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THE OUTLOOK FOR JOBS AND THE ECONOMY

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

ONE HUNDRED SECOND CONGRESS

SECOND SESSION

NOVEMBER 6, 1992

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JOINT ECONOMIC COMMITTEE

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Thursday, April 2, 1992

SUBMISSIONS FOR THE RECORD

THE OUTLOOK FOR JOBS AND THE ECONOMY

FRIDAY, NOVEMBER 6, 1992

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

The Committee met, pursuant to notice, at 11:00 a.m., in room SD–628, Dirksen Senate Office Building, Honorable Paul S. Sarbanes (chairman of the Committee) presiding.

Present: Senator Sarbanes

Also present: William Buechner, professional staff member.

OPENING STATEMENT OF SENATOR SARBANES, CHAIRMAN

SENATOR SARBANES. Our second hearing this morning will explore the outlook for jobs and economic growth through the end of this year and into 1993.

We have a panel of knowledgeable witnesses this morning: Eric Greenberg, Director of Research and Surveys for the American Management Association; Allen Sinai, chief economist for the Boston Company Economic Advisors; and Richard Rahn, President of Novecon, a consulting firm, and formerly chief economist for the Chamber of Commerce.

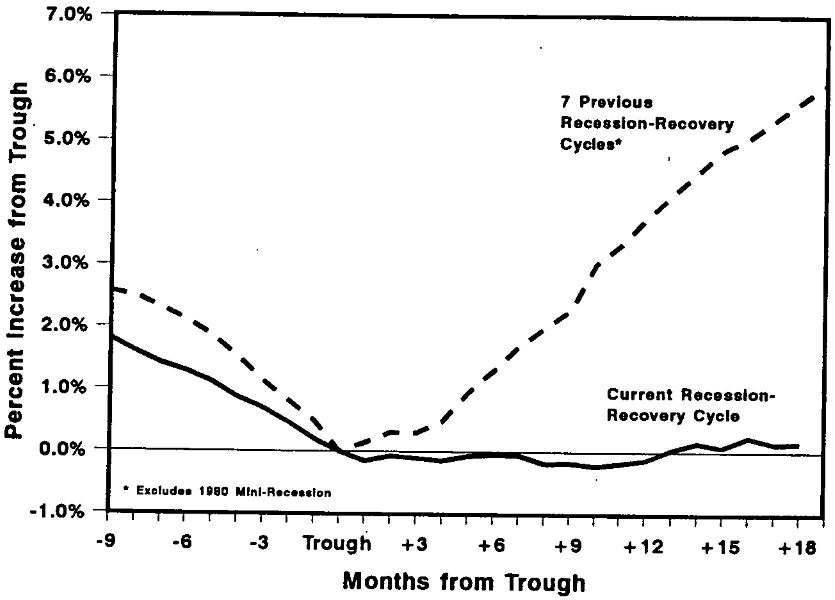
Our first hearing this morning illustrated one of the most urgent challenges that will be before the incoming Clinton Administration. The economy is locked into a pattern of low growth that is simply not creating jobs. The growth the Commerce Department reported for the third quarter, a figure that surprised everyone, in fact failed to create any jobs. In fact, during that quarter, the total number of jobs fell by 10,000, and private sector jobs showed a net loss of 84,000.

The list of firms announcing layoffs or job cuts continues to grow. In just the last ten days, dozens of firms said that they plan new or additional rounds of job cuts early next year: American Express, Bristol Myers, Pratt & Whitney, General Dynamics, Borden, on and on and on.

We are stuck in a serious jobs recession that has persisted for 18 months, with economic growth so slow that the economy is unable, really, to create new jobs. The chart we indicated, which showed the contrast between this recession and past recessions, I think, is quite dramatic. (See chart below.) In the other postwar recessions, we were getting vigorous job growth during the 18 months of recovery, enough to replace all the jobs lost during the recession, and add even more. In one instance, I think the figure was 129 percent. That was the best of the recoveries in the postwar period. The least was at 97 percent. And in this recession, it has been at 14 percent.

The Jobs Recession

Growth of Payroll Employment from Trough



Source: Bureau of Labor Statistics and Joint Economic Committee

The latest economic indicators do not seem to give much hope of an imminent pickup in economic activity or a rebound in jobs. The index of leading economic indicators continued to decline in September. Consumer confidence has fallen 27 percent since June. Durable goods orders are down. Domestic auto sales fell in October.

The Fed's Beige Book, just released, concluded that the economy is crawling forward in a slow and uneven manner, and most districts reported a new downturn in manufacturing activity. Putting people back to work will obviously be a most urgent task of the new Administration, but clearly it will not be easy.

In fact, we have had, I think, probably the longest period of anemic economic growth since the Great Depression. The previous recessions, some in a sense were deeper, but the recovery coming out of them were much stronger, had vigorous recovery, strong economic growth. And to have this kind of stagnation this far along into the recovery period is unprecedented in the postwar period.

We have asked this panel to give us a view of the economic conditions that the new Administration will be facing, and we look forward to hearing their testimony.

I think, gentlemen, we will begin with you, Mr. Greenberg, and then we will move right across the panel to Mr. Sinai and then to Mr. Rahn.

Thank you very much for coming this morning. Mr. Greenberg, please proceed.

STATEMENT OF ERIC ROLFE GREENBERG, RESEARCH AND SURVEY DIRECTOR, AMERICAN MANAGEMENT ASSOCIATION

MR. GREENBERG. Thank you, Senator. On behalf of the American Management Association, I want to express our appreciation for this invitation.

The American Management Association, which is a not-for-profit membership organization, has surveyed its corporate membership annually since 1987 on work force reductions. Our 7,000 corporate members employ in total a quarter of the American work force, and the current survey represents a representative sampling of that membership. It is important to note that our findings do not mirror the American economy as a whole. We focus on larger companies, not all Fortune 500-sized companies, by any means, but on larger firms that employ more than 100 workers, and we tilt toward the manufacturing sector.

I have supplied the Committee with an executive summary.

SENATOR SARBANES. When you said 25 percent——

MR. GREENBERG. Of the American work force.

SENATOR SARBANES. Of the work force. Okay. So the companies that you survey——

MR. GREENBERG. Are representative of our corporate membership, which in total employs 25 percent of the American work force.

SENATOR SARBANES. Okay. Very good. Thank you.

MR. GREENBERG. I have supplied the Committee with an executive summary of our key findings and the tabulated data and copies of the research report that we will make this week to our corporate members. Allow me, then, in these remarks to take a wider view and share with you three important lessons we have learned in six years of survey activity in this area.

The first is that downsizing is not the child of recession. It preceded the recession, it expanded due to the recession, and it continues and will continue beyond the recession. From 1987 to 1989, the pre-recessionary period, about a third of our companies every year were reporting job cuts, averaging a little over 10 percent of the work force. And a majority of these cuts had nothing to do with current economic performance, nor was profit performance an immediate concern then or later. Year after year, 75 percent of the firms that downsize in a given year are profitable in that year. These are structural or strategic reductions, driven by such factors as mergers and acquisitions, the transfer of work to other locations, including offshore locations, plant obsolescence.

SENATOR SARBANES. By offshore, you mean out of the country?

MR. GREENBERG. Exactly.

MR. GREENBERG. Plant obsolescence, and automation or other new technological processes. Most importantly, these are attempts to increase worker productivity, to do more with fewer people. Our questionnaire calls it "improved staff utilization."

For the past three years, a majority of reported cuts have been recession-driven, and this year 63 percent of the cuts were due in whole or in part to a business downturn. But the rest, more than a third, were strategic or structural. Structural cuts are usually not as deep as recession-driven cuts; they eliminate fewer positions, and they particularly target the middle manager. And this is the second of the lessons our surveys have taught: The middle manager is a special target of downsizing.

Now, it is important to remember that when companies downsize, most of the people who lose their jobs are hourly workers. But that is because there are more hourly workers on the payroll. But in percentage terms, middle managers are being fired far out of proportion to their presence in the work force. Middle managers make up between 5 and 8 percent of the American work force, but last year 22 percent, on average, of the jobs eliminated belonged to middle managers.

SENATOR SARBANES. I don't intend to interject this much, but it is sometimes opportune. You said that about two thirds of the downsizing in the last three years was because of the recession.

MR. GREENBERG. Were driven in whole or in part by recessionary pressures.

SENATOR SARBANES. All right. And about one third was structural?

MR. GREENBERG. Right. Exactly.

SENATOR SARBANES. Now, of the middle management, how much of them are in the two thirds driven by the recession, as opposed to the one third that was structural?

MR. GREENBERG. Middle managers tend to take a harder hit when the rationale for the downsizing is a merger or acquisition, or a search for improved staff utilization. They, in percentage terms, take a lesser cut when these cuts are recession-driven.

SENATOR SARBANES. All right.

MR. GREENBERG. Hourly workers tend to take a larger hit when the cuts are entirely recession-driven.

There are three reasons, generally, for this special targeting of the middle manager. The first is economic. Firing an $80,000-a-year manager saves more payroll costs than firing a $20,000-a-year clerical worker.

There is also a technological reason. Now, we think of automation as something that threatens blue-collar assembly line workers. But information technology is having a tremendous impact on middle management ranks. A middle manager's job can be roughly defined as gathering, analyzing, and dispersing information. That's what they do all day. And a desktop computer working on a decision support software can do that job more quickly and arguably more cost effectively than a middle manager.

One bit of survey data dramatically underlines this. Of the cuts planned by our respondents in the current period—that is, through June 1993—18 percent are ascribed in whole or in part to automation or other new technological processes. But of the manufacturers who plan cuts, only 13 percent list automation as the rationale, compared with 22 percent in the service sector and 31 percent in the financial services sector where number-crunching is the core of the business. And with the economic and technological factors, there is an organizational practice that targets middle managers: flattening the company, reducing the reporting levels that intercede between the customer and senior management, and improving the accuracy and speed with which information travels through the organization and making it more market-responsive.

So, for reasons of economy, technology and organizational structure, the middle manager is more and more an endangered species. Of the 280,000 jobs identified by position that our respondent firms have cut over the last three year, 19 percent were held by middle managers, and when the cuts are structural or strategic—that is, the result of a merger or acquisition or a search for improved staff utilization—when those are the rationales, an even larger share of the jobs eliminated come from the middle management ranks.

But does all this downsizing work? Here is the third lesson from our survey: The after-effects of downsizing are problematic at best and raise the question as to whether or not the cure is worse than the disease. Among the surveyed companies that have downsized once or more since 1987, fewer than half—43 percent—report that operating profits improved after the cuts were made; 24 percent said that profits fell after the downsizing. While 31 percent said that worker productivity increased after the cuts were made, nearly as many, 28 percent, said that productivity declined. Community relations tended to suffer; 27 percent reported a decline in the quality of their relations with the wider community of stakeholders. And one thing that happens for sure in the wake of a work force reduction is that morale plummets: 22 percent of the companies reporting cuts said that morale declined severely and an additional 52 percent said that morale declined somewhat.

In every regard, things were worse in companies that had a second or third round of cuts. Profits dropped. Productivity suffered. And morale disintegrated.

SENATOR SARBANES. When you say "cuts"—I want to be clear on this—you mean people actually lost their jobs?

MR. GREENBERG. Absolutely.

SENATOR SARBANES. Does the survey include shrinking the work force through attrition?

MR. GREENBERG. The survey asks whether or not positions have been eliminated.

SENATOR SARBANES. So it could be either of the two.

MR. GREENBERG. Exactly. Downsizing will continue come recovery or recession. Twenty-five percent of our respondents reported plans to downsize by June 1993, which provides a baseline number that will only increase as the year plays out, because typically the share that reports downsizing at the end of a period is double and sometimes even triple the share that reports plans to downsize at the beginning of the period.

Nearly half the cuts that will come by mid-1993 are strategic or structural rather than recession-driven. Also, downsizing tends to be repetitive; on average, 63 percent of the companies that make cuts in a given year repeat the exercise in the following year.

Companies are trying to find that irreducible core of permanent employees, the minimum number necessary to open the door in the morning and turn out the lights at night. Cutting payroll costs does give an immediate boost to the bottom line, but the long-term effects of downsizing are less happy. Departing workers take with them years of experience and corporate memory, as well as contacts with internal and external customers. Companies that cut themselves out of a line of business may find it impossible to reenter that business when economic conditions change, and the infrastructure of sales and distribution disappears with the people.

Why, then, do companies continue to downsize despite the mixed results? Most would say that things would be worse if the cuts hadn't been made, and payroll reductions offer the most immediate and obvious savings available to companies trying to compete in a global economy.

Lord Melbourne—the 19th century British politician—put into a single phrase the entire conservative philosophy of his time and ours when he said, "If it were not absolutely necessary, it were the foolishest thing ever done." If downsizing is not absolutely necessary, if it is done without full consideration in its planning and humane practices in its execution, it may prove for many companies the foolishest thing ever done.

Thank you, sir.

[The prepared statement of Mr. Greenberg, together with attachments, starts on p. 29 of the Submissions for the record:]

SENATOR SARBANES. Thank you very much, sir. That was very interesting testimony, and we look forward to exploring it in the question period, but we will take Mr. Sinai and Mr. Rahn first.

Allen, please proceed.

STATEMENT OF ALLEN SINAI, PRESIDENT AND CHIEF EXECUTIVE OFFICER, THE BOSTON COMPANY ECONOMIC ADVISORS, INC.

MR. SINAI. Thank you, Senator. I am happy to be here to talk about the economy and offer a few perspectives on policy.

The economy, after this presidential election, appears much as before the election. It is beset by macro problems and micro difficulties. The macro problems are an underperforming and stagnant economy, the lack of jobs and income, still outsized federal budget deficits, prolonged economic weakness in major industrialized countries, and a decline in our long-run potential economic growth. Dealing with so many macro problems in this scarce-resource environment and in the context of a difficult global environment is one of the new tasks for the new Administration. Figuring out if there are ways to grow both the economy and jobs and to reduce the deficit is another task. Determining the necessary policy contexts for dealing with more than one macro problem, a number of macro problems, is yet another.

Our macro problems are more numerous than after the election of 1988. Then the big problem was the federal budget deficit. The economy was doing well here and overseas. We were essentially fully employed at the time. What was needed then was fiscal restraint to reduce economic growth and some easier offsetting monetary policy. Instead, action on the deficit was delayed and did not occur until late 1990, which unfortunately was just the wrong time, and has contributed and still is contributing to our underperformance.

Now we have two problems: We have poor growth, no jobs creation to speak of, and still an outsized deficit. And, unfortunately, those problems can't be solved at the same time. Reducing federal budget deficits can be incompatible with raising economic activity and creating jobs. Raising economic activity can be incompatible with cutting the deficit. Both can be achieved simultaneously—raising growth and reducing deficits—but that is difficult. Monetary policy is one source of raising growth and reducing budget deficits; that is, easier monetary policy. But we have had a lot of that, and it has not worked yet.

Increased efficiency and productivity is yet another way to get both increased growth and reduce deficits. New waves of innovations or invention, lower-cost provision of health care—those are all possibilities, but not easy to achieve.

So, policywise, we now have a sequencing problem of choosing between reducing the deficits or increasing growth first, then working on the other problem later. If the choice is for more growth, then what fiscal policies are used is critical, along with the need for monetary policy to be accommodating.

One reason for taking action to increase growth first is that the economy gets additional tax receipts and reduced government transfer payments that can partially offset any extra deficit that might be created. Tackling deficit reduction first probably would weaken the economy and cost jobs, also losing some tax receipts and causing extra spending and then be self-defeating to the objective of deficit reduction.

The current economic situation remains, I think, one of stagnation with the greatest risk now from the international side. The recent data for the economy do show some signs of life. Orders were a little better over the past reported month. Hiring is a little bit better. Retail sales are stronger the last three months. There is some pickup in big ticket-item buying.

Now, these days, we watch these numbers with a very big magnifying glass, and I wouldn't want to overemphasize or exaggerate these little bits of improvement that are showing up. Compared with other episodes, we are talking about a magnitude of 15-20 percent of what we used to see happen when we moved into a real recovery. But there are some signs that things are a little bit better.

Other statistics paint a picture of hesitation. The leading economic indicators, for example, down three times in four months; home sales softer in late summer, and the manufacturing sector, underscored by today's employment data, does appear to be again in recession. Overseas, none of the European countries appears to be reviving. There appears to be a loss of momentum, and Japan continues to show up weak.

There is nothing on the horizon that we can see that is occurring to suggest that we are going to get a significant pickup in growth anywhere in the industrialized world soon.

Over the next six to nine months, there is really little effect on the economy from any actions by a new Administration. The economic difficulties are complicated, they're complex, there are no simple, easy answers, and we do have a $6 trillion economy which is hard to move. In the typical post-election circumstance, a new Administration has not been able to affect the macro economy during the first year, usually beginning to have an impact only in the second year.

The Clinton economic plan, "Putting People First," actually would not be a big macro event. It would not change, I think, the outlook for the next year or two very much, as now indicated. The ex ante figures show a net $81 billion subtraction out of the economy from reductions in Government spending on both defense and nondefense, and higher taxes versus lower taxes and the higher Government spending initiatives.

The $20 billion to $25 billion per annum deficit restraint in that plan, as indicated, would prevent much additional growth from occurring. Even under a more realistic scenario where the Clinton Administration might find that new programs and initiatives cost more than estimated, tax receipts from increased levies on the affluent and foreign corporations were not so much as thought, and the projected nondefense spending savings could not be fully realized, the resulting positive effect on the economy would be minimal.

If we relax that program of "Putting People First" and assume that it doesn't work as well in actuality as in the plan and end up with, oh, say a $100 billion deficit ex ante for the four years of the plan, all that does to the economy is to produce two- or three-tenths of a percentage point extra growth in the first year or two. The extra jobs that would be created by that would be minimal. These kinds of numbers and the numbers in all the candidates' programs, most of them, really are, when you think of a $6 trillion economy, not that big, and it takes a lot to move that sized economy.

Now, let me turn a little bit to the outlook for the rest of the year and next year that we carry for our economy and the world economy, because the world economy is now having a significant effect on our economy, particularly through a slowdown in the growth of exports and impacts on manufacturing.

The weakness overseas is significant. It is continuing. And it does carry implications for us. Now, I don't think that it's debatable that the United States and the world economies are in trouble and have been for a long time. I think the word stagnation is an appropriate word to describe what is going on, and certainly in the United States jobs growth has been nonexistent. And despite a little better news in the report today, ex-summer jobs and special factors like postal workers retiring, one can squeeze out a net 100,000-person increase in jobs creation. That is maybe one third of what we see in a recovery, and over the long run, unless we do better, that is going to turn out to be inadequate.

This is the most unusual business cycle episode that I have studied or seen. We have had 15 quarters since early 1989 that are really not describable in terms of how we have done. Nine of them have shown zero percent to 1.7 percent growth. Three have shown what I would call bona fide recovery, growth in excess of our potential output, which we estimate at 2.0 to 2.5 percent. And three were full-fledged recessions.

The latest data suggest more of the same, despite that 2.7 percent increase in the GDP report. That third-quarter report was picked up by some data spikes, one in computers, information processing and communications, almost $14 billion. There was a $4 billion increase in defense spending, and we know that defense spending is programmed to decline by 5 percent a year in real terms. So that was an aberration.

The rate of increase in consumer spending at almost 3.5 percent in the third quarter will be hard to sustain when we have so few jobs being created and real income growing so slowly.

So I think the fourth quarter is more likely to show a 1 to 2 percent rate of growth in gross domestic product. Next year, we expect 2.5 percent growth. That is better than this year. This year, the number fourth quarter to fourth quarter would be 1.8 percent. Last year, it was flat. So one can say that business is improving, that the economy is improving. But this sequence is unusual, different. There is nothing like it in our postwar history, in anything that we have described by the word recovery.

Now, I don't think of recovery, and I don't think Americans feel recovery, on an economy that grows at 2.0 or 2.5 percent, because that is barely our trend. That is barely the trend or potential rate of growth, and we don't generate many jobs or even should expect to bring down the unemployment rate if that is our base of growth.

Now, elsewhere, all is not well either. Europe is suffering from what I would call the German problem, the stagflation problem, a sliding German economy and a high inflation engendered by the shock of unification. At 3.5 to 4.0 percent, the German inflation is far in excess of their 2 percent target.

To fight that, the Bundesbank has followed a policy of high interest rates, and through the ERM that has spilled over to other countries, slowing down growth on the Continent and the United Kingdom. The momentum is locked that way for yet two, maybe more, quarters. And Europe is also stagnating.

In Japan, we have trouble as well. A pattern of 1 to 2 percent growth has emerged in that previously booming country. The Japanese situation is, I think, unique for Japan in the postwar period. It's a situation we would describe as one of financial fragility, where you have overleveraged financial institutions, a slipping real economy, and policymakers that are trying to help but doing too little too late.

There is a risk that an international credit crunch emanating from Japan could occur if things stay this weak in Japan. Japan is a big spender around the world. Japan has been one of the world's biggest lenders, biggest investors, and trouble there on the financial side can be trouble everywhere.

So, I think for 1993 the best that we can expect is weak, sluggish but positive growth in the United States and most major industrialized countries.

SENATOR SARBANES. Could I just interrupt you a second?

Before you leave Germany and Japan, you say in your prepared text:

> With the three major economies of the world, the U.S., Germany, and Japan, all having economic difficulties, the U.S. and world economies cannot easily mount a solid recovery. The problems of the major industrial countries appear unique to each, are interactive, and no easy common solution exists. The risk of continuing recession or stagnation is high, with the current episode in many ways more like the 1930s than typical post-World War II situation

Now, that is a very serious evaluation, it seems to me, of the situation.

MR. SINAI. Yes. Actually, my notes, I was supposed to read that. But I skipped over it, so I am glad that you did read that.

SENATOR SARBANES. Yes. It just struck me that that is a very grave estimate of what the international situation is.

MR. SINAI. I think it's more difficult than most people think, in my opinion. You know, the unification of Germany was unique, and that is the source of German difficulties, which also are problems for Europe.

Now, the inflationary and recessionary shock to Germany, because the German economy is declining in gross domestic product, really does reverberate all through Europe, and reaches out to the United States through our exports, because our exports to Europe and the United Kingdom are fairly sizable. And that is what I meant by a special, unique situation.

Let's take Japan. For the first time in postwar history, Japan has a very serious financial situation. It is very familiar to students of U.S. financial crises and troubles; the bursting of the bubble and the fallout on the financial institutions and the real economy, a lack of recognition by the policymakers of the problem, and then acting too little too late and ending up behind the power curve.

But it is a separate kind of thing that is going on in Japan. And what is going on in Germany is a separate kind of thing, which is unique to Germany. Our own stagnation, which is more structural, I believe, than cyclical, reflects a slowdown in our potential rate of growth and a cyclical downturn, both together. It is also very unique to our business cycle episodes, and there is no easy way out, you see. It's not as if we can just lower interest rates around the world and solve all the problems, when each one has its special origin.

That is the reason why I think we have a higher degree of risk and danger to the world economies, and a possibility of continuing to be disappointed in terms of what we would like to see happen on economic performance. Previously, you were stressing jobs and jobs flow right from that. There is more going on in the jobs market this time than just the overall economy effect, in terms of a whole new way of thinking about managing businesses. But, yes, I regard it as a very serious problem for the world economies, absolutely.

SENATOR SARBANES. Well, thank you for that elaboration.

MR. SINAI. Thank you for stopping me there. I did speed up because I don't want to take too much time. I should simply report to you what we are forecasting and why, quickly, for 1993: 2.6 percent growth, fourth quarter to fourth quarter; inflation low, which is a byproduct and a positive one for the long run; and the unemployment rate, though, still as high as 7 percent in the fourth quarter of 1993. Of course, that depends on labor-force growth. If the labor force continues to decline every month, you will have a lower unemployment rate even with poor job creation. But on economic growth of 2.5 percent, it's hard to expect much improvement in the unemployment rate over the next year.

Expectations on growth for the European Economic Community reflect the comments that I made. Very slow for the EC, at one point 3 percent. And for the OECD, a little under 2 percent. And we are assuming, in these forecasts, some help from a new Administration, a modest amount of fiscal stimulus. The fiscal policy assumptions we make is that we do get ultimately some additional fiscal stimulus on the order of $30 billion in the first year and maybe $20 billion in fiscal year 1994, to try and lift the U.S. economy up. These are working assumptions for forecast purposes. We cannot know if this is the way it will work out, but we do assume that any stimulus follows the profile of the Clinton plan, "Putting People First," with spending on infrastructure, some investment tax credits retroactive to January 1, and a small, modest tax cut for middle-income families, and then some financing in the way that Clinton promised in the campaign, including higher taxes on high-income families, higher corporate taxes, and some attempt to save money on the operations of the Government. But that doesn't produce a lot of growth for us. That 2.6 percent estimate probably, with that fiscal plan, we're getting three-tenths, maybe five-tenths of a percentage point of extra growth.

We also assume that Germany reduces interest rates in 1993, but slowly. And in the kind of picture of the economic world we have, including that $30 billion dose of fiscal help, the unified federal budget deficit that we are estimating for next year would be $381 billion. We did save a lot of funds in the budget this year because of very little spending on the RTC, and that will come back into the budget next year.

The problem or the question of what to do about an economy that is stagnating the way it is, in a, I think, unique way for our business cycle history, the answer to that question, I have always believed, depends on the diagnosis of why things are the way they are. I would suggest that you take a look at the chart in my testimony, which highlights, I believe, what is so different about this episode. It is a combination of declining long-run potential economic growth and a cyclical downturn.

The chart shows, on the dotted line, what potential GDP would have been if the potential 1961 to 1973 rate of growth had been sustained at about 3.2 percent.

SENATOR SARBANES. Are you talking about this chart [indicating]?

MR. SINAI. Exactly, yes. The top dashed line.

SENATOR SARBANES. And this is what it would have been?

MR. SINAI. It would have been.

SENATOR SARBANES. On historical projections.

MR. SINAI. Three percent plus. The curved solid line, the black line, which begins to slow down in the rate of increase around 1973, is what the potential rate of growth has been doing since that time. In the table in the chart framework, you see the decade averages, as we estimated, for potential growth in GDP: In the decade of the 1960s, 3.4 percent; in the decade of the 1970s, 3.2; in the decade of the 1980s, 2.3 percent. And our estimate for the next five years, just 2 percent.

So that tilting down of our long-run potential rate of growth is a reflection of those numbers in the column under "potential." That's as good as we could do if we were fully employed, is what that solid black line shows.

SENATOR SARBANES. This line here?

MR. SINAI. The thin black line.

SENATOR SARBANES. Yes. And how much does this gap represent in output?

MR. SINAI. The gap right now is running about $80 billion in terms of the actual thicker black line, which represents the actual gross domestic product that we are doing, and you see that up until the line, which is the line that is the forecast horizon, we have had a long period of a gap with a rather subpar rate of growth of potential.

SENATOR SARBANES. Right. And how much is the gap between this growth in GDP at the revised level, compared with what it would have been if we could have sustained the old growth path?

MR. SINAI. Well, that figure is probably $300 billion to $400 billion.

SENATOR SARBANES. $300 billion to $400 billion.

MR. SINAI. Yes. I could check that, but it's easily that.

And so I think the message of this chart, to me, is that we have a long-run and a short-run problem combined, for a whole host of reasons at this time, and looking back at prior periods, it is really very, very different this time. And I think we don't have time to go into all of the reasons why except to point to the problem and, I think, what it implies for policy. What it implies for policy is that if we were to apply the usual cyclical remedies or medicine to get us out of a short-run problem in growth in our economy, that isn't enough.

We could get, through aggressive monetary and fiscal policies, back to the new potential line, but the rate of growth at which that would happen might be 3 percent or so. And after a time at that rate, we would develop inflation, and the Federal Reserve would not then tolerate that kind of growth with that kind of inflation, they would tighten, and we would be back down to 2 percent again. We are kind of doomed to a life of relative stagnation, if we use only the old-time medicine.

So, this time, policies have to take account of the fact that our long-run potential is so much worse and be designed to do double-duty, to help short-run growth and jobs, and at the same time, if it's possible to devise such policies, to lift our long-run potential back toward where we used to be, could have been, can be, if we can figure out how to do it. And that, I think, is really the challenge of the 1990s and the challenge for the new Administration, the Congress, and for everyone who thinks about these kinds of problems. When we solve that or make progress in doing that, then I think we would be able to have an economy and a society that might be moving toward health again.

But until then, in terms of growth and jobs and the potential for the standard of living for all of our people, we, I believe, will, on average, be in an underperforming mode. I think that from my point of view, I am very encouraged to see the thrust of discussions on macroeconomic policy. I think we are headed down the road to figuring this out. But step one is recognizing that we have been sick in our economy and see why, and then begin to figure out how to deal with it.

[The prepared statement of Mr. Sinai starts on p.45 of the Submissions for the record:]

SENATOR SARBANES. Thank you very much. Mr. Rahn, please proceed.

STATEMENT OF RICHARD W. RAHN, PRESIDENT, NOVECON

MR. RAHN. Thank you, Mr. Chairman. It's a pleasure to be here with you again today.

In each of my appearances before this Committee over the last four years, I have warned that unless the Congress and the Administration took immediate action to reduce the growth in Government spending, reduce excessive regulation, and reduce tax impediments to productive capital formation, we would have a stagnant economy. Congress and the Administration have not acted. And my predictions have, unfortunately, proven all too accurate.

As you may recall, during the period from 1982 through 1989, I consistently predicted a high-growth economy. At the beginning of this decade, my forecasts became increasingly pessimistic until early 1990 when I forecasted the recession. I also argued that the strong economic recovery predicted by many was unlikely. Despite the recent encouraging economic news, I still remain pessimistic. I expect we will have a couple of reasonably robust quarters of economic growth, but then we are likely to slip back to the meager economic crawl that we have experienced over the past year. The reason, quite simply, is the causes of our economic stagnation have not been addressed.

In order to understand what has happened to us, reflect on the economic performance of the past 30 years. We have had two high-growth periods during this time. The first was 1962 through 1966, and the second was 1983 through 1989. We suffered low growth with high inflation from 1967 through 1982, and we have experienced very low growth with low inflation from 1990 through the third quarter of this year

Both high-growth periods were characterized by economic policies that included cutting marginal income tax rates, keeping Government spending below the growth in nominal GDP, and restraining regulatory growth. In both cases, only when we succumbed to higher levels of Government spending and rapid growth in regulations did the economy leave the high-growth path.

This data comes as no surprise to any good classical economist who is familiar with the recent studies of comparative performance from around the globe which show the same relationship. In fact, the evidence shows that economic growth is maximized when total Government spending is between 15 and 25 percent of GDP, a point well below where the United States is today.

Only the discredited Keynesians and socialists are still surprised when things get worse as Government gets bigger. Under their models, the last three years should have been a boom period with falling unemployment rates, and the Eastern European economies should now be the healthiest in the world. Although few knowledgeable people will any longer claim to be Keynesians or socialists, much of their economic nonsense still permeates political discourse in this country.

One example is that Government spending creates jobs. The claim is based upon the myth that dollars are spontaneously generated in Washington, or that public-sector jobs are vastly more efficient than private-sector ones. One need only to realize that Government cannot spend money without either taxing or borrowing an equivalent amount from the private sector, and the extraction costs of taxation or borrowing are very high, to understand the silliness of the claim that Government can create jobs.

Our economic stagnation of the last three years cannot be blamed on any external cause. There have been no commodity price shocks, and the Gulf War had only a minimal economic impact. In fact, with the collapse of communism, we had an unprecedented opportunity to rectify many of our persistent economic imbalances. If the Bush Administration and Congress had enacted the flexible freeze promised in the 1980 campaign, we probably would have achieved a balanced budget by next year in a rather painless way because of the unique opportunity to reduce defense spending.

If Congress is serious about restoring economic growth, it won't take much to accomplish. First, reduce the growth in Government spending to less than the growth in nominal GNP. Government can still grow, even at a rate that is a bit higher than the rate of inflation. You did it in the 1960s and again in the late 1980s, and both times things were better, not worse. Second, reduce the growth rate of new regulations by applying honest cost-benefit analysis to any new regulation, and remove the regulatory impediments that have been built up over the years. Regulatory reduction not only stimulates the economy, but also has the side benefit of increasing human freedom. Third, make a few changes in the tax law to get rid of the obviously destructive and nonproductive features. You should begin with capital gains. Most good economists believe the present rate is well above the revenue-maximizing rate, and all good economists are opposed to taxing the purely inflationary component of capital gains. The majority of both Houses of Congress have gone on record as supporting the indexing of capital gains, as have President Bush and President-elect Clinton. Yet, the taxation of inflation continues.

We will be able to quickly determine if the new Congress is any more responsible than the last when it comes to economic issues. Most Members of Congress claimed in their election campaigns that they wanted to increase the savings rate in productive investment. Again, it's not that difficult to do.

In addition to capital gains relief and improved depreciation allowances, we should eliminate the double taxation of dividends and enact laws to greatly expand IRAs for all Americans. Now, some among you will say that these are nice things to do, but we can't afford the deficit. Some of you say these things because you get lousy numbers from the Congressional Budget Office, the Treasury, or the Office of Management and Budget.

If you want to begin to have good economic policy, you should begin to demand honest numbers. And for the most part, you are not going to get them from Government agencies. Merely look at the projections of the great benefits we were going to get from the infamous 1990 budget deal, according to OMB and CBO or the revenue projections stemming from the various capital gains tax rate changes. These numbers were off by hundreds of percent.

If a private financial firm or a CPA had given such projections to stockholders or the public, you would be screaming for indictments. Why no calls for the indictment of Dick Darman of OMB or Bob Reischauer of CBO? Were not their misstatements far more damaging to the American people than those made by any S&L executive?

Many of you knew at the time that the numbers were phony because many of us told you, or you already knew they were using static rather than dynamic analysis. There were a number of responsible forecast groups which were close to the mark, such as IRET and Fiscal Associates, and many others. The lessons should be clear. Use private-sector forecasters, whose reputation rests on accuracy, rather than those in the public sector who use forecasts to acquire power or curry favor.

Many of you are concerned about the lack of new businesses and the resulting lack of new jobs. I can tell you from personal experience that the

Government has erected enormous barriers to getting the new enterprise under way. This year we set up the Novecon companies to form productive partnerships between U.S. businesses and the newly privatized businesses in the former communist countries of Eastern Europe. We are both trying to aid the economic transition of these countries and, most importantly, to provide a good rate of return for our stockholders.

To raise capital for the Novecon companies, I had to demonstrate to the potential investors that they would earn money on their investment after discounting for normal business and political risks in the relevant countries. But in addition, I have to compensate them for the fact that they will be paying one of the world's highest capital gains tax not only in real earnings but also that due to inflation.

I also have to provide an additional risk premium to offset the fact that if we should happen to fail, they will only be able to write the loss off at a rate of $3,000 per year. Again, if a private party offered such a "heads I win, tails you lose" deal, as the IRS offers, many of you would demand they be carted off to jail for fraud. And you would be right. What kind of rate of return do you think is required to offset all these risks?

We have had to spend tens of thousands of dollars on legal fees to make sure we comply with all the regulations of the FCC and the states, even though we are only soliciting "accredited investors"—these are wealthy and experienced people—for private placement. For the most part, these regulations only benefit the lawyers and tax authorities and deny smaller investors the opportunity to benefit from many of the most desirable ventures.

In addition, I challenge any of you to set up an accounting and payroll system that meets all the requirements of the Government authorities without using a costly CPA.

In sum, Government taxation regulations have made it extraordinarily difficult for most people who do not have considerable wealth to go start a new business and comply with all the laws and regulations. In fact, I would estimate 60 percent of my legal costs would be totally unnecessary if it wasn't for ridiculous regulations, and 50 percent of our accounting costs.

Congress, in its desire to tax, protect and control, has become the mass strangler of economic growth. As a former economic spokesman for the American business community and now as an entrepreneur, I say to you, if you really want the American economy to begin to grow rapidly, listen to your colleague, the distinguished economist and congressman, Dick Armey, and get your invisible foot of excessive spending and taxing, and regulation off our necks so that we can breathe again.

Finally, as important for the sake of America that President-elect Clinton succeed, we know from experience that economic prosperity comes only from restraining spending and regulatory growth and reducing tax impediments. In fact, when Government spending was falling as a percentage of gross domestic product in the two years before the presidential election, the party in power was reelected to office. Those cases in which Government was growing as a percentage of GDP, the party in power was thrown out. Reducing Government spending more than any other single variable, such as interest rates or deficit reduction, is the key to the Nation's economic health. Thus, its relationship to political success should be of no surprise. It is up to the Democratic Congress whether or not President-elect Clinton will be reelected in 1996. Government spending is a controllable variable, one controlled by the Congress.

I will restate it immodestly as Rahn's law: If Government spending is growing as a percentage of GDP during the last two years of an Administration, the party in power will lose office. Conversely, if Government spending is declining as a percentage of GDP, the party in power will remain in office. I am confident in my prediction that if Government spending falls as a percentage of GDP in 1995 and 1996, the Democrats will be reelected. If not, they won't. You indeed are masters of your and the Nation's destiny.

I thank you.

[The prepared statement of Mr. Rahn, together with attachments, starts on p. 59 of the Submissions for the Record:]

SENATOR SARBANES. SENATOR SARBANES. Thank you very much.

Let me just ask you one quick question. Then I want to go to Mr. Greenberg to return to his presentation.

Your law, which you say you immodestly put forward, the ratio is a relationship between how much the Government is spending and what the GDP is, right?

MR. RAHN. Right.

SENATOR SARBANES. It is a percentage of GDP.

MR. RAHN. Right.

SENATOR SARBANES. So the Government spending could be constant, or in fact even increasing, but if the GDP is increasing at a faster rate, the percentage figure would go down. Is that correct?

MR. RAHN. That's true. And we saw that in the 1960s and again in the 1980s.

SENATOR SARBANES. Well, in which case you had actually an increase in Government spending, but the GDP grew at a faster rate, and therefore the percentage of GDP with which Government spending represented declined.

MR. RAHN. That's correct.

SENATOR SARBANES. Now, Mr. Greenberg, I wanted to ask you, on your survey, the 25 percent figure represents those who plan further cuts, as I understand it?

MR. GREENBERG. Yes.

SENATOR SARBANES. And then you made the point that this is what they tell you at the beginning of a period, and that figure doubles.

MR. GREENBERG. Sometimes triples.

SENATOR SARBANES. Yes.

MR. GREENBERG. Over the course of the year, only the largest companies, Senator, tend to make their plans up to a year in advance.

SENATOR SARBANES. Okay. Now, is the 25 percent figure itself in this year's survey at the beginning of the period higher than it has been in past surveys?

MR. GREENBERG. It's the highest we have ever seen, Senator. The previous period, the future index, if I can call it that, was 22 percent, and that was the first time it had been over 20 percent. This year it's up to 25 percent.

SENATOR SARBANES. So, in other words, you are warning us, first of all, that the figure will grow, it always grows through the period, and that the starting figure that you are confronting this time is higher than it has been at any time?

MR. GREENBERG. In any of the previous five surveys that we've done.

SENATOR SARBANES. Now, do you have any sense of whether these people will be called back with this downsizing if economic conditions improve?

MR. GREENBERG. Again, Senator, it very much depends.

SENATOR SARBANES. Let me just add before you answer, I do not know whether you were here earlier when we had the BLS people.

MR. GREENBERG. I was here.

SENATOR SARBANES. They made the point that in previous recessions, roughly half of the people laid off could expect to be called back if economic conditions improve. In this recession, at least according to the figures that they gave us this morning, only 10 percent of the people laid off can expect to be called back if economic conditions improve. Now, that is a dramatic change.

MR. GREENBERG. Yes, sir.

SENATOR SARBANES. I wondered what your survey shows.

MR. GREENBERG. Senator, all of the numbers that we collect, which pertain to downsizings past or future, are affected greatly by the reasons that companies downsize. When the cuts are recessionary in nature, driven in whole or in part by an anticipated or actual business downturn, then those jobs are likely to come back when economy recovers. But if they are driven, as nearly half of these projected cuts are, by these structural or strategic rationales—mergers and acquisitions that create redundancies within the organizations, automation or other new technological processes, movement of jobs to other locations, and improved staff utilization, trying to do more with fewer people—those jobs are not coming back, Senator.

SENATOR SARBANES. Now, the group you survey are the larger employers?

MR. GREENBERG. Again, although virtually all the Fortune 1000 companies are members of the American Management Association, our model member is a company in the Midwest, a manufacturer who employs around 500 people. That is the single largest bloc.

SENATOR SARBANES. Now, do you have any fix on whether downsizing is as prevalent among firms that are not within your management beat?

MR. GREENBERG. We do have a small presence of these smaller companies in our survey, Senator, and what we see among those very small companies is that year after year they are less likely to downsize than larger ones, but when they do downsize, they take a much deeper cut of the work force when they actually bite the bullet. When they bite the bullet, they bite it harder.

SENATOR SARBANES. Well, interestingly, that leads to the next question that I wanted to ask you. When firms downsize, what percent of their work force do they usually cut?

MR. GREENBERG. We have seen an ongoing slight diminution of the percentage of the work force cut over the course of the last three years, from over 10 percent to 9.6 percent, most recently to 9.3 percent. Among the reasons for that is that companies are often embarking on a second or third or fourth round of downsizing, and sooner or later you get down to, or you approach, an irreducible minimum where the number or the percentage of the work force that you are cutting simply gets smaller because the opportunities to cut are small.

You're getting down to, as I said, that irreducible minimum number of core employees whom you absolutely need to turn on the lights in the morning and turn them off at night. And when you start rehiring, Senator, you are very likely to do so on a closed-ended basis; that is, on the contract basis, a consultant basis, a project basis. So when you rehire, you are very loath to rehire on a permanent payroll basis. And, thus, by hiring on this closed-ended basis, you save yourself the costs of medical coverage, you save yourself the costs of pension contributions.

SENATOR SARBANES. Yes. Of course, the employee then is left without those benefits.

MR. GREENBERG. Exactly.

SENATOR SARBANES. Yes. I think in your testimony, as I recall it, you said that companies that downsize, a very large percentage of them downsize again and again, subsequently.

MR. GREENBERG. On average, 63 percent that downsize in a given year downsize again the following year. Now, part of this, Senator, is that they will announce the cut in a year, and proceed with half of the downsizing in that calendar year.

SENATOR SARBANES. I see.

MR. GREENBERG. And the rest of it in the next calendar year. Many of the companies that you have talked about earlier that have announced work force reductions are not going to get rid of all of those jobs this month; they are going to phase these jobs out. So that is a reason. But we do see year after year that the best indication of future downsizing is past downsizing. Companies that have done it tend to do it again and again.

SENATOR SARBANES. Is there any sort of magic thread that seems to characterize companies that are not downsizing?

MR. GREENBERG. They're smaller. They're startup. They are in the service sector. And I think that just about encompasses what characterization we can make of them.

SENATOR SARBANES. I take it, in the manufacturing sector, it is pretty grim, what is taking place. Is that correct?

MR. GREENBERG. Yes, indeed. And in the manufacturing sector, because there are more on the payroll, a larger segment of those that get fired are hourly workers.

SENATOR SARBANES. Could I ask you, do you have any basis on which to compare the downsizing issue in this country as compared with other countries?

MR. GREENBERG. Unfortunately, no, Senator. Though we do have an office, Management Center, Europe, in Brussels, and we do have a survey operation there, and we will have such comparative data available in the future.

SENATOR SARBANES. Well, that will be very helpful on what is taking place over there.

MR. GREENBERG. Exactly. Of course, there are real, or de facto, or de jure lifetime employment situations in Europe and in Japan which simply do not apply to the American economy.

SENATOR SARBANES. Now, as I understood it, you said that a lot of the downsizing followed after mergers and acquisitions?

MR. GREENBERG. About 10 percent, generally, of the reported downsizings are ascribed, in whole or in part, to mergers and acquisitions, which of course create redundancies within the organization, and these kinds of work force reductions are especially hard on middle-management ranks.

SENATOR SARBANES. There has been some perception that the downsizing that follows mergers and acquisitions does not only, or perhaps even primarily, reflect the elimination of duplication and so forth, which the merger/ acquisition makes possible, but that the financial arrangements on the basis of which the merger or acquisition was done places then an enormous financial pressure on the remaining entity, and that the downsizing is taking place not as an economic decision relating to cost and effectiveness and production, but, in a sense, a financial or economic decision of a financial dimension driven by, for instance, the assumption of large debt in order to accomplish the merger and things of that sort.

MR. GREENBERG. Well, it is certainly true that long-term debt is part and parcel of mergers and acquisitions as they have played out through the 1980s. And it is true that when one is looking to cut costs, payroll is the first place that companies look. And I think that that is really getting to the heart of the problem, Senator.

Payroll savings do offer an immediate boost to the bottom line in this quarter. But the mid-term and long-term effects of downsizing are, as I said earlier, less happy. Downsizing should be seen as an opportunity of last resort rather than first resort, to cut costs and to improve the company's performance over the mid and long run.

I was surprised this year, Senator—and for the first time, we did ask these questions about does it work—when we found that only 43 percent of the companies that have downsized over the last five years report increased profits after the downsizing.

I was especially surprised to see that almost as many said that worker productivity decreased as said that worker productivity increased.

In the aggregate, not company by company, Senator, what American companies have been doing with this ongoing downsizing has been firing their customers. Lee Iacocca said fairly recently that when he fired 6,000 people, that's 6,000 people who can't buy Chryslers. And the aggregate effect on purchasing power of all this downsizing is, I think, a major factor in why there has been no consumer-driven recovery that people have been looking for in the past two years.

And, again, Senator, just to add one more point, when you are firing a whole lot of middle managers, that's where you are really hurting the purchasing power. A $20,000 worker who goes on unemployment insurance isn't going to have his or her total discretionary income cut by all that much. But someone at $80,000 a year who loses a job is going to have discretionary income cut enormously. And the mid-term effect is that there is no consumer-driven recovery.

SENATOR SARBANES. Yes. Of course, in this recession—I would make the observation because it is an issue I have been very much working on—the coverage provided by the unemployment insurance program has been percentage-wise much less than in previous recessions, both in terms of the people covered and the percentage of their wages covered. And, of course, we had a major fight with the President over extending the benefits.

Mr. Sinai, you, I think, being sensitive to time considerations, moved over the last part of your statement very quickly, and I really want to invite you to put some of it, at least, on the record for us, and then we can deal with it. The part where you are talking about future policies and how we want to address things. If you could just lay out some of those things, I think it would be helpful.

MR. SINAI. To get the economy to do better, it seems to me, requires an increased emphasis on generating more growth in jobs near-term than we have had in the last three or four years, where essentially the "Government" has had a hands-off attitude, hoping that the economy would come back on its own or that the federal Reserve easing of monetary policy would do it. And I think that didn't work because we have a lot of things going on that are unusual but they are permanent: The switch out of defense into nondefense, which takes a lot of purchasing power out of the economy, debt and debt service problems, etc. And so we're going to have to face up to a more active approach to dealing with this stagnation that exists.

Now, the old-time way was monetary easing and fiscal stimulus, both, and that combination has been used in every recession and post-recession period except for, I think, the second term of the Eisenhower Administration.

I think our hands have been tied this time because we have a very big deficit, and I would encourage people to look at the structural budget deficit, not the overall deficit, which is higher because of the shortfall from the weak economy.

SENATOR SARBANES. Let me say on that point, I want to be clear in understanding that. I take it that you are making the point that a weak economy in and of itself will contribute to an increase in the deficit.

MR. SINAI. Correct.

SENATOR SARBANES. So efforts to reduce the deficit, if they in fact weaken the economy and cause job loss, may in fact be counterproductive and result in increasing the deficit. Would that be correct?

MR. SINAI. Yes. Or certainly not the kind of improvement in the deficit in which the measures initially taken to reduce the deficit might lead one to think. I think you get a partial offset to deficit reduction from, say, higher taxes and lower Government spending in terms of the lost economic growth, lost tax receipts, lost jobs. And an unknown side effect when you run that kind of economy, because it's hard to tell what the byproducts are in running a weak economy in the name of getting the overall full budget deficit down, like bankruptcies, failures, financial distress, international repercussions.

SENATOR SARBANES. And social tensions in the country.

MR. SINAI. Social tension, yes. It's very difficult policywise to distinguish between the structural or full-employment budget deficit and the budget deficit. And I would encourage this Committee and all of the committees to start to make that distinction, because in trying to reduce the budget deficit, which we have to do ultimately so that we do not keep accumulating debt and debt service, if we balance a budget that has a shortfall of tax receipts as a significant reason for the big budget deficit, if we try to do that, it really is counterproductive. The part of the budget deficit that we have to balance is the deficit that would exist at full employment, the structural budget deficit.

And there are some calculations in the testimony on that. That is running on the order of $200 billion of next year's $380 billion deficit estimate. That is the task to be done. It's not $380 billion or $300 billion, it's more like $200 billion. It's still a big number, but it's not as big as $300 billion. That is one point.

The second point is the choice between growth and deficits. And I would say at this point the choice has to be toward picking up growth, except we can't do it the old way with the same kind of fiscal instruments. This time fiscal instruments that are selected have to do double duty or be efficient—kill two birds with one stone is another way of looking at it. And maybe it's easier for me to illustrate with examples.

SENATOR SARBANES. Investment tax credits.

MR. SINAI. Yes. Investment tax credits. It's pretty well documented in the short and intermediate, more the intermediate term, years two and three, will create some extra spending and some jobs in capital goods industries, and some capital for workers to work with, that should help productivity in the long run in potential output.

An example of a fiscal instrument that would not do double duty would be pure tax cuts for consumers. They do have an incentive effect in terms of our potential work output and work effort. But I think it's very small empirically, at least in our estimates, compared with the consumption effect, which is just outright spending of the money and not a creation of a lot of capital.

Another example would be infrastructure, which is more contemporary. There is a lot of recent research which suggests—including some we do—that nondefense infrastructure building and repair, which has been going down as a percentage of GDP over recent years, will create jobs and income and some growth short run— that's the old pump-priming effect—but will also in the modern economy improve our long-run potential or productivity possibilities.

SENATOR SARBANES. By providing the public infrastructure which the private sector needs to use; for instance, in transportation?

MR. SINAI. Yes. Or the case of someone like me, who travels a lot, it's amazing that I get anything done, trying to get to an airport, get out of an airport, congestion on the runways, driving our roads and highways. Compared to other countries, the infrastructure here is very inferior.

Now, the research is showing empirically that people are getting increased potential output and productivity growth when they study this. But this is a new experiment. I do not think we know for sure. That's what the research is showing.

But I think infrastructure building and repair, which is part of the new Administration's program, is one of those items that might do double duty.

Inflation indexing for capital gains is, I think, another one. Besides removing a distortion, our work has said that there is some help to the economy from capital gains tax reduction. It also can be a very cheap thing, depending on the unlocking effect.

I am just picking a number of items. Pure pump priming, the kind of thing we did in the 1930s, pure Government spending for the sake of Government spending, just to put people to work in the parks, basically would not be efficient stimulative and do double duty.

So, I think, if we accept that we have both a long-run and a short-run problem, which I now believe is getting to be mainstream thinking, then that drives the choice of anything we might do fiscally to help the economy.

SENATOR SARBANES. Now, what about the worry that the federal Reserve might just pull the rug out from under all of this? I do not understand. I mean, I have been critical of the Fed over this period because I do not think they eased the monetary policy enough soon enough; I mean, both the amount and the time period, and we are always lagging behind.

In fact, we did a study that showed, compared with previous recessions, the contribution they made was the worst.

MR. SINAI. I could believe that. I am in 100 percent agreement with you. Since we had fiscal restraint, they should have done more.

SENATOR SARBANES. Now, about this idea that we should start doing some of the things you are talking about; I mean, we have a low inflation, it's not as though we're currently confronted with an inflationary problem. That does not mean we may not have one. We have to be on the alert for it. But what about the danger that the Fed will simply move in the other direction and negate much of what you are trying to do?

Mr. Rahn, I would like you to address that point, too.

MR. SINAI. Well, I think, first of all, that a dose of fiscal stimulus is fairly small for an economy of this size. We will not bust the deficit nor will we push economic growth so high as to re-ignite inflation right away. So figures like $30 billion to $50 billion of net fiscal stimulus are about one half, or less normally than is done in terms of fiscal stimulus.

Second, the Federal Reserve, in an economy that has underperformed as it has now for 3½ years, in an economy where the unemployment rate is above what everyone would like—maybe 5.5 percent is a full employment unemployment figure—in an economy where inflation is running 2.5 to 3.0 percent, the classic reaction of the central bank to some fiscal stimulus is to accommodate it, to hold short-term interest rates constant as that fiscal stimulus works into the economy. I would be amazed if our central bank wouldn't accommodate, given the state of the economy.

SENATOR SARBANES. You would be amazed if they what?

MR. SINAI. I would be amazed if they would not.

SENATOR SARBANES. Would not?

MR. SINAI. No. Yes, because it would be a horrible policy mistake. In 1988, when inflation was accelerating and the economy was essentially at full employment, fiscal stimulus at that time, policywise, had to be met by monetary restraint. But now we have a totally different picture, not just here in the United States, but in Europe and Asia Pacific. It would be unthinkable for a central bank to raise interest rates in the face of a modest dose of fiscal stimulus in the current situation. I do not think they would do it.

There is a question about long-term interest rates and expectations in bond markets through some extra deficit injection into the economy, and that brings about another part to a dose of fiscal stimulus that might be applied; which is, it would have to be accompanied by, perhaps, legislation that would write into the books the actions that would be taken when the economy returned to a more healthy position, so markets understood that there was a commitment once the economy was up and running, to start fiscal restraint going that would get the structural budget deficit back toward balance.

SENATOR SARBANES. Is there anything working in the markets that make it advantageous to people to have the economy functioning at the level it is functioning at? I am just curious, are there elements in the market that really can benefit out of this situation instead of out of a high-growth situation?

MR. SINAI. No, I really do not think so. Markets react different ways. Interest rates, of course, tend to be lower if the economy does poorly. If we ran our economy to satisfy the fixed-income market and to make the fixed-income market participants the most money, we would run our economy into a depression. Then they would make a lot of money.

If we ran our economy to make the most money for people in the equity market, depends on the short run or long run, we would probably try to run a balanced economy growth-wise and have low inflation. And I think the equity market can do well over time if we run at 2 to 3 percent growth, with low inflation and low interest rates.

But I do not think so. I think the markets are not telling us what we should do, they will tell us when we make mistakes, but they are not telling us what we should do. They're just reacting to what is done and what's going on.

It's interesting, so often Washington, when looking at policy, will look at the markets and say, what will the markets say and do? And my answer is generally: Do what it is right to do and then let the markets react. Watch what the markets do, they will signal you sometimes when you've made an egregious mistake.

But I think it's a mistake to make policy based on what the stock market will do, or what the bond market will do, or, frankly, what Wall Street will do. Wall Street is a smaller community than Main Street. Main Street is where the jobs are, and really that's what a healthy economy depends on most.

SENATOR SARBANES. Right.

Mr. Rahn, what is your view on this Federal Reserve question?

MR. RAHN. I largely agree with Allen on it. If you look back at the last four years, you see that Chairman Greenspan has consistently overestimated both the dangers of inflation and the likelihood of economic growth. And that's one reason I think the Fed was tighter than they should have been or had less monetary growth.

You will also notice that they did not hit their own targets and they have tended to be below target, particularly with M2. And that gets into the changes I think we have made in terms of bank regulation, that bankers feel they are in a position where they will be severely punished or criticized for making high-risk loans, so they have tended to move toward just buying T-bills, and you've had less bank credit expansion than you normally would have had, other things being equal.

But part of the fundamental monetary problem, I believe, is a misunderstanding about the sources of the little bit of inflation that we've had. And many of the Fed members believed their job was to bring us zero inflation. Now, what happens if the Congress and the Administration pass laws which increase taxes or regulatory costs on business? Let's take something like automobiles. If an automobile firm is faced with additional costs for the Clean Air Act or employment costs, medical care costs, which are mandated by Government, the automobile manufacturer cannot reduce the cost of his automobile, or even hold it constant. He has to increase the price just to deliver the same product because he has mandated costs that are driving it up.

Now, if the Fed says we need zero inflation, and yet the price of automobiles is driven up because of Government mandates, that means the prices of other assets have to fall. And it will usually be assets that have already been produced; specifically, real estate. That's why you had the depression in the real estate market at the same time that new manufactured items were rising slightly in the cost level. That's one of the reasons we have had the continuing economic problems.

SENATOR SARBANES. I note that Chairman Greenspan of the federal Reserve was in Japan in mid-October, and at a news conference, the article said, he repeatedly emphasized, and I quote:

> One of the most troubling aspects of these difficult times is that the tried and true methods of economic analysis and the old monetary tools just do not seem to be working. No models explain the types of patterns we are having. This is really a quite extraordinarily difficult type of environment.

That may be the case. But I am struck by the fact that they didn't move their monetary policy. I mean, both of you, and there have been many other critics at the time, were saying to them to do more and do it quicker. And they sent such strong messages on the fiscal side that they helped immobilize fiscal policy. Now, of course, it is, in part, immobilized because we have gotten ourselves into this box, which you have addressed in your deficit question.

Mr. Rahn, I want to add, you have been here many times and we have had some interesting exchanges, and I want to put one question to you. You talked about Government spending creates jobs is a myth or that public-sector jobs are vastly more efficient than private sector ones. And just from my own thinking, when the Government issues a contract to build a highway or an air traffic control system to a private company, a highway paving company, wherever, or an air traffic control system to the Westinghouse Corporation, are those jobs that result on the basis of this contract, is that, by your analysis, a public-sector job or a private-sector job?

MR. RAHN. Well, if the Government is paying for it, you have the public expenditure. If you bear with me just a minute, let me explain the problem. Let's assume, to build a new airport runway—since both Allen and I travel a lot, we're both desperately aware of the inadequacy of our Nation's air infrastructure—clearly, we need more infrastructure. But if you have the Government taxing, there is a certain extraction cost, just the cost of collection, which I think runs around seven or eight cents for each dollar. And I have seen estimates of extraction costs of $1.57 or so for I know that Mr. Niskanen had done it when he was over at the Council of Economic Advisers.

But, in theory, you are absolutely right, the infrastructure jobs paid for, even indirectly, by the Government should add to national output. And I'll go back to when I was a professor, I used to argue this. Allen is probably more familiar with more recent empirical evidence than I am. But in the late 1970s, we looked at this question very carefully. We looked at three different types of Government expenditures: transfer payments, purchases of goods and services, and so-called infrastructure. Transfer payments clearly were a net negative on GNP, because the people who are the beneficiaries of Government transfer payments—for instance, social security recipients—in many cases, they could not get the benefits of the transfer payment unless they promised not to engage in productive labor. And you did have the normal disincentives on the taxpayers and the extraction costs in the private sector. That was unambiguous.

The purchases of goods and services, the Government is not as efficient as the private sector, again getting back to both the inefficient processes typically in Government managing and also the extraction costs.

Now, with infrastructure, if a private power company goes ahead and erects a dam and it's used for power generation, flood control, irrigation, we know that if the analysis has been done right, it should add to GNP over the same time. If the Army Corps of Engineers does the same thing, indeed it should add to GNP over the same time.

I remember how we were struck by the empirical evidence back in the late 1970s when we were looking at this, even though in theory this should have been of great benefits, we found that many of the projects had been so ill-conceived and the Army Corps of Engineers was doing things they ought not to—and you have heard plenty of this over time—that these things ended up not being additions to GNP—again, these studies come from 1978-79, if I recall correctly—at that time, it was about a wash of whether infrastructure spending was a gain or a loss.

Now, clearly, if you are going to maintain Government spending at current levels, to the extent you switch out of transfer payments and goods and services into infrastructure, that would be a net gain for the economy. Whether in itself it is a net gain, I think the evidence is most ambiguous on that.

SENATOR SARBANES. Well, I am just trying to understand the terms of reference of your analysis. When the Government—let's take a defense contract —gives a defense contract to a private company, General Dynamics, Pratt & Whitney, whoever it is, and then the private company engages in the production of that item, are those jobs, by your analysis, would you call those public-sector jobs or are they private sector jobs?

MR. RAHN. I would say publicly funded, and they would have many of the characteristics of a public-sector job because the question is: Has the Government done the proper analysis and obtained the good at the most cost-efficient way? Now, we know the defense industry seems to do a very good job in turning out weaponry, as we saw in the Gulf war, but I do not think anybody has argued that they are the paragons of cost effectiveness.

MR. SINAI. Well, I think the data would count a job created that way in the nonfarm payroll sector at somewhere other than the Government sector. How would BLS count that job? That does not necessarily——

SENATOR SARBANES. Count it as what?

MR. SINAI. It would be counted as a private-sector job.

SENATOR SARBANES. Private-sector job?

MR. SINAI. Yes. You know, if the Government hires somebody to work here at the Joint Economic Committee, that's going to show up in the Government sector. You let a contract out and the contractor hires some people, it counts under the private sector.

Now, I think there is a difference, though, in the source of public funding. Now, this is hypothesis, but I think there is a difference in the source of funding. And I do think private-sector funding of projects will result in more productive results than public-sector funding, because it's my guess that there isn't the same kind of monitoring or bottom-line discipline on the Government funding that there would be in the private funding.

Suppose the same job is created in two different sources of funding. You made the distinction that it was Government funding.

SENATOR SARBANES. Yes.

MR. SINAI. My guess would be—this would be a hypothesis to be tested, and we'd have to think about how you'd do that—the private-sector funded project will have a higher productive impact on, say, potential output than the Government one would.

MR. SINAI. You might disagree with that.

MR. RAHN. No.

SENATOR SARBANES. Take highway projects, a state or local highway authority puts out for bids on a highway project, and a half a dozen, eight or ten private companies, highway contractors, come in to bid on the job.

Now, the fact of the matter is, from what I understand—and this is anecdotal—this is a very good time to be putting out those kinds of contracts from the public's point of view, because people are really bidding low because they do not have a lot of work and they are anxious to get the work, keep their work force together and so forth. So they are getting some very good bids, but there is not the resources with which to put out the contracts.

Now, you have a competitive situation there. I do not know how else you are going to do that project that would work. I mean, I do not know what the structure is to do it differently.

MR. SINAI. Well, I think you might get a low cost in terms of competitive costs, in terms of the bid, how the bidding process goes. But I am not sure about how the project is run, the accountability of the project, the management of the project. And my hypothesis is that it would be different from the private side than it would be from the public side.

You see, on the infrastructure notion, which I raised, is a good way to lift jobs short run and pick up potential output long run, which I believe in—I believe in further research.

What I am not sure about is, say in the Clinton plan, which is $20 billion a year for Rebuild America, there is nothing in there about how it's going to be bid—I will assume it's competitively bid—how it's going to be managed, how it's going to be tracked in terms of meeting certain targets at certain times. It's the management of a project to produce bottom-line results. And the Government function in our economy is by pattern and habit; it does not do things the same way as a nonprofit institution. The private sector, to survive, has to do it that way.

So that's some of the reasoning behind this notion that the source of funding, regardless of whether it counts as a Government job or a private sector job, there is going to be a difference. If I add it all up across all the projects, I would have to believe that, maybe, one way to deal with it would be to set up a private corporation with all the market discipline and bottom-line dangers—like Richard and I are now involved in as entrepreneurs, starting our own business—produce some seed money and then let the private sector figure it out, and make their living at it. And we would probably get better result.

MR. RAHN. Mr. Chairman, I think you have an opportunity, if the new Administration is going to expand infrastructure spending, to do some testing. For instance, we have had this big debate about the Virginia toll road from Dulles Airport out to near Leesburg, which is supposed to be a private-sector project. And it would be interesting to have some comparative examples of where we encourage some things to be done almost strictly private-sector infrastructure, and try to get some notion of the comparative costs. Clearly, Government spending and building highways is one of the most beneficial or least destructive uses of public monies from a purely economic standpoint, and I do not think that any of us would argue that the Nation isn't far better off because we built the Interstate Highway System. The question is, are there ways to do it better? And I think privatizing more of that activity, at least we should try to test this out in a much greater way than we have in the past.

SENATOR SARBANES. Would you say that the European countries have a better developed infrastructure than we do?

MR. SINAI. Absolutely. Also there's a different attitude toward it. For example, in France the highways are really very, very well done. Now, I am told by some French people that there is a difference in the materials, that there is a certain pride about the roads and highways, so the materials that are used are not the same as some of the materials that are bought here.

I did see one article about our own, what is used to pave the roads. We all travel the roads, we are all kind of consumers. It mystifies me why everywhere I go and drive, the roads are nothing but potholes, because people are working all the time, and they are really a mess, still. Or in New York, it mystifies me—I have been going back and forth to New York for ten years and they still haven't finished the projects they started ten years ago, or, if they finished it three or four years ago, they had to repair it and start all over again. And I notice they are only out there, sometimes it looks like they are working half-time.

Now, that's the Government function that I am talking about. I cannot believe that if it was a private company running that activity, it would be the same because it wouldn't be in business.

MR. RAHN. It's interesting, when you ask about Europe, because you clearly have in, say, Germany a very fine highway system. And in Italy. But the Italian equivalent of our Interstate Highway System is virtually all private.

There were concessions granted and it was built by private contractors, and it is a private toll-making facility. You go to a place like England, and I think most of us would feel the U.S. highway infrastructure is far superior to what you get in Great Britain these days.

SENATOR SARBANES. I do not think the French or German system is like the Italian, though, is it?

MR. RAHN. That is all public, as far as I know.

MR. SINAI. It is public, yes.

SENATOR SARBANES. And the same thing about their mass transit and their rail system.

MR. SINAI. It's certainly true in France.

SENATOR SARBANES. They are regarded as first-rate compared to ours.

MR. RAHN. But remember, they have enormous subsidies on most of the rail systems.

SENATOR SARBANES. Well, this is another subject to be discussed at another time. But if you were to do the rails solely on a market basis, it could not carry itself. On the other hand, there are lots of benefits that we realize from an effective rail system that can't be factored in. They are a benefit that you cannot put at the farebox, although Claytor has done a very good job with Amtrak in increasing the percent of their costs paid at the farebox. It is now above 75 percent.

But the benefits you get because the rails are running, those people therefore are not off trying to use the highways or other ways to get to work, the energy efficiency that comes from it, and the environmental benefits that come from it, there is no way in which to factor it in as some sort of market cost to the actual consumer of that service. Isn't that the case?

MR. RAHN. Well, I think we could do a far better job in pricing all transportation than we do and dealing with these neighborhood effects and a lot of the other external costs. Our whole transportation infrastructure is not well balanced. But the problem is, when you start building Government systems, let's take the New York City subway system, now that is a totally socialized system, and I do not think that we would look at that as a model for anybody.

SENATOR SARBANES. What about the D.C. Metro system?

MR. RAHN. The D.C. Metro system, yes, it runs well. But look at the enormous subsidy. Is that justified or not? I think it is debatable. And if the people in the local community want to go ahead and subsidize it, that's one thing. But asking farmers in Iowa to subsidize the D.C. system, which they do, I find that difficult to build a case for.

MR. GREENBERG. Well, with all the talk about airports and highways, I would like to put in something for the No. 11 bus that goes up Amsterdam Avenue in Manhattan and see if we can get some help there, too.

SENATOR SARBANES. Thank you all very much.

The hearing is adjourned.

[Whereupon, at 12:32 p.m., the Committee adjourned, subject to the call of the Chair.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF ERIC ROLFE GREENBERG AMERICAN MANAGEMENT ASSOCIATION

The American Management Association, a not-for-profit membership organization has surveyed its corporate membership annually since 1987 on work force reductions. Our 7,000 corporate members employ a quarter of the American work force, and the current survey presents a representative sampling of that membership.

It is important to note that our findings do not mirror the American economy as whole. We focus on larger companies—by no means all Fortune 500 size, but larger firms that employ more than 100 workers—and we tilt towards the manufacturing sector.

I've supplied the committee with an executive summary of our key findings, the tabulated data, and copies of the research report we'll mail this week to our corporate members. Allow me then, in these remarks, to take a wider view and share with you three important lessons we've learned in six years of survey activity in this area.

First, downsizing is not the child of recession. It preceded the recession; it expanded due to the recession; and it continues and will continue beyond the recession.

From 1987 to 1989, about a third of our companies were reporting job cuts every year, averaging a little over ten percent of the work force. A majority of these cuts had nothing to do with current sales or market share. Nor was profit performance an immediate concern, then or later. Year after year, over 75 percent of the firms that downsize in a given year are profitable in that year.

These are structural or strategic reductions, driven by such factors as mergers and acquisitions, the transfer of work to other locations (including offshore locations), plant obsolescence, and automation or other new technological processes. Most importantly, they are attempts to increase worker productivity—to do more with fewer people.

For the past three years, a majority of reported reductions have been recession-driven; this year, 63 percent of the cuts were due in whole or in part to a business downturn. But the rest—more than a third—were structural or strategic.

Structural cuts are usually not as deep as recession-driven cuts; they eliminate fewer positions. And they particularly target the middle manager.

This is the second of the lessons our surveys have taught: the middle manager is a special target of downsizing.

It is important to remember that when companies downsize, most of the people who lose their jobs are hourly workers—because there are more hourly workers on the payroll. But in percentage terms, middle managers are being fired far out of proportion to their presence in the work force. Middle managers make up between five and eight percent of the American work force, but last year 22 percent on average of the jobs eliminated belonged to middle managers.

Why is this so? There are economic reasons: firing an $80,000 a year manager saves more than firing a $20,000 clerical worker.

There is also a technological reason. We think of automation as something that threatens blue-collar, assembly-line workers. But information technology is having a tremendous impact on middle management ranks. A middle manager's job can be roughly defined as gathering, analyzing, and disbursing information. A desktop computer working on decision-support software can do that job more quickly and (arguably) more cost-effectively than a middle manager.

One bit of survey data dramatically underlines this. Of the cuts planned by our respondents in the current period—that is, through June 1993—18 percent are ascribed, in whole or in part, to automation or other new technological processes. But of the manufacturers who plan cuts, only 13 percent list automation as a rationale, compared with 22 percent in service industries—and 31 percent in the financial services sector, where number-crunching is the core of the business.

And with the economic and technological factors, there is an organizational practice that targets the middle manager: "flattening" the company, reducing the reporting levels that intercede between the customer and senior management, improving the accuracy and speed with which information travels through the organization, and m making i it more market-responsive.

So, for reasons of economy, technology, and organizational structure, the middle manager is more and more an endangered species. Of the 280,000 jobs identified by position that our respondent firms have cut since 1989, 19 percent were held by middle managers. And when the cuts are structural or strategic, rather than recession-driven, an even larger share of the jobs eliminated are in the middle management ranks.

But does it work? Here is the third lesson from our survey: <u>the after-effects of downsizing are problematic at best</u>, and raise the questions as to whether the cure is worse than the disease.

Among the surveyed companies that have downsized once or more since 1987, fewer than half (43 percent) report that operating profits improved after the cuts were made. Twenty-four percent said that profits fell after the downsizing.

While 31 percent said that worker productivity increased after the cuts were made, nearly as many—28 percent—said that productivity declined.

Community relations tended to suffer; 27 percent reported a decline in the quality of their relations with the wider community of stakeholders.

One thing that happens for sure in the wake of a work force reduction: morale plummets. Twenty-two percent of companies reporting cuts said that employee morale declined <u>severely</u>, and an additional 52 percent said that morale declined somewhat.

In every regard, things were worse in companies that had a second or third round of cuts; profits dropped, productivity suffered, and morale disintegrated.

Downsizing will continue, come recovery or recession. Twenty-five percent of our respondents reported plans to downsize by June 1993, and this is a baseline number that will only increase as the year plays out. Typically, the share that reports downsizing at the end of the period is double, and sometimes triple, the share that reports plans to downsize at the beginning of the period.

Nearly half the cuts that will come by mid-1993 are strategic or structural, rather than recession-driven. Also, downsizing tends to be repetitive. On average, 63 percent of the companies that m make cuts in a given year repeat the exercise the following year.

Companies are trying to find that irreducible core level of permanent employees—the minimum number necessary to open the door in the morning and turn out the lights at night.

Cutting payroll costs does give an immediate boost to the bottom line, but ht long-term effects of downsizing are less happy. Departing workers take with them years of experience and corporate memory, as well as contacts with internal and external customers. Companies that cut themselves out of a line of business may find it impossible to re-enter that business when economic conditions change. The infrastructure of sales and distribution disappears with the people.

Why, then, do companies continue to downsize, despite the mixed results? Most would say that things would be worse if the cuts hadn't been made. Payroll reductions offer the most immediate and obvious savings available to companies trying to compete in a global economy.

Lord Melbourne, the 19-century British politician, put into a single phrase the entire conservative philosophy of his time and ours when he said, "If it were not absolutely necessary, it were the foolishest thing ever done." If downsizing is not absolutely necessary, if it is done without full consideration in its planning and humane practices in its execution, it may prove for many companies the foolishest thing ever done.

ATTACHMENTS TO MR. GREENBERG'S TESTIMONY

AMA NEWS
From the American Management Association

1992 AMA SURVEY ON DOWNSIZING

Summary of Key Findings

Workforce reductions dipped slightly in the twelve months ending June 1992, with 46% of surveyed companies reporting cuts, compared with 55% in the preceding twelve months. Two-thirds cited a business downturn as a primary rationale for the action, compared with 73% a year ago. The reductions shrank the workforce by an average 9.3%, compared with 9.6% in the previous period.

The five-year trend:

Survey Period	Pct that Downsized	Avg Pct of Workforce
7/91-6/92	46.1	9.3
7/90-6/91	55.5	9.6
7/89-6/90	35.7	10.9
7/88-6/89	39.1	10.1
7/87-6/88	34.9	10.2

The decrease in the percentage of the workforce affected by the cuts is a reflection of the ongoing nature of the reductions, as companies seek an irreducible core of permanent employees. Two-thirds of the current sample have downsized at least once since January 1987; 43%, at least twice; 24%, three times or more.

Geographic: Reductions soared in the mountain states and desert southwest and remained high on the Pacific Coast, but eased elsewhere. Geographic breakouts:

	7/91-6/92		7/90-6/91		7/89-6/90	
Region	Pct that Downsized	Avg Pct of Workforce	Pct that Downsized	Avg Pct of Workforce	Pct that Downsized	Avg Pct of Workforce
New England	47.4	7.2	64.5	9.1	49.1	10.4
Mid Atlantic	48.0	9.5	62.1	9.7	32.5	11.1
Midwest	42.3	8.3	56.2	9.4	34.4	9.4
South	37.3	8.0	54.2	8.2	35.7	13.7
West	56.6	11.3	36.1	7.4	29.0	13.5
Pacific	58.9	12.5	57.8	12.6	34.9	10.8

Organizational Size: Larger companies were more likely to trim jobs than smaller ones, but small firms cut more deeply when they downsized. The findings by number of employees:

	7/91-6/92		7/90-6/91		7/89-6/90	
Employees	Pct that Downsized	Avg Pct of Workforce	Pct that Downsized	Avg Pct of Workforce	Pct that Downsized	Avg Pct of Workforce
Under 100	39.3	21.7	47.2	18.0	28.9	16.6
100 to 499	46.0	12.1	53.4	10.9	34.7	11.2
500 to 2,499	42.0	9.3	54.9	9.5	34.8	9.9
2,500 to 9,999	49.0	7.2	58.0	6.1	42.7	6.9
10,000 or more	57.0	8.8	71.8	3.4	50.0	6.6

Because of the dramatic increase in the percentage of the workforce eliminated by the largest firms in the sample, the average number of positions eliminated rose to 317 from 133 in the previous survey.

Business Category: Manufacturers led in reported reductions, but providers of business and professional services made the deepest cuts when downsizing. The findings by business category:

	7/91-6/92		7/90-6/91		7/89-6/90	
Category	Pct that Downsized	Avg Pct of Workforce	Pct that Downsized	Avg Pct of Workforce	Pct that Downsized	Avg Pct of Workforce
Manufacturing	55.7	10.6	60.4	10.4	43.5	11.7
Financial Svcs	44.0	9.2	51.3	9.4	38.9	10.8
Wholesale/Retail	43.2	9.2	71.2	11.1	42.2	11.6
Bus/Prof Svcs	47.2	13.1	59.2	11.5	30.2	10.0
Other Svcs	37.7	6.3	43.8	6.3	26.8	9.7

Sixty percent of the firms reporting reductions hired workers in other units or locations. As a result, 11% of the companies reporting cuts realized an average net gain of 6.5% in employees over the twelve-month period, and an additional 11% reported no net change. But the rest had an average net decrease of 10.5%, and among all companies reporting cuts the average net change was -7.5%.

Employee Level: Middle managers continue to be special targets in workforce reductions. While making up 5% to 8% of the workforce, middle managers held 19% of 280,000 positions eliminated by AMA respondent firms since July 1988. The profile of the cuts by level:

Avg Pct of Jobs Cut That Were:	7/91-6/92	7/90-6/91	7/89-6/90	7/88-6/89
Hourly	50.5%	56.6%	55.5%	51.6%
Supervisory	16.7%	12.4%	12.0%	14.8%
Middle Management	21.8%	16.3%	13.5%	17.2%
Other	11.0%	14.8%	19.1%	16.4%

Union Jobs: In unionized shops, an average 25% of jobs cut belonged to union members. Among all respondents, the average was 12%. Unionized workers represent some 15% of the U.S. workforce.

Rationales and Descriptors: The recession was the sole cause cited for 31% of the reported reductions, and a contributing factor in 32%; the total of 63% is a decline from the previous survey. The three-year trend (pcts are of firms that downsized):

Recession Cited As:	7/91-6/92	7/90-6/91	7/89-6/90
Sole cause	31.4%	43.2%	45.3%
Contributing cause	32.2%	29.9%	9.7%
Total	63.6%	73.1%	55.0%

Upward trends continued in the share of reductions ascribed to increased productivity, automation, and transfers of production to other locations. The three-year trend (pcts are of firms that downsized; totals exceed 100% due to multiple answers):

Rationales:	7/91-6/92	7/90-6/91	7/89-6/90
Business downturn (actual or anticipated)	63.6%	73.1%	55.0%
Improved staff utilization (productivity)	40.0%	33.9%	23.2%
Merger or acquisition	10.1%	8.5%	9.2%
Plant or office obsolescence	3.1%	3.6%	2.5%
Automation or other new technology	12.2%	8.1%	3.4%
Transfer of production or work	17.9%	10.5%	7.6%

Increasingly, the cuts are across-the-board, affecting most corporate units, and a trend towards plant closings appears. The three-year trend (pcts are of firms that downsized; totals exceed 100% due to multiple answers):

Descriptors:	7/91-6/92	7/90-6/91	7/89-6/90
Organization-wide	41.8%	36.0%	34.0%
Targeted at specific functions or locales	53.3%	57.6%	56.3%
Involving plant or office closings	11.7%	9.5%	8.3%

Future Cuts: A quarter of respondents firms plan reductions before the end of June 1993, the highest record of planned reductions in the survey's six-year history. Typically, the share of respondents reporting cuts at the end of the period is double (and sometimes triple) the share reporting plans in hand at the beginning of the period. Larger firms are far more likely than smaller ones to plan cuts up to a year in advance. The five-year trend:

Survey Period	Pct reporting Future Plans	Pct Downsized, Following Year
7/91-6/92	25	?
7/90-6/91	22	46
7/89-6/90	15	55
7/88-6/89	17	36
7/87-6/88	14	39

Actions to Reduce Layoffs: Among the actions companies take to alleviate work-force reductions, early retirement incentives and voluntary separation plans show a definite upward trend. Policies that seek to "share the pain" -- shortened work weeks and salary freezes or reductions -- are on the decline. The three-year trend (pcts are of firms that downsized):

Action	7/91-6/92	7/90-6/91	7/89-6/90
Hiring Freeze	61.6%	68.1%	62.8%
Demotions/downgrades/transfers	44.2%	69.5%	44.1%
Salary reductions or freezes	35.1%	36.2%	46.2%
Early retirement incentives	34.3%	26.5%	19.3%
Voluntary separation plans	28.6%	23.4%	19.5%
Voluntary job sharing	15.8%	11.7%	11.0%
Mandatory short work week/day	15.3%	19.4%	24.1%
Limited duration furloughs	13.8%	13.3%	NA

Forms of Assistance: The reported rise in outplacement assistance requires a cautionary note. These are includes firms that gave any level of assistance to any displaced worker. Only 45% of companies that downsized offered outplacement aid to all those fired (although that compares favorably with the 30% reported two years ago).

Moreover, actual assistance can vary from full services by a professional outplacement firm to mimeographed handouts on writing resumes. Managers are far more likely to receive professional outplacement help than nonexempts. The three-year trend (pcts are of firms that downsized):

Action	7/91-6/92	7/90-6/91	7/89-6/90
Outplacement assistance	77.1%	65.3%	52.2%
Extended severance pay	45.1%	41.0%	37.2%
Extended health benefits	36.9%	36.0%	27.1%
Job retraining	17.7%	12.1%	12.9%

After-Effects of Downsizing: As earthquakes are followed by aftershocks, workforce reductions have an ongoing effect on the organization. The most frequent of these is another round of downsizing. On average, 63% of companies that downsize in a given year do so again the following year. Among the current sample, companies are more likely to have downsized twice or more since January 1987 (43%) than once (23%) or not at all (35%).

Moreover, fewer than half the firms that have downsized since January 1987 reported that profits increased after the cuts were made, while 24% saw profits decrease. Firms that downsized were nearly as likely to report declines in worker productivity than improvements. In most cases, companies paid a heavy price in worker morale. In every case, the more frequently a company downsized, the worse the after-effects:

	Number of calendar years in which company reported downsizing (1987-1992)			
Employee Morale	1	2	3 or more	Total
Declined	71%	72%	85%	77%
Remained constant	19%	22%	11%	17%
Increased	2%	2%	3%	2%
Worker Productivity	1	2	3 or more	Total
Declined	23%	28%	34%	28%
Remained constant	41%	36%	32%	36%
Increased	28%	31%	33%	31%
Operating Profits	1	2	3 or more	Total
Declined	17%	25%	28%	24%
Remained constant	22%	22%	24%	23%
Increased	47%	44%	41%	44%

Community relations also suffered, though customer relations were likely to improve, and in one respect downsizing absolutely succeeded: the quality of the company's products or services tended to improve in relation to the number of times it cut jobs. In that, at least, less was more.

Many would say that whatever the negative effects on profits and productivity, it would have been worse without the payroll savings realized from workforce reductions. But the data raises the argument: is the cure worse than the disease?

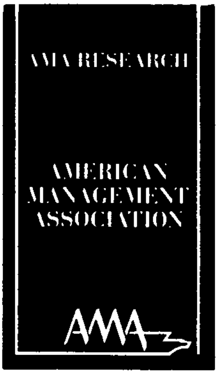
AMA RESEARCH

AMERICAN
MANAGEMENT
ASSOCIATION

AMA

1992
AMA SURVEY
ON
DOWNSIZING
AND
ASSISTANCE TO
DISPLACED WORKERS

A Research Report published
exclusively for corporate members of the
American Management Association

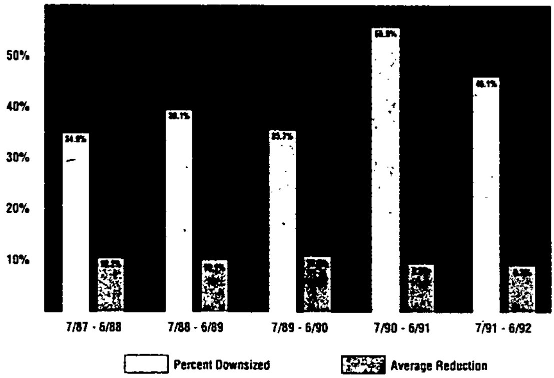


Downsizing and Assistance to Displaced Workers

The findings of AMA's sixth annual survey on workforce reductions can be easily summarized: better than last year, but worse than most. In an economy that grew fitfully where it grew at all, the share of respondent firms reporting workforce reductions between July 1991 and June 1992 slipped to 46% from 56% in the previous year. But both figures are significantly higher than in earlier surveys.

The average percentage of the workforce affected by these cuts also decreased, to 9.3% from 9.6%. The average continues to fall as companies undergo a second or third round of job cuts, seeking an irreducible core level of permanent employees.

Downsizing: The Five Year Trend



For this survey, we expanded our questionnaire to create a histogram and to gather information on the after-effects of downsizing. Again, those findings can be briefly summarized: companies that make cuts tend to do it again, and the results are quite likely to be negative -- lower profits and declining worker productivity.

Twenty-five percent of our respondent firms already plan to downsize by June 1993, the highest share in the survey's history for planned reductions. That is a baseline number which will surely increase: typically, it doubles through the year as smaller, more market-sensitive firms adjust to changing conditions. With economic recovery uncertain, an end to downsizing is nowhere in sight.

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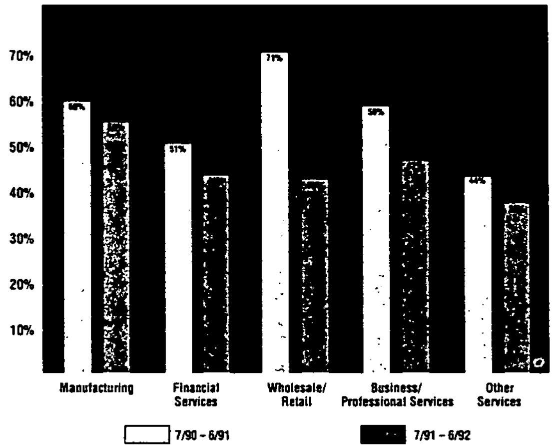
Summary of Key Findings

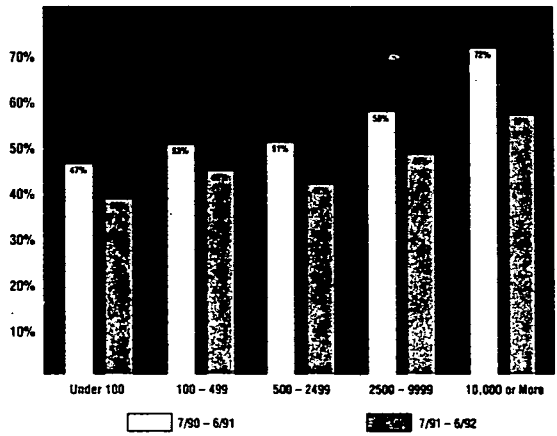
There were decreases across the range of business categories, but those reported by manufacturers and providers of financial and non-business services are within the sample's margin of error and not statistically significant.

Regionally, reductions soared in the mountain states and desert southwest and stayed high (59%) on the Pacific Coast, but eased elsewhere.

Downsizing — By Business Category



Downsizing — By Organizational Size



As in previous surveys, larger companies were more likely to make reductions, but smaller ones cut more deeply when they downsized.

Among companies making cuts, 60% said they hired workers in other units or locations. As a result, 11% reported a net gain in total employees, and 11% had no net change. But the rest -- 36% of the whole sample -- averaged a net decrease of 10.5%.

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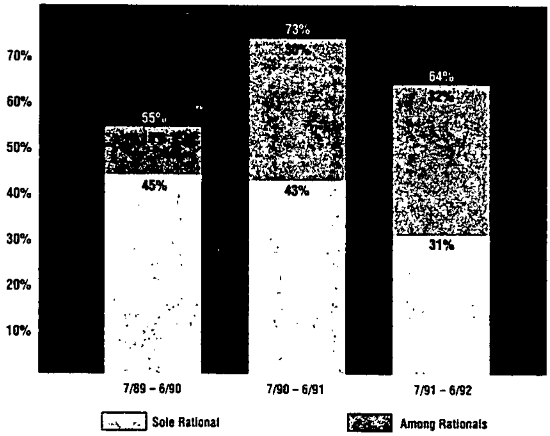
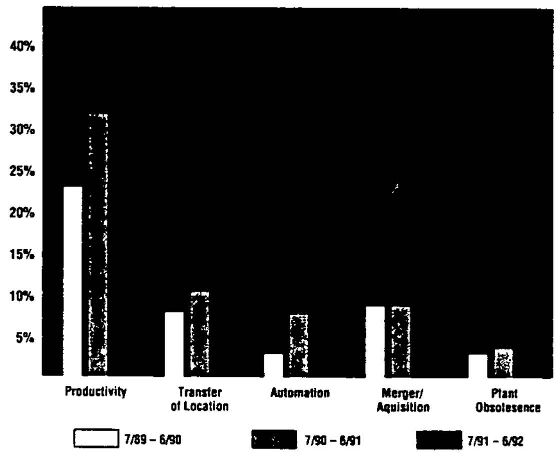
Why Cuts Were Made: Two-thirds of the reported reductions were recession-driven in whole or in part. There was a significant decrease in those citing a business downturn as the sole rationale.

Though reductions increase as the economy worsens, downsizing is not a child of the recession. Prior to 1989, a majority of reported cuts were for reasons other than an actual or anticipated business downturn, and non-recessionary cuts continue to account for 37% of all reported reductions. Moreover, three-quarters of the firms that downsize were profitable in the year they made the cuts.

Recession as Rationale For Downsizing



Other Rationales for Downsizing



The three-year trend line shows that more companies are downsizing in an attempt to increase staff utilization and thus realize productivity gains. The share citing a transfer of production or work to other locations has doubled, and the share ascribed to automation or other new technological processes has quadrupled.

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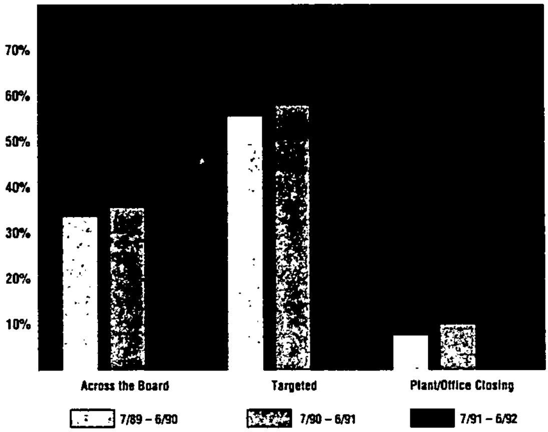
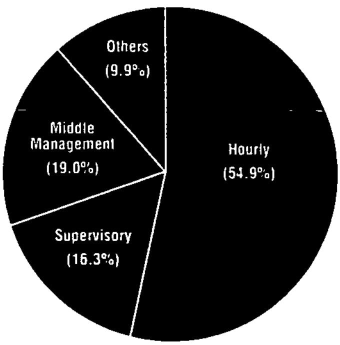
Targets: As recessionary pressures increase, so do the number of reductions that are organization-wide and involve plant or office closings.

DESCRIPTORS



JOBS ELIMINATED – BY LEVEL



Middle managers continue to be special targets. Middle managers represent 5% to 8% of the American workforce, but in the most recent survey they held an average of 22% of jobs cut.

Of 280,000 jobs eliminated by AMA respondent firms over the past four years, 53,000, or 19%, belonged to middle managers.

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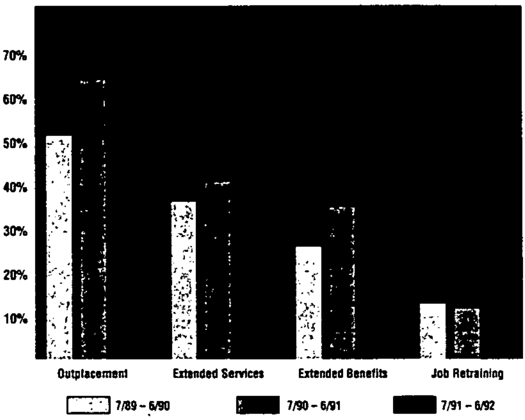
Forms of Assistance: The three-year trend shows a sharp increase in outplacement assistance to at least some discharged workers. This year, 45% said they gave outplacement help to all who lost jobs, up from 30% two years ago. But help varies from full professional assistance by outplacement specialists to quick courses in resume writing.

The trend line shows less dramatic increases in extended health benefits and severance packages beyond normal policy provisions.

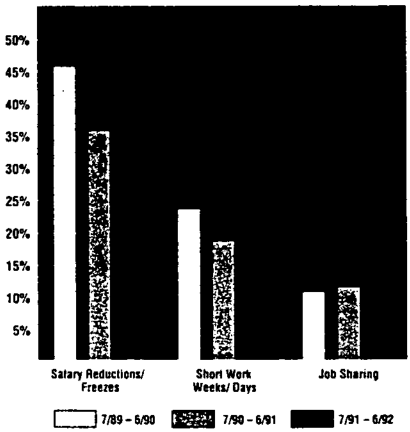
FORMS OF ASSISTANCE



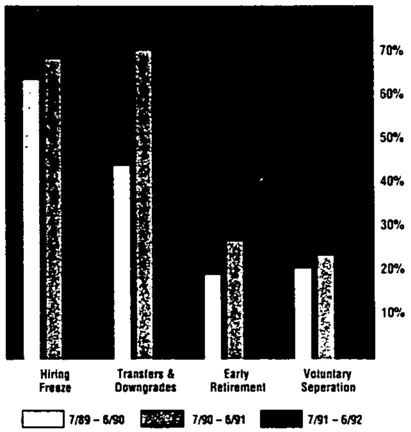
Fewer companies are embracing policies that "share the pain" and reduce the necessity for layoffs, such as salary reductions and shortened work time.

Among other actions to alleviate reductions, early retirement incentives are making a comeback to pre-recessionary levels, and voluntary separation plans continue to increase.

"SHARING THE PAIN"



OTHER ACTIONS



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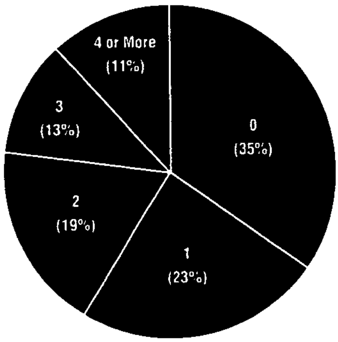
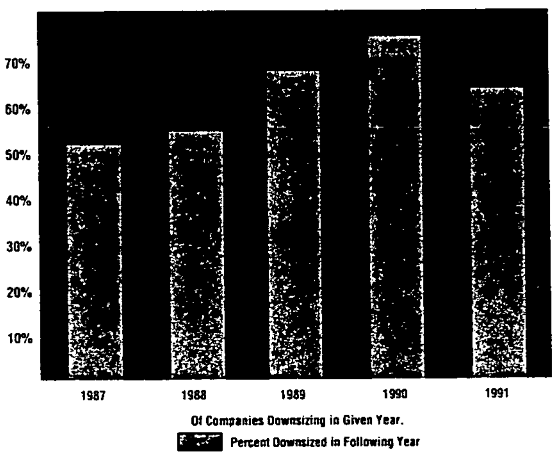
Downsizing as a Way of Life: The best predictor of future reductions continues to be the past: companies that downsize tend to do it again, and quickly.

Among the current sample, more companies (43%) downsized in two or more of the past six calendar years than once or not at all.

DOWNSIZING: HOW MANY ROUNDS?



ONGOING NATURE OF REDUCTIONS



On average, 63% of the companies that downsize in a given year repeat the exercise the following year.

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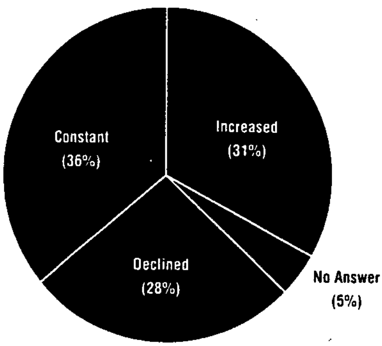
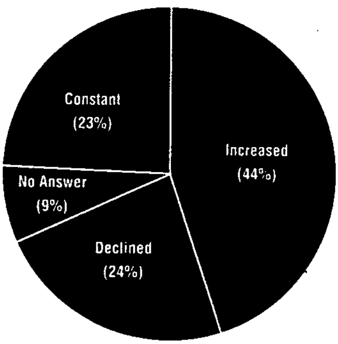
After-Effects of Downsizing: The goals of increased worker productivity and higher operating profits have proven elusive. Companies that have downsized since January 1987 are nearly as likely to report a decline in productivity as an increase.

AFTER – EFFECTS ON PRODUCTIVITY



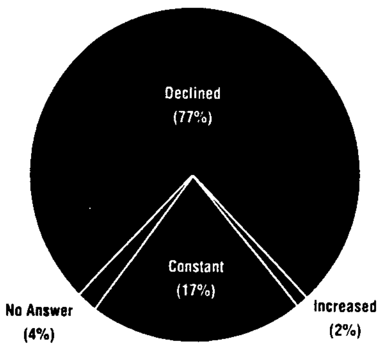
AFTER – EFFECTS ON OPERATING PROFITS



Fewer than half the downsized firms said profits increased after the cuts were made, and a quarter of them said they went down.

In most cases, companies paid a heavy price in worker morale.

AFTER – EFFECTS ON EMPLOYEE MORAL



In every case, the more frequently a company downsized, the worse the after-effects. Community relations also suffered, though customer relations and product quality tended to improve. The data raises the argument: is the cure worse than the disease?

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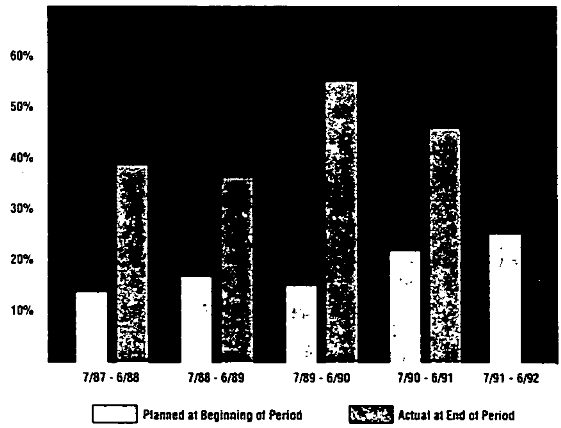
Planned Reductions: The AMA questionnaire asks about future plans as well as past actions. One-fourth of surveyed firms said that they planned to make cuts between July 1992 and June 1993 -- the highest "future index" yet reported in the survey's six-year history.

While this figure is certainly lower than the 46% that downsized from July 1991 to June 1992, it is not a prediction of fewer cutbacks in the future. Typically, the actual share of companies that downsize in a survey period is double -- and in some years triple -- the share that report plans in hand at the beginning of the period. Larger firms tend to set plans well in advance; smaller ones are more market-responsive.

DOWNSIZING: PLANNED VS. ACTUAL



In a troubled economy, the question for corporate managers is less whether to downsize than how. The trend towards more generous levels of assistance to discharged workers is a positive indication.

Two-thirds of respondent firms say they are "well prepared" for future reductions, with most necessary elements in place. It is likely that those elements will be put to the test.

RESEARCH

About this Survey

The 1992 AMA questionnaire on downsizing and assistance to displaced workers was mailed on August 31, 1992, to human resources managers in AMA-member companies. By September 28, we had 836 usable responses, giving the sample a 3.5% margin of error.

An AMA membership poll is not reflective of the American economy as a whole. For example, only 2% of incorporated U.S. businesses gross as much as $10 million annually: 96% of the current sample gross $10 million or more. Similarly, manufacturing concerns, 20% of American businesses, make up 36% of the sample. But in total, AMA corporate members employ some 25% of the American workforce, and the current sample accurately represents that membership.

Business Category

■ Manufacturing	35.7%
■ Wholesale & Retail Trade	9.7%
■ Financial Services	9.0%
■ Business & Professional Services	8.6%
■ Other Services	36.8%
■ Total Services	64.1%
■ Unclassified and Unclassifiable Establishments	0.2%

Annual Sales (or operating budgets, if nonprofit)

■ Under $10 million	4.3%
■ $10-$49 million	8.6%
■ $50-$249 million	33.4%
■ $250-$499 million	17.5%
■ $500 million or more	32.9%
■ Not Reported	3.4%

Total Number of Employees

■ Fewer than 100	3.4%
■ 100-499	7.5%
■ 500-2,499	45.0%
■ 2,500-9,999	30.7%
■ 10,000 or more	12.0%
■ Not Reported	1.4%

PREPARED STATEMENT OF ALLEN SINAI
THE BOSTON COMPANY ECONOMIC ADVISORS, INC.

The economy after the 1992 Presidential Election appears much as before, beset by "macro" problems and "micro" difficulties.

The macro problems are an underperforming and stagnant economy, lack of jobs and income, still outsized federal budget deficits, prolonged economic weakness in the major industrialized countries, and a decline in long-run potential economic growth.

Dealing with these problems in a scarce resource environment and in the context of an increasingly globalized and interactive world economy is one task for the new Administration. Figuring out if there are ways to grow both the economy and jobs and to reduce the deficit is another. Determining the necessary policy context for dealing with a multitude of macro problems rather than just a single major macro problem is yet another.

The micro issues are every bit as perplexing as the macro ones and include health care provision, delivery, and costs; the U.S. educational system, especially K-12; the lack of saving and investment; welfare; and international competitiveness.

Solving these problems in an economy with so many macro difficulties and quite limited resources presents a difficult and perhaps insurmountable task for the short- to intermediate-term. Health care and support pose the most thorny policy problem that the nation has ever faced. Health Care now is a big industry in the U.S. economy, accounting for about 12% of GDP, 16% of federal government spending, and 14.9% of consumer spending. Health care expenditures represent a sizeable cost and drain on the cash flow, incomes and revenues of the private and public sectors.

The macro problems are more numerous than after the last Presidential Election. Then, the federal budget deficit presented the greatest difficulty. Economic performance in the U.S. and worldwide was quite good. The U.S. economy was essentially fully employed. The economy was in need of fiscal restraint to reduce economic growth and the structural budget deficit and easier monetary policy to offset any fiscal drag that might have occurred as a result. Instead, action on the deficit was delayed until late in 1990 and Federal Reserve policy, although incrementally easier over time, was not so aggressive as it might have been. Fiscal restriction came at the wrong time, aggravating and intensifying the downturn in the economy and contributing to the failure of a meaningful upturn to emerge.

Now, there are two big macro problems facing the new Administration—too little growth and too high a federal budget deficit—against a backdrop of an uncertain international situation.

One plus is that some of the excesses that existed nearly four years ago have been worked down. The banking system is quite profitable, with risky loans pared down, few risks being taken on new loans, operating costs lower, and capital adequacy ratios higher. The thrift crisis is beginning to wind down. Household and business financial positions are improved, although still nowhere near more typical historical levels. And, inventories are lean in relation to sales.

Unfortunately, the problems of growth and deficits cannot both be solved at the same time. Reducing federal budget deficits can be incompatible with raising economic activity and creating jobs. Raising economic activity can be incompatible with cutting the deficit. Changes in budget deficits often come from changes in government spending or taxation.

Raising growth and reducing deficits simultaneously is not impossible, but difficult. Both can occur if other sources of growth such as easier monetary policy, increased economic activity abroad, increased efficiency and productivity in the private and public sectors, new waves of innovation or inventions, lower cost provision of health care, or other exogenous sources of growth or cost-savings can be achieved.

Thus, policywise, there now is a sequencing problem of choosing between reducing the deficits or increasing growth first, then working on the other problem later. If the choice is more growth, then what fiscal policy instruments are used is critical, along with the need for monetary policy to be accommodative.

The reason for taking action to increase growth first is the additional tax receipts and reduced government transfer payments that can partially offset any extra deficit that might be created. Tackling deficit reduction first probably would weaken the economy and cost jobs, also losing some tax receipts and causing extra spending, to some extent self-defeating rather than self-reinforcing to the objective of deficit reduction.

The current economic situation remains one of stagnation, with the greatest risks from the international side. Recent data for the U.S. economy do show some signs of life, with better orders, a little better hiring, stronger retail sales, and some pickup in big-ticket item buying. Other statistics, however, paint a picture of hesitation. The Leading Economic Indicators (LEI) have declined three times in the last four months. Home sales were softer in late summer. And, the manufacturing sector appears flat or perhaps in recession again. Overseas, none of the European countries appear to be reviving; indeed, there appears to be a loss of momentum. And, Japan continues to show up weak. Nothing on the horizon seems to be occurring in the way of strong monetary or fiscal stimulus to accelerate U.S. or worldwide economic growth very much soon.

For at least the next six to nine months, there can be little effect on the economy from actions by the new Administration and not much done on the micro problems. The economic difficulties are complicated and complex, with no simple, easy answers, and the $6 trillion economy is hard to move. Under typical post-election circumstances, a new Administration has not been able to affect the macroeconomy during the first year, with a beginning only in the second year.

The Clinton Economic Plan, as stated in Putting People First, actually would not be a big macro event. The ex-ante figures show a net $80.8 billion subtraction out of the economy from reductions in government spending, defense and nondefense, and higher taxes versus lower taxes and high government spending. The $20 billion to $25 billion per annum deficit restraint that is indicated would prevent much additional growth from occurring. Even under a more realistic scenario, where the Clinton Administration might find that new programs and initiatives cost more than estimated, tax receipts from increased levies on the affluent and foreign corporations were not so much as thought and the projected nondefense spending savings could not be fully realized, the resulting positive effect on the economy would be minimal.

According to simulations with the Sinai-Boston Model of the U.S. Economy, a large-scale 550-equation macro econometric model, a more realistic Clinton program that raises the federal budget deficit, ex-ante, by $100 billion over four years, a $180 billion swing from the plan in Putting People First, would only increase economic growth 0.2 to 0.3 percentage points a year over the first couple of years.

The stimulus in a more realistic case simply is not enough to move the huge $6 trillion U.S. economy very much. Not much change would occur in inflation. Federal budget deficits would be higher. Interest rates would be somewhat higher. The unemployment rate probably would come down somewhat compared with otherwise. The model simulations show that productivity growth and the growth in potential output in later years would be significantly higher, but still far from what used to the case in the U.S. economy. Infrastructure spending, equipment investment tax credits, and educational training through spending and tax credits principally give this result.

The new Administration would be well-advised to make key appointments quickly, set up task forces on the major problems with options and contingencies to be ready even before the inauguration, setting up shop and the transition to actions early, perhaps in an unprecedented way, so as to hit the ground running at Inauguration Day.

The state of the economy and prospects, here and abroad, call for a more active, vigilant businesslike approach by the government to economic problems than has existed before. The momentum of a $6 trillion economy is hard to reverse or to accelerate. Complicated problems are hard to deal with quickly, with potential long lags in identification, the surfacing of ideas for possible solutions or problem management, proposed legislative actions, approval, and implementation. The current problems of the economy are such that time is of the essence.

The machinery for policymaking determination and action has to be modernized, government must be more alert and proactive, and economic policies more subtle and targeted. A "just-in-time approach" to monitoring and instituting policy actions, if needed, as in business, should be developed. Contingency plans can be set on the shelf, ready to use, but implemented only if actual conditions warrant. The failure to recognize the economic weakness in the United States and to take actions early are a major reason for the stagnation that still exists.

State Of The Economy

That the United States and world economies are in trouble should not be debatable.

In the U.S., real economic growth has been only 0.5% per annum since the second quarter of 1989. The unemployment rate is far above the low of 5% in March 1989. Jobs creation has been woefully inadequate, with a net increase of 532,000 persons since the first quarter of 1989. Job losses of 1.669 million have occurred since the peak of the business expansion in July 1990. The federal budget deficit remains extremely high, at levels near $300 billion, although to a significant extent because of the weak economy itself. No single sector of the U.S. economy, except health care, has been or is poised for recovery in the traditional sense. Expenditures on health care, however, reduce the income or cash flow available for discretionary spending, hurting the economy elsewhere. And, despite repeated actions to ease monetary policy, some 24 instances by the Federal Reserve between June 1989 and September 1992, the economy has failed to show a meaningful revival.

In fifteen quarters since early 1989, including estimates for the fourth quarter of 1992, only three have shown a bona fide recovery, real economic growth in excess of growth in potential output of 2% to 2-1/2%. Three quarters were characterized by a full-fledged recession, the third quarter of 1990 to the first quarter of 1991. The other nine quarters have exhibited growth in-between, ranging from zero percent to only 1.7 percent.

Indeed, the current business cycle episode is the most unusual of the postwar era, aberrant and perhaps different from all others in U.S. economic history.

The latest data suggest more of the same, despite the 2.7% result reported in the recent Advance GDP report.

The GDP figure was inflated by the spike up in Information Processing and Communications ($13.8 billion), a surprising $4 billion rise of Defense Expenditures, and a strong 3.4% annual rate of increase on overall Consumption, none of which seems likely to be repeated in the fourth quarter. Growth in incomes and jobs has not been sufficient to sustain so strong an increase in consumer spending. Much of the increase in Information Processing and Communications was in Computers, pumped up by a sharp annualized 30% drop in the price index used to deflate nominal computer outlays. Defense spending has been programmed by the Bush Administration to decline about 5% per year, in real terms, so that defense outlays could be significantly lower in the fourth quarter. Other categories of spending do not seem set to pop up as an offset, most particularly real net exports which are deteriorating because of economic weakness abroad.

Economic growth of 1% to 1-1/2% in the fourth quarter is more likely, a return to the stagnant no-recovery pattern of the last 3-1/2 years, rather than an acceleration and lifting off in self-sustaining expansion.

Some recent high frequency economic indicators do show a firming of the economy and a tilting up in activity, most principally declining unemployment insurance claims and state benefits, even accounting for the new extended federal jobs legislation. Auto and retail sales have picked up somewhat. Orders, production and inventories could accelerate if final sales move higher soon.

Elsewhere, all is not well either. Prolonged world economic weakness has emerged as a major problem. The industrialized countries have exhibited an extended period of weak growth and some are suffering full-fledged recession. The U.K. is in the fourth year of recession or no recovery. Switzerland has been in recession. France and Italy are growing, although slowly. Real economic growth in the OECD countries was only 0.9% in 1991 and will be about 1.5% in 1992. Lately, the German economy has shown a decline in GDP. And now Japan is showing only anemic growth, just 1% to 2%, by historical Japanese standards, a recession.

Europe is suffering from a "German Problem"—the stagflation of a sliding German economy and high inflation engendered by the shock of unification. At 3-1/2% to 4%, the German inflation is far in excess of the 2% target.

In order to restrain inflation, the Bundesbank has followed a policy of high interest rates. Through the defense of currencies in the Exchange Rate Mechanism (ERM) that links the currencies of Europe and until recently the U.K. and Italy, higher interest rates than might be domestically necessary have occurred in France, the U.K., Netherlands, Spain and elsewhere, dragging down these economies. As the spending boom from German reunification has receded, the reduced pace of outlays has been felt throughout Europe. The German stagflation shows no signs of ending soon, although a reduction of inflation recently to near 3-1/2% and widespread economic weakness have brought some reductions in German interest rates, and for other countries as well.

Unfortunately, the negative economic effects from German unification, a unique one-time but permanent shock, have been exported to other countries, prolonging European and U.K. economic weakness, limiting U.S. exports, raising U.S. interest rates and, in turn, holding down worldwide growth.

Yet a third reason for world economic weakness is the Japanese situation—the unraveling of a boom or bubble economy combined with the financial fragility of overleverged financial institutions beset by asset price and debt deflation.

In Japan a Western-style recession-like pattern has emerged, with a fragile financial system and weak real economy combining to depress the economy. The financial fragility of the Japanese economy, a term previously applied only to the U.S., suggests a combination of overleverged and overextended financial institutions, a weak real economy, and policy actions too little or too late to reverse the momentum of the financial and economic problems. Financial institution exposure to loan losses and regulatory capital adequacy requirements are great.

The collapse of real estate and stock prices in Japan, deceleration of the real economy, and liquidity squeeze on financial institutions are new to the postwar era. The recognition lag by Japanese policymakers has been long because of unfamiliarity with the economic and financial problems and reactions too slow to offset the slide in real and financial activities. Fears of reviving a bubble economy, of reigniting inflation, or worsening a politically troublesome trade surplus with the West have helped to prevent action. The result is a major economic slowdown fraught with risks of a full downturn and an international credit crunch as Japan cuts back on spending, lending, investment, production and employment.

With the three major economies of the world—the U.S., Germany and Japan—all having economic difficulties, the U.S. and world economies cannot easily mount a solid recovery. The problems of the major industrial countries appear unique to each, are interactive, and no easy common solution exists. The risk of continuing recession or stagnation is high, with the current episode in many ways more like the 1930s than typical post-World War II situations.

1993 Prospects

The best that can be expected for the rest of 1992 and 1993 is weak, sluggish, but positive, growth in the U.S. and most major industrialized countries, with subdued inflation and high unemployment rates, sticky in moving down.

Why should there be any expansion at all?

For the U.S., the main reason is trend growth in consumption and other categories of spending. Consumers almost always increase spending, in real terms 1% per annum over the postwar period. It is rare that consumer spending declines. So long as no other sector of the economy is caving-in, consumer spending alone, which is two-thirds of aggregate outlays, should carry the economy up.

Consumer spending on necessities such as services, food, clothing, shelter and generated by a rising population likely will produce some lift. Residential construction should continue moving higher. Some inventory building will be necessary. And, should the economy falter or keep underperforming, monetary and fiscal policies probably would be used to help raise growth.

Sustained low inflation and a low profile of interest rates should be by-products of the economic weakness. But, so should a high unemployment rate. Continuing high budget deficits are also in prospect, in part, from the poorly performing economy. Profits can rise nicely, mainly because of the much lower breakeven points achieved by business.

The expectation of The Boston Company Economic Advisors, Inc. (TBCEA) for 1993 is real economic growth at 2.6%, fourth quarter-to-fourth quarter, inflation at a low 2.9%, and the unemployment rate still as high as 7% in the fourth quarter of 1993 (Table 1).

Interest rates are expected to move sideways and then somewhat higher, so long as no major fiscal initiatives are taken. Corporate profits should be higher, up 8.5% on the S&P500 Earnings Per Share, benefiting from much lower breakeven points, continuing low finance costs, and a modest pick up in revenue growth.

Overseas, the European Community (EEC) likely will face another difficult year, although somewhat better than 1992, with growth at 1.3% (Table 2). The OECD overall growth rate for the major industrial economies is expected at 1.9%. Germany will have trouble reaching growth of 1%, given the slide over the middle two quarters of 1992 and only a slow turnaround and reversal in 1993. Inflation will remain above the German 2% target. The U.K. can finally recover, but only modestly. Unemployment rates likely will rise and inflation decline, with interest rates gradually coming down.

These forecasts assume that the Clinton Administration speeds up or proposes a small dose of net fiscal stimulus in 1993 and 1994 consistent with the Clintonomics long-run plan outlined in the election campaign. Additional spending on infrastructure as part of the Rebuild America portion of the plan, targeted equipment investment tax credits retroactive to January 1, 1993 and a small tax cut for middle income families can help stimulate the economy. Financing is to be achieved by additional reductions in defense spending, higher taxes on high income families, higher corporate taxes, and some efficiencies in the operations of the federal government. The fiscal plan of the forecast produces net stimulus of approximately $30 billion, ex-ante, over the next year and $20 billion in FY94. Beyond, a longer-run plan of net fiscal restraint is expected to be proposed and put into place.. Monetary policy is accommodative under this scenario, with the central bank acting in a classical way to allow the increased economic growth from the fiscal program to emerge. Not much additional growth comes from such a program, approximately 0.5 percentage points in FY93 and 0.2 percentage points in FY94. The assumption is that the still outsized federal budget deficit constrains the Democratic President and Democratic Congress from a large dose of fiscal stimulus, given the election-year stress on the long-run rather than for a quick fix.

Internationally, the Bundesbank is assumed to reduce interest rates slowly, but consistently over 1993 in response to the stagnation in Germany and on the Continent. The fiscal stimulus set in Japan should begin to take hold in the second half, but is not enough to prevent the Japanese economy from underperforming again in 1993, rising at just 2.2%.

The unified federal budget deficit, as estimated by TBCEA, is projected at $380.8 billion, up significantly from the $290.2 billion record of 1993. In FY94, a $327.5 billion deficit is expected. This projection includes the $30 billion and $20 billion, respectively, of net fiscal stimuli assumed to come from the new Clinton Administration and the Congress.

On a current services basis, shown in Table 3, assuming no change in fiscal policies by the Clinton Administration and the Congress, the deficit would be $349.4 billion in FY1993 and $306.2 billion in FY94. Much of the deficit results in FY1993 and FY1994 stems from continuing expenditures by RTC, a shortfall in tax receipts because of the underperforming economy, and higher expenditures from the cyclical effects of a weak economy.

The structural or full employment budget estimates produce little change year-to-year over the next two fiscal years.

<u>What's Wrong With The Economy</u>?

Chart 1 portrays the problem of the U.S. economy—a combination of a secular or long-run slowing of growth and a cyclical recession. In all previous postwar business cycle episodes, the principal problem was cyclical.

The Chart illustrates that the current situation is very different from prior episodes when the primary problem of recession and its aftermath appears to have been cyclical. This time, a slowdown in the trend rate of growth <u>and</u> a cyclical downturn together have produced the current stagnation.

Trend or potential growth can be seen to have fallen over the postwar era, the result of secular changes to the economy. There is also a cyclical component, with actual growth fluctuating about a trend that has moved down. The trend and cycles do interact, with cyclical changes in the economy affecting the potential rate of growth through effects on labor and capital, R&D entrepreneurship and productivity growth. A lower rate of growth in potential output, or in the supply-side of the economy, can limit growth through higher inflation and higher interest rates than otherwise would have occurred. This, in turn, can limit potential economic growth itself. Both the trend and cyclical fluctuations have been tending to produce lower growth for some time, on average.

The up-cycle of the 1980s did not, as usually occurs, produce a pick up in the growth of potential output. Much of the expansion in the 1980s was consumption-oriented or involved debt-financed transactions in the business sector, with little saving or provision for an increase in the quality and quantity of labor, capital, and of productivity. The shift of the U.S. economy from goods-producing to lower productivity services-producing activities may have been one reason for the declining growth in potential. Growing debt and debt service burdens are a possibility. A lack of infrastructure spending may have been another. Slowing labor force growth could be yet another. A full explanation has not yet been elucidated. The decline in potential growth appears to have begun around 1973.

A true economic revival depends on achieving both a cyclical upturn and also raising the long-run potential rate of growth.

Measures that are designed to raise cyclical growth, if unrelated to potential output or only somewhat so, will not fully deal with the U.S. stagnation. Measures that do "double-duty," that is, affect both the short-run cyclical behavior of the economy and the long-run potential rate of growth, are needed. The efficiency of macro policies, determined in this sense, is a new consideration for economic policy. Also, because of high budget deficits, the "bang-for-a-buck" of any policy instrument must be calibrated, perhaps in terms of gains for output, inflation and employment. Resource constraints and costs are high now. High productivity policy measures are necessary. If economic weakness is due to structural causes, policies that largely have a cyclical effect would be inappropriate and vice-versa.

How best to lift the economy thus involves a different policy approach and framework than what typically has been used in dealing with a weak economy. If potential growth had remained as it was earlier, only policies designed to reverse the cyclical downturn would be necessary.

The structural impediments in place are numerous, with still some cyclical difficulties remaining. Apparently, the negatives are more than offsetting the lift to the economy from the positives that are emerging.[1]

Policies Under The New Administration

The failure of the U.S. and world economies to perform as expected indicates that policies should be altered to bring about improvement.

Varying doses of fiscal and monetary stimulus are needed in the U.S., Germany and Japan. The U.S. can relax its deficit modestly with up to $50 billion of fiscal stimulus without fear of reigniting an unwanted inflation. Further deficit reduction can come after growth is revived or a trigger growth rate for instituting restraint can be established. Germany need not run such high interest rates on an annualized rate of inflation in the 3-1/2% range and with its economy declining. All countries can reduce interest rates, given the relatively low inflation in each. Japan has room for even more fiscal stimulus, given its budget and trade surpluses, and some more monetary easing.

Monetary policy is fundamental and should be aimed at maintaining a low profile of interest rates so long as inflation stays subdued.

The inability of the economy to revive after so many instances of monetary ease has been one of the puzzles of this episode. Lags between the time of easier monetary policy and economic recovery had been thought to be from six to twelve months. The lags now have stretched to over three years, longer than for any other postwar situation.

With many structural impediments, the stimulative effects of lower interest rates have been overwhelmed. Monetary policy stimulates the economy by reducing marginal borrowing costs, lowering debt service, reducing breakeven costs for business, improving financial positions, diminishing the cost of capital, and boosting the stock market and consumer confidence.

However, in the face of massive declines in defense spending, overwhelming burdens of debt and debt service, a tax increase in 1990, for a time financial institution fragility and a credit crunch, changes in demographics that limit big-ticket item buying, a glut in real estate, deflation in asset prices and deteriorating balance sheets and economic weakness abroad, it is easy to see why monetary policy has failed to revive the economy so far.

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[1] A.Sinai, "What's Wrong With the Economy?" forthcoming in Challenge, November-December 1992, discusses the sources of the prolonged economic weakness.

Put simply, the demand for money and credit has been shifting down because of these factors, faster than the supply of funds has been expanding, driving interest rates lower, but not enough to reverse the weakness in spending and in the demand for money.

Indeed, the Federal Reserve practice of pegging the federal funds rate in order to achieve price level stability and sustainable economic growth probably has erred in setting short-term interest rates too high for equilibrium between a sinking demand for funds and the supply of funds.

The slow and cautious reductions in the federal funds rate that have occurred, and thus in other short-term interest rates, probably have kept interest rates higher than equilibrium, limiting the quantity demanded of funds and credit, and preventing the economy from rebounding faster. The by-products of aweakeconomy—lowerinflationand higher unemployment—represent prima facie evidence that short-term interest rates are being set too high. The surplus of funds in the financial system has gone toward investments in U.S. Treasury securities. This, in turn, has brought less economic growth and reduced the demand for money and credit, impairing economic performance and slowing growth of the monetary aggregates.

U.S. monetary policy must continue to sustain a low profile of interest rates, perhaps the key ingredient for lasting improvement in long-run potential output.

More desirable than the current policy of setting the federal funds rate at levels not those of the market would be a freeing of interest rates to whatever levels the demand and supply of funds might bring.

The U.S. central bank should target bank reserve growth to achieve monetary growth targets, letting the demand and supply of funds determine the federal funds and other short-term interest rates. If the demand for funds is weak, then the federal funds rate would quickly drop to lower levels. Significantly lower short-term interest rates would then act more quickly to revive economic growth and the demand for funds.

Simulations with the Sinai-Boston Model of the U.S. Economy have long indicated that a quick reduction in the federal funds rate to around 2% is required to achieve 2-1/2% real economic growth given the structural impediments that exist. A reignition of inflation would not occur even if the federal funds and discount rates were lowered by another percentage point. Plenty of slack exists in an economy with a high unemployment rate and low inflation.

Simulations with this computerized model of the economy also show that a low profile of interest rates helps to reduce the federal budget deficit, by reducing the debt service of the federal government, now the third largest expenditure outlay, and stimulating capital formation. Monetary policy indeed is an exogenous source of both increased economic growth and lower budget deficits. The higher economic growth from easier money raises tax receipts and lowers the government expenditures associated with an underperforming economy.

Fiscal policy can help to simultaneously engineer a faster cyclical expansion and to raise the potential growth of the economy.

With high structural budget deficits and the Budget Enforcement Act of 1990, any relaxation of fiscal policy and imposition of fiscal stimulus is difficult. Higher deficits add to debt and debt service burdens, one of the major structural problems of the economy. Interest rates can rise, limiting the positive effects of the stimulus.

But, it is clear that the combination of monetary ease and fiscal restraint that has been in place, along with the other negative factors, has not produced the desired results for the economy.

Current services budget estimates of TBCEA suggest that fiscal policy will be neutral in the next few years, not acting to provide stimulus to the economy. Table 4 shows that the structural or full employment budget deficit declines slightly from fiscal years 1992 to 1995, indicating a neutral to somewhat restraining affect of the budget at full employment.

A temporary relaxation of the deficit restraint set by the Budget Enforcement Act thus is indicated.

A moderate dose of net fiscal stimulus on the order of $30 billion to $50 billion is necessary, set higher near-term and lower in a second year, for example $30 billion to $35 billion in year one and $15 billion to $20 billion in year two, so long as the measures involved do "double-duty" —serving to lift near-term economic growth and to enhance long-run productivity and the potential output of the economy. A fiscal stimulus of this size would be minimal in a near $6 trillion economy, far less than any employed in other similar situations.

Examples of "double-duty" fiscal measures that would enhance growth and long-run productivity include: 1) investment tax credits targeted at productive investment; 2) nondefense infrastructure spending and repair; 3) capital gains tax reduction, especially indexing for inflation; 4) well thought-out expenditures to improve education, especially K-12; and 5) education and retraining programs. Types of policies that would not do "double-duty," that is, be efficient given the budget constraints and still large deficits that exist, include reductions in personal income taxes, public works expenditures of the 1930s variety, and government outlays that are not targeted nor tracked in accountability.

Calibration of the results obtained in terms of output, the unemployment rate, and inflation per dollar of lost revenue or extra spending is another way to judge the relative efficiency of any fiscal measure.

Relaxation of the budget deficit necessary to permit a modest dose of fiscal stimulus would tend to raise economic activity without a noticeable cost to inflation and interest rates, generating jobs, economic activity, and perhaps jump-starting a chronically stagnant economy. Some sort of fiscal stimulus always has been necessary to lift the economy out of slack, whether post-World War II or pre-World War II.

A temporary relaxation of the move to deficit reduction should be done, but without permitting the goal of deficit reduction in the long-run to be lost. The deficit to be balanced, it should be noted, is the structural or full employment budget deficit, not the overall federal budget deficit which has ballooned because of economic weakness.

At the same time that an increase in the budget deficit is established, measures to reduce the deficit in later years can be chosen and legislated. Once a target rate of growth is achieved and the internal mechanisms of the economy are driving growth, the problem of eliminating the structural budget deficit can take top priority.

For example, real growth of GDP at 3-1/2% per year might then trigger measures such as higher gasoline taxes, caps on the growth of some entitlements, higher taxes on social security benefits to the affluent, or an even greater acceleration of defense spending reductions, if warranted.

Modest and gradual doses of fiscal restraint would not severely curtail economic activity and, if chosen carefully to preserve those fiscal policies aimed at raising productivity and potential output, could sustain the gains achieved in raising the trend growth rate of the economy. The fiscal instruments chosen should be cyclical in impact and least subject to interactions of near-term growth with long-run potential output.

The above are examples of possible fiscal instruments that might lift the cyclical behavior of the economy and improve its long-run potential, consistent with the Clinton Economic Plan of Putting

People First.

If the economy strengthens over the next several months, then the fiscal plan can be put on hold. On the other hand, if the economy continues to underperform and appears in need of a lift, then such a program could be introduced.

Deficits And Interest Rates

Additional fiscal stimulus does tend to raise interest rates, but in an economy that is performing well below trend, with considerable slack, low utilization rates and a high unemployment rate, and low inflation, monetary accommodation by the central bank would be indicated. Short-term interest rates need not rise in such a situation and the economy could be permitted to grow above trend for awhile until a lower unemployment rate was achieved. At that time, the fiscal stimulus would be tapered off and perhaps a program of fiscal restraint implemented.

The new Administration could well set a plan of tapering fiscal stimulus and then fiscal restraint in the outyears contingent upon the behavior of the economy.

With inflation low, a key ingredient of long-term interest rates, a modest increase in the budget deficit ex-ante need not lead to greatly higher interest rates through expectations effects. This is especially true if the fiscal stimulus demonstrates long-run benefits to potential output rather than only a short-run lift to spending, output and employment.

It is not necessary for long-term interest rates to rise in response to an increase in the federal budget deficit, if it is modest, not permanent, and raises the long-run supply potential of the economy. Financial market participants certainly will be skeptical that a little bit of fiscal stimulus might turn into massive overspending and runaway deficits. Legislated outyear reductions and the structural deficit are thus necessary. But, not until the legislation is matched by action could the discounting of such a risk be undone.

Concluding Perspectives—Deficits And Economic Growth, The Conflict And Choice

In 1992-93, the U.S. economy is confronted with several economic problems—growth and jobs, large budget deficits, and stagnant overseas economies. In 1988-89, the only major problem was the deficit.

If budget deficits fell of their own accord, then the resulting lower interest rates could increase economic activity in interest sensitive spending, increasing growth and lowering deficits together. But, this generally can happen only through reductions of interest rates by the Federal Reserve.

Reducing deficits by cutting government spending and/or raising taxes lowers economic activity, decreases jobs, and actually does not produce as much deficit relief as planned because of lost tax receipts from lower economic activity. Interest rates do decline in such a situation, softening somewhat the effects on the economy. But, mainstream thinking in macroeconomics and virtually all econometric models indicate that the gains to the economy and jobs from lower interest rates are more than offset by the losses from reductions in spending and higher taxes.

A time for deficit reduction through reduced spending and/or higher taxes is when the economy is at or near full employment, with rising inflation. Such is not the case now, after 3-1/2 years of prolonged weakness and growth below trend, the lowest inflation rates in 30 years, an unemployment rate near 7-1/2%, and stagnation in much of the industrialized world.

The lifting of growth should be from below, with a small to modest dose of fiscal stimulus, unlike the typical applications of fiscal stimulus in the past. In this way, especially with large budget deficits, the effects on financial markets would be limited and the stimulus were not enough, more could be applied later. Also, the economy does tend to relieve excesses over time, setting up for expansion later. Too much stimulus might end up superimposed on an economy that already was doing better, leading to overshoot or too much growth relative to potential supply and a potential reignition of inflation.

An efficient choice of fiscal policy measures in a modest and temporary relaxation of the federal budget deficit to higher planned levels, along with a low profile of interest rates induced by the Federal Reserve or by market forces, is a policy combination that offers relief for the lagging U.S. and world economies.

Both increased growth and lower deficits can occur if other sources of growth such as easier monetary policy, increased economic activity abroad, increased efficiency and productivity in the private and public sectors, lower cost provision of health care, or other new exogenous sources of growth or cost-savings can be achieved.

But, outside of these, dealing with chronically subpar economic growth and a chronically high federal budget deficit is a sequencing problem—one first, then the other.

What's wrong with the economy is largely structural, depressing growth, jobs, income and profits, the key generating mechanisms of the economic system. Growth needs to be dealt with first, then the deficit, to solve the complicated macroeconomic problems now facing the U.S. and world economies.

Table 1

THE BOSTON COMPANY
Boston Safe Deposit and Trust Company

Allen Sinai, Chief Economist

Economic Advisors, Inc.
(Boston - New York - London - Tokyo)

U. S. Economic Forecast

November 6, 1992

Forecast of the U.S. Economy and Financial Markets
(Probability of 0.65)

	Quarters						Years			
	1992:1	1992:2	1992:3	1992:4	1993:1	1993:2	1991	1992	1993	1994
Gross Domestic Product-1987 Dollars	4873.7	4892.4	4924.5	4937.9	4966.3	4997.1	4821.0	4907.1	5014.5	5152.0
Annual Rate of Change	2.9	1.5	2.7	1.1	2.3	2.5	-1.2	1.8	2.2	2.7
Percent Change Year Ago	1.6	1.6	1.9	2.1	1.9	2.1	0.1	2.1	2.6	2.8
Consumption	3289.3	3288.5	3316.1	3330.5	3350.3	3371.9	3240.8	3306.1	3384.9	3470.1
Annual Rate of Change	5.1	-0.1	3.4	1.7	2.4	2.6	-0.6	2.0	2.4	2.5
Business Fixed Investment	495.8	514.7	515.1	517.6	522.3	525.4	500.2	510.8	527.1	547.8
Annual Rate of Change	3.0	16.1	0.3	1.9	3.7	2.4	-7.1	2.1	3.2	3.9
Residential Construction	185.6	191.2	191.4	195.5	203.2	205.8	170.2	190.9	207.5	211.5
Inventory Investment	-12.6	7.8	14.7	11.5	9.2	10.7	-9.3	5.4	10.0	19.9
Net Exports	-21.5	-43.9	-51.5	-52.5	-54.3	-58.3	-21.8	-42.4	-58.1	-61.1
Federal Government	375.3	372.7	376.7	372.7	370.4	372.0	388.3	374.4	372.5	379.5
Annual Rate of Change	-3.0	-2.7	4.4	-4.2	-2.4	1.7	1.2	-3.6	-0.5	1.9
State and Local Government	561.8	561.5	562.1	562.6	565.2	569.6	552.7	562.0	570.7	584.4
Annual Rate of Change	5.1	-0.2	0.4	0.4	1.9	3.2	1.2	1.7	1.5	2.4
Industrial Production (1987=1.000)	1.072	1.086	1.089	1.092	1.105	1.119	1.071	1.085	1.125	1.176
Annual Rate of Change	-3.1	5.5	1.2	1.0	4.9	5.0	-1.9	1.3	3.7	4.5
Housing Starts (Mils. Units)	1.259	1.143	1.198	1.269	1.327	1.401	1.015	1.217	1.388	1.441
Auto Sales-Total (Mils. Units)	8.3	8.5	8.1	8.2	8.4	8.6	8.4	8.3	8.6	9.0
Unemployment Rate-Civilian (%)	7.2	7.5	7.6	7.6	7.5	7.3	6.7	7.5	7.3	6.7
Federal Budget Surplus										
Unified (Quarterly Rate, NSA, FY)	-115.5	-28.4	-62.4	-92.2	-93.5	-99.1	-269.5	-290.2	-380.8	-327.5
Implicit Price Deflator (%CH)	3.1	2.7	2.0	2.6	2.9	2.9	4.0	2.6	2.7	3.1
CPI- All Urban (%CH)	2.8	3.4	2.6	2.8	3.0	2.9	4.2	3.0	2.9	3.1
PPI-Finished Goods (%CH)	0.0	3.1	1.7	2.5	2.8	3.4	2.1	1.3	2.8	3.4
Hourly Compensation (%CH)	3.8	2.4	3.7	3.0	2.7	2.4	5.1	3.4	2.8	2.5
Trade-Weighted Exchange Rate	0.849	0.852	0.815	0.858	0.863	0.871	0.855	0.844	0.880	0.935
Annual Rate of Change	4.3	1.5	-16.3	22.8	2.4	3.8	-1.2	-1.4	4.3	6.3
Merchandise Trade Balance (Bils. $'s)	-58.7	-83.7	-95.0	-99.0	-90.8	-89.6	-65.4	-84.1	-89.2	-93.2
Corporate Profits Aftertax (Bils. $'s)	229.7	232.7	234.4	236.4	241.5	243.6	210.7	233.3	249.3	268.8
Percent Change Year Ago	6.2	11.1	11.8	14.0	5.1	4.7	6.9	10.7	6.9	7.8
Adjusted Profits Aftertax (Bils. $'s)	247.6	244.2	253.3	251.4	255.5	257.6	222.3	249.1	263.3	282.8
Percent Change Year Ago	8.4	8.8	18.3	13.1	3.2	5.5	21.0	12.1	5.7	7.4
Real Disposable Income (Bils. 87$'s)	3565.7	3576.0	3576.4	3598.6	3619.0	3642.3	3509.1	3579.2	3656.1	3755.8
Annual Rate of Change	4.0	1.2	0.0	2.5	2.3	2.6	-0.2	2.0	2.2	2.7
Personal Saving Rate (%)	4.9	5.4	4.5	4.7	4.7	5.0	4.8	4.9	5.1	5.3
M2 (Bils. $'s)	3466.1	3469.1	3469.9	3506.5	3547.8	3588.1	3429.9	3506.5	3675.9	3867.4
Annual Rate of Change	4.3	0.3	0.1	4.3	4.8	4.6	2.8	2.2	4.8	5.2
Prime Rate (%)	6.50	6.50	6.01	6.00	6.00	6.00	8.46	6.25	6.04	6.73
Federal Funds Rate (%)	4.08	3.84	3.30	3.04	3.00	3.21	5.73	3.57	3.27	4.19
3-Month Treasury Bills (%)	3.91	3.69	3.09	2.91	2.97	3.09	5.38	3.40	3.20	4.23
10-Year Treasury Note (%)	7.29	7.38	6.60	6.64	6.65	6.82	7.85	6.98	6.87	7.11
30-Year Treasury Bond (%)	7.80	7.89	7.44	7.53	7.44	7.60	8.13	7.67	7.65	7.87
New AAA-Equiv. Corporate Bonds (%)	8.35	8.35	8.15	7.89	7.90	8.05	8.74	8.19	8.06	8.15
Bond Buyer Index (%)	6.68	6.58	6.17	6.50	6.48	6.62	6.91	6.48	6.66	6.63
S&P 500 Index of Common Stocks	411.94	409.85	417.18	422.87	432.77	444.60	376.48	415.46	450.73	486.72
Annual Rate of Change	28.1	-2.0	7.3	5.6	9.7	11.4	12.6	10.4	8.5	8.0
Earnings Per Share - S&P 500 ($)	5.36	5.39	5.69	5.76	6.00	6.21	15.97	22.20	24.95	27.16
Percent Change Year Ago	4.3	18.7	52.1	125.9	11.9	15.2	-25.2	39.0	12.4	8.9
Price-Earnings Ratio - S&P 500	19.2	19.0	18.3	18.4	18.0	17.9	23.6	18.7	18.1	17.9

Table 2

Allen Sinai, Chief Economist

THE BOSTON COMPANY
Boston Safe Deposit and Trust Company

Economic Advisors, Inc.
(Boston - New York - London - Tokyo)

World Outlook Summary

November 6, 1992
(Probability of 0.65)

	Real Growth *** (Percent Change)				Inflation - Consumer Prices ** (Percent Change)				Unemployment Rate (Percent)				Current Account Balance **** (Billions of U.S. Dollars)			
	1990	1991	1992	1993	1990	1991	1992	1993	1990	1991	1992	1993	1990	1991	1992	1993
United States *	0.8	-1.2	1.8	2.2	5.4	4.2	3.0	2.9	5.5	6.7	7.5	7.3	-90.4	-3.7	-59.2	-74.5
Canada *	0.5	-1.7	0.9	2.0	4.8	5.6	1.4	1.5	8.1	10.3	11.2	10.9	-22.0	-25.5	-24.5	-21.2
Europe	2.9	1.2	0.9	1.3	5.0	4.5	3.9	3.5	7.4	7.8	8.6	8.8	12.4	-47.8	-59.0	-45.2
France * §	2.2	1.2	2.0	2.2	3.4	3.1	2.9	2.8	9.0	9.6	10.3	10.0	-9.2	-5.8	-2.0	-0.5
Germany (West) * §	4.9	3.6	1.2	0.8	2.7	3.5	4.0	3.5	7.2	6.3	6.6	6.9	47.9	-19.9	-24.5	-19.2
Italy * §	2.2	1.4	1.5	1.5	6.1	6.5	5.3	4.9	9.9	10.1	11.0	11.1	-14.7	-21.1	-25.0	-20.5
Switzerland *	2.3	-0.1	-0.5	1.8	5.4	5.8	4.1	3.5	0.6	1.3	3.0	3.5	8.6	10.2	15.0	13.0
United Kingdom * §	0.7	-2.4	-0.9	1.0	9.5	5.9	3.8	3.5	5.8	8.1	9.7	10.3	-20.2	-11.2	-22.5	-18.0
Average Measure (1)	0.6	-2.4	-0.6	1.2	--	--	--	--	--	--	--	--	--	--	--	--
Asia - Pacific	5.3	4.3	2.1	2.5	3.7	3.7	2.3	2.4	2.4	2.6	2.7	2.9	31.5	68.9	107.3	82.8
Japan *	5.3	4.4	1.7	2.2	3.1	3.3	2.0	2.2	2.1	2.1	2.2	2.4	36.0	72.9	115.8	90.5
Korea	9.3	8.4	6.8	5.9	8.6	9.7	6.4	5.9	2.5	2.3	2.5	2.4	-2.2	-8.7	-6.4	-4.2
Taiwan	5.0	7.2	7.0	5.5	4.1	3.6	4.4	3.5	1.7	1.5	1.5	1.5	10.8	12.0	8.0	7.9
Hong Kong	3.0	4.2	4.9	5.3	9.8	11.4	9.9	10.1	1.3	1.3	1.2	1.1	-0.3	-1.7	-4.1	-6.9
Singapore	8.3	6.7	6.0	5.8	3.4	3.4	2.3	2.5	1.7	1.2	1.0	1.0	2.2	4.2	4.5	4.0
Australia *	2.5	-1.2	1.2	2.2	7.3	3.2	1.0	1.5	7.0	9.6	10.7	10.6	-15.0	-9.8	-10.5	-8.5
Latin America	0.5	3.1	2.5	2.8	792.9	235.6	549.2	580.1	4.5	4.7	5.2	4.8	13.8	-2.1	-5.9	-8.7
Argentina	0.4	5.5	5.8	5.8	1343.9	84.0	19.8	15.0	7.4	6.5	6.0	5.3	1.9	-1.0	-1.8	-2.2
Brazil	-4.0	1.0	0.9	2.0	1585.2	475.1	1154.0	1221.0	4.3	4.8	6.3	5.5	11.0	10.5	14.2	12.5
Mexico	4.4	3.6	2.5	3.2	29.9	18.8	11.3	9.8	2.7	2.8	2.2	2.0	-7.1	-13.3	-20.5	-20.5
Venezuela	5.3	9.2	7.5	4.0	36.5	31.0	33.5	35.2	10.4	9.7	10.0	10.1	8.0	1.7	2.2	1.5
World	2.6	1.2	1.6	2.1	38.4	14.0	26.2	27.5	5.0	5.7	6.3	6.3	-54.7	-10.2	-41.3	-66.8
OECD *	2.6	0.9	1.5	1.9	4.7	4.1	2.9	2.8	5.2	6.0	6.6	6.6	-79.0	-13.9	-37.4	-58.9
EEC §	2.9	1.3	0.9	1.3	5.0	4.4	3.9	3.5	7.6	8.0	8.8	9.0	3.8	-58.0	-74.0	-58.2

*** Expenditure Real GNP or GDP, depending on the country.
(1) Average of Expenditure, Production, and Income Measures.

** Annual average, except for Latin American countries, which are percent change, December-over-December.

**** Hong Kong; Brazil trade balance.
* OECD § EEC

Table 3
Budget Summary - TBCEA Estimates November 92 Forecast

(Billions of dollars, fiscal years)	1991	1992	1993	1994	1995	1996	1997
Current services budget							
Receipts	1054.3	1091.8	1144.2	1227.6	1317.8	1396.2	1474.9
Individual income taxes	467.8	476.5	498.1	540.6	586.0	624.6	662.3
Corporate income taxes	98.1	100.3	106.7	114.5	122.8	127.7	132.2
Social insurance	396.0	413.7	438.0	470.6	501.6	532.1	564.3
Other	92.4	101.3	101.4	102.0	107.4	111.7	116.1
Outlays	1323.7	1381.9	1493.6	1533.8	1576.9	1654.1	1768.9
Restricted outlays	534.8	533.3	543.7	538.5	541.6	554.5	570.5
Defense	319.7	303.8	297.0	286.0	286.0	290.0	298.0
International affairs	19.7	18.1	20.7	21.2	21.5	22.0	22.5
Other nondefense discretionary	195.4	211.4	226.0	231.3	234.1	242.5	250.0
Net interest	194.5	199.4	200.9	229.3	249.3	269.6	287.4
Social Security Benefits	266.8	287.5	301.0	319.0	338.0	360.0	382.0
Deposit Insurance	66.3	2.9	52.0	23.0	-5.0	-15.0	-16.0
Other	261.3	358.8	396.0	424.0	453.0	485.0	545.0
Current services deficit	269.5	290.2	349.4	306.2	259.1	257.9	293.9
Percent of GDP	4.8	4.9	5.7	4.7	3.7	3.5	3.8
Economic assumptions (calendar years, except where noted)							
Real GDP (% Chg. 4th qtr./4th qtr.)	0.1	2.1	2.6	2.8	2.4	2.3	2.3
GDP deflator (% Chg. 4th qtr./4th qtr.)	3.4	2.6	2.9	3.2	3.5	3.8	3.5
Real GDP (% chg.)	-1.2	1.8	2.2	2.7	2.7	2.3	2.3
GDP deflator (% chg.)	4.0	2.6	2.7	3.1	3.7	3.7	3.6
Civilian unemployment rate (%)	6.7	7.5	7.3	6.7	6.7	6.8	6.8
91-day Treasury bill rate (%)	5.4	3.4	3.2	4.2	4.6	4.8	4.6
10-year Treasury note rate (%)	7.9	7.0	6.9	7.1	7.3	7.3	7.3

Source: The Boston Company Economic Advisors, Office of Management and Budget

Chart 1
Potential and Actual Real Economic Growth: Trend and Cycle
(1962 to 1995, Billions of 1987 $'s)

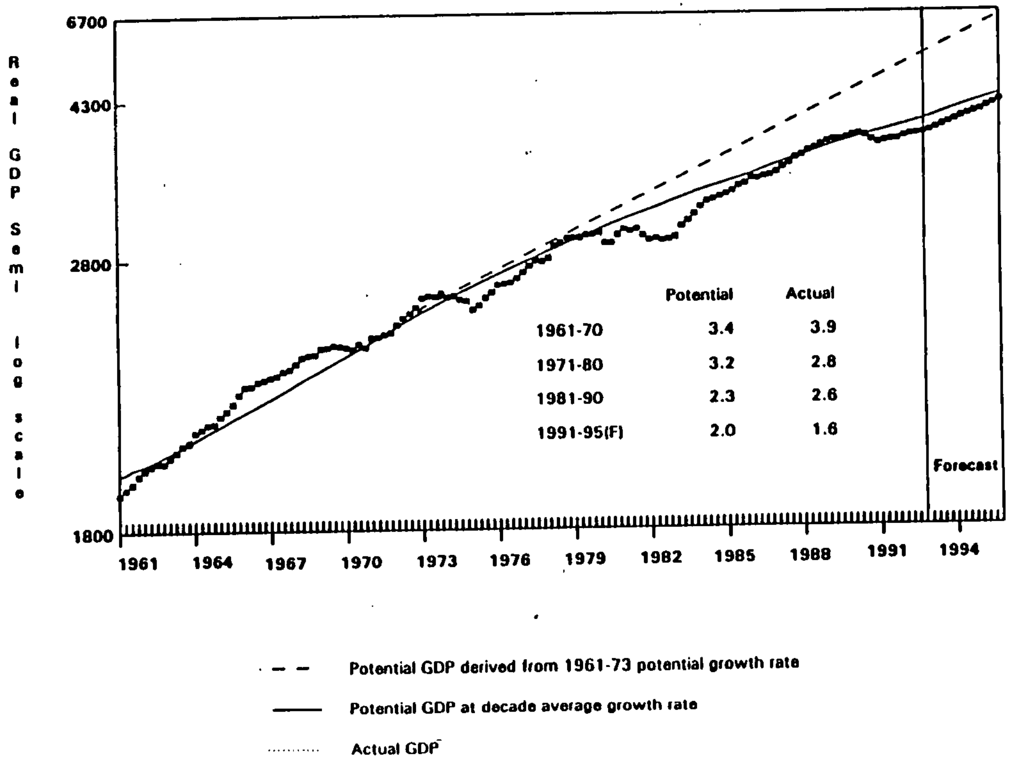

Table 4
Unified and Structural Budget Estimates*
(Fiscal Years, Billions of Dollars)

	1991	1992	1993	1994	1995	1996	1997
Congressional Budget Office (CBO)--(8/92)							
Unified Budget Deficit	269	290	331	268	244	254	290
Less:							
Deposit Insurance Costs	66	3	49	17	5	-7	-16
Desert Storm	-43	-5	0	0	0	0	0
CBO Net Deficit	246	292	282	251	239	261	307
"Cyclical" Effects	55	74	59	37	27	21	16
Structural or Full Employment Budget Deficit (Unified Basis)	190	218	223	214	212	240	291
The Boston Company Economic Advisors, Inc. (TBCEA)--(11/92)							
Unified Budget Deficit	269	290	349	306	259	258	294
Less:							
Deposit Insurance Costs	66	3	52	23	-5	-15	-16
Desert Storm	-43	-5	0	0	0	0	0
TBCEA Net Deficit	246	292	272	283	264	273	310
Less:							
NIPA Translation	-6	0	0	0	0	0	0
NIPA Deficit	239	292	297	285	264	273	310
"Cyclical" Effects	46	86	90	77	66	69	83
Structural or Full Employment Budget Deficit (NIPA Basis)	193	206	207	208	198	204	227

Economic Assumptions

CBO (8/92)						
Real GDP (% chg.)	1.9	3.1	2.8	2.6	2.4	2.2
CPI-U (% chg.)	3.2	3.4	3.4	3.4	3.4	3.4
Unemployment Rate (%)	7.5	6.8	6.1	5.9	5.7	5.6
TBCEA (11/92)						
Real GDP (% chg.)	2.2	2.7	2.8	2.4	2.3	2.3
CPI-U (% chg.)	3.0	2.9	3.1	3.4	3.5	3.4
Unemployment Rate (%)	7.5	7.3	6.7	6.7	6.8	6.8

*Current Services Basis; No New Fiscal Programs.

PREPARED STATEMENT OF RICHARD W. RAHN, NOVECON

Mr. Chairman, I am Richard W. Rahn, President of the Novecon companies, and adjunct scholar of the CATO Institute. I thank you for inviting me to testify on the state of the U.S. economy and the proper course of economic policy.

In each of my appearances before this Committee over the last four years, I have warned that unless Congress and the Administration took immediate action to reduce the growth in government spending, reduce excessive regulation, and reduce the tax impediments to productive capital formation, we would have a stagnant economy. Congress and the Administration have not acted, and my predictions have unfortunately proven to be all too accurate. As a number of you may recall, during the period from 1982 through 1989, I consistently predicted a high growth economy, and was one of a relatively few well known economists never to have predicted a recession during that period. At the beginning of this decade, my forecasts became increasingly pessimistic until early in 1990, when I and my former colleagues at the U.S. Chamber of Commerce were among the first to forecast the recession. We also argued that the strong recovery predicted by many was unlikely.

Despite the recent encouraging economic news, I still remain pessimistic. I expect we will have a couple of reasonably robust quarters of economic growth, but then we are likely to slip back to the meager economic crawl we have experienced over the past year. The reason quite simply is that the causes of our economic stagnation have not been addressed.

In order to understand what is now happening to us, reflect on the economic performance of the past thirty years. We have had two high growth periods during this time. The first was from 1962 through 1966, and the second was from 1983 through 1989. We suffered low growth with high inflation from 1967 through 1982, and we have experienced very low growth with low inflation, from 1990 through the third quarter of this year. Both high growth periods were characterized by economic policies that included cutting marginal income tax rates, keeping government spending below the growth in nominal GDP, and restraining regulatory growth. In both cases, only when we succumbed to higher levels of government spending and rapid growth in regulations did the economy leave the high growth path. Government spending as a percent of gross domestic product grew at an average annual growth rate of .19% from 1966 to 1975, accelerating to a rate of .56% from 1975 to 1982, which was almost duplicated by the .53% average annual growth rate from 1989 through this year. Again, the high growth periods of 1962-1966 and 1983-1989 were characterized by government spending shrinking as a percent of GDP - an average reduction as a percent of GDP of -.32% per year from 1961 to 1966 and -.10% per year from 1982 to 1989. (Please see table I)

This data comes as no surprise to any good classical economist who is familiar with recent studies of comparative economic performance from around the globe which show the same relationship. In fact, the evidence shows that economic growth is maximized when total government spending is between 15 and 25 percent of GDP, a point well below where the U.S. is today. Only the discredited Keynesians and Socialists are still surprised when things get worse as government gets bigger. Under their models, the last three years should have been a boom period with falling unemployment rates, and the Eastern European economies should now be the healthiest in the world. Even though few knowledgeable people will any longer claim to be Keynesians or Socialists, much of their economic nonsense still permeates political discourse in this country. One example is the claim that government spending creates jobs. This claim is based on the myth that dollars are spontaneously generated in Washington, or that public sector jobs are vastly more efficient than private sector ones. One need only to realize that government cannot spend money without either taxing or borrowing an equivalent amount from the private sector, and that the extraction costs of taxation and borrowing are very high, to understand the silliness of the claim that government can create jobs.

Our economic stagnation of the last three years cannot be blamed on any external cause. There have been no commodity price shocks, and the Gulf War only had minimal economic impact. In fact, with the collapse of much of the communist world, we had an unprecedented opportunity to rectify many of our persistent economic imbalances. If the Bush Administration and the Congress had enacted the flexible freeze promised in the 1988 campaign, we would have achieved a balanced budget by next year, in a rather painless way because of the unique opportunity to reduce defense spending. But you in the Congress and the Bush Administration frittered it away, because of your unwillingness to restrain the growth of middle-class "entitlements", and eliminate costly subsidies to farmers and others.

If the Congress is serious about restoring economic growth, it won't take much to accomplish. First, reduce the growth in government spending to less than the growth in nominal GDP. Government can still grow even at a rate that is a bit higher than the rate of inflation. You did it in the mid '60s and again in the late '80s, and both times things were better, not worse. It only takes a little leadership and a little more responsibility.

Second, reduce the growth rate of new regulations by applying honest cost-benefit analysis to any new regulation and remove the regulatory impediments that have built up over the years. Regulatory reduction not only stimulates the economy, but also has the side benefit of increasing human freedom.

Third, make a few changes in the tax law to get rid of the obviously destructive and non-productive features. You should begin with capital gains. Most good economists believe the present rate is well above the revenue maximizing rate, and all good economists are opposed to taxing the purely inflationary component of capital gains. The majority of both houses of Congress have gone on record as supporting the indexing of capital gains, as have President Bush and President-Elect Clinton, yet the taxation of inflation continues. Every member of Congress who has impeded the indexation of capital gains and depreciation has much to atone for - it is not only economically irresponsible but also morally repugnant. Millions of jobs have been lost and many in our Country are poor because of this irresponsibility. The great hypocrisy is that many in Congress who have resisted capital gains relief are the ones who shed crocodile tears about unemployment. It is no wonder that the American people have such a low opinion of Congress.

We will be able to quickly determine if the new Congress is any more responsible than the last few when it comes to economic issues. Most members of Congress claimed in their election campaigns that they wanted to increase the savings rate and productive investment. Again, it is not that difficult to do. In addition to capital gains relief and improved depreciation allowances, they should eliminate the double taxation of dividends and enact laws to greatly expand IRA's for all Americans.

Now some among you will say these are nice things to do but we can't afford it with the deficit. But some of you say those things because you get lousy numbers from the Congressional Budget Office, the Treasury or Office of Management and Budget. If you want to begin to have good economic policy, you should begin to demand honest numbers, and for the most part, you are not going to get them from government agencies. Merely look at the projections of the great benefits we were going to get from the infamous 1990 budget deal according to OMB and CBO, or the revenue projections stemming from the various capital gains tax rate changes. These numbers were off by hundreds of percent. If a private financial firm or CPA had given such projections to stockholders or the public, many of you would have been screaming for indictments. Why no calls for the indictment of Dick Darman of OMB or Bob Reischauer of CBO? Were not their misstatements far more damaging to the American people than those made by any S&L executive. Many of you knew at the time that the numbers were phony, because many of us told you, or you already knew they were using static rather than dynamic analysis. There were a number of responsible forecast groups which were close to the mark, such as the IRET and Fiscal Associates. The lesson should be clear: use private sector forecasters whose reputation rests on accuracy rather than those in the public sector who use forecasts to acquire power or curry favor. Many of you are concerned about the lack of new businesses and the resulting lack of new jobs. I can tell you from personal experience that the various levels of government have erected enormous barriers to getting a new enterprise underway. This year, we set up the Novecon companies to form productive partnerships between U.S. businesses and the new and newly privatized businesses in the former communist countries of Eastern Europe. We are trying both to aid the economic transition of these countries and most importantly to provide a good rate of return for our stockholders. To raise capital for the Novecon companies, I have to demonstrate to potential investors that they will earn money on their investment after discounting for normal business risks and political risks in the relevant countries; but in addition, I have to compensate them for the fact that they will be paying one of the world's highest capital gains tax rates not only on real earnings, but also that due to inflation. I also have to provide an additional risk premium to offset the fact that if we should happen to fail, they will only be able to write the loss off at a rate of $3,000 per year. (Again, if a private party offered such a heads I win-tails you lose deal as the IRS offers, many of you would demand they be carted off to jail for fraud, and you would be right). What kind of rate of return do you think is required to offset all of these risks? Fortunately, I am lucky to have an extraordinarily skilled and experienced group of people working with me, so we will probably make it.

We have had to spend tens of thousands of dollars on legal fees to make sure we comply with all of the regulations of the SEC and the States, even though we are only soliciting "accredited investors" (i.e. wealthy and experienced people) for a private placement. For the most part, these regulations only benefit the lawyers and the tax authorities, and deny smaller investors the opportunity to benefit from many of the most desirable ventures. In addition, I challenge any of you to set up an accounting and payroll system that meets all the requirements of the government authorities without using a costly CPA. In sum, government taxation and regulation have made it extraordinarily difficult for most people who do not have considerable wealth to both start a new business and comply with all the laws and regulations.

Congress in its desire to tax, protect, and control has become the mass strangler of economic growth. As a former economic spokesman for the American business community, and now as an entrepreneur, I say to you if you really want the American economy to begin to grow rapidly, listen to your colleague, the distinguished economist and Congressman Dick Armey, and get your invisible foot of excessive spending, taxing, and regulation off our necks so we can breath again. Finally, it is important for the sake of America that President-Elect Clinton succeed. We know from experience that economic prosperity only comes from restraining spending and regulatory growth, and reducing tax impediments. In fact, when government spending was falling as a percentage of GDP in the two years before the Presidential election as it was in 1964, 1972, 1984, and 1988 the party in power was re-elected to office. Those cases in which government spending was growing as a percentage of GDP as it was in 1968, 1976, 1980 and 1992 the party in power was thrown out. Reducing government spending more than any other single variable, such as interest rates or deficit reduction, is the key to the Nation's economic health; thus, its relationship to political success should be of no surprise. It is up to the Democratic Congress whether or not President-Elect Clinton will be re-elected in 1996. Government spending is a controllable variable — one controlled by you. I will restate it in all immodesty as Rahn's Law —"If government spending is growing as a percentage of GDP during the last two years of an Administration, the party in power will lose office; conversely, if government spending is declining as a percentage of GDP, the party in power will retain office". I am confident in my prediction that if government spending falls as a percentage of GDP in 1995 and 1996 the Democrats will be re-elected, if not they won't. You indeed are masters of your and the Nation's destiny. Thank you.

I have appended to this statement the latest economic forecast, which I fully concur with, prepared by my former colleagues and successor of the U.S. Chamber of Commerce, Dr. Lawrence Hunter, Vice President and Chief Economist and Dr. William K. MacReynolds, Director Economic Policy Center. In Addition, I have appended a study prepared by Fiscal Associates on the "Economic and Revenue Effects of Indexing Capital Gains and Depreciation 'Basis' for Inflation."

ATTACHMENTS TO MR. RAHN'S TESTIMONY

U.S. ECONOMIC GROWTH AND GOVERNMENT EXPENDITURES

Growth Type	Period	Average Annual Rate of Economic Growth	Government Expenditures as a % of GDP*	Average Annual Change
High	1962-1966	5.32	18.4-16.8	-.32
Low	1967-1975	2.34	16.8-18.5	+.19
Low	1976-1982	2.26	18.5-22.4	+.56
High	1983-1989	3.67	22.4-21.7	-.10
Low	1990-1992	0.57	21.7-23.3	+.53

* Change from preceding year to remove effect of business cycle.

Source: Economic Report of the President, 1992.

UNITED STATES ECONOMIC OUTLOOK 1992-1993
Prepared by the U.S. Chamber of Commerce
Fourth Quarter 1992

(Percent change from previous periods at seasonally adjusted annual rates unless otherwise indicated by shading.)

	QUARTERS							YEARS				
	Actual		Forecast					Actual			Forecast	
								Annual Average				
GROSS DOMESTIC PRODUCT	92/2	92/3	92/4	93/1	93/2	93/3	93/4	'83-'88	1990	1991	1992	1993
Nominal GDP	4.3	4.5	4.7	5.6	5.0	4.9	4.8	7.5	5.2	2.8	4.6	5.0
Real GDP	1.5	2.7	2.9	2.7	1.7	1.3	0.8	4.0	0.8	-1.2	1.9	2.2
Consumption	-0.1	3.4	3.0	2.2	-0.9	1.0	0.9	4.1	1.2	-0.6	2.1	1.5
Residential Investment	12.6	0.4	4.8	6.6	4.5	4.8	5.6	10.8	-9.1	-12.6	11.9	5.2
Nonresidential Investment	16.1	0.3	5.1	5.9	14.9	4.9	10.6	4.8	-0.4	-7.0	2.3	7.7
Equipment	24.1	8.5	7.4	8.1	23.7	6.9	13.6	8.5	-1.0	-4.6	6.9	12.5
Structure	-0.8	-17.7	-0.9	0.0	-9.3	-1.1	1.5	-2.6	0.9	-12.0	-7.6	-4.4
Real Net Exports (87$B)	-43.9	-51.5	-54.3	-51.6	-52.1	-49.1	-48.4	-88.7	-51.8	-21.8	-42.8	-50.3
Exports	-1.4	1.9	4.0	5.6	4.6	5.4	4.4	6.7	8.1	5.8	5.0	4.2
Imports	14.7	6.9	5.5	3.4	4.5	3.1	3.6	10.5	3.0	-0.1	8.6	5.1
Government Purchases	-1.2	2.0	0.9	2.9	1.5	2.4	-1.7	3.2	2.8	1.2	-0.3	1.5
Change in Business Inventories (87$B)	7.8	14.7	17.4	12.1	15.8	6.0	-5.8	21.6	6.2	-9.3	6.8	7.0
Final Sales of Domestic Product	-0.1	2.1	2.7	3.1	1.4	2.1	1.7	3.8	1.3	-0.8	1.6	2.2
EMPLOYMENT, PRODUCTION, PROFITS, INTEREST RATES, INCOME AND PRICES												
Civilian Unemployment Rate (%)	7.5	7.6	7.6	7.5	7.4	7.5	7.6	7.2	5.5	6.8	7.5	7.5
Industrial Production	5.2	1.6	2.0	3.0	1.1	2.9	1.0	4.9	1.0	-1.9	1.0	2.3
New Car Sales (mill.)	8.4	8.2	8.6	8.9	9.0	8.8	8.9	10.5	9.5	8.4	8.3	8.9
Domestic Car Sales (mill.)	6.2	6.0	6.4	6.7	6.8	6.6	6.7	7.6	6.9	6.1	6.1	6.7
New Housing Starts (mill.)	1.14	1.20	1.27	1.28	1.31	1.35	1.39	1.68	1.20	1.01	1.22	1.33
Compensation	2.6	3.7	3.8	4.2	4.4	3.9	3.8	4.3	5.4	4.7	3.6	4.0
Productivity	2.0	3.6	2.1	2.7	1.5	1.4	1.1	1.9	0.0	0.1	2.7	2.2
Unit Labor Costs	0.6	0.1	1.7	1.5	2.9	2.5	2.7	2.3	5.4	4.5	0.9	1.8
Consumer Price Index	2.6	2.6	3.2	3.2	4.1	3.8	3.4	3.5	5.4	4.3	3.1	3.4
Implicit GDP Deflator	2.7	1.9	1.8	2.9	3.3	3.4	3.8	3.3	4.3	4.0	2.6	2.8
Prime Interest Rate (%)	6.5	6.0	6.0	6.0	6.0	6.0	6.0	9.8	10.1	8.5	6.2	6.0
3-month Treasury Bill Rate (%)	3.7	3.2	3.0	3.1	3.3	3.6	3.4	7.8	7.5	5.4	3.5	3.4
Corporate Bond Rate (%)	8.3	8.1	8.0	7.9	7.8	7.7	7.8	10.7	9.3	8.8	8.2	7.8
Real Personal Disposable Income	1.2	0.0	1.6	2.6	2.0	1.5	1.0	3.6	0.9	-0.2	1.9	1.7
Changes in Profits from Current Production ($B)[1]	4.4	3.4[2]	2.1	-3.2	1.0	5.0	2.1	29.8	-1.1	-15.4	43.2	4.9

[1] Corporate profits with inventory valuation and capital consumption allowances.
[2] USCOC estimate.

FORECAST ASSUMPTIONS

s forecast table contains advance estimates of the National Income and Product Accounts for the fourth quarter of 1992. The nation's money supply M(2) is assumed to grow by 2.0 percent in 1992 and 3.5 percent in 1993. The trade weighted exchange value of the dollar falls by 2.8 percent in 1992 and falls by 1.8 percent in 1993.

SOURCE: U.S. Chamber of Commerce, Forecast Section.

U.S. Chamber of Commerce

Washington, D.C. 20062

August 24, 1992

The U.S. Chamber of Commerce is pleased to release "The Economic and Revenue Effects of Indexing Capital Gains and Depreciation 'Basis' for Inflation." In this important new study, former Treasury Economists Gary and Aldonna Robbins find that both the indexation of capital gains and depreciation "basis" would prove a powerful boost to the struggling U.S. economy. Indexing capital gains alone would have an immediate positive effect on growth and would create some 938,000 new jobs and $1.6 trillion in additional GDP by the year 2000.

The authors conclude that indexation of the basis of both capital gains and depreciation, when taken together, would "lead to an additional 1 percentage point increase in the growth rate over the next six years. The 2.4 percent average long-run growth rate currently predicted by most forecasters could become the 3.4 percent enjoyed during the last six years of the Reagan Administration."

The study estimates that during the first four years, using a static revenue estimating procedure (i.e., assuming no increase in economic growth due to indexing), the unlocking effect of indexing capital gains will generate $20 billion in new capital gains revenues for the federal government alone, which will offset an estimated $20 billion static revenue loss in federal revenues due to indexing depreciation. When the dynamic effects of increasing economic growth are taken into account (i.e., when increased economic growth due to indexing is factored in), the study estimates that the combined indexation of capital gains and depreciation will actually yield a five-year revenue increase to the federal government equaling $176.5 billion. State and local governments can expect to increase their total revenues by approximately $134.6 billion during this same five year time period.

The case for indexation is not ideological. Even those economists who favor taxing ordinary income and capital gains at identical rates, for example, agree that the part of capital gain attributable to inflation should not be taxed. The taxation of inflationary gains is unjust and economically damaging. Thwarted by continued congressional inaction, the president is said to be looking intently for actions he can take on his own to help get the economic recovery out of low gear. No other single action he could take alone would be more helpful to the economy than to use his administrative authority to index capital gains and depreciation for inflation.

Lawrence A. Hunter
Vice President and Chief Economist

ECONOMIC AND REVENUE EFFECTS OF INDEXING CAPITAL GAINS AND DEPRECIATION "BASIS" FOR INFLATION

Prepared by:
Fiscal Associates, Inc.

For:
The U.S. Chamber of Commerce

August 24, 1992

Capital gains income and tax depreciation depend on the definition of "basis." Generally, basis is the "cost" of obtaining an asset — either financial or physical. In measuring income for tax purposes, taxpayers are allowed to recover their cost (basis) without tax. Tax law, however, does not index the basis for inflation that has occurred between the time of acquisition and sale of the asset.

The capital gains tax applies to the value of the asset less its basis. Much of the capital gains from an asset held for a number of years results from the increase in price due solely to inflation.

Depreciation deductions also depend on the basis concept. The purpose of depreciation is to exclude the principal used in purchasing an asset from a third layer of taxation. Here again, however, inflation taints the adjustment for original cost. Replacing an asset generally costs more than the original cost.[1]

Adjusting an asset's basis for inflation would more accurately reflect the true economic effects involved. In the case of capital gains only "real" economic gains would be taxed. In the case of depreciation the adjustment would acknowledge rising costs of replacement due to inflation.

Indexing the Basis for Capital Gains

Tables 1 through 3 show the economic and revenue effects of allowing the capital gains basis to be indexed from the last time it was determined.[2] We have assumed that the change would be effective in the last third of 1992. All other tax provisions, including depreciation, are assumed to remain the same as current law.

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[1] Lengthening cost recovery also distorts investment decisions because it does not adjust for the time value of money.

[2] In other words, the last time the asset was evaluated for tax purposes such as original purchase or step up at the time of inheritance.

Indexing will dramatically unlock capital gains that have been building over the last several years. The forty percent increase in capital gains tax rates contained in the Tax Reform Act of 1986 has led to a significant drop in capital gains realizations. Realizations in 1990 are below those in 1984 despite a large increase in stock market values and normal economic growth. In short, as we and others predicted, tax revenues from capital gains are no higher today than they were before the rate increase.

We estimate that realizations from the unlocking would increase capital gains tax revenues by about $20 billion over the first four years. In the long-run, we estimate that the change would be, on average, equivalent to an 80 percent exclusion of nominal (unadjusted) capital gains.

Indexing capital gains also would lower the cost of capital and increase economic growth. We estimate that indexing capital gains for inflation would:

- Create 542,000 jobs by 1996 and 938,000 by the year 2000.
- Increase U.S. capital formation by $1.6 trillion by 1996 and by $2.7 trillion at the end of the decade.
- Add $473 billion to GDP by 1996 and $1.6 trillion by the end of the decade.

By the year 2000, we estimate that the *static* revenue loss would be $16.3 billion a year. The additional $54.8 billion in federal revenue resulting from higher economic growth, however, would produce a net revenue gain of $38.6 billion a year. Higher economic growth also would benefit state and local governments, increasing their annual revenues by $38.1 billion.

<u>Indexing the Basis for Depreciation</u>

Tables 4 through 6 show the economic and revenue effects of applying the inflation adjustment to the basis for depreciation deductions. Following the capitals gains convention, we have assumed that the new adjustment would apply to the ***last adjusted basis***. This assumption limits the inflation adjustment to the remaining basis of the existing U.S. capital stock and to new investment. The limitation prevents an immediate $40 billion a year revenue loss that would simply represent a windfall gain to owners of existing assets.

Indexing depreciation deductions would lower the cost of capital and increase economic growth. We estimate that this indexing would:

- Create 931,000 jobs by 1996 and 1.7 million by the year 2000.
- Increase U.S. capital formation by almost $3 trillion by 1996 and by $4.8 trillion at the end of the decade.

- Add $804 billion to GDP by 1996 and $2.8 trillion by the end of the decade.

The static revenue loss would amount to about $20 billion over the first four years — matching the static revenue increase from unlocking capital gains. By the year 2000, the provision would be losing almost $45 billion annually. The prospective (or backloaded) nature of the revenue loss allows the government to provide substantial investment incentives with a minimal initial static revenue loss. It is as if the government provides a break to businesses if they agree to defer taking it until later.

Higher economic growth, however, would produce a net annual revenue gain of $55.1 billion by the year 2000. Higher economic also would benefit state and local governments, increasing their revenues by $68.6 billion a year.

<u>Indexing the Basis for Both Capital Gains and Depreciation</u>

Combining indexing for capital gains and depreciation is a highly effective way to provide investment incentives. The initial static revenue losses are zero over the first four years. Incentive effects, however, are at their maximum immediately. The static revenue losses that critics will claim are either far into the future or wishful thinking. The current low levels of capital gains realizations will continue as long as tax rates are high. The choice is between more revenue now at a lower tax rate with the fall off later on or a continuation of the current anemic dribble in hopes of getting a little more in the future.

When economic growth is considered, indexing capital gains and depreciation would yield enormous dividends to government and to workers (Tables 7 through 9). High taxes on capital drive businesses overseas, costing workers their jobs and government its tax base. The basis adjustment will lower the capital cost of doing business in the U.S. by 20 percent and make the mix of labor and capital more efficient. These two effects will lead to an additional one percentage point increase in the growth rate over the next six years. The 2.4 percent average long-run growth rate currently predicted by most forecasters could become the 3.4 percent enjoyed during the last six years of the Reagan administration.

Table 1
EFFECT OF BASIS ADJUSTMENT CHANGE FOR CAPITAL GAINS
(billions of nominal dollars, millions of jobs)

Calendar Year	Change in GDP	Change in Jobs	Change in Capital
1992	11.7	0.022	116.7
1993	44.9	0.095	435.0
1994	91.4	0.224	857.3
1995	139.3	0.377	1,270.6
1996	185.7	0.542	1,649.7
1997	226.2	0.689	1,958.8
1998	260.4	0.805	2,204.0
1999	292.4	0.880	2,434.3
2000	323.4	0.938	2,653.4

Table 2
EFFECT OF BASIS ADJUSTMENT CHANGE FOR CAPITAL GAINS
(percentage deviation from OMB baseline)

Calendar Year	Percent Change in GDP	Percent Change in Jobs	Percent Change in Capital	Change in Growth Rate
1992	0.22%	0.02%	0.59%	0.11%
1993	0.80%	0.09%	2.09%	0.26%
1994	1.51%	0.20%	3.92%	0.38%
1995	2.15%	0.34%	5.53%	0.43%
1996	2.69%	0.48%	6.82%	0.44%
1997	3.07%	0.60%	7.69%	0.43%
1998	3.31%	0.69%	8.22%	0.41%
1999	3.48%	0.74%	8.62%	0.38%
2000	3.61%	0.78%	8.91%	0.36%

Table 3

EFFECT OF BASIS ADJUSTMENT CHANGE FOR CAPITAL GAINS

(billions of nominal dollars)

Calendar Year	Static Federal Revenue Change	Federal Change Due to Growth	Dynamic Federal Revenue Change	State & Local Revenue Change	Net to All Governments
1992	6.4	3.2	9.6	1.9	11.5
1993	8.9	9.7	18.6	6.2	24.8
1994	4.7	16.6	21.3	11.3	32.6
1995	0.0	24.2	24.2	16.7	40.9
1996	-2.7	31.8	29.1	22.1	51.2
1997	-5.6	38.6	33.0	26.9	59.8
1998	-8.9	44.6	35.7	30.9	66.6
1999	-12.4	49.8	37.4	34.6	72.0
2000	-16.3	54.8	38.6	38.1	76.7

Table 4

EFFECT OF BASIS ADJUSTMENT CHANGE FOR DEPRECIATION

(billions of nominal dollars, millions of jobs)

Calendar Year	Change in GDP	Change in Jobs	Change in Capital
1992	13.0	0.024	129.5
1993	67.9	0.137	662.6
1994	152.6	0.357	1,449.6
1995	242.6	0.635	2,247.9
1996	327.9	0.931	2,963.8
1997	405.4	1.199	3,583.0
1998	466.6	1.409	4,031.8
1999	523.8	1.558	4,446.4
2000	578.5	1.668	4,835.9

Table 5
EFFECT OF BASIS ADJUSTMENT CHANGE FOR DEPRECIATION
(percentage deviation from OMB baseline)

Calendar Year	Percent Change in GDP	Percent Change in Jobs	Percent Change in Capital	Change in Growth Rate
1992	0.25%	0.02%	0.66%	0.12%
1993	1.21%	0.13%	3.19%	0.40%
1994	2.53%	0.32%	6.63%	0.63%
1995	3.75%	0.57%	9.77%	0.74%
1996	4.75%	0.82%	12.25%	0.78%
1997	5.50%	1.04%	14.07%	0.77%
1998	5.93%	1.20%	15.04%	0.72%
1999	6.24%	1.31%	15.74%	0.67%
2000	6.45%	1.39%	16.25%	0.63%

Table 6
EFFECT OF BASIS ADJUSTMENT CHANGE FOR DEPRECIATION
(billions of nominal dollars)

Calendar Year	Static Federal Revenue Change	Federal Change Due to Growth	Dynamic Federal Revenue Change	State & Local Revenue Change	Net to All Governments
1992	-0.9	3.4	2.4	2.0	4.5
1993	-3.9	14.9	11.0	9.5	20.4
1994	-7.4	27.6	20.1	18.8	39.0
1995	-11.5	42.0	30.4	29.1	59.6
1996	-16.3	56.0	39.8	39.1	78.8
1997	-21.8	68.9	47.2	48.1	95.3
1998	-28.1	79.8	51.7	55.5	107.2
1999	-35.4	89.5	54.1	62.2	116.3
2000	-43.8	98.9	55.1	68.6	123.7

Table 7

COMBINED EFFECT OF CAPITAL GAINS AND DEPRECIATION

(billions of nominal dollars, millions of jobs)

Calendar Year	Change in GDP	Change in Jobs	Change in Capital
1992	23.4	0.044	234.4
1993	99.8	0.159	993.4
1994	213.7	0.474	2,054.9
1995	332.9	0.861	3,119.2
1996	447.2	1.267	4,091.3
1997	549.2	1.631	4,912.5
1998	633.0	1.919	5,539.2
1999	712.2	2.125	6,127.0
2000	788.0	2.275	6,681.5

Table 8

COMBINED EFFECT OF CAPITAL GAINS AND DEPRECIATION

(percentage deviation from OMB baseline)

Calendar Year	Percent Change in GDP	Percent Change in Jobs	Percent Change in Capital	Change in Growth Rate
1992	0.45%	0.04%	1.19%	0.22%
1993	1.77%	0.15%	4.78%	0.59%
1994	3.54%	0.43%	9.40%	0.87%
1995	5.15%	0.77%	13.56%	1.01%
1996	6.48%	1.11%	16.91%	1.05%
1997	7.45%	1.41%	19.29%	1.03%
1998	8.05%	1.64%	20.66%	0.97%
1999	8.48%	1.79%	21.69%	0.91%
2000	8.79%	1.89%	22.45%	0.85%

Table 9
COMBINED EFFECT OF CAPITAL GAINS AND DEPRECIATION
(billions of nominal dollars)

Calendar Year	Static Federal Revenue Change	Federal Change Due to Growth	Dynamic Federal Revenue Change	State & Local Revenue Change	Net to All Governments
1992	5.4	6.5	11.9	3.8	15.7
1993	5.0	21.9	26.9	13.9	40.9
1994	-2.7	38.5	35.8	26.4	62.2
1995	-8.9	54.3	45.4	38.7	84.1
1996	-16.3	72.8	56.5	51.8	108.3
1997	-24.6	89.4	64.8	63.6	128.4
1998	-34.1	103.6	69.5	73.4	143.0
1999	-44.7	116.3	71.6	82.4	154.1
2000	-56.8	128.5	71.6	91.0	162.7

Notes for Tables 1 through 9

1 The baseline is the assumed OMB July 1992 mid-year review forecast.
2 Employment and capital stock estimates are cumulative.
3 All dollar figures are in nominal dollars.
4 Simulations assume that the Fed maintains inflation at the mid-year review levels.

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