1993

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THE 1993 JOINT ECONOMIC REPORT

REPORT

OF THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

ON THE

1993 ECONOMIC REPORT OF THE PRESIDENT

together with

MINORITY VIEWS

APRIL 19, 1993.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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LETTER OF TRANSMITTAL

April 19, 1993.

The Hononable Thomas S. Foley
Speaker of the House
U.S. House of Representatives
Washington, D.C.

DEAR MR. SPEAKER: Pursuant to the requirements of the Employment Act of 1946, as amended, I hereby transmit the *1993 Joint Economic Report*. The analyses and conclusions of this *Report* are to assist the several Committees of the Congress and its Members as they deal with economic issues and legislation pertaining thereto.

Sincerely,

David R. Obey, *Chairman.*

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Mr. OBEY, from the Joint Economic Committee, submitted the following

REPORT

together with

MINORITY VIEWS

CHAPTER I

INTRODUCTION AND SUMMARY

From 1945 through 1973, both parties managed the economy in a way that brought record prosperity to American families. Growth was so strong that the national debt fell from more than 100 percent of national income to less that 25 percent by the early 1970s.

But changes in the domestic and world economy and America's failure to keep up with those changes by making the right investments and right economic decisions caused the economy to begin to falter in the 1970s. Policy failures by both parties in the 1970s meant slower growth, larger deficits, and no further reduction in the national debt relative to national income.

In the early 1980s, a new administration and Congress changed policies in hopes of restoring faster growth and reducing deficits. In fact, growth did not pick up, deficits soared, and debt as a share of national income has almost doubled since 1980. As the figures in this report show, economic policies since 1981 have contributed to the creation of four major deficits:

- A financial deficit, reflecting the massive increase in debt taken on by households, businesses, and governments. This financial deficit is not just a problem of the Federal Government. The rapid buildup in private debt, by both households and businesses, has contributed to slow economic growth in recent years.

- An investment deficit, resulting from low investment in people's education and training, in businesses' plant and equipment, and in public infrastructure. The priorities of the Federal Government have shifted dramatically away from investment functions, such as education, worker training, health improvement, creation of new knowledge, and improvement of the capacity of local communities to grow and prosper.

- An income deficit in the pockets of most Americans. Real wages have fallen for most workers, and families have been forced to work longer and harder simply to stay in the same place. Poverty rates have risen, particularly for children, as have the number of Americans who work for much of the year but at wages too low to keep their families out of poverty.

- A growth deficit, which most Americans experience as a failure of the economy to generate jobs. Although the economy has technically been in a "recovery" for two years, we have yet to regain all the jobs lost in the recession. Such sluggish growth creates uncertainty and a lack of confidence which feeds back into prolonging a substandard recovery.

These deficits are both an indictment of past policies and a measure of the challenge facing the President and the Congress. The American people expect government to make tough choices and tackle the Federal Government's financial dificit. They also expect effective responses to the other deficits which are eroding the foundation of our economy. Economic policy will be judged not only on how much progress is made on eliminating the federal budget deficit, but also on how much progress is made on restoring economic growth, raising incomes and providing the public and private investment needed to secure a prosperous future for our children.

CHAPTER II

THE AMERICAN ECONOMY IN DEFICIT, 1981-1992

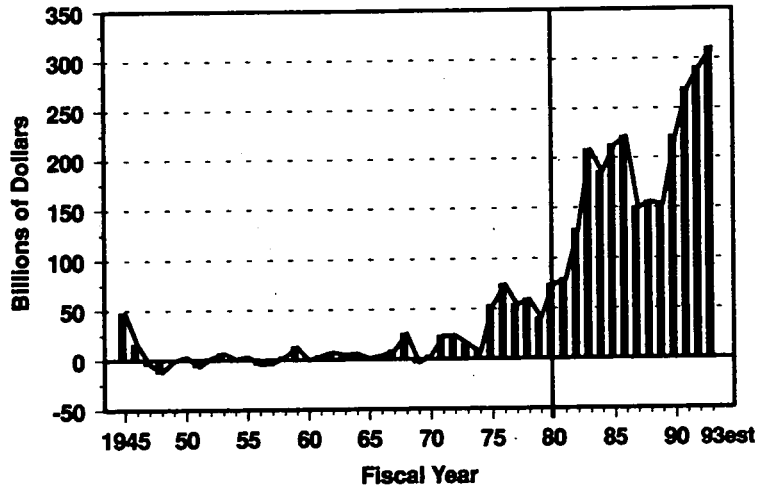
The period since 1973 has been one of grave disappointment to the vast majority of working Americans. After more than three decades of strong growth in employment, incomes, and well-being for middle-class families, progress slowed markedly in the 1970s, a fact which led to the introduction of a radical experiment in economic policy during the 1980s. Despite promises to turn things around, the 1980s turned out to be primarily a decade of deficits. Huge budget deficits throughout the decade combined with substantial investment deficits in both the private and public sector to produce a deficit in the growth of jobs and income.

THE FISCAL DEFICIT

The most familiar problem is the federal budget deficit. Prior to the 1980s, the Federal Government incurred periodic deficits, as Figure 1 shows. The figure measures the annual amount of borrowing by the Federal Government. This understates the true magnitude of the problem because it includes a large and rising Social Security surplus (including interest, $81 billion in fiscal year 1993) which must be set aside to meet the costs of retirement

Figure 1

Budget Deficits
Fiscal Years 1945 to 1993



Source: Office of Management & Budget; Congressional Budget Office

of the Baby Boom generation. Excluding the Social Security surplus would mean an estimated fiscal year 1993 deficit of $391 billion instead of the $310 billion shown in Figure 1.

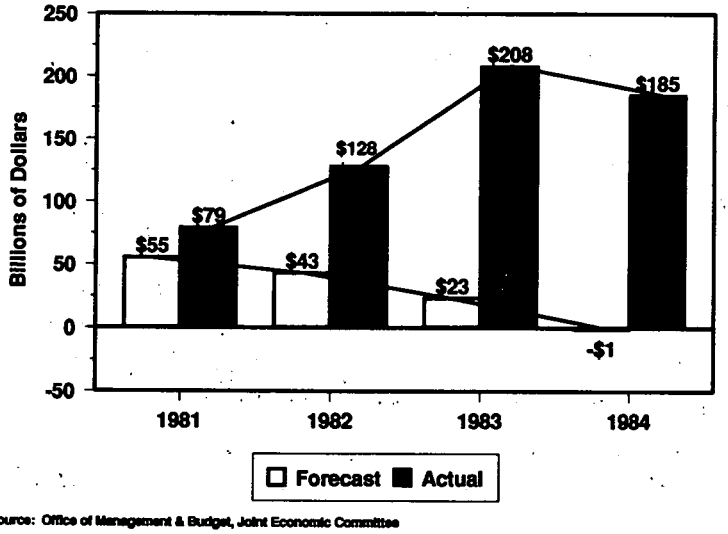
Prior to the 1980s, it took an unusual event, such as the Vietnam war or the severe recession of 1973-75, to cause a serious rise in the deficit. These deficits, however, were temporary; once the cause had passed, the deficit would begin to decline. Except for deficits incurred during World War II, the largest federal deficit prior to the 1980s was the $73.7 billion shortfall in fiscal year 1976. By 1979, this had been cut almost in half, to $40.2 billion and, apart from the effects of the recessions in 1980 and 1981-82, the deficit was being brought under control.

The deficits of the 1980s were fundamentally different from those earlier in the postwar period. First, they were much larger than ever before. Second, they became permanent, no longer tied to wars or recessions. The 1981 budget proposals to cut and double military spending, were justified by claims that the economy would grow so fast that the deficit would be reduced to zero by fiscal year 1984. Instead, the deficit exploded from $79 billion in fiscal 1981 to $208 billion just two years later (see Figure 2). This was almost triple the pre-1980 record.

Figure 2

Reagan Administration Deficits

Fiscal Years 1981-1984



Source: Office of Management & Budget, Joint Economic Committee

The policies that created the high deficits in the early 1980s made it impossible for growth alone to reduce the deficit to zero.

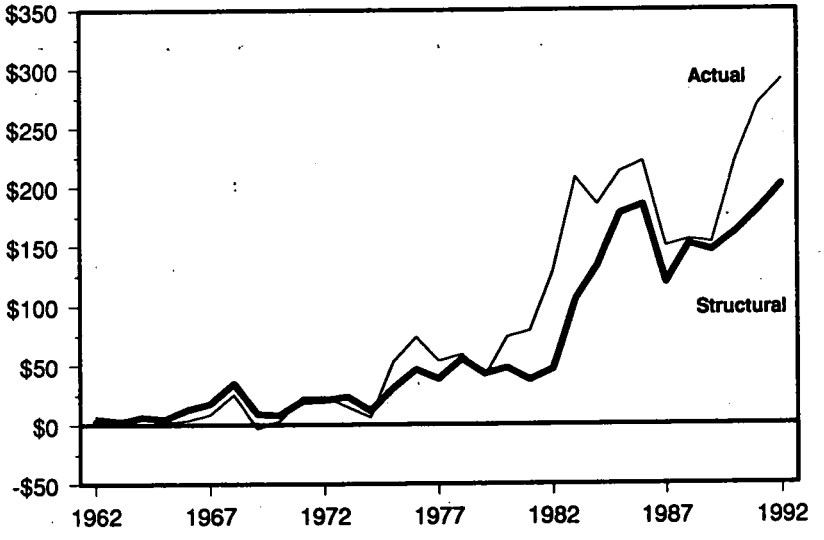
The recovery from the 1981-82 recession and the end of the Cold War in the early 1990s could make only a dent in the deficit. At no time since 1981 has the deficit fallen below $150 billion.

Thus, we see in Figure 3 that the deficits of the 1980s were largely "structural." The "structural" budget deficit excludes the effects of cyclical changes in revenues and safety-net spending by measuring what the deficit would be were the economy at full employment. Some of the rise in the deficit between 1981 and 1983 was caused by the deterioration of the economy during the 1981-82 recession. But much of the increase would have occurred even if the economy had remained near full employment; this portion of the deficit was the direct result of changes in tax and spending policy. By 1989, when the unemployment rate had declined to 5.3 percent, virtually all of the $150 billion deficit was structural.

Figure 3

Federal Budget Deficits

Structural vs. Actual



Source: Congressional Budget Office

At the end of fiscal year 1981, the federal debt held by the public was $785 billion.[1] By the end of fiscal year 1993, the debt held by the public will have ballooned to $3.3 trillion, more than four times its initial level. In other words, in just 12 years, the

[1] This excludes federal debt held by U.S. Government trust funds, which is debt the government owes to itself.

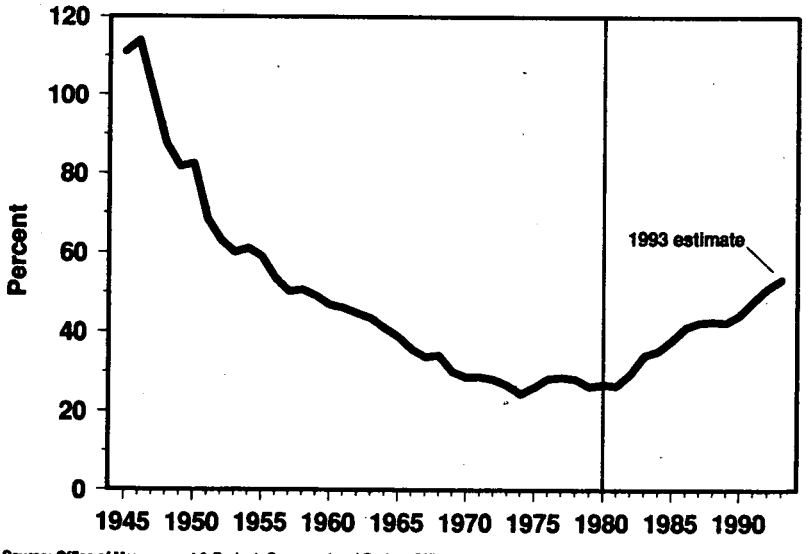
Nation incurred three times as much debt as it had in the previous 200 years. The increase in federal debt came to ten thousand dollars for every man, woman, and child in the United States in 1993.

A more meaningful measure of the financial burden of the federal budget deficit is the ratio of the debt of the Federal Government to the Gross Domestic Product, the total output of our economy. At the end of World War II, the total federal debt actually exceeded GDP. For the next 30 years, strong economic growth and small deficits reduced the burden of the federal debt to about 25 percent of GDP by 1974, where it stayed until 1980. But since 1980, the burden of federal debt has persistently risen, doubling to 51 percent of our National GDP by 1992 (see Figure 4). If we continue down the high-deficit path of recent years, the burden of the federal debt will continue to rise, to 67 percent of GDP by the year 2000 and over 70 percent by 2003.

Figure 4

Debt Held By the Public

Percent of GDP



Source: Office of Management & Budget; Congressional Budget Office

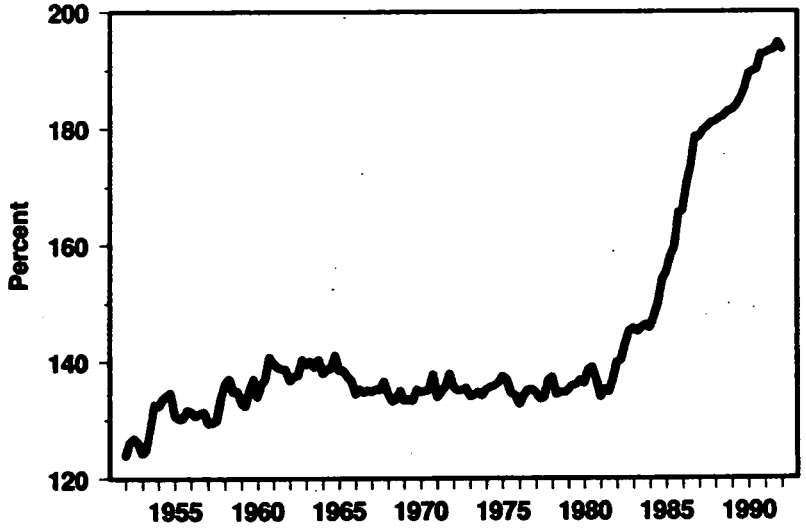
FINANCIAL DEFICITS IN THE PRIVATE SECTOR

Private debt exploded along with the Federal Government debt in the 1980s. The total debt of the nonfinancial sectors of the U.S. economy held steady at 1.4 times GDP throughout the 1950s, 1960s and 1970s (see Figure 5).

Figure 5

Debt of Non-Financial Sectors

Percent of Nominal GDP



Source: Federal Reserve Board

According to the Federal Reserve, only a quarter of the increase was accounted for by the growth in the debt of the Federal Government. Other sectors of the economy proved to be even bigger borrowers during the 1980s. Most of the increase was accounted for by households and businesses (65 percent), with state and local governments accounting for the rest.

Businesses and households took on significant amounts of debt during the 1980s. Between 1981 and 1990, the total indebtedness of households rose from $1.5 trillion to $3.8 trillion; the indebtedness of nonfinancial businesses rose from $1.7 trillion to $3.6 trillion.

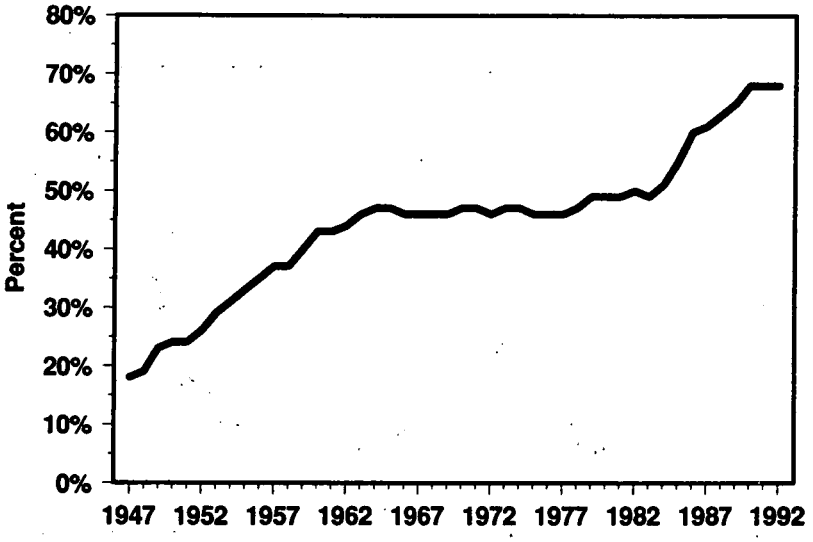
The growth of debt during this time far outstripped the growth of the economy. Between 1981 and 1990, the indebtedness of households rose from 48.6 to 67.6 percent of Gross Domestic

Product, a 40 percent increase, while the debt of nonfinancial businesses rose from 52.7 to 64.7 percent of GDP, a 23 percent increase. For both households and businesses, the ratio of debt to GDP at the end of the 1980s were at postwar records (see Figure 6).

Figure 6

Household Debt

Percent of GDP



Source: Federal Reserve Board

This rapid growth of debt during the 1980s was not sustainable; it was outstripping the growth of real capital and of incomes. By the end of the decade, the growth of business and household borrowing slowed dramatically. Then came the "credit crunch." Business debt fell from 65.5 percent of GDP at the end of 1989 to 60.0 percent by the third quarter of 1992.

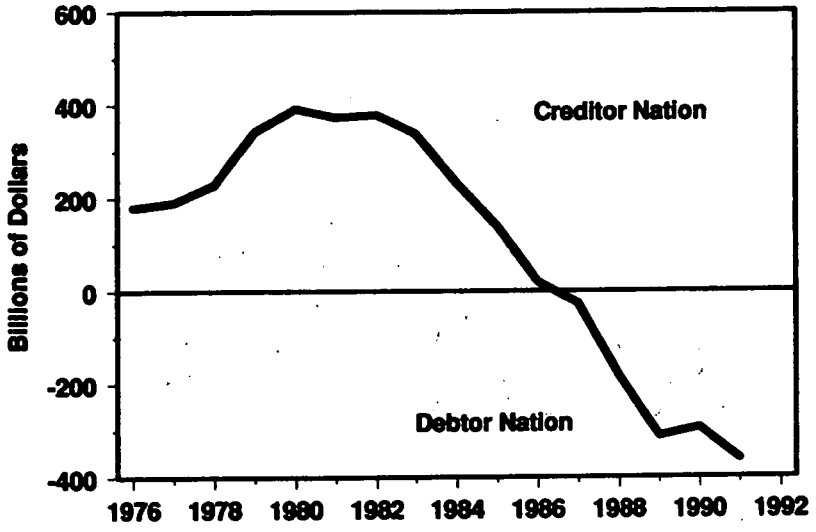
Households have not done so well. Since the late 1980s, consumer debt has continued to grow, albeit much more slowly than during the earlier part of the decade. A noticeable decline occurred in credit cards and other forms of consumer credit, but this was offset by a rise in mortgage debt.

We also went into debt to the rest of the world. Prior to 1980, we were the world's biggest creditor nation, owning factories, raw materials, and other assets throughout the world. But early in the 1980s, with the need to finance rising budget deficits, we began

borrowing from the rest of the world. By the late 1980s, we had become the world's biggest debtor nation, with many of our Nation's assets in the hands of foreign owners (see Figure 7).

Figure 7

U.S. Net Foreign Investment Position



Source: Bureau of Economic Analysis, Department of Commerce

THE INVESTMENT DEFICIT

The legacy of the federal deficit and the growing debt burden of the 1980s is compounded by a second deficit of equal importance–the investment deficit.

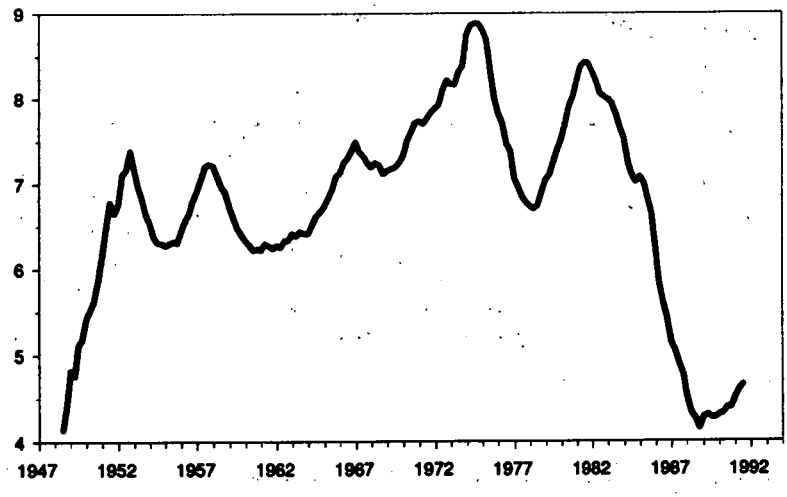
It is ironic that the dramatic change of direction of economic policy that began at the beginning of the 1980s was intended to boost investment by the private sector. Proponents argued that lower tax rates on income- and wealth-producing activities would create powerful incentives to pursue such activities. In particular, private savings and investment would increase because the effective tax on wealth accumulation was lowered. With a greater supply of savings to finance new investment and a smaller tax bite taken out of the proceeds of that investment, new spending for productive capital was predicted to rise.

As Figure 8 shows, savings fell precipitously immediately after this new program was initiated. By the end of the 1980s, the personal saving rate had dropped to a level not seen since the explosion of spending during the first years after World War II. The reasons for the decline are difficult to pin down, but the phenomenon persists. Although the saving rate has recovered slightly during the last three years, it remains well below the rates that prevailed throughout the preceding four decades.

Figure 8

Personal Saving Rate

Percent, 5-Year Centered Moving Average



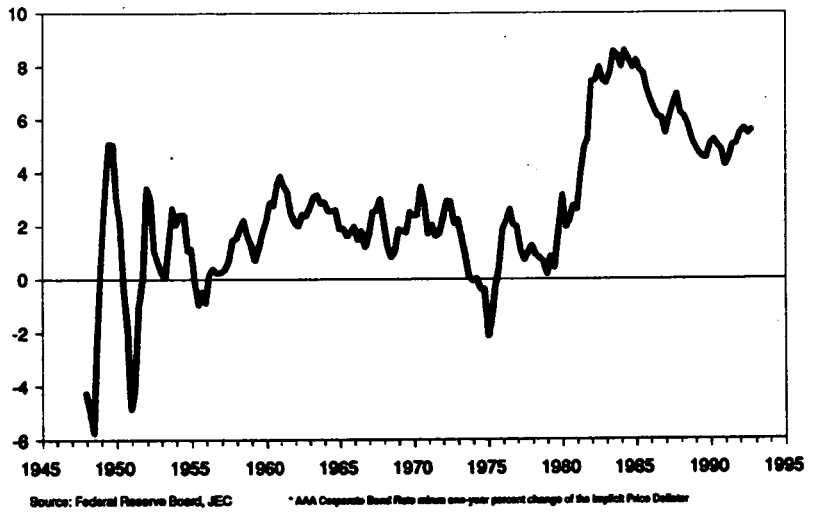
Source: Dept. of Commerce

The abrupt increase in the federal deficit in the 1980s coincided with the decline in private savings. The Federal Government's expanded financing needs absorbed a much larger share of the available pool of loanable funds. The decline in private savings and rise in the deficit, together with the monetary policy of the Federal Reserve, put strong upward pressure on interest rates (see Figure 9). These higher rates were a significant cause of declining investment in productive capital during the 1980s.

Figure 9

Real Long-Term Interest Rates*

Percent



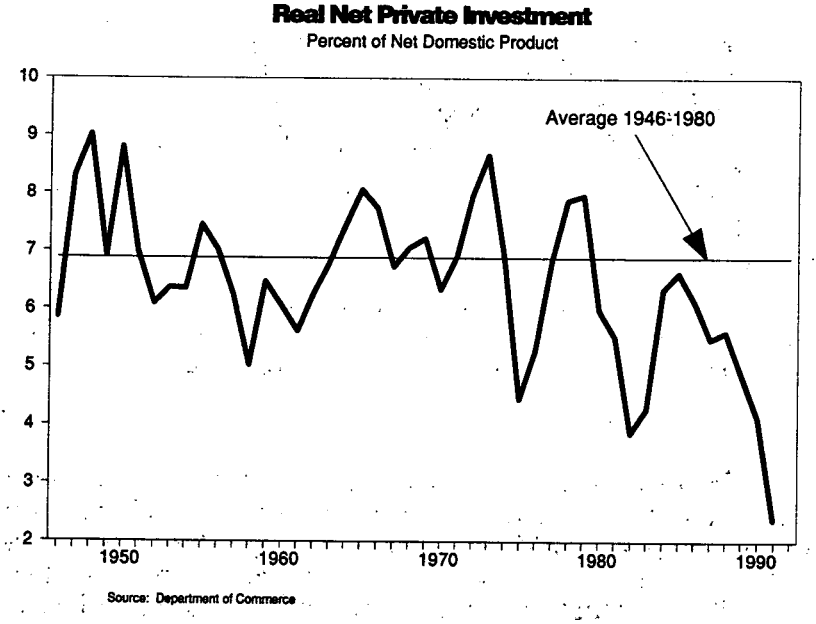
Source: Federal Reserve Board, JEC * AAA Corporate Bond Rate minus one-year percent change of the Implicit Price Deflator

Real interest rates, that is, market interest rates after adjustment for inflation's erosion of principle, rose to levels not seen before in the post-World War II period. Over the course of the decade, real rates eased only slightly as lower inflation rates largely offset declines in market rates. Inflation-adjusted interest rates on long-term debt today still are higher than at any time in the postwar period prior to the 1980s.

With the real cost of financing exorbitantly high, investment in new plant and equipment fell. Few projects were likely to have returns that would either exceed the costs of a loan or exceed the returns on alternative uses of the funds in financial markets. Real investment's slump, of course, defied the predictions of the "supply-siders" who had endorsed the new direction in monetary and fiscal policy.

Real net private investment–that is, the portion of total investment above depreciation that actually expands our National stock of capital–declined in 1991 to a recent low of only 2.4 percent of real Net Domestic Product (real GDP less depreciation) compared to an average of 6.9 percent per year prior to the 1980s (see Figure 10). In fact, at no point between 1981 and 1991 did the level of net investment as a percent of NDP meet the average level for the years from 1946 through 1980.

Figure 10

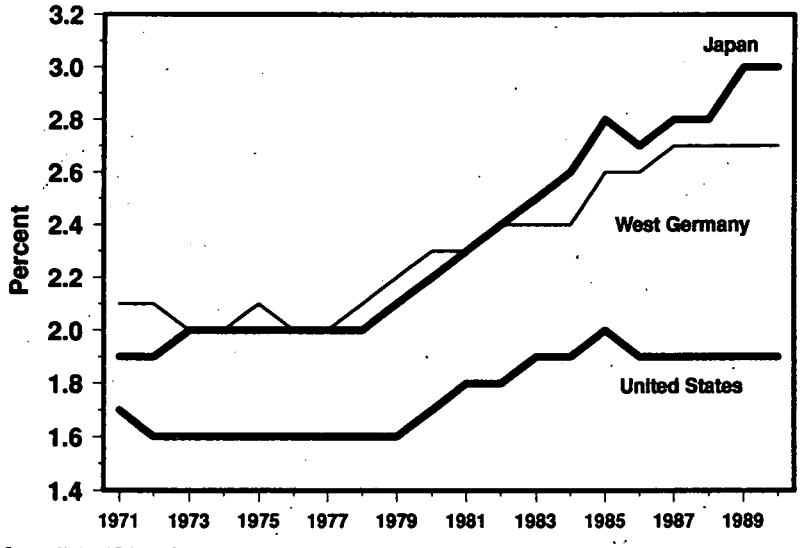


The investment shortfall has occurred not only in tangible forms of capital, such as factories and equipment, but in intangibles as well. Our investment in nondefense research and development is far below that of Japan and West Germany as a fraction of GNP (see Figure 11). This gives them an advantage in the development of new technologies. Although the United States spends more than other countries on basic research, the concentration of R&D funds on commercial applications in other countries, particularly Japan, frequently puts American firms at a disadvantage in developing and marketing new products and new technologies.

Figure 11

Nondefense Research & Development

Percent of GNP

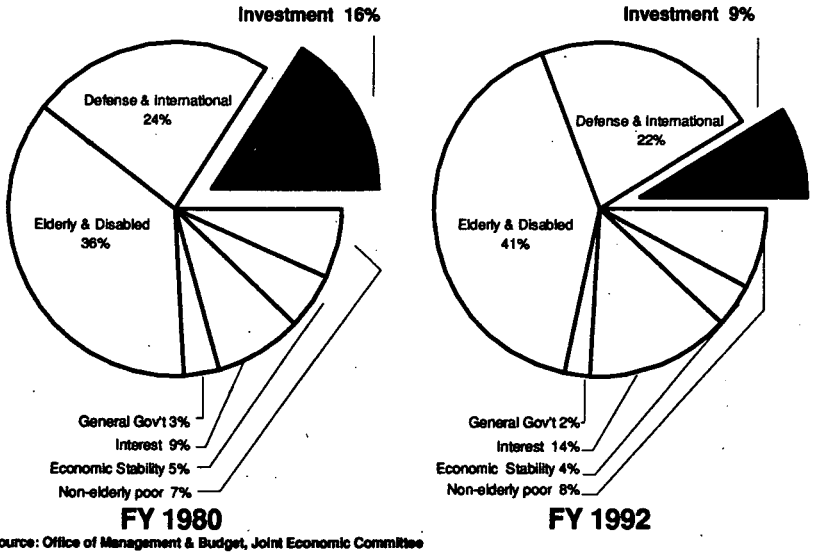


Source: National Science Foundation

Similar trends were at work undermining investment in the public sector. During the 1980s, the investment portion of the federal budget–which covers both physical investment and investment in human capital–went from 16 percent of total outlays to 9 percent, a decline of almost 40 percent (see Figure 12). Budget austerity during this period applied to virtually every federal activity that contributes to the long-term strength of the economy–construction of roads and bridges, education, worker training, airports, mass transit, nondefense research and development, and other federal contributions to economic growth.

Figure 12

Shrinking Federal Investment



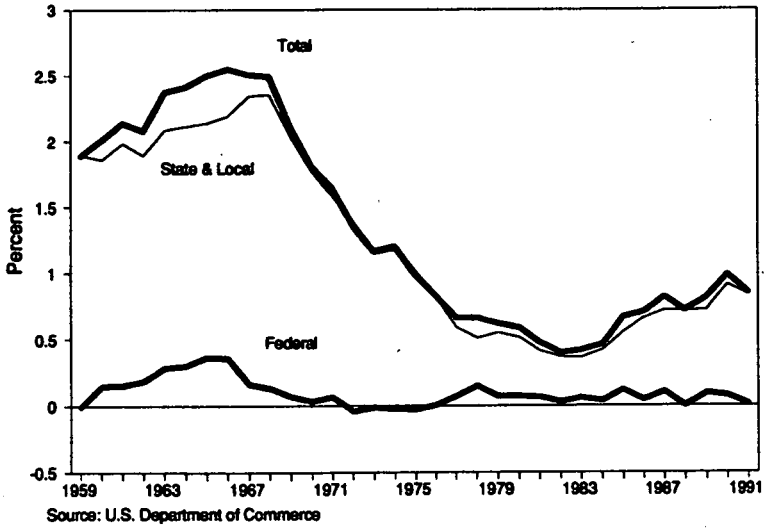
Source: Office of Management & Budget, Joint Economic Committee

The cutback at the federal level paralleled a similar decline by state and local governments, where most of the Nation's investment in public physical capital takes place (see Figure 13). After peaking in the late 1960s, investment activities by state and local governments fell to a postwar low by the mid-1980s. (In part, the federal, and the state and local patterns were intertwined as federal grants fell off.) A modest revival occurred late in the decade, as state and local governments recognized the importance of a strong physical infrastructure to economic development and faced rising school enrollments. But the economic troubles of the past three years, and the budget cuts that state and local governments have had to make during the 1990s, have caused a renewed decline.

Figure 13

Net Public Investment

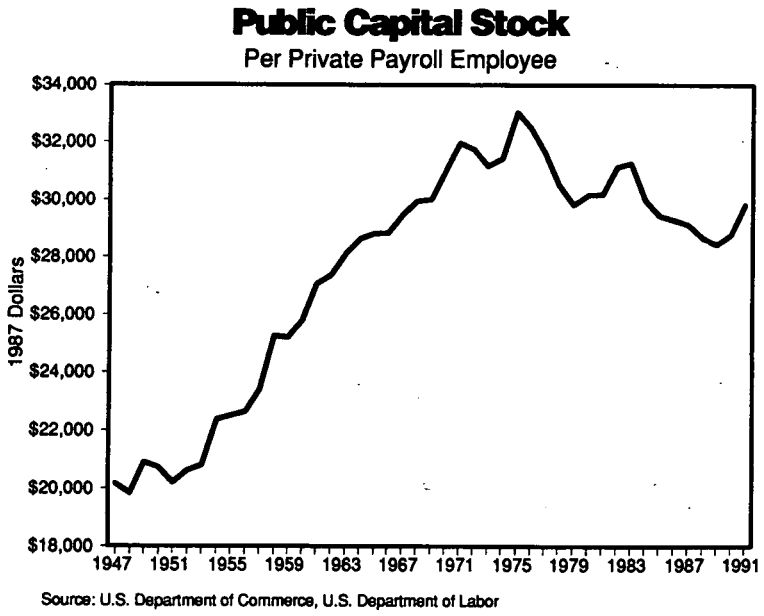
In Physical Capital, Percent of NDP



Source: U.S. Department of Commerce

There is much concern that the decline in investment by the federal, state and local governments has impaired the productivity and competitiveness of American business and industry. Economists have come to recognize that a modern economy requires a substantial investment in both public and private capital. Modern factories and equipment are essential; but roads, airports, water systems, schools, and other public infrastructure are also indispensable to the strength of private industry. Viewing the trends in the stock of public capital per private-sector worker (see Figure 14), it is little wonder that some economists attribute a substantial part of the shortfall in productivity during the past two decades to the decline in public sector investment spending. (The upturn in 1991 results from fewer workers, not an upsurge in investment.) Despite recent strong gains in productivity as the economy moves out of recession, productivity growth during the past decade has been the lowest in the postwar period.

Figure 14



Source: U.S. Department of Commerce, U.S. Department of Labor

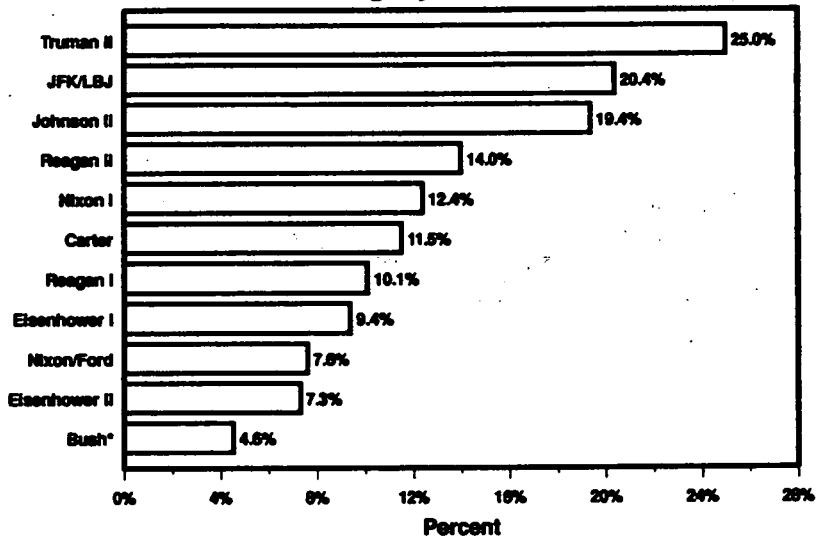
THE GROWTH DEFICIT

The failure to invest for the future has drained our economic energy and left us with yet another deficit: a growth deficit. The growth of the economy during the past four years was the lowest of any four-year presidential term in the postwar period. Figure 15 ranks postwar presidential terms in descending order of overall economic growth. The chart shows that Eisenhower's second term held the record for slowest growth until overtaken by the record of the Bush administration. From 1947 through 1988, the real Gross Domestic Product of the American economy grew at an average annual rate of 3.4 percent. From 1989 through 1992, real GDP grew at an average rate of only 1.0 percent, less than one third the postwar average.

Figure 15

Real Economic Growth

During 4-year Term



Source: Bureau of Economic Analysis, Joint Economic Committee

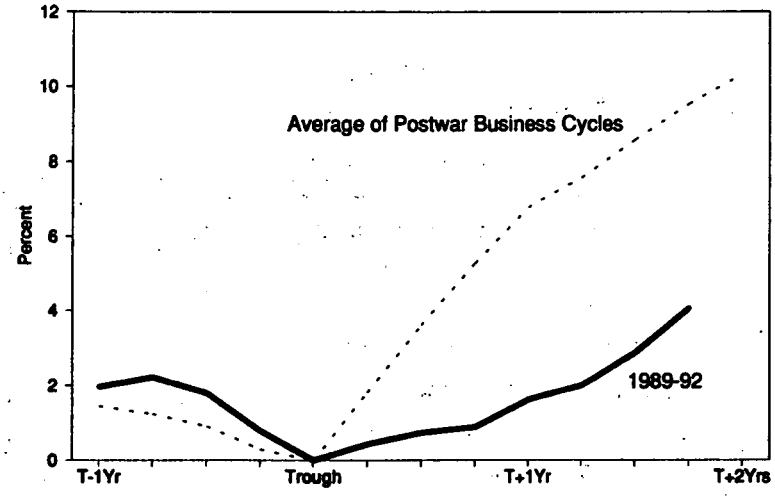
* Through 4th Quarter 1992

The period of slow growth began in the second quarter of 1989 and was compounded by the recession from July 1990 through March 1991. But of most serious concern at present is the anemic pace of the recovery that followed the 1990-91 recession. During the seven quarters since the trough of the recession, the economy has grown at an annual rate of only 2.3 percent. This is less than half the 5.7 percent average rate of growth during comparable stages of the previous seven business cycles (see Figure 16).

Figure 16

Real GDP

Percent Change from Cycle Trough

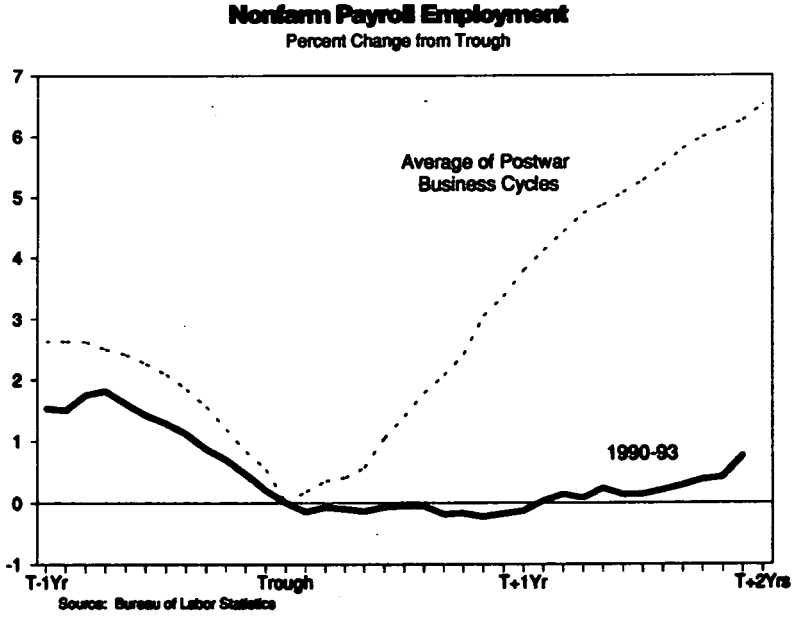


Source: Dept. of Commerce

There are some signs that the economy is starting to improve. According to the most recent data from the Commerce Department, the economy grew at an annual rate of 4.7 percent in the fourth quarter of last year, the strongest growth in five years. But the rate for this single quarter still falls short of the average 5.7 percent growth rate for the first seven quarters of prior recoveries.

Despite the recent growth in the economy, the United States remains in a jobs recession. In the 23 months of this recovery, job growth has been only about one-fifth of the typical postwar economic recovery. As Figure 17 shows, within the first few months in previous recoveries, the economy had regained all of the jobs lost during the previous recession. In contrast to the most recent period and the abortive one-year recovery after the 1980 recession, by 30 months after the recession began, total payroll employment was always significantly above the pre-recession level.

Figure 17

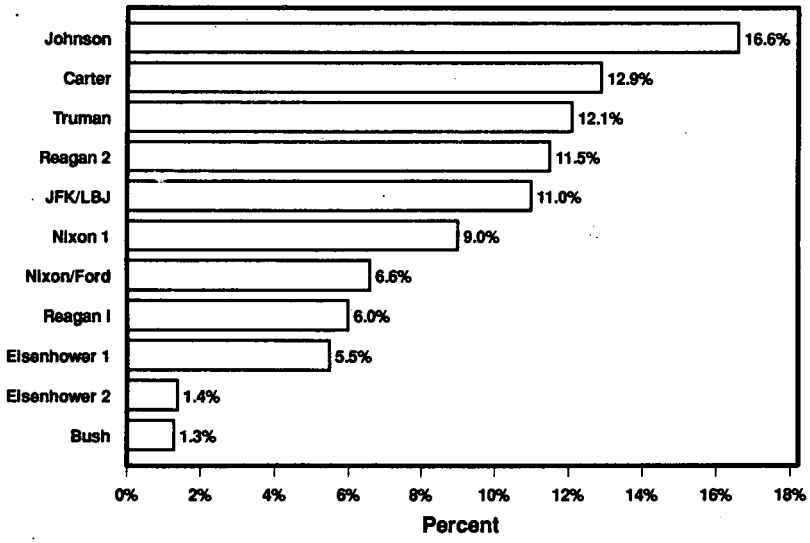


Between January 1989 and January 1993, the total number of jobs in the American economy grew only 1.3 percent, the smallest job gain during any postwar Presidential term. Figure 18 ranks Presidential terms in descending order of job growth. Most of the job growth that did occur during the Bush Administration occurred in state and local governments; private-sector job growth was a minuscule 0.3 percent. The Bush Administration barely escaped being the first postwar administration to suffer an actual net loss of private sector jobs during its term in office.

Figure 18

Employment Growth

During 4-year Term



Source: Bureau of Labor Statistics; Joint Economic Committee

THE INCOME DEFICIT

There is a final deficit that must be addressed, one that every American family feels: the income deficit. By virtually every measure of income, the average American family has failed to make any progress during the 1980s.

WAGES

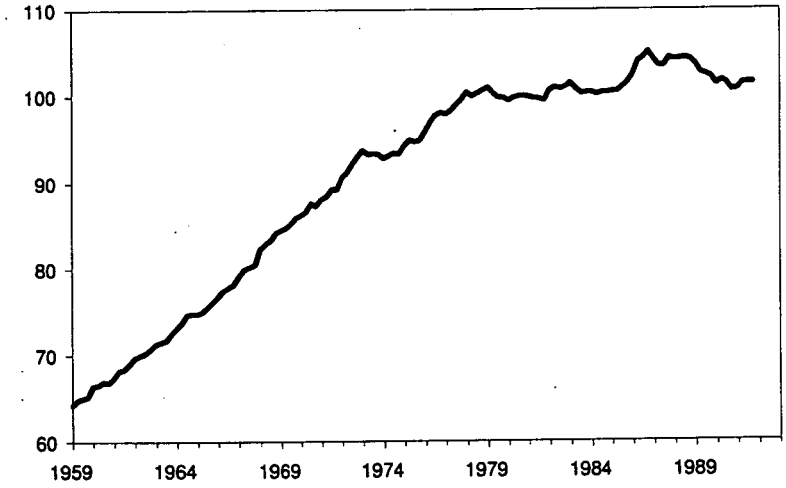
The Bureau of Labor statistics produces several different measures of hourly pay, the broadest of which is "real compensation

per hour" (see Figure 19). This measure covers all worker in all industries and includes not only money wages but all additional labor costs that employers pay, such as health care, pension contributions, and federal taxes for Social Security, Medicare, and Unemployment Insurance.

Figure 19

Real Compensation Per Hour

Deflated by CPI-U X1



Source: Department of Labor, Bureau of Labor Statistics.

This series is used by many analysts as a sign of labor market performance because of its broad coverage and scope. In tracing real compensation per hour from 1959 to the present, three periods stand out: strong growth through 1973, slower growth through the mid-1980s, and decline since then.

Real hourly compensation has never before declined during four consecutive years of expansion as it did from 1986 to 1990. The recession of 1990-91 has caused even further erosion, leaving real compensation per hour in fourth quarter of 1992 at the level of 1978.

The real compensation data series has drawbacks for measuring wage trends for many workers. Superior growth among very high earners, as has occurred in the last decade, causes the "average" to show significantly more growth than most workers experience.

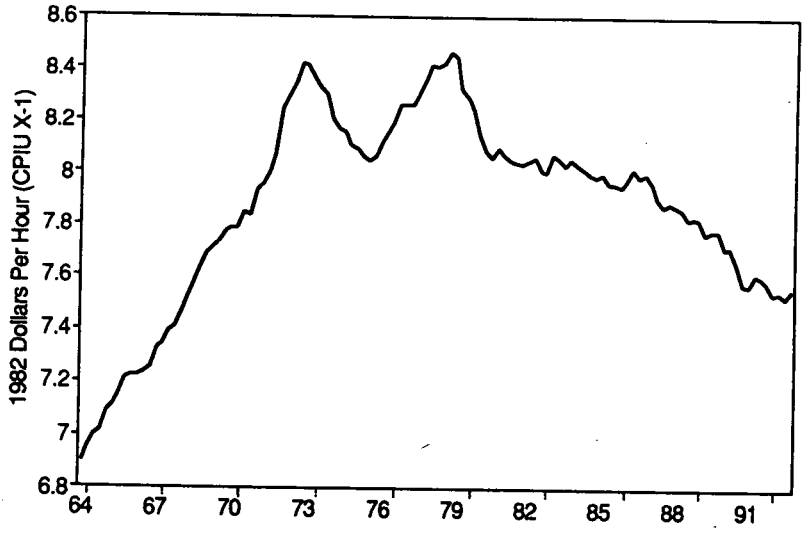
The Bureau of Labor Statistics compiles another data series on hourly wages, which includes only direct pay and not fringe benefits and taxes. In addition, it limits its calculations to production and non-supervisory workers. This accounts for 80 percent of the labor force but excludes high-earning managers, supervisors, and professionals who have been faring much better than most American workers.

Figure 20 traces the history of real average hourly earnings, using the same method of adjusting for inflation as was used in the real compensation series. This measure of real wage shows a sharp and steady deterioration in the average wage paid to over 80 percent of American workers since the late 1970s.

Figure 20

Average Real Hourly Earnings

Production and Non-Supervisory Workers



Source: Department of Labor, Bureau of Labor Statistics.

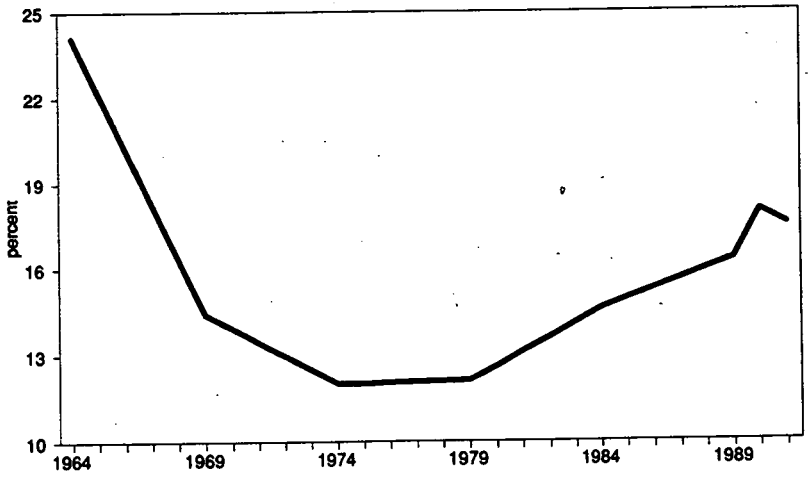
Both the real compensation and the average hourly earnings series are aggregate indices compiled for the economy as a whole. They are derived from payroll information supplied by employers who simply fill out responses on number of workers and amount of labor costs. As a result, it is impossible to derive any measure of the distribution of wages from these sources.

A Census study attempted to look at the distribution of wages by focusing on low-wage workers. It focused exclusively on workers who were full-time and full-year and defined low wages at the level necessary to support a family of four at the poverty line, $13,924 in 1991 dollars. Figure 21 shows that the share of workers with low wages declined dramatically from 1965 through the early 1970s; it has risen significantly since 1979.

Figure 21

Workers With Low Wages

Percent of Year-Round,Full-Time Workers

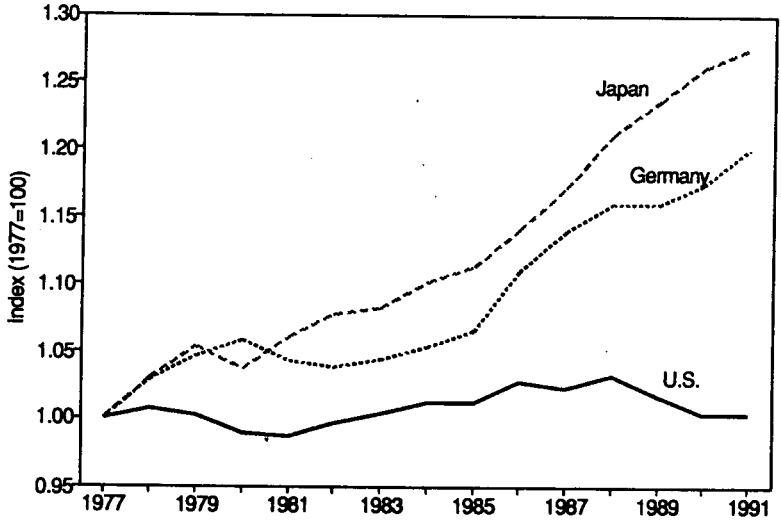


Source: Dept. of Commerce, Census Bureau

Before leaving the earnings discussion, it is important to compare our experience with that of other industrialized countries. As Figure 22 shows, there was strong growth in hourly compensation in Japan and West Germany that has been sustained since 1977. These countries continue to record gains in pay as fast as we did during the initial postwar period, although this growth rate was slower than they had enjoyed prior to 1973.

Figure 22

Real Compensation Per Hour
Economy-Wide Estimates

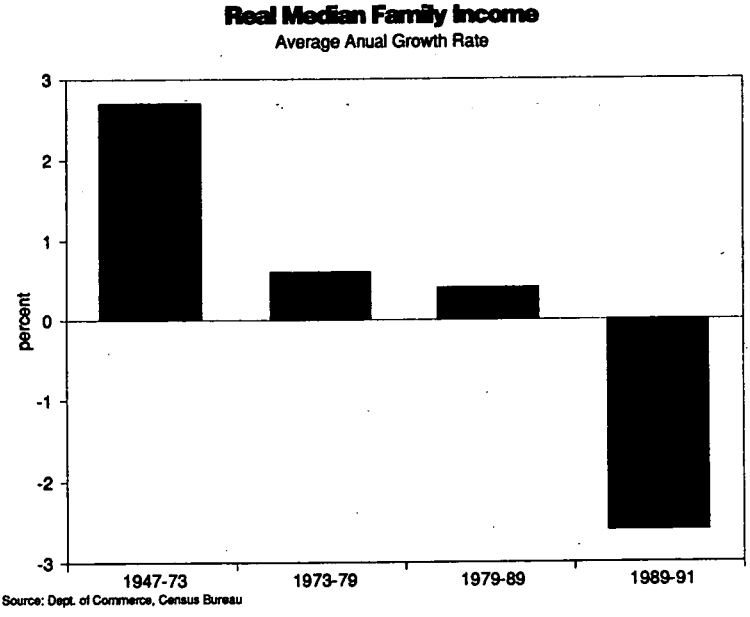


Source: Organization for Economic Cooperation and Development.

FAMILY INCOME

Family income has fared a bit better than hourly wages over the past decade, but only because families have been resourceful in putting more hours of work into the paid labor market. Figure 23 shows the path of median family income. Instead of yearly gains of almost 3 percent, median family cash income adjusted for price inflation barely inched forward from 1973 through 1989. The recession of 1990-91 has caused average incomes to decline by 5 percent since 1989.

Figure 23



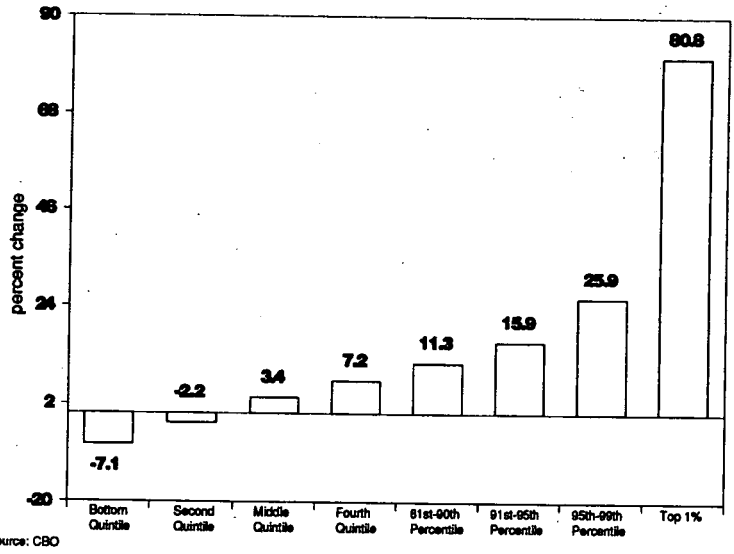
But the squeeze on families has not been even. The richest 10 percent of the population have captured the lion's share of our economic growth and have basically maintained their former rate of annual improvement in their living standards. The lowest 40 percent have actually had their real (inflation-adjusted) incomes decline. For the remaining 50 percent, incomes have kept ahead of inflation, but this has largely been due to more family members working more hours.

Figure 24 shows changes in post-tax family income (adjusted for changing family sizes) from 1979 to 1989. As can be plainly seen, the further up one moves on the income ladder, the greater the gains.

Figure 24

Growth Rate By Family Income Group

1979-1989

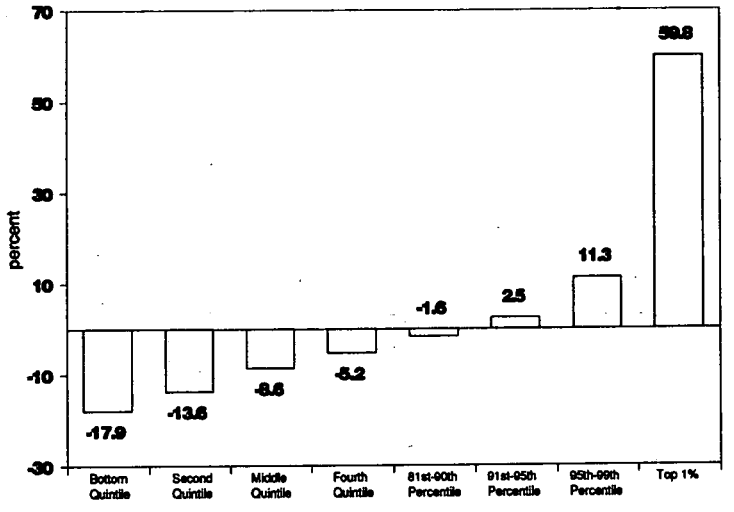


Source: CBO

The sharp difference in income growth has led to a substantial shift in the overall distribution of income. Figure 25 shows changes in the share of total family income going to each quintile of the income distribution. Because of the large increase in the share of the richest 10 percent, the share of the other 90 percent has decreased.

Figure 25

Change in Share by Family Income Group
1979-1989



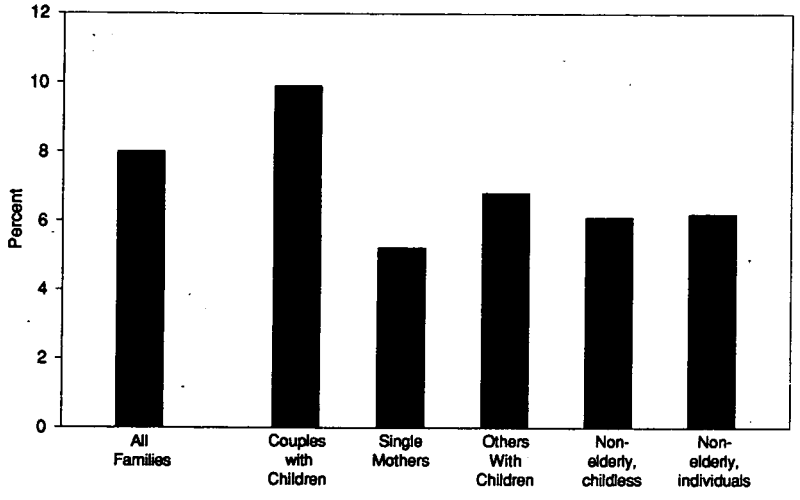
Source: CBO

The decline in real hourly earnings and real compensation means that families had to search for other means to maintain their standard of living during the 1980s. For most families, this meant working more hours either by sending additional family members into the labor force, or extending the hours of those already in the labor force. It was once very rare for a married mother with a child under three to be in the paid labor force; now, it is commonplace with over one half of married mothers with very young children working for money to support their families.

All family types significantly increased their hours of paid work per worker in the 1980s. A Congressional Budget Office report based on the Current Population Survey found an increase in 8 percent per adult in average annual hours in nonelderly families between 1979 and 1989. As shown in Figure 26, the increases ranged from 5 percent for families composed of single mothers with children to 10 percent among married couples with children.

Figure 26

Increases in Hours Worked Per Family
Percent Change, 1979-89



Source: Congressional Budget Office

This reality creates concerns for the actual standard of living of American families. There is reason to wonder whether living standards are actually rising if increased money income is brought about only by significant increases in time spent at work. A recent staff study done for the Committee on two-parent families illustrates the problem. Families in the middle fifth of the income spectrum had 5 percent more real income in 1989 than in 1979. However, to accomplish this, they were spending 11 percent more hours at work.

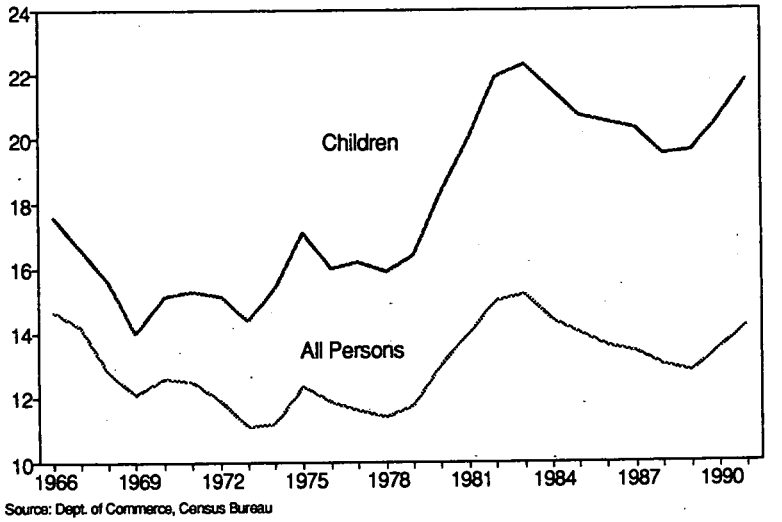
Spending more time in the labor force means additional anxiety for parents who lose personal time for family, community, and themselves. Their flexibility to do the day-to-day chores of life is reduced and they require others to do what they once did for themselves. According to a recent poll conducted by the National

Commission on Children, 59 percent of parents said that they would like to spend more time with their children.

Finally, as Figure 27 shows, the percentage of the population living in poverty has stayed very high throughout the 1980s despite the lengthy expansion. Because young workers (those most likely to be having children) have had particularly hard times finding good jobs, the poverty rate of children has hovered around 20 percent. It should be noted that many analysts believe that the official poverty line measures (for example, $13,924 for a family of four in 1991) have not increased fast enough during this period (due, for example, to faster housing and health cost inflation). Thus, the increase in poverty has been understated.

Figure 27

Official Poverty Rates
Percent



Source: Dept. of Commerce, Census Bureau

In 1991, 33.6 million Americans, 14.2 percent of the population, were poor. This represents a substantial jump from the 12.8 percent level of 1989. Clearly, the current recession has taken its toll, but it is also true that throughout the 1980s, the share of Americans living in poverty was higher than at any point during the 1970s.

Many of the commonly discussed causes of high poverty rates do not stand up to close scrutiny. The poor appeared to have

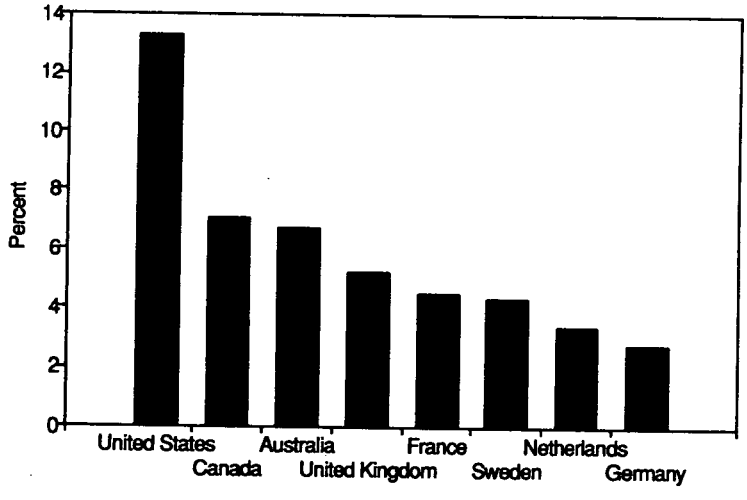
worked harder in the 1980s than in the past, ruling out declining work effort as the principal cause of persistent poverty. Including in-kind transfers in the measurement of income does not change the pattern of slow improvement in poverty. Finally, the proportional increase of single parent families was greatest in the 1960s and 1970s when poverty rates were declining. Instead, a major answer to why poverty rates have remained so high lies in the wage rates for poor heads of households.

It should be noted that the U.S. poverty rate is much higher than that of other countries. As Figure 28 shows, the share of persons in poor families after taxes and transfers is significantly higher here than in other advanced industrialized societies. Our poverty rate ranges from twice as high as Canada's to over four times the level found in West Germany.

Figure 28

Percent of Persons in Poor Families

After Taxes and Transfers



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

CHAPTER III

THE STATE OF THE ECONOMY

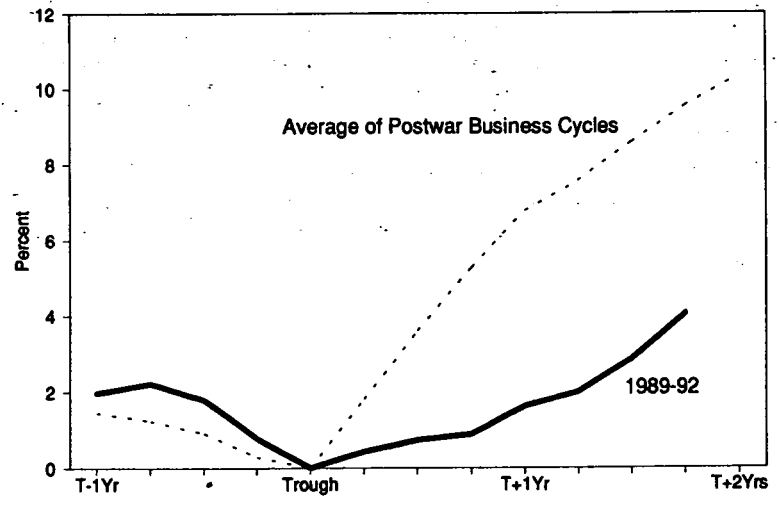
The legacy of multiple deficits has contributed to an extremely uncertain short-term outlook for the economy. The economy has been in a technical "recovery" since March of 1991, yet it has been by far the weakest cyclical upturn on record. By virtually every measure, the economy's improvement over the last two years has fallen far short of the typical business-cycle recovery.

Figure 29 illustrates the weakness of the current upturn by comparing it to real GDP growth averaged in the eight preceding recoveries. In the past, real GDP usually rose strongly in the first year of recovery before growth tapered off to just under 4 percent per year. In this "recovery," growth averaged only 1.6 percent for the first five quarters and then picked up to a 4.1-percent rate in the second half of 1992.

Figure 29

Real GDP

Percent Change from Cycle Trough



Source: Dept. of Commerce

Some have claimed that mild recessions normally are followed by slow recoveries. An examination of the data, however, show that this argument is incorrect on two counts.

First, the slack in the economy by March 1991 (the end of the recession) was comparable to the slack typical at the end of previous recessions. The 1.8-percent decline of real GDP between mid-1990 and early 1991 was only a bit shy of the 2.4 percent averaged in recessions since World War II. Three of the eight preceding recessions had witnessed smaller GDP declines. Furthermore, the recent downturn was preceded by a year and a half of marginal growth, averaging only a 0.9-percent rate, well below the long-run potential growth rate and much slower than the rate preceding previous recessions.

Second, an examination of the historical record shows that there is no correlation between the severity of a recession and the vigor of the subsequent recovery. Until the most recent business cycle, real GDP always had managed to grow between 7.5 and 11 percent in the first seven quarters of recovery, compared to 3.8 percent this time. The only exceptions to this were the whopping 22-percent rebound from the 1948-49 recession and the truncated recovery from the 1980 downturn.

THE JOBLESS RECOVERY

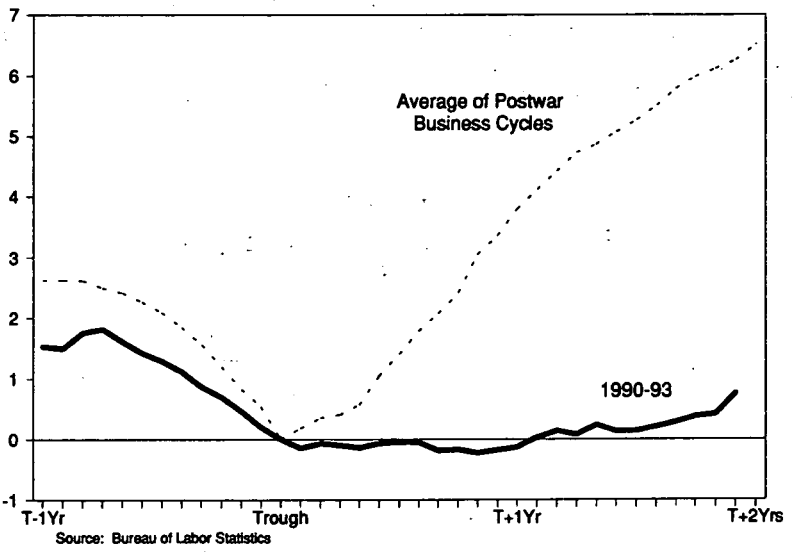
The inadequacy of the current expansion is most evident in the labor market. Figure 30 compares recent job growth with that typically experienced during economic recoveries. The contrast between current experience and the historical average is much more striking than in Figure 29, which showed a similar comparison for GDP.

Job growth has been anemic since March 1991, in sharp contrast to the usual pattern. If the job count had shown the percentage gains typical of the past, we would have millions of additional jobs at this point.

Figure 30

Nonfarm Payroll Employment

Percent Change from Trough



Source: Bureau of Labor Statistics

Also, the type of job loss is very different. During the 1975 recession, 24 percent of the increase in unemployment from the previous business cycle peak had been employed in white collar jobs before they were laid off. In the recent recession, this figure rose to 44 percent.

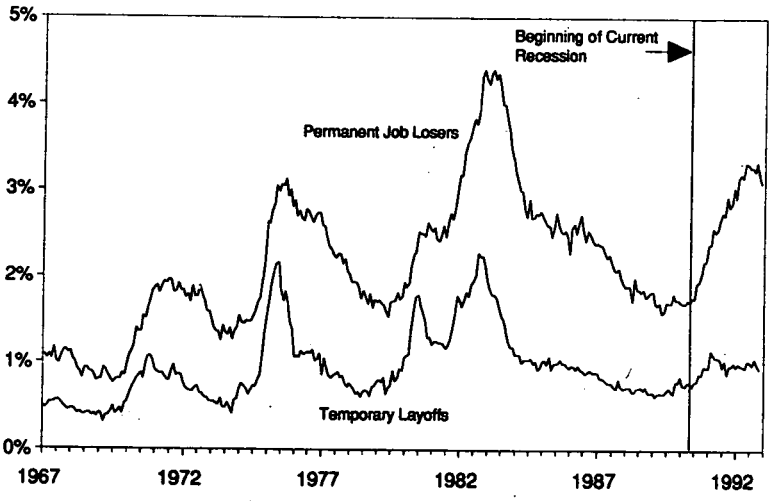
The most recent rise in unemployment has been caused by an unusually high proportion of permanent job separations relative to temporary layoffs. In previous recessions, the ranks of the unemployed were filled heavily by workers who had been "laid off" and expected to be recalled to work at their last employer. Since the last recession began in mid-1990, the number of workers on layoff has risen less than in the past, but the share of the work force that remains unemployed after permanent separation from their last job now exceeds 3 percent. That is not only significantly higher than in previous recoveries at this stage, but also higher than in some previous recessions.

Figure 31 shows the pattern of recent unemployment due to job loss. Those who have lost their job but expect to be recalled by their previous employer when sales improve are on "temporary layoff." While temporary layoffs increased modestly in the recent recession, the number of permanent job losers increased substantially. Perhaps more troubling, although the ranks of those permanently separated fell sharply after previous recessions, they have continued upward long after the last recession technically ended in March 1991.

Figure 31

Permanent Job Loss Exceptionally High

Percent of the Labor Force



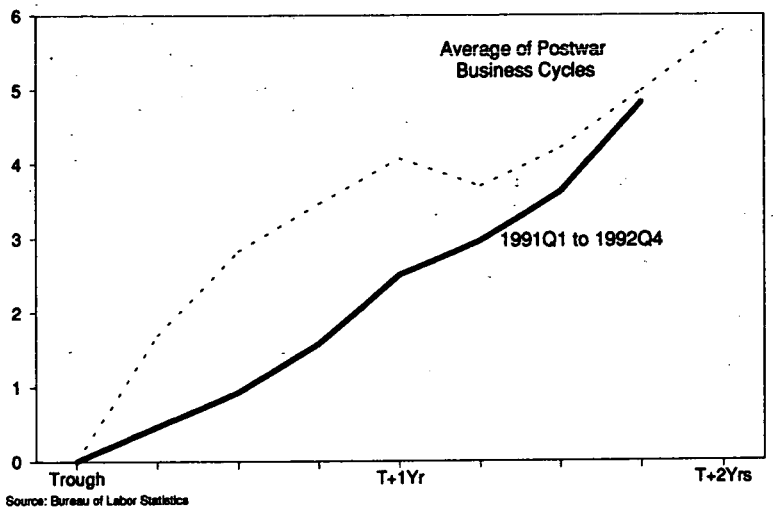
Source: Bureau of Labor Statistics

Some analysts have argued that the virtual absence of job growth conceals a positive development in the economy, namely a robust rebound in productivity. Figure 32 shows that the improvement in productivity over the past seven quarters actually has differed little from the average productivity improvement in past recoveries. When demand improved in the first two years of past expansions, firms responded both by working existing employees harder and by adding new employees. This time around, demand has been strong enough only to prompt firms to do the former, squeezing extra output from their existing work force.

Figure 32

Productivity Growth in Recoveries

Percent Change from Cycle Trough



Source: Bureau of Labor Statistics

The impression that firms are not seeking to expand employment is strengthened by data on job openings. Dun and Bradstreet compiles an index of help wanted advertising, which provides some indication of the extent of labor demand when scaled by the number of jobs in the economy. Analysis of this data by Harvard University economist James Medoff concludes that there are many fewer jobs being offered by firms during this recovery than in the past. Based on the Medoff research, Nobel Laureate James Tobin told the Committee:

> *The point is that the vacancy index is a lot lower than you might have expected it to be at the rates of unemployment that we are currently seeing, overall unemployment. The jobs just aren't out there.*

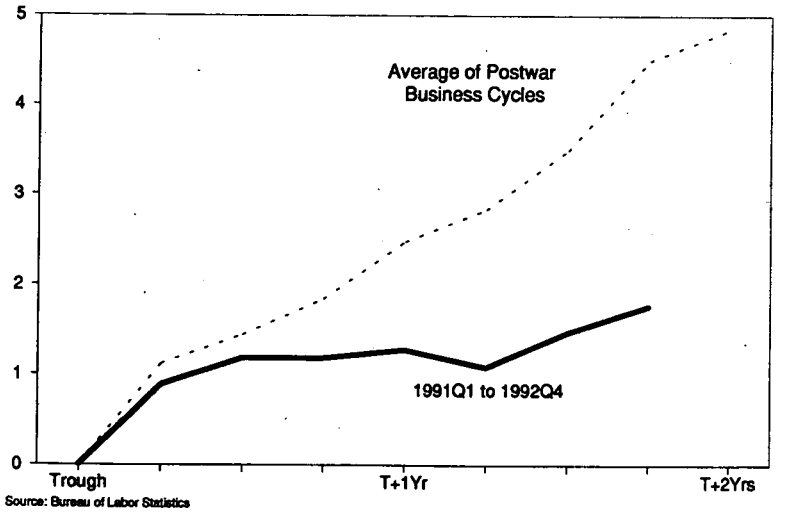
Finally, there is growing concern that the few jobs being offered by employers do not meet the expectations or needs of workers. Increasingly, firms are offering temporary or part-time jobs where in the past they would have offered full-time ones.

PALTRY INCOME GROWTH

Even those workers fortunate enough to retain their jobs have benefitted very little from the economy's "recovery." Figure 33 shows that workers' real hourly pay has lagged well behind the historical pattern. Although inflation-adjusted hourly compensation improved at about the usual pace early in the "recovery," it subsequently flattened out. To some extent, even these modest increases in real hourly compensation overstate the improvement in workers' well-being, because most of the increase in non-wage benefits has merely gone to cover health care cost inflation. Real hourly take-home pay continues to sag.

Figure 33

Real Compensation per Hour
Percent Change from Cycle Trough



Source: Bureau of Labor Statistics

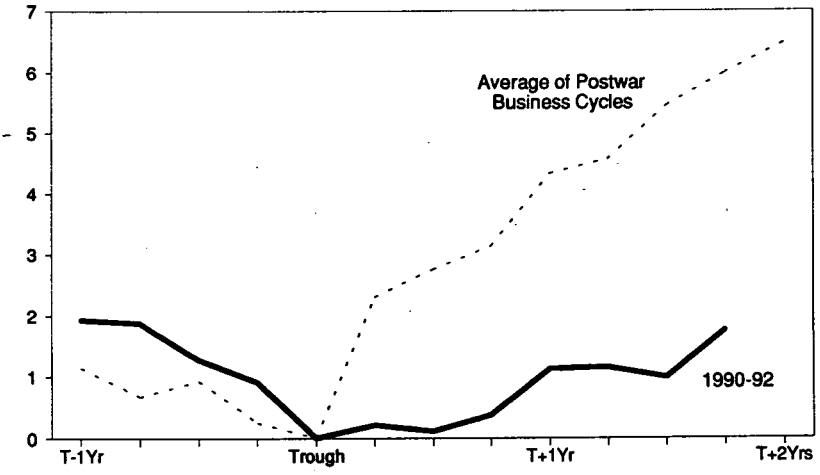
The stagnation of labor pay has been a primary reason that overall income growth has lagged. However, even if one adds in nonlabor forms of income (interest, dividends, rent, and proprietors' income, but not government transfers), one finds that incomes derived from the private economy fall far short of the mark. Real private-sector income has grown at only a 3.6-percent

annual rate since the recession's trough, a little more than a third of the improvement typically seen in a recovery.

Continuing population growth, coupled with the stagnation of incomes has resulted in virtually no improvement in per capita living standards. Figure 34 shows that living standards have advanced a mere 1.7 percent over the last seven quarters, even when income from government transfers is included. In past business cycles, real disposable income per capita typically had risen 6.0 percent by this point, surpassing its pre-recession peak within six months. In the current "recovery," per capita living standards still have not regained their level before the recession.

Figure 34

Real Disposable Income per Capita
Percent Change from Trough



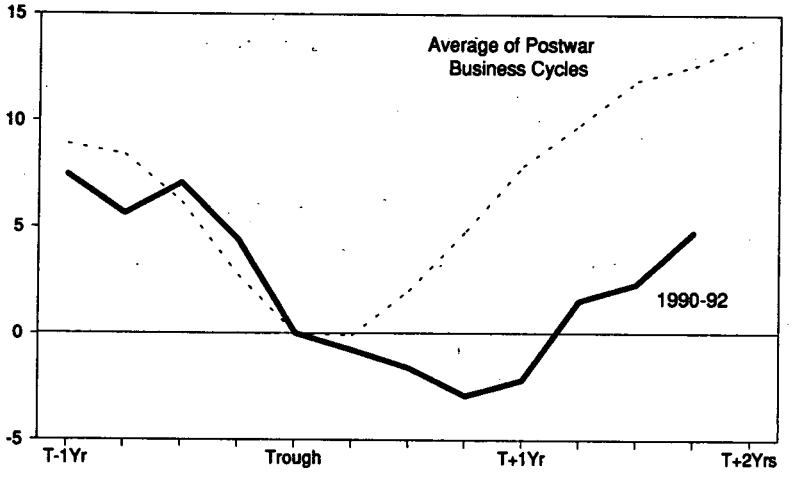
Source: Dept. of Commerce, Bureau of Economic Analysis

The current recovery is also not generating the investment needed to lay a firm foundation for future growth. Figure 35 shows that private nonresidential investment continued to drop sharply during the first year of "recovery" and has only recently risen enough to surpass its level at the recession's end. In this very direct way, the persistence of the economy's short-run cyclical problems is compounding our most serious long-term problem.

Figure 35

Real Nonresidential Fixed Investment

Percent Change from Cycle Trough



Source: Dept. of Commerce, Bureau of Economic Analysis

CHAPTER IV

THE FIRST CHALLENGE: RESTORING ECONOMIC GROWTH

The headwinds facing the economy have slackened somewhat, but they have not yet disappeared. This is still, in some respects, a tentative expansion, and the possibility of further setbacks, albeit temporary, cannot be dismissed out of hand.

Alan Greenspan, March 13, 1993

It is extremely important that the U.S. economy experience strong and sustained growth over the next several quarters. The fourth quarter of 1992 posted reasonably strong growth of 4.7 percent, but most private forecasters do not expect this pace to be sustained. The quote from Federal Reserve Chairman Alan Greenspan above indicates that the economy is not yet launched on a strong, self-sustaining recovery path.

While few are forecasting an imminent downturn in the economy, the current consensus forecast is for lackluster growth. The Congressional Budget Office, reflecting this consensus, is currently projecting a growth rate of roughly 3 percent per year over the next several years. If achieved, this rate of growth will fall far short of the typical post-recession experience and will complicate efforts to adjust to new economic realities.

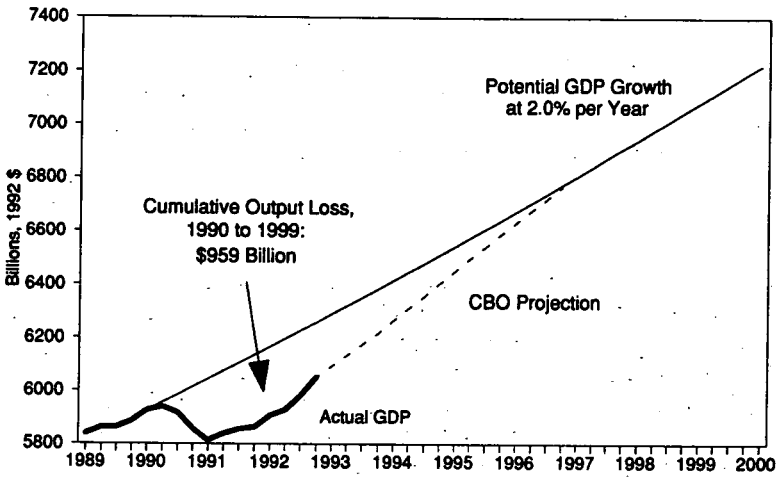
At this rate of growth, the economy would not return to full employment until about 1997. This prolonged slack would impose a terrible cost in lost output. The Nation would forego about $500 billion (in 1992 dollars) of output and income that would have been produced if the economy were operating at full capacity (see Figure 36). This loss would come on top of the losses that the recession and weak "recovery" have already induced. Once foregone, this output can never be recouped.

Maintaining a persistently slack economy also would aggravate our most serious long-term problems. Most importantly, firms are reluctant either to hire permanent, full-time employees or to invest in new productivity-enhancing capital in an economy with persistent slack. This has already occurred during the current sluggish "recovery" as firms have continued to restrain investment spending in a manner more typical of recession than recovery.

Figure 36

Closing the GDP Gap

Actual and Projected Real GDP, 1992 $



Source: Bureau of Economic Analysis; Congressional Budget Office; Joint Economic Committee

A persistently sluggish labor market would also make more difficult the economy's structural adjustments. More rapid growth would make it easier for firms and communities to adjust to declining military spending, and workers re-training for new jobs will find their training worthless without available positions in which to put their new skills to work.

Finally, little progress will be made on reversing the pernicious trend towards income inequality in a stagnant economy. Although shares of family income became slightly more equal in 1991, this resulted from somewhat larger income declines for upper income families rather than from income growth for the middle and bottom. A softening in the economy typically has been associated with a worsening of the income distribution, and another growth setback might well have this result again. The continuing erosion of real hourly labor pay suggests that the middle and bottom continue to be squeezed and that poverty probably is still rising.

STRUCTURAL OBSTACLES TO A STRONG RECOVERY

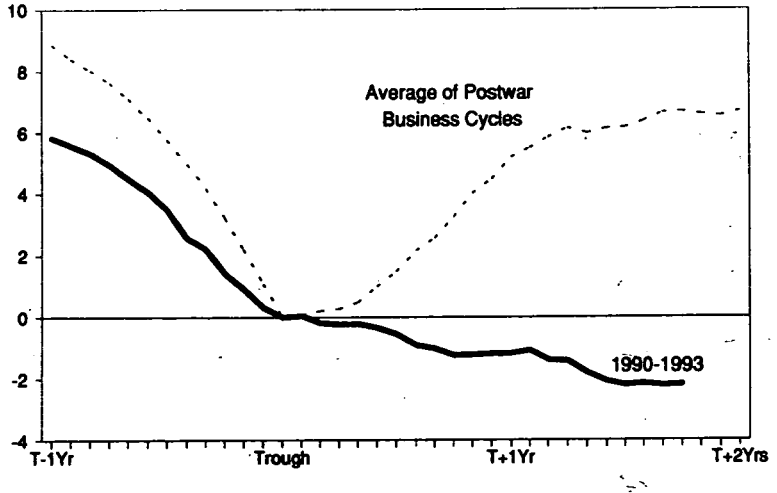
Putting the economy on a more rapid growth path will be hampered over the next year or two by a considerable accumulation of structural problems in the economy. Several key sectors remain weak, corporations are in the midst of substantial restructuring in employment, the rest of the major industrialized countries remain mired in recession, and the need to reduce today's large budget deficits means that fiscal policy cannot be expansionary as it has been coming out of previous recessions.

SECTORAL WEAKNESS

A serious risk to the expansion is the ongoing weakness in the important manufacturing and construction sectors. These two industries typically lead broader changes in economic activity because they are sensitive indicators of economy-wide demand and because they are themselves a significant source of demand for inputs from services sectors. Figure 37 shows that employment in these two bellwether industries has fallen during the "recovery," in contrast to the usual sharp rebound.

Figure 37

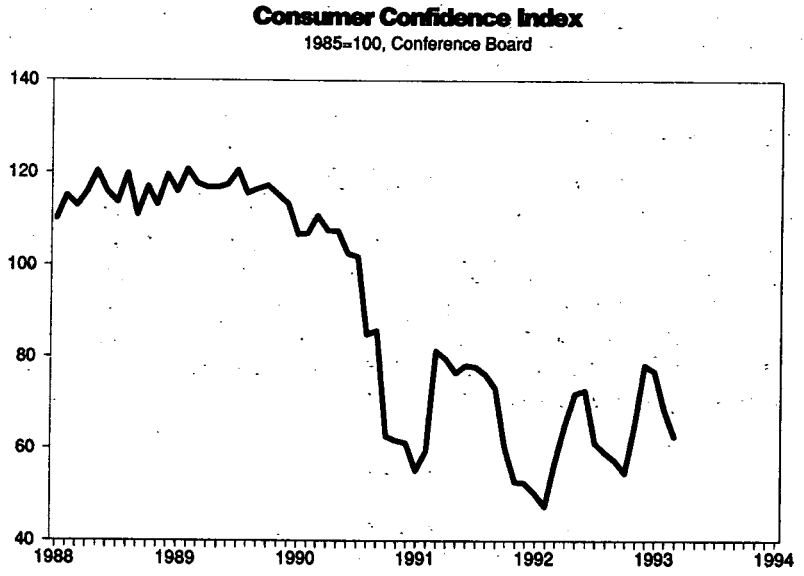
Manufacturing and Construction Jobs
Percent Change from Trough



Source: Bureau of Labor Statistics

Key indicators do not suggest that a strong turnaround is imminent for this sector. Sales of domestically produced autos, for instance, remain at recession levels despite continuing sales promotions. Consumer confidence, though up from a few months ago, still stands at a level no better than in the middle of 1992 or 1991 (see Figure 38).

Figure 38



In the near future, the most important risk to the manufacturing sector comes from the impact of weak economies abroad on U.S. exports. The major economies of Europe may see further economic declines in 1993. Japan's economy also may continue to slow, though the effects of fiscal stimulus efforts could avert this. Growing U.S. imports continue to satisfy domestic goods demand, and a slowing or reversal of recent export growth would severely constrain any expansion of U.S. manufacturing.

Construction indicators also are unpromising. Residential building has continued to make modest gains mirroring the easing of mortgage interest rates. However, nonresidential building has plunged and shows no sign of an imminent upturn.

Cutbacks in military spending are likely to contribute to continued weakness in the defense sector. According to a recent

analysis by the National Planning Association, job cuts associated with the Bush Administration's reductions in military spending are barely half complete, with the largest losses expected to come in 1993 and 1994. Reflecting this concern, Federal Reserve Chairman Greenspan recently told a group of bankers meeting in California that:

> *We are continuing to work through a major downsizing of military spending...in the short run, lower defense spending depresses economic activity--as is obvious here in Southern California.*
>
> *Alan Greenspan, March 13, 1993*

The government's fiscal posture is another major downside risk to the economic outlook. Though the Administration has put forth a modest proposal for fiscal stimulus in 1993, continuing budget stringency for state and local governments may offset this. The most notable example is California, where the State currently projects a deficit of between $8 and $10 billion for the fiscal year beginning July 1.

Large budget gaps began to appear in the state and local sector in 1986-87, four years before the official peak of the business cycle in 1990. Although these budget problems were initially concentrated in certain regions that were experiencing particular problems–such as the "oil patch" when oil prices fell sharply in 1986–problems became more widespread as the pace of economic expansion and revenue growth slowed while spending pressures intensified. School enrollments began to grow once again, Medicaid mandates and health-care costs claimed increasing shares of budget outlays, court orders compounded pressures for more correctional facilities, and delayed infrastructure repairs and construction began to create a mounting backlog.

When the recession really hit, state and local governments had few financial resources, and legal constraints on deficit financing forced spending cuts and tax increases. These fiscal responses drained purchasing power from the private sector, worsening the cyclical downturn.

With the economy showing some signs of pick up, the pressures on the state and local sector have recently abated somewhat. But continued sluggishness in the economy could still force state and local governments into measures that depress the economy.

RESTRUCTURING OF EMPLOYMENT

The second main structural obstacle to a strong recovery is the continued reluctance of firms to hire new workers, and the continued trend toward shedding employees in an effort to "streamline."

Such measures raise anxiety about job security and threaten to undermine consumer confidence and spending.

In January alone, corporations announced significant new layoffs (see Box). All these are in addition to other massive cutbacks previously announced at General Motors, IBM, Xerox, and Eastman Kodak. These decisions, sometimes euphemistically called "corporate restructuring," have resulted in a decline in total employment at Fortune 500 Companies.

Such announcements have been rare in the early stages of past recoveries, when firms typically started adding workers. This new pattern creates a climate of uncertainty about employment security which is likely to cast a pall over the normal rebound in confidence once recessions end. And there is every prospect that this process will continue.

A recent series of stories in the *Wall Street Journal* drew attention to what it called "the four horsemen of the workplace–global competition, technology, downsizing and the growth of the contingent work force."

Increased global competition has become a fact of life for workers at virtually all skill levels in virtually all industries. Factory workers have long been under pressure from overseas competition, particularly from relatively low paid workers in the developing world. Now more skilled workers are facing similar competition from the well-educated work forces of Asia, Latin America and Eastern Europe. In an era of internationally mobile capital and technology, few workers can be as confident in job or income security today as they could only a few years ago.

Technology provides a second source of job insecurity as the new information processing technologies mature in the workplace. Traditionally labor intensive service industries, such as communications, banking and finance, have already seen substantial employment cutbacks as a result of more efficient new technologies, a trend which is likely to accelerate with the introduction of more efficient communications infrastructure and more elaborate "expert systems" software to automate decisionmaking.

MAJOR RECENT LAYOFF ANNOUNCEMENTS

- January 4: Northwest Airlines, to layoff an additional 1,000 jobs, above and beyond the 2,100 it cut last year.
- January 6: United Airliness, to cut 2,800, and not fill a planned 1,900 new jobs.
- January 24: McDonnell Douglas, to cut 8,700 jobs, or 10% of its work force.
- January 25: Sears, Roebuck, and Co., to cut 50,000 jobs, nearly 14% of its work force.
- January 26: Armco, Inc., to cut 1,400 jobs.
- January 26: Boeing Co., to cut up to 20,000 jobs and cut production by 25%.
- January 26: United Technologies/Pratt & Whitney Division, to cut up to 10,000 jobs.

"Downsizing" often represents the response of companies to the pressures of competition and technology. As Stephen Roach, co-director of global economic analysis at Morgan Stanley and Company told the *New York Times*:

> *Sadly, job compression has been an unavoidable ingredient of the strategies needed for competitive survival...Harsh as it sounds, Corporate American can no longer afford to subsidize the bloat of unproductive workers. Hiring is a luxury that only world-class competitors can afford.*[1]

Don Strazheim, Chief Economist at Merrill Lynch made essentially the same argument in testimony before the Committee. He noted:

> *The recession was unusual and companies' response to this recession has been unusual as well, and we have seen company after company lay off overhead in a permanent way. These people are not going to find their jobs back at their prior employer.*

A recent study by the American Management Association found that 25 percent of companies surveyed planned to downsize employment in the coming year, the largest percentage since the survey began six years ago.

As permanent jobs are being eliminated through downsizing, a growing number of firms is turning to the use of temporary or part-time workers -- a group coming to be called "contingent workers". Such workers are paid lower wages than full-time workers, enjoy no job security and qualify for few fringe benefits. Richard Belous, economist at the National Planning Association, estimates 30 million to 37 million people are contingent workers, roughly 25 percent of the labor force. If current trends continue, he predicts that 35 percent of the U.S. work force will be contingent by 2000.

Prospects are not particularly bright for those entering the labor market. A recent survey found that firms plan to cut new hires of college graduates again in 1993, for the fourth year in a row. Although this year's cuts will be down to 2.1 percent from the 10 percent pace prevailing in earlier years, for the first time in recent memory, starting salaries for college graduates are expected to fall in real terms from the salaries offered graduates last year.

[1] *New York Times*, March 14, 1993.

THE GLOBAL SLOWDOWN

Many of our major trading partners are in the midst of recessions or slowdowns that seem to be spreading and in some cases gathering intensity. The causes of the poor economic performance vary from country to country and from region to region.

In Europe, many of the present difficulties are related to the high costs of German reunification. The United Kingdom's problems have been of longer duration. In Japan, the rapid expansion of credit in the late 1980s has led to a bursting of the "bubble" of unsustainably high asset prices. Additional strains are being placed on the global economy by the downturns in the former communist countries of Central and Eastern Europe, and in the newly independent republics of the former Soviet Union, as they attempt to make the transition from central planning to market-type systems.

Growth in Latin America, which had been strong in the early 1990s, has fallen to a current rate of roughly 1.5-2.0 percent. For example, problems are worsening in Mexico, where the currency has become overvalued to a point where growth is being depressed.

Early in February, the German Economics Minister Guenter Rexrodt gave this grim assessment of conditions there: "Growth has come to a standstill. Almost all the important indicators are going in the wrong direction."

The severity of some of the economic reversals is startling. Both Germany (not including the former East Germany) and Japan experienced moderately rapid growth in the late 1980s through 1991. The growth rate for all OECD countries averaged 4.4 percent in 1988 and 3.3 percent for 1989. By 1991 growth had generally slowed or turned negative for many OECD countries, although Japan grew by 4.4 percent and Germany grew by 3.7 percent. Total OECD growth averaged 0.8 percent in 1991.

West German GDP expanded by only about 1 percent in 1992, with declines in output after the first quarter of the year. The drop in output was a surprising 5.5 percent annual rate in the fourth quarter. In December, most forecasters expected a slight rise in 1993. But analysts now forecast an overall decline of 1.1 percent for this year.

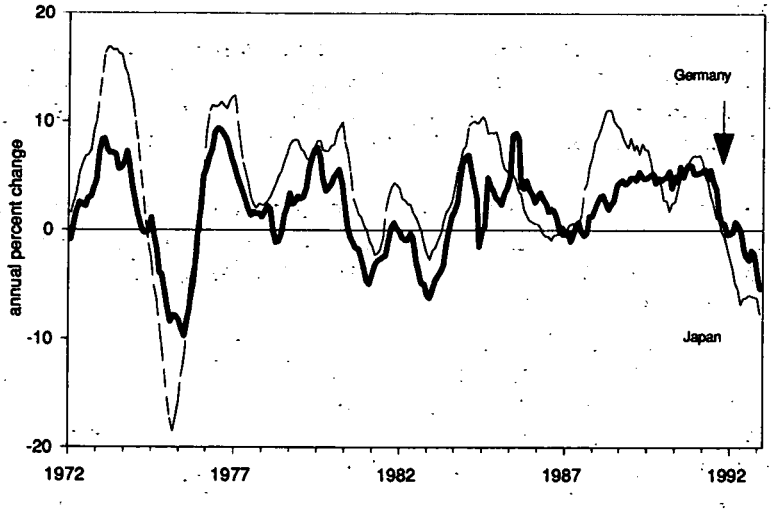
Japanese GDP eked out a gain of only 1.5 percent in 1992, the worst performance since the recession of 1974. As was the case with Germany, all of the growth occurred in the first quarter. Similarly, slow growth is forecast for 1993, this time with more strength later in the year with help from a stimulus package.

Conditions in the industrial sector have been deteriorating in both countries. In 1992, industrial production declined by 6.7 percent in West Germany and by 7.6 percent in Japan. (See Figure 39.) German automobile output has declined and advance orders for a wide range of manufactured products are down. A number of companies have laid off large numbers of workers or indicated there will be layoffs in the near future. Business confidence among manufacturing firms appears to be low. The unemployment rate reached 7.5 percent in January 1993. Unemployment was close to 14 percent in East Germany.

Figure 39

Industrial Production Abroad

Year over Year Change



Source: OECD

The situation is much the same in Japan where there have also been major reductions in the work force, with more to come. Many analysts agree that business firms overinvested in the 1980s resulting in considerable excess capacity. By the end of 1992, business pre-tax profits had fallen for 10 consecutive quarters. Unemployment had risen only modestly, to 2.4 percent. However, the informal "lifetime" employment system in the larger firms is under considerable pressure.

The United Kingdom has been experiencing a longer term recession, although conditions there do not seem to be worsening. GDP declined by 2.2 percent in 1991 and appears to have been

flat in 1992. Unemployment was about 10 percent. The growth rates in France and Italy were 1.2 percent and 1.4 percent respectively in 1991, and slightly below those rates in 1992. Unemployment in both countries was in the 10 percent range last year. Most of the smaller countries in the European Community experienced stagnation levels of growth (1 percent or less) and rising unemployment in 1992.

FISCAL POLICY

Given these obstacles to sustained and significant economic growth, it would be natural to expect federal fiscal policy to play a stimulative role. In the rebounds from all but one previous postwar recession, the Federal Government has supplied fiscal stimulus of about 1 percent of GDP, which in today's economy would translate into an increase in the deficit of about $60 billion. This argument is strengthened by the fact that the current "recovery" stalled once before in the fourth quarter of 1991, and almost stalled again last summer. Given the unusually weak pace of the current upturn, a modest dose of fiscal stimulus would seem to be prudent insurance against the possibility of the recovery stalling once again.

Nobel Laureate James Tobin made this argument most clearly in recent testimony before the Committee:

> *I don't think recovery is by any means in the bag from the news that we have been getting. I think we have quite a long way to go before we restore full employment, and there is little risk that a modest stimulus package will overheat the economy, and there is minimal risk right now in the foreseeable future of any serious increases in the rate of inflation.*

Today's fiscal situation is, however, markedly different from the past. Large budget deficits, a legacy of the 1980s, make it more difficult for fiscal policy to play its traditional role in supporting recovery. It is widely believed that monetary policy, not fiscal policy, needs to take the lead in pulling the economy forward.

The economic plan presented by President Clinton is focused primarily on long-term deficit reduction, but also contains a modest amount of new investments and tax cuts which will raise the deficit in the short run. Although often discussed as separate policies, deficit reduction and the early implementation of the investment program in the "stimulus" package are intimately connected. It would have been risky to separate them. Deficit reduc-

tion, while positive for the economy over the long run, imposes some short-term drag on economic activity. The faster deficit reduction occurs, the more downward pressure fiscal policy exerts on the economy.

The early implementation of the investment portions of the Clinton plan are designed to strengthen the economy so that it can withstand the contractionary effects of deficit reduction. If deficit reduction is applied to an economy with insufficient forward momentum, the result could well be a perverse increase in the deficit, as slow economic growth raises the deficit by more than the reductions resulting from tax increases or spending cuts.

This has happened before. In 1980, after the House had adopted a budget resolution, Congress was told by the Federal Reserve that it needed to cut $16 billion more from spending in order to reduce the deficit and respond to concerns in financial markets. The cuts were made, but the deficit rose instead of falling, because a weakening economy increased the deficit by more than the policy changes reduced it.

It is widely recognized that the economy has a powerful impact on the deficit. As the economy slows, tax receipts fall and federal "safety net" expenditures rise, producing a sharp widening of the deficit. A strengthening economy has the opposite effect: rising tax revenues and falling expenditures.

The budget also has an impact on the growth of the economy, but this impact is best measured by changes in tax and spending policies, not the level of the deficit. If the federal policy raises the deficit from zero in one year to a deficit of $10 billion the next, then it adds $10 billion of stimulus to the economy. If the deficit remains at the same $10 billion in the following year, however, there is no additional stimulative impulse. Once the economy has become accustomed to the federal government borrowing $10 billion per year to finance its expenditures, then continuing at the same level of spending and revenues conveys no extra kick. Policies to reduce the deficit from $10 billion to zero, however, produce a contractionary impulse for the economy, as such a move would remove $10 billion of purchasing power from the economy.

The huge size of today's federal deficit tends to obscure this basic point. During the early 1980s, fiscal policy was stimulative because deficits were increasing each year. In recent years, fiscal policy has contributed very little if anything to economic growth because the deficits, while large, have not changed significantly from year to year.

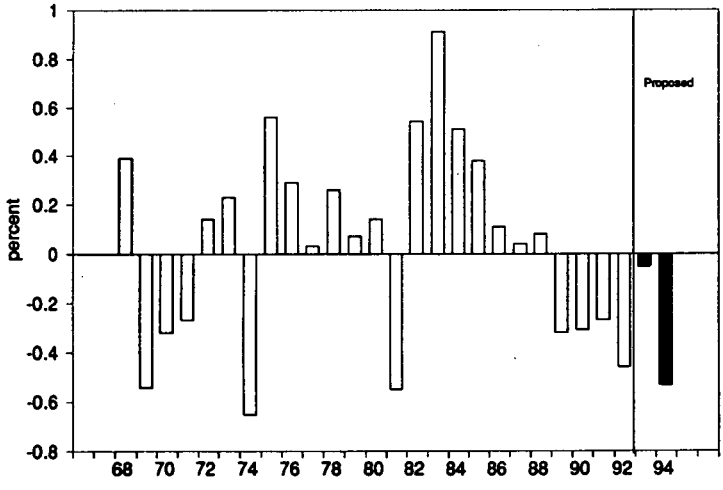
To measure the impact of changes in the deficit on the economy, economists have developed a concept called "fiscal impulse." This concept measures the impact on the economy of changes in tax and spending policies as a share of GDP. [2]

Figure 40 plots this fiscal impulse measure for the past 25 years and projections of the impulse as called for in the plan as proposed by President Clinton and re-estimated by CBO. The projections for 1993 and 1994 show the combined effects of the Administration's deficit reduction and stimulus plans for the coming two fiscal years (including both the unemployment compensation and other spending parts of the stimulus proposals and the proposed temporary ITC). The Administration proposes to essentially neutralize the contractionary impulse from baseline fiscal policy in fiscal year 1993, and then proceed with contraction amounting to some 0.5 percent of potential GDP in fiscal year 1994.

Figure 40

Fiscal Impulse

As a Percent of GDP



Source: JEC Staff calculations using data from CBO and Federal Reserve.

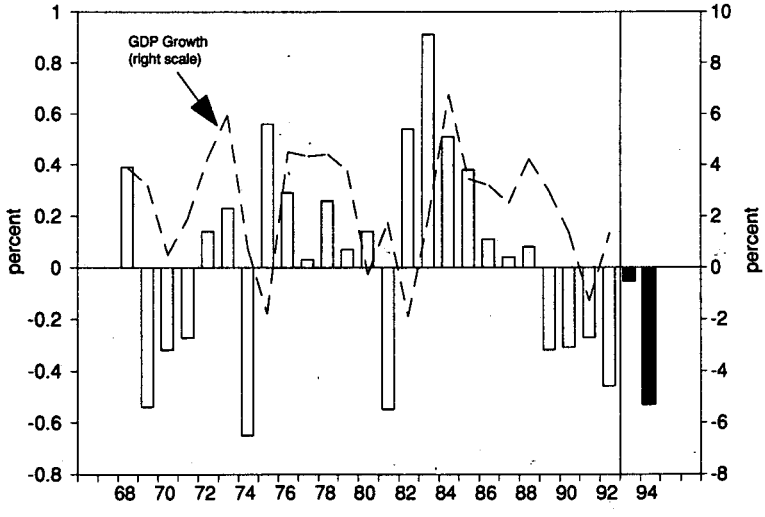
[2] The Fiscal Impulse measure used here was developed and tested statistically by Dr. Darrel Cohen, of the Research Division staff of the Federal Reserve Board. This measure is a weighted sum of discretionary budget policy changes, built by adding up real changes in federal purchases of goods and services, the initial effects on federal spending of changes in laws determining benefit programs and federal grants, and the initial effects on revenues of changes in tax laws. Tax law changes are weighted to take into account the fact that a part of the change will be absorbed in private sector saving rather than passing through into a dollar-for-dollar effect on total national spending and output. The historical series for this measure has been compiled by Dr. Cohen, using data from the Bureau of Economic Analysis. The projections of this measure were made by JEC staff using CBO's budget baseline calculated on a GDP account basis and the effects of the Clinton program as re-estimated by CBO.

Figure 41 is the same as Figure 40, except that a line has been added tracking the growth of real GDP. There appears to be a strong relationship between the stance of fiscal policy and the growth rate of the economy. Periods of strong growth generally follow a shift in fiscal policy toward expansion, and recessions similarly tend to follow a shift toward contraction in fiscal policy. The recessions of 1970, 1975, 1981 and 1990 were all immediately preceded by a shift in the stance of fiscal policy toward contraction, while the periods of strong growth in the late 1970s and mid-1980s were both preceded by sharp shifts toward expansion in fiscal policy. In the early 1970s, fiscal restraint was associated with a recession, followed by adequate growth largely as a result of substantial monetary stimulus. Clearly, monetary stimulus has proved essential over the past year in counteracting the effects of fiscal contraction, and it will continue to be essential in offsetting future fiscal restraint.

Figure 41

Fiscal Impulse

As a Percent of GDP



Source: JEC Staff calculations using data from CBO and Federal Reserve.

As the figure suggests, fiscal policy was roughly neutral between 1986 and 1988, but moved toward restraint in fiscal year 1989. This pattern continued throughout the recent recession, as the federal government refrained from using fiscal policy to stimulate the economy. This may help account for the extremely slow recovery we are now experiencing. Never before in recent history has the economy been asked to absorb a contractionary impulse from the federal budget for four years in a row.

President Clinton's deficit reduction plan will continue to exert downward pressure on economic activity through the next five years. But the Administration also recognizes that this contractionary impulse is being applied to an economy just struggling to recover from recession. There is a risk, therefore, that excessive contraction could jeopardize both the recovery and the task of deficit reduction. The fact that this recovery has almost stalled twice before suggests that we should not take lightly the risk of another setback.

To ensure against this risk, the Administration has proposed a short-term stimulus program to go alongside the deficit reduction program for the first two fiscal years, 1993 and 1994. The stimulus program will counteract some of the contractionary impulse from the long-term deficit reduction program so as to keep both deficit reduction and economic recovery on track.

The stimulus program is largely an effort to buy some insurance against the possibility of a future downturn in the economy. There is very little risk that the nation's economic problems next year will involve too much growth and a surplus of jobs for American workers. With little risk of too rapid a rate of growth, it is prudent to buy some small amount of fiscal insurance against the possibility of weaker growth.

Some have proposed eliminating the stimulus component of the Administration's program, but the fiscal impulse calculations suggest that the legislative measures now in train for stimulus are economically sound.

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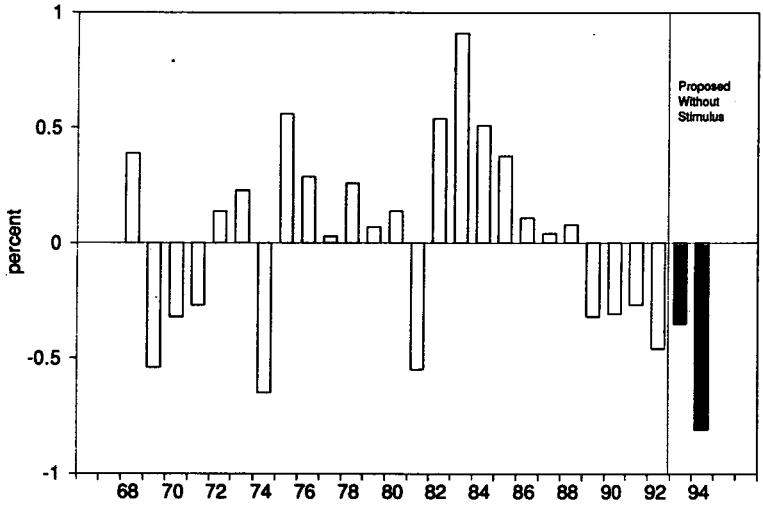
Figure 42 shows what would happen to fiscal impulse if the Administration's stimulus proposals had been removed entirely from the program in fiscal years 1993 and 1994. The contraction anticipated for fiscal year 1994 would be over 0.8 percent of potential GDP. This is large relative to the history of swings in these data.

Figure 42

Fiscal Impulse

As a Percent of GDP



Source: JEC Staff calculations using data from CBO and Federal Reserve.

In addition, a significant move toward fiscal contraction in fiscal year 1994 does not mean that a recession will necessarily follow. Other macroeconomic factors, particularly the decline in interest rates which has taken place since the Clinton plan was announced, will provide an expansionary impulse to counter the restraint imposed by fiscal policy. Monetary policy, however, will have to continue to focus largely on the task of sustaining growth. There is danger that the recovery could stall if monetary policy does not provide the stimulus needed to counteract the restraint imposed by contractionary fiscal policy.

Whether monetary policy provides this stimulus will be determined both by the actions of the Federal Reserve and by the responses of financial market actors to those actions. If rates do not fall fast enough, or if financial institutions do not extend credit at

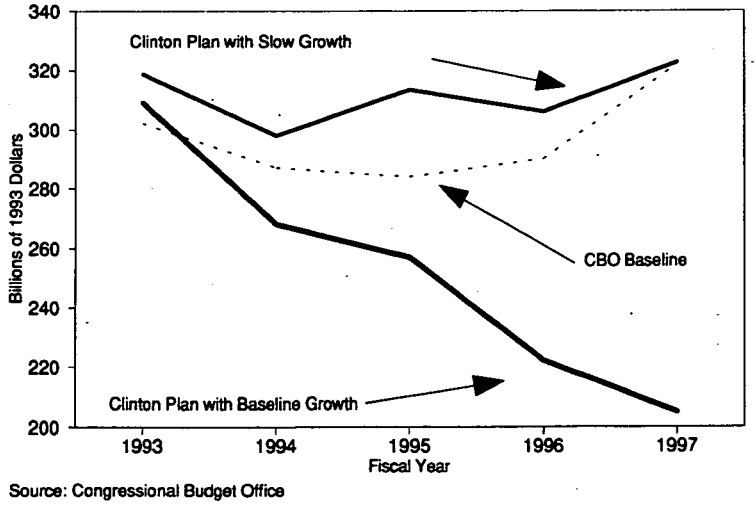
an adequate pace, the recovery could be in jeopardy. Should this happen, we need to be ready to make additional policy changes to ensure that the recovery continues.

There is no doubt that we face an extremely delicate balancing act in crafting an economic policy for the next several years. Forces for future economic expansion and contraction both will be at work as we attempt to address our serious long-term problems without jeopardizing short-term growth. In such a climate, policymakers must weigh carefully the risks of additional contraction beyond that supported by the Administration. It is quite possible that additional short-term deficit reduction exceeding that proposed by Clinton could backfire, weakening the economy and driving up the deficit.

Figure 43 illustrates the problem. The dotted line shows the current CBO baseline; the lower line shows the anticipated deficits assuming both that the President's program is enacted and that the economy grows as projected by OMB (roughly 3 percent). The upper line in Figure 43 shows what could happen to the deficit if growth through 1997 averages only 1.6 percent, as it did during the first six quarters of the current recovery. With such slow growth, the deficit would rise rather than decline, despite enactment of all the revenue increases and spending cuts in the President's plan.

Figure 43

Alternative Deficit Projections
Billions of Dollars, CBO Scoring



Source: Congressional Budget Office

None of the lines in Figure 43 is a prediction. The current consensus among economic forecasters is that the economy will grow sufficiently to keep the deficit on the steady downward path envisioned by Clinton. But economics is not an exact science, and the consensus forecast has been proven wrong in the past. This points to the need for close monitoring of the economy over the next several months to ensure that both the economic recovery and the process of deficit reduction remain on track.

Combining deficit reduction and economic growth in some ways resembles the practice of medicine—part science and part art. In testimony before the Joint Economic Committee in favor of short-term fiscal stimulus, Nobel Laureate Robert Solow invoked this analogy with respect to our current economic situation:

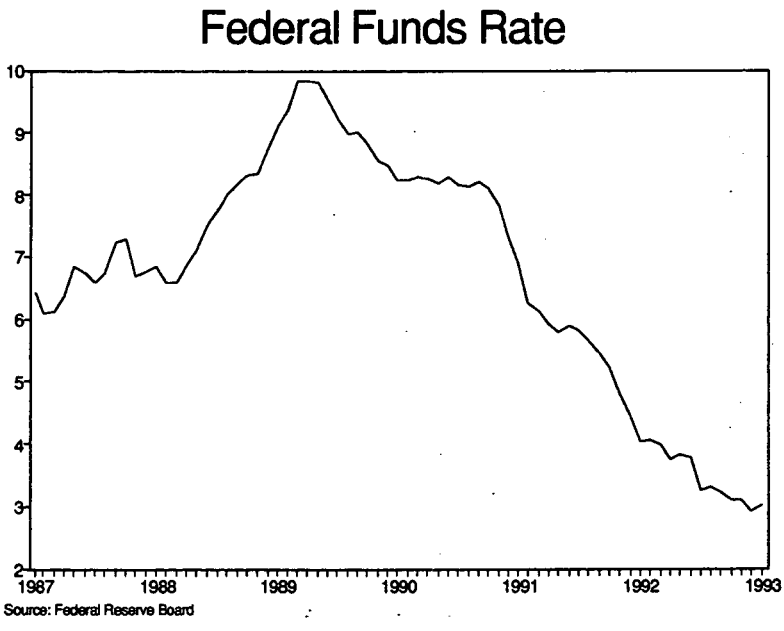
> *I am tempted to adopt a medical analogy...I am of an age where a certain number of my friends are having surgery every year and it is not unknown for them to have to be built up to a degree of health where they can withstand surgery. Deficit reduction will be contractionary for the economy. That is why the Fed is needed to take up some of that slack. It would be a terrible mistake, I think, to impose that necessary contractionary force at a time when the economy is just struggling to emerge from what has not been a very deep recession but has not been a typical recession either. It has lasted a long time....The important thing is to commit the patient to that surgery and then to build him or her up to health where the surgery can be withstood.*

THE ROLE OF MONETARY POLICY

As Professor Solow's remarks suggest, even with modest fiscal stimulus, the primary responsibility for ensuring an economic recovery rests with the Federal Reserve. With fiscal policy largely dedicated to the long-term task of deficit reduction, much of the responsibility for maintaining economic growth over the short to medium term falls to monetary policy. While monetary policy can be a powerful tool to promote growth, the conduct of the Federal Reserve between 1988 and 1992 raises questions about how willing the monetary authorities will be to ensure adequate overall growth.

Four years ago, Federal Reserve Chairman Alan Greenspan and other Federal Reserve spokesmen talked of achieving a "soft landing"—a slowing of economic growth sufficient to reduce inflation but not so abrupt as to precipitate a recession. At the same time, Chairman Greenspan and other Federal Reserve officials actively endorsed the medium-term goal of eliminating inflation. In apparent pursuit of a "soft landing" and no inflation, the Federal Reserve raised short-term interest rates for funds available to banks to 9.85 percent by March 1989 (see Figure 44).

Figure 44

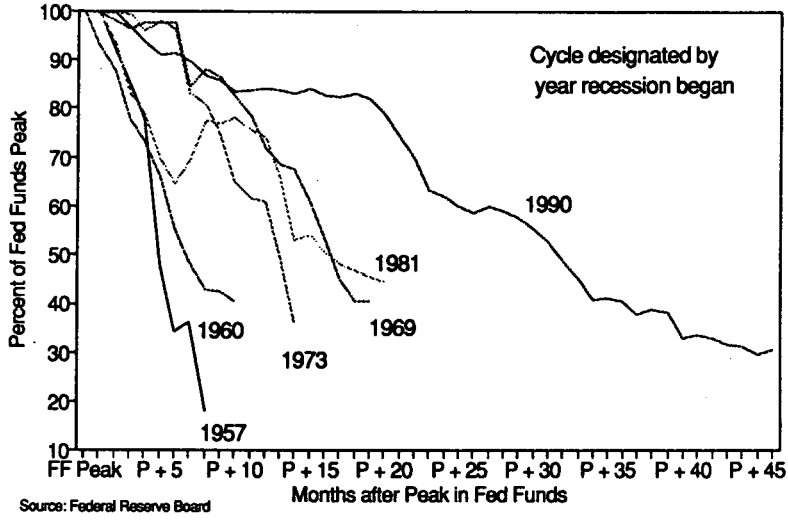


Rather than a "soft" landing, the economy actually experienced the "hard" landing that typically occurs with the Fed tightening to squelch inflation. The growth rate averaged only 1.7 percent in 1989 and the first half of 1990, before plunging into a three-quarter recession. In the seven quarters after the recession, growth has averaged only 2.3 percent, in contrast to an average growth rate of more than 5 percent in the first seven quarters of previous postwar recoveries.

When the economy went into recession, the Fed responded in a fashion that Nobel Laureate Paul Samuelson described as "too little and too late." Instead of a strong and powerful signal of its intent to ease, the Fed responded with a series of gradual easing moves, which left participants in the economy uncertain about the desires and intentions of the monetary authorities (see Figure 45).

Figure 45

Fed "Too Little, Too Late" in Rate Cuts
(peak to trough % chg in Fed Funds)

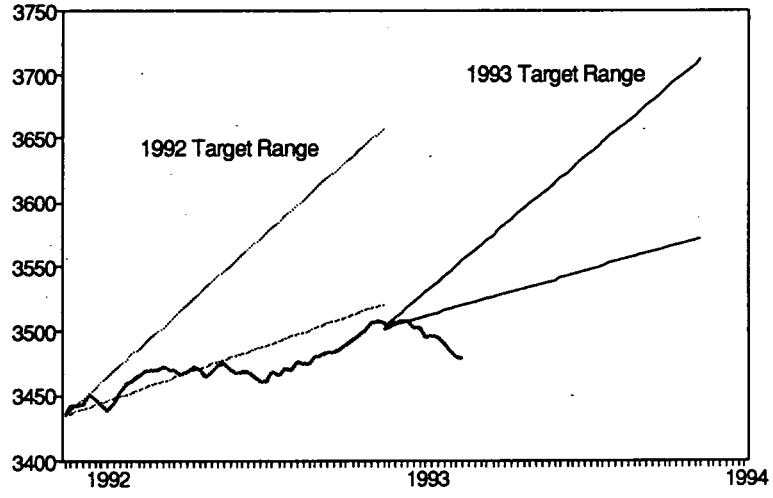


Some have argued that monetary policy could not have improved upon the poor record of economic growth in recent years due to structural problems, such as overbuilt real estate, defense cutbacks and the "credit crunch." When asked at a JEC hearing whether the Fed could overcome such structural barriers to growth, economist Edward Kane gave an analogy: a driver may turn on the air conditioner on a hot day and still drive 55 miles per hour if he pushes the accelerator down harder. Likewise, he asserted, the Fed could ease credit conditions further to maintain adequate growth, despite current structural problems in the economy.

Figure 46 suggests that the Fed did not follow Kane's advice. M2, the monetary aggregate most closely watched by the Fed, barely grew over the past year and has been moving down in recent months. Fed Chairman Greenspan testified before the Committee that firms are taking advantage of other financing opportunities that do not involve M2 balances. However, credit growth, from depository institutions and otherwise, has not grown strongly.

Figure 46

M2 and FOMC Target Ranges
Billions of Dollars



Source: Federal Reserve Board

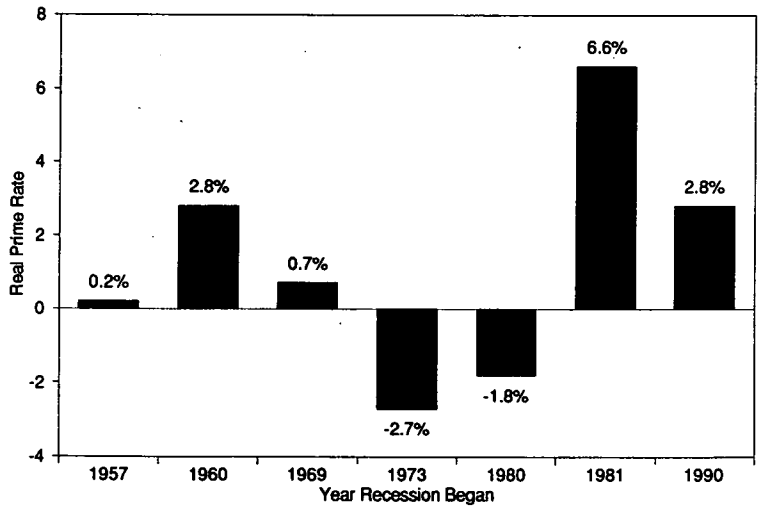
Defenders of Fed policy point to the fact that the Fed funds rate (the interest rate paid by banks to each other for additional funds to lend) is lower now than in 20 years. However, the nation's economic activity responds to the rate at which the banks lend money, not the rate at which banks borrow money (the Fed funds rate).

For a variety of reasons, banks today are keeping a wider margin than in the past between the Fed funds rate and the rate at which they lend. Moreover, the true cost of money to a borrower is reduced by inflation. Thus, the Federal Reserve's effort to stimulate the economy is better measured by the real prime rate (the rate at which the prime customers of banks can borrow, adjusted for inflation) than by the nominal rate of Fed funds. The only postwar recession/recovery period with a higher real prime rate than today's 2.8 percent came in 1982-3 when fiscal policy was extremely stimulative (see Figure 47).

Figure 47

Low in Real Prime Rate for Cycle

(Prime Rate less Annual Inflation)

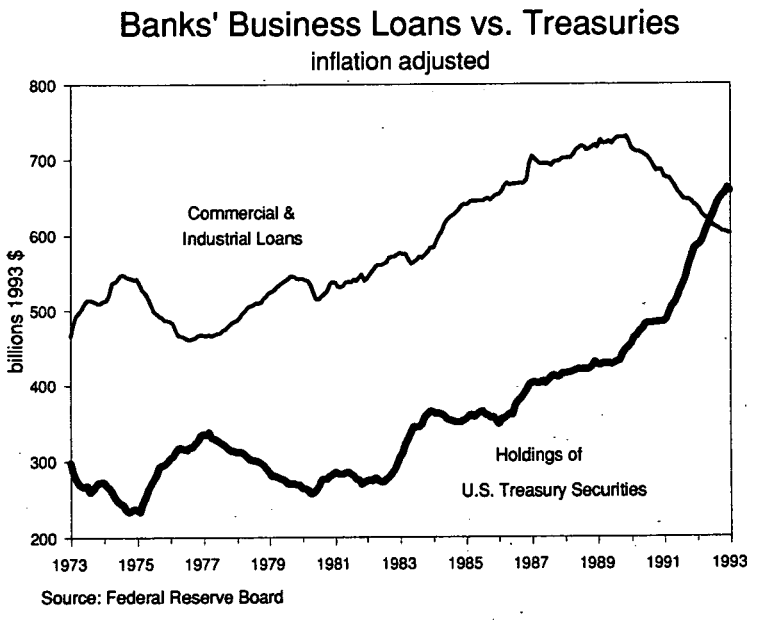


Source: Federal Reserve Board

Perhaps the most graphic evidence of the shortcoming of monetary policy has been the dramatic decline in bank lending. When the Federal Reserve pulls the reins to slow the economy (as it did in 1988 and 1989), it does not affect all of the economy equally. The most directly affected are the depository institutions (banks, savings and loans, credit unions) and the borrowers who depend most heavily upon them.

Credit extended by depository institutions has contracted continuously for more than three years. Total bank lending hit a peak in real terms in October 1989 and has fallen steadily through January 1993, for a total decline of 8 percent. Meanwhile, a 47 percent increase in banks' holdings of Treasury securities entirely offset the decline in loans. The trend has persisted throughout the last year, with loans off 3 percent and holdings of Treasuries up by 12 percent (see Figure 48).

Figure 48



The most heavily squeezed bank borrowers over the last three years have been commercial and industrial borrowers (loans down 18 percent in real terms) and private individuals (down 16 percent). Through the issuance of long-term bonds and short-term commercial paper, major corporate borrowers have been able to borrow despite the banks' credit squeeze. Since small businesses do not have those options and must rely heavily on banks for their credit, they have had to manage with less credit.

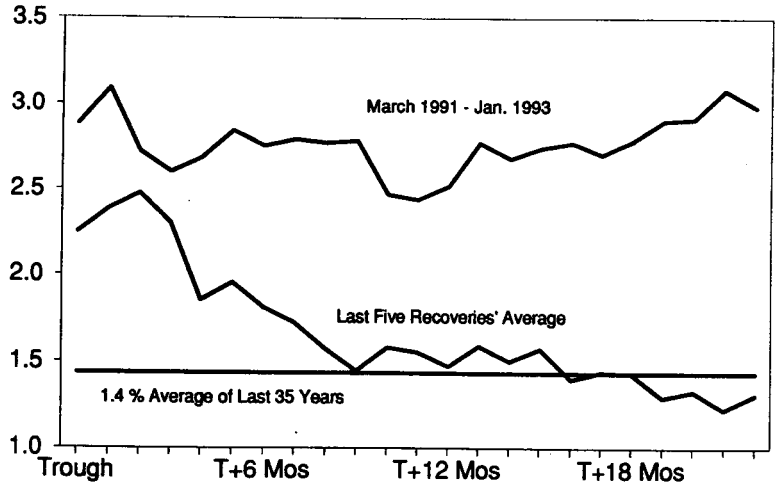
These trends suggest that interest rates to bank borrowers still have not come down enough to spur borrowing by commerce and industry—or that banks are restricting lending using administrative procedures rather than interest rates.

Bank interest rates for borrowers could be lowered in either of two ways: banks lower their margins or the Fed lowers banks' cost of money. Figure 49 plots the margin between banks' cost of money (in terms of the Fed funds rate) and the rate at which they lend to their best customers (the prime rate). It shows that this margin has been hitting record highs. In part, this results from industry-wide pressures to compensate for higher losses on bad loans. In part, this reflects the drop in volume as borrowers try to reduce their excessive debt burdens. Margins typically rise in recessions.

Figure 49

Bank Margins at Record Highs

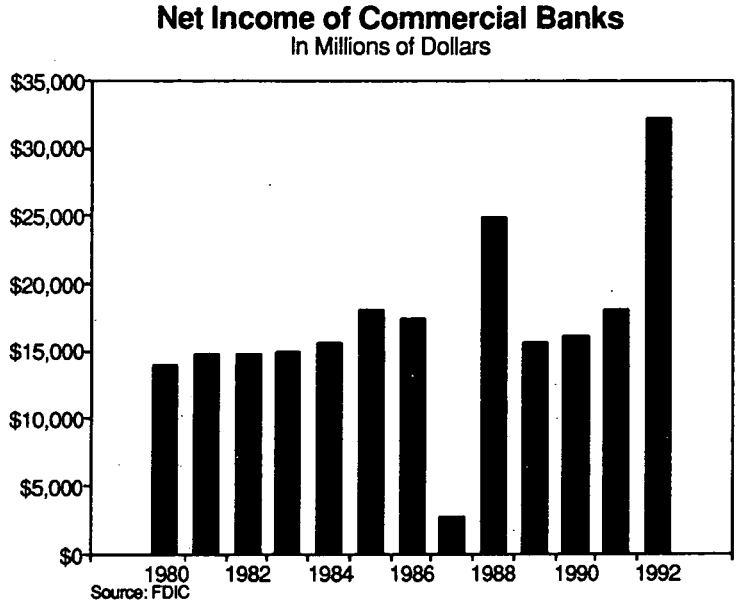
(Prime Rate minus Fed Funds rate)



Source: Federal Reserve Board

The rise in bank margins more than compensated for loan write-offs in 1992. As a result, banks have substantially increased profits in recent quarters. Profits for the banking sector as a whole hit an all-time high in 1992, not just in dollar terms (see Figure 50), but also relative to bank assets.

Figure 50



With bank interest rates of 6 percent for prime borrowers, and even higher for many other credit worthy borrowers, ample room remains to lower bank lending rates, through cuts in either banks' profit levels or the Fed funds rate. Lower bank interest rates would attract more borrowers and arrest the 3½ year decline in bank credit. This is particularly crucial to small and medium-sized businesses. While a 1980s style explosion of bank lending would be unhealthy and unwelcome, some modest real growth of credit is a necessary part of a strong and sustained economic expansion.

Just as in the recent past, monetary policy will largely determine whether we have satisfactory growth over the next several years. For the foreseeable future, fiscal policy will have a neutral to contractionary effect on the economy. Likewise, many of the structural problems weighing down the economy may ease, but will remain for some time. In such an environment, any significant move toward monetary tightening could derail the recovery and lead to rising unemployment and falling output. If we are asking fiscal policy to pay primary attention to deficit reduction, then we must ask monetary policy to pay primary attention to growth.

CHAPTER V

THE LONG-TERM CHALLENGE

Once the recovery is assured, attention will need to shift to addressing the long-term health of the economy. Here there is a broad consensus among economists that the appropriate goal is the creation of a high-wage, high-productivity economy. The economic problems which are most visible to average Americans–falling wages, stagnant family incomes, widening income disparities–can only be addressed over the long term by improving the nation's rate of productivity growth. Only by improving overall productivity growth do we have a chance of producing decent job and income opportunities, not just for the educated elite of our country, but also for the vast majority of Americans who do not have college educations.

Recent sharp rises in productivity have led some to conclude that we have already solved this problem. Unfortunately, this may not be the case. Productivity typically rises strongly in the early stages of recovery as firms produce more output with the existing work force rather than add new employees.

Sustaining strong productivity growth will require a major reorientation of both public policy and private-sector behavior. Public policy must shift toward activities which promote investment–including both increase emphasis on investment in public spending and decreased reliance on deficits as a mechanism for financing public expenditures. Private economic actors must also increase emphasis on investment, both in capital equipment and in the skills of the work force.

FISCAL POLICY FOR A HIGH-PRODUCTIVITY ECONOMY

Federal macroeconononomic policy needs to be concerned with two problems: short-term business cycle fluctuations and the long-term trend growth of the economy. The long-term trend rate of growth of output ("potential GDP") and employment ("full" employment) are determined by growth in the labor force and in the improving capacity of that labor force to produce output (productivity). Over the course of the business cycle, however, actual employment and actual production of goods and services are largely determined by demand conditions. Recessions occur when demand for goods and services falls short of the economy's

capacity to produce goods and services. Inflation occurs when there is excess demand relative to capacity. Inflation is typically not a threat when actual output is as far below potential output as it is now.

With well-designed macroeconomic policies and good luck, however, potential output will grow at a satisfactory sustainable pace and actual output will track potential output closely without sharp increases in either unemployment or inflation. But we have not been doing well on either count. A strong, sustainable recovery from the 1990-91 recession is not yet in the bag and the economy continues to languish well below its potential. In addition, potential output has been growing too slowly for too long. So, even if we get back to potential, we will not see the increases in our standard of living that we want unless we find ways to increase the rate of growth of potential output. The one beneficial aspect of this generally sad record is that inflation is under control and there is little risk that any policy options now under serious discussion will reignite it.

The Clinton program attempts to address both aspects of our recent weak growth performance. The stimulus component is designed to get the economy moving towards its potential more rapidly and more surely. The investment and deficit reduction components are designed to increase the rate of growth of potential. The stimulus component is aimed at creating jobs and restoring full employment. The investment and deficit reduction components are aimed at raising productivity and hence wages and incomes at full employment.

DEFICIT REDUCTION

Deficit reduction works to raise potential output and income through its impact on saving and investment. In an economy closed to international capital flows, saving and investment are the same thing. Such an economy grows by saving more and investing that saving productively. Deficit reduction raises saving and investment, and hence potential output. Things are a little more complicated in an economy open to international saving and investment flows: national saving can exceed investment in the domestic economy, with the surplus invested abroad. Or, as happened in the United States in the 1980s, national saving can fall short of domestic investment, with the difference made up by foreign borrowing. Deficit reduction acts most directly on national saving. Some of the increase in national saving translates into increased domestic investment and the rest translates into reduced foreign borrowing.

Both changes are aimed at raising future national income in the United States. Using growth accounting techniques common to such exercises, the Congressional Budget Office estimates that a permanent shift of 1 percentage point of output from consumption to investment raises long-term sustainable consumption by about a percentage point. New theories of economic growth suggest bigger gains may be achieved. Reduced foreign borrowing means that more investment is domestically-owned and financed and that the returns on that investment contribute to U.S. national income rather than to foreign national income. Thus, reduced foreign borrowing affects U.S. consumption in much the same way as increased domestic investment.

Although the qualitative effects of deficit reduction are reasonably well-understood, their quantitative magnitudes are more difficult to determine. Besides uncertainty about how an increase in national saving will be split between domestic investment and reduced foreign borrowing, there is uncertainty about the net increase in national saving that will result from deficit reduction. Economic theory suggests that some deficit reduction might be offset by a decline in private saving (although private saving fell in the 1980s at the same time the deficit rose).

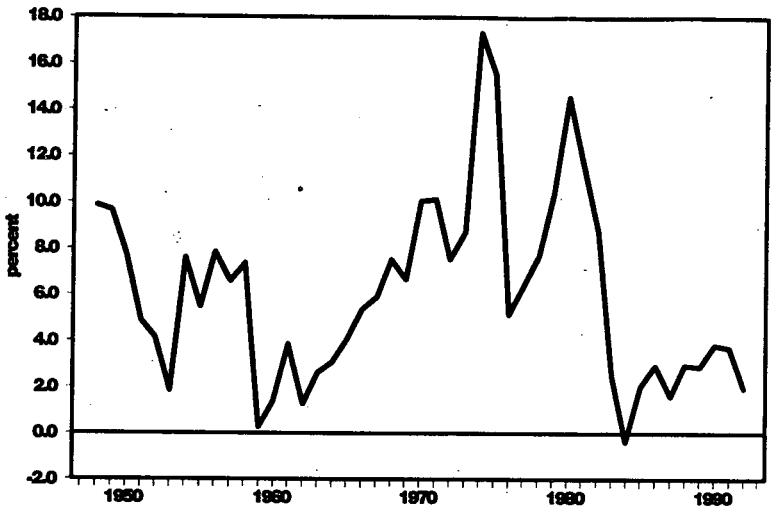
CBO estimates that a dollar of deficit reduction translates into 30 cents of increased domestic investment, 40 cents of reduced foreign borrowing, and 30 cents of reduced private saving. They also estimate that under the policies inherited from the Bush Administration, the deficit will rise by more than 3 percentage points of GDP over the next ten years. This would reduce national saving by more than 2 percentage points and ultimately lower sustainable consumption by roughly the same amount.

A fiscal policy tilted toward increasing private investment is long overdue. Despite a broad consensus that workers become more productive when they have access to increasing amounts of capital at their disposal, recent trends in the growth of the capital stock are not encouraging. Figure 51 shows the annual growth rate in the amount of private physical capital available to each American worker.

Figure 51

Growth of Private Capital per Worker

Percent Change



Source: BEA; BLS; JEC calculations

During most of the period since World War II, capital per worker rose steadily, following a fairly regular exponential growth path. However, at the beginning of the 1980s, there is a distinct break where the growth of capital per worker abruptly slows. It is important to note that this flattening of the capital-labor ratio did not result from a sudden increase in employment growth. Employment expanded more slowly during the 1980s (1.9 percent, at an annual rate) than during the 1970s (2.5-percent annual rate), when most of the Baby Boom generation first entered the labor force.

High real interest rates shifted the mix of activity away from some sectors of the economy that tend to have high output per hour. For example, high rates pushed up the exchange value of the dollar, causing the trade deficit to swell. This hurt industries whose products are internationally traded, mainly agriculture, mining and manufacturing. High interest rates also hurt the construction industry, which had a burst of activity due to specialized tax breaks, but then collapsed.

PUBLIC INVESTMENT

The private sector is not the only source of investment in the U.S. economy. Investment by government, typically in the areas of transportation, communications, information, education and public health, have also made a major contribution to growth in productivity. Private markets often fail to provide adequately in these areas because private interests find it difficult, if not impossible, to capture the diffuse benefits of these investments as profit. Societies that have neglected these investments have found their private sectors encumbered by inefficiencies that are not in any individual's private interest to correct.

The radical experiment in economic policy that began in the 1980s had a severe impact on public investment. At the state and local level, the rise in real interest rates had an effect on projects requiring financing similar to that experienced by private investors. At the federal level, the decline of public investment stemmed from the postponable character of investment activities.

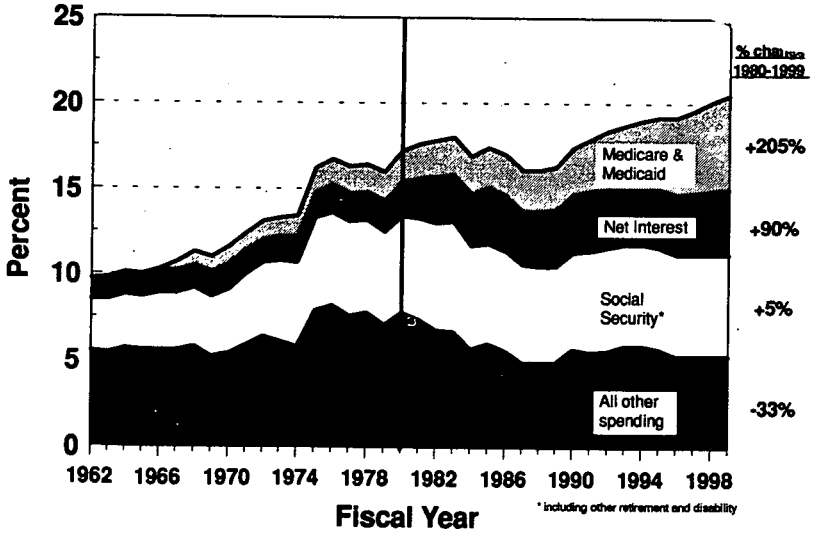
The benefits of investments, by their very nature, accrue in the future. However, the costs must be paid in the present. When tax cuts and defense spending increases caused the budget deficit to swell at the beginning of the 1980s, the Federal Government's investment accounts came under severe pressure.

Figure 52 shows recent trends and current CBO projections for federal spending. While overall nondefense spending has risen as a share of GDP in recent years, none of this rise is accounted for by increased investment spending. Most nondefense spending goes to honor commitments to the elderly through Social Security and Medicare or to government bondholders through interest payments. Spending for the former expanded during the 1980s because of increasing numbers of beneficiaries and because of escalating health-care costs. In fact, health care costs are the principal factor contributing to spending increases. Interest on the federal debt must be paid, because defaulting would make it impossible for the government subsequently to raise money. Clearly, these expenditures cannot be construed as investment.

Figure 52

Federal Non-defense Outlays

(percent of GDP)



Source: CBO

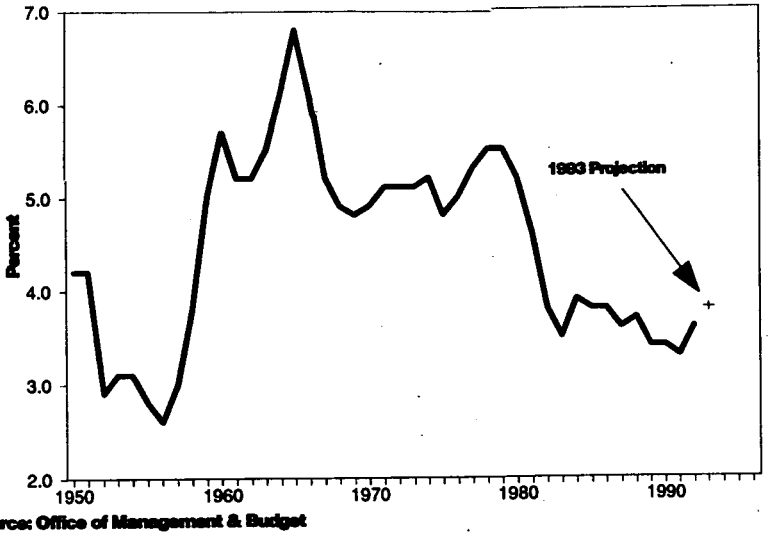
Some other smaller components of nondefense spending also cannot be classified as public investment, though they may be quite necessary. Activities like law enforcement, air traffic control and meat inspection, for instance, have little future payoff, but nonetheless are necessary for an orderly society. Though these accounts were squeezed by budget pressures over the last 12 years, they are harder than postponable investments to cut back on because of the immediacy of the needs that they serve.

The share of federal outlays going into physical capital has declined since the 1970s, as is shown in Figure 53. It probably is easier to postpone investments in physical assets like roads, bridges and waterways than to terminate ongoing operational programs. Easier still is not making new investments based on new opportunities or technologies, the absence of whose benefits may not be noticed because of their diffuse nature.

Figure 53

Nondefense Physical Capital Outlays

Percent of Total Federal Outlays



Source: Office of Management & Budget

It is important to reverse the trend toward declining public investment. It is equally important to define investment broadly, as those activities which significantly increase the capacity of the economy to produce. These fall into four broad categories: investments in people, investments in infrastructure, investments in ideas and investments in economic restructuring.

INVESTING IN PEOPLE

Moving toward a higher-productivity economy will require substantial attention to upgrading the Nation's stock of "human capital"–the stock of skills workers use to operate effectively in changed economic circumstances.

Investment in human capital includes, but is not limited to "training." The ability of a worker to succeed in a training

program depends in large part on his or her prior education and general intellectual development. That in turn reflects nutrition and health investments, as well as those in education. Improving labor-management relations, providing better information to labor-market participants, and facilitating labor reallocation through mobility are also components of investment in human resources.

It is common to pair "education-and-training" in discussions of human capital investment, in part because it is difficult to distinguish which is which. If we follow Nobel Laureate Theodore W. Schultz's insight that more educated people are better able to cope with change, we can define training as learning how to take appropriate action in situations that can be anticipated to occur, while education is learning how to choose appropriate responses in situations not previously encountered. Professor Richard Murnane finds, for instance, that "education is particularly important in fostering productivity growth when production processes are changing and new technologies are being introduced."[1]

At the individual, firm or industry level, productivity growth can be enhanced by working smarter as well as working harder. What have come to be called "high performance work organizations" gain in productivity through organizational changes as well as through investment in physical and human capital. The most important change facing managers is devolving as much decision-taking authority to the front-line work force as possible, so as to take maximum advantage of the productivity gains inherent in computerized production systems.

As economist Alan Blinder wrote recently, "to remain a rich, high-wage nation, we must keep changing our industrial structure. ... If we try to compete with low-wage labor in routine production tasks, America is bound to lose."[2] Firms that can evolve to new products and production processes, and industries that can meet the demands of global competition are going to need production workers, technicians and managers better able to cope with change.

What kinds of education and training changes are needed to be consistent with this model of a modern major economy? In the mass production model on which American economic preeminence was based in the 30 years after World War II, only an elite of managers and professionals needed to think. High

[1] "Education and the Productivity of the Work Force: Looking Ahead," in R. E. Litan, R. Z. Lawrence and C. L. Schultze, eds., *American Living Standards: Threats and Challenges*, The Brookings Institution (Washington, D.C., 1988, p. 221).

[2] "Maintaining Competitiveness with High Wages," International Center for Economic Growth, (San Francisco, 1992, pp. 13-14.)

performance work organizations, however, need thinking skills pervading the production system.

In the short term, this will require upgrading the present work force, including the present teaching work force. In the longer run, new approaches to education and training that take advantage of the higher base from which we start are appropriate. The time to start designing and testing these new approaches is now, in parallel with the remediation needed to aid worker reallocation and skill improvement. The Administration's program recognizes these new realities and makes a start at dealing with both tracks of the problem.

For those already in the work force, job-based education and training needs to be the focus. Employers should be encouraged to provide training and retraining to their existing work force, a process which could well be facilitated by extending the model of agricultural extension to other sectors of the economy. Further investment in the information infrastructure, through "one stop shopping" at Employment Service offices, and the profiling of displaced workers when they file for Unemployment Insurance are also well worth pursuing.

For those not yet in the work force, the focus of attention must be on the education system. Many people would likely agree with Lester Thurow that "the United States is unique among industrial countries in that it does not have an organized postsecondary education system for the noncollege bound."[3] Over the past several years, the JEC has held hearings on this topic, featuring reports requested from the General Accounting Office (GAO) that support Thurow's assertion.

A major problem is that a significant share of young workers do not get established in steady work until, or even after, their late 20's, ten or so years after their counterparts in Germany, Japan and elsewhere. The Administration is supporting several strategies that have promise for improved school/work integration. These include expanding the Job Corps and summer youth programs that focus on disadvantaged youth, and helping develop a system of "youth apprenticeships" that would be open to noncollege bound students. Considerable attention has been devoted by U. S. analysts and policymakers to such programs in Germany and other advanced industrial countries. As with the proposals for improving training of adult workers within firms, a key consideration is how best to induce employers to provide training to workers not all of whom would become permanent employees. Other aspects needing further study are potentials for tracking that

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[3] *Head to Head*, Basic Books (New York, 1992, p. 275).

would limit later options, and the implications of such a system for equitable treatment of women and minorities.

International comparisons indicate that challenging academic material is available primarily for the college-bound minority. As former Secretary of Labor Ray Marshall testified to the JEC in February, the remainder tend to leave school not just inadequately prepared for good jobs as young adults, but also not well prepared to qualify for good jobs later on. A major problem in this respect, which adversely affects the ability of young workers to get good jobs is the disconnect between school performance and employment rewards. Non-college bound students perceive little incentive to work hard for good grades and subject mastery, and employers have not chosen to make grades a significant hiring criterion, as is the case in, for example, Japan.

Similar to the situation of public schools, the general level of preparation by pre-schoolers and their families needs improvement. Here is where investments in nutrition, health, socialization and early education have the most leverage, especially for disadvantaged children, but for the broader child population as well. Good preschool programs have been shown to have significant long-term payoffs, but the costs may be out of reach for many working families, especially if there is just one adult earner.

In general, the Administration's proposals represent a welcome reemphasis on needs that can't be dealt with on a one-time or solely market-oriented basis. Just as it is impossible to maintain good health with poor nutrition in childhood, even good nutrition needs to be maintained as an adult to stay in good shape. Investment in our human capital resources follows the same rules–we need to nourish our minds in recurrent ways that maintain and enhance skills.

INVESTING FOR THE FUTURE: INFRASTRUCTURE

A modern industrial Nation requires a high level of investment to remain competitive in today's world economy. This applies not only to private-sector investment in new factories, equipment, technology and training, it applies equally to public sector investment in such basics as roads, bridges, water and sewer systems and schools.

During the 1950s and 1960s, U.S. governments at all levels invested heavily in physical infrastructure. At its peak in the late 1960s, federal, state and local government infrastructure spending amounted to almost 4 percent of GDP, according to Commerce Department data. Net public investment–government investment above the amount needed to offset the wear and tear on existing infrastructure–was almost 2.5 percent of GDP.

This period of high government investment was followed by two decades of austerity. By the early 1980s, government capital investment had fallen to just over 2 percent of GDP, half the peak level. Net investment fell to less than 0.5 percent of GDP; government investment was barely enough to offset the annual depreciation on existing infrastructure. Recently, there has been a modest increase in infrastructure spending by state and local governments. But federal spending on infrastructure continued to decline throughout the 1980s.Overall, the level of government investment is still well below its 1968 peak.

Inadequate infrastructure hurts the competitiveness of American industry. Private investment in new factories, equipment, technology and training is only one component of competitiveness, albeit a very important one. The public infrastructure which ties the American economy together is an equally essential component; inadequate roads, bridges, airports, harbors, water and sewer systems and schools, raise business costs and impair the competitiveness of U.S. industry in world markets.

The Administration has put forward an ambitious program aimed at building a world-class infrastructure for American business. For fiscal year 1994, the Administration's stimulus program calls for spending an additional $2.5 billion on infrastructure, primarily on highways, airports and mass transit. For the longer term, the President's plan calls for spending a total of $47.5 billion between fiscal years 1994 and 1998 on investments to rebuild America, only one-quarter of which will be tax incentives to spur private investment. The rest will fund public investment in transportation, environmental protection, rural development, defense conversion and community development.

The infrastructure for a high-productivity economy is not confined to the traditional areas of road, rail, water and sewer. Today, it also encompasses an infrastructure for moving data and ideas within our increasingly information-based economy. Throughout American history, advances in transportation and communications have been a driving force in our economic development. In the past, investments in the transcontinental railroad, long-distance telephone service, and the interstate highway system helped to make our economy more productive while binding us together more tightly as a nation. Today, investment in realizing the full potential of advances in our ability to transmit and process information can be just as important.

Advanced communications is the basis of the current "Information Age." In today's high technology economy, the ability to transmit large amounts of data is becoming as important as the

ability to transport goods. Just as the development of the national railroad and highway systems fostered industrial expansion over the past century, the development of a national high speed fiber optic network will promote the development of tomorrow's high technology economy. The Administration plans to fund investment in communications pilot projects by states, local governments, universities, school districts and nonprofit organizations as a way of picking up the pace of implementation of this new form of infrastructure.

INVESTING FOR THE FUTURE: TECHNOLOGY POLICY

Productivity growth is also critically dependent upon an increase in the knowledge base of the society, what some have called the "intellectual capital" of the country.

America's system of basic science education and research is unrivaled in terms of quality and productivity, and has been a catalyst for U.S. technological progress and economic growth since World War II. This system has its foundations in Vannevar Bush's 1945 report *Science: The Endless Frontier*, which laid the basis for the creation of the National Science Foundation and led to the establishment of robust research programs in each of the federal mission agencies.

The combination of strong federal support for basic science and American industrial preeminence almost across the board was a major factor in American industry's ability to lead the world in the application of new technologies and the creation of high-wage jobs through the 1970s. During this period, government missions —especially defense and space—drove technology development and government provided a crucial early market for many high-tech products, from computers and semiconductors to transport aircraft. However, over the last two decades America's economic competitors have made great strides, to the point where the U.S. is no longer the unrivaled scientific and technological superpower it once was. And the commercial marketplace, not government mission needs, increasingly drives technology development.

The loss of U.S. preeminence is due in part to the redevelopment of foreign economies following World War II, and more specifically, to the success of U.S. efforts to rebuild the economies of Japan and Germany. That is not the entire story, however. As noted above, the American basic science system remains the best in the world. Where we have fallen behind is not in basic research but in the application of the results of that research in the commercial sector.

Numerous public and private critical technology reports in recent years have pointed out that the U.S. is losing ground in many

key technological areas. This has translated directly into the loss of jobs and the decline of entire high-tech industrial sectors where the U.S. once held the lead, including consumer electronics, machine tools, and semiconductor manufacturing equipment.

U.S. technological decline was particularly pronounced through the 1980s, in part because of Reagan and Bush Administration insistence that the federal government should play little if any role in the research and development of commercially-relevant technologies. A limited number of initiatives, such as the creation of Sematech and the National Center for Manufacturing Sciences, were launched on the basis of national security needs. Since critical commercial technologies and critical defense technologies were fast becoming one and the same, these initiatives provided an opportunity to experiment with new models of public-private partnership in technology development. Nevertheless, despite the fact that the U.S. federal investment in research and development dwarfs that of our economic competitors, a much smaller percentage of that investment is coupled to the needs of the private sector in the U.S. than is the case overseas.

At the same time, the U.S. private sector itself critically underinvests in R&D compared to its principal economic rivals, devoting only 1.4 percent of GNP to R&D annually, compared to 2.4 percent in Japan and 2.1 percent in Germany. In fact, when comparisons are made on the basis of international exchange rates, the Japanese private sector is already investing more of its own resources in R&D in absolute terms than is the U.S private sector.

The United States needs a coherent technology policy if it is to remain competitive in the future. That policy needs to address both public and private sector R&D investments, and ultimately be at least as good as the technology policies pursued by our economic rivals. To maximize its impact on the economy, such a policy must also be integrated with tax, trade, regulatory, health care, defense, and as is discussed later in this chapter, defense conversion and reinvestment.

In February, the Clinton Administration released a technology policy that does just that. The development of this policy represents the most fundamental shift in federal technology policy since Vannevar Bush's report. The Clinton plan recognizes the importance of world leadership in basic science, mathematics, and engineering, as Vannevar Bush did, but it goes on to recognize that "the nation urgently needs improved strategies for government-industry cooperation in support of industrial technology."

This new paradigm has at its heart partnerships between government and industry aimed at long-term economic growth that

creates jobs and protects the environment. This New Partnership brings with it a new metric for judging the success of the federal R&D enterprise, namely its relevance to our private sector's needs. This change puts the country on a fundamentally different path, one that holds the potential to bring with it profound benefits for American workers.

Major components of the administration's technology policy include:

- Increased funding for the National Science Foundation.
- Improvements in education and training technology.
- Permanent extension of the research and experimentation tax credit.
- Incentives for long-term investment in small companies.
- Incentives to increase private investment is capital equipment.
- Investment in a national information infrastructure.
- Increased investments in civilian and dual-use technologies.
- Government-industry partnerships in critical technologies at each of the mission agencies.

DEFENSE ADJUSTMENT AND REINVESTMENT

The second policy challenge for creating a high-productivity economy is adjusting to the post-Cold War defense drawdown. While the macroeconomic effects of planned cuts in the defense budget are moderate, regional impacts will in many cases be severe. The challenge is to minimize the disruption associated with this adjustment, particularly at the local level, while supporting the growth of a high-productivity economy by reinvesting human and capital resources in high-productivity activities.

Meeting this challenge requires both macroeconomic and micro-economic policies. At the macro level, a rapid rate of overall growth in the economy would ensure that resources released from the defense sector are quickly redeployed. This is what ultimately happened after World War II when rapid growth in housing, autos, and consumer durables spurred by pent-up demand during the war years provided strong job growth for workers being released from the armed forces and from defense industries. Government investments, in areas such as the federal highway

system and support for private investment in housing, also played a role in spurring this redeployment.

DEFINING REINVESTMENT AND CONVERSION

Anemic growth since 1990 has magnified the adjustment problems caused by defense budget cuts. However, many of the adjustment problems faced by defense companies, defense workers, and defense-reliant communities today are the same general problems that face companies, workers, and communities dependent on declining commercial industries. General solutions, such as workforce training and employment assistance; economic development funding; capital formation; and research, development, and manufacturing assistance for companies seeking to enter new markets—in short, new job creation—will alleviate much of the national impact. These issues are being addressed by the Clinton Administration through the appropriate federal agencies, as discussed in the preceding sections "Investing in People," "Investing for the Future: Infrastructure," and "Investing for the Future: Technology Policy."

That is not the whole story, however. The defense base in World War II was primarily made up of commercial companies that converted to military production during the war and were ready and able to convert back to commercial production at its completion. Today's defense production base is a product of the Cold War and a defense acquisition system which over the past two decades has created a wall between the defense and commercial sectors, particularly at the prime contractor level.

Many of the companies in the defense sector, especially the large prime contractors, are not prepared to compete in the commercial marketplace and seem committed to a strategy of acquisitions, liquidations, and consolidations to remove excess capacity. Many other companies, particularly at the subtiers where the overlaps between commercial and military technologies are obvious—electronics, sensors, machine tools, manufacturing, software, and communications, to name a few—are both committed to a diversification strategy and better able to implement such a strategy because they remain involved in the commercial marketplace.

Similarly, defense companies and/or military bases make up the economic base of the communities that will be most strongly affected by defense cuts. After forty years of reliance on defense spending, few of these communities will be able to develop new, commercially-based economies without federal assistance. In these cases, general solutions are not enough. The severity of the local impact in some regions and the adjustment problems unique

to today's defense establishment require efforts targeted specifically at defense reinvestment.

A second factor arguing for targeted efforts is the need to maintain a robust and responsive technology and industrial base capable of meeting future national security contingencies. However, the very same workers and companies that will be most affected by the defense drawdown constitute that technology and industrial base. This issue, the need to provide speedy and effective adjustment assistance while at the same time maintaining critical defense capabilities, runs throughout the defense adjustment debate.

The unique nature of today's defense draw-down is best exemplified by the situation facing active duty military personnel who will be released from service due to defense cutbacks. In each of the previous defense draw-downs in this century, downsizing the military primarily involved releasing military draftees who had careers or career plans and were happy to return to civilian life. Today's all volunteer military is significantly different. For today's servicemember, the military is the career of choice, and the transition to civilian employment may be difficult. However, transition assistance programs need to be balanced against the need to maintain an effective, though smaller, fighting force. Issues such as retainment of critical personnel and maintenance of a balanced fighting force (i.e., one that is neither top-heavy with personnel nearing retirement nor lacking in experienced officers) require targeted assistance programs.

Traditional notions of "defense conversion" tend to ignore the military needs that will remain after the drawdown has been completed. Defense adjustment and reinvestment must include an up-front acknowledgment of future military needs, and focus not on a transition out of the defense sector, but on the transition from a separate defense technology and industrial base to an integrated national technology and industrial base that can serve future economic and defense needs.

Since 1990, when it became clear that defense budgets would continue shrinking, programs aimed at alleviating the impact of defense reductions have been enacted by Congress. The Bush Administration opposed federal efforts targeted at defense adjustments, arguing that the private sector would adequately and rationally deal with any transition problems. As a result, implementation of Congressionally mandated programs was slow at best, and in some cases appropriated funds not expended. For example, the Bush Administration refused for almost two years to allocate funding provided by a 1990 appropriation of $200 million for economic development assistance and worker training

programs. (It was not until late in the Presidential election cycle, after defense conversion had become a hot political issue, that the first of those funds were delivered to their intended recipients.)

Faced with a growing national need for defense transition assistance and an unresponsive administration, Congress in 1992 passed a more broad-based, $1.6 billion defense conversion, reinvestment, and transition assistance package, which embraced several ideas which had been fleshed out in hearings held by the Joint Economic Committee. The package primarily targeted those aspects of the transition that required specific attention by the Defense Department, but also included a transfer of funds to the Departments of Commerce and Labor as a down payment on the more general economic development and workforce training issues, which have traditionally been addressed through programs managed by those agencies.

In March, the Clinton Administration released its defense reinvestment and conversion plan, which endorses last year's Congressional action and lays out a comprehensive, five-year, $20 billion assistance program. Implementation of the Congressional initiative is underway, and in some areas has developed into a model of effective interagency implementation and cooperation that bodes well for the future.

Major components of the fiscal year 1993 and administration defense reinvestment and conversion plans include:

- Early retirement benefits, retirement credit for service in law enforcement, teaching, and other critical professions, and pilot training programs for separating military personnel and defense workers.
- Funding for government- and employer-sponsored training programs for displaced workers.
- Transition assistance for members of the National Guard and Reserve, and severance pay and health benefits for separating civilians.
- Increased funding for DoD's Office of Economic Adjustment.
- Increased funding for Commerce Department revolving-loan programs and grants for communities impacted by the defense contraction.
- Efforts to streamline defense acquisition law to support commercial-military integration.
- Funding for manufacturing extension programs and regional technology alliances to support the transition of

defense firms, particularly smaller firms at the subtiers of the defense sector, to commercial sector work.

- Funding for government-industry partnerships in dual-use technologies to create opportunities for commercial-military integration.

MAINTAINING AN ADEQUATE PACE OF GROWTH

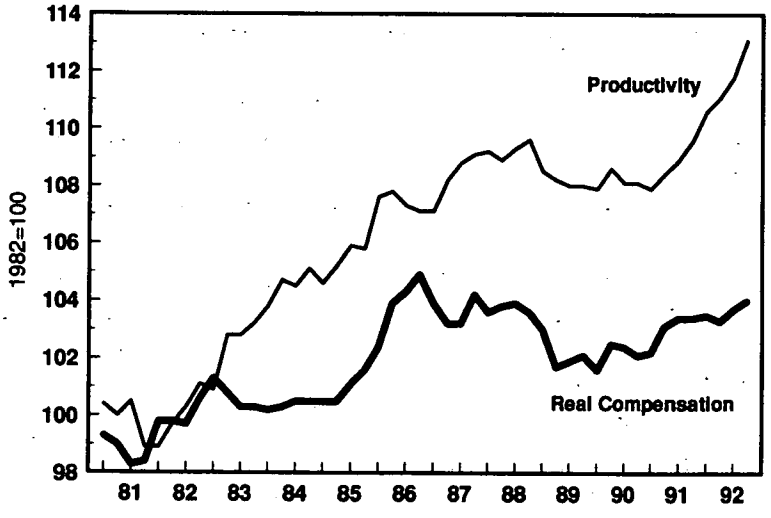
Continued progress toward a high-wage, high-productivity society will require macroeconomic policies that maintain an adequate rate of overall growth in the economy. Without such growth, increased productivity could come to be seen as threatening to workers, who might then resist the changes needed rather than embracing them.

Recent developments suggest how this could come about. For the past several quarters, GDP growth has been quite slow, but productivity growth has steadily increased. In a climate of slow growth and high unemployment, firms are not passing along the benefits of increased productivity to their workers in the form of increased compensation. Figure 54 shows the widening gap between productivity and compensation in the recent period.

Figure 54

Rising Productivity, Lagging Compensation

1981 - Present



Source: Bureau of Labor Statistics

If this trend were to continue, a significant number of American workers could easily come to see increased productivity as inimical to their own self interest–leading only to layoffs or pay cuts rather than improved wages and a rising standard of living. The widening gap between productivity and compensation, taken together with the trends toward part-time and contingent work noted earlier, pose a real threat to the social consensus needed to keep making progress toward a high-wage, high-productivity society.

Clearly, the best route to avoiding this problem is to maintain a rate of overall macroeconomic growth which is sufficient to lower the unemployment rate and tighten labor markets. The faster productivity grows, the faster the rate of overall growth we must have in order to keep the unemployment rate on a downward path. With the labor force expected to grow at roughly 1 percent per year, a 2 percent growth rate for productivity requires a 3 percent growth rate for real GDP just to keep unemployment from rising. If productivity grows at a 3 percent rate, it will take 4 percent overall growth to stabilize the unemployment rate.

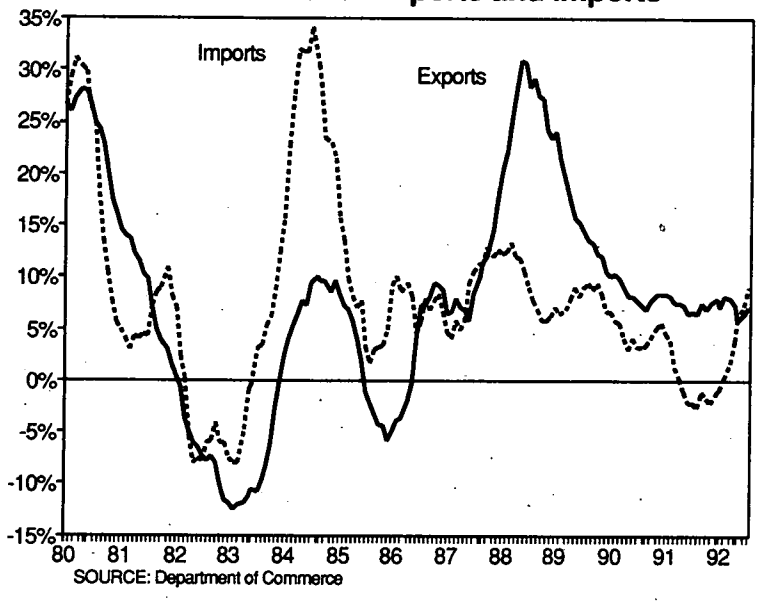
As was mentioned earlier, the numerous structural problems in the economy lead most forecasters to assume only a modest rate of growth in the overall economy for the next several years. If this forecast materializes, and productivity continues to grow strongly, then the issue of productivity-related job and income loss will become a much more significant factor in economic policy making.

Strong productivity growth could, however, create the foundations for faster overall growth. Increased productivity growth diminishes the threat of inflation, and could therefore make room for a substantially more expansionary monetary policy. If the Federal Reserve were to respond effectively to sustained increases in productivity, we could expect an acceleration in overall growth despite the structural problems elsewhere in the economy.

The principal threat to this scenario, however, is the international trade position of the United States. Figure 55 shows the recent growth of both exports and imports. After a strong export surge late in the 1980s, export growth has been on a steady downward track, while import growth has picked up substantially. In the past year, import growth has surged past export growth, leading to a pronounced widening of the trade deficit.

Figure 55

Growth Rates for Exports and Imports



SOURCE: Department of Commerce

Part of the problem is unfair trading practices abroad, but a larger contributor to the deteriorating U.S. trade position is the divergent macroeconomic circumstances of the major trading nations. While the U.S. has been in the early stages of a recovery, most of our major trading partners have been sinking deeper into recession. If these trends continue, stronger growth in the U.S. is likely to lead to a continued worsening of the trade balance. At some point, a deteriorating trade balance could lead to financial market uncertainty about the stability of the dollar, risking the kind of foreign exchange crisis which has recently destabilized Europe. Monetary authorities traditionally respond to such crises by tightening policy and raising interest rates, a move which would clearly jeopardize continue growth in the U.S.

This reality puts the U.S. in a dilemma which was well described by Lester Thurow in a recent piece in the *Financial Times*.

The U.S. Locomotive
by Lester Thurow

Over the past 20 years the distribution of earnings in the US has been changing in a way which, until recently, has not been matched in the rest of the industrial world. Despite the fact that the real American per capita gross national product has been rising (up almost 30 per cent from 1973 to 1992), real earnings have been falling for much of the work force. While about 20 per cent of the male work force has been on a rapidly rising up escalator, another 20 per cent has been on a level moving sidewalk, and the remaining 60 percent has been on a down escalator.

Two factors lie behind these statistics. Technology seems to be demanding a much more skilled work force. Wages have been rising for the skilled and falling for the unskilled. As the US is much more open to manufactured imports from low-wage third-world countries than from Europe or Japan, what economists know as 'factor price equalization' (in a global economy those with third-world skills will make third-world incomes even if they are living in first-world countries) also seems to be pushing down wages of the unskilled.

To some extent America's working wives have come to the rescue. By working an increasing number of hours a year they have succeeded in holding the real family incomes of the bottom 60 percent of the population approximately constant, even though male wages have been falling. The average American family rightly sees itself working much harder yet making no economic progress. Even more frightening, most of these families now have little unused female work effort that they can throw into the economic fray. Wives are already working close to full-time. Nothing but economic decline looms ahead.

Not surprisingly, voting studies reveal that those on the up escalator voted overwhelmingly for President George Bush while those on the down escalator voted overwhelmingly for President Bill Clinton. To have any chance of delivering on his promise to stop the down escalator, Clinton needs to offer a number of things, such as greater investment in skills. And a 4 to 4.5 per cent rate of growth is an absolute necessity if he is to create better job opportunities and rising real wages for the 80 per cent male work force that did not participate in the economic gains of the 1970s and 1980s.

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But suppose he were to succeed and the 4.8 per cent growth rate of the fourth quarter of 1992 were to be sustained. Mr Clinton would immediately have a trade problem. The US starts with a large trade deficit (rising towards $100 billion) and could expect a huge surge of imports if its economy were to grow much faster than the economies of rest of the industrial world.

But if this surge of imports were to occur, it would essentially drown President Clinton's economic recovery. If one looks at the relationship between output and employment in American manufacturing, every $45 billion in extra manufactured imports essentially costs the American economy 1m jobs. Mr Clinton cannot afford to lose those jobs. If he does, he will not be able to deliver on his promises to those that elected him. As a result, the president has no choice but to take whatever actions are necessary to ensure that the US trade deficit does not worsen. To put it bluntly, President Clinton cannot let the American economy become a locomotive for the rest of the world.

The rest of the world is now an economic train too large for the US locomotive to pull alone. If the US were to try, its recovery would simply stall. The right answer from the perspective of the US and the world is an aggressive co-ordinated fiscal and monetary expansion with the three big economies (Germany, Japan and the US) acting as a joint locomotive. If such coordination cannot be arranged quickly, however, Mr Clinton will have no choice but to take direct action to stop the US trade deficit from worsening.

The clash between the world's desire to hook on to the American locomotive and President Clinton's need to decouple his locomotive from the rest of the world's economic train will be most acute with respect to Japan. Japan has a $135 billion trade surplus, which is rising at the rate of $50 billion a year. Based upon history, if the US were to grow substantially faster than Japan, Japanese exports to the US could be expected to surge.

The problem is very simple. Japan does not know how to engineer an economic recovery without such an export surge; the US will not have a domestic recovery if such a Japanese export surge were to occur.

The immovable object meets the irresistible force.

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If we cannot afford to pull the rest of the world along behind our locomotive, then we will need to persuade the other major nations to shoulder some of the "locomotive" burden themselves.

Investment banker Jeffrey Garten put the problem in these terms at the Economic Summit held in Little Rock last December:

> *My first point here is that when we think about stimulus, I don't think it's enough to think about stimulus in a domestic context. I think there has to be some global stimulus, and I think we have to work as hard as we can with the Europeans and with Japan to help them follow policies, to encourage them to follow policies that are growth-oriented as opposed to deflationary, as is now the case.*
>
> *Jeff Garten, Little Rock Summit*

The U.S. response to the slow and negative growth rates being experienced by our major trading partners should be considered in the light of the present policies of our trading partners and our interests in a stable, growing global economy. Generally speaking, the governments of the European Community and Japan acknowledge their difficulties and have begun to take measures to promote growth. U.S. policy should encourage those governments to strengthen their present courses of action.

The German government has spent large amounts to stimulate the East German economy, but not much to help West Germany where the slowdown is now taking place. The German central bank has recently made a small cut in interest rates. In view of the fact that new taxes will be implemented in 1995, and that the spillover effects of high German interest rates are slowing down other European economies, further easing by the Bundesbank would appear to be required to improve prospects for growth.

The departure of the United Kingdom and others from the European Monetary System gave it more flexibility in setting its own monetary policies. The United Kingdom proceeded to reduce interest rates significantly and this action was accompanied by a slight turnaround in the latter part of 1992. The recently announced Budget provides a marked dose of fiscal stimulus to the British economy, which should add further growth impetus to the economy.

Japan adopted a large spending package last year but, as has often been the case in Japan, it was not as prompt or as substantial as initially claimed. An additional stimulus package is being discussed, reportedly to include supplementary spending and tax cuts. Monetary policy has been eased and short-term and long-term interest rates have declined, in part because of government policy, in part the result of the weakness of demand. These

measures, especially the expectation of a surge in government spending, has encouraged analysts to forecast modest growth for 1993. However, if there is no follow through for the stimulus measures the recovery may not materialize.

The slowdown abroad should not alter the determination of the Clinton Administration to vigorously pursue its policy of opening foreign markets. The Administration has promised to take an activist role in this regard, in contrast to the more passive one of the recent past. In Europe, care must be taken that the emergence of a single market does not result in discrimination or new barriers against U.S. companies. In Japan and other countries, such as China, where there are high and chronic bilateral trade deficits, efforts must be stepped up to gain greater access to markets.

CONCLUSION

Most of this report has focused on public policy actions to improve the performance of the economy. It is important to recognize, however, that most of the critical decisions which will determine how well the economy performs in coming years will be made in the private sector. Government policy can help set a context for economic growth, and can create incentives for job creation and productivity enhancement. But it is up to the private sector to respond to this environment with the actions which will actually produce economic growth.

In the end, it is business more than government who will make the critical decisions that determine whether this country adequately invests in plant and equipment, in R&D and in the skill enhancement of the workforce. It is business more than government who will efficiently or inefficiently select economic targets of opportunity.

Government must, however, learn to relate effectively to other major economic institutions. Every modern industrialized economy is characterized by extensive relationships between government and the other major economic institutions of the society. The question is not whether there should be such a relationship, but what type of relationship does the best job in advancing the economic interests of all members of the society.

Answering this question requires that we reach a common understanding of how we go about strengthening America's economy, and intelligently promoting America's interests in the world economy. What this implies is nothing less than defining a new relationship between the public and private sector.

The living standard of every American will be determined in the end by how successful we are in forging this new relationship. We cannot afford to be the only industrialized country in the world that does not have a strategy for expanding family income, strengthening key economic capacities, and enhancing its ability to compete effectively n world markets.

The Clinton Administration clearly recognizes the economic problems facing the Nation. Its initial budget proposals have set broad, constructive outlines that leave many important elements to be resolved. The President has promised an administration prepared to "experiment" with new approaches to address the widely recognized problems with investment, growth and incomes. In the end, the success of these experiments will depend upon how effectively America moves beyond the almost theological debate about whether there should be an American strategy, to the question of what that strategy ought to be and how we go about designing it.

This is the key question before us in the coming year. Let the debate begin.

REPUBLICAN VIEWS

CHAPTER I

ECONOMIC OVERVIEW

ECONOMIC PERFORMANCE SINCE 1977

Between October 1977 and October 1981 (FY 1978-82), the U.S. economy experienced diminished long-term economic growth and a general decline in the growth of the American standard of living. This economic deterioration did not result from an act of God. It came about as a direct consequence of the failed economic policies of President Carter and the Democrat-controlled Congress.

During this period, government grew dramatically and levied more burdensome and economically distorting taxes on individuals and businesses. Federal spending as a share of gross national product (GNP) rose from 21.3 percent to 22.9 percent, a level of spending that at that time had not been seen since the end of World War II. Federal revenue went from 18.5 percent of GNP to 20.2 percent, a level of taxation never before achieved even during World War II.

Federal interventions into the marketplace increased dramatically and the number of Federal regulations soared.[1] As a result, work, saving and investment were stifled, and an economic malaise settled over the Nation. Consumer price inflation spiraled to over 13 percent a year. Short-term interest rates skyrocketed above 18 percent, and mortgage interest rates hit 20 percent. Job

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

growth averaged less than 2 percent a year, and after hovering near 7 percent for the entire period, the unemployment rate reached 7.6 percent in 1981. Real economic growth averaged a dismal 2.2 percent a year. As a consequence, real family incomes declined between 1978 and 1981.

Beginning in 1981, President Reagan and the Republican-controlled Senate worked with a group of Democrats in the Democrat-controlled House of Representatives to pass a package of economic reforms aimed at reducing the tax burden on work, saving and investment and designed to slow the growth of Federal spending and regulations. Before the reforms were allowed to take effect fully, however, the Federal Reserve Board (Fed), in its zeal to staunch the inflation inherited from the previous administration, went too far too fast in tightening monetary growth. The result was a severe recessionary period that lasted from July 1981 to November 1982.

Finally, President Reagan's tax cuts took full effect, the recession ended, and the economy set off on an unprecedented peace-time economic expansion, which lasted until 1990. The policies of Reaganomics -- sound money, low tax rates, regulatory relief, and budget control -- transformed an era of economic crisis into a decade of industrial revival and prosperity. From 1982 to 1989, GNP grew by nearly one-third -- a real increase of more than $1 trillion in eight years.

Industrial production expanded 32 percent between 1982 and 1989. Employment growth was brisk with 18 million new jobs created and the unemployment rate tumbling in Reagan's last year in office to 5.3 percent -- its lowest level in 20 years. Contrary to popular mythology, all income groups shared in the prosperity. Average middle class family income rose by 12 percent during the 1982-89 period; and even the poorest fifth in income enjoyed a 10 percent income rise.

The surge of economic success and prosperity brought success on the fiscal front as well. After peaking at 31.8 percent of GNP in 1987, the national debt declined as a share of national income through 1989, when it reached 31.5 percent of GNP. During this period, spending was growing slower than the economy, and deficits were well on their way to insignificance.

Beginning in 1986, however, clouds began to darken the economic horizon. Congress enacted a tax reform measure that greatly increased the tax burden on capital, even while reducing marginal tax rates. Then in 1988, monetary policy turned excessively tight, and the Fed began intentionally to slow economic growth in hopes of achieving a "soft landing" out of a misguided belief that an inflationary outbreak was imminent. Compounding the Fed's negative actions, Federal regulatory activity began a resurgence. The final reversal of the economic principles that had produced the record peace-time economic expansion was the bipartisan budget agreement of 1990. With enactment of this agreement, taxes went up dramatically, government spending growth accelerated, economic growth sagged, deficits exploded and the debt began to rise again.

As a consequence, between 1989 and mid-1992, the U.S. economy struggled, posting real growth averaging only 0.6 percent a year. The economy fell into recession in mid-1990, and after the recession's end early in 1991, the U.S. economy experienced the slowest postwar economic recovery on record -- averaging a meager 1.5 percent annual growth rate for five consecutive quarters after adjusting for inflation.

Finally, having absorbed the 1990 budget deal and a regulatory onslaught, in the last half of 1992, the economy began to regain some of its past vigor. Recent indicators on the health of the economy show definite improvement. Real gross domestic product (GDP) grew by 3.4 percent in the third quarter and 4.7 percent in the fourth quarter. The unemployment rate has fallen steadily since the third quarter of 1992 from 7.6 percent in August to 7.0 percent in February of this year. Consumer price inflation as measured by the Consumer Price Index has held steady at slightly over 3 percent, and the prime interest rate remains unchanged at 6.0 percent. Today, a home buyer can obtain a 30-year fixed rate mortgage for 7-1/4 percent.

This performance represents marked improvement over the past four-and-one-half years. Impressive as this burst of growth has been, however, the economy's overall performance remains substandard when compared to other post-recession periods, and employment continues to lag.

Unless concrete steps are taken to reverse persisting errors in economic policy and to reduce the burden placed on the economy by government, economic growth will slow again. There is a distinct possibility that if the wrong policy choices are made, the economy will fall back into recession in late 1994 or early 1995.

COMPETING ECONOMIC THEORIES

The economic program that President Clinton and this Democrat-controlled Congress are preparing to impose on the country does not consist of change but rather an extension and intensification of the failed policies of the recent past, now marketed cleverly to the American people using the language of change and renewal. However they may be dressed up, these ideas are anything but new. They are variants of discredited Keynesian notions of macroeconomic management and bureaucratic planning that have failed repeatedly in the past.

Whether the Democrat program is identified forthrightly as "tax and spend" or camouflaged as "contribute and invest," the economic effects will be equally as destructive. Whether "command and control planning" is acknowledged for what it is or disguised as "industrial policy," "public-private partnerships" and "economic democracy," the politicizing of economic decisions will be just as great and equally damaging to economic efficiency. Whether their proposed market interventions in health care are identified accurately as "price controls and rationing," or euphemistically labeled as "market-based" reforms, the economic consequences will be just as disastrous. When government attempted to manage the market in gasoline, America got long lines at service stations and watered-down gasoline. If President Clinton and the Democrat-controlled Congress succeed in imposing price controls and rationing on the health care market, one safely can predict long queues for medical procedures and a decline in the quality of health care.

Practically speaking, economic performance cannot be improved significantly over the long run without increasing the Nation's capital stock and entrepreneurial risk-taking. More capital requires more investment. While selected public investment can make some contribution to increasing the Nation's capital stock, the only way to increase economic growth sufficiently to raise real wages and

reduce unemployment is to increase private investment. The only way to increase private investment is to reward it, not penalize it. This is not "trickle-down" economics. It is simply an objective statement of the way free enterprise works. To deny this fundamental economic fact and pretend otherwise is to consign the Nation to economic stagnation and class warfare.

Even Lawrence Summers, former economic advisor to Michael Dukakis and now Undersecretary Designate of the Treasury for International and Foreign Affairs, recognizes that macroeconomic fine tuning has failed. In a recent article, Summers recognizes that macroeconomic policy choices appear incapable of stemming a general, worldwide slowdown in productivity. He also is skeptical of the public investment strategy to lift productivity and raise economic growth. In that article, he wrote:

> Even substantial increases in [public] investments that yield social returns of even 15 percent per year will have only modest effects on observed rates of productivity growth. Only increases in specific investments with very high social returns well in excess of private returns have a prospect of arresting any substantial part of the productivity slowdown. . . . If public policy in the industrialized world does succeed in reversing any large part of the productivity slowdown, its success will have an important *microeconomic* component. Policy will succeed either by *changing incentives in such a way that average returns on investment significantly increase*, or by successfully raising the share of national output that is devoted to forms of investment that have large external benefits and therefore very high social returns. [Emphasis added.][2]

What about "specific investments with very high social returns?" Summers admits they are rare, difficult, if not impossible to identify before the fact and relatively insubstantial as a grand economic strategy for increasing overall economic growth:

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[2] De Long, J. Bradford and Lawrence H. Summers, "Macroeconomic Policy and Long-Run Growth," *Economic Review*, Fourth Quarter 1992, Vol. 77, No. 4, Federal Reserve Bank of Kansas City, Kansas City, pp. 5-25.

> Studies of the travel time savings from highways, or the wage increases from better schooling do not suggest the kind of extraordinary returns or externalities that are necessary if increases in these categories of investment are to offset a large part of the productivity slowdown.[3]

Industrial policy, targeted tax breaks, managed markets, and Federal subsidies have consistently failed to offer a way out of the slow-growth rut. The only way out is to unshackle the risk-taking and innovation of entrepreneurs and to unleash the industriousness of the American worker. In the 1980s, we got a glimpse of what is possible when thrift and hard work are rewarded and when restraints on risk-taking and innovation are lifted even slightly. Creating wealth is one of the most powerful forces driving humans and giving them gratification. And, the process of creating wealth, like bringing children into the world and rearing a family, is neither tidy nor painless. But in its efforts to tidy things up, government is creating a bigger mess.

LONG-TERM ECONOMIC OUTLOOK

Today's economic forecasts must be put into perspective, and the debate, sometimes heated, among economic forecasters over the outlook for the next few quarters should not obscure the more fundamental consensus that exists among economists on the long-term outlook for the economy. The Congressional Budget Office (CBO) and the Office of Management and Budget (OMB) both forecast real GDP growth at 2.8 percent for 1993. The Blue Chip Consensus of 50 private forecasters puts real GDP growth for 1993 at 3.0 percent although the range of forecasts among the participants runs from a high of slightly over 4 percent to a low of slightly less than 2 percent. The differences in these forecasts result largely from the divergence of views regarding the second half of the year. While the majority of the Blue Chip forecasters foresee rising or constant rates of growth throughout the year, a substantial group of them believe economic growth will decline as the year progresses.

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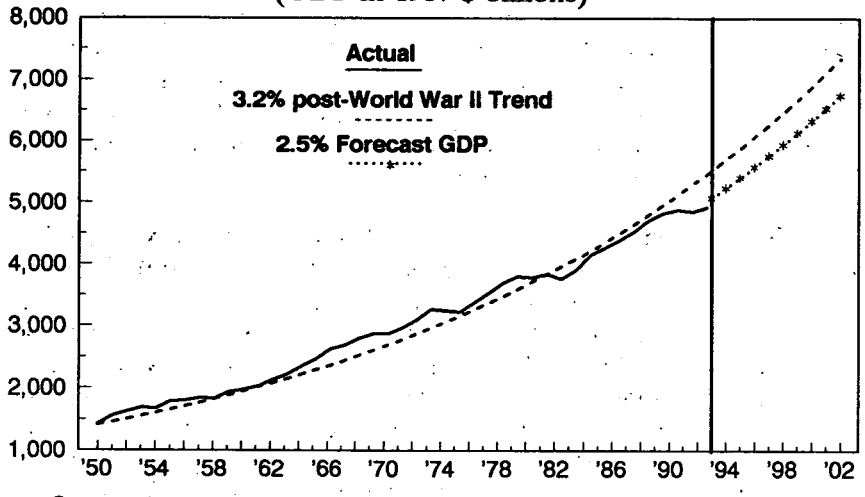
[3] Ibid.

Over the long run, however, economic forecasts tend to converge toward an annual real growth rate of 2.5 percent. In other words, there is a general consensus among forecasters that, over the long run, economic output will tend to fluctuate around a growth path that would be traced out if the economy experienced a constant 2.5 percent rate of real growth. Consequently, whenever the economy is rising at a rate greater than 2.5 percent, one would expect growth eventually to decline to bring the level of output in the economy back to its sustainable, long-run path.

This situation contrasts starkly with the entire postwar period when the economy grew on average by 3.2 percent annually after taking inflation into account. Although the change in real GDP from any one year to the next may be considerably more or less than 3.2 percent, the level of real GDP has oscillated around this trend line -- falling down to it after surges of high growth and climbing back up to it after sinking into recession. This time around, however, there appears to be a break with historic precedent. If the consensus long-term forecast of 2.5 percent average growth is correct, it means the level of GDP, which serves as a proxy for our standard of living, will continue to fall farther and farther below trend, creating a "growth gap" between actual economic performance and historical precedent. This situation is depicted in Figure I.1.

Figure I.1
Growth Gap
(GDP in 1987 $-billions)



Source: Hunter, Lawrence A., "The Never-Ending Recession," The Wall Street Journal, September 19, 1991.

If the economy remains trapped on this lower level growth path, it will have seriously negative implications for the future prosperity of America. A 2.5 percent growth rate will not suffice to satisfy the American public's expectations of growing prosperity.

Long-run real growth of 2.5 percent a year is insufficient to generate permanent job growth, and it is inadequate to increase the real income of the average worker. In other words, 2.5 percent a year real growth will not lead to any observable increase in the American standard of living within an acceptable time frame.

There is no earthly reason Americans should be asked to lower their expectations to accommodate this sluggish performance.

At present, with the recovery from recession complete, the economy stands well below the expected postwar standard. The economic slowdown, which began in 1989, coupled with the 1991 recession and the anemic recovery, have left the Nation into a deep economic trench. And, continued slow growth promises to make the task of digging back out very difficult. As the figure depicts, the economy appears to have downshifted into a lower gear, and each

year it remains stuck in low gear it falls further beneath its expected output level. It will take growth in excess of 4 percent a year for a number of years to get back up to trend. This is not an unreasonable economic policy goal. Thus, the near-term goal of economic policy making should be to double the expected rate of growth, from 2.5 percent to 5 percent. **The long-run national economic objective should be, at a minimum, to restore the economy to the average level of performance it had maintained prior to 1989, i.e., to close the "growth gap."**

POLICY IMPEDIMENTS TO ECONOMIC GROWTH

Since the passage of the 1986 Tax Reform Act, incentives to invest, work and produce have diminished. The primary problem has been a reduction in the return to investment or, in other words, a rise in the cost of capital -- precisely the opposite of what Undersecretary Designate Summers recommends as the best policy for raising economic growth. The primary culprits are less equitable depreciation allowances, increased capital gains taxes and the alternative minimum tax. As a result, despite the tax rate reductions enacted in the 1980s, marginal tax rates on capital are higher today than they were in 1983.

The 1986 Act lengthened depreciation lives for most assets, especially structures. It is no coincidence that since 1987, commercial property values have diminished in major economic areas of the United States. This asset depreciation has contributed to bank and thrift failures, bankruptcies, a small business credit crunch and a depression in the construction industry.

The Result: Real investment has declined by 3.7 percent since 1988.

The cost of labor also has increased and the rewards for work have been significantly eroded. Rising social security and Medicare payroll taxes have more than wiped out the income tax rate cuts for the middle class and raised the price of labor to employers. Large increases in the minimum wage since 1990 have increased the cost of unskilled labor by 27 percent and destroyed employment opportunities for millions of low-skilled workers.

The Result: Private employment increased only 475,000 between December 1988 and December 1992.

Another factor seriously affecting the economy is the compliance cost of new regulations. These mandated costs on the private economy, although difficult to measure, are substantial. Estimates of additional compliance costs from major regulation range from $40 billion to $70 billion in 1993 alone. Purchases of equipment to help the environment may amount to almost $20 billion. One wild card is what will happen now that the regulatory moratorium imposed in 1992 has been lifted. A whole slew of new regulations held back by the moratorium of 1992 may now hit the economy in the last half of 1993.

The Result: An intermediate cost estimate of the economic burden of government regulation, which substantially understates the true burden, places the direct cost of regulation at $461.4 billion annually and rising.

A small business credit crunch has cut off the life-blood of small businesses. A series of laws in recent years, culminating in the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), have put a wet blanket over the business lending market. FDICIA and other laws have added new banking regulations designed with the unrealistic goal of eliminating risk in lending, resulting in micro-management of banking by Washington. Compliance costs with all banking regulations imposed by the Federal government now reach almost $18 billion per year, which is equivalent to total bank earnings in 1991.

The Result: Banks now hold as assets more in government securities than in private business loans.

The Federal Reserve also contributed to the extremely sluggish economic growth by allowing the slowest growth in the money aggregates in three decades resulting in an actual decline in real M2 money supply.

CONCLUSION

Since 1986, a series of economic policy mistakes have combined to inhibit private markets and retard investment. In particular, by lowering the rate of return on investment and raising the cost of capital, they put a damper on entrepreneurial risk-taking. By 1990, policy mistakes had accumulated to such a point that the long-run growth capacity of the economy was depressed by approximately one full percentage point a year. The recession was merely the culmination of that build-up of policy errors. The slow-motion recovery was the result of a weakened economy struggling to overcome these policy handicaps.

These policy impediments to economic growth remain in place today. Until they are removed, one can expect the economy to continue to under-perform and the growth gap to widen. Therefore, although the recovery from the recession is complete, the economic expansion remains fragile. The danger today is that rather than correcting the economic policy errors that led to stagnation and recession, this Democrat-controlled Congress has adopted an economic program that will exacerbate existing impediments to growth and create a host of new impediments. This kind of change, the country should be spared.

CHAPTER II

TAX AND SPEND

"Those who cannot remember the past are condemned to repeat it."
— Santayana

The current budget situation stems from the taxing and spending decisions made in the 1990 budget agreement. Proponents of the agreement argued that it would stimulate the economy through lower interest rates and virtually eliminate the deficit by mid-decade. The Congressional Budget Office projected that the agreement would reduce deficit spending to a level of $29 billion by 1995.

Opponents of the pact argued that the massive tax increases in the agreement would stimulate additional congressional spending. A Joint Economic Committee/Republican (JEC/GOP) study was cited often which showed that Congress historically increased its spending $1.58 for every dollar of new taxes raised.[4] Higher taxes tend to increase deficits directly by stimulating more congressional spending. Higher taxes also have an indirect effect on deficits by undermining economic growth which boosts transfer spending and shrinks the tax base. In addition, new revenues projected under tax increase measures often are overstated.

According to this point of view, the budget agreement simply would not work to achieve its stated purpose. Instead, its lasting effects would be to drive congressional spending, taxes, and deficit to new highs, while crippling the already weak economy. A straightforward application of the $1.58 ratio would suggest that $160 billion of new taxes would add about $253 billion to Federal outlays over five years. Deficit spending would be at least $50 billion higher on an annual basis.

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[4] A JEC/GOP study, "Federal Tax Increases and the Budget Deficit, 1947-86, Some Empirical Evidence," prepared for Senator William V. Roth, Jr., April 29, 1987. A subsequent version of this study revised this figure upward to $1.59.

The evidence is now in: CBO has released its annual budget submission to Congress. The scenario projected by the CBO in its 1990 promotion of the budget pact has melted away. Members of Congress who relied upon the CBO projections in 1990 now are informed that the outlook for deficit spending is worse than ever. It seems the economy didn't perform quite as expected under the growing weight of new taxes and regulations, and that mysterious "technical," i.e., unexplained, errors affected revenues.

The results of the budget deal can be gauged by the latest CBO projection which adds about $250 billion to the 1995 deficit and results in a deficit level more consistent with the view that additional taxes drive spending and deficits higher. In 1990, a reliance on this view would have produced a more accurate view of the 1995 deficit than all the CBO reports, computer printouts, and testimony combined.

Table II.1 displays the deficit trends as projected by CBO in 1990, after approval of the budget pact. The figures show how many could have believed that the budget agreement would virtually eliminate deficit spending. A "balanced" package of about one-third tax increases and two-thirds of purported spending "cuts" would supposedly constitute a reasonable compromise for those who really wanted to take practical steps to eliminate the deficit, with nearly $500 billion in deficit reduction over five years. CBO projections seemed to demonstrate that massive tax increases really would solve our fiscal problems.

TABLE II.1

CBO DEFICIT PROJECTION

	1990	1991	1992	1993	1994	1995
1990 Deficit Estimate	200	253	262	170	56	29
1993 Deficit Estimate				310	291	284

Source: CBO: The 1990 Budget Agreement: An Interim Assessment, December 1990, and The Economic and Budget Outlook: Fiscal Years 1994-1998, a report to the Senate and House Committees on the Budget, January 1993.

Instead of a 1995 deficit of $29 billion as originally projected shortly after the budget deal was consummated, the deficit in that year now is projected as $284 billion, nearly 10 times higher. **This difference translates into a CBO forecasting error of 879 percent.** It is clear that future CBO projections of deficit savings resulting from similar policies should be received more skeptically, especially given CBO's active role in promoting the 1990 budget agreement and the lack of objectivity this entailed.

The actual results of the budget agreement demonstrate that the basis of this policy was flawed. Though often justified in terms of pragmatism -- the philosophy of what works -- the strategy underlying the budget deal failed, and it failed spectacularly. A major source of the problem was the unrealistic assumptions made about the response of the Congress to new revenues. Congress responded to the new revenues by spending them, and then spending some more.

While a range of alibis have been offered in an attempt to explain the failure of the 1990 Act, a review of the spending directly under congressional control shows the lack of real budget discipline. For example, domestic discretionary outlays increased from a level of $169 billion in 1989 to $183 billion in 1990, $195 billion in 1991, $214 billion in 1992, and $236 billion in 1993. Spending in this category is appropriated annually by Congress, and is a good gauge of the actual measure of fiscal policy restraint. Policy makers in 1990 chose to increase this category of spending sharply in the face of what they referred to as a deficit crisis.

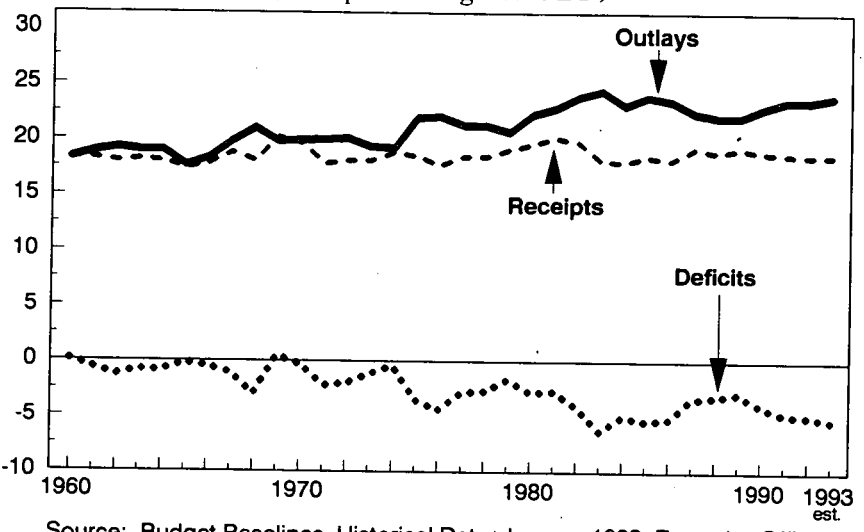
Between 1989 and 1993, the level of annual outlays in this category rose $67 billion, a 40 percent increase over the 1989 level. Annual caps were placed on this category of spending to give the appearance of curbing spending growth, but the caps were set high enough to accommodate new spending. Now this higher level of spending is embedded in the budget baseline, and will add $330 billion to the national debt in the next five years unless pared.

FISCAL TRENDS IN RECENT DECADES

An examination of fiscal trends since 1960 is one good way to put the current budget situation in perspective. Budget aggregates expressed as a share of gross domestic product provide a useful

view of the major trends during this period. As one can see in Figure II.1, the revenue share of GDP has oscillated around 18 to 19 percent of GDP, while the Federal spending share has trended upward. This rise of Federal spending accounts entirely for the growth of the budget deficit as a percentage of GDP.

FIGURE II.1
RISE OF DEFICIT SPENDING
(as a percentage of GDP)



Source: Budget Baselines, Historical Data, January 1993, Executive Office of the President, Office of Management and Budget.

As Figure II.1 indicates, nearly 24 percent of economic output currently is devoted to Federal spending, compared to 19 percent in the early 1960s. Given the stability of the revenue share over this period, the five-percentage-point rise in the outlay share fully accounts for the rise in the deficit, from 0 to a level of 5 percent of GDP. The rise of the deficits reflects an underlying unwillingness to control congressional spending.

The inconvenient facts about the record spending and revenue levels often are ignored in political discourse, with sole attention devoted to "the deficit" in the abstract. Many policy makers seem to be unaware of current and higher projected levels of Federal tax revenue and spending, and tend to treat the "deficit problem" as an

abstraction. The term "deficit spending," which accurately expresses the key issue, has fallen into disfavor.

The cumulative effect of continued deficit spending is growth in the national debt. Though the level of the national debt expressed as a share of GDP has been much higher in the past than it is now, current and future unconstrained growth in the national debt is of immediate concern. Expressed as a share of the economy, the rise in publicly held Federal debt halted by the late 1980s and for a short period even reversed itself. Unfortunately, President Clinton's budget plan would add over $1.4 trillion, and probably much more, to the national debt over the next four complete fiscal years. (See Chapter III.)

Deficits, and the growth of the national debt they produce, are the direct consequences of excessive congressional spending. While expanding government spending usually does not cause abrupt crises in economic policy, it does gradually increase the burden of government on the private sector by removing resources from the economy. Moreover, the cost of servicing the debt, the extraction costs of taxation, and inflation all represent very real additional costs to the economy over and above the reduction in resources that results when government takes wealth from the private sector and shifts it to the public sector.

Nonetheless, some have continued to argue that the American people are undertaxed. It is alleged that the 1981 tax bill, which cut tax rates across the board, caused the current deficit problem. However, revenues have risen $631 billion since 1980, while spending has jumped $884 billion; the difference is simply the rise in the deficit over this period. When President Reagan left office, deficit spending amounted to $153 billion. It approximately doubled after 1989. **The level of deficit spending at the time Reagan left office is still much lower than the level Mr. Clinton, none too convincingly, promises to reach at the end of his four years in office.**

POLICY OUTLOOK

The congressional propensity to spend $1.59 for every dollar of new taxes, along with the negative economic impact of these taxes, has pushed the deficit to record levels. In the wake of the failed

1990 budget deal to "reduce" the deficit, deficit spending has soared -- to an estimated $327 billion in 1993. Despite record deficit spending, the Clinton Administration and the Democrat-controlled Congress propose more deficit spending to stimulate the economy. This raises the obvious question: If $300 billion deficits are not stimulatory, how much difference is another $30 billion likely to make in a $6 trillion economy?

Despite record levels of spending, taxes and deficits, special interest advocates are not satisfied. The Democrat-controlled-Congress's insatiable appetite for more is about to trigger another round of damaging tax increases, pork-barrel spending and higher deficits. Though there has been much talk of "change," it is clear that the more things change, the more they stay the same. There is nothing new in the politics of tax and spend.

All the elements are now in place for a repetition of the disastrous 1990 budget agreement. When all is said and done, taxes, spending and deficits will all be pushed to record highs.

Moreover, public works spending cannot create jobs. A public-works jobs program designed with the hope of stimulating aggregate demand and priming the economic pump, which is a major part of what the Democrat plan proposes, will only displace private sector jobs in the short run and actually destroy jobs in the long run. Past experience and the empirical evidence demonstrate conclusively that governments cannot spend the economy out of stagnation, even if the spending choices are well-made, which or course they never are when the "pump-priming frenzy" sets in.

Furthermore, the total costs associated with financing a dollar of public spending is almost always more than a dollar, which means this policy will actually contract the economy. If the money is borrowed, debt service must be paid, and the extraction costs of taxation have been estimated to range from 34 to 48 cents additionally for each dollar extracted.[5] Transferring resources from the

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[5] Shoven, Charles L. and John B. Whalley, The Welfare Cost of Distortions in the United States Tax System: A General Equilibrium Approach. Cambridge, Mass., NBER, 1982, Working Paper No. 1043, p. 42.

productive sector of the economy to the public sector for pork barrel spending cannot increase the size of the economic pie, but only alter its composition for the worse.

Another delusion suffered by the Administration relates to the budgetary cost of health care. If the President and his administration think their health care plan is the key to reducing deficit spending, and will produce savings to offset the coming spending increases, they will be sorely disappointed. Their plans in this area, as in so many others, will only add to the problem.

What is needed instead is a recognition that the growth of government implies a degree of resource extraction from the private sector that is inimical to solid economic growth. The enormous size and power of government is simply too great a burden on the private economy to permit a strong economy. Federal spending should be restrained so that deficit spending shrinks as a share of the economy. Mandates, taxes and regulations should be examined with the goal of minimizing the degree to which economic growth and job creation are undermined. Performance standards should be established wherever possible to require government operations to more effectively perform their functions according to preestablished criteria. In addition, other reforms will be needed to improve economic policy decisionmaking.

CHAPTER III

THE CLINTON ECONOMIC PLAN

INTRODUCTION

President Clinton has put forth *A Vision of Change for America*[6], a package of broad-based tax increases ($328 billion), targeted tax breaks ($77 billion), selected spending reductions ($375 billion) and spending increases ($153 billion) that he contends will stimulate the economy and reduce the deficit. **After careful review, the JEC/GOP has concluded that the majority of spending cuts are not real, and on balance, the Clinton plan would retard economic growth, speed inflation, accelerate the rate of growth of government and fail to reduce the deficit sufficiently to control the growth of the national debt.**

The Clinton economic plan is based on assumptions about how best to improve economic conditions in the near term, as well as the appropriate role of government in the economy. The plan assumes that the economy currently is too weak to expand adequately under its own power, and that fiscal stimulus, i.e., more Federal spending, can accelerate the pace of the economy to desired levels. The plan also reflects a fundamental long-term shift towards aggressive government intervention in the economy.

Discussion of specific elements in the Clinton budget proposal is hampered by the fact that, despite its having been passed by Congress, no formal submission has yet been made by the Administration. For the first time in memory, Congress acted on the budget resolution without the information underlying the budget totals. For example, most of the defense savings are unspecified, as are savings in administrative costs and other areas. In presenting its plan on February 17, the Administration claimed deficit reduction of $493 billion, and only a day later admitted that this figure did not account for spending increases under the proposal. All told,

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[6] "A Vision of Change for America", United States Government Printing Office, February 17, 1993.

purported fiscal restraint in the package was exaggerated by $170 billion.

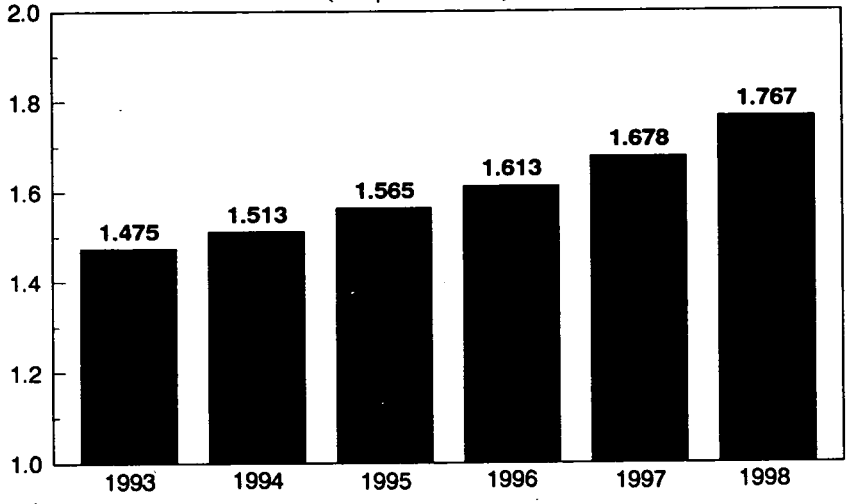
Furthermore, as JEC Republicans have pointed out, the Administration chose to hide new discretionary spending by overstating the increase in Federal outlays under current policy by manipulation of its baseline. When this new spending is accounted for, net savings on the outlay side of the budget are reduced further.

THE CLINTON BUDGET, 1994-98

Given the available information, the Clinton proposal may be analyzed from a number of different perspectives. A review of the budget data on outlays shows that there is virtually no net spending reduction in the plan. Even if the Clinton budget numbers are taken at face value, Federal spending rises each year under the proposal. From a level of $1.475 trillion in fiscal 1993, Federal outlays grow to a level of $1.767 trillion by fiscal 1998, an increase of nearly $300 billion. Moreover, between fiscal 1995 and 1998 there is no claimed reduction in deficit spending.

Figure III.1 displays the increased spending under the Clinton plan.

FIGURE III.1
GROWTH OF SPENDING UNDER THE CLINTON BUDGET
(in $-trillions)



Source: "Vision of Change for America," OMB, p. 143.

Another way to evaluate the true degree of fiscal restraint in the plan is to closely examine the claimed spending cuts for the accounting period preferred by the Administration, 1994-97. According to the Administration, net spending cuts amount to $247 billion. However, on review, the claimed net spending cuts melt away to virtually nothing. A ratio of $5 dollars of tax increases for every dollar of purported spending cut would appear to be generous to the Administration.

The Administration has rightly emphasized the importance of programmatic specificity in evaluating budget alternatives. If this same test is applied to the Administration's proposed package, no net outlay savings result. A simple experiment, removing misclassified, unspecified and unlegislated items from the outlay savings, reveals that very little, if any, spending restraint is left if these items are deleted.

Accounting for social security tax increases of $21 billion, Earned Income Tax Credit (EITC) outlay increases conservatively estimated at $10 billion, and only $7 billion of the available user fees reduce the purported outlay savings by $38 billion. The outlay

effects of the British Thermal Unit (BTU) tax in higher government costs for energy, and higher payments on transfer programs indexed to inflation, amount to another $10 billion. Altogether, these tax related adjustments reduce claimed outlay savings by $48 billion.

Hidden new spending folded into the inflated baseline used by the Administration nets another $32 billion from claimed savings. Also, about $16 billion in payroll reductions and "other" administrative savings are assumed, but exactly how this is to be achieved is not explained. The $32 billion in new hidden spending along with only $8 billion of the undefined "other" administrative savings account for another $40 billion of claimed savings. Addition of the $11.5 billion for changes in debt management, which even CBO refuses to score because these policy changes are unspecified, brings these outlay adjustments to $51.5 billion.

Together these tax and spending adjustments amount to $100 billion, reducing claimed Administration outlay savings from $247 billion to $147 billion. Furthermore, the lion's share of $76 billion of discretionary defense savings are completely unspecified. Congress has had trouble terminating major weapons systems. If only $15 billion of the Administration's proposed unspecified savings fail to pass muster for any number of reasons, the net outlay savings claimed falls to $132 billion. Finally, given the reality that the Clinton proposal is not a deficit reduction proposal but a tax and spend proposal, $24 billion of claimed debt servicing savings is completely speculative, just as these savings were under the 1990 budget agreement. Their removal would reduce the total savings package to $108 billion.

The effect of these savings, netted against $109 billion of new spending proposed, is a grand total of $1 billion in outlay *increases*. **While other adjustments for budgetary and economic effects could reasonably be made, and produce larger net spending increases, the main point is that after a fairly conservative adjustment of the plan for misclassified, uncounted, unspecified and unlegislated savings, the net outlay savings disappear.**

TABLE III.1
ADJUSTMENTS TO CLINTON NET SPENDING CHANGES, 1994-97

Claimed Spending Savings	$247
Social Security Taxes	-21
User Fees	-7
Inflated Baseline Spending & Deficit	-32
EITC Outlay Effect	-10
BTU Tax Outlay Effect	-10
Unspecified Management Saving	- 8
Debt Service	-36
Unspecified Defense	-15
Net Spending "Cuts"	$108
Stimulus and Investment	-109
Net Spending Increase	**$ 1**

A review of the outlay growth path under the Clinton plan, or, alternatively, of the claimed spending savings, leads to the same conclusion: There is no net spending reduction in the Clinton package. The level of Federal spending will continue to grow, and the policy changes proposed do not reduce total spending growth from what it would otherwise be. Furthermore, the Administration's projected costs of its new spending are underestimated, and its aggressive expansion of domestic programs likely will trigger a response in Congress to boost this spending even more. The health package can only increase Federal spending further, given the desire to increase effective demand for medical services.

In sum, the Clinton spending projections do not reflect any net spending restraint, and there is every indication the projected growth path of spending is understated. The reliance on unspecified spending cuts, attempts to hide new spending growth, and failure to provide programmatic changes underlying the budget totals undermine Administration assertions that its budget numbers are reliable.

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Another issue regards the response of Congress to new tax revenues. Research conducted by the JEC/GOP concludes that Congress will spend $1.59 for every dollar of new tax revenues.[7] Much of this effect is due to the change in institutional incentives produced by new tax resources. Essentially, Congress faces a budget constraint formed by the level of expected revenues, plus the maximum politically acceptable deficit. When the revenue side of the equation is lifted, more room is provided to accommodate additional congressional spending. In short, Congress will spend every dollar of new taxes, and then some. Thus relying on tax increases to address deficit spending is an ultimately counter-productive and self-defeating strategy.

CLINTON TAX INCREASE

The Clinton tax increase would be the largest in U.S. history. Between 1994 and 1998 the Administration estimates that its program would raise $328 billion of gross revenues, minus $77 billion in tax incentives, for a net tax increase of about $251 billion. Over the 1994-97 time frame preferred by the Administration, the net tax increase comes to about $207 billion, including the proposed social security tax increases.

However, this figure assumes that the EITC is a tax reduction, whereas at least half, or $10 billion, of the proposed expansion is an outlay increase due to refundability of this credit. Other adjustments must also be made to the revenue figures because they do not adequately reflect their impact on the economy and on the behavior of individual taxpayers. Here we focus on the two largest single elements of the Clinton tax plan, income tax increases on upper income taxpayers, and energy tax increases on all families.

History shows that the proposed higher income tax rate and surtax will not collect the expected revenue because of changes in taxpayer behavior. As we have pointed out for many years, taxpayers do adjust their realization of taxable income with changes

[7] op.cit., "Taxes and Deficits."

in their marginal tax rates. More recently, Martin Feldstein[8] has emphasized how even relatively minor changes in taxpayer behavior induced by higher tax rates can vitiate projected revenue increases. The fact that about two-thirds of the returns filed with over $200,000 in adjusted gross income (AGI) also file as small businesses illustrates why these proposed tax rate increases will undermine investment, economic growth and job creation, and thus contract the tax base relative to what it would otherwise be.

Similarly, the BTU tax is projected to net $71 billion between 1994 and 1998. However, this is a static estimate in the sense that the negative impact of this tax on economic growth and the tax base is not is not fully considered. According to a Data Resources Incorporated (DRI) analysis,[9] about half the gross revenues raised by a BTU tax would be offset by losses in other Federal taxes, an offset much larger than that used by the Treasury. Moreover, the BTU tax also would increase Federal spending by increasing government oil purchase costs, and by increasing spending on indexed transfer programs.

The DRI, JEC/GOP, and Institute for Research on the Economics of Taxation (IRET) analyses of energy taxation all conclude that energy tax increases, including the BTU tax, generate a magnitude of output and job losses large enough, along with spending effects, to offset at least 70 percent of the gross revenues projected.[10] The destruction of hundreds of thousands of jobs and $50-60 billion in lost output annually would not appear to be a reasonable tradeoff for a relatively modest increase in revenue, even if one thought more revenue were needed.

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[8] Feldstein, Martin and Daniel Feenberg, "Higher Tax Rates with Little Revenue Gain: An Empirical Analysis of the Clinton Tax Plan," NBER, March 9, 1993.

[9] Yanchar, Joyce, "Closing the Deficit: An Income Tax Surcharge Versus Energy Taxes," Data Resources U.S. Review, November 1987.

[10] JEC/GOP staff study, "Increasing the Motor Fuels Tax: Stalling the Economy and Fueling Higher Deficit Spending," released by Congressman Dick Armey, September 1991, and "Clinton Energy Tax Increases: Much Damage, Little Gain," IRET, March 1993.

Taken as a whole, the Clinton tax plan is anti-growth and anti-jobs. The proposed tax incentives are much too modest to undo more than a small fraction of the damage inflicted by the largest tax increase in American history. The revenue increase in the plan is overstated because the damage done to the economy is understated.

Moreover, as suggested earlier, even the tax side of the Clinton plan will do nothing to reduce the deficit. Congress will perceive the lifting of its fiscal constraint and respond by increasing congressional spending even more. The Clinton plan is just a larger and more tax-heavy version of the failed 1990 budget agreement, which CBO projected would reduce the 1995 deficit to $29 billion. CBO now acknowledges that the 1995 deficit will be closer to $284 billion, 879 percent higher than earlier estimated.

The impact of the tax plan is also disturbing. Instead of the tax relief promised for the middle class during the campaign, the Administration has proposed broad middle class tax increases. It appears single taxpayers with incomes as low as $15,000 could be subject to the energy taxes without the offsets in proposed program expansions. The impact of the BTU tax as a share of income will be about four times larger for a consumer in the bottom fifth of households relative to one in the top fifth.

As a result of depressed economic growth, Fiscal Associates estimates that only about 31 percent of the increased revenues claimed by the plan actually will materialize: $78.2 billion rather than $252 billion.[11] Consequently, assuming all of Mr. Clinton's spending reductions actually occur, and that his new spending initiatives do not exceed his initial estimates, the negative economic effects on tax revenue reduce the five-year deficit reduction total by over two-thirds -- from the $355 billion estimated by CBO to $108 billion.[12]

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[11] Robbins, Gary and Aldona, "President Clinton's Economic Plan," Media Backgrounder, #125, National Center for Policy Analysis, Dallas, Texas, March 1993.

[12] Ibid., p. 12.

Finally, two-thirds of the spending cuts in the Clinton plan are pushed out into 1997 and 1998, and the President proposes $117 billion in new spending over the next five years. With past budget agreements, a significant share of spending cuts slated for the future never occur, and new spending programs cost more than originally estimated. If historical precedent is any guide, one can expect $1.59 in higher spending for each new tax dollar raised.[13] Thus, between now and 1998, spending is likely to increase another $124 billion. Even in the unlikely event that all of the spending reductions actually occur, the five-year cumulative deficit still will increase about $16 billion.

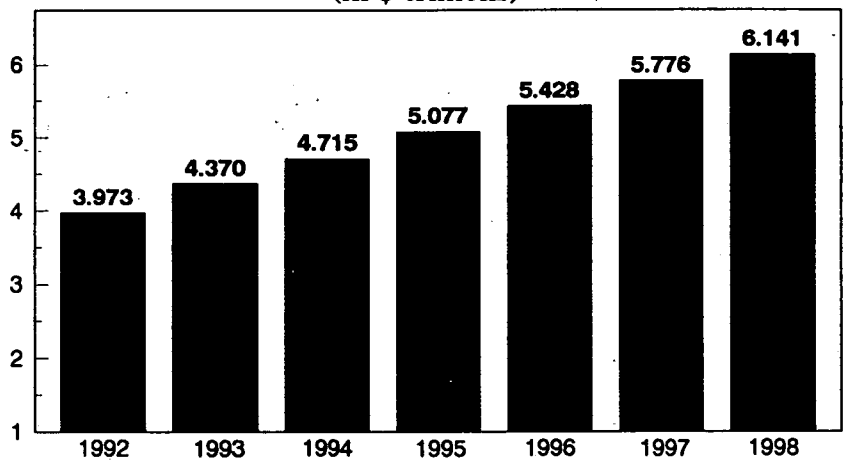
RISING NATIONAL DEBT

As Alan Greenspan, among others, has pointed out, given the trajectory of Federal spending growth in coming years, the deficit cannot effectively be reduced by tax increases, but only by restraint of Federal spending. However, of the policy changes specified in the Clinton package, the net result is a policy almost entirely based on tax increases. This tax-heavy policy has been tried many times before, and it has completely failed to reduce deficit spending. The outcome will be a rapid rise in the national debt over the next several years.

This is even reflected in the Administration's own economic proposal. As Figure III.2 shows, between year-end 1992 and 1996, the Federal debt subject to limit under Clinton policies would grow $1.455 trillion. Unfortunately, this is an optimistic appraisal of a policy that will increase the national debt at an even faster rate by the end of the decade, according to the trend reflected in the Administration's own deficit estimates. The figure shows the Administration's estimate of the growth of the national debt under Clinton policies.

[13] JEC/GOP staff study, "Taxes and Deficits: New Evidence ('The $1.59 Study')," prepared for Senator William V. Roth, Jr. and Representative Dick Armey, October 30, 1991.

FIGURE III.2
RISE OF FEDERAL DEBT UNDER CLINTON PLAN
(in $-trillions)



Source: OMB and 1994 House Budget Resolution.

An analysis of the Clinton program shows that it contains little or no real spending restraint, the largest tax increase in U.S history, and almost certainly the largest four-year increase in the national debt by any administration in U.S. history. Moreover, if the plan reduces real GDP growth by only one percentage point a year through 1998, it would add another $357 billion to the national debt, and $124 billion to the already rising fiscal 1998 deficit.

The policy direction of the United States in the context of world events is an anomaly. As countries around the world are moving in the direction of constraining government powers to tax, spend, and regulate, the Clinton Administration is moving in exactly the opposite direction. We join all Americans in wanting to move our nation forward, to increase economic growth, and to expand employment opportunities. The tragedy is that the Clinton program cannot realize any of these objectives.

ECONOMIC IMPACT OF THE CLINTON FISCAL PROGRAM

Economic forecasting is an imprecise science at best, even when the mix of government policies affecting the economy remains constant. When major policy changes are contemplated, the

forecasting problem is magnified, and precise economic predictions become all-the-more problematical. However, it is possible with considerable confidence to establish a range of economic effects that might be expected from contemplated policy changes.

When the range of effects runs from insignificant economic gains at best to significant economic losses in the worst case, one may safely conclude that the risk is too great, and the policy changes should not be implemented. Such is the case with the Clinton Administration's *Vision of Change* proposal.

THE BEST CASE: INSIGNIFICANT ECONOMIC GAINS

The long-range Blue Chip Consensus forecast of 50 private economists, published prior to release of the President's plan, provides a benchmark against which to measure the efficacy and adequacy of President Clinton's economic and budget proposal assuming it has the claimed effects. Under existing policy, the Blue Chip Consensus forecasted average real economic growth of 2.7 percent a year between 1993 and 1998, which would raise the level of real GDP to $5,792 billion in 1998. The Administration forecasts that enactment of its package would produce average real growth of 2.8 percent a year and raise the level of real GDP to $5,832 billion in 1998, a scant 0.7 percent higher after five years, or about $150 more national output per capita, than the Blue Chip Consensus forecasts will result under current policy.

The Clinton Administration claims that its proposal is a recipe for restoring long-term economic growth and creating good jobs at good wages. Yet, by the Administration's own estimates, *A Vision of Change* would fail to raise economic growth significantly above the rate most private economists foresee without the program -- 2.5 percent average annual real growth through the end of the decade. As a measure of its long-run failure, the Clinton *Vision* would fail to close the "growth gap" between actual economic performance and historic precedent that has emerged during the last four-and-one-half years. (See Chapter I.)

THE WORST CASE: SIGNIFICANT ECONOMIC LOSSES

Historical experience suggests that the direction of the Clinton plan, particularly the massive tax increases proposed, are inimical to economic growth and job creation. The JEC/GOP staff analysis

and that of most private economic forecasters predict that the Clinton economic program will cause a significant economic slowdown, and perhaps a recession.

It is important to emphasize the magnitude of the Clinton tax hike. When properly accounted for, the tax increase of nearly $300 billion through 1998 proposed by Clinton is 50 percent larger than the tax hike George Bush approved in 1990. Federal taxes will rise to just under 21 percent of GDP by 1997 and the four-year average (1994-97) under Clinton will exceed 20 percent. This means that taxes as a share of national output will be higher under Bill Clinton than any other post-World War II president.

These higher taxes will have a substantial contractionary impact on the economy. We assess the Clinton economic plan by using a simple economic model that tracks the tax burden with economic growth and unemployment rates in the next year over the period 1960-92. This model successfully predicts 70 percent of the variation in economic growth and unemployment. The Clinton plan, according to our analysis, would in 1996 increase unemployment by 0.5 percentage points and reduce economic growth by 0.8 percentage points. This is a loss of roughly 600,000 jobs and a reduction in output of about $45 billion. (See Table III.2.)

TABLE III.2
IMPACT OF CLINTON PLAN ON ECONOMIC GROWTH AND UNEMPLOYMENT

	1993	1994	1995	1996	1997	1994 -97
Tax Burden Without New Taxes	19.8	19.8	19.8	19.9	19.9	19.8
Projected Tax Burden with Clinton Plan*	19.8	20.1	20.2	20.5	20.8	20.5
Predicted Increase in Unemployment**	0.0	0.3	0.3	0.5	0.6	0.4
Predicted Reduction in Economic Growth**	0.0	0.4	0.5	0.8	1.0	0.5

Source: JEC/GOP staff calculations.
*Taxes as a percentage of GDP, based on national income product account data.
**As a consequence of higher taxes.

Other economic forecasters are even more pessimistic. For example, the DRI/McGraw-Hill economic model suggests that assuming interest rates do not continue to fall, the likely scenario,[14] the Clinton budget plan could lead to a loss of 1.1 million jobs in 1996.[15] Economist Allen Sinai of the Boston Company predicts that if interest rates are not held down, the Clinton plan will lead to more than 200,000 lost jobs by 1996.[16] Economists at the National Center for Policy Analysis in Dallas project that the Clinton plan will destroy 1.4 million jobs over the 1993-98 period and reduce investment by $1.8 trillion through 1998.[17]

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[14] The Clinton plan is premised on twin false economic assumptions: 1) High interest rates currently are holding back investment, and 2) there is significant deficit reduction in the Clinton program that will reduce interest rates sufficiently to encourage investment more than the higher taxes in the plan will discourage investment. These are highly dubious assumptions. Interest rates currently are so low that the real, after-tax rate of return on investment in financial instruments yields less than 2 percent for most investors. It is hard to see how rates can fall further unless taxes are cut or the Fed provides an inflationary burst of monetary growth. The Democrat-controlled Congress and President Clinton have refused to cut taxes and instead are going to raise taxes. If the Fed attempts to accommodate these higher taxes, i.e., to offset the economically depressing effect of higher taxes with loose money, inflation expectations, and eventually inflation itself, will rise, and interest rates will rise, not fall. Indeed, the Fed will find itself in a most delicate situation. All economists agree that the proposed major tax hikes will dampen economic growth. Hence, the Fed may find it must throttle back the current 11 percent growth of high-powered monetary-base money lest the same rate of future dollar creation end up chasing a lower future rate of new production, which is the very definition of inflation and rising interest rates.

[15] Cited in "Steven Greenhouse, "Clinton Plan's Two Aces: Fed and the Bond Market," New York Times, March 18, 1993.

[16] Ibid.

[17] Robbins, Gary and Aldona Robbins, "President Clinton's Economic Plan," National Center for Policy Analysis, March 1993.

The most destructive element of the Clinton tax program is the rise in the marginal income tax rates (corporate and personal). These will almost certainly raise the cost of capital in the United States, thus reducing investment here and handicapping U.S. global competitiveness. Higher tax rates also will move the United States in the opposite direction of most other industrialized nations in the world which have been aggressively chopping income tax rates to attract investment. The increase in the social security benefit tax will push many elderly workers with incomes as low as $25,000 into tax brackets of 50 percent and more, thus substantially punishing the elderly for working and investing.

Finally, the Clinton BTU energy tax will hit families of all incomes and create substantial economic hardship. For automobile owners, for example, the Clinton BTU tax is the equivalent of an 8 to 12 cents-a-gallon gasoline tax hike. In cold-weather states, many families will pay $200 to $500 more per year to heat their homes. The non-partisan Institute for Research on the Economics of Taxation projects that Clinton's energy taxes alone will cost the economy 500,000 jobs and $50 billion in lost output when fully implemented.[18]

CONCLUSION

Although the Clinton Administration has touted its plan as pro-growth, it is instructive to note that financial markets and economic forecasters have not interpreted it that way. For example, in its February 1993 report, compiled the month before the Clinton program was released, the Blue Chip Economic Consensus forecasted real economic growth of 3.3 percent for 1994. In March, after release of the Clinton proposal, Blue Chip economists revised their estimate of 1994 real growth *down* to 3.1 percent. Republicans believe that the way to increase economic growth and new jobs is by lowering taxes on investment and savings, rather than raising them.

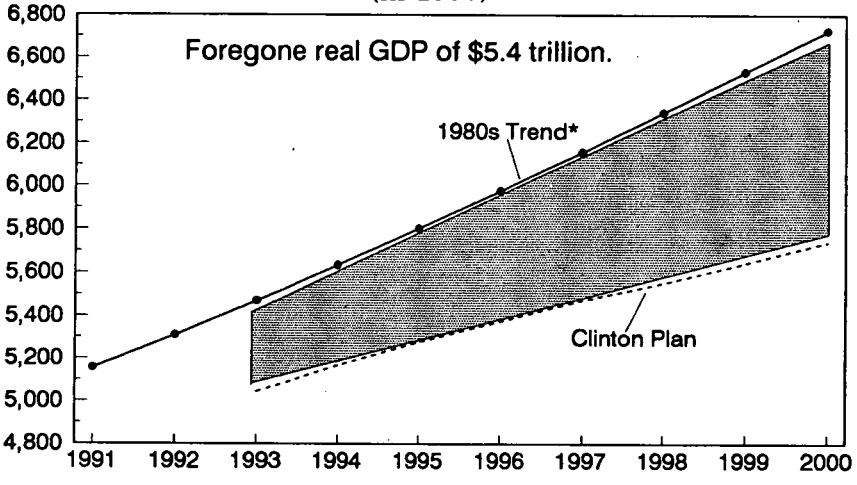
Finally, Figure III.3 provides a sobering snapshot of the economic damage the Clinton *Vision* portends for the economy. **By the Administration's own economic forecast, America stands to lose**

[18] op.cit., "Clinton Energy Tax Increases."

$5.4 trillion in GDP between now and the end of the decade because the Clinton economy will not match the performance of the 1980s.

President Clinton says this program represents change from the policies and outcomes of the 1980s. How sad but true.

Figure III.3
REAL GDP GROWTH 1980S TREND VS CLINTON
(in 1987)



*Assumes 3 percent real growth rate from 1988 on.
Source: Robbins, Gary and Aldona, "President Clinton's Economic Plan," Media Backgrounder, #125, National Center for Policy Analysis, Dallas, Tx, March 1993.

CHAPTER IV

REALISM AND PUBLIC POLICY

Recent advances in economic and social thought have enriched and extended the constitutional and political philosophy expressed by the Founders in *The Federalist*, and applied it to topical problems in economic policy. Two Nobel Laureates figure prominently in this intellectual renaissance: the late F.A. Hayek, and James M. Buchanan. Though the work of these two economists in this area have important differences of emphasis and orientation, their views are complimentary and have provided many valuable insights into economic policy making in contemporary democracies.

With the Founders, Hayek and Buchanan acknowledge the limitations and frailties of human nature, whether found in public or private settings. The very real imperfections of men within government require appropriate institutions such as limited government, individual freedom, and equal justice under law. As Madison stated:

> If men were angels, no government would be necessary. If angels were to govern men, neither external nor internal controls on government would be necessary. In framing a government which is to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself.[19]

For some time during this century this traditional view of the role of government and government officials was eclipsed by an ideological perspective which postulates a much more ambitious role for government. While appearing in different forms, this ideology expresses considerable idealism about the ability of government to foresee and solve complex economic and social problems. Moreover, this attitude is defined by the implicit assumption that government officials are more knowledgeable, virtuous, and public spirited than their counterparts in the rest of society. Consequently, a transfer of power and authority in many areas from society, or "private interests," to state officials, would

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[19] Hamilton, Alexander, The Federalist, p. 264.

increase public welfare. If only disruptive private interests and institutions could be "managed," controlled, or otherwise guided by wise public policy makers, the economy would function more efficiently and the public interest advanced.

The heyday of this view was reached in the 1960s. The theoretical possibility of "market failure" was used to justify government intervention in a wide range of activities. Some even argued that government could "fine tune" the economy to achieve targeted levels of economic growth, unemployment, and inflation. However, the attempts to fine tune the economy were not successful, and ended in the late 1970's experience of rising inflation and unemployment. According to Hayek, the presumed rationale behind such policies as "fine tuning" is based on the assumption that government officials possess more information than they actually have; he calls it "the pretense of knowledge." The broadly perceived failure of fine tuning undermines the belief that extensive government intervention can improve economic welfare. Consequently, Americans today are more aware of the potential of "government failure," and have tended to support measures to reduce tax rates, curtail excessive regulation, and according to polls, require a balanced budget/tax limitation constitutional amendment.

In addition to economic concerns, Hayek also argues that the observance of constitutional limits are essential to preserve the integrity of democratic government. Limited government means that state intervention is strictly confined and that official actions aim at the uniform application of rules and procedures. In other words, discretionary actions favoring specific groups are to be minimized. Under this framework, the potential for gain by bribery and corruption is limited. Moreover, the energy and attention of public officials can be concentrated on performing functions enjoying the broadest support.

However, when the scope of government action expands to benefit discrete groups of citizens at the expense of others, the potential for consensus or compromise on policy becomes progressively more difficult. At some point in this expansion, democratic processes become increasingly unable to reconcile the conflicting claims of the growing numbers of special interest groups. Voters respond by becoming cynical about democratic institutions, and special interests redouble their efforts to win favored treatment.

When politics is viewed primarily as a means for some groups of citizens to exploit others, the integrity of the democratic system is jeopardized.

The Founders were well aware of this threat that coalitions of special interests, which they called factions, posed to democracy. Madison stated in the *Federalist Number 10*:

> Hence it is that such democracies have ever been spectacles of turbulence and contention; have ever been found incompatible with personal security or the rights of property; and have in general been as short in their lives as they have been violent in their deaths.

The solution, as Madison saw it, was to contain and channel the influence of factions. The structure of the Constitution was designed to prevent hasty enactment of ill-considered measures favored by transitory coalitions of special interest groups. However, the Constitution is not perfect, and special interests clearly are able to exert considerable influence.

Similar conclusions have been reached in modern times. Economists Wilhelm Röpke and Hayek both pointed out that democratic legislatures are undermined by their transition from law-making to decree-making redistributive entities. Upon reflection, of course, it is not surprising that the nature of a law-making institution would change with the character of the law. Over 30 years ago Röpke wrote, in eerily prophetic terms, of this process:

> The power of the state grows uncontrollably; yet, since powerful forces are at the same time eroding its structure and weakening the sense of community, there is less and less assurance that administration and legislation unswervingly serve the whole nation and its long-term interests. Demagogy and pressure groups turn politics into the art of finding the way of least resistance and immediate expediency or into a device for channeling other people's money to one's own group.
>
> Government, legislation, and politics of this kind are bound to forfeit public esteem and to lose their moral authority.

Thus, fundamental reforms are needed to improve the institutional setting in which policy decisions are made. In particular, the framework for tax and spend decisions in Congress should be improved.

THE RISE OF FACTION AND EROSION OF DEMOCRATIC INSTITUTIONS

Fortunately, a coherent body of thought has been developed that permits analysis of economic policy making in democratic institutions -- public choice. Public choice may be viewed as a restatement and refinement of the Federalist heritage, which had been ignored for decades.

According to James M. Buchanan, "public choice is the analysis of political decisionmaking with the tools and methods of economics." Politics is viewed not primarily as a means of establishing truth or justice in the abstract, but principally as a type of exchange process. The fiscal policy results of democratic decision processes are conditioned by the constitutional and nonconstitutional rules under which decisions are made.

Throughout most of American history, the balanced budget rule was powerful enough to be considered part of the unwritten constitution. By holding the level of Federal outlays at the level of revenues, this rule acted as a spending constraint. The belief in balanced budgets was so strong as to be considered part of the unwritten constitution.

However, with the popularity of Keynesian economics, the taboo against deficit spending was broken by the early 1960s. Though not intended, the practical result of this development was to loosen the constraint on Federal spending growth in good times as well as bad. The tremendous pressures generated by coalitions of special interest groups pushed Federal spending even higher. There were few problems which could not be placated by the establishment of some policy or regulation and spending vast sums from the public treasury.

According to James M. Buchanan, once the "taboo" against deficit spending was broken in the early 1960s, an important constraint on government spending was removed. The result was

that Federal spending expanded both in absolute amount and as a percentage of the economy.

Institutional reforms to improve congressional decisionmaking are essential, and we reiterate our support for a balanced budget/tax limitation constitutional amendment; adoption of a line-item veto by Congress; disuse of the current services baseline budget (which assumes spending growth as given) substituting prior-year budget levels as the baseline for budget policy; and a biennial budget process.

We advocate these institutional reforms as a way to improve consideration of the costs and benefits of Federal spending, which we believe would slow budget growth. The resources directly and indirectly diverted from the private sector as a result of excessive congressional spending undermine the ability of the private economy to expand. While the economic consequences of this trend are serious, the negative effects on democratic institutions also merit consideration.

One key aspect of our fiscal problem is that the benefits of each congressional spending measure are concentrated, while the costs are diffused over all taxpayers. Therefore, each item of spending enjoys intense support among interested and usually well-organized groups, while the costs to each taxpayer are not felt as intensely or considered as carefully. Moreover, coalitions of special interest groups can form to push jointly otherwise separate spending measures; thus logrolling in the legislative process can facilitate the adoption of the coalition program.

As discussed earlier, the expansion of government over the last three decades reflects the relaxation of the deficit rule. This, in turn, has set in motion forces which undermine other weaker institutional constraints, such as the requirement for votes on increasing the debt limit, timely consideration of the budget, and effectiveness of the veto. As institutional constraints on congressional spending have become less important, the scope and size of government have grown. The growth of government has qualitatively altered our system of government and undermined the rule of law and congressional consideration of fiscal matters.

The erosion of the balanced budget norm suggests the need for formal adoption of a balanced budget/tax limitation constitutional

amendment. Special interest pressures upon legislators in support of expanded constituent programs could then be contained under a restoration of fiscal responsibility. This reform would shift the burden onto program advocates to show that the value of their proposed expenditures is at least equal to that of other programs which would have to be cut back, or alternatively, to the costs imposed by additional taxation. In other words, the potential benefits of new expenditures would have to be balanced with their costs. This would require policy makers to choose budget priorities in keeping with the level of projected tax revenues provided by law.

Under present institutional arrangements, it is more likely that a "tax and spend" approach will be adopted rather than rejected by Congress. Because the tax cost of Federal programs is diffused among all taxpayers, and the benefits concentrated among particular constituencies, it follows that support for additional spending will be more intense and thus successful in attracting the support of special interest beneficiaries. The overwhelming probability is that any new taxes will not be devoted to deficit reduction, but instead will stimulate another round of increased Federal spending. History shows clearly that tax increases only tend to undermine economic growth and spur spending, not shrink the deficit.

The moral dangers of excessive Federal spending put the institutions of our government at risk. In addition to the economic costs imposed, the costs incurred by questions about the integrity of government are also gravely serious. Thus, fiscal profligacy is hazardous to both our economic and political well being.

CHAPTER V

ECONOMIC REVISIONISM

The Administration's economic program is predicated on statements about income trends which are either false or misleading. For example, the first chapter of the Administration's budget submission, referring to alleged income trends "throughout the 1980s," states that "people at the bottom of the income scale actually lost ground: measured in inflation-adjusted dollars, their incomes fell between 1977 and 1991."[20] By folding the years 1977-80 into the 1980s, and adding 1991, it is possible to show this result. However, the Carter Administration (1977-80) was not part of the 1980s, and neither was 1991. The 1980s comprise the years 1981 through 1990, and during this period the average income in the bottom fifth climbed 4.8 percent.

This insistence on accuracy in dating is not merely fastidiousness. The three eras at issue were characterized by distinctly different regimes of economic policy. In order to evaluate the efficacy of the policy mix in each era, it is essential that the dating be accurate.

A "Legacy of Failure" did occur during the Carter Administration, when the average income of the bottom fifth did decline. However, some have contended that use of comparable points in consecutive business cycles justifies using a 1979 to 1989 time frame. In the past JEC Democrats, for example, have used the 1979 to 1989 period to measure income changes, and it is true that the average income of the bottom fifth dropped $406 over this time. However, between 1979 and 1980, this average at the bottom plunged $566, accounting for 140 percent of the drop over the 1979-89 period.

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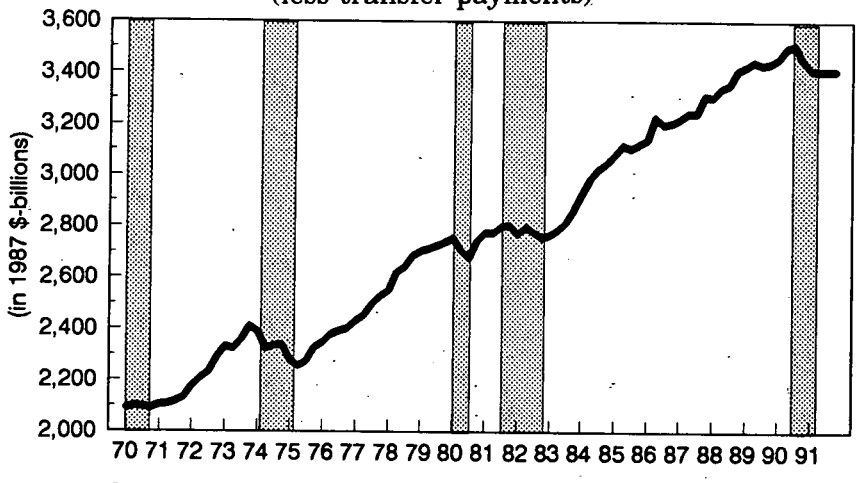
[20] op. cit., "A Vision of Change."

INCOME GROWTH

Figure V.1 depicts recent business cycles. As one can see, the business cycle peak previous to 1989 was 1981, not 1979. An analysis of consecutive business cycle peaks would properly refer to 1981 and 1989. During this time the income growth in the bottom quintile was 5.9 percent.

FIGURE V.1
REAL PERSONAL INCOME
(less transfer payments)



Source: Bureau of Economic Analysis

The figure shows trends in personal income, with cyclical downturns reported by the Bureau of Economic Analysis and National Bureau of Economic Research shaded in grey. The figure shows that there are actually two business cycle peaks, one in 1980 and one in 1981 -- after 1979 but before implementation of a new policy direction adopted in 1981. The 1979-89 "peak-to-peak" argument is fallacious.

One can argue that annualized data are unavailable for the 1981 peak, but inconvenience of data collection or measurement does not justify analytical error. Confusion of measurement problems with substantive issues is simply a logical mistake. If a peak that should be measured cannot be measured in a desired way, this does not

excuse selection of another peak which is more easily measured. In other words, just because something is worth doing does not mean it is worth doing badly.

Another problem with this argument is what it says about economic and income trends. Even if 1979 were the previous peak, then 1980-82 should be viewed as one long period of economic decline. If so, the trend that began in 1980 cannot be blamed on an Administration that took office only in 1981. Thus, the income declines of 1980, 1981, and 1982 logically should be assigned to the previous administration. This accurate dating would free the incoming administration from responsibility for the income declines. However, partisan critics want to blame 1980 on the Reagan Administration by invoking 1979 as a peak year, and by absolving the Carter Administration for the decline which began on its watch.

The data show that income trends follow overall trends in the economy. Sustained income growth is strongly linked to healthy economic growth. Evaluation of the income trends of the 1980s must be viewed in the context of the Carter economic legacy. While income growth during the 1980s expansion was not unprecedented, it was good by the conventional measures of median household and family income and marked a turnaround from the years of "malaise." The record shows that what is now needed are policies to encourage short- and long-term economic and productivity growth to lay a solid foundation for income growth in the 1990s.

1980 INCOME MELTDOWN DOMINATES 1979-89 TIME

The most serious problem raised by using 1979 as a base year is the misrepresentation of income changes for the 1979-89 period. Essentially, the effects of a single year, 1980, are inappropriately used to represent a 10-year trend during the 1980s, or "Reagan-Bush years." The usual political misuse of this approach misleads the reader into assuming that the income effects of 1980 are related to policies implemented years later.

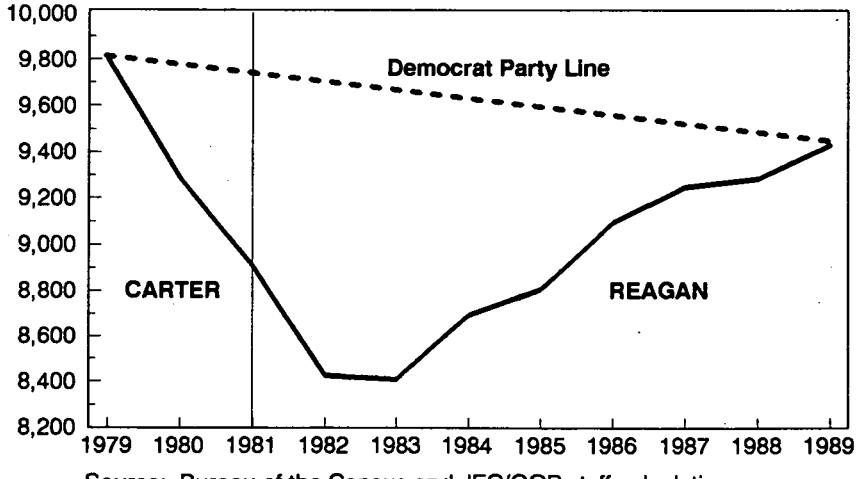
According to this view, during that period the rich got richer and the poor got poorer. The average real household income of the top quintile, those earning over $55,000, did increase during this period, though many of the two-earner couples in this quintile might be surprised to learn they are considered "the rich." On the other

hand, the decline in income for the bottom quintile during 1979-89 is entirely explained by 1980, the last year in which Democrats controlled both the White House and the Congress. This was the worst year for family income in the entire postwar period, with real median family income plunging by $1,209, or 3.5 percent, in 1980 alone.

In these Republican Views, we present annual income data to permit readers to examine the evidence and reach their own conclusions. There is nothing legitimate to be gained by selective choice of base years which eliminates important information and distorts income trends.

A review of the data shows that the 1980 drop in income for the bottom quintile comprises 139 percent of the income decline attributed to the whole period (see Figure V.2). However, the average income of this group increased between 1980 and 1989. The scenario that there was a straight drop in this quintile's income between 1979 and 1989 is what we call "the Democrat Party Line," since this fallacious assertion is usually made to score partisan points.

FIGURE V.2
"DEMOCRAT PARTY LINE"
REAL AVERAGE INCOME OF THE BOTTOM FIFTH, 1979-89
(in 1989 dollars)



Source: Bureau of the Census and JEC/GOP staff calculations.

In other words, of the much touted income decline of the bottom fifth reported in innumerable partisan reports, Census data show that all of it occurred in one year, the last years of the Carter Administration. This 1980 decline is not only large enough to explain all, or 100 percent, of the decline over the 10-year period, but amounts to about 140 percent of the income decline over 10 years. Without the rest of the decade of net income growth, this one Carter year would have produced an income decline 40 percent larger. The other nine years produced enough income gain to erase this income deficit and produce a net gain whether 1980, 1981, or 1982 are selected as base years.

Similar selectivity has been used by the Congressional Budget Office in preparing income data for political use by Ways and Means Democrat Members and staff, duly released to media and blown up in extensive graphs in newspapers and television news.

Such income data always portray the decade of the 1980s as one in which the average income of the bottom fifth of families declined while that of the top fifth advanced, thus landing the desired headline of "Rich richer, poor poorer." A 1990 JEC/Democrat release went further in asserting that "the average real incomes of the bottom 40 percent of families are lower now that they were in 1979," even though the "economic pie grew during most of the 1980s."[21]

Unfortunately, CBO data used in the report to illustrate the evils of the 1980s contained a **$130** billion error, selective and biased measures of income, and a miscalculation of real capital gains. Of course, these were never acknowledged nor corrected by JEC and Ways and Means Democrats, who proceeded to use the faulty data for political purposes in 1990, and as late as 1993. While capital gains and partnership income are fully counted by CBO, net capital losses are limited and most partnership losses excluded altogether. The CBO data are distorted further by the way non-family units are included in the CBO "family income" measure. Consequently, the CBO data on income trends during the 1980s for the bottom three quintiles are flatly contradicted by official Census data, even though CBO income data are drawn largely from Census sources. Furthermore, the CBO reports on this

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[21] JEC/Democrat Press Release, 1990.

subject completely ignore the critical reality of income mobility. Perhaps the broadly perceived problems with the most used CBO income data explain why they were discontinued in the most recent *Green Book*. In any event, even these flawed data show that during the Carter Administration, the top 1 percent of "families" received 100 percent of the income gains, while middle and lower family income declined or stagnated. By comparison, the 1980s showed much broader sharing of income gains than the period which preceded them.

FAMILY INCOME SINCE 1973

In reviewing family income data it will be recalled that the composition of each quintile is constantly changing as families move between quintiles. This means the changes in income do not represent the changes of the income of actual families, many if not most of whom are only temporarily in a given quintile. Furthermore, average income measures are subject to distortion by changes in the income of relatively small subgroups. Given the degree of income mobility in our society, one cannot reach conclusions about the economic well being of actual persons or gauge how broadly changes in average income of quintiles affect the population from these data.

These qualifications, although important in avoiding misleading and simplistic results, are usually ignored. (This aspect of mismeasurement is discussed in the subsection that follows.) In this section we will take the quintile income data at face value to examine how they can be manipulated to arrive at preconceived results. This narrow examination of these income data is for illustrative purposes only: Income mobility alone makes their use in describing the changing economic welfare of actual families statistically meaningless.

Table V.1 shows real average income levels for each quintile from 1973 to 1989. In general, movement in family income follows that of the business cycle. The income data shown below tend to move in the same direction as the economy. When the economy is performing well, income increases, and when the economy is in decline income tends to fall. For example, average income for all quintiles fell during the 1974-75 recession, and climbed during the subsequent expansion.

TABLE V.1

REAL AVERAGE FAMILY INCOME SINCE 1973

(in constant 1991 dollars)

Year	Lowest Fifth	Second Fifth	Middle Fifth	Fourth Fifth	Highest Fifth
1973	10,746	23,451	34,457	47,090	80,794
1974	10,584	23,104	33,811	46,321	79,216
1975	10,205	22,226	33,119	45,351	77,481
1976	10,444	22,780	34,068	46,549	79,567
1977	10,282	22,865	34,483	47,588	81,584
1978	10,599	23,588	35,499	48,911	84,099
1979	10,765	23,750	35,870	49,395	85,589
1980	10,199	22,904	34,695	48,140	82,433
1981	9,782	22,126	33,958	47,682	81,741
1982	9,256	21,785	33,370	47,332	83,371
1983	9,236	21,823	33,648	47,964	84,381
1984	9,547	22,413	34,658	49,563	87,341
1985	9,675	22,711	35,132	50,356	90,627
1986	9,990	23,501	36,471	52,115	94,926
1987	10,157	23,872	37,069	53,053	96,956
1988	10,197	23,848	37,111	53,298	97,792
1989	10,359	24,184	37,571	54,055	101,780
1990	10,247	23,900	36,808	52,935	98,377
1991	9,734	23,105	35,851	51,997	95,530
			Change		
1979-80	-566	-846	-1,175	-1,255	-3,156
1979-89	-406	434	1,701	4,660	16,191
1981-89	577	2,058	3,613	6,373	20,039
1982-89	1,103	2,399	4,201	6,723	18,409
1990-91	-513	-795	-957	-938	-2,847
			Percent Change		
1979-80	-5.3%	-3.6%	-3.3%	-2.5%	-3.7%
1979-89	-3.8	1.8	4.7	9.4	18.9
1981-89	5.9	9.3	10.6	13.4	24.5
1982-89	11.9	11.0	12.6	14.2	22.1
1990-91	-5.0	-3.3	-2.6	-1.8	-2.9

Source: Bureau of the Census and JEC/GOP staff calculations.

This expansion ended in the first half of 1980, with renewed, albeit weak growth starting in July 1980 and continuing through July 1981. The slow nominal income growth and high inflation of this period caused a sharp across-the-board decline in real income in 1980, with further declines spilling over into 1981 and 1982 as the Federal Reserve tightened monetary policy. The absence of sustained economic growth along with high inflation proved a damaging combination for families at all income levels.

The pivotal year of 1980 merits especially close examination. As shown in Table V.1, the average real income of the bottom quintile declined by $566 in 1980 alone, a decline of 5.3 percent. Meanwhile, the average real income of the middle quintile fell $1,175, or by 3.3 percent. The income decline of 1980 was more than enough to erase all income growth in the bottom quintile occurring in the previous two years. The setback to income growth of other quintiles was also severe.

Table V.1 shows income growth for every quintile in the 1980s whether 1980, 1981, or 1982 is used as a base year. While the choice of any of these three years does change the amount of income growth, there is no way to show declines for any quintile without relying on the last year of the Carter Administration. This explains the insistence of partisan analysis to rely on the income meltdown of 1980 to taint the income growth under policies adopted later.

INCOME MOBILITY AND ECONOMIC OPPORTUNITY

Great attention has been given to changes over time in the average incomes of "quintiles," families or households ranked top to bottom by income and divided into fifths. However, such time-line comparisons between rich and poor ignore a central element of the U.S. economy, which is the extent to which individuals move from one quintile to another. Figures on income mobility are more characteristic of the nature of our fluid society than comparisons of average incomes by quintile, which would only be statistically meaningful if America were a caste society where the people comprising the quintiles remained constant over time.

Unfortunately, while data on average income by quintile have been plentiful, however misleading, data on income mobility have been scarce.

This section is an analysis of data based on income tax returns filed from 1979 through 1988, which were tabulated by the U.S. Department of the Treasury. The Treasury sample consists of 14,351 taxpayers filing returns in all of the above years. This sample tends to understate income mobility to the extent the movement of younger and older filers in and out of the population of taxpayers is missed by the requirement that returns be filed in all years. On the other hand, this understatement is at least somewhat offset at the low end of the income scale by the presence of an underclass which does not file tax returns year after year. For our purposes, the bottom quintile consists of those who earn enough income to at least file income tax returns, if not to actually pay taxes.

Earlier studies of income mobility have demonstrated a startling degree of income mobility in as short a period as one year. However, as a January 1992 study noted[22], additional data over more extended periods were needed to draw more precise conclusions about income mobility over the longer term. This need has now been largely satisfied by the provision of longitudinal panel data from tax return files. However, much more data and research on income dynamics in coming years is needed.

LEVEL OF INCOME MOBILITY BY QUINTILE

The tax return data support the conclusion that the degree of income mobility in American society renders the comparison of quintile income levels over time virtually meaningless. According to the tax data, 85.8 percent of filers in the bottom quintile in 1979 had exited this quintile by 1988. The corresponding mobility rates were 71 percent for the second lowest quintile, 67 percent for the middle quintile, 62.5 percent for the fourth quintile, and 35.3 percent for the top quintile.

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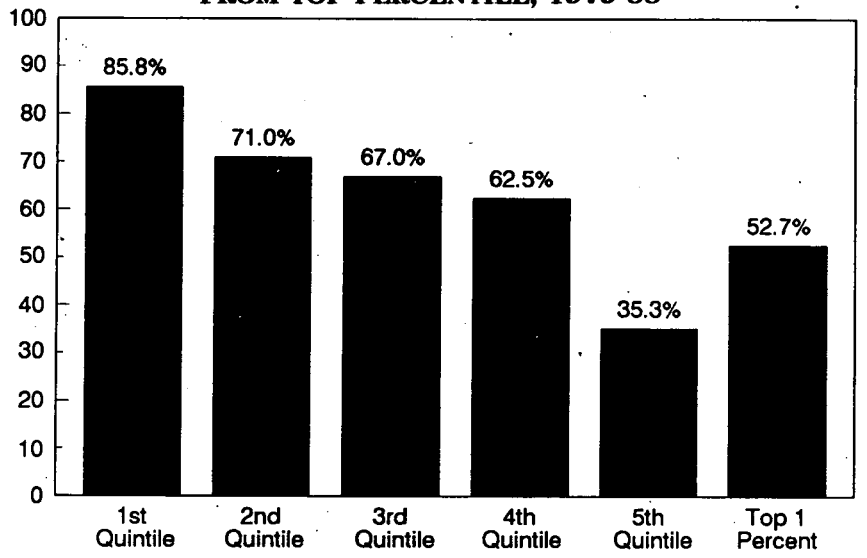
[22] JEC/GOP staff study, "Income Mobility and the U.S. Economy: Open Society or Caste System?," released by Congressman Dick Armey, January 1992.

Of those in the much discussed top 1 percent, over half, or 52.7 percent, were gone by 1988. These data understate income mobility in the top 1 percent to the extent mortality contributes to mobility and the diffusion of income. Figure V.3 displays the income mobility of the various groups.

FIGURE V.3
PROPORTION MOVING TO DIFFERENT QUINTILES OR FROM TOP PERCENTILE, 1979-88



Source: United States Treasury.

In all but the top quintile, at least 60 percent of filers exited their 1979 income quintile by 1988, with two-thirds or more exiting in the bottom three quintiles. Though much more stability was observed in the top fifth, over one-third had slipped downward to be replaced by others moving up. Even most of the top 1 percent had exited by 1988, to be replaced by others.

The very high degree of income mobility displayed above shows that the composition of the various quintiles changes greatly over time. A majority of filers have indeed moved to different quintiles between 1979 and 1988. Thus intertemporal comparisons of average wages, earnings, or private incomes of quintiles cannot provide meaningful measures of changes in the income of actual

The IRS data clearly show that average income tax payments of the top 1 percent of taxpayers jumped 48.2 percent between 1981 and 1988. Meanwhile, the average tax payment of the lowest 50 percent fell 26.0 percent. Of the $412.8 billion in personal income taxes collected in tax year 1988, $113.8 billion, or 27.6 percent, was contributed by the top 1 percent of taxpayers. Over one-fourth of all personal income tax revenue came from the top 1 percent, while the top 5 percent accounted for 45.6 percent, and the top 10 percent for 57 percent. Table V.4 and Figure V.6 show a massive shift in the tax burden, but its direction is upward onto the shoulders of the high income earners.

TABLE V.4

INCOME TAX BURDEN SHIFTED TOWARDS WEALTHY

Year	Top 1%	Top 5%	51-95 Percentiles	Lowest 50%
1981	17.89%	35.36%	57.22%	7.42%
1982	19.29	36.39	56.30	7.32
1983	20.73	37.71	55.18	7.11
1984	21.79	38.64	54.08	7.27
1985	22.30	39.28	53.61	7.10
1986	25.75	42.57	50.97	6.46
1987	24.81	43.26	50.67	6.07
1988	27.58	45.62	48.66	5.72
1989	25.30	44.04	50.25	5.71
1990	25.30	44.13	50.25	5.62

Source: IRS.

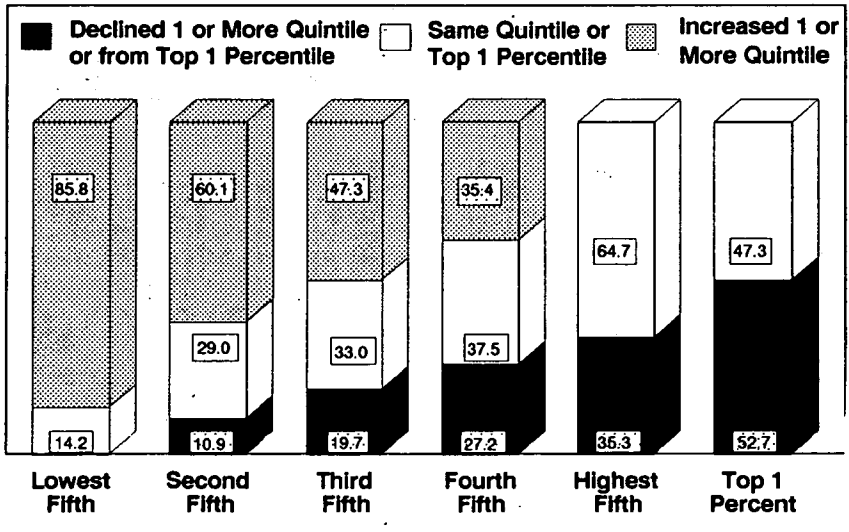
families and persons only temporarily in a given quintile or percentile. Quintiles may be a convenient way of presenting snapshots of income data for a group of people at a certain point in time. Nonetheless, the notion of a quintile as a fixed economic class or social reality is a statistical mirage.

DIRECTION OF INCOME MOBILITY

Movement is important, but the direction of that movement is more important. While a strong argument can be made for a flexible and open market economy which presents opportunities to lower and middle income workers, instability alone is not necessarily a virtue. Figure V.4 summarizes the income mobility data to display the direction of movement between 1979 and 1988. For example, in the third, or middle 1979 fifth, 47.3 percent had moved to a higher quintile by 1988, while 33.0 remained in this same quintile, and 19.7 percent fell into a lower quintile.

FIGURE V.4

NET PROGRESS IN THE BOTTOM FOUR QUINTILES, 1979-88



Source: United States Treasury.

Given the relative starting position, the very high mobility from the bottom quintile obviously reflects improvement. In addition, the upward movement in the second, third, and fourth quintiles is much

larger than downward movement. For example, 60 percent of the second quintile had moved to one of the higher three quintiles by 1988. Over this same time, only 10.9 percent had fallen from the second into the lowest quintile.

In the long overdue debate over the significance of income mobility, some may argue that mobility would tend to reflect slippage, especially among the middle class. The data contradict this contention. Of those in the middle quintile in 1979, nearly half moved upward to the fourth or fifth quintiles by 1988. Overall, in the bottom four quintiles, net improvement was the rule, not the exception.

DETAIL ON INCOME MOBILITY, 1979-88

Table V.2 displays the movement of filers from 1979 quintiles to their positions in 1988. Each row can be read across: of 100 percent of each 1979 quintile, the table shows their dispersion among the various fifths by 1988.

TABLE V.2
AMERICA ON THE MOVE

1979 Quintile	Percent in Quintile in 1979	Percent in Each Quintile in 1988				
		1st	2nd	3rd	4th	5th
1st	100%	14.2%	20.7%	25.0%	25.3%	14.7%
2nd	100	10.9	29.0	29.6	19.5	11.1
3rd	100	5.7	14.0	33.0	32.3	15.0
4th	100	3.1	9.3	14.8	37.5	35.4
5th	100	1.1	4.4	9.4	20.3	64.7

Source: United States Treasury.

About 86 percent of those in the bottom quintile in 1979 had managed to raise their incomes by 1988 enough to have moved up to a higher quintile. The data show that these were not all grouped at the bottom at the second quintile. While 20.7 percent were in the second quintile, 25.0 percent had made it into the middle fifth, and another 25.3 percent into the second highest quintile. The 14.7 percent in the top quintile was actually higher than the 14.2 percent still stuck in the bottom fifth.

In other words, a member of the bottom income bracket in 1979 would have a better chance of moving to the top income bracket by 1988 than remaining in the bottom bracket.

In the second quintile, 71 percent had exited between 1979 and 1988. Though 29.0 percent still remained in the second quintile in 1988, 29.6 percent had moved up to the third quintile, 19.5 percent to the fourth, and 11.1 percent to the top quintile. Only 10.9 percent had moved down to the lowest quintile.

Of those in the middle quintile in 1979, 32.3 percent had moved to the fourth quintile and 15.0 percent to the fifth quintile by 1988.

Over this period, 47.3 percent had moved up, while 19.7 percent had moved down. The net effect of income mobility in the middle range clearly reflected net overall improvement.

While the fourth quintile exhibited powerful income mobility, the top quintile is the most stable. However, all income mobility from the top quintile is by definition downward mobility. The share of this group dropping into lower quintiles was 35.3 percent, while 27.2 percent of the fourth quintile also dropped at least one quintile. Many of these with declining fortunes are still better off than many of those with upward mobility from a low quintile, however, the overall pattern is that there tends to be strong upward mobility from the lower quintiles, while income mobility from a high level often reflects economic reversals. Without income mobility, many in the top fifth would be better off, and the great majority of those in the lower quintiles would be worse off. Income mobility reflects improvement in the lower four quintiles, but this fact has been virtually ignored in public discussion of income trends.

While 35.3 percent fell from the top quintile into the fourth quintile or below, 40.0 percent of the bottom quintile had moved into the fourth or fifth quintiles by 1988. Of all of those in the bottom quintile in 1979, about two-thirds, or 65 percent, had moved to the middle or higher quintiles by 1988. These data demonstrate that the U.S. economy, not without problems over this period, still remains dynamic, open, and productive enough to permit most Americans in the bottom three-fifths to work their way up the economic ladder. What is needed are policies to ensure that this

flexibility and opportunity are extended as widely as possible, especially to those who actually fall below the bottom fifth of taxpayers.

Currently there are two models of the American economy, one static, and the other dynamic. The first portrays the United States as a caste system and misapplies the characteristics of a permanent income strata to those only temporarily moving through income brackets. The alternative view portrays a much more complex and interesting social reality in which the composition of income classes are in constant flux. According to this latter point of view, simplistic generalizations about actual persons and families (or "the rich" and "the poor") cannot be drawn from data on a conceptual artifice that does not exist as such in reality.

The empirical data support the view of the market economy as a dynamic and open society that provides opportunity to those who participate. There is no evidence of stagnation, with the turnover rate in the most stable quintile -- the top fifth -- exceeding 35 percent. The turnover rates in the bottom four quintiles were at least 60 percent over the period, with most of this reflecting upward progress. Analysis that assumes or suggests stable composition of family or household income quintiles rests on invalid assumptions.

It makes no sense to draw sweeping conclusions such as "the income of the bottom 20 percent of families fell" in a 15-year period when most of the people originally in that category have long since improved their standard of living enough to have moved up from the bracket entirely.

TAX FAIRNESS

In the years leading up to its passage, proponents of the 1981 Roth-Kemp tax cut argued that a 30 percent across-the-board reduction in personal marginal tax rates would lower the tax barriers obstructing the flow of resources into production. According to this view, extant resources were being withheld from productive use because they were locked up in inefficient tax-sheltered investments, underutilized capital, consumed leisure, unexploited entrepreneurial opportunities, unrealized capital gains, and other types of income. Lower tax rates, it was argued, would

improve economic growth by reducing the after-tax price of productive resources and improving the efficiency of redeployed resources.

It was also argued that shifting these resources from the untaxed to the taxable economy would actually increase the tax payments of those most affected by punitive tax rates. In practical terms, this means that high income taxpayers would be expected to pay more of the income tax burden while middle and lower income taxpayers would assume less. This view was disputed by the Congressional Budget Office and Joint Tax Committee, both of which projected that average tax payments of upper income taxpayers, expressed in nominal terms, would fall after 1981, producing, in the words of then House Speaker Tip O'Neill, a "giveaway to the rich." Ironically, this tax cut was structured virtually identical to a tax cut initiated by President Kennedy two decades earlier, which was hailed as a great breakthrough.

The Internal Revenue Service (IRS) data reported in Table V.3 and Figure V.5 prove conclusively that the Congressional Budget Office and the Joint Committee on Taxation were completely wrong about the impact and even the direction of the tax rate cuts' effects. Actual income tax payments by the top 1 percent increased sharply, even after adjustment for inflation. Oddly, CBO simulations of tax payment declines for upper income groups continued to be released in the face of contradictory IRS data on actual returns, a classic example of cognitive dissonance.

TABLE V.3

AVERAGE INCOME TAX PAYMENTS BY TAXPAYER GROUP

(1990 dollars)

Year	Top 1%	Top 5%	51-95 Percentiles	Lowest 50%
1981	$77,939	$30,802	$5,538	$647
1982	77,501	29,234	5,026	588
1983	78,195	28,453	4,625	537
1984	83,970	29,779	4,631	561
1985	87,615	30,874	4,682	558
1986	110,378	36,502	4,856	553
1987	99,234	34,605	4,504	485
1988	115,523	38,217	4,529	479
1989	102,961	35,841	4,545	465
1990	101,572	35,010	4,430	446
		Percent Change		
1981-86	41.6%	18.5%	-12.3%	-14.5%
1981-88	48.2	24.1	-18.2	-26.0

Source: IRS and JEC/GOP staff calculations.

FIGURE V.5

INCOME TAX PAYMENTS OF AFFLUENT RISE AFTER REAGAN TAX CUTS, DECLINE FOR BOTTOM HALF

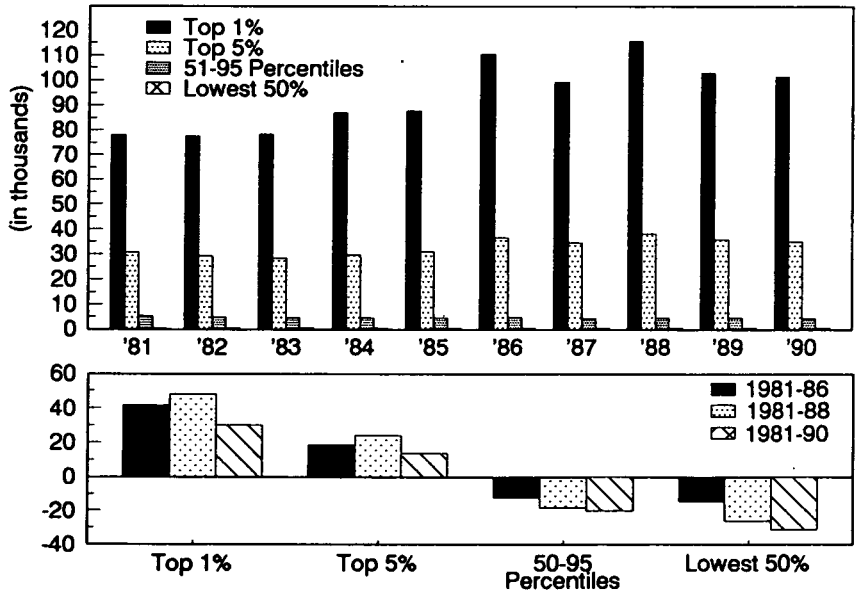
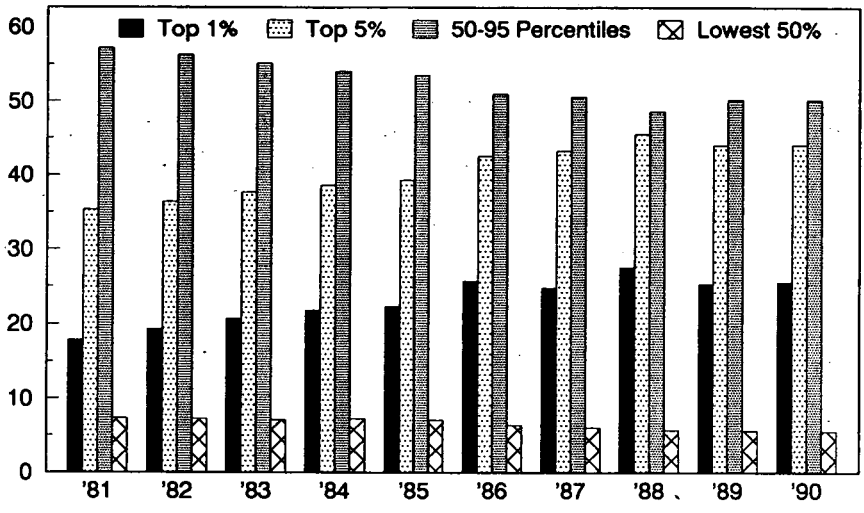


FIGURE V.6

WEALTHY SHOULDER MORE OF THE INCOME TAX BURDEN



Source: IRS and JEC/GOP staff calculations.

In 1990, the JEC Republican Members introduced the Fairness Ratio in our annual report. This measure is the ratio of the average income tax payment in the top 1 percent for every dollar paid on average in the bottom 50 percent. In 1981 the average income tax payment in the top 1 percent was $120.54 for every dollar of average tax payment in the bottom 50 percent. By 1988 the fairness ratio had jumped to $241.03, an increase of 100 percent (see Table V.5 and Figure V.7).

TABLE V.5

FAIRNESS RATIO* IN TAX PAYMENTS

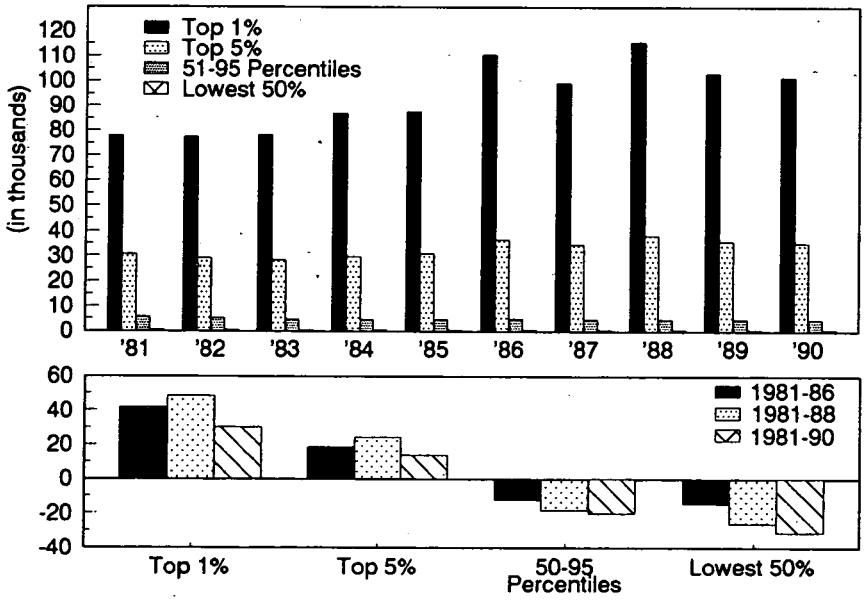
1981	$120.54
1982	131.78
1983	145.69
1984	149.81
1985	156.94
1986	199.43
1987	204.45
1988	241.03
1989	221.57
1990	227.85
Percent Change	
1981-86	65.4%
1981-88	100.0%
1981-90	89.0%

Source: JEC/GOP staff calculations.

*Average tax payment of taxpayer in top 1 percent for each dollar of tax paid by each taxpayer in the bottom 50 percent.

FIGURE V.7

TAX FAIRNESS ON THE RISE



Among the best evidence for the rise in average income tax payments by the affluent in the 1980s is the fact that the CBO no longer publishes these data. Since 1987 a new methodology has been developed. The Democrat majority in Congress derives from CBO a warped income and tax methodology to generate huge estimation and analytical errors. It includes the absurd assumption that the extra income elicited by the 1981 tax cuts can be subjected to 1977 tax rates. The income and growth unlocked by the Reagan tax cuts are thus retroactively taxed at 1977 marginal rates. This fantasy "lost revenue" from income that was sheltered from taxes or otherwise would never have been created is labeled a "giveaway" to upper income groups to justify new attempts to raise marginal tax rates. These scenarios are presented instead of IRS income tax data which contradict the CBO data. Given the choice between actual IRS data and CBO fabrications, many seem to prefer simulations, even when components of CBO family income are mismeasured by over 100 percent.

During the Reagan years, the share of the tax burden borne by low and middle income groups declined, and hundreds of thousands of low-income taxpayers were removed from the tax rolls entirely.

By 1988, the bottom 50 percent of taxpayers bore only 5.7 percent of the income tax burden, not counting those removed entirely from the tax roles. Unfortunately, this group is subject to a heavier tax load courtesy of the social security tax increase of 1977, passed by the Congress and signed into law by President Carter. To the extent aggregate tax burdens have increased for low income groups, the overwhelming proportion of that increase is accounted for by these stiff increases in the payroll tax. From 1977 to 1990, the social security payroll tax rate rose by nearly one-third, from 11.7 to 15.3 percent. The current level of the payroll tax was set in the 1977 legislation, though some try to attribute its painful effects to the 1981 tax legislation, which cut personal income tax rates for all groups.

TAX CUTS AND REVENUE

After the full implementation of the Roth-Kemp tax cuts, Federal revenues increased, contradicting the argument that the Treasury would be starved of revenue. Between 1980 and 1989, personal income tax revenues increased 22 percent (after adjustment for inflation). While one can argue about the degree of

revenue growth that would have occurred without the rate cuts, the bottom line is that actual personal income tax revenues expanded with the tax base in the 1980s, as did Federal revenues in general. Federal spending, however, outstripped this growth in revenue.

Upper income taxpayers paid more taxes after the rate cuts, while middle and lower income taxpayers got tax relief, lowering their income taxes relative to projections. When Washington politicians deplore the $750 billion in lost revenue allegedly resulting from tax cuts in the 1980s, they are really saying that the average taxpayer should have paid $7,500 more to fund the wasteful growth in Federal spending. This is why liberals tried to block the third year of the Roth-Kemp tax cut and bracket indexing, both of which benefitted primarily middle income taxpayers.

Following the passage of lower marginal tax rates in 1981, annual IRS data confirmed the view that average income tax payments were increasing at the top end. Meanwhile, the third installment of the tax cut as well as tax indexing, both beneficial primarily to the middle class, survived repeated attempts at repeal launched by congressional Democrats. In the end, the Roth-Kemp personal income tax cuts were permitted to reduce income tax payments on middle income taxpayers by about $2,000.

Unfortunately, we are now headed in the opposite direction -- towards higher taxation of the middle class. The Clinton Administration and its supporters in Congress seem determined to tax low and middle income taxpayers more heavily. In its first few months in office, the Administration proposed to take back about $500 of the $2,000 of the tax savings enjoyed by the average family due to 1980s tax cuts. Presumably coming years will witness further attempts to erase all the tax benefits for the middle class passed in the 1980s. Meanwhile, the higher proposed top tax rates will increase incentives to shelter income and avoid tax liability, lessening the exposure of the affluent to income taxation. The result will be a shift in the burden of taxation away from the rich back to the middle class.

The whole tax fairness debate has been plagued by an inability on the part of some to understand the difference between hypothetical and actual progressivity. Superficially a tax rate of 100 percent

on the rich would seem most progressive, but in reality virtually no taxes would be paid at such a rate. While punitive tax rates on high income taxpayers may satisfy ideological or emotional needs, they do not raise much revenue. The statistical evidence on income tax cuts provided by IRS data demonstrates that if one wants to extract more revenues from the rich, lower rather than punitive tax rates are most effective.

CHAPTER VI

THE U.S. HEALTH CARE MARKET

Health care costs have exploded. As a result, Americans have become increasingly concerned about the viability of the health care delivery system, questioning whether they are receiving value for their money and what, if anything, can be done to stem rising costs and deal with persistent access problems, which are exacerbated by skyrocketing costs. Indeed, the national health care debate during the recent presidential election, as well as the 1,215 initiatives related to health care introduced in the 102nd Congress, underscore its importance.

HEALTH CARE EXPENDITURES

In 1991, total spending on health reached $751.8 billion, an increase of 11.4 percent from the 1990 level.[23] The spending growth rate was the same as 1990 but was nearly **four times** as fast as the 2.8 percent growth of the economy as measured by gross domestic product. Nineteen ninety-one marks the seventh consecutive year when growth in health spending outpaced growth in the economy. In fact, health care spending has grown faster than the overall economy in almost every one of the last 30 years. In 1991, national health spending absorbed 13.2 percent of the GDP, the highest portion ever achieved and the second largest jump since 1960. There appears to be no prospect of health care spending levelling off or falling in the future. The Office of Management and Budget projects that, in the absence of program and policy change, health care spending will reach 17 percent of the GNP by 2000 and 37 percent by 2030.[24]

In fact, the United States spends more for health care than do residents of other nations, yet there is a growing consensus that our

[23] Unpublished data provided by the Office of the Actuary, Health Care Financing Administration.

[24] OMB, Budget of the United States, Fiscal Year 1991. After FY90, health expenditures will be expressed as a percent of GDP.

health care system performs poorly. The argument for reform of the health care system is largely based on the premise that the free market has failed, thus, we need government intervention to correct the private market's shortcomings. While reform of the U.S. health care system may be warranted, it is wrong to characterize this market as dominated by laissez-faire or perfectly competitive forces. In fact, the medical services industry is so heavily regulated and influenced by government bureaucracies that it probably is the most socialized sector of the American economy.

If indeed the health care market is failing, the more reasonable explanation for that failure is government intervention rather than government neglect.

Provision of health care in the United States is a strange hybrid of private and public activities dominated by legislative rule-making, government regulatory policies, tax subsidies, direct and indirect grants and loans, and direct price and output controls. Government owns and operates medical facilities while, at the same time, it purchases vast amounts of medical sector output at prices it helps to set. Virtually every aspect of the supply and demand sides of the health care market is distorted by government, either directly or indirectly.

An important explanation for the increasing importance of government in the health care market is the elevation of medical care to a quasi-human right by many in our society.[25] Expressions such as "everyone has a fundamental right to needed medical care" and "medical care must be available for all" are characteristic of this view and seem to suggest that the consumption of general medical care confers external benefits on society. If this is true, then medical services are different from shoes, books, automobiles, and most other commodities and should not be left to the control of the market.

Prior to designing any reforms of the U.S. health care delivery system it is critical to understand the primary factors driving up health care costs in the face of an ever-increasing supply of health resources.

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[25] For a summary of this viewpoint, see, Bill Clinton,"Putting People First: A National Economic Strategy for America," June 1992, Little Rock, Arkansas.

WHAT DRIVES HEALTH CARE COSTS?

By itself, the $751.8 billion spent on health care in 1991, while an enormous sum, tells us little about what we as a nation "should" spend. Whether the rate of growth is too high or too low depends on the value consumers derive from medical market services relative to their cost. Higher costs may reflect greater benefits through advanced medical technology and increased use of health services. For example, new diagnostic procedures, such as computer axial tomography (CAT) scans, magnetic resonance imaging (MRI) and positron emission tomography (PET) scans, cost thousands of dollars per procedure which may be of value if they reduce the need for invasive surgery or produce improved accuracy of medical and surgical therapy. For the U.S. health care consumer the difficulty arises in determining the effectiveness of alternative procedures as most medical procedures have never been subject to controlled evaluation.[26]

Setting aside normative judgments regarding health costs, it is possible to identify factors that give rise to increased health care spending. Demographic trends, rising incomes, increased government intervention, the tort liability system, technological changes, inflation and the expansion of third-party payers all play a role in increases in medical costs. The economic incentives implied by our current health care system encourage consumers to demand more, providers to supply more, and charges to escalate.[27]

National health care spending can be divided into two broad categories: expenditures related to current health care (health services and supplies) and research and construction of medical

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[26] For a discussion of the issues involved in medical outcomes research, see, Robert H. Brook and Mary E. Vaiana, Appropriateness of Care: A Chart Book, National Health Policy Forum, George Washington University, June, 1989; and John E. Wennberg, "Outcomes Research, Cost Containment, and the Fear of Health Care Rationing," New England Journal of Medicine, October 25, 1990, pp. 1202-04.

[27] For an excellent overview, see, Gary Robbins, Aldona Robbins, and John C. Goodman, How Our Health Care System Works, National Center for Policy Analysis, February 1993.

facilities. Spending on health services and supplies accounted for 96.6 percent of all medical spending in 1991, with personal health care expenditures (spending for health services received by individuals and health products purchased in retail outlets) accounting for 87.9 percent of all health care spending.

The growth rate of personal health care expenditures is affected by a number of complex and interrelated factors. Such factors as population increases can be measured directly while other components such as changes in the mix of medical services consumed or introductions in new technologies are more difficult to quantify. Much of the growth in health spending can be accounted for by factors not directly related to the medical market, such as increased demand from rising income levels, population increases, general price inflation, lifestyle and behavioral choices, and the graying of the population. As these factors are not specifically related to the health care financing and delivery system, we label them external factors.

EXTERNAL FACTORS

Demographic Forces: Expansion of the U.S. population contributes to the growth of medical expenditures by increasing the demand for such services. Population growth contributed to approximately 10 percent of the increase in personal health care expenditures over the last 30 years. In addition to population growth, the United States is experiencing an increase in the average age of the population as well as rising numbers of the very old. Actuaries project that during the 1990s, the population 65 years of age and older will increase 1.1 percent per year while the population 75 years of age or over will increase 2.3 percent per year.[28] By 2040, with the retirement of the baby boom generation, the number of people aged 65 and over will number 72 million and comprise 20 percent of all Americans.

The consumption of health care rises sharply with age, per capita health care spending by persons 65 years of age or older is 3.5 times that of working-age adults and about seven times that for

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[28] The Annual Report of the Board of Trustees of the Old Age, Survivors, and Disability Trust Funds, May 1991.

children.[29] While making up only 11 percent of our current population, those over 65 consume nearly 30 percent of the Nation's health care. According to health expert Victor Fuchs, the United States is currently spending about 1 percent of GNP on health care for elderly persons who are in their last year of life.[30] The aging of the U.S. population will contribute to rising health care spending. According to a common estimation methodology, the graying of the American population will boost per capita health care spending relative to 1990 levels by 12 percent in 2020 and by 23 percent in 2040.[31]

General Price Inflation (GPI): Comparisons of expenditures over time reflect any number of combinations of price and/or output changes, thus, it is impossible to meaningfully compare spending levels with such a "flexible yardstick." Real expenditure calculations involve the separation of changes in total expenditures into changes in price and changes in quantity produced or sold.[32] To further complicate the problem, not all sectors of the economy experience the same rate of price fluctuation across time, thus, it is necessary to decompose price level changes to more accurately reflect conditions in any specific sector. Further, using per capita measures simplifies the analysis. Our sector of interest, health care, has experienced more rapid growth in spending than other sectors of the economy over much of the last 30 years. One approach to

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[29] Waldo, D.R., S.T. Sonnefeld, D.R. McKusick, and R.H. Arness,III, "Health Expenditures by Age Group, 1977 and 1987," Health Care Financing Review, 10(4), Summer, 1989, pp. 111-120.

[30] Fuchs, Victor R., "'Though Much is Taken': Reflections on Aging, Health, and Medical Care," Milbank Memorial Fund Quarterly:Health and Society, 62, Spring, 1984, pp. 143-66.

[31] Arron, Henry J., Serious and Unstable Condition: Financing America's Health Care, Washington, D.C.: The Brookings Institution, 1991.

[32] In addition, the quality of many medical services has changed dramatically in the past 30 years, so much so that it is almost meaningless to compare treatments over time. For example, in the 1960s most eye surgeries required long hospital stays with the patient immobilized by sand bags. Now these same procedures are performed by lasers as out-patient surgery in the doctor's office.

deflating health care spending is to separate out the effect of general price inflation.[33]

Deflating personal health care spending by the gross national product fixed-weight price index (GNP-FWPI) allows us to remove economy-wide inflation and provides us with what might be considered the "opportunity cost of health care" -- that is, the value of goods and services foregone in order to buy health care.[34] A major factor in health cost escalation in recent years has been rising price levels throughout the economy. Economy-wide inflation accounted for 22 percent of the increase in health expenditures during the period 1960-70 and over 50 percent of increased health spending from 1970 to 1990. Eliminating the impact of generalized price inflation, a cause of growth over which the health system has little control, allows the focus to health costs which are driven by our specific methods of financing and delivery.

Lifestyle and Behavioral Choices: The general level of the health of any population is a function of a multiple of determinants, medical care being only one factor. An individual's health depends most heavily on other factors such as heredity, nutrition, alcohol, drug and tobacco use, education, environmental influences, sexual behavior and general "life-styles."[35] Providing more medical services will not alter these factors and thus is unlikely to make us a healthier nation. A striking example of the importance of non-medical factors is provided by a comparison of death rates at all age levels and by sex for residents of Nevada and Utah, two states with

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[33] For a detailed discussion of the methodology employed in adjusting for the effects of price growth in health spending, see, Katharine R. Levit, Helen C. Lazenby, Cathy A. Cowen, and Suzanne W. Letsch, "National Health Expenditures, 1990," Health Care Financing Review, 13(1), Fall, 1991, pp. 29-54 and "Revisions to the National Health Accounts and Methodology, Health Care Financing Review, 11(4), Summer, 1990, pp. 42-54.

[34] Levit, et. al., p. 43.

[35] For a thoughtful examination of the determinants of health status, see the Proceedings of the Second NBER Health Conference, Victor R. Fuchs, ed., Economic Aspects of Health, Chicago: The Univ. of Chicago Press, 1982.

similar income and medical care. For example, the 1988 death rate per 1,000 population in Nevada was 8.0 while Utah's figure was 5.5.[36] What explains this 45 percent differential in death rates? The fact that Utah's population is predominately Mormon and their religion prohibits both smoking and drinking certainly is a contributing factor.

The total increase in health care spending resulting from unhealthy lifestyle and behavioral choices cannot be easily quantified, but the costs are large. Individuals with potentially harmful habits are hospitalized more and are more expensive to treat than others. One recent study of high-cost patients in community hospitals found that potentially harmful habits were noted more than 40 percent more often in the records of this group of patients.[37] The Federal government estimates that in 1990 smoking cost the Nation $52 billion, alcohol abuse cost $136 billion, and drug abuse cost $44 billion in higher medical expenditures.[38] The cost of AIDS care is projected to be between $5 billion and $13 billion in 1992 and will continue to rise rapidly for the remainder of the decade.[39]

Rising Incomes and Expectations: Economic growth and rising incomes tend to stimulate the demand for goods and services, and health care is no exception. As incomes rise, people tend to attach

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[36] U.S. National Center for Health Statistics, Vital Statistics of the United States, Vol. II, Part A, 1988.

[37] Zook, Christopher J. and Francis D. Moore, "The High Cost Users of Medical Care," New England Journal of Medicine, 302, pp. 996-1002, 1980.

[38] U.S. Department of Health and Human Services, Office of Smoking and Health, Report to Congress, National Statistics: Second Edition, Section 2, February 1990; U.S. Department of Health and Human Services, National Institute on Alcohol Abuse and Alcoholism, Seventh Special Report to the U.S. Congress on Alcohol and Health, January 1990; and U.S. Department of Health and Human Services, Public Health Service, National Institute on Drug Abuse Census, September 1990.

[39] Commitment to Change: Foundation for Reform, A Report of the Advisory Council on Social Security, December 1991.

more importance to trying to live longer and healthier lives. Further, Americans have become enamored with advances in medical technologies that have led them to have rising expectations concerning the viability of medical procedures. Consumers are less willing to accept a medical diagnosis based solely on the opinion of the medical practitioner. This phenomenon occurs in part due to the increasing reliance of medical practitioners on sophisticated new technologies and in part due to the fact that the consumer seldom faces prices that reflect the true marginal cost of the medical resources utilized.

External factors shape the environment in which our health care financing and delivery system operates and independently account for well over 50 percent of the rising costs of U.S. health care we have experienced in the past 30 years.

INTERNAL FACTORS

Internal or controllable factors are those elements which are variable with a given health care financing and delivery system, such as the rate of medical price inflation in excess of general inflation, the regulation of health care providers, third-party payments, the tort liability system, the utilization of medical services and the intensity of use, the method of paying providers and suppliers, and the importance of technological changes.

Excess Medical Inflation (EMI): If one corrects for the health care price increases that have resulted from general price inflation in the economy, it is possible to focus in on increases in real per-capita health care expenditures. Even this refinement, however, leaves us uncertain about how much of the increase in real per-capita health care expenditures has resulted from increases in the quantity of health care services delivered and how much of the increase resulted from medical care price inflation in excess of general price inflation. Deflating by the personal health care expenditure fixed-weight price index (PHCE-FWPI) is possible to obtain a measure of real growth in the quantity of per capita health care services delivered over the past 30 years.[40]

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[40] For a discussion of the development and use of the PHCE-FWPI methodology, see Levit, et. al; for a discussion of the limitation of price

(continued...)

The importance of decomposing real personal health care spending into its component parts is that the process allows us to pinpoint the cause of increasing outlays over time. During the 1960s nearly 60 percent of the growth in per capita health care spending was attributable to increases in real health services output with the remaining 40 percent due to increases in medical-specific price levels. By the 1980s, medical-specific price inflation accounted for more than 75 percent of the increase in real health service spending for the decade.

Third-Party Payments: Perhaps the most unique feature of the U.S. health care market is that consumers of medical services overwhelmingly "send the bill to someone else." That is, the direct beneficiaries to medical services in the majority of cases pay with someone else's money and are effectively isolated from the cost of treatment. The components of health care spending supported by third-party payments have continued to grow over the past 30 years. Further, these third-party payments vary quite dramatically by type of spending. For example, in 1960 consumers paid for 62.7 percent of physician services out-of-pocket, while only 18.7 percent of such payments were out-of-pocket in 1990. Even more dramatically, the share of hospital care paid out-of-pocket fell during the past 30 years from 20.7 percent in 1960 to 5.2 percent in 1990. That is, 94.8 percent of all hospital care costs are paid by someone other than the user. Because net out-of-pocket costs to health care consumers are so low, they choose more expensive and sophisticated medical care than they would if they faced true prices.

To illustrate the behavioral effect of third-party payment, we use an automobile illustration. Imagine now that the government pays 94.8 percent of the cost of your automobile. Would we still find that Honda Accord is the most popular car in America? Hardly. Consumers would not only buy more cars, they would buy more expensive, better quality vehicles -- Jaguars, Mercedes and Porsches -- which cost more to produce as long as the government foots the bill, there is no reason for people to alter their behavior. The United States would soon experience spiraling, out-of-control

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[40](...continued)
indices to quantify medical price inflation, see Joseph P. Newhouse, "Has the Erosion of the Medical Marketplace Ended?," Journal of Health, Politics, Policy and Law, 13(2), Summer, 1988, pp. 263-278.

automobile costs. Further, we would find that the market for low cost, no frill automobiles had dried up as "they are no longer competitive." We can predict that this automobile subsidy would soon consume an ever-expanding portion of GDP, not unlike what is happening in the medical market place.

Tort Liability System: While it is not possible to know for certain exactly how much our legal system adds to the cost of health services, most estimates are quite large. The American Medical Association places the annual cost of malpractice insurance and defensive medical practices in excess of $17 billion.[41] Our legal system generates perverse incentives for medical practitioners and results in a diminished quality of care of our citizens.

As noted above, the causes of the health care cost explosion are multiple, complex and interdependent; thus, it is not easy to disentangle these factors to point to a simple easy solution to this problem.

CAN GOVERNMENT CURB HEALTH COSTS WITH GLOBAL BUDGETS?

Some analysts suggest that all health care expenditures should be tied together within a government-imposed global budget. The purpose of the budget would be to control escalating health care spending by rigidly setting a limit on total health spending. This is only the latest variant of governmental attempts to control health system costs.

In previous attempts to contain health costs, the Federal government has intervened aggressively to regulate health care supplier's price and output decisions. Faced with skyrocketing hospital costs, the Federal government in 1983 enacted legislation to establish a "prospective payment system" (PPS) and a peer review system for Medicare hospital reimbursement. While the purpose of this legislation was to make hospitals more competitive and price conscious, the result has been to create a major shifting of costs to

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[41] Huber, Peter W., Liability: The Legal Revolution and Its Consequences, New York: Basic Books, 1988.

private sector activities not covered by controls. As a result of this cost shifting, Medicare program costs were constrained somewhat in the short run by legislation and regulation. But, savings to the Federal government were passed on to private payors.

The overwhelming economic evidence suggests that artificially setting prices and controlling inputs and/or outputs via regulation is a policy doomed to failure whether it's rent control in New York City or taxi cab regulation in Chicago. It is impossible to devise a scheme to both artificially "cap" costs and maintain quality. There are always margins that are not controlled which can be exploited to adjust to the legislation. Inevitably, the unintended consequences of such a policy would do serious damage to those the policy was intended to help. No crystal ball is needed to predict that the global budgets, if adopted, will not succeed in controlling long-term health care costs. The experience of other nations confirms that these price controls generate very harmful consequences.[42]

CONCLUSION

Control over the cost of medical care is possible only when the provider or the patient is the primary decision maker and has a stake in the conservation of scarce medical resources.[43] There is clearly a danger that excessive attention to the cost of health care will lead us to neglect problems of health and access to care. What is needed, of course, is not simply cost containment, but cost-effective medicine. Every 24 hours Americans spend more than a billion dollars on health care. Some of that money goes for services of extraordinary value -- deaths averted, pain relieved, functions restored. Some of it does more harm than good. A significant portion of that expenditure is for procedures, tests, prescriptions, and hospitalizations, the true value of which is virtually unknown.

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[42] Haislmaier, Edmund F., "Why Global Budgets and Price Controls Will Not Curb Health Costs," Heritage Foundation, March 8, 1993.

[43] For a thoughtful analysis of market-based reforms, see, John C. Goodman and Gerald L. Musgrave, Patient Power: Solving America's Health Care Crisis, Washington, D.C.: Cato Institute, 1992.

Government financing, service provision, and bureaucratic regulation of health care services has fundamentally flawed the U.S. health care market and contributed to its reduced viability. Government health care policies all too often drive costs up and contribute to overutilization by many. At the same time, an increasing number of workers, poor and elderly Americans are being priced out of the market due, in part, to misguided government health policies. We must identify and retain the strengths of our health care system while instituting market based reforms which have the potential to control costs and expand access.

CHAPTER VII

REPUBLICAN TRADE POLICY

The challenges of international trade reached new heights in 1992 as the United States continued its slow economic recovery, and other countries moved into recession. The countries of Eastern Europe and the former Soviet Union continued uneven progress in transforming their systems into free markets and integrating their markets into the world economy. European Community (EC) leaders faced rejection by Danish voters and a near rejection by French voters of a plan for a complete union. Many Europeans felt the plan would give too much power to a centralized European government. Conclusion of the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) remained elusive. In this hemisphere the United States, Canada and Mexico signed the North American Free Trade Area (NAFTA) agreement to create the world's largest free trade zone. But new conditions that President Clinton wants added to the plan threaten its future.

Republicans have supported efforts through the GATT, Free Trade Area (FTAs), and other mechanisms to open markets worldwide for American goods and services. This approach is the constructive alternative to erecting new barriers to trade which only penalizes American consumers, workers, exporters and all but a handful of privileged industries.

TODAY'S TRADE PICTURE

The volume of world trade has grown from some $250 billion in 1970 to $3 trillion today. America is more integrated than ever in this global economy. Overseas merchandise trade now accounts for 16.4 percent of U.S. gross domestic product, double the percentage in 1970. America's exports have doubled since 1986, reaching $448.2 billion last year.

But American exporters continue to face barriers to their goods and services, and unfair trade practices by other countries. Further, U.S. trade barriers harm American consumers and lead to charges of hypocrisy by other countries. This is why America's approach to trade policy over the past decade, seeking market opening agree-

ments on a bilateral and multilateral basis, while acting against specific unfair practices, is in the best interest of the country's economic future.

THE IMPORTANCE OF GATT

The GATT, created in 1947, sets the framework for trade between over 100 signatories to its principles. Through a series of negotiating rounds since its inception, GATT has reduced general tariff levels from about 40 percent to an average of 5 percent today.

In the current Uruguay Round the United States seeks: 1) to open markets further to trade in goods and services and to foreign investments; 2) to protect intellectual property rights; 3) to tighten the GATT enforcement mechanism; and 4) to eliminate trade barriers and subsidies to agriculture products.

While gaining most of what they wanted, U.S. negotiators encountered an intransigent European Community on agriculture trade. But in November of last year U.S. and the EC negotiators agreed to a more limited phase-down of agriculture trade barriers and subsidies.

American businesses stand to gain much from a completion of the Uruguay Round.

THE NORTH-AMERICAN FREE TRADE AREA (NAFTA)

One significant trade achievement of last year was the conclusion of the NAFTA, which will incorporate Mexico into an expanded version of the current FTA between the United States and Canada. The U.S. Congress now must approve the pact. The NAFTA will create the world's largest single market. All parties will gain net jobs from the agreement. The United States stands to gain especially from sales of high valued capital goods and equipment to the growing Mexican market.

Under President Carlos Salinas, the Mexican government has enacted major economic reforms. These include: joining the GATT and cutting its tariffs and other trade barriers; selling off government enterprises; reducing inflation from triple-digit levels down to 11 percent; managing the debt crisis; and balancing the budget.

The United States, which exported nearly $44 billion to Mexico last year for a trade surplus of $7 billion, under NAFTA will be in on the ground floor of what promises to be one of the fastest growing economies in the world. A growing and prosperous Mexican economy will give its citizens a strong incentive to stay at home and take local jobs rather than entering the United States illegally to seek employment. It creates an alternative to corruption by allowing individuals to prosper through their own efforts in the market, rather than forcing them to seek government jobs and sell favors.

A growing and prosperous Mexico will better be able to deal with its serious pollution problems. The United States is correct to demand that cross-border pollution be dealt with, whether there is a NAFTA or not. But with a growing economy Mexican businesses will purchase more efficient and cleaner machines, bearing the label "Made in U.S.A." The Mexican government will be able to tighten further their environmental standards without causing major worker displacements.

But the NAFTA faces an uncertain future. President Clinton has insisted on a set of new talks to deal with environmental and labor issues. These talks may change a free trade agreement into a managed trade agreement that simply increases bureaucracies and government interference in the economies of both countries. Worse, if the negotiations interfere too much in the domestic affairs of Mexico, the NAFTA could die. In such a case Mexico would probably be forced to search for other free trade partners.

JAPAN

Japan is America's second most important trading partner and its largest market for agricultural products. Japan has made efforts, often with strong American prodding, to open its market more to foreign products. But problems still remain, especially with non-tariff barriers. The United States should continue to push the Japanese to eliminate its trade restrictions, not only through the GATT but on a bilateral basis.

THE NEW EUROPE, EAST AND WEST

The EC last year completed most of its EC-1992 enterprise, which removed remaining trade barriers between the member

countries to flows of goods and services. But the hastily formulated "Treaty of European Unity," also called the Maastricht agreement, ran into problems. Maastricht would create a single currency, centrally planned social, welfare, labor and industrial policy, and common foreign and security arrangements. Rejection of the agreement by Danish voters and the near rejection by the French electorate showed that the average European is concerned about too much power becoming centralized in Brussels.

The United States recognizes that how they run their internal economic affairs generally is a matter for the EC members. But if a more united EC seeks new non-tariff barriers to keep American products out of its market, that goes against the spirit if not the letter of the GATT, and would be a matter of concern for the United States.

The move toward free markets by the former East bloc countries has had varied result. Poland, Hungary, the Czech lands and Bulgaria continue to progress. Russia faces a serious economic crisis. These successful former communist countries are seeking freer trade with and membership in the EC. But the EC, while offering limited free trade, has fallen far short of what it can do to offer these countries the economic opportunity they need to prosper.

If the EC does not offer these countries satisfactory trade arrangements, and especially if the GATT negotiations should collapse as a result of EC stubbornness over agriculture, the United States might consider offering free-trade area arrangements with reformed Eastern European countries. Such arrangements not only would help these countries, they would help get the United States in on the ground floor of future growing economies.