I am not disagreeing with you. I personally would have preferred doing more of it on the income tax structure than we did. We picked a few industries here that are very sensitive to pricing and taxes, and as a result, it is somewhat self-defeating. It has hurt them badly, hurt demand badly, and not generated the revenues.

You have to make a distinction here between whether we should have had any taxes or these specific ones. If you wanted to substitute something different, a small increase in the marginal tax rate or the average tax rate, or broadening the personal income tax base, I would have been your biggest supporter.

REPRESENTATIVE ARMEY. Let me make one final observation. I did want to substitute something different that did not include taxes. The Rules Committee did not allow that.

Second, I said of all the taxes being contemplated by that summitry, the luxury taxes were the least worst. They would have been the least repressive to the economy. The only value I saw in taking that option rather than the income tax rate increase or the gasoline tax was that they were immediately tractable, and we could document how bad they were, and we have done that.

So, I will give the summit agreement credit for taking the least worst tax, and thereby providing for those of us who look for truth before votes some evidence of how bad the impact is on the real lives of real people. But even Keynes in the first draft of the general theory was clear. You do not raise taxes in a recession.

Excuse me for going on and on, Mr. Chairman.

REPRESENTATIVE HAMILTON. It is OK. I think we have had an excellent hearing.

I think the thing that has come across to me as you testified—and your testimony has been excellent this morning—is that all of you apparently agree that the economy is fundamentally off track, and we have some very deep-seated problems in the economy that we are not dealing with as effectively as we should. I think there is a remarkable amount of agreement among you as to what those fundamental problems are.

So, I thank you for your testimony. It has been a good session.

We stand adjourned.

[Whereupon, at 12:14 p.m., the Committee adjourned, subject to the call of the Chair.]

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